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ABSTRACT

Hedge funds are complex financial products which have grown exponentially during the past decade. While hedge funds provide benefits to the world's capital markets, they also pose challenges. The potential risk to the stability of the world's financial system combined with an increase in hedge fund fraud led the Securities and Exchange Commission (SEC) to attempt to regulate hedge fund advisers. After the court rejected the SEC's expansion of its regulation, the SEC adopted regulations that insufficiently address the problems posed by hedge funds. This article proposes more effective solutions involving a coordinated international approach to hedge fund regulation. The hedge fund regulations proposed in this article aim to achieve a reliably stable financial system, financial market integrity through greater transparency, and protection for all investors from fraud.

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I. Introduction

Hedge funds conjure up vivid images of easy money, enormous profits, risk to the world's financial stability, notorious secrecy, and exotic offshore locations.[1] Some people believe that given the lack of meaningful governmental regulation existing over hedge funds, these funds represent the unknown: the "'wild, wild west'" of the financial world,[2] the "black hole of the

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1 *See* Sir John Gieve, Deputy Governor, Bank of England, Speech at the HEDGE 2006 Conference: Hedge Funds and Financial Stability (Oct. 17, 2006).

2 Shaheen Pasha, *FBI Sees More Indictments from Backdating*, CNN MONEY.COM,

international financial system,"[3] or a "dark, shadowy world with no legitimacy."[4]

In their diversity, hedge funds defy definition and are often classified by their characteristics. They are closed-end, private investment vehicles with "accredited investors," they engage in active trading, and they charge performance-based fees.[5] Hedge funds are known for using leverage,[6] short-selling,[7] and other sophisticated techniques to maximize financial returns.

Hedge funds are distinguishable from other investment

Oct. 12, 2006, http://money.cnn.com/2006/10/12/news/companies/whitecollar_crime/index.htm (citing a statement by Chip Burrus, an Assistant Director of the FBI); *see also* David Goldstein, *Better the way it was*, 25 INT'L FIN. L. REV. 53, 53 (2006) (citing a characterization of hedge funds by U.S. Sen. Orrin Hatch).

3 *Hedge-Funds Crisis Breaks Into the Open*, EXEC. INTELLIGENCE REV., June 17, 2005, at 14 (citing the statement of Jochen Sanio, President of the German financial supervision agency BaFin). "In Europe and Japan, political leaders denounce hedge funds as locusts, parasites and predators . . . . Critics label [hedge funds as] fair-weather friends who dominate trading in good times but, when difficulties arise, liquidate in haste, accelerate the fall, and multiply the damage." Adam Lerrick, *Demystifying Hedge Funds*, AEI POLICY SERIES, May 15, 2006, at 6, *available at* http://www.aei.org/docLib/20060512_LerrickNPNRFinal.pdf.

4 *See* Elliot Wilson, *Cultivating Chinese Hedges*, ASIAMONEY, Oct. 2006, at 24 (quoting a Hong Kong-based hedge fund manager's description of traditional Chinese attitudes).

5 *See* David A. Vaughan, Partner, Dechert LLP, Selected Definitions of "Hedge Funds," Comments for the SEC Roundtable on Hedge Funds (May 13, 2003), http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm (citing fourteen different definitions of hedge funds found in government and industry publications). The term "hedge fund" is not defined in securities laws. *Id.* Even the hedge fund industry has not agreed on a single definition of a hedge fund. *See* INT'L ORG. OF SEC. COMMISSIONS, TECHNICAL COMM., THE REGULATORY ENVIRONMENT FOR HEDGE FUNDS: A SURVEY AND COMPARISON (FINAL REPORT) 12 (2006) [hereinafter IOSCO], *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf.

6 "Leverage exists whenever an entity is exposed to changes in the value of an asset over time without having first disbursed cash equal to the value of that asset at the beginning of the period." COUNTERPARTY RISK MANAGEMENT POLICY GROUP, TOWARDS GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE app. a, at a-1 (2005), http://www.crmpolicygroup.org/docs/CRMPG-II.pdf (last visited Sept. 8, 2007) [hereinafter CRM POLICY GROUP II]. Leverage can exist through borrowing, shorting stocks or bonds, or using derivatives. PHILIPP VON COTTIER, HEDGE FUNDS AND MANAGED FUTURES 163 (Paul Haupt 1997).

7 "Shorting" is selling stock the seller does not own. In doing so, the seller is betting that the price of the stock will fall and the same seller can buy it back later at a lower price. *See* 17 C.F.R. § 242.200(a) (2007).

products.[8] They are unlike mutual funds because mutual funds are highly regulated investment vehicles. Mutual funds only invest in stocks and bonds, and provide liquidity for investors by permitting redemption on a daily basis.[9] The differences are especially noticeable in liquidity and leveraging practices, as well as in the fees charged to investors.[10] Hedge funds are also distinguishable from private equity funds. Hedge funds invest in a variety of assets[11] and may even make private equity investments, but they do not commit to invest in a business over its life.[12] Unlike mutual funds, hedge funds and private equity funds have escaped meaningful government regulation.

Little government regulation of hedge funds currently exists.[13] The lack of regulation has provided hedge funds with an advantage of lower costs compared to traditional investments,

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8 *See* ORG. FOR ECON. CO-OPERATION AND DEV., STEERING GROUP ON CORPORATE GOVERNANCE, THE IMPLICATIONS OF ALTERNATIVE INVESTMENT VEHICLES FOR CORPORATE GOVERNANCE: A SYNTHESIS OF RESEARCH ABOUT PRIVATE EQUITY FUNDS AND "ACTIVIST HEDGE FUNDS" 17-20 (2007), *available at* http://www.oecd.org/dataoecd/60/11/39007051.pdf. Venture capital investments represent longer time-frame investments than do hedge funds and offer business advice to the entrepreneurs. *See* Mark Heesen, *The Slippery Slope of Hedge Fund Regulation*, 44 VENTURE CAPITAL J. 71 (2004).

9 Also, a mutual fund often has an unlimited number of investors, is available to the general public, and usually has less leverage than a hedge fund. Alan L. Kenard, *The Hedge Fund Versus the Mutual Fund*, 57 TAX LAWYER 133, 133 (2003); *see also* Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 ANN. REV. BANKING & FIN. L. 235, 239 (2006).

10 *See* Inv. Co. Inst., The Differences Between Mutual Funds and Hedge Funds, http://www.ici.org/funds/abt/faqs_hedge.html (last updated Apr. 2007).

11 *See* SEC. & EXCH. COMM., DIV. OF INV. MGMT & OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 4 (2003) [hereinafter SEC STAFF, 2003 REP.], *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf. The SEC staff reviewed sixty-five hedge funds advisers who managed about 650 hedge funds with $160 billion in total assets. *Id.* at vii.

12 Phaedra Hise, *Your New Bankers: Hedge Funds*, FORTUNE SMALL BUS., Dec. 8, 2006. *See generally* Steven E. Hurdle, Jr., *A Blow to Public Investing: Reforming the System of Private Equity Fund Disclosures*, 53 UCLA L. REV. 239, 241–43 (2005).

13 Some argue that indirect regulation of hedge funds occurs because their prime broker is regulated. Imposing further disclosure obligations on the prime broker is an easy way to acquire information about hedge fund activities. *See* Anthony Hanlon, Proposals for Reform of Hedge Fund Regulation 108 (Apr. 24, 2002) (unpublished LL.M. written work requirement submission, Harvard Law School), *available at* www.law.harvard.edu/programs/pifs/pdfs/tony_hanlon.pdf.

such as stocks and bonds, and other "alternative investments."[14]

Hedge funds are often described in extremes.[15] Hedge funds are "the new barbarians, rattling the gates of entrenched corporate management."[16] They are "the lords of havoc" who are described as having potential responsibility for the next great crash.[17] More favorable references to hedge funds include describing them as "the financial system's benevolent fire fighters"[18] in creating a market for buying risky assets, such as stocks of "distressed companies."[19] The widespread disparity in opinion contributes to the lack of Congressional consensus for stronger government regulation.

Important advantages to the financial markets are provided by hedge funds. They make the financial markets more efficient by aligning prices across markets.[20] By actively participating in secondary markets and the market for derivatives, hedge funds

14 "Alternative investments," which are generally the investments not regulated by the SEC, include hedge funds, real estate, private equity, and venture capital. *See* Bryan M. Place, *Alternative Investments Offer New Options for Investors*, CENT. N.Y. BUS. J., Aug. 3, 2007, at 6.

15 *See, e.g.*, Laura Santini, *Would You Like Hedge Funds With That Deal?* WALL ST. J., Nov. 30, 2005, at C1 ("[Hedge funds are] the fast-food consumers of the financial world gorging on quick trades that can create market volatility."); Neil Weinberg & Bernard Condon, *The Sleaziest Show on Earth*, FORBES, May 24, 2004, at 110 (discussing the lack of regulation of the hedge fund industry).

16 *See* Alan Murray, *Hedge-Fund Lessons from the Icahn Affair*, WALL ST. J., Feb. 22, 2006, at A2.

17 *See* Janet Bush, *Sell-Out: Why Hedge Funds Will Destroy the World*, NEW STATESMAN, July 31, 2006, at 26. Hedge funds can represent a "tsunami of 'hot money' crashing in and rolling out as fast as it arrived." *Id.* at 28.

18 Sebastain Mallaby, *Hands Off Hedge Funds*, FOREIGN AFFAIRS, Jan.-Feb. 2007, at 91.

19 Distressed companies are those in need of legal action or business restructuring to revive their financial stability. Hedge funds that buy the stock of distressed companies "do their homework, spotting sources of cash and earnings that a troubled company can use." Karen Richardson, *Street Sleuth: New Way to Play Distressed Firms: Acquire the Stock*, WALL ST. J., May 1, 2006, at C1.

20 *Federal Reserve's Second Monetary Policy Report for 2004: Hearing on Oversight on the Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978 Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 35 (2004) (statement of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys.).

bring market liquidity to the capital markets.[21] They also play an important role in financial innovation and the reallocation of financial risk.[22] Because of the benefits provided by hedge funds, any regulations should not eliminate their ability to positively impact the financial markets.

Business is impacted by hedge funds in several ways.[23] As activist shareholders,[24] hedge funds have pressed for corporate reforms, such as removing under-performing chief executive officers[25] or forcing companies to streamline operations[26] and return the cash to shareholders as dividends.[27] Hedge funds have

21 SEC STAFF, 2003 REP., *supra* note 11, at 4.

22 *Id.*; *see also* Hee Chul Kang, *The Current State of Equity Investments by Foreign Funds in South Korea and Related Legal Issues*, 15 PAC. RIM L. & POL'Y J. 73 (2006).

23 *See generally* Andrew M. Kulpa, *The Wolf in Shareholder's Clothing: Hedge Fund Use of Cooperative Game Theory and Voting Structures to Exploit Corporate Control and Governance*, 6 U.C. DAVIS BUS. L.J. 78 (2005).

24 About one hundred activist hedge funds existed in 2006. *See* Curtis G. Carlson, *Be Prepared*, DAILY DEAL, Dec. 14, 2006. Activist hedge funds take large ownership positions in companies. Their goal is to try to force changes in the companies by proposing new strategies, negotiating with management, initiating proxy battles, or even taking control of companies. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1028 (2007). Hedge funds buying more than five percent of a company's stock and disclosing their intention to influence the management of the company to the SEC were successful in getting the target company to acquiesce to their demands in sixty percent of cases. *See* April Klein & Emanuel Zur, *Hedge Fund Activism* 27 (European Corporate Governance Institute Working Paper Series in Finance, Paper No. 140/2006, 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913362 (follow "Download Document" hyperlink; then follow "Social Science Research Network" hyperlink). However, if a proxy vote is needed, activist hedge funds are less successful because many institutional investors routinely vote with management. *See* Laura Santini, *Investor Activism Grows Globally, But Wins Are Rare*, WALL ST. J., July 3, 2006, at C1.

25 In Germany, hedge fund pressure removed Deutsche Borse CEO Werner Seifert. *See* Alan Murray, *Business: Heinz Is Better Served With Peltz Outside of the Board Room*, WALL ST. J., Aug. 9, 2006, at A2.

26 Hedge funds have significantly impacted the auto parts industry restructuring. Jeffrey McCracken et al., *For Car Industry, Sum of the Parts May Be a Lifeline; Hedge Funds, Buyout Companies Line Up to Pour Billions of Dollars Into Slimmed Down Suppliers*, WALL ST. J., Oct. 26, 2006, at C1.

27 Hedge funds as bond-holders are demanding immediate payout of debt when a technicality arises for default. *See* Peter Lattman & Karen Richardson, *Hedge Funds Play Hardball with Firms Filing Late Financials*, WALL ST. J., Aug. 29, 2006, at A1. For example, when a public company does not timely file its financial statements with the SEC, some hedge funds then extract substantial fees from the company or higher

determined the survival of many businesses through start-up ventures,[28] mergers and acquisitions,[29] and bankruptcy creditor committees.[30] The aggressive tactics used by some hedge funds have caused controversy, particularly in Asia.[31] As financiers, hedge funds provide a new avenue for financing risky ventures like producing films[32] and acquiring transfer rights in professional athletes.[33] Because hedge funds have achieved higher than normal returns during the past decade, their sophisticated investment strategies now serve as role models for others by applying "modern portfolio theory."[34] As a result, some convergence now

interest rates from the company's bonds in exchange for an extension of their default deadline. *Id.*

28 Rebecca Buckman, *Need Cash? Call a Hedge Fund: Some Young Tech Companies Move Beyond Venture Capital*, WALL ST. J., Apr. 5, 2006, at C1. Unlike venture capitalists, hedge funds offer little experience dealing with small, private firms which often need nurturing to succeed. *See* Margot Patrick, *Hedge-Fund IPO Is the Latest Test for Nascent Sector*, WALL ST. J., Dec. 8, 2006, at C12.

29 *See* Chris Kentouris, *Political Chill Hits Hedge Fund 'Locusts,'* SECURITIES INDUSTRY NEWS, May 30, 2005, at 12 (discussing Deutsche Borse's alleged takeover of the London Stock Exchange). Target company managers often find hedge fund shareholders "uncooperative and disruptive." William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1381 (2007).

30 *See* Stephen Taub, *Hedge Fund Bankruptcy Role Seen Probed*, CFO.COM, Nov. 29, 2005, http://www.cfo.com/article.cfm/5244187/c_5242799. Hedge funds investing in distressed debt sometimes convert their debt holdings into control of a company if the company re-emerges from bankruptcy. *See* Henny Sender, *A Company's Road to Restructuring May Teem With Hedge Fund Potholes*, WALL ST. J., Mar. 30, 2006, at C1.

31 "In Japan, . . . [hedge fund] activism has generated two different reactions." Young-Joon Kim, *Hedge Funds Spur Business Debate in Asia*, INT'L FIN. L. REV., June 2006, at 19, 21. Some Japanese believe that hedge funds provide the external pressure for needed reform. *Id.* Other Japanese believe the law should provide more effective defenses from hedge fund attacks. *Id.* The aggressive tactics used by hedge funds have also caused controversy in Korea. *See* Laura Santani & Jason Singer, *Icahn's Push in Korea Shows Rise of Raiders is Roiling New Markets*, WALL ST. J., Mar. 2, 2006, at A1.

32 Pierre Paulden, *Coming to a Fund Near You*, 40 INSTITUTIONAL INVESTOR 22 (2006); *see also* Kate Kelly, *Creative Financing: Defying the Odds, Hedge Funds Bet Billions on Movies*, WALL ST. J., Apr. 29, 2006, at A1.

33 Gregory Zuckerman & Keith Johnson, *Pure Play in Soccer: Hedge Fund Invests in Portuguese Stars*, WALL ST. J., July 5, 2006, at A1.

34 *See Institutional Demand for Hedge Funds 2*, INSTITUTIONAL DEMAND FOR HEDGE FUNDS UPDATE (Bank of N.Y., New York, N.Y. & Casey, Quirk & Associates, Darien, Conn.), Oct. 2006, at 18, http://www.adrbny.com/files/ BNYHedgeFundWhitePaper2006.pdf. Modern portfolio theory concludes that an investment portfolio is less volatile by adding noncorrelated investment assets, even if

exists between hedge funds and other financial products.[35]

Hedge funds also have a major societal impact. They have created a new class of wealth, the "centimillionaires."[36] Just as the "net entrepreneurs" symbolized the 1990s, the international hedge fund managers may come to symbolize the brightest in the current decade.[37] Without adequate regulation to safeguard against potential abuses, the success of hedge funds may diminish, similar to the struggles of the net entrepreneurs after the dot-com crash in 2000.

Major problems stemming from hedge funds include the risk of destabilizing the financial markets through "systemic risk,"[38] exploitation of conflicts of interest, and outright securities fraud.[39] Losses to investors resulting from fraud in hedge funds between

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those individual assets individually have higher volatility. *See* Harry Markowitz, *Portfolio Selection*, 7 J. OF FIN. 77, 89 (1952).

35 Increased convergence exists between hedge funds and other categories of financial products, such as private equity funds and mutual funds. *See* ALTERNATIVE INVESTMENT EXPERT GROUP TO THE EUROPEAN COMM'N, MANAGING, SERVICING, AND MARKETING HEDGE FUNDS IN EUROPE 4 (2006), http://www.hedgeweek.com/reports/index.jsp (follow "Report of the Alternative Investment Expert Group to the European Commission Managing, Servicing and Marketing Hedge Funds in Europe.pdf" hyperlink) [hereinafter ALT. INV. GROUP]; Jonathan Bevilacque, *Convergence and Divergence Blurring the Lines Between Hedge Funds and Private Equity Fund*, 54 BUFF. L. REV. 257 (2006). An example of convergence is the "130/30 funds" which allow mutual funds to include a moderate amount of leverage and some shorting. *See* Emma Trincal, *The Face of Convergence: New SEC Rules May Boost Nascent 130/30 Market*, HEDGEWORLD, Dec. 27, 2006.

36 *See* Ianthe Jeanne Dugan & Anita Raghavan, *The Atlas of New Money: Awash in Cash, Hedge-Fund Moguls from Greenwich to Hong Kong Reshape the World of Weath*, WALL ST. J., Dec. 16, 2006, at A1.

37 Julian Delasantelles, *Speaking Freely: Hedge Funds Playing Dice With the Investor*, ASIA TIMES, July 6, 2006, at 4, *available at* http://www.atimes.com/atimes/Global_Economy/HG06Dj02.html; *accord* Peter Walker, *The Latest MBA Must Have Job*, CNN.COM, Jan. 18, 2007, *available at* http://edition.cnn.com/2007/BUSINESS/01/12/execed.private/index.html.

38 Systemic risk is the possibility of correlated defaults among financial institutions over a short period of time, often caused by a single major event creating a financial shock that presents a danger of inflicting significant damage to the financial system and real economy. Nicholas Chan et al., *Do Hedge Funds Increase Systemic Risk?*, 91 ECON. REV. 49, 49 (2006); *Hedge Funds and Systemic Risk in Financial Markets: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 104 (2007) (statement of E. Gerald Corrigan, Managing Director, Goldman, Sachs & Co.).

39 *See, e.g.*, Gregory Zuckerman, *Hedge Fund Fraud is Alleged by SEC*, WALL ST. J., Nov. 10, 2005, at C6.

2000 and 2004 exceeded $1.1 billion.[40] Over $1 billion of these losses were caused by hedge fund investment advisers who were not registered with the SEC.[41] Market instability and significant instances of fraud highlight the need for more stringent regulation of hedge funds.

The SEC concluded in 2004 that some light regulation of hedge funds was needed because of hedge fund fraud, indirect sales of hedge funds to the ordinary investing public, and the enormous size of the hedge fund industry.[42] However, the District of Columbia Circuit Court of Appeals in June 2006 overturned the SEC's first attempt to regulate most hedge funds.[43] Thus, the SEC was forced to drop its regulation of hedge fund advisers in 2006. Instead, in 2007, the SEC adopted a regulation that extended the anti-fraud portion of the securities law to hedge funds[44] and proposed regulations to restrict which "individuals" could purchase hedge funds.[45]

This article examines how to improve the regulation of hedge funds in the global economy in order to ensure more stability and integrity in the financial markets. Proper regulation will make investing in hedge funds safer and more transparent, while still enabling hedge funds to continue to provide their substantial benefits to the financial markets.

Part II of this article examines hedge funds' characteristics, epitomized by their power, riskiness, and mysteriousness. Part III identifies the problems that have arisen from hedge funds, such as

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40 Registration under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056 (Dec. 10, 2004) (to be codified at 17 C.F.R. pt. 275, 279) [hereinafter SEC Hedge Fund Adviser Rule].

41 *Id.* at 72,078. Almost half of the SEC's enforcement actions against hedge funds involved false documentation by a hedge fund attempting to hide fraud. SEC STAFF, 2003 REP., *supra* note 11, at 74. One third of the actions involved criminal charges. *Id.*

42 *See* SEC STAFF, 2003 REP., *supra* note 11, at 89. It is expected that the hedge fund industry will exceed $3 trillion in a few years and $6 trillion by 2015. *Testimony Concerning Hedge Funds Before the Subcomm. on Securities and Investment of the S. Comm. on Banking, Housing and Urban Affairs*, 109th Cong. (2006) (statement of Susan Ferris Wyderko, SEC Director, Office of Investor Education & Assistance), *available at* http://www.sec.gov/news/testimony/ts051606sfw.htm.

43 Goldstein v. SEC, 451 F.3d 873, 887 (D.C. Cir. 2006).

44 17 C.F.R. § 230.206(4) to 230.206(8) (2007).

45 *See* 17 C.F.R. § 230.506 (2007).

endangering the markets, engaging in fraud, and providing losses caused by lack of risk management. Part IV explores the lack of regulation of hedge funds under current U.S. securities laws and the SEC's regulatory attempts.

Part V proposes a three-part solution for controlling hedge funds: (1) a coordinated international approach, (2) adding prudential regulation to reduce both systemic risk to the financial system and fraud to the investors, and (3) enhancing market integrity regulation to ensure efficient markets that can assist investors and the public. The ultimate goals are to acquire greater transparency for the financial markets to operate effectively, to generate more accountability from hedge funds, and to preserve the fundamental benefits that hedge funds offer to the financial system.

II. Characteristics of Hedge Funds

Evolving from their origins as hedging transactions that were designed to lessen risk in portfolios,[46] hedge funds have existed for almost 60 years.[47] During the last decade, hedge funds have become a major economic force, having established a record of

46 Hedge funds originally employed a hedging strategy of making additional trades to counterbalance any risk in the existing portfolio. *See* Willa Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 684 (2000). Traditionally, hedge funds were generally defined as any pooled investment vehicles that were "privately organized, administered by professional investment managers, and not widely available to the public." PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999) [hereinafter WORKING GROUP REPORT I], *available at* http://www.treasury.gov/press/releases/reports/hedgfund.pdf (the Working Group consists of representatives from the SEC, the Commodity Futures Trading Commission, the Federal Reserve and the U.S. Treasury Department).

47 Alfred Winslow is generally credited as having founded the first hedge fund in a limited partnership in 1949. *See Hearing on Regulation of the Hedge Fund Industry Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. 14 (2004) (statement of Charles J. Gradante, Managing Principal, The Hennessee Group LLC), *available at* http://banking.senate.gov/_files/gradante.pdf. It was not until the stock market boom of the late 1960s that private investment entities generally began adopting hedging and arbitrage techniques. *See* Memorandum from William H. Heyman, SEC Director of Market Regulation, & Marianne K. Smyth, SEC Director of Investment Management, to SEC Chairman Breeden 1 (June 12, 1992) ("In the 1970s and 80s, the activities of hedge funds broadened into other activities."), *available* at http://www.sec.gov/rules/proposed/s73004/s73004-34.pdf. *See generally* William Fung & Daniel A. Hsieh, *A Primer on Hedge Funds*, 6 J. OF EMPIRICAL FIN 309, 311 (1999).

producing higher returns than traditional investments in stocks and bonds.[48] Investors like the fact that hedge funds provide portfolio diversification through financial returns not generally correlated with the traditional financial returns from investments in stocks and bonds.[49] Hedge funds represent a paradigm shift[50] to alternative investments in an effort to take advantage of modern financial instruments and techniques, such as options,[51] derivatives,[52] arbitrage,[53] and shorting.[54]

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48 *See* Daniel Capocci & Georges Hübner, *Analysis of Hedge Fund Performance*, 11 J. OF EMP. FIN. 55, 56–57 (2004). *But see* Anne Tergesen, *It's* Gloomy *In These Hedges: For Retail Investors, Hedge Funds of Funds Aren't Paying Off*, BUSINESS WEEK, Oct. 23, 2006, at 134.

49 *See* SEC STAFF, 2003 REP., *supra* note 11, at 5.

50 *See* Melanie Merrifield & Nancy C. Godson, *Finance to the Rescue*, BAYLOR BUS. REV., Sept. 2005, at 2; Fin. Services Auth., *Hedge Funds: A Discussion of Risk and Regulatory Engagement* 5 (Fin. Services Auth., Discussion Paper No. 05/4, 2005), http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf.

51 Options enable recipients to buy stock in the future at the price on the date the option was granted. Options trading has expanded over fifty percent since 2004. *See* Annette L. Nazareth, Commissioner, Sec. & Exch. Comm'n, Remarks at the Securities Industry Association Options Market Structure Conference (Oct. 24, 2006), http://www.sec.gov/news/speech/2006/spch102406aln.htm.

52 Derivatives are financial instruments that derive their value from hedging the risk of owning an underlying asset which is subject to unexpected price fluctuations. *See generally* Robert F. Schwartz, *Monitoring a Game of Winks, Nods, and Risk: Derivatives Regulation in the E.U. and Poland*, 2 BYU INT'L L. & MGMT REV. 233, 239–41 (2006). An estimated two quadrillion dollars in derivative trades occur per year. *Hedge Fund Crisis*, *supra* note 3. In the first half of 2006, the use of derivatives in the United States grew at the fastest pace in eight years. *See* James Quinn, *Paulson Probes Leverage*, THE DAILY TELEGRAPH (London), Jan. 26, 2007, at C1.

53 Arbitrage takes advantage of usually small price differentials existing between two markets by buying from one market and immediately selling to the other. BLACK'S LAW DICTIONARY 99 (7th ed. 1999).

54 *See* Amendments to Regulation SHO and Rule 10a-1, Exchange Act Release No. 54,891, [2006-2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,719, at 83,840-41 (Dec. 7, 2006). Reg. SHO regulates short-selling and applies to hedge funds and the rest of the securities industry. *See* 17 C.F.R. § 242.200 (2006). Reg. SHO allows market makers to "short-sell naked," shorting without having to borrow the underlying security. *See* Chidem Kurdas & Christopher Faille, *SEC Proposal May Cause New Short Squeeze*, HEDGEWORLD, Jan. 12, 2007. The SEC is concerned about short-selling in selected circumstances and has proposed barring a short sale in the five day period before a stock offering. *See* Short Selling in Connection with a Public Offering, Exchange Act Release No. 54,888, [2006-2007 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 87,718, at 83,826 (Dec. 6, 2006) (proposing the amendment of 17 C.F.R. § 242.105).

As financial products, hedge funds usually demonstrate similar characteristics. They exhibit power by engaging in high-speed computerized and leveraged trading activity in order to take advantage of short-term market inefficiencies of diverse risks or complex financial products, as discussed in Part V.a.[55] Hedge funds are very risky, as explained in Part V.b. They are also mysterious because they provide very limited information about their portfolios while they operate in a complex international environment, as examined in Part V.c.

A. Powerful Due to Size, Growth, and Strategies

Hedge funds have become an important component of the global financial capital markets. About sixty percent of the roughly two trillion dollar hedge fund industry[56] is based in the United States.[57] The financial impact of hedge funds far exceeds their size because they trade so much.[58] Hedge funds account for between one-third and one-half of the trading volume on the London[59] and New York Stock Exchanges.[60] Also, hedge funds

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55 *See* IOSCO, *supra* note 5, at 29-32 app. d (identifying hedge fund characteristics in various countries).

56 *See* Chidem Kurdas & Bill McIntosh, *HF Asset Levels Much Higher, Administrators Report*, HEDGEWORLD (July 27, 2007). It is expected that the hedge fund industry will exceed $3 trillion in a few years and $6 trillion by 2015. *Testimony Concerning Hedge Funds*, *supra* note 42.

57 Hedge fund assets in the world are roughly divided as follows: United States 62%, Europe 26%, Asia-Pacific 10%, and other areas 2%. Ferrel Daste, Director, Deutsche Bank Hedge Fund Capital Group, The Role of Capital Introduction in the Growth of the Hedge Fund Industry 2 (2006) (Deutsche Bank advertisement). More investments from the Middle East and Asia, especially India, are expected. Neil Behrman, *Middle Eastern Institutional Hedge Fund Demand Could Rise to 14% of Global Total*, INFOVEST21 NEWS (HedgeWorld), Dec. 19, 2006; Rajesh Abraham, *Hedge Funds Wait for India to Open*, INDIA LTD., Dec. 4, 2006, *available* at http://www.rediff.com/money/2006/dec/04hedge.htm; Margot Patrick, *Hedge Funds for the Masses; U.K. Weighs Broadening Range of Products Individuals Can Buy*, WALL ST. J., Mar. 24, 2006, at C12.

58 SEC STAFF, 2003 REP., *supra* note 11, at 2.

59 London is the capital for European hedge funds, while New York and its Connecticut suburbs are the center for U.S. hedge funds. *See* Dugan & Raghavan, *supra* note 36.

60 David Chapman, Bullion Mgmt. Group, Inc., Roaring Government Bond Market (July 1, 2005), http://www.bmsinc.ca/content/view/194/33/. One hedge fund's frantic

are dominant in select markets:[61] they represent most of the trading in "convertible bonds"[62] and half of the trading in commodities.[63]

Hedge funds hold a huge amount of assets, mostly due to their dramatic growth worldwide in the past decade. Especially since 2000, hedge fund assets have grown much faster than most assets.[64] Hedge fund assets are about twice the size of private equity funds[65] and represent about fifteen percent of mutual fund assets.[66] Hedge funds have grown even faster in certain

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trading on the New York Stock Exchange was rumored to account for almost three percent of the daily trading. Alan Murray, *Hedge Funds Need to Open Up*, WALL ST. J., Apr. 5, 2006, at A2.

61 Greenwich Associates estimates that hedge funds account for about eighty percent of the trading in distressed debt. *Role of Hedge Funds in Our Capital Markets: Hearing Before the Subcomm. on Securities and Investment of the S. Comm. on Banking Housing and Urban Affairs*, 109th Cong. (2006) (statement of Patrick M. Parkinson, Deputy Director, Federal Reserve Board, Division of Research and Statistics), *available at* http://federalreserve.gov/boarddocs/testimony/2006/20060516/default.htm.

62 *See* Anita Raghavan, *Hedge Fund GLC Is Probed on Role of a Star Trader*, WALL ST. J., Oct. 26, 2005, at C1. "Convertible bonds" are bonds with an embedded option that can turn the bond into stock at a predetermined price. *See* VON COTTIER, *supra* note 6, at 133. Convertible bonds were popular with hedge funds because trading strategies enabled funds to make money off of small movements in the price of the bonds or the underlying stock. *See* Alistar MacDonald, *Street Sleuth: Burst of New Convertible Bonds Jump-Starts Gains for Hedge Funds*, WALL ST. J., Apr. 24, 2006, at C3. The lack of new convertible bonds and relatively stable equity markets forced some hedge funds into other investment strategies in 2005. *See id.*; *see also* Henny Sender, *Hedge Funds Skid on Convertible Bonds*, WALL ST. J., June 30, 2004, at C4.

63 *See Demystifying Hedge Funds: Hearing Before the Subcomm. on Securities and Investment of the S. Comm. on Banking Housing and Urban Affairs*, 109th Cong. 3 (2006) (statement of Adam Lerrick, Director, Gailliot Center for Public Policy), *available at* http://banking.senate.gov/_files/ACF82BD.pdf. *See, e.g.*, Ann Davis, *New Exotic Focus for Hedge Funds: Uranium Market*, WALL ST. J., Mar. 5, 2007, at A1 (discussing hedge fund investment in the energy sector).

64 Hedge funds have historically yielded double digit returns. *See* Nicholas Chan et al., *Systemic Risk and Hedge Funds* 1 (MIT Sloan Sch. of Mgmt., Working Paper No. 4535-05, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=671443 (follow "Download Document" hyperlink; then follow "Social Science Research Network" hyperlink). *See also* Steven Brull, *Hedge Fund Holdouts*, 39 INSTITUTIONAL INVESTOR 22, 23 (2005).

65 Shareholder Activism, Hedge Funds, and Securities Law Developments, Presentation at the Federal Securities Institute 15 (Feb. 16, 2006) (on file with author).

66 Mutual funds represent almost $10 trillion in assets. *See* Judith Burns, *SEC to Revisit Independence Rule; Fund-Governance Measure Revives Contentious Issue As It*

geographic areas[67] such as Asia.[68]

The growth in hedge funds is partly attributable to the investor base expanding beyond wealthy individuals.[69] For example, institutional investors now represent the majority of investment in U.S. hedge funds,[70] with the rest of those funds owned by individual investors.[71] Institutional investors include university endowment foundations,[72] pension funds,[73] life insurance

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Gets Its Third Look, WALL ST. J., Dec. 12, 2006, at C13.

67 Canada presents an example of the dramatic growth in hedge funds. Within the last five years, Canadian hedge funds have increased to $40 billion. David Clarke, *Toronto Hedge Funds May Take on New York*, CANADIAN HEDGE WATCH, Nov. 20, 2006. Canadian hedge funds also accounts for about one-third of the Canadian stock market activity. James L. McGovern, *Hedge Funds Market Poised for Tremendous Growth*, HEDGEWEEK, Jan. 1, 2005, *available at* http://www.hedgeweek.com/articles/detail.jsp?content_id=15393&livehome=true.

68 For example, assets in Hong Kong based hedge funds jumped from almost $2 billion in 2000 to almost $16 billion in 2005. *See* Amanda Cantrell, *Hedge Funds Make Big Bets on China boom*, CNN MONEY, Apr. 24, 2006, *available* at http://money.cnn.com/2006/04/24/markets/hedgefunds_china/; *Asian Interest Fuels Growth in Cayman Islands Hedge Fund Industry*, PR NEWSWIRE, Feb. 22, 2005, *available at* http://prnewswire.co.uk/cgi/news/release?id=140381 (stating that Asian hedge funds increased over 400% from 1999 to 2004). Asian regulators have begun to express specific concerns about the hedge fund industry. *See* Alexa Lam, Executive Director, Intermediaries and Investment Products, Securities and Futures Commission, Address: The Outlook and Regulatory Challenges for the Fund Management Industry in Hong Kong (Jan. 18, 2007), www.sfc.hk/sfc/doc/EN/speeches/speeches/07/speech_18_01_07.pdf (expressing concern about hedge fund side-letters, valuations, and substandard offering documents).

69 Investment in hedge funds is limited to wealthy individuals because of high minimum investment requirements, like the U.S. "accredited investor" standards, imposed by many governments. *See infra* p. 58 and notes 289-90 and accompanying text.

70 Alex R. McClean, Note, *The Extraterritorial Implications of the SEC's New Rule Change to Regulate Hedge Funds*, 38 CASE W. RES. J. INT'L L. 105, 113 (2006) (citing FRANCOIS-SERGE LHABITANT, HEDGE FUNDS: QUANTITATIVE INSIGHTS 11 (John Wiley & Sons 2004)).

71 Individual ownership in other major countries range from a low of 16% in Japan to a high of 67% in Australia. *See* Financial Services Agency (Japan), Office of International Affairs, Summary of Hedge Fund Survey Results and Discussion Points (Dec. 22, 2005), *available at* http://www.fsa.go.jp/en/newsletter/2006/03c.html; *Big Hitters*, ECONOMIST, Dec. 16, 2006, at 79 (discussing the high level of individual investment in hedge funds in Australia).

72 Large university endowment foundations have invested over one-third of their portfolio in alternative investments. Martin van der Werf, *Endowments Earned 10.7 Percent in 2006*, THE CHRON. OF HIGHER EDUC., Jan. 5, 2007. For example, Princeton

companies,[74] and others.[75] Institutional investors are expected to continue increasing their share of hedge fund investments in the future,[76] despite a lack of information about hedge fund investments that makes it difficult to fulfill any fiduciary

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University has invested almost half of its portfolio in hedge funds. *Hedge Funds and Systemic Risk in the Financial Markets: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 112 (2007) (statement of Andrew K. Golden, President, Princeton University Investment Co.). Yale University invested twenty-five percent of its $18 billion portfolio in hedge funds. YALE UNIV., THE YALE ENDOWMENT 2005 19 (2005), *available at* http://www.yale.edu/investments/Yale_Endowment_05.pdf; E. S. Browning, *Boola, Boola: The Yale Money Management Fad*, WALL ST. J, Dec. 2, 2006, at B3.

73 U.S. pension funds started ramping up their investment in hedge funds after a 2002 report by the Pension Benefit Guarantee Corporation concluded a potential pension crisis was possible. At that time, many pension plans were under-funded, especially after the stock market declines of 2001. Following the issuance of the report, pension trustees generally became more willing to ignore risk and pursue the higher possible financial returns offered by investment in hedge funds. *See* Michele Weldon, *The Quest for Higher Returns Leads Investors to Alternatives*, 172 PwC EVENTS AND TRENDS 10, 12 (2003). Subsequent changes in accounting for pensions have also motivated some pension plans to take more risk and invest in hedge funds. *See* Bank of New York, *supra* note 34, at 13. For example, in 2004, pension fund assets provided about thirty percent of hedge fund asset inflows. Gregory Crawford, *Buying Up: Hedge Fund Success Has Everyone Wanting In*, PENSIONS & INVESTMENTS, Oct. 4, 2004, at 15–18. Shortly thereafter, pension funds in other countries also began to invest in hedge funds. *See, e.g.*, Chester Dawson, *Japan's Hedge Heyday: Funds are Sprouting and Thriving, Despite the Red Tape*, BUSINESS WEEK ONLINE, Sept. 26, 2005, http://www.businessweek.com/magazine/content/05_39/b3952149.htm.

74 Life insurance companies' investments are often regulated. Thus, life insurance companies have only a relatively small amount invested in hedge funds. *See, e.g.*, Stefan Engels, *Derivatives Take Larger Role With Hedge Funds*, HEDGEWEEK SPECIAL REPORT, Aug. 2006, at 5, 7.

75 ALT. INV. GROUP, *supra* note 35, at 4. *See also* Amy Borrus, *Is the Hedge Fund Party Over?*, BUS. WK. ONLINE, Aug. 8, 2005, http://www.businessweek.com/bwdaily/dnflash/aug2005/nf2005088_7712_db016.htm.

76 Global institutional demand for hedge funds is expected to triple by 2010. *See* Bank of New York, *supra* note 34, at 13. Kelly Bogdanor, *Hedge Fund Headwinds and Tailwinds: Examining the Impact of Hedge Funds on the U.S. Stock Market*, DAIN RAUSCHER PRIVATE CLIENT EQUITY RESEARCH, Nov. 17, 2006, at 3; JPMORGAN ASSET MGMT., INSIGHTS: U.S. MID-SIZE INSTITUTIONS INVESTING SURVEY (2006), www.jpmorgan.com/pages/jpmorgan/am/ia/research_and_publications/survey_reports (follow "U.S. Mid-Size Institutional Investors Respond" hyperlink). Similarly, only forty percent of Europe's largest institutional investors had invested in hedge funds. *See* Informed Portfolio Management, Regional Differences Highlighted as European Institutions Continue to Move Into Alternative Investments, Survey Reveals (2004) (on file with author).

responsibilities.[77]

It is not just the size of hedge funds that has increased. The number of hedge funds worldwide now exceeds 13,000.[78] The U.S. market accounts for about seventy percent of these hedge funds.[79] Larger hedge funds are typically defined as those exceeding $10 billion, and midsize funds are defined as those exceeding $1 billion. The average size of a hedge fund, however, just exceeds $100 million.[80] Thus, ten percent of the hedge funds hold about ninety percent of the total hedge fund assets.[81] Leading investment banks and securities dealers have played a major role in expanding the investment in hedge funds.[82] Each year roughly ten percent of the hedge funds close down,[83] but new funds

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77 *See* Anne Tergesen, *Big Risk on Campus*, BUSINESS WEEK, May 15, 2006, at 32.

78 *Hedge Funds and Systemic Risk in the Financial Markets: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 123 (2007) (statement of George E. Hall, Managed Fund Association). Approximately 3,000 hedge funds existed in 1998. WORKING GROUP REPORT I, *supra* note 46, at 1.

79 Pratima Desai, *Man Group Says Hedge-Fund Fraud a U.S. Phenomenon*, REUTERS, Mar. 2, 2006, *available at* http://www.libertypost.org/cgi-bin/readart.cgi?ArtNum=131593.

80 NORTHERN TRUST, THE 'FORCED' INSTITUTIONALISATION OF THE HEDGE FUND INDUSTRY 4 (2006), http://www-ac.northerntrust.com/content//media/attachment/data/white_paper/0606/document/whitepaper_hedgefunds.pdf.

81 *See* John Wilkinson, *Fund of the Fund the Best Hedge Fund Strategy*, MONEYMANAGEMENT.COM, Aug. 7, 2006, http://www.moneymanagement.com.au/Articles/Fund-of-fund-the-best-hedge-fund-strategy_0c04383b.html. Bogdanor, *supra* note 76, at 3 (stating that 300 hedge funds having more than $1 billion each manage ninety percent of hedge fund assets).

82 For example, the Bank of New York has grown hedge fund assets under its administration to over $100 billion, the vast majority of which occurred in the last five years. *See Bank of New York Tops $100 Billion in Hedge Fund Assets*, PR NEWSWIRE, Jan. 24, 2007.

83 *See* Alistair Barr, *Hedge Fund Launches, Liquidations Drop in 2006, HFR Says*, MARKETWATCH, Mar. 29, 2007. Hedge funds are routinely shut down because they are unable to deliver consistently positive returns. CHRISTOPHER B. PHILIPS, UNDERSTANDING ALTERNATIVE INVESTMENTS: A PRIMER ON HEDGE FUND EVALUATION 3 (Vanguard Inv. Counseling & Research 2005). Many hedge funds fail "because they couldn't manage their business." *See* Scot Blythe, *Pitfalls of Hedge Fund Investing: A Trustee's Guide to Alternative Investments, Part III*, BENEFITS CANADA, Nov. 2005, at AG1, AG2, http://www.benefitscanada.com/news/article.jsp?content=20060714_140710_4896. In tracking a group of 331 hedge funds for almost one decade, noted Princeton University economist Burton Malkiel, who authored A RANDOM WALK DOWN WALL STREET, found that less than twenty-five percent of the original hedge funds were still reporting. Brull, *supra* note 64, at 7.

constantly open up.[84]

Various investment styles and strategies are used by hedge funds,[85] and they often use complex mathematical models.[86] Strategies include market-trend or directional strategies[87] (exploiting broad market trends in equities, interest rates, or commodity prices), event-driven strategies[88] (exploiting discrete

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84 Press Release, Hedge Fund Intelligence, New Hedge Fund Launches Slow (Feb. 7, 2007) (on file with author) (stating that, in 2006, eighty-two new U.S. hedge firms were launched, raising $34 billion). Overall, the start-up size of hedge funds continues to increase. *Id.* In 2006, one hedge fund was started with a record high $6 billion in investment. Emma Trincal, *The Hedge Fund Report: Graduating from Harvard*, THE STREET.COM, Feb. 13, 2006, http://www.thestreet.com/markets/hedgefunds/10268102.html (stating that the record-breaking fund was created by the former manager of Harvard's endowment). Twelve years earlier, $6 billion represented the largest hedge fund in existence; whereas, in 2007, a $6 billion hedge fund would not make the list of top fifty U.S. hedge funds. *See Hedge Funds and Systemic Risk in the Financial Markets: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 135 (2007) (statement of Jeffrey L. Mathews, General Partner, Ram Partners, LP).

85 SEC STAFF, 2003 REP. *supra* note 11, at 4. Different research groups categorize the basic investment strategies differently. For example, while Tremont Capital identifies nine strategies, the Henesee Group classifies twenty-three strategies. PHILIPS, *supra* note 83, at 5. Two-thirds of large hedge funds pursue multiple strategies. *See* Heidi Moore, *Wall Street's Prime Cut*, DAILY DEAL, June 27, 2005.

86 *See, e.g.*, Randall Smith, *Goldman Gurus Strike It Rich With Hedge Fund; Global Alpha's Stellar Returns Means Pay-Dirt for Ex-Academics; The Envy of Wall Street Firms*, WALL ST. J., Apr. 20, 2006, at C1. Goldman "quants" first built mathematical models for hedge funds. *See id.* In some financial markets, it's also important to have more than mathematical models, such as having investigators who provide on-the-ground research. *See* Mindy Rosenthal, *China Bound*, 31 INSTITUTIONAL INVESTOR 97, 98 (2006).

87 In 2004, market-trend strategies represented 47% of the hedge fund assets (market-trend strategies include long/ short, 42%, and other strategies, 5%). *See* Nadja Pinnavaia, Hedge Fund Strategies, Goldman Sachs, Presentation at the U.K. and Irish Pensions and Investing Summit: Taking the Plunge: Entry Strategies for Hedge Fund Exposure 4 (2004), http://www.iapf.ie/Events/RecentEvents/UKIrishInvestingPensionsSummit-Oct18-19/file,693,en.pdf.

88 Event driven strategies have increased from nineteen percent of hedge fund assets in 1995 to twenty-five percent in 2006. *Hedge Funds and Systemic Risk in the Financial Markets: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 71 (2007) (statement of Stephen J. Brown, David S. Loeb Professor of Finance, NYU Stern School of Business) [hereinafter Brown]. Thus, the U.K. Financial Service Authority recently announced that it was increasing the number of hedge fund managers under supervision in an effort to monitor the growing influence of these event-driven funds. *See* Melanie Feisst, *Watchdog Widens Scrutiny as Managers Wield More Influence*, DAILY TELEGRAPH (London), Aug. 29, 2006, at C1.

events such as bankruptcies, mergers, and takeovers), arbitrage or relative-value strategies (exploiting pricing discrepancies between closely related securities),[89] and global or macro strategies (exploiting macroeconomic opportunities in global equity, fixed income, currency, and commodities markets).[90] The strategy or strategies used by a hedge fund may attract a particular type of investor.[91]

A contributor to the increased growth in the hedge fund industry is the "Fund of Funds" (FOFs).[92] FOFs are a mix of hedge fund investments[93] which represent over one-third of the total investment in hedge funds.[94] FOFs offer the advantages of

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89 SEC STAFF, 2003 REP., *supra* note 11, at 35–36. In 2004, relative-value strategies represented twenty-two percent of the hedge fund assets. Pinnavaia, *supra* note 87.

90 Karim Rozwadowski & Brynjar Pétursson Young, *Buyout Competition: The Emergence of Hedge Funds in the World of Private Equity*, J. OF PRIVATE EQUITY, Winter 2005, at 67, 68-69. Macroeconomic strategies have dramatically fallen during the past decade from nineteen percent of hedge fund assets down to three percent. Brown, *supra* note 88, at 71. "Macro hedge funds enjoy extraordinary flexibility regarding investment policy and investment strategies." VON COTTIER, *supra* note 6, at 139. Macro hedge funds are often large and appear in the media more frequently than other hedge funds. *Id.*

91 For instance, institutional investors generally look for a low volatility, absolute return stream of income. *See* Jenny Anderson, *Hedging '06: Year to Read the Caveats*, N.Y. TIMES, Dec. 11, 2006, at C1. For example, New Mexico's $13 billion pension plan has $1 billion invested in hedge funds. However, the N.M. pension plan decided against investing in emerging markets. Scott Patterson, *Cocktail of Hedge Funds, Emerging Markets Is a Risky Mix But the Big Investors Love It*, WALL ST. J., Mar. 23, 2006, at C1.

92 FOFs are generally regulated. *See, e.g.*, Fund of Fund Investments, Investment Company Act Release Nos. 33-8713, IC-27,399, 71 Fed. Reg. 36,640 (effective July 31, 2006) (adopting new rules relating to fund-of-funds investments). FOFs often provide better redemption terms than hedge funds. However, FOFs may have more restrictions on leverages, short-selling, and other risk-taking activities. *See* EUROPEAN CENTRAL BANK, LARGE EU BANKS' EXPOSURES TO HEDGE FUNDS 41 (2005), *available at* www.ecb.int/pub/pdf/other/largeeubanksexposureshedgefunds200511en.pdf. Some divide FOFs into two basic categories: diversified and niche. The assets of diversified FOFs are invested in various types of hedge funds. Niche FOFs invest all their assets in hedge funds of a similar type. Lipper HedgeWorld, Lipper HedgeWorld's Education Center: Fund of Funds, www.hedgeworld.com/education/index.cgi?page =fund_funds (last visited Sept. 9, 2007).

93 FOFs typically invest in fifteen to twenty-five hedge funds. SEC STAFF, 2003 REP., *supra* note 11, at 67.

94 Loch Adamson, *Cultural Divide*, INSTITUTIONAL INVESTOR, Aug. 13, 2006, at 50, 53 (citing figures from Chicago-based Hedge Fund Research).

lower minimum investment amounts[95] and less risk through investment diversification. FOFs have the disadvantage of charging higher investment expenses and having even less transparency than individual funds, which are often opaque. Many investors start their investments in hedge funds by purchasing FOFs.[96] FOFs will likely continue to grow, especially as their visibility increases through listing on European stock exchanges.[97]

B. Risky Due to Activity, Leverage, and Operations

Active trading through substantial, computerized, short-term trading characterizes many hedge funds. Thus, the investment positions within a hedge fund are frequently changed.[98] Some funds even employ split-second trading strategies in which a computer program decides when the hedge fund will buy or sell securities.[99] Active trading by a hedge fund can diminish if they are facing credit limits or if market liquidity disappears.[100]

High leverage is characteristic of many hedge funds but varies, in part, depending on the investment strategy used.[101] Leveraging of assets enables hedge funds to expand their trading activity. Hedge funds obtain leverage not only by borrowing, but also through various risky means such as purchasing securities "on

95 FOFs can have a minimum investment level as low as $25,000. Francois-Serge Lhabitant, *Interview: The Future Is Bright, the Future Is Hedge Funds: An Interview with James R. Hedges IV, President and Chief Investment Officer of LJH Global Investments*, 46 THUNDERBIRD INT'L BUS. REV. 1 (2004). *See also* SEC STAFF, 2003 REP., *supra* note 11, at 69 (detailing initial investment requirements of an FOF).

96 FOFs' initial value was to secure investor access to the best funds, which were otherwise unavailable. *See* Edmond Warner, *To the Point, These Replication Hedge Funds Are the Real Thing*, DAILY TELEGRAPH (London), Feb. 8, 2007, at 5.

97 *See* Arindam Nag, *For Some Funds of Funds, Public Is Peachy*, BARRON'S, Oct. 30, 2006, at 36; James MacIntosh, *The London Stock Exchange Join Fight to Host Alternative Funds*, FIN. TIMES, July 12, 2007, at 17.

98 *See* WORKING GROUP REPORT I, *supra* note 46, at 5.

99 *See* Aaron Lucchetti, *Firms Seek Edge Through Speed As Computer Trading Expands*, WALL ST. J., Dec. 15, 2006, at A1.

100 *See* WORKING GROUP REPORT I, *supra* note 46, at 5.

101 *See* SEC STAFF, 2003 REP., *supra* note 11, at 37. Hedge funds are classified as "highly leveraged institutions" by the Bank for International Settlements (Basel Committee on Banking Supervision). BANK FOR INT'L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, BANKS' INTERACTIONS WITH HIGHLY LEVERAGED INSTITUTIONS 8 (1999), www.bis.org/publ/bcbs45.pdf.

margin,"[102] shorting securities, and using repurchase agreements and derivative contracts.[103] Leveraging enables hedge funds to seek greater returns but also enhances the risk for large economic impact if losses result.[104] Leverage also increases the risk when the assets held are illiquid.[105] "Hedge funds are limited in their use of leverage only by the willingness of their creditors and 'counterparties'[106] to provide such leverage."[107] Leverage is sometimes created through relaxed margin or collateral requirements.[108] Government regulations should seek to limit excessive leverage used by many hedge funds.

Employees in a hedge fund are very few, despite the fact that hedge funds often supervise substantial assets.[109] Hedge fund employees are often hired through private networking within the investment banking community or even through nepotism.[110] The fund manager is an investment advisor who determines the hedge fund's investment strategies, provides day-to-day management of the investments, and arranges the outside service providers.[111]

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102 Buying on margin involves borrowing money from a stock broker to purchase the securities.

103 Gibson, *supra* note 46, at 686–87.

104 *See* Randall Smith & Susan Pulliam, *As Funds Leverage Up, Fears of Reckoning Rise*, WALL ST. J., Apr. 30, 2007, at A1.

105 *See* SEC STAFF, 2003 REP., *supra* note 11, at 37.

106 Counterparties extend credit to hedge funds through credit lines and manage their financial exposure by using various safeguards, such as due diligence, disclosure, collateral practices, credit limits, and monitoring. WORKING GROUP REPORT I, *supra* note 46, at 7.

107 *Id.* at 5. Registered investment companies, however, are subject to borrowing and leverage restrictions. *See Recent Developments in Hedge Funds: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 34 (2003) (statement of William H. Donaldson, SEC Chairman).

108 *See* SEC STAFF, 2003 REP., *supra* note 11, at 38.

109 Seventy percent of investment advisers report having ten or fewer employees. *See Investment Advisers Now Manage $31.4 Trillion*, PENSION BENEFITS, Oct. 2006, at 6. Depending on the hedge fund's size and its strategies, the fund manager may oversee portfolio managers, provide financial engineering expertise, and direct portfolio managers to employ particular investment strategies or focus on particular industries. *See* SEC STAFF, 2003 REP., *supra* note 11, at 10.

110 Grace Wong, *Why A Job in Private Equity Pays*, CNN MONEY, Feb. 13, 2007, http://money.cnn.com/2007/02/13/markets/pe_jobs/index.htm.

111 Among the over 10,000 investment advisers registered with the SEC, almost one-quarter manage hedge funds. *See* Judith Burns, *Hedge Funds Pump Up Ranks of*

Some hedge fund managers were formerly talented mutual fund portfolio managers or proprietary traders[112] who were lured away by hedge funds' promise of more lucrative entrepreneurial opportunities.[113] However, some managers have little relevant experience.[114] Hedge funds that are regulated each have a "Chief Compliance Officer" (CCO),[115] who is viewed by the SEC as its "'partner in the protection of investors.'"[116] The tendency of hedge funds to have few employees increases the need for government regulation to assure adequate staffing of personnel necessary in order to maintain proper internal controls and legal compliance.

Hedge funds employ third parties, including prime brokers. A prime broker is an investment bank or brokerage firm that serves as the major outside service provider for hedge funds. The prime broker executes the trades ordered by the hedge fund manager[117] and often facilitates the financing and risk management for the

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SEC Registry, WALL ST. J., July 31, 2006, at C9. "Offshore hedge funds typically contract with an investment adviser, which may employ a U.S. entity to serve as subadviser." SEC STAFF, 2003 REP., *supra* note 11, at 10.

112 Arguably, some mutual fund managers move to hedge funds to escape mutual fund regulation limits. *See* Eric J. Greupner, *A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1574 (2003).

113 *See* Keith Button, Growth in Hedge Funds Lures Wall Street (Dec. 26, 2004) (on file with author). Similarly, hedge funds have changed the nature of Wall Street equity research. Industry analysts are under more pressure to supply short term trading ideas to hedge fund clients. *See* Bogdanor, *supra* note 76, at 3.

114 Not requiring relevant knowledge or experience from a manager invites scam artists to enter the hedge fund industry.

115 17 C.F.R. § 270.38a-1 (2007).

116 Steven J. Tsimbinos & Scott H. Moss, *Managing a Hedge Fund as a Registered Investment Adviser: Avoiding Common Pitfalls*, *in* LIPPER HEDGEWORLD, SEC REGISTRATION REPORT 2005-2006 78 (2005) ("[The SEC] expects the CCO to (1) be respected in his or her organization, (2) have support from the highest levels of management, (3) have enough power, responsibility and authority . . . , (4) have sufficient resources . . . , and (5) be independent of business units."); *see also* Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74,714 (Dec. 24, 2003) (codified at 17 C.F.R. § 275.206(4)-7 (2007)); Gene Gohlke, Associate Director, SEC Office of Compliance Inspection and Examinations, Address at Managed Funds Association Educational Seminar Series 2005: Procedural Guidance for Hedge Fund CCOs Under the SEC's New Regulatory Framework (May 5, 2005), http://sec.gov/news/speech/spch050505gg.htm.

117 *See Prime Brokerage Debate: The Race to Keep Up With the Clients*, EUROMONEY, Nov. 2006, at 92; SEC STAFF, 2003 REP., *supra* note 11, at 53–55.

hedge fund transactions.[118] Prime brokers generate about $10 billion per year from servicing hedge funds.[119] For the three major largest brokerage firms,[120] this represents about one-third of their revenues.[121] Thus, there is often a conflict of interest between the largest hedge funds and prime brokers because of this mutually beneficial relationship.[122] The potential for a conflict of interest raises the concern of whether these prime brokers will exercise independence. Government regulation of hedge funds is needed to assure that prime brokers do not compromise their fiduciary duties in the interest of their own financial benefit.

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118 Prime brokers often provide intra-day credit to facilitate foreign exchange payment. *See* Hanlon, *supra* note 13, at 28–29.

119 Press Release, TABB Group, Hedge Funds Now Spend $10 Billion on Prime Brokerage, $1 Billion on Data, and $500 Million on SEC Registration as Expansion to New Markets Continues Says TABB Group Report (May 10, 2006), http://www.tabbgroup.com/PageDetail.aspx?PageID=16&ItemID=59; *see Hedge Funds and Independent Analysts: How Independent are Their Relationships: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 16-19, 97-111 (2006) (statement of Gary Aguirre, Former Investigator, SEC), *available at* http://www.gpoaccess.gov/chearings/109scat2.html (follow "PDF" hyperlink under "Hedge Funds and Independent Analysts: How Independent are Their Relationships?"). Mr. Aguirre, in his written testimony, stated that hedge funds paid $25 billion to Wall Street banks in 2004. *Id.* at 102; *see also* Liz Moyer, *Hedge Hogs*, FORBES, June 28, 2006, http://www.forbes.com/business/2006/06/28/hedgefund-senate-regulations-cx_lm_0628hedge.html.

120 Morgan Stanley, Goldman Sachs, and Bear Stearns control more than sixty percent of the prime brokerage market. Pascal Lambert, *Trends in Prime Brokerage*, HEDGE FUNDS REV., Aug. 2005, at 2, 3, *available at* www.incisivemedia.com/hfr/specialreport/primebroking.pdf; Bill McIntosh, *JP Morgan Exploits Derivatives Trading Growth*, HEDGEWORLD, Dec. 28, 2006.

121 *See* Alix Nyberg Stuart, *Are Your Secrets Safe?* CFO, Oct. 2006, at 64, 64.

122 As evidence of this cozy relationship, the two largest hedge fund managers are subsidiaries of investment banks: Goldman Sachs and J.P. Morgan. *See* David Enrich, *J.P. Morgan Climbs Hedge Fund Ranks*, WALL ST. J., Sept. 27, 2006, at B5. Massachusetts regulators have determined that at least one hedge fund was paying for office space through higher than normal trading fees with their prime broker and not disclosing the arrangement to investors. *See* John Hechinger, *Hedge Funds Gift Grabs*, WALL ST. J. ONLINE, June 28, 2007, at C3; Jenny Anderson, *Banks' Leases to Hedge Funds Are Questioned*, N.Y. TIMES, Jan. 2, 2007, at A1. The SEC Staff has expressed concern about a quid pro quo for a hedge fund's placement in a prime broker's preferred list. *See* SEC STAFF, 2003 REP., *supra* note 11, at 85. Gatekeepers often become advocates for their clients, rather than watchdogs for the public. *See* Robert Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1640 (2000).

Many other outside service providers also assist hedge funds. The offshore fund administrator calculates the net asset value of a hedge fund's holdings and maintains the financial information and records.[123] A few countries, such as Ireland, Bermuda, and the Cayman Islands, have thriving fund administration and financial reporting businesses.[124] Legitimate concerns about the independence of the professional work conducted in these offshore tax haven countries increase the need for government regulation of hedge funds.

External auditors are sometimes hired to audit the financial statements prepared by the fund administrators.[125] Legal counsel is needed to establish the business, conduct certain business transactions, and address various legal issues.[126] Additional specialized expertise is sometimes acquired by a hedge fund, particularly for investing in technology and the acquisition of timely market data.[127] Hedge funds have become the prime clients

123 The fund administrator should also provide information directly to the fund auditors. For an example of an offshore fund administrator helping to circumvent proper audits and allow the fund manager to perpetuate crime, see Fin. Asset Mgmt., Inc., Securities Act Release No. 8052, Securities Exchange Act Release No. 45,224, Investment Advisers Act Release No. 2007, Administrative Proceeding File No. 3-10,670, 76 SEC Docket 1421-3 (Jan. 3, 2002).

124 Fund administration is often handled in Ireland, the Cayman Islands, or Bermuda. *Cayman Panel Gives Hedge Fund Industry Mixed Bill of Health*, CAYMAN ISLANDS SUPPLEMENT, Apr. 2006, at 4, 5, *available at* http://incisivemedia.com/hfr/specialreport/Caymans2006.pdf.

125 Ninety-five percent of U.S. domestic hedge funds use one of five accounting firms to perform annual audits. *See* Gradante, *supra* note 47, at 6. Trustees of a hedge fund should hire the auditors to serve as independent watchdogs to protect the interests of the hedge fund shareholders. *See generally* F. Scott Thomas & John C. Jaye, *Converting Hedge Funds Into Mutual Funds – A Primer*, J. OF INVESTMENT COMPLIANCE, Dec. 22, 2005, at 25 (analyzing the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934).

126 "A small group of law firms with long ties to hedge funds managers dominate the business." Amy Kolz, *Hedged Bets*, THE AMERICAN LAWYER, Apr. 1, 2006, at 104. The legal work for hedge funds has changed as hedge funds become more involved with distressed debt, derivatives, and private equity. *Id.* U.S. law firms are expanding in Asia to assist their hedge fund clients acquisitions, corporate buyouts, and financial restructurings. *See* Margot Patrick, *U.S. Law Firms Expand Operations in Asia*, WALL ST. J., Dec. 18, 2006, at C4.

127 *See* Tabb Group, *supra* note 119 (stating that $1 billion was invested by hedge funds in technology and information). For other examples, see Brody Mullins, *Hedge*

of outside service providers because they provide substantial work and are often less price-sensitive than other clients.[128]

Unusually lucrative fees are typically paid to hedge funds.[129] Hedge funds typically charge 1% or 2% management fees and a 20% performance fee for fund earnings over a certain benchmark.[130] Therefore, successful hedge fund investment advisers are the most highly compensated group in the already high paying financial services industry.[131] FOFs charge investors even higher rates.[132] The enormous fees collected have enabled hedge funds to cover their high administrative costs[133] and to pay

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Funds Hire Lobbyists to Gather Tips in Washington, WALL ST. J., Dec. 8, 2006, at A1; Francisco Guerrera, *Hedge Fund's Hired Gumshoe to Give Lowdown on US Executives*, FIN. TIMES, Dec. 23, 2006, at 1.

128 *See* Nina Mehta, *The Trillion-Dollar Payoff*, INSTITUTIONAL INVESTOR, Oct. 2005, at 70; Chris Clair, *Hedge Funds Altering European FI Scene*, HEDGEWORLD, Dec. 21, 2006; Janet Lewis, *Shark on Shark Investment Banks Are Still Trying to Suss Out How to Treat Hedge Funds: As Clients or Rivals*, INVESTMENT DEALERS' DIGEST, Nov. 2005, at 1.

129 Besides management and performance fees, some hedge funds impose additional fees, such as up-front sales fees and redemption fees. *See* Canadian Securities Administrators, Hedge Funds, Staff Notice 81-316, Jan. 12, 2007, *available at* www.sfsc.gov.sk.ca/ssc/files/nat-noti/81-316.pdf.

130 Eurekahedge, Frequently Asked Questions, www.eurekahedge.com/news/faq.asp (last visited Sept. 9, 2007); Christine Williamson, *Psst! That Will Be an Extra 8%*, PENSIONS & INVESTMENTS, Aug. 7, 2006, at 3. Hedge funds often use a "hurdle rate" and a "high-water mark." *Id.* A "hurdle rate" is a minimum rate of return prior to applying the performance fees. Often the hurdle rate equals some variable index, such as a floating interest rate. *Id.* A "high-water mark," requires the hedge fund to recover any losses and return to the last high-water mark before fully imposing the performance fees. *Id.* Thus, performance fees are often eliminated or reduced when the hedge fund makes money back that was previously lost. *See* Amey Stone, *Hedge Funds, Fees Down? Close Shop*, BUS. WEEK ON-LINE, Aug. 8, 2005, http://www.businessweek.com/bwdaily/dnflash/aug2005/nf2005088_1711_db042.htm (citing an explanation by Ron Geffner, attorney for hedge funds at Sadis & Goldberg). When losses are small, high-water marks help to encourage the hedge funds to work harder for the investor; but when losses are large, high-water marks may encourage the hedge fund to close down. *See* Edward Chancellor & John Christy, *Exile for a Failed Hedgie?*, WALL ST. J., Jan. 8, 2007, at C10.

131 Compensation for the top twenty-five hedge fund advisers averaged $363 million in 2005. Adam Shell, *$363 is Average Pay For Top Hedge Fund Managers*, USA TODAY, May 26, 2006, at B1.

132 FOFs often charge up to an additional one percent management fee and an extra ten percent of the profits. PHILIPS, *supra* note 83, at 19.

133 *See* COTTIER, *supra* note 6, at 31.

the highest salaries for top talent.[134] The lucrative compensation structure also provides incentives to hedge fund managers who attempt to maximize high financial returns for the hedge funds,[135] even when the transactions represent risky behavior. The SEC notes that these performance fees create an environment where hedge fund advisers have tremendous financial rewards if successful, and little to lose if not.[136]

C. Mysterious Due to Secrecy, Off-shoring, and Complexity

Deeply mysterious and bordering on sinister is the public image of the hedge fund business.[137] This mysteriousness arises from hedge fund secrecy, routine off-shoring of hedge fund administration, and other complexities in understanding hedge funds' structures and values. An EU official argues that hedge funds have an image problem because they have failed to promote their contributions to society.[138] However, hedge fund secrecy poses more risks for financial stability now that the industry has grown so large and powerful. Government regulation can mandate some financial disclosure to help prevent hedge fund secrecy from undermining the integrity and stability of the global financial markets.

Hedge funds release only limited information, hiding their trading activities and assets from the public, regulators, and often

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134 Hedge funds pay professional employees roughly 50% to 100% more than investment firms. Hedge funds reward fixed-income professionals with an average annual salary of $210,000 and an average bonus of $625,000. Christopher O'Leary, *Hedge Funds: Big Question New Research Shows Just How Large a Role Hedge Funds Have in the High Yield Market Today*, INVESTMENT DEALERS DIGEST, Oct. 2, 2006, at 7.

135 This behavior is sometimes referred to as hedge funds seeking "absolute returns," rather than the more prudent financial returns based upon risk. *See* SEC STAFF, 2003 REP., *supra* note 11, at viii.

136 SEC STAFF, 2003 REP., *supra* note 11, at 62 n.213.

137 Jenny Anderson, *Hedge Funds Walk a Hard Line Between Silence and Sharing*, N.Y. TIