In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation

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TABLE OF CONTENTS

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INTRODUCTION[1]

Direct regulation of hedge funds, arguably the most important and sophisticated new investment vehicle, with over \$2 trillion under management,[2] is unlikely and infeasible. The term *hedge fund* is not statutorily defined; however, it "encompasses any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[3] Hedge funds escape the disclosure requirements of every major federal securities law because of their elusive organizational structure.[4] Determined lobbyists

1. This Comment is current as of February 2008. *See infra* note 92.
2. U.S. GOV'T ACCOUNTABILITY OFFICE, HEDGE FUNDS: REGULATORS AND MARKET PARTICIPANTS ARE TAKING STEPS TO STRENGTHEN MARKET DISCIPLINE, BUT CONTINUED ATTENTION IS NEEDED 1 (2008) [hereinafter GAO Report], *available at* http://www.gao.gov/new.items/d08200.pdf. The report notes that hedge funds have over \$2 trillion in management globally with roughly \$1.5 trillion managed by U.S. hedge fund advisers.
3. PRESIDENT'S WORKING GROUP ON FIN. MKTS., 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/hedgfund.pdf.
4. *See infra* Part I.B for a description of how hedge funds escape regulation.

have also played a role in ensuring hedge funds are not directly regulated.[5]

Direct regulation of hedge funds is unlikely namely because it has been attempted and failed. In 2004, responding in part to the collapse of Long Term Capital Management (LTCM),[6] a highly leveraged hedge fund, the SEC attempted to directly regulate hedge funds by requiring hedge fund managers to register, pursuant to the Investment Advisers Act of 1940.[7] However, the District of Columbia Circuit Court of Appeals struck down the SEC's new rule, holding that it constituted arbitrary rulemaking.[8] In addition, many academics have advocated for direct

5. *See Hedge Funds Increase Political Clout via Lobbying, Donations*, MONEY MGMT. EXECUTIVE, May 21, 2007, at 1. The article states:

> Especially now that the news has leaked that hedge fund managers are raking in incredible salaries—some making more than $1 billion a year—Congress is undoubtedly going to be taking a serious look at increasing regulation of hedge funds, according to a number of reports. And that has many hedge fund managers stepping up their political contributions, hiring lobbyists and, in some cases, forming their own political action committees, according to *The Economic Times*.

Id.; *see also* Jenny Anderson, *Big Money Still Learning to Lobby*, N.Y. TIMES, Mar. 13, 2007, at C1 (noting that three hedge fund lobbying groups exist in Washington, and they are all banded by the quest of avoiding restrictive regulation).

6. *See infra* Part I.C.1 for an overview of the LTCM collapse.

7. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,059 (Dec. 10, 2004) [hereinafter Registration Under Advisers Act] (to be codified at 17 C.F.R. pts. 275, 279), *available at* http://www.sec.gov/rules/final/ia-2333.htm.

8. See *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), where the court held that the SEC's attempt at direct regulation constituted arbitrary rulemaking because the regulation exceeded the SEC's statutory authority. *Id.* at 881–84. The court addressed the issue of whether the term *client* in the Advisers Act included only the funds of the investment advisers or the funds' investors as well. *Id.* at 876–79. Previously, the SEC had interpreted the term *client* to mean the entity, as opposed to the individual clients of the entity. *Id.* at 876. In December 2004, amidst strong opposition, the SEC adopted the Hedge Fund Rule, which mandated that private funds count the "shareholders, limited partners, and beneficiaries of the fund" as "clients." *Id.* at 877; 17 C.F.R. § 275.203(b)(3)-2(a) (2008). The SEC argued that because the term *client* was ambiguous and was not clarified by the legislative history, it had the regulatory authority to interpret the meaning of the term. *See* Brief of the Securities and Exchange Commission, Respondent at 20–22, *Goldstein*, 451 F.3d 873 (No. 04-1434). The court held that just because the term *client* is not defined in the Advisers Act does not mean the term is ambiguous and can be accorded any meaning the SEC chooses. *Goldstein*, 451 F.3d at 878. The court further noted that the meaning must be gleaned from context and that the legislative history clearly indicated Congress's intent not to regulate hedge fund investment advisers. *Id.* For an interesting analysis of the *Goldstein* decision, see generally Recent Cases, *Administrative Law—Judicial Review of Agency Rulemaking—District of Columbia*

regulation of hedge funds,[9] yet the hedge fund industry continues to roam wild and free from any meaningful direct regulation.

Moreover, as former Chairman of the Federal Reserve Alan Greenspan has also noted, direct hedge fund regulation is also infeasible because direct regulation runs the risk of inviting more aggressive funds to escape from U.S. regulatory jurisdiction.[10] Hedge funds also bring many benefits to the economy, such as "increasing liquidity, improving market efficiencies and . . . provoking new and more efficient means of managing risk and generating returns."[11] Thus, the risk of an exodus of such funds caused by direct regulation should not be ignored.

Notwithstanding these difficulties, hedge funds remain important and controversial actors in the financial markets. In 1998, LTCM, a $6

Circuit Vacates Securities and Exchange Commission's "Hedge Fund Rule."—Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).*, 120 HARV. L. REV. 1394 (2007).

9. Some of the many articles advocating some sort of direct hedge fund regulation include, but certainly are not limited to Melissa Antoszewski, Comment, *Las Vegas Style Investing: In the Absence of Regulation, Risky Hedge Fund Bets Can Win Big and Lose Even More*, 8 TRANSACTIONS: TENN. J. BUS. L. 381, 381 (2007) (calling for congressional legislation); Alison S. Fraser, *The SEC's Ineffective Move Toward Greater Regulation of Offshore Hedge Funds: The Failure of the Hedge Fund Registration Requirement*, 92 CORNELL L. REV. 795, 825, 830 (2007) (calling for regulation of offshore hedge funds and a reevaluation of the definitions of *accredited investor* and *qualified purchaser*); Jonathan H. Gatsik, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV 591, 620 (2001) (suggesting eliminating or capping incentive-based fees, limiting leverage, limiting amount of credit provided, mandating disclosure, and advocating self-discipline); Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 682 (2000) (calling for disclosure of trading positions); Joseph Hellrung, *Hedge Fund Regulation: Investors Are Knocking at the Door, but Can the SEC Clean House Before Everyone Rushes in?*, 9 N.C. BANKING INST. 317, 345 (2005) (arguing that the SEC may need a more stringent registration requirement); Sue Ann Mota, *Hedge Funds: Their Advisers Do Not Have to Register with the SEC, but More Information and Other Alternatives Are Recommended*, 67 LA. L. REV. 55, 57 (2006) (arguing for hedge fund registration as well as increased information gathering and oversight of registered managers); Jessica Natali, Comment, *Trimming the Hedges Is a Difficult Task: The SEC's Attempt to Regulate Hedge Funds Falls Short of Expectations*, 15 U. MIAMI BUS. L. REV. 113, 115 (2006) (advocating for the SEC to regulate hedge fund investments and restrict types of investors permitted to invest in hedge funds).

10. *See infra* Part II.B.1. Another example of the resistance among key regulators toward the idea of directly regulating hedge funds is evidenced by a speech in 2006 by Federal Reserve Chairman Ben Bernanke. Bernanke stated that "[t]he primary mechanism for regulating excessive leverage and other aspects of risk-taking in a market economy is the discipline provided by creditors, counterparties, and investors." Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, Sea Island, Georgia: Hedge Funds and Systemic Risk (May 16, 2006), http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm [hereinafter Bernanke May 2006 Speech]. Regulating creditors, counterparties, and investors, of course, would *indirectly* regulate hedge funds.

11. Fiona Stewart, *Pension Fund Investment in Hedge Funds* 8 (Org. for Econ. Co-operation & Dev., OECD Working Papers on Insurance and Private Pensions No. 12, 2007), *available at* http://www.oecd.org/dataoecd/4/46/39368369.pdf.

billion, highly-leveraged hedge fund, collapsed,[12] and concern grew as to whether hedge fund collapses may pose broad "difficulties at other firms, in other market segments, or in the financial system as a whole."[13] Thus, after LTCM, the public became aware of the broad economic impact a hedge fund collapse could pose.[14] The controversy and importance of hedge funds resurfaced in 2007 when several other leveraged funds imploded, triggered by their deep exposure to the U.S. subprime mortgage market.[15]

Another major issue that underscores the controversy and importance of hedge funds is that pension funds, the largest institutional investors, which invest retirees' money, are increasingly investing those assets in hedge funds to boost returns.[16] The number of U.S. corporate defined-benefit pension funds investing in hedge funds has been increasing throughout the last several years, and the percentage is expected to continue increasing.[17] This could be a dangerous trend considering some

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12. FRANK PARTNOY, F.I.A.S.C.O.: THE INSIDE STORY OF A WALL STREET TRADER 262–63 (1999). LTCM "leveraged a few billion dollars into $1.25 trillion of derivatives bets." *Id.* at 262.

13. GAO Report, *supra* note 2, at 2. "For example, hedge funds may impose losses on their creditors and counterparties and thereby disrupt the credit availability to financial markets or through market disruptions that could accompany liquidation of funds' positions." *Id.*

14. *Id.* (noting that, in the case of LTCM, poor market discipline is often cited as a factor contributing to the demise of the fund).

15. *See infra* notes 70–72 and accompanying text. In brief, the subprime mortgage collapse is the outcome of an increasing amount of foreclosures on subprime loans. *See* Chris Isidore, *Subprime Woes: How Far, How Wide?*, CNNMONEY.COM, Mar. 5, 2007, http://money.cnn.com/2007/03/05/news/economy/subprime/index.htm. The implosion of hedge funds triggered by their exposure to the subprime market is also referred to as "the great unwind." *The Great Unwind*, FIN. TIMES.COM, Aug. 10, 2007, http://www.ft.com/cms/s/2/d709a4e4-471b-11dc-9096-0000779fd2ac.htm; *see also* Jon Markman, *Are We Headed for an Epic Bear Market?*, MSN MONEY, Sept. 20, 2007, http://articles.moneycentral.msn.com/Investing/SuperModels/AreWeHeadedForAnEpicBearMarket.aspx (stating that many subprime loans were "invented so that hedge funds would have high-yield debt to buy").

16. Riva D. Atlas & Mary Williams Walsh, *Pension Officers Putting Billions into Hedge Funds*, N.Y. TIMES, Nov. 27, 2005, at A1. Note that institutional investors also include endowments, insurance companies, and foundations, as well as pension plans. SUSAN M. MANGIERO, RISK MANAGEMENT FOR PENSIONS, ENDOWMENTS, AND FOUNDATIONS 7 (2005). Hedge fund investors also include high net worth individuals. PWG 1999 Report, *supra* note 3, at 1.

17. *See* WILLIAM KLUNK, PENSION FUNDS INVESTING IN HEDGE FUNDS 2 (Cong. Research Serv., CRS Report for Congress Order Code RS 22679, June 15, 2007), *available at* http://assets.opencrs.com/rpts/RS22679_20070615.pdf; Atlas & Walsh,

pension funds have lost substantial amounts of retirees' money by investing in hedge funds, such as the San Diego County Retirement fund, which lost $100 million after Amaranth Advisers collapsed in 2006.[18] Consultants and academics question "whether hedge funds, with risks that are hard to measure, are appropriate for pension funds, whose sole purpose, by law, is to pay out predetermined benefits to retired workers."[19] Thus, the pension fund-hedge fund affair provides yet another reason to question why the status quo should be maintained, particularly given the increasing controversy and importance of hedge funds, and the recognition that direct regulation is unlikely and infeasible.

The foregoing analysis can be summarized into three major points: (1) LTCM's collapse, the subprime mortgage crisis and ensuing hedge fund implosions, and the quandary of pension funds investing in hedge funds highlight the important and controversial nature of hedge funds; (2) it is evident from LTCM's collapse and the subprime mortgage crisis that the restraints of the free market failed to impose adequate market discipline on hedge fund market participants; and (3) because direct regulation of hedge funds is unlikely and infeasible, other measures need to be taken to ensure that adequate market discipline exists. This Comment puts forth the case for indirect hedge fund regulation, which places the regulatory focus on market participants,[20] and essentially mandates best risk management practices. This approach will preserve the benefits hedge funds provide to U.S. capital markets and still minimize the potential for systemic risk.[21]

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supra note 16; *see also* Jonathan Peterson, *Rest Later; Check Pension Plan Now*, L.A. TIMES, May 13, 2007, at C1.

18. Peterson, *supra* note 17; *see also* Jenny Strasburg, *Failed Hedge Fund Firm Is Sued for Fraud in U.S.*, INT'L HERALD TRIB. (Paris), Apr. 2, 2007, at 14, *available at* http://www.iht.com/articles/2007/04/01/bloomberg/bxfund.php.

19. Atlas & Walsh, *supra* note 16. *See generally* MANGIERO, *supra* note 16.

20. Hedge funds' market participants include investors, creditors, and counterparties such as prime brokers.

21. Other regulatory approaches would have a far more restrictive impact on hedge funds. For example, regulators in other countries have implemented outright bans on pension fund investment in hedge funds. Stewart, *supra* note 11. An outright ban on pension fund investment in hedge funds would have a devastating impact on the ability of hedge funds to continue to operate. This Comment's proposal, however, simply seeks to lightly regulate the key players while stabilizing the financial markets. For a discussion of other potential regulatory schemes, see *id.* Systemic risk refers to the "potential that a single event, such as a financial institution's loss or failure, may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected." *Hedge Funds and Systemic Risk: Perspectives of the President's Working Group on Financial Markets: Hearing Before the H. Comm. on Financial Servs.*, 110th Cong. 63 (2007) [hereinafter *Testimony of Steel*] (testimony of Robert K. Steel, Under Secretary for Domestic Finance, United States Department of the Treasury), *available at* http://www.treasury.gov/press/releases/hp486.htm. Given the complexity of

Part I of this Comment will provide an overview of hedge funds, describe the failure of direct regulation of hedge funds, and analyze the failure of free market restraints. Part II will discuss the theory of indirect regulation, compare and contrast it to direct hedge fund regulation, and apply the theory of indirect regulation to hedge funds. Part III will discuss the mechanics of the proposed indirect regulatory scheme which places the regulatory focus on market participants. This Part will also explain how pension funds fit into an indirect framework and then offer an international solution to the task of uniformly regulating hedge fund creditors. This Comment will continue by analyzing the disclosures needed by market participants and how these disclosures should be provided. Finally, this Comment will conclude by demonstrating that this proposal will not drive hedge funds out of the United States and will therefore provide a practical way of ensuring market discipline.[22]

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the financial markets, systemic risk will never be eliminated. One hedge fund manager commented on systemic risk and stated:

> You don't deliberately obliterate hundreds of billions of dollars of investor money. . . . [I]t [referring to LTCM and other market crises] is going to happen again. The financial markets that we have constructed are now so complex, and the speed of transactions so fast, that apparently isolated actions and even minor events can have catastrophic consequences.

RICHARD BOOKSTABER, A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION 1 (2007).

22. The following is a brief summary of the key proposals of this Comment: First, the Employee Retirement Income Security Act (ERISA) should be amended to state that any private pension fund that seeks to invest money into a hedge fund may only do so if that hedge fund discloses certain material information and is registered with the SEC. Second, Congress should enact new legislation that would allow hedge funds to voluntarily register with the SEC as *hedge funds*, to provide an avenue for hedge funds to, at a minimum, furnish the SEC with audited financials, follow SEC rules in calculating the value of their assets, and disclose their trading strategies in confidence. Because hedge funds are not yet statutorily defined, this can be done by simply using the commonly accepted definitions and standards to designate a fund as a hedge fund, as described *supra* p. 990. Third, an international regulatory solution is necessary to address the arduous task of uniformly regulating hedge fund creditors. This could be done through the Bank for International Settlements (BIS), an international organization which serves as a bank for central banks, which, in its capacity as a forum to promote discussion and policy among central banks, should establish international banking standards with hedge funds. *See infra* text accompanying notes 230–34. These standards should include mandating that all banks engaging in hedge fund financing should only do so if the hedge funds provide them with audited financials, follow SEC or other accepted rules in calculating the value of their assets, and disclose their trading strategies in confidence.

I. HEDGE FUNDS, DIRECT REGULATION, AND MARKET IMPLICATIONS

A. Hedge Fund Basics

Although the first hedge fund was started in 1949,[23] during the last twenty years, the hedge fund industry has grown exponentially.[24] With over $2 trillion under management,[25] although large in size when compared to other sectors of the financial market, hedge funds are actually relatively small.[26] Nonetheless, some experts believe that hedge funds account for approximately fifty percent of all U.S. trading volume.[27] Hedge funds are also known for their abusive use of leverage.[28] Many regulations

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23. PWG 1999 Report, *supra* note 3, at 1.

24. *Id.*

25. GAO Report, *supra* note 2, at 1.

26. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS THIRD QUARTER 2007 (Dec. 6, 2007) (presenting statistics of total financial assets: $8 trillion in mutual funds, at 77; $10.9 trillion in commercial banks, at 69; $5 trillion in life insurance companies, at 75; $5.9 trillion in private pension funds, at 75; $1.4 trillion in property and casualty insurance companies, at 74; and $3.2 trillion in state and local employee retirement funds, at 76), *available at* http://www.federalreserve.gov/releases/z1/20071206/z1.pdf.

27. *Testimony of Steel*, *supra* note 21, at 62. In addition, see also GAO Report, *supra* note 2, stating:

> Hedge funds are key players in many financial markets. For example, hedge funds reportedly account for more than 40 percent of the trading volume in the U.S. leveraged loan market, more than 85 percent of the distressed debt market, and more than 80 percent of certain credit derivatives markets. Institutional investors, such as endowments, foundations, insurance companies, and pension plans, seeking to diversify their risks and increase returns, have invested in hedge funds and contributed to the rapid growth in these funds.

Id. at 1.

28. *Leverage* refers to the use of various forms of credit extensions to augment returns. Press Release, Testimony of Randal K. Quarles, Under Sec'y for Domestic Fin., U.S. Dep't of the Treasury, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (July 25, 2006), *available at* http://www.treas.gov/press/releases/hp24.htm. Examples include repurchase agreements, short positions, derivative contracts, loans, and margin, to name a few. *Id.* Increasing leverage necessarily increases risk. *Id.* In its report after the LTCM failure, the PWG noted that excessive leverage can significantly amplify the negative effects of market conditions. *Id.* Moreover:

> Linked closely with the issue of leverage and the potential for impaired liquidity in a period of market stress is the issue of concentration of market positions or 'crowded trades.' Sometimes referred to as 'herding,' crowded trades can arise to the extent that hedge fund managers are inclined to pursue the same or similar investment strategies. If numerous market participants establish large positions on the same side of a trade, especially in combination with a high degree of leverage, this concentration can contribute to a liquidity crisis if market conditions compel traders simultaneously to seek to unwind their positions. The risk, of course, is market disruption and illiquidity, possibly exacerbating the risk of a systemic financial market crisis.

that apply to registered investment companies, such as mutual funds, do not apply to hedge funds. Examples include: liquidity requirements; redemption requirements; disclosure requirements of fees, holdings, and performance; and limitations on the use of leverage.[29]

Additionally, hedge fund fees are performance-based and hedge funds typically employ short-term investment strategies, whereas mutual fund fees are not performance-based and usually do not engage in short-term investment strategies.[30] Different hedge funds employ very different trading strategies and investment styles, some quantitative, some subjective.[31] Similarly, different hedge funds trade very different types of financial instruments, ranging from long or short positions in equity or fixed income securities to exchange traded futures, over-the-counter derivatives, and foreign exchange markets.[32]

B. The Failure of Direct Regulation of Hedge Funds

This section will explain two major federal securities laws that fail to regulate hedge funds, discuss how the funds are designed to evade their regulatory reach, and examine the SEC's attempt to regulate them under the Investment Advisers Act of 1940.

Id.; *see also* PWG 1999 Report, *supra* note 3, at 2 (noting that hedge funds are often responsible for disruptive movements in markets, particularly in vulnerable economies). Furthermore, see Richard Beales, *Wary Credit Market Awaits Hedge Funds' Longer Term Impact*, FIN. TIMES (London), Nov. 11, 2005, at 40:

> One [concern] is about the leverage employed by hedge funds. If a fund lost money, and at the same time was forced, perhaps by its prime broker, to reduce leverage, it could be forced to sell assets quickly, magnifying any shock. If that happened to even a few large funds, the impact on the financial system could be widespread . . . .

Id.

29. Adam R. Bolter, Comment, *Regulation of Hedge Fund Advisers: A Valid Exercise of Rulemaking Authority or the Promulgation of New Law?*, 57 ADMIN. L. REV. 595, 599 n.17 (2005).

30. *See* PWG 1999 Report, *supra* note 3, at 2; Bolter, *supra* note 29, at 599. In other words, hedge fund managers have a greater incentive to take on risk for short term gains.

31. PWG 1999 Report, *supra* note 3, at 2–3.

32. *Id.* at 3.

1. *The Investment Company Act*

The Investment Company Act limits transactions with "affiliated persons,"[33] requires funds to maintain ample liquidity,[34] regulates corporate governance of the funds,[35] and sets forth rules for pricing of the funds' portfolios.[36] A key distinction between investments obligated to register under the Investment Company Act and those that are free from the registration requirements is the restrictive limits on borrowing that apply to registered companies.[37] Therefore, in order to employ the leverage for which hedge funds are known, they are structured to avoid registering as investment companies.

There are three components to the definition of an "investment company," all of which must be met in order for registration to be required under the Investment Company Act.[38] There is "an operating component,"[39] "a manner of offering component,"[40] and "an investor component."[41] Hedge funds cannot avoid the operating component of the definition because they are primarily in the business of "investing, reinvesting, or trading in securities," as defined in the Act.[42] However, hedge funds do fall under exceptions to the other two components of the definition. With respect to the manner of offering component, hedge funds offer their securities in private, rather than public, offerings. Therefore, hedge funds do not meet the manner of offering definition, and so they are exempt from regulation under the Investment Company Act.[43] With respect to the investor component, hedge funds either limit the number of beneficial owners of their shares to one hundred or limit their investors to qualified purchasers who, as individual investors, own at least $5 million in investments.[44] They are therefore able to escape registering as investment companies.

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33. Investment Company Act, 15 U.S.C. §§ 80a–9, –10, –12, –17 (2006).
34. *Id.* § 80a–22.
35. *Id.* § 80a–16.
36. *Id.* § 80a–22. Another major feature of the Investment Company Act is its view of debt. *Id.* § 80a–1(b). Section 1 of the Investment Company Act emphasizes that the national interest is harmed when investment companies borrow excessively and increase the speculative nature of their junior securities. *Id.*
37. Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 324, ¶ 19 (2007), http://blj.ucdavis.edu/article.asp?id=654&print=true.
38. *See generally* 15 U.S.C. § 80a.
39. *Id.* § 80a–3(a)(1)(A).
40. *Id.* § 80a–3(c).
41. *Id.*
42. *Id.* § 80a–3(a)(1)(A).
43. *Id.* § 80a–3(c)(1), –3(c)(7).
44. *Id.*

2. *The Investment Advisers Act of 1940*

The Investment Advisers Act of 1940 (Advisers Act) requires anyone "who, for compensation, gives investment advice as to the purchase and sale of securities" and manages over $30 million in assets to register as an investment adviser.[45] Section 204(b)(3) of the Advisers Act creates an exception on which almost every hedge fund relies—this section exempts any investment adviser with fewer than fifteen "clients."[46] The entire hedge fund is considered one client,[47] and thus the rule would only prohibit a fund manager from managing more than fifteen funds. A regulation that would alter this counting method was struck down in *Goldstein v. SEC*.[48]

a. Goldstein v. SEC

Responding in part to the LTCM fallout, the SEC promulgated a new regulation in 2004 that required hedge fund managers to register pursuant to the Investment Advisers Act of 1940.[49] The SEC's regulation would have changed the way an investment adviser would count "clients."[50] Hedge fund managers who previously were not required to register because they had fewer than fifteen clients would be required by the SEC to count each investor in a hedge fund, as opposed to the fund itself, as a client for purposes of meeting the fewer than fifteen client rule.[51] The District of Columbia Circuit in *Goldstein v. SEC*, however, rejected the adjustment to the client counting rule, holding that it constituted arbitrary rulemaking by the SEC.[52]

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45. *Id.* § 80b–2(a)(11).
46. *Id.* § 80b–3(b)(3).
47. Ian D. Prior, *An Opportunity Lost: The U.S. Securities and Exchange Commission's New Rule Requiring Registration of Hedge Fund Advisers Has an Achilles Heel—and Hedge Funds Will Take Advantage*, 25 ANN. REV. BANKING & FIN. L. 471, 477 (2006).
48. 451 F.3d 873, 883–84 (D.C. Cir. 2006).
49. Registration Under Advisers Act, *supra* note 7.
50. Ordower, *supra* note 37, ¶ 7.
51. *Id.*
52. 451 F.3d at 884; *see supra* note 8 (explaining the Court's rationale). It is worth noting that some hedge fund advisers, although not required to, still register with the SEC as investment advisers. The GAO January 2008 Report on hedge funds noted that the "SEC regulates an estimated [1991] hedge fund advisers that are registered as investment advisers, which include [forty-nine] of the largest U.S. hedge fund advisers that account for about one-third of hedge funds' assets under management in the United States." GAO Report, *supra* note 2, at 5. One reason for this could be because "[i]nvestors,

The SEC never appealed the ruling, although shortly thereafter, it adopted rule 206(4)-8 under the Investment Advisers Act of 1940, which provides the SEC with the ability to bring SEC enforcement actions against hedge funds or pooled investment vehicles.[53] This new rule "is designed to clarify, in light of a recent court opinion [*Goldstein*], the Commission's ability to bring enforcement actions under the Investment Advisers Act of 1940 against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle."[54] Thus, the SEC is still closely monitoring hedge funds, even though the funds are not required to register, as would have been mandated by the now invalidated rule.[55] This current rule allows the SEC to bring enforcement actions, although it does not require registration and disclosure by hedge funds, nor does it provide a private right of action.[56]

C. The Failure of the Free Market

This section will discuss market failures such as Long Term Capital Management's collapse and the subprime mortgage meltdown—two events that made hedge funds famous for their risky bets and ability to have a serious impact on the economy at large. It will also discuss how hedge funds are making their way into average investors' portfolios and highlight the increase in fraud within the hedge fund industry.

1. Long Term Capital Management

In 1994, John Meriwether founded Long Term Capital Management (LTCM), a prestigious hedge fund that employed various complex trading strategies.[57] LTCM's team was made up of some of the most highly regarded financial experts in the world, including Merton and Scholes,

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creditors, and counterparties impose market discipline on hedge funds by providing more funding or better terms to those hedge funds willing to disclose credible information about the fund's risks and prospective returns." *Id.* at 6.

53. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,758 (Aug. 9, 2007) [hereinafter Prohibition] (to be codified at 17 C.F.R. pt. 275), *available at* http://www.sec.gov/rules/final/2007/ia-2628.pdf.

54. *Id.* at 44,756.

55. Also note that hedge funds are still subject to some regulatory reporting requirements. As the GAO's January 2008 Report on hedge funds noted, for example, "upon acquiring a [five] percent beneficial ownership position of a particular publicly traded security, a hedge fund may be required to file a report disclosing its holdings with SEC." GAO Report, *supra* note 2, at 11–12.

56. Prohibition, *supra* note 53.

57. *See* PWG 1999 Report, *supra* note 3, at 10; FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 251 (2003).

who together won the 1997 Alfred Nobel Memorial Prize in Economic Sciences for their research in options theory.[58] LTCM was highly leveraged, which made it extremely vulnerable to the market movements that followed the fall of the Russian ruble.[59] Concern grew within the financial markets about the effect of an LTCM collapse on the then fragile world markets.[60] The situation escalated to the extent that in 1999, the Federal Reserve Bank of New York intervened and arranged a consortium of fourteen firms to effectively bail out the dying fund.[61] LTCM "lost nearly all of its investors' money in a period of weeks . . . [and] many investors did not realize the extent of their exposure to particular risks."[62] LTCM's collapse demonstrated the failure of the free market's ability to restrain hedge funds and maintain market discipline.[63]

2. The Subprime Mortgage Meltdown and Ensuing Hedge Fund Implosions

In 2007, the subprime mortgage market collapsed. In brief, the subprime mortgage collapse is the outcome of an increasing amount of foreclosures on subprime loans.[64] These subprime loans—loans to borrowers with poor credit—were packaged into securities called Collateralized Debt

58. *See* PARTNOY, *supra* note 57, at 252.
59. PWG 1999 Report, *supra* note 3, at 11–12.
60. *Id.* at 12–13.
61. *Id.* at 13. To understand how one hedge fund can pose such a sweeping risk to the economy, see BOOKSTABER, *supra* note 21. Bookstaber described the LTCM situation as:

> [S]tart[ing] with a relatively minor loss for the hedge fund, a loss that required LTCM to liquidate positions to meet demands for margin. A simple exercise in raising cash through a security sale generated a downward cascade when the liquidated securities sucked prices down, causing the overall portfolio to lose value. The drop in the portfolio elicited further demands for cash to cover declining positions. These in turn precipitated further liquidations. The market reacted more to each wave of selling, and the next cycle of demands of the creditor banks then followed immediately. The crisis came to an end unnaturally, when the Federal Reserve strong-armed the creditor banks to break the cycle, effectively unlinking the tight coupling.

Id. at 145. For a more detailed explanation of the LTCM collapse, see PARTNOY, *supra* note 57, at 251–66.
62. PARTNOY, *supra* note 57, at 228–29.
63. *See* PWG 1999 Report, *supra* note 3, at 30 (explaining how market discipline broke down in the case of LTCM).
64. *See* Isidore, *supra* note 15.

Obligations (CDOs) and sold to individual and institutional investors, including hedge funds.[65]

It is believed that many of these subprime loans were "invented so that hedge funds would have high-yield debt to buy."[66] A June 2007 *New York Times* editorial stated that "Wall Street—abetted by lax federal regulation—is largely to blame for this fiasco. Wall Street firms encouraged the issuance of risky loans to troubled borrowers and then reaped a financial windfall by packaging them as investments to hedge fund clients."[67] Some experts believe that more blame should be placed on hedge funds for betting so heavily on these CDOs rather than on the bad subprime loans themselves.[68] It has been noted that the market for CDOs would not have existed without "[w]illing investors who stood ready to buy the repackaged subprime debt. There was no shortage of buyers because these instruments offered a tempting higher yield."[69]

Several hedge funds have collapsed as a result of placing heavy bets on CDOs, including two large hedge funds operated by the investment bank and trading firm, Bear Stearns.[70] The two Bear Stearns hedge funds had bet on CDOs and lost approximately $1.5 billion of investors' money when the subprime loans which comprised the CDOs were discovered to be virtually worthless.[71] These Bear Stearns hedge funds were also highly leveraged, which magnified the losses.[72]

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65. *See* David Henry, *This Investment Could Turn Ugly*, BUS. WK., June 18, 2007, at 68.

66. Markman, *supra* note 15.

67. Editorial, *Housing and Hedge Funds*, N.Y. TIMES, June 28, 2007, at A20 [hereinafter *Housing & Hedge Funds*]. The article also commented that lenders, banks, and hedge funds should not be permitted to "risk everyone's economic well-being in their attempts to enrich the few." *Id.*

68. Peter Morici, *It's the Hedge Funds, Stupid; Fed and European Central Bank Must Calmly Reassure Beleaguered Markets*, PITTSBURGH POST GAZETTE, Aug. 14, 2007, at A12.

69. Michael Brush, *Who's to Blame for the Mortgage Mess?*, MSN MONEY, Nov. 15, 2007, http://articles.moneycentral.msn.com/Investing/CompanyFocus/WhosToBlameForTheMortgageMess.aspx.

70. *See* Mark Pittman, *Bear Stearns Fund Collapse Sends Shock Through CDOs (Update 2)*, BLOOMBERG.COM, June 21, 2007, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=ahWfhEJ7dra4.

71. *See* Gretchen Morgenson, *Bear Stearns Says Battered Hedge Funds Are Worth Little*, N.Y. TIMES, July 18, 2007, at C2.

72. See *Housing & Hedge Funds*, *supra* note 67, stating: "The Bear Stearns funds, like many others, borrowed big to invest in subprime loans. Investing with borrowed money juices returns in hot markets and magnifies losses in down markets, making losers out of lenders as well as equity investors." The Bear Stearns hedge funds managers were later indicted for fraud. Patricia Hurtado & Thom Weidlich, *Ex-Bear Stearns Fund Managers Indicted for Fraud (Update 4)*, BLOOMBERG.COM, June 19, 2008, http://www. bloomberg.com/apps/news?pid=20670001&refer=home&sid=as3ef9aE2W_8. For a brief discussion of the Bear Stearns bailout which ensued, see Elliot Blair Smith, *Bear Stearns Rescue Is 'Finger*

A study in 2005 noted a trend in the credit derivatives market[73] of "increased participation by hedge funds and other leveraged counterparties as sellers of credit protection."[74] The study noted that hedge fund participation "may marginally increase counterparty credit risk due to some hedge funds' leveraged nature."[75] Much has been learned since 2005—it is arguable that the abovementioned statement significantly understates the risk that hedge funds have brought to the credit derivatives market.

A crisis such as the subprime mortgage debacle brings about broad adverse effects that trickle down into the wallet of everyday consumers, even those who have no direct exposure to any subprime loan or related financial derivative.[76] In addition to the expected rise in foreclosures and the subsequent impact on housing values generally,[77] experts have also noted that credit card policies and auto loans have become more restrictive and less beneficial to consumers in response to the losses

in Dike,' Scholars Say (Update 1), BLOOMBERG.COM, Mar. 16, 2008, http://www.bloomberg.com/apps/news?pid=20670001&refer=home&sid= acAqXkb6aIJM.

73. A CDO is a type of credit derivative. See Bartly Dzivi, *Viewpoint: Another Depression?*, ORIGINATION NEWS, Oct. 1, 2007, at 4, for a discussion of the role hedge funds and credit derivatives have played in the subprime mortgage collapse. The author stated:

> Warren Buffett has a succinct view of financial derivatives: they are a time bomb for those who trade them, and for the economy as a whole. In 2003, Mr. Buffett said, "Those who trade derivatives are usually paid (in whole or part) on 'earnings' calculated by mark-to-market accounting. But often there is no real market . . . and 'mark-to-model' is utilized. This substitution can bring on large-scale mischief. . . . In extreme cases, mark-to-model degenerates into what I would call mark-to-myth."

Id. at 4.

74. COUNTERPARTY RISK MGMT. POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE 110 (2005) [hereinafter Report of CRMPG II], *available at* http://www.crmpolicygroup.org/docs/CRMPG-II.pdf. A counterparty is simply someone who is a party to a contract (or financial transaction). A DICTIONARY OF FINANCE AND BANKING 95 (John Smullen & Nicholas Hand eds., 3d ed. 2005).

75. Report of CRMPG II, *supra* note 74, at 110.

76. *See* Jim Jubak, *Credit Contagion Infects Your Wallet*, MSN MONEY, Oct. 26, 2007, http://articles.moneycentral.msn.com/Investing/JubaksJournal/CreditContagionInfectsYourWallet.aspx. The article discusses how the subprime crisis has spread to car loans and credit cards. *Id.* Jubak cites many changes in credit card policies that have hurt consumers, such as higher monthly interest rates, higher penalty rates, late fees, over limit fees, shorter grace periods, and lower credit limits. *Id.* Jubak believes these policies were implemented to "pull in more revenue from cardholders to offset the squeeze on their profits." *Id.*

77. *See* John W. Schoen, *Foreclosures Jump 30 Percent in 3rd Quarter*, MSNBC BUS., Nov. 1, 2007, http://www.msnbc.msn.com/id/21551909/ (reporting that foreclosures in the third quarter of 2007 had risen thirty percent from the second quarter of 2007, and double from the third quarter of 2006).

many banks have recently suffered.[78] Consumer confidence has been falling throughout the second half of 2007 and into the start of 2008, partly as a result of the concerns people have due to the credit crunch.[79] Moreover, worries about subprime mortgage losses have resulted in much volatility and many tough days for the stock market.[80] In addition, "[t]he credit crunch that rattled mortgage lenders has spread to the education lending market, with dramatic results."[81] This demonstrates the extent of the damage to the economy that this financial crisis, arguably driven by the hedge fund industry, is beginning to cause.

Analysts predict that "worldwide losses from bad subprime-mortgage loans will reach as much as $400 billion."[82] Market strategists' expectations for a recession in 2008 have increased significantly as a result.[83] In late 2007, Merrill Lynch wrote off billions of dollars and forced the retirement of their seasoned CEO due to the risky bets he placed on CDOs.[84] E*Trade's stock price fell by about fifty-eight percent in a single day of trading in November 2007—from $8.59 per share to around $3.55 per

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78. *See* Jubak, *supra* note 76.

79. Associated Press, *Consumer Confidence Falls to Two-Year Low*, MSNBC BUS., Oct. 30, 2007, http://www.msnbc.msn.com/id/21543609/.

80. Charley Blaine & Elizabeth Strott, *Dow Falls 362 on Citigroup, Financial Weakness*, MSN MONEY, Nov. 2, 2007, http://articles.moneycentral.msn.com/Investing/Dispatch/071101markets.aspx (reporting that the Dow fell 362 points "on weakness in financial stocks, especially Citigroup"); *see also* Charley Blaine & Elizabeth Strott, *Dow Falls 121 as Fear Slams Financial Stocks*, MSN MONEY, Nov. 15, 2007, http://articles.moneycentral.msn.com/Investing/Dispatch/071115markets.aspx (reporting a 121 point drop in the Dow due to the "fear of the unknown in financial stocks"); Charley Blaine & Elizabeth Strott, *Dow Falls 237; Citigroup Gets a Partner*, MSN MONEY, Nov. 27, 2007, http://articles.moneycentral.msn.com/Investing/Dispatch/ 071126markets.aspx (reporting that the Dow fell more than 237 points as credit fears escalated). Also noteworthy is that the recent increase in foreclosures has even led to an increase in crime in states such as Atlanta. This increase in crime is even affecting suburban and moderate income areas because many homeowners have no choice but to accept any renter they can find, bringing bad renters to the areas and planting the seeds of crime in otherwise safe areas. *See* Associated Press, *Squalor, Crime Follow Wave of Foreclosures*, MSNBC BUS., Nov. 13, 2007, http://www.msnbc.msn.com/id/21773482/ (noting an increase in prostitution and drug activity and citing a study that states that a one percent increase in the foreclosure rate increases neighborhood violent crime by 2.33%); Charley Blaine & Elizabeth Strott, *Citi's Big Loss, Weak Retail Sales Batter Stocks*, MSN MONEY, Jan. 15, 2008, http://articles.moneycentral.msn.com/Investing/Dispatch/080115markets.aspx (stating that the Dow fell 277 points as Citigroup wrote off billions).

81. Liz Pulliam Weston, *The Coming Student Loan Crunch*, MSN MONEY, Feb. 21, 2008, http://articles.moneycentral.msn.com/CollegeAndFamily/CutCollegeCosts/TheComingStudentLoanCrunch.aspx.

82. Brush, *supra* note 69.

83. *Id.*

84. NPR Reports & Associated Press, *Embattled Merrill Lynch CEO O'Neal Steps Down*, NPR, Oct. 30, 2007, http://www.npr.org/templates/story/story.php?storyId=15768986.

share—after the company stated that it could not predict new credit losses, and analysts discussed the possibility of bankruptcy.[85]

Yet, one hedge fund manager made hundreds of millions of dollars betting against the mortgage industry.[86] He has commented that "we're headed into a deep recession, the worst since the Depression, as dozens of banks will fail."[87] The role hedge funds have played in the demand for CDOs is troubling and the problem is only compounded by the fact that some hedge funds are actually benefiting from the ensuing CDO losses their industry helped to create.[88]

Thus, the current market failures of the subprime mortgage crisis have been driven in large part by a hedge fund industry free from meaningful oversight,[89] hedge funds' excessive use of leverage, and an overall lack

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85. Ben Steverman, *E*Trade's Meltdown*, BUS. WK., Nov. 12, 2007, http://www.businessweek.com/investor/content/nov2007/pi20071112_893992.htm.

86. Jon Markman, *Getting Rich off the Subprime Mess*, MSN MONEY, Nov. 27, 2007, http://articles.moneycentral.msn.com/Investing/SuperModels/GettingRichOffTheSubprimeMess.aspx.

87. *Id.*

88. See Jon Markman, *For an Elite Few, Credit Pain Means Profit*, MSN MONEY, Nov. 15, 2007, http://articles.moneycentral.msn.com/Investing/SuperModels/CreditPainIsGainForASelectFew.aspx, for an explanation of how numerous hedge fund managers engaged in credit arbitrage because they knew "these towers of debt were houses of cards just waiting to be pushed over." *Id.* In essence, these hedge fund managers sought to destroy confidence by betting in the $70 trillion market for credit-default swaps (CDSs), a set of securities that are issued by financial institutions as a kind of insurance policy on debt:

> The arbitrage funds bought the credit-default swaps on the investment banks that issued the CDOs and shorted investment banks' stocks, two actions that created the impression of vulnerability among other market players. It's a bit like taking out a life insurance policy and buying a headstone for a sick relative. Someone might get the impression that your uncle's prospects aren't good.
>
> You might wonder how there could be $70 trillion in CDS money out there, and the reason is pretty interesting. Imagine that you are at a horse race at which the winner can earn a $10 billion prize, which in this case would be the amount a CDS would pay off in the event of a bank default. In the stands, however, are bettors with access to huge lines of credit that are betting up to $1 trillion among themselves on the outcome of the race. It doesn't matter that the most a CDS holder could ever win is $10 billion, because the betting—or trading of the derivatives—is a completely separate game.

Id.

89. It should also be noted that blame has been placed everywhere for the subprime mess. Some experts believe much of the blame falls with the failure of the rating agencies to properly rate these risky investments. *See, e.g.*, Aaron Lucchetti & Serena Ng, *How Rating Firms' Calls Fueled Subprime Mess*, WALL ST. J., Aug. 15, 2007, at A10 (stating that "[h]ad the securities initially received the risky ratings that

of transparency.[90] Securities regulators and members of Congress seem to respond most effectively to a disaster,[91] and once again in these current market failures, a disaster is unfolding. Economic crises give birth to regulation, but in the case of hedge funds, not much has changed after LTCM's collapse. These recent market failures in the subprime crisis now present yet another opportunity for legislators and regulators to respond.[92]

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some of them now carry, many pension and mutual funds would have been barred by their own rules from buying them," and some mortgage lenders may have refrained from making the loans to begin with if it had not been for the eager secondary market for them).

90. Report of CRMPG II, *supra* note 74, at 125 (stating that lack of transparency in the markets of today is due in part to the increasing complexity of financial innovation). Moreover, the GAO January 2008 Report on hedge funds noted that, "although most hedge funds may be willing to provide information on aggregate position and holdings, many hedge funds decline to share specific position transparency" due to the need to keep such information confidential for fear that disclosure may allow other market participants to capitalize on their trading positions and thus compromise the fund and its investors. GAO Report, *supra* note 2, at 28. This at least partially explains why lack of transparency is so prevalent in the hedge fund community.

91. Just as the tragedy of the Great Depression led to long overdue legislative reforms, so too did the collapse of Enron, WorldCom, Global Crossing, and several other corporate scandals. *See Enron Board Aided Firm's Collapse, Senate Report Charges; Reforms Urged*, 34 SEC. REG. & L. REP. 1133, 1145–46 (2002) (discussing findings of fiduciary failure, high risk accounting, conflicts of interest, excessive compensation, and lack of independence, leading to recommendations of legislative reform); *see also* PARTNOY, *supra* note 57, at 2 ("Congress expressed outrage and mollified some investors with relatively minor accounting reforms."). In an attempt to reform the financial markets at that time, Congress passed the Sarbanes Oxley Act of 2002, which extended the penalties for financial fraud, mandated increased independence of corporate directors, and initiated a review board to penalize unprincipled accountants. *Id.* at 393.

92. As stated at the outset, this Comment is current as of February 2008. However, in the months leading up to the publication of this Comment, the subprime mortgage crisis developed into a full blown market meltdown, and several other failures of the free market materialized. In early September 2008, the U.S. government bailed out The Federal National Mortgage Association (Fannie Mae) and The Federal Home Loan Mortgage Association (Freddie Mac), two of the country's largest financial institutions, due to the severe losses they endured on mortgage defaults. James R. Hagerty et al., *U.S. Seizes Mortgage Giants*, WALL ST. J., Sept. 8, 2008, at A1. Shortly thereafter, ninety-four-year-old Merrill Lynch was sold to Bank of America for half of its all-time peak value because of the risky assets it carried on its balance sheets—CDOs. Matthew Karnitschnig et al., *Bank of America to Buy Merrill*, WALL ST. J., Sept. 15, 2008, at A1, A19. This caused a shock in the financial markets and was followed by news of bankruptcy court filings by Lehman Brothers Inc., which was selling "its most prized businesses before too many employees and customers walk out the door." Susanne Craig et al., *AIG, Lehman Shock Hits World Markets*, WALL ST. J., Sept. 16, 2008, at A1. Then, "[t]he U.S. government seized control of American International Group, Inc.—one of the world's biggest insurers—in an $85 billion deal that signaled the intensity of its concerns about the danger a collapse could pose to the financial system." Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 17, 2008, at A1. AIG's liquidity issues stemmed in large part from their unit which sold "credit default swap contracts designed to protect investors against default in an array of assets, including

3. Retailization of Hedge Funds

Hedge funds are not directly available to the average investor. Net worth as well as sophistication requirements must be met by all investors in order for the hedge funds to maintain their unregistered status.[93] Nonetheless, through a process referred to as "retailization," hedge funds are made available to average small investors, typically through registered funds of hedge funds (FOHF).[94] FOHFs are set up as a single fund that invests in multiple hedge funds.[95] FOHFs typically have lower minimum investment requirements, but investing in FOHFs actually

subprime mortgages." *Id.* at A6. Shortly thereafter, "[i]n what is by far the largest bank failure in U.S. history, federal regulators seized Washington Mutual Inc. and struck a deal to sell the bulk of its operations to J.P. Morgan Chase & Co." which "mark[ed] a new low point in the country's mortgage crisis." Robin Sidel et al., *WaMu Is Seized, Sold off to J.P. Morgan, in Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, at A1. Then, "President George W. Bush signed into law an unprecedented $700 billion plan to rescue the U.S. financial system, one of the largest-ever government interventions in the nation's economy." Greg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Further*, WALL ST. J., Oct. 4–5, 2008, at A1. The next week was characterized as the "worst week in its 112-year history" for the Dow Jones Industrial Average. E.S. Browning et al., *Wild Day Caps Worst Week Ever for Stocks*, WALL ST. J., Oct. 11–12, 2008, at A1. On October 23, 2008, former Federal Reserve Chairman Alan Greenspan testified before the House of Representatives Committee on Oversight and Government Reform regarding the breakdown in U.S. credit markets and stated, "[t]he consequent surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem." Dr. Alan Greenspan, Testimony Before the House Committee of Oversight and Government Reform 3 (Oct. 23, 2008), *available at* http://oversight.house.gov/documents/20081023100438.pdf. Thus, the predictions of this Comment have unfortunately begun to unfold, as blame for the economic downturn is being placed in large part by the surge in demand of subprime securities by hedge funds, underscoring the relevance of this Comment's proposal to indirectly regulate hedge funds.

93. Hedge funds usually seek exemption under Rule 506 of Regulation D, which is a safe harbor for private offerings. Antoszewski, *supra* note 9, at 398. This is how hedge funds are able to raise money and remain exempt from the registration requirements of the 1933 Act. The SEC realized the expense associated with securities registration and disclosure, and created exemptions for certain types of securities and certain types of transactions. *See* RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 403 (8th ed. 1998). In doing so, the SEC weighed the benefits and burdens of disclosure, taking into account the type of offering and the type of investor. The United States Supreme Court realized that certain high net worth or institutional investors are "able to fend for themselves" and access information, and thus do not need the protections of the Securities Act. SEC v. Ralston Purina Co., 346 U.S. 119, 125–26 (1953).

94. U.S. Securities and Exchange Commission, Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds, http://sec.gov/answers/hedge.htm (last visited Nov. 5, 2008).

95. *Id.*

subjects the investor to two layers of fees—the fees charged by the FOHF and those charged by the underlying hedge funds.[96] The retailization of hedge funds is another illustration of how the hedge fund industry is beginning to find a way into average investors' portfolios, exposing them to risks they likely are not able to bear or comprehend.[97] This underscores the importance of maintaining adequate market discipline within the hedge fund industry, which is the principal aim of the indirect regulatory proposal of this Comment.

4. Increase in Growth and Increase in Fraud

Alfred Winslow Jones is credited as the first investor to start a hedge fund.[98] Jones held short and long positions in stocks and sought to insulate himself against market fluctuation.[99] Modern hedge funds have grown in terms of investment strategies and number of assets, and now incorporate all of the complexities of modern finance.[100] In 1968, there were roughly 215 hedge funds.[101] By 2007, the number of hedge funds had grown to nearly 9000.[102]

As hedge funds have grown, so too have incidences of fraud enforcement cases against hedge funds.[103] These fraud enforcement cases have included: "misappropriation of assets; misrepresentation of portfolio performance; falsification of experience, credentials, and past returns; misleading disclosure regarding claimed trading strategies; and improper valuation of assets."[104]

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96. *Id.*

97. As described in the introduction of this Comment, another way that hedge funds have reached many average investors is through pension fund investment into hedge funds.

98. *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 25 (2000).

99. *Id.*

100. *Id.* at 26. To understand the downside of financial innovation, see BOOKSTABER, *supra* note 21, stating:

> [T]he positive effects of innovation come at a price. Innovation increases complexity. Many innovative instruments are in the form of derivatives with conditional and nonlinear payoffs. When a market dislocation arises, it is difficult to know how the prices of these instruments will react. Innovation and mechanical efficiency have also increased complexity by pushing markets to become more interconnected.

Id. at 255.

101. *See* LOWENSTEIN, *supra* note 98, at 26.

102. *Testimony of Steel*, *supra* note 21, at 62.

103. DIV. OF INV. MGMT. & OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 72–75 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

104. *Id.* at 73–74.

In 2003, the SEC held a two day roundtable on hedge funds, which assembled experts to debate important issues in the hedge fund industry.[105] Participants included hedge fund managers, consultants, service providers, academics, prime brokers, investment bankers, investors, and foreign and U.S. regulators.[106] It was noted that some of these experts "argued that if the SEC staff were able regularly to examine hedge fund managers, not only would incidents of fraud potentially decrease, but investors would have more information upon which to make their investment decision."[107]

These failures of the free market approach to restrain hedge funds lead to the conclusion that something more needs to be done—something other than direct regulation.

II. THEORY AND RATIONALE BEHIND INDIRECT HEDGE FUND REGULATION

A. General Theory of Indirect Regulation

The proposal this Comment puts forth in essence seeks to change the behavior of hedge funds. Because natural market forces are insufficient to cause that change, and because directly changing that behavior is unlikely and infeasible, this Comment assesses changing the behavior of hedge funds *indirectly*.

Behavior can be regulated by four types of constraint—law, social norms, markets, and natural constraints.[108] In addition, regulation has

105. *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Servs.*, 108th Cong. 60–61 (2003) [hereinafter Donaldson Testimony] (testimony of William H. Donaldson, Chairman, United States Securities and Exchange Commission), *available at* http://www.sec.gov/news/testimony/052203tswhd.htm.

106. *Id.*

107. *Id.*

108. Lawrence Lessig, *The New Chicago School*, 27 J. LEGAL STUD. 661, 662–63 (1998). The following provides an illustration of how regulators could take into account these four types of behavioral constraints:

> Say the government's objective is to reduce the consumption of cigarettes. There are any number of means that the government could select to this single end. A law could ban smoking. (That would be law regulating the behavior it wants to change directly.) Or the law could tax cigarettes. (That would be the law regulating the market to reduce the supply of cigarettes, to decrease the consumption of cigarettes.) Or the law could fund a public ad campaign against smoking. (That would be the law regulating social norms, as a means

two aspects—direct and an indirect: "In its direct aspect, the law uses its traditional means to direct an object of regulation (whether the individual regulated, norms, the market, or architecture); in its indirect aspect, it regulates these other regulators so that they regulate the individual differently."[109]

B. Direct *Versus* Indirect *and Application to Hedge Funds*

The objective of this proposal is to minimize systemic risk to the economy by ensuring that hedge fund market participants have certain material information about the hedge funds with which they are involved. This Comment proposes to directly regulate hedge fund market participants, so as to indirectly regulate hedge funds.

1. Most Agree that Change Is Needed

Regulating hedge funds is clearly not a new topic—academics continue to assess the issue[110]—and the SEC has already made an attempt to directly regulate them by mandating that they register as investment advisers.[111] In 1998, in the aftermath of LTCM, then Federal Reserve Chairman Alan Greenspan testified before Congress regarding

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> to regulating smoking behavior.) Or the law could regulate nicotine in cigarettes, requiring manufacturers to reduce or eliminate nicotine. (That would be the law regulating the architecture of cigarettes, as a way to reduce their addictiveness, as a way to reduce the consumption of cigarettes.) Each action by the government can be expected to have some effect (call that its benefit) on the consumption of cigarettes; each action also has a cost. The regulator must test whether the costs of each outweigh the benefits or, better, which most efficiently achieves the regulator's end.

Id. at 667–68.

109. *Id.* at 666. It is also important to remember that the law often regulates indirectly:

> When regulating indirectly, law changes the constraints of one of these other structures of constraint. Law can tax cigarettes, directly regulating the market so as to indirectly change the consumption of cigarettes. Law can put advertisements on television showing the consequences of not wearing seat belts, directly working on a norm against seat belts so as to indirectly effect the use of seat belts. Law can order that buildings be built differently, directly regulating building codes so as to indirectly regulate discriminating behavior with respect to the disabled. And obviously, law can regulate all three of these constraints simultaneously, when, for example, it cuts the supply of drugs, runs "just say no" campaigns, and sprays fields of marijuana with paraquat. Law can select among these various techniques in selecting the end it wants to achieve. Which it selects depends on the return from each.

Id. at 671–72.

110. See *supra* note 9 for an overview of law review article recommendations on direct hedge fund regulation.

111. See *supra* Part I.B.2.a for an overview of the *Goldstein* case, which held the SEC's rule to be an instance of arbitrary rulemaking.

the appropriate regulatory approach to take with hedge funds. His testimony questioned the feasibility of direct regulation and advocated for indirect regulation:

> [D]oes the fact that investors have lost most of their capital and creditors may take some losses on their exposure to LTCM call for direct regulation of hedge funds? It is questionable whether hedge funds can be effectively directly regulated in the United States alone. . . . [H]edge funds' physical presence is small. Given the amazing communication capabilities available virtually around the globe, trades can be initiated from almost any location. Indeed, most hedge funds are only a short step from cyberspace. Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. The best we can do in my judgment is what we do today: Regulate them indirectly . . . . We are thus able to monitor far better hedge funds' activity, especially as they influence U.S. financial markets. If the funds move abroad, our oversight will diminish.[112]

Because *direct* regulation could lead hedge funds to react by emigrating away from U.S. regulatory jurisdiction, as Greenspan predicted, it is worthwhile to consider as an alternative some more aggressive forms of *indirect* regulation.[113]

Hedge funds continue to be closely monitored. In late February 2008, the U.S. Government Accountability Office (GAO) released a report on hedge funds.[114] The report essentially concluded that hedge funds remain a source of potential systemic risk and require continued monitoring.[115] The GAO's report also noted that:

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112. *See Hedge Fund Operations: Hearing Before the H. Comm. on Banking and Financial Servs.*, 105th Cong. 160–61 (1998) (statement of Alan Greenspan, Chairman, Federal Reserve System Board of Governors), *available at* http://www.federalreserve.gov/boarddocs/testimony/1998/19981001.htm.

113. *See* Steven Pearlstein, *Regulate Hedge Funds? Nope, Just the Investors*, WASH. POST, Aug. 16, 2006, at D1, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/08/15/AR2006081501259.html (outlining briefly the benefit of indirectly regulating hedge funds, and stating, "Regulate hedge funds? Why bother when you can just as easily regulate the outfits that invest in them, lend them money and execute their trades?"). Two examples of potential direct regulation include forcing adviser registration under the Advisers Act and amending the definition of *Accredited Investor* and *Qualified Client*. *See* Erik J. Greupner, Comment, *Hedge Funds Are Headed Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1591–94 (2003).

114. The report (1) described the extent of federal financial regulatory oversight on hedge funds under existing authorities, (2) examined the steps counterparties, investors, and creditors have taken to apply market discipline on hedge funds, and (3) assessed the potential systemic risk hedge funds pose and set forth the ways in which regulators have addressed that risk. GAO Report, *supra* note 2, at Highlights.

115. *Id.* at 2.

> [F]or market discipline to be effective, (1) investors, creditors, and counterparties must have access to, and act upon, sufficient and timely information to assess a fund's risk profile; (2) investors, creditors, and counterparties must have sound risk management policies, procedures, and systems to evaluate and limit their credit risk exposures to hedge funds; and (3) creditors and counterparties must increase the costs or decrease the availability of credit to their hedge fund clients as the creditworthiness of the latter changes.[116]

The GAO report recognized that market participants need access to more information and that they need better risk management policies to maintain an appropriate amount of credit exposure to hedge funds.[117] Under the current regulatory framework, hedge funds are not required to provide this information to market participants.[118] However, if market participants were directly regulated to only deal with hedge funds that provided them with certain material information, hedge funds would be *indirectly* regulated and the goals of the GAO report would be accomplished.

2. *Infeasibility of Direct Regulation*

Hedge funds bring many benefits to the economy, as previously discussed, so the risk of an exodus of such funds caused by direct regulation should not be ignored.[119] In May 2006, Federal Reserve Chairman Bernanke also commented on why direct regulation of hedge funds is unjustified and inappropriate:

> Direct regulation may be justified when market discipline is ineffective at constraining excessive leverage and risk-taking but, in the case of hedge funds, the reasonable presumption is that market discipline can work. Investors, creditors, and counterparties have significant incentives to rein in hedge funds' risk-taking. Moreover, direct regulation would impose costs in the form of moral hazard, the likely loss of private market discipline, and possible limits on funds' ability to provide market liquidity.[120]

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116. *Id.*
117. *Id.*
118. PWG 1999 Report, *supra* note 3, at 6.
119. *See* Stewart, *supra* note 11, at 8.
120. Bernanke May 2006 Speech, *supra* note 10. In the midst of the turmoil in the credit markets following the subprime mortgage collapse and the implosion of several funds, the "Great Unwind," there are signs that counterparties are adjusting their dealings with hedge funds even absent direct regulation. See Jeff Benjamin, *Subprime Chaos, Credit Crunch Recast Alternatives; Emphasis Is Shifting to Management Skills*, INVESTMENT NEWS, Jan. 7, 2008, at 18, quoting George Feiger, chairman and chief executive of Contango Capital Advisors Inc. as stating:

> Until now, much of the growth in the hedge funds industry has come from the use of leverage, but we're now looking at a systematic reduction in the willingness of prime brokers to provide leverage. . . . This will lead to a huge rebalancing of the whole industry away from reliance on leverage and toward

Many free market theorists in addition to Alan Greenspan, who generally oppose any sort of hedge fund regulation, cite to benefits that hedge funds provide—increased diversification for investors[121] and benefits to capital markets overall such as liquidity, price discovery, and risk dispersion.[122] Further, by providing liquidity to the marketplace, hedge funds make markets attractive to investors by bringing information to markets and enhancing market efficiency.[123] Hedge funds also play a positive role of dispersing risk by developing new risk management tools and techniques.[124] However, the same Treasury Department officials who cite to the advantages of hedge funds also recognize that increased observation is necessary due to hedge fund managers' excessive use of leverage, the increase in transaction volumes, and the increasing impact of hedge funds on the overall market:

> While hedge funds can provide benefits to investors and the overall marketplace, they present some challenges as well. The scale, complexity and dynamic nature of these business models and their investment strategies emphasize why we believe heightened vigilance is necessary. Managers are now relying more heavily on the use of leverage, transaction volumes are increasing, and the impact of hedge funds on markets continues to grow.[125]

Therefore, this Comment recommends an indirect regulatory scheme which seeks to preserve the abovementioned benefits of hedge funds to the U.S. capital markets, while minimizing any potential systemic risk.

> management skill, and from there we'll see a sorting out and massive compression on the leverage side of the business.

Id.

121. RESEARCH DEP'T., CTR. FOR INT'L SEC. & DERIVATIVES MKTS., THE BENEFITS OF HEDGE FUNDS: 2006 UPDATE, at 14 (2006), *available at* http://cisdm.som.umass.edu/research/pdffiles/benefitsofhedgefunds.pdf.

122. *Testimony of Steel*, *supra* note 21, at 61; *see also Riding the Cycle: Why Volatility Will Never Go Away*, ECONOMIST, Jan. 12, 2008, at 67 ("[V]olatility has moved to a structurally lower level thanks to the activity of hedge funds and to the development of complex products and derivatives. A new, more sophisticated financial system had spread risk more efficiently.").

123. *Testimony of Steel*, *supra* note 21, at 62.

124. *Id.* Steel notes that because "hedge funds are often willing counterparties on derivatives transactions with financial institutions seeking to distribute the risks inherent in their normal business activities" and because hedge funds are attractive to investors because of the diversification they offer and are able "to engage in absolute value return strategies," hedge funds afford investors the advantage of being able to profit in down markets. *Id.*

125. *Id.*

3. *Unlikelihood of Direct Regulation*

As discussed previously, the SEC attempted to directly regulate hedge funds by requiring that they register under the Advisers Act.[126] This attempt did not withstand judicial scrutiny, as the D.C. Circuit Court of Appeals ruled against the SEC in *Goldstein*.[127] Additionally, in its latest report, the Presidents Working Group on Financial Markets, which was formed in 1999 after LTCM failed, advocated against direct regulation of hedge funds.[128] In fact, it stated that "risk-taking is the rule and government regulation is the exception."[129] Therefore, it is clear that direct regulation of hedge funds is not the preferred solution of both regulators and the hedge fund community.

4. *Applied Theory of Indirect Regulation to Hedge Funds*

A principal goal of proponents of hedge fund regulation is to minimize systemic risk.[130] As previously mentioned, systemic risk refers to the "potential that a single event, such as a financial institution's loss or failure, may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected."[131] The indirect regulatory proposal set forth in this Comment will minimize systemic risk because market participants will be more informed prior to entering into a transaction with any given hedge fund.

LTCM's collapse accelerated the first comprehensive assessment by lawmakers of the potential systemic risks brought about by the thriving hedge fund industry.[132] In theory, *direct* hedge fund regulation would reduce systemic risk through a mechanism of mandatory disclosure, because fund participants would be aware of the risks involved and therefore would be able to act to reduce their risk before any sort of market failure.[133] For example, if hedge funds disclosed more information

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126. See *supra* Part I.B.2.a for an overview of the *Goldstein* case.
127. *Id.*
128. PRESIDENT'S WORKING GROUP ON FIN. MKTS., AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL 1 (2007) [hereinafter Agreement], *available at* http://www.treas.gov/press/releases/reports/hp272_principles.pdf.
129. *Id.*
130. *Testimony of Steel*, *supra* note 21, at 63.
131. *Id.* (cautioning also that significant losses by a highly leveraged hedge fund could be problematic for the entire financial system).
132. Bernanke May 2006 Speech, *supra* note 10.
133. This relates to the concept of disclosure that is at the core of the federal securities laws. See Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 478 (2006), for an interesting perspective on disclosure regulation and some of the costs of disclosure. The author notes, "Our securities regulatory regime is a disclosure regime." *Id.* at 478.

about their leverage, creditors would be able to better understand the risks in extending credit to hedge funds, regardless of whether they requested the information. In better understanding these risks, creditors may choose not to extend credit to certain hedge funds, or they may choose to limit the amount they extend. Similarly, if hedge funds disclosed more information about their leverage, large institutional investors such as pension funds would be better equipped to assess the risks involved in investing workers' retirement money into a given hedge fund. For example, pension fund managers who truly understand the risks associated with hedge fund investments and the extent of their leverage might choose to limit their exposure to hedge funds as part of their portfolio of alternative investments. Similarly, they may choose not to invest in certain hedge funds.

The goal is disclosure, but because directly regulating hedge funds to disclose more information is unlikely and infeasible, this Comment proposes indirect regulation—mandating investor and counterparty risk management practices. Indirect regulation would shift the regulatory focus away from hedge funds, and onto hedge fund market participants. If market participants were mandated to only deal with hedge funds which offer a minimum amount of disclosure, the regulatory goal of greater disclosure could be achieved indirectly.

If hedge funds are directly regulated, there is a risk that many funds would be invited to conduct business from abroad. This would reduce the benefits hedge funds provide to capital markets in the United States and afford the United States less oversight—without reducing undesirable risks and potential harms. This Comment's proposed indirect regulatory scheme would indirectly force hedge funds to disclose certain material information when they seek investment capital from United States-based private pension funds or leverage from creditors. Thus, the potential negative incentive upon hedge funds to move overseas to escape a regulatory burden is greatly reduced because the regulatory focus would not be on the funds, but rather on market participants such as United States-based investors, like pension funds, upon whom the hedge funds are greatly reliant.[134]

134. See Figure 1, *infra* Part III.D, which illustrates that the bulk of the world's largest pension funds are U.S. based.

III. THE MECHANICS OF INDIRECT HEDGE FUND REGULATION

This Comment proposes implementing indirect hedge fund regulation by focusing on market participants such as pension fund investors and banks that lend to hedge funds. The following is a brief summary of the key proposals of this Comment: (1) the Employee Retirement Income Security Act of 1974 (ERISA)[135] should be amended to state that any private pension fund that seeks to invest money into a hedge fund may only do so if that hedge fund discloses certain material information and is registered with the SEC; (2) Congress should enact new legislation that would allow hedge funds to voluntarily register with the SEC as *hedge funds*, to provide an avenue for hedge funds to, at a minimum, provide the SEC with audited financials, follow SEC rules in calculating the value of their assets, and disclose their trading strategies in confidence;[136] and (3) an international regulatory solution is necessary to address the arduous task of uniformly regulating hedge fund creditors. This could be done through the Bank for International Settlements (BIS), an international organization which serves as a bank for central banks, which, in its capacity as a forum to promote discussion and policy among central banks, should establish international banking standards with hedge funds. These standards should include mandating that all banks engaging in hedge fund financing should (1) only do so if the hedge funds provide them with audited financials, (2) follow SEC or other accepted rules in calculating the value of their assets, and (3) disclose their trading strategies in confidence.

A. How Pension Funds Fit into an Indirect Hedge Fund Regulation Framework

This Comment proposes that ERISA should be amended to mandate that if a private pension fund chooses to invest assets into a hedge fund, it can only do so if the hedge fund provides the pension fund with certain material information made available through SEC registration.[137] Similarly,

135. ERISA is a federal law protecting individuals in private pension plans. *See infra* note 168 and accompanying text.

136. Because hedge funds are not yet statutorily defined, this can be done by simply using the commonly accepted definitions and standards to designate a fund as a hedge fund. *See supra* text accompanying notes 2–5.

137. Despite possible concerns, Regulation D would not "lose its punch" through this Comment's proposed indirect regulatory scheme, whereby private offerings otherwise exempt from registration under Regulation D are now registering, because Regulation D would only be limited to the extent necessary to consider a broader public interest when hedge funds pose systemic risks to the entire economy. Regulation D is premised on the notion that certain sophisticated or high net worth investors are able to fend for themselves and therefore do not need the protection of the federal securities laws. *See*

banks that extend credit to hedge funds and provide them with leverage should be restricted to do so only if the hedge fund makes certain material disclosures. This would indirectly cause hedge funds to change their behavior and disclose more information to market participants. This indirect regulatory scheme promotes market discipline by providing hedge funds with an incentive to disclose material information.[138]

1. An Introduction to the Pension Fund-Hedge Fund Affair

Because pension funds account for about forty percent of all institutional investment money, making them by far the largest institutional investor,[139] there is inevitably a risk in leaving the pension fund-hedge fund relationship unregulated. Pension funds are understood as funds established by a corporation, labor union, governmental entity, or other organization, to disburse the pension benefits of retired workers.[140] "Pension funds invest billions of dollars annually in the stock and bond markets" and thus play a major role in the supply-demand balance of the markets.[141]

Some pension funds have small stakes in hedge funds, although others

SEC v. Ralston Purina Co., 346 U.S. 119, 125–26 (1953). Thus, by limiting hedge funds to sophisticated investors, disclosure should be unnecessary. This theory recognizes that these investors are generally able to protect themselves due to their sophistication, purchasing power, and other factors. However, the theory is insufficient in a key respect—it does not take into account the interest of protecting the economy at large from the systemic risks posed by hedge funds. Moreover, Federal Reserve Chairman Bernanke, reflecting on the collapse of LTCM, has also recognized that even sophisticated hedge fund investors fail to ask the right questions: "Investors, perhaps awed by the reputations of LTCM's principals, did not ask sufficiently tough questions about the risks that were being taken to generate the high returns." Bernanke May 2006 Speech, *supra* note 10. This suggests that the premise of Regulation D, that certain investors are able to fend for themselves, is not always applicable to hedge fund investors.

138. Hedge funds that choose not to take money from United States based private pension funds would have no incentive to register and disclose any information. This is because hedge funds are not being directly regulated and therefore they are not being forced to change their behavior. The funds that remain unregistered, however, would not add much systemic risk to the U.S. economy because any collapse would directly affect only foreign pension fund investors. Hedge funds that choose to seek investment and debt capital from abroad may still pose some systemic risk to the world economy, depending on the size of the fund.

139. Atlas & Walsh, *supra* note 16.

140. JOHN DOWNES & JORDAN ELLIOT GOODMAN, BARRON'S FINANCE AND INVESTMENT HANDBOOK 673 (6th ed. 2003).

141. *Id.* In addition, earnings on pension fund investment portfolios are tax deferred. *Id.* Fund managers ensure that the rate of return on their portfolios equals or surmounts the anticipated payout needed by making actuarial assumptions about how much they will be required to pay out to pensioners. *Id.*

have invested more than twenty percent of their assets into hedge funds.[142] The number of "U.S. corporate defined-benefit pension funds investing in hedge funds has increased to 24% in 2006, up from 19% in 2004 and 12% in 2000."[143] Although statistics vary, in 2006 the total share of corporate pension fund assets allocated to hedge funds was approximately 2.1%.[144] To provide an example, Boeing planned on changing the composition of its pension plan by increasing its bond allocation from 37% to 45%, cutting equity from 55% to 28% and simultaneously increasing its investment in alternative investments—including private equity, real estate, and hedge funds—from 2% to 14%.[145] According to the Casey Quirk consulting firm, roughly 10% of all large pension funds are invested in hedge funds, and that is expected to reach 18% in the next few years.[146] This could be a dangerous trend considering some pension funds have lost substantial amounts of retirees' money by investing in hedge funds, such as the San Diego County Retirement fund which lost $100 million after the hedge fund Amaranth Advisers collapsed in 2006.[147] The San Diego Employees' Retirement Association has alleged that the hedge fund repeatedly misled it about its strategies and activities in the marketplace.[148] This leads many to question whether pensions should invest in hedge funds at all, given that hedge funds' risks are hard to measure and the "sole purpose [of pensions funds], by law, is to pay out predetermined benefits to retired workers."[149]

Pension benefits are deemed so crucial that a federal agency, the Pension Benefit Guarantee Corporation (PBGC), covers corporate pension failures, and many fear that a taxpayer funded bailout would result in the PBGC's failure.[150] Pension failures by state and local governments are covered by taxpayers.[151] Further, because pension benefits are paid on a consistent schedule, it is questionable whether it is wise to depend on investments that yield returns which are difficult to predict, managed by private partnerships that offer little disclosure about their undertaking, and charge some of the most outrageous fees on Wall Street.[152] Pension

142. Atlas & Walsh, *supra* note 16. For more data on hedge funds, see Hedge Fund Research, Inc., http://www.hedgefundresearch.com (last visited Nov. 5, 2008).

143. KLUNK, *supra* note 17.

144. *Id.*

145. Whitney Kvasager, *Boeing Cuts Equity, Raises Bonds, Alts*, FUNDFIRE, Apr. 26, 2007, http://www.fundfire.com/articles/20070426/boeing_cuts_equity_raises_bonds_alts.

146. Peterson, *supra* note 17, at C8.

147. *Id.*; *see also* Strasburg, *supra* note 18.

148. Peterson, *supra* note 17, at C8.

149. Atlas & Walsh, *supra* note 16; *see also* MANGIERO, *supra* note 16.

150. Atlas & Walsh, *supra* note 16; *see also* KLUNK, *supra* note 17.

151. Atlas & Walsh, *supra* note 16.

152. *Id.*

fund managers are starting to become very aggressive in seeking high returns, hoping for no downturns.[153]

The nation's largest private pension fund, the General Motors fund, managing over $90 billion, was also one of the first to invest in hedge funds following a successful test run.[154] "Most pension funds have modest stakes of less than 5 percent, according to a recent J. P. Morgan survey."[155] "[T]he 100 largest companies that sponsor pension funds predicted last year that their average long-term returns would be 8.5 percent, according to Milliman, Inc., an actuarial firm."[156] Yet some pension fund managers do not engage in the sort of analysis that the Department of Labor expects of them regarding investing in derivatives.[157] In fact, some were not even aware that they had derivatives in their portfolios.[158]

Some, like former Treasury Assistant Secretary Emil Henry, believe that because corporate pension funds are inherently risk averse investors, they will be diligent in investigating various investments before committing their funds.[159] Secretary Henry has stated that the hedge fund industry will impose risk management upon itself to mitigate risk in order to attract pension fund capital.[160] Other experts view the use of derivatives-based strategies to be increasingly complex for pension fund managers to oversee.[161] Senators Max Baucus and Chuck Grassley are

153. *Id.*
154. *Id.*
155. *Id.*
156. *Id.* The article noted that regulators of pension funds, labor department officials, declined to comment on the hedge fund-pension fund phenomena, and referred to a 1996 letter the department wrote to the United States comptroller of the currency. *Id.* The letter stated that the Labor Department still expected pension officials to exercise care when investing in derivatives, a type of investment product hedge funds often trade. *Id.* The letter also reminded pension officials to understand their hedge fund investments, particularly how they would perform and how they may affect the pension fund, under various conditions. *Id.*
157. *Id.*
158. *Id.*; *see also* KLUNK, *supra* note 17; MANGIERO, *supra* note 16. The Pension Protection Act of 2006 (PPA) modified the rules under which hedge funds are deemed fiduciaries of pension funds. KLUNK, *supra* note 17. Under the PPA, limited partnerships and investment funds, including hedge funds, are not deemed fiduciaries under ERISA if less than twenty-five percent of the partnership or fund assets come from ERISA-covered plans. *Id.* This Comment, however, does not suggest making hedge funds ERISA fiduciaries because that would shift who is managing the pension assets to hedge funds, which would produce an even worse scenario. Rather, this Comment recommends amending ERISA to require pension funds to only invest in *registered* hedge funds.
159. KLUNK, *supra* note 17, at 5–6.
160. *Id.* at 6.
161. Report of CRMPG II, *supra* note 74, at D-1.

among many who have expressed concern that hedge funds may pose a threat to workers' retirement security.[162] It is prudent, therefore, to mandate that pension fund managers only invest in hedge funds that provide an appropriate amount of necessary disclosure.

Some believe that because hedge funds provide pension funds with "alpha,"[163] returns uncorrelated to market performance, they should therefore be unrestricted in their dealings with hedge funds, aside from the ordinary fiduciary duties they owe to the plan trustees.[164] This argument is flawed, however, because pension funds can still achieve this alpha in registered hedge funds; the difference is they will be generating it with more consistency and less risk.[165] Others argue that any hedge fund that accepts pension money should be regulated "because doing so exposes everyday Americans to outsized investments."[166] There is clearly a risk in leaving the pension fund-hedge fund relationship unregulated; however, because direct regulation of hedge funds is unlikely and infeasible, the regulatory focus should be aimed at market participants such as pension funds.[167]

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162. KLUNK, *supra* note 17, at 6.

163. Alpha is a coefficient which measures the piece of an investment's return that arises from specific (nonmarket) risk. DOWNES & GOODMAN, *supra* note 140, at 187. Explained otherwise, alpha is a mathematical evaluation of the expected return from an investment's basic values, such as the growth rate in earnings per share. *Id.* Alpha is distinct from the beta coefficient, which measures the amount of return caused by volatility. *Id.* To illustrate, "an alpha of 1.25 indicates that a stock is projected to rise 25% in price in a year when the return on the market and the stock's beta are both zero. An investment whose price is low relative to its alpha is undervalued and considered a good selection. In the case of a mutual fund, alpha measures the relationship between the fund's performance and its beta over a three-year period." *Id.*

164. Such fiduciary duties include the "Prudent Pension Rule," which requires pension fund fiduciaries to invest in accordance with "the prudential principles of security, profitability, and liquidity." INS. & PRIVATE PENSIONS COMM. & WORKING PARTY ON PRIVATE PENSIONS, ORG. FOR ECON. CO-OPERATION & DEV., OECD GUIDELINES ON PENSION FUND ASSET MANAGEMENT 2 (2006), *available at* http://www.oecd.org/dataoecd/59/53/36316399.pdf.

165. It is also worth noting that while hedge funds may be considered "alternative investments" for investors such as pension funds, some believe that one day they will become the standard. See BOOKSTABER, *supra* note 21, stating: "This simple point, that an unconstrained investment process will dominate a constrained one, means that in the end hedge funds, whether in their present or some reformulated structure, will move from being the alternative to the standard." *Id.* at 253. This reality only advances the argument that something needs to be done in order to initiate market discipline among hedge funds market participants before their popularity increases.

166. *Housing & Hedge Funds*, *supra* note 67.

167. Another explanation of the additional risk pension funds are beginning to carry due to investing assets in hedge funds has been given by the report of the Counterparty Risk Management Policy Group II, a group of senior officials from private financial institutions. The group notes that because the assets in a hedge fund arrangement are not held in trust and governed by a trust agreement, as in the traditional pension fund model, no protection exists for the pension fund. Report of CRMPG II, *supra* note 74, at D-3.

The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that provides protection to individuals in private pension plans.[168] ERISA currently has no controls in place to monitor the number of hedge funds which plan sponsors invest in or the amount invested.[169] Commentators argue that such information should be made available, and would allow policymakers to enumerate the share of pension assets that are being invested in hedge funds and differentiate between pension funds whose hedge fund investments are directed primarily in one or two funds as opposed to those that are more diversified and spread over a greater number of hedge funds.[170]

The increased risk that the allocation of assets into hedge funds brings about to pension funds illustrates the need for pension funds to gather more information about these investments before placing retirees' money in them. The Counterparty Risk Management Policy Group II (CRMPG II), a group of senior officials from private financial institutions, assessed the increased risk pension funds assume in hedge fund investments and suggested a solution that would only lead to more of the same—that pension fund fiduciaries should monitor their investments in hedge funds.[171] Such recommendations are inadequate, however, given the stakes and the lessons of the San Diego County Retirement fund.

Moreover, as pension funds increase their investment in hedge funds, which keep funds assets with one or more prime brokers, the pension fund assumes many additional risks, especially considering that hedge fund managers are often not plan fiduciaries. *Id.* at D-3, D-4.

168. U.S. Department of Labor, Health Plans & Benefits: Employee Retirement Income Security Act—ERISA, http://www.dol.gov/dol/topic/health-plans/erisa.htm (last visited Nov. 5, 2008). ERISA calls for plans to (1) make available to participants information, including critical information regarding plan features and funding; (2) set forth fiduciary responsibilities for those who manage and control plan assets; (3) set up a grievance and appeals process for participants to obtain benefits from their plans; and, (4) provide participants with the right to sue for benefits and breaches of fiduciary duty. *Id.*

169. *See* Employee Retirement Income Security Act, 29 U.S.C. §§ 1001–1461 (2006).

170. KLUNK, *supra* note 17, at 6.

171. Report of CRMPG II, *supra* note 74, at D-4. The group recommended that fiduciaries "continue to conduct and, as applicable, enhance their due diligence and monitoring practices regarding their investments and investment managers." *Id.* The group said that fiduciaries should be able to: "(a) monitor indirect investments, including derivative positions and/or risk characteristics, on a timely basis to ensure their investment managers are not taking risks beyond represented levels in terms of allowable investment exposures, leverage, etc.; (b) aggregate risk across their entire pool of assets in order to understand portfolio level implications; and (c) determine whether their investment managers are adhering to a stated investment strategy or style." *Id.* Further, the group called for fiduciaries and investment managers to work together, and with

There are several ways to regulate pension funds' ability to invest in hedge funds.[172] Rather than recommending what pension fund managers should expect to receive from hedge funds, it is more prudent to *require* that pension funds receive such disclosures by the hedge fund through this Comment's proposed amendment to ERISA. It does not appear that such a requirement will be a crippling burden for either party to comply with.[173]

2. State and Local Government Pension Funds

A regulatory consideration that arises in the context of state and local government pension funds is that they are exempt from ERISA—ERISA only applies to private sector and federal pension funds.[174] This means that each individual state regulates its respective state and local pension funds.

The average *public* pension fund has about eight percent of its assets in alternative investments.[175] Alternative investments can include anything from private equity to real estate, to commodities, to hedge funds.[176] Many public pension funds,[177] especially those that are underfunded,[178] are looking to diversify their portfolios and generate higher returns and so have been increasing the amount of assets they dedicate to alternative

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industry groups, to put together a consensus on commonly accepted methods of "supplying risk characteristics on a bilateral basis" to provide ample information to generate an "independent analysis of credit and market risk being undertaken by institutional investors, as required by ERISA." *Id.* Such efforts should result in the enabling of "fiduciary investors to measure and monitor aggregate risk exposures in a manner that is consistent with their responsibilities as fiduciaries." *Id.*

172. Stewart, *supra* note 11, at 10–11. Some ways include: "limiting investments in unregulated investment instruments; limiting investment in geared instruments; limiting investment to 'fund of funds'; monitoring investment via governance requirements." *Id.* at 8.

173. *See infra* note 234 and accompanying text.

174. *See* 29 U.S.C. §§ 1001–1003.

175. Adrienne Carter, *Hopped up on Hedge Funds*, BUS. WK., Sept. 25, 2006, at 46.

176. Daniel Judge, *Quant Managers Steal a Lead Says Morgan Study*, INVESTMENT ADVISER, Apr. 11, 2005, *available at* http://www.ftadviser.com/InvestmentAdviser/Archive/News/article/20050411/e6efc626-ea50-11dc-abcd-0015171400aa/Quant-Managers-steal-a-lead-says-Morgan-study.jsp. The article notes that alternative investments include "hedge funds, property funds, private equity, structured products and portable alpha structures." *Id.*; *see also Pension Funds Down on Alternative Investments*, NIKKEI WKLY. (Tokyo), Nov. 5, 2007, at 24 ("Investments in hedge funds, real estate investment trusts and other unconventional financial instruments are frequently being employed in pension fund management, with a Nikkei Inc. survey of major corporate pension funds finding that 75% of respondents include such alternative investments in their portfolios.").

177. Public pension funds consist of state and local pension funds.

178. An underfunded pension fund is one whose assets are insufficient to meet its obligations to retirees.

investments.[179] However, some pension funds that recently decided to increase their exposure to alternative investments will not be able to invest in the highest performing funds because the highest performing funds are too difficult to access.[180] Therefore, they will only have access to hedge funds that produce lower returns.

Some state pension funds are very large players. The California Public Employees' Retirement System (CalPERS), for example, is the largest public pension fund in the United States, managing roughly $253 billion in assets as of December 31, 2007, for over 1.5 million California public employees, retirees, and their families.[181] Because the recommended amendment to ERISA, prohibiting pension funds from investing in unregistered hedge funds, would not apply to state and local pensions, each state would control whether its state and local governmental entities would adopt such a rule. There have been many attempts and calls to federally regulate state and local pension plans under a public sector equivalent to ERISA, and if any such legislation is introduced in the future, then this Comment's recommendation to bar pension fund investment in unregistered hedge funds should also be a part of that piece of potential future legislation.[182] An alternative approach would be to promulgate a uniform act which would model the proposed ERISA amendment recommended by this Comment, and encourage each state to adopt it individually into their existing regulatory scheme.[183]

3. Another Possible Pension Fund Approach

Recognizing that there may be some resistance, even from plan trustees, to amending ERISA and various equivalent state regulations to impose an outright ban on investment in unregistered hedge funds, an

179. Carter, *supra* note 175.
180. *Id.*
181. *See* Steve Lohr, *Venture Fund to Seek Out Cost Cutters in Health Care*, N.Y. TIMES, June 5, 2007, at C3 (noting that CalPERS is the largest public pension fund in the U.S.); *see also* CalPERS, Facts at a Glance, http://www.calpers.ca.gov/index.jsp?bc=/about/facts/home.xml (last visited Nov. 5, 2008).
182. For further reading on one such call for federal regulation of state pension funds, see Jon G. Miller, *Is Your Client's Government Pension Safe?: Making the Case for Federal Regulation*, 2 ELDER L.J. 121 (1994).
183. The question also arises of who would enforce the rule and what remedies would exist for a violation of the rule. Because the amendment to ERISA would be statutory, there is the possibility that individual participants could file civil suits to enforce the rule.

alternative approach is to limit, temporarily or permanently, the percentage of plan assets that can be invested in unregistered hedge funds to some value less than five percent.

As noted, pension funds indirectly expose retail investors to complex instruments and strategies. Federal Reserve Chairman, Ben Bernanke, in a May 2007 speech, reiterated that the fiduciary duties that are already imposed on pension fund managers should be sufficient in protecting the pension fund participants.[184] However, it seems clear that relying on these fiduciary duties alone is not enough. If mere reliance on fiduciary duties was sufficient, one could not explain devastating incidents such as the hit taken by the San Diego County Retirement fund by the collapse of Amaranth.[185]

Other experts have recognized that it is not wise to rely on the fiduciary duties of pension fund trustees, simply because they likely do not understand the complexities of these investments. Given the potentially high risk nature of their investments, hedge funds were originally intended for high-net worth individuals.[186] Therefore, it is debatable whether individuals who cannot invest their discretionary savings in hedge funds should be exposed to them through what may be their subsistence low-risk pension savings.[187] This phenomena is justified because pensions are managed by knowledgeable investors, however, it is unclear whether pension fund trustees even comprehend these complex products.[188] Even if they do, because hedge funds are not offered directly to the public and are exempt from many disclosure requirements, they operate opaquely and by their nature are riskier for investors.[189]

Therefore, although this alternative approach of limiting pension fund investment in unregistered hedge funds is an option, it is clearly not the preferential option. As described above, this approach still places retirees' money at risk by allowing a pension fund manager to invest a significant percentage of assets without any requisite disclosure by the hedge fund.

184. *See* Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Federal Reserve Bank of Atlanta's 2007 Financial Markets Conference, Sea Island, Georgia (via satellite): Regulation and Financial Innovation (May 15, 2007), http://www.federaleserve.gov/newsevents/speech/bernanke20070515a.htm (noting the importance of supervising fiduciaries).

185. *See supra* notes 147–48 and accompanying text.

186. Stewart, *supra* note 11, at 6.

187. *Id.*

188. *Id.*

189. *Id.*

B. Hedge Fund Creditors

A critical component of this Comment's proposal to indirectly regulate hedge funds involves focusing on hedge fund creditors—the entities that enable hedge funds to maintain their notorious levels of leverage. This Comment recommends mandating that hedge funds' creditors only lend to hedge funds that disclose certain material information as specified below. Although the pension fund-hedge fund relationship is relatively straightforward to explain, the hedge fund-creditor relationship is intentionally made far more complex. The discussion of how hedge funds are able to become so highly leveraged necessarily involves detailing some peculiarities within the investment banking business.

1. Demystifying Hedge Fund Leverage

As noted, other major players in the hedge fund mix are Wall Street trading firms and investment banks. These entities provide hedge funds with the leverage that makes them so risky.[190] Regulating hedge fund lenders, however, is no easy task. Hedge funds typically use prime brokerage accounts to achieve their leverage. Firms that offer prime brokerage provide various services including financing, customer support, and research.[191] The recent growth of the hedge fund industry has made prime brokerage a substantial source of revenues for banks and other providers.[192]

Because prime brokers are typically large Wall Street trading firms like Morgan Stanley or Goldman Sachs, one would suspect that the SEC margin requirements of Regulation T would apply and therefore limit the amount of leverage hedge funds can undertake. SEC Regulation T was enacted pursuant to section 7 of the Securities Exchange Act of 1934.[193] It imposes a fifty percent margin requirement[194] on investors in single securities in the cash markets and a significantly lower margin requirement

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190. See *supra* Part I.C.1 for a discussion of the leverage and thus risk undertaken by LTCM.

191. Nicola Cetorelli et al., *Trends in Financial Market Concentration and Their Implications for Market Stability*, FED. RES. BANK OF N.Y. ECON. POL'Y REV., Mar. 1, 2007, at 40–41, *available at* http://www.newyorkfed.org/research/epr/07v13n1/0703hirt.pdf.

192. *Id.* at 41.

193. Federal Reserve Reg. T., 12 C.F.R. § 220 (2008).

194. *Id.* § 220.12. A margin requirement is simply an amount that an investor must deposit in a margin account prior to buying on margin or selling short. *See id.* § 220.4(b).

for futures transactions.[195] However, broker-dealers typically arrange financing for hedge funds through foreign affiliates, which are not SEC registered and are therefore not subject to SEC jurisdiction.[196] By using these foreign banking subsidiaries, hedge funds can borrow without any limits and accumulate enormous amounts of leverage.[197]

The competition for hedge fund business is a significant factor in the loosening of credit standards and the ultimate breakdown of market discipline. CRMPG II has noted:

> The competitive pressure to secure relationships with hedge funds, including newly established funds, may lead, if not prudently managed, to an erosion of the credit standards and protections applied to this new business. It is essential that institutions on both sides of these arrangements fully understand and consider

195. *See id.* § 220.12; *see also* Frank Partnoy, *Some Policy Implications of Single-Stock Futures*, FUTURES & DERIVATIVES L. REP., Mar. 2001, at 8 (noting that futures transactions normally mandate margin of only a few percent). In addition, the Commodities Futures Modernization Act (CFMA) amends section 7 of the Securities Exchange Act of 1934 to provide that the Board of Governors of the Federal Reserve System shall set forth the margin requirement appropriate to the trading of single-stock futures. *Id.* Nevertheless, the CFMA also states that the Federal Reserve may delegate its authority to the Securities Exchange Commission and Commodity Futures Trading Commission, who then would jointly set forth the pertinent margin requirements. *Id.*

196. Roel C. Campos, SEC Comm'r, Remarks Before the SIA Hedge Funds & Alternative Investments Conference, New York, New York (June 14, 2006) [hereinafter Campos June 2006 Speech], *available at* http://www.sec.gov/news/speech/2006/spch061406rcc.htm. Campos stated that "the Commission's consolidated supervision program for certain investment banks now allows the staff to examine not only the broker-dealer entities within a group, but also the unregulated affiliates and holding company where certain financing transactions with hedge funds are generally booked." *Id.* The "consolidated supervision program" referred to is part of a 2004 rule the SEC instituted which created a voluntary program to supervise U.S. firms with international, unregulated affiliates, on a consolidated basis. *See* Alternative Net Capital Requirements for Broker-Dealers that Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428, 34,428 (June 8, 2004) (to be codified at 17 C.F.R. pts. 200, 240), *available at* http://www.sec.gov/rules/final/34-49830.htm. The firms are referred to as "Consolidated Supervised Entities" (CSEs). *Id.* Five of the major U.S. securities firms are currently CSEs. *Id.* at 34,452; *see also A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate: Hearing Before the Subcomm. on Financial Institutions and Consumer Credits of the H. Comm. on Financial Servs.*, 109th Cong. 114 (2006) (testimony of Robert L.D. Colby, Acting Director, United States Securities and Exchange Commission Division of Market Regulation), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_house_hearings&docid=f:31549.pdf. Also see the GAO's January 2008 Report on hedge funds, which states, "[I]n 2004 [the] SEC established a program to oversee the large internationally active securities firms on a consolidated basis. These securities firms have significant interaction with hedge funds through affiliates previously not overseen by SEC." GAO Report, *supra* note 2, at 5.

197. Campos June 2006 Speech, *supra* note 196. Hedge funds' "financing transactions" are generally booked through foreign, unregulated affiliates. *Id.* This explains how less restrictive margin requirements may apply and explains how hedge funds are able to accumulate so much leverage.

> the terms that govern such credit relationships from a credit, risk and funding/ treasury perspective.[198]

Federal Reserve Chairman Bernanke has also expressed concern about hedge fund counterparty risk management due to the increasing complexity of financial products.[199] First, Bernanke noted that because hedge funds are such profitable customers for dealers, the competition for hedge fund business has eroded initial margin levels.[200] Second, he noted that because the volume of complex transactions is so high, it is questionable whether counterparty exposures are being accurately measured.[201] Third, he stated his concern that not enough stress-testing and aggregate stress-testing is being done.[202] Finally, Bernanke expressed concern that "the assessment of counterparty risks should be better tied to the amount of transparency offered by hedge funds."[203] He argued that good risk management should bring about hedge funds' "willingness to provide information on its strategies and risk profile."[204] To ensure that credit standards are not eroded, it is imperative that these entities improve their risk management. Directly regulating them to do so will ensure that such measures are consistently taken.

a. Prime Brokerage

The task of indirectly regulating hedge funds through directly regulating their creditors is further complicated by the business of prime brokerage. Hedge funds typically execute trades with multiple dealers, but then consolidate the clearing and settlement of their trades at one firm, known as the "prime broker."[205] Along with settlement services,

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198. Report of CRMPG II, *supra* note 74, at 63.
199. Bernanke May 2006 Speech, *supra* note 10.
200. *Id.*
201. *Id.*
202. *Id.* Stress testing is a generic term which encompasses several techniques used to assess resilience to extreme events. Stress tests are commonly used to measure the stability of a particular system or entity. Stress tests involve trial above standard operational capacity, typically to a breaking point, in order to notice the results. Stress testing is typically referenced with respect to asset portfolios, however, it has recently been applied to entire banks, banking systems, and financial systems. Martin Čihák, *Introduction to Applied Stress Testing* 4–5 (Int'l Monetary Fund, Working Paper No. WP/07/59, 2007), *available at* http://www.imf.org/external/pubs/ft/wp/2007/wp0759.pdf.
202. Bernanke May 2006 Speech, *supra* note 10.
203. *Id.*
204. *Id.*
205. *Id.*

the prime broker also provides financing and back office accounting services to the hedge fund.[206] The number of firms offering prime brokerage services has increased, and so too has the scope of the services they provide, including foreign exchange and over-the-counter (OTC) derivative trades.[207] Experts acknowledge that prime brokers are not necessarily aware of all of a hedge fund's activity.[208] Federal Reserve Chairman Ben Bernanke highlighted some of the unique challenges prime brokers are beginning to pose to the hedge fund mix. Prime brokers must ensure that they have sufficient information and controls to protect against counterparty credit risk, must implement controls to monitor and track executed transactions to ensure that they meet specified transaction terms, and must ensure that firms are fully aware of—and manage—associated risks.[209]

In July 2005, the CRMPG II also noted in a detailed report some of the problems associated with the prime brokerage business. As they did with pension funds, CRMPG II noted problems and provided suggestions to improve risk management practices, but did not recommend that mandatory best risk management practices be imposed by regulation, as this Comment does.[210]

The CRMPG II called for additional due diligence by market participants to "ensure that their counterparties are not mismanaging the incremental liquidity provided in these arrangements."[211] Despite liberalization of

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206. *Id.*
207. *Id.*
208. Donaldson Testimony, *supra* note 105, at 66.
209. Bernanke May 2006 Speech, *supra* note 10.
210. Report of CRMPG II, *supra* note 74, at 67. The CRMPG II Report made several suggestions. CRMPG II noted that if properly executed, prime brokerage activities have the potential of reducing overall systemic risk. *Id.* However, they are also subject to numerous legal, operational, credit, as well as other risk challenges. *Id.* In order to mitigate those challenges, CRMPG II recommended "that significant industry participants intensify industry-sponsored efforts to define the important relationships among hedge funds and other customers, executing dealers and prime brokers across all product areas and business lines." *Id.* CRMPG II also suggested that all participants in the prime brokerage market maintain a comprehensive understanding of the various risk challenges incurred in the market, as well as their internal controls, and their various contractual relationships. *Id.* CRMPG II suggested prime brokers "ascribe a high priority to actively monitoring the credit quality of each of their counterparties, including conducting regular due diligence calls and/or meetings." *Id.* CRMPG II encouraged developing cross-product prime brokerage and netting agreements that would fully address credit, commercial, and risk issues that would "serve to harmonize disparate credit and other material credit terms." *Id.* As derivative prime brokerage products continue to develop, CRMPG II recommended that market participants continue to collaborate with industry groups to develop standardized terms and agreements. *Id.* Because of the size of prime brokerage trading volume, CRMPG II also suggested further automation of systems and processes. *Id.*
211. *Id.* at 54.

initial margin levels and the increasing complexity of margining methodologies, CRMPG II believed that financial risk among leveraged counterparties was not excessive in 2005.[212] Moreover, it claimed that even leverage among hedge funds appeared modest.[213] But it did temper its conclusion by acknowledging that "the lack of transparency inherent in more sophisticated products makes a definitive conclusion problematic."[214] Additionally, it realized that collateral standards based on inadequate information or improper risk evaluations clearly set forth the potential for leverage to rise to levels that may increase systemic risk."[215] And as this Comment has demonstrated above, much has changed since the burgeoning economy of 2005, and the potential risks identified by the CRMPG II have now begun to be realized.[216]

William H. Donaldson, Chairman of the SEC, testified before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises and noted that firms that provide prime brokerage services to hedge funds claim to protect themselves through a comprehensive screening process, which involves a review of the hedge funds' business model consistency, credit quality, leverage, as well as other areas of risk management.[217] However, Donaldson was straightforward in acknowledging that "a prime broker is not necessarily aware of all of a hedge fund's activity."[218] Statements such as these suggest that standards are too lax. Free market restraints failed in 1999 with LTCM, failed again in 2007 with the subprime debacle, and could fail in the future unless more aggressive steps are taken. A prime broker should be aware of all of a hedge fund's activities. Directly regulating these counterparties to ensure that best risk management practices are conducted will provide the market discipline that is currently lacking.

In order to completely understand how hedge funds maintain such high levels of leverage, it is necessary to also understand "joint back office" arrangements.

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212. *Id.*
213. *Id.*
214. *Id.*
215. *Id.*
216. See *supra* Part I.C.2 for a discussion of the recent economic deterioration and the role hedge funds have played.
217. Donaldson Testimony, *supra* note 105, at 66.
218. *Id.*

b. Joint Back Office Arrangements

While some hedge funds register with the SEC as broker-dealers to obtain margin benefits available to broker-dealers,[219] others use the joint back office arrangement.[220] A "joint back office" (JBO) is a clearing operation that a hedge fund jointly owns with a prime broker for the purpose of exceeding the Federal Reserve's limits on margin borrowing.[221] Understanding at least the fundamentals of the JBO arrangement is necessary in order to determine how hedge fund creditors can be regulated, both effectively and practically. A JBO avoids the Federal Reserve's Regulation T limits on margin borrowing because, through its ownership of part of the clearing operation, a fund can "effectively render all transactions with its prime broker as internal transfers—giving the prime broker the ability to reduce margin loan requirements substantially, under section 220.7(c) of Regulation T."[222] While "most U.S. investors can leverage only half of their investments pursuant to Regulation T," hedge funds on the other hand, by establishing a JBO, can borrow "an amount equal to many times its equity capital."[223]

The creation of JBO arrangements is authorized by section 220.7(c) of Regulation T. A JBO permits "a creditor [to] effect or finance transactions of any of its owners if the creditor is a clearing and servicing broker or dealer owned jointly or individually by other creditors."[224]

Arthur Levitt, then Chairman of the SEC, remarked on JBOs in a speech in 1999:

> [W]hen day-trading firms are organized as LLCs and individual day traders contribute to the firm's capital, the day traders are permitted to trade using the firm's capital. These LLC firms typically participate in [JBO] arrangements, which allow them to enhance their borrowing power. JBO arrangements have become popular because they allow day-trading firms to receive preferential margin treatment from their clearing firms. Specifically, a day-trading firm that

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219. CHI. BD. OPTIONS EXCH., CBOE INVESTOR SERIES—PAPER NO. 5, HEDGE FUNDS & LISTED OPTIONS: PORTFOLIO MANAGEMENT STRATEGIES 7 n.20 (2001), *available at* http://www.cboe.com/Institutional/pdf/hedgefundwhitepaper_11-2001.pdf; *see also* Federal Reserve Board's Regulation T margin rules at 12 C.F.R. §§ 220.7, 220.12 (2008) (setting forth margin requirements and benefits).

220. For a detailed summary of the JBO general rules, see Trader Status.com, F.A.Q. 6.21, http://www.traderstatus.com/faq.htm (last visited Nov. 5, 2008).

221. Hedge Fund Alert, Glossary: Joint Back Office, http://www.hfalert.com/NewPages/Index.cfm?Article_ID=61250 (last visited Nov. 5, 2008).

222. *Id.*

223. *Id.*

224. *Day Trading: An Overview: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Governmental Affairs*, 106th Cong. 67 (1999) [hereinafter Testimony of Levitt] (testimony of Arthur Levitt, Chairman, United States Securities and Exchange Commission), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_senate_hearings&docid=f:61159.pdf; *see also* 12 C.F.R. § 220.7(c) (2008).

> participates in a JBO arrangement can receive credit from its JBO clearing firm on "good faith" terms. As a result, the customer margin requirements found in Regulation T and SRO rules do not limit the extension of credit to a JBO participant. Rather, credit can be extended for up to 100 percent of the purchase price of the securities. . . . Because of the borrowing power permitted by JBO arrangements, the leverage of day-trading firms organized as LLCs is limited only by the net capital rule. This essentially allows firms to leverage their position 6 to 1, rather than the 2 to 1 leverage allowed day traders under SROs' rules.[225]

A commonly recognized trade-off for the leverage JBOs provide hedge funds is oversight because the hedge funds are able to take on substantial credit risk.[226]

The President's Working Group (PWG), a group consisting of the Secretary of the Treasury as well as the Chairmen of the Federal Reserve, the SEC, and the Commodity Futures Trading Commission, which was established primarily to recommend solutions to enhance the integrity of financial markets,[227] has recognized some of the concerns raised by hedge funds, and has called for better "counterparty risk management."[228] However, its recommendations fall short of what is needed to ensure risk management is in place. Banks and other counterparties that are eager for hedge fund business have an incentive to lower their standards. They have failed and may continue to fail to request the necessary disclosures and due diligence materials. Recommending best practices is not enough—what is needed is mandatory counterparty risk management, to ensure all the information is available prior to a given transaction.

225. Testimony of Levitt, *supra* note 224, at 67.
226. Garry Weiss, *A Street Scandal That May Not Die*, BUS. WK., Aug. 9, 1999, at 77.
227. Exec. Order No. 12,631, 3 C.F.R. 559–60 (1989).
228. *See* Agreement, *supra* note 128, at 3–4.

2. An International Solution

As the above discussion demonstrates, regulating hedge fund creditors is far more complex than regulating hedge fund investors. United States corporate pension funds are inescapably regulated by ERISA. In contrast, Wall Street trading firms and investment banks carefully structure their hedge fund financing transactions to evade SEC jurisdiction. Through the use of foreign affiliates, they are able to arrange financing for hedge funds without being subject to the margin requirements of Regulation T. Therefore, international standards are needed in order to uniformly reach hedge fund creditors.[229]

It has been noted that policymakers must embrace global regulation of hedge funds similar to the increasingly global regulation of banking.[230] One such forum to undertake this task could be the Bank for International Settlements (BIS). BIS is "an international organization which fosters international monetary and financial cooperation and serves as a bank for central banks."[231] BIS acts as "a forum to promote discussion and policy analysis among central banks and within the international financial community," as well as an institute of "economic and monetary research," a "prime counterparty for central banks in their financial

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229. It should be noted that the GAO January 2008 Report on hedge funds mentioned a 2006 effort to assess risk management policies with hedge funds through prime brokers, on an international level. The Report stated:

> In late 2006, FRBNY, SEC, OCC, FSA, and bank regulators of Germany and Switzerland—collectively, the "multilateral effort"—jointly conducted a review of the largest commercial and investment banks that transacted business with hedge funds as counterparties and creditors. The agencies met with nine major U.S. and European bank and securities firms to discuss risk management policies and procedures related to interactions with hedge funds through prime brokerage, direct lending, and over-the-counter derivative transactions. According to one U.S. regulator, the reviewers found that the current and potential credit exposures of these banks to hedge funds were small relative to the banks' capital because of their extensive use of collateral agreements. However, the reviewers identified a number of issues related to the management of exposures to hedge funds and the measurement of potential exposures in adverse market conditions. The regulators participating in this effort have been addressing these issues by gathering additional data or information to help regulators learn more about the condition and quality of the firms' risk management practices. The regulators are conducting an ongoing follow-up review, which entails more detailed work by the principal regulator of each firm.

GAO Report, *supra* note 2, at 36–37. Although this is a good sign, it is not enough. More aggressive steps should be instituted to establish international standards for banks' dealings with hedge funds, such as those proposed in this Comment.

230. *Housing & Hedge Funds*, *supra* note 67.

231. Bank for International Settlements, About BIS, http://www.bis.org/about/faq.htm (last visited Nov. 5, 2008).

transactions," and an agent or trustee with respect to international financial operations.[232]

In its capacity as a forum to promote discussion and policy among central banks, this Comment recommends that BIS meet with all fifty-five of the member central banks to establish uniform international standards for banks worldwide in extending credit to hedge funds.[233] At a minimum, the member banks should mandate that all entities that engage in hedge fund financing should only engage in such financing if the hedge funds provide them with audited financials, follow SEC or other accepted rules in calculating the value of their assets, and disclose their trading strategies in confidence.[234]

C. Hedge Fund Registration with the SEC

In the context of requiring pension funds or creditor counterparties to only deal with registered hedge funds, it is important to examine how hedge funds would register with the SEC and what disclosures such registration would entail. As a result of the Supreme Court decision in *Goldstein v. SEC*, it is implausible to have hedge funds register as investment advisers.[235] Further, because hedge funds are very different from investment companies such as mutual funds, having them register as investment companies would also be implausible.

Therefore, because the current securities laws afford no practical way of reaching hedge funds, Congress would have to enact new legislation. This legislation should provide that hedge funds should register with the

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232. *Id.*

233. Members are the central banks or monetary authorities of: Algeria, Argentina, Australia, Austria, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, the Republic of Macedonia, Malaysia, Mexico, the Netherlands, New Zealand, Norway, the Philippines, Poland, Portugal, Romania, Russia, Saudi Arabia, Singapore, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, the United Kingdom, and the United States, plus the European Central Bank. Bank for International Settlements, Organisation and Governance, http://www.bis.org/about/faq.htm (last visited Nov. 5, 2008).

234. If this approach through the BIS is unsuccessful or infeasible, another way to internationally regulate hedge fund creditors would be through the President's Working Group on Financial Markets (PWG). PWG could establish a joint regulatory task force, with an investor component, charged with garnering international cooperation in mandating uniform standards in extending credit to hedge funds.

235. See *supra* Part I.B.2.a for an overview of the *Goldstein* case, which held the SEC's rule to be an instance of arbitrary rulemaking.

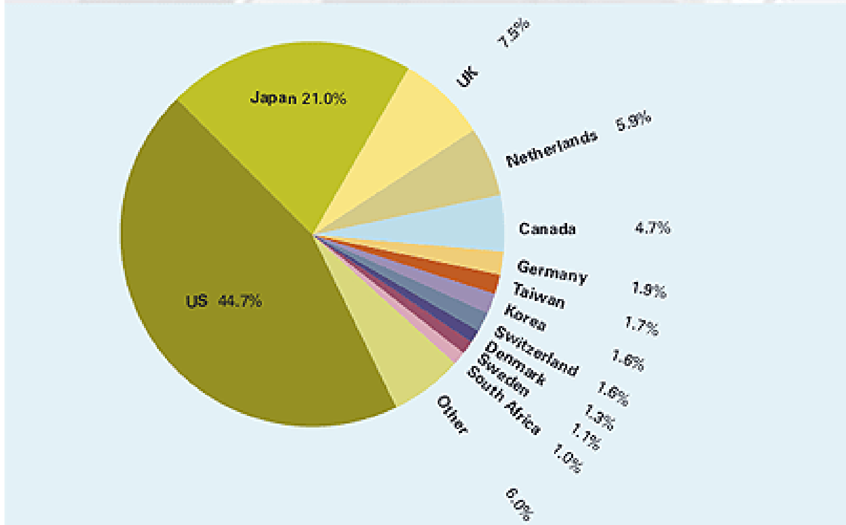
SEC as *hedge funds*, and the legislation should incorporate the commonly accepted definitions and standards for designating a fund as a hedge fund. While this registration would be voluntary as opposed to mandatory, pressure from pension funds and creditors would provide an indirect incentive for hedge funds to register and disclose audited financials, follow SEC rules in calculating the value of their assets, and disclose their trading strategies in confidence. Further, this legislation should not focus on prescribing rules of conduct or attempts to regulate strategies or leverage. It should simply provide an avenue for disclosure—to ensure that market participants are fully informed so that they can exercise prudent levels of risk management. The CRMPG II noted in 2005 that "[h]edge funds' ability to generate credit-relevant information (e.g., VaR and stress-tested exposures) has generally improved."[236] Therefore, providing such information should not be an overwhelming burden.

D. Would This Proposal Drive Hedge Funds Out of the Country?

If U.S. corporate pension funds are prohibited by ERISA from investing in hedge funds that are not registered with the SEC, and so disclose minimal information to improve pension fund due diligence efforts and minimize systemic risk, the question arises whether this will be a sufficient disincentive to drive hedge funds out of the country. It is unlikely that hedge funds would be driven abroad by such indirect regulation given the reality that most pension money is located in the United States.[237] In fact, it is plausible that other countries will follow the United States' lead and improve their counterparty risk management as well. Further, to the extent that hedge funds do seek capital abroad from less conservative investors, the U.S. economy will be in a better position. The global economy cannot afford another market crisis such as LTCM or the subprime mortgage collapse. It has become clear that the only way to prevent such a crisis is to improve market discipline and raise the standards of risk management.

236. Report of CRMPG II, *supra* note 74, at 45.
237. *See* Figure 1, *infra* p. 1035.

Figure 1: The 300 largest pension funds by country of origin



Source: Pensions & Investments/Watson Wyatt Global 300 survey

IV. CONCLUSION

As Federal Reserve Chairman Ben Bernanke recognized, systemic risk can never be entirely eliminated.[238] Attempting to do so would "likely stifle innovation without achieving the intended goal."[239] He stated that "authorities should (and will) try to ensure that the lapses in risk management of 1998 do not happen again."[240] Bernanke also noted:

> Authorities' primary task is to guard against a return of the weak market discipline that left major market participants overly vulnerable to market shocks. Continued focus on counterparty risk management is likely the best course for addressing systemic concerns related to hedge funds. This public policy approach does not entail the moral hazard concerns created by authorities' monitoring of positions using a private database. Rather, a focus on counterparty risk management

238. Bernanke May 2006 Speech, *supra* note 10.
239. *Id.*
240. *Id.*

> places the responsibility for monitoring risk squarely on the private market participants with the best incentives and capacity to do so.[241]

Direct regulation is unlikely and infeasible; it has been attempted and failed, and it runs the risk of moving hedge funds outside of the United States' regulatory jurisdiction. Groups such as the PWG recommend focusing on indirect regulation in order to preserve some of the benefits hedge funds provide. Placing the regulatory focus on market participants will limit systemic risk because best risk management practices will now be mandatory. This will minimize agency costs and ensure that adequate market discipline exists.

It is still unclear how much money major pension funds have lost due to their exposure to hedge funds. Several hedge funds have started to collapse because of their bets on CDOs, and it is likely that only the tip of the iceberg has been exposed. Indirect hedge fund regulation should be implemented soon so that losses are minimized, and so that those losses are absorbed by the appropriate parties—those who are fully informed, understand the risk of their investment, and based on that understanding, are able to withstand any potential losses.

241. *Id.*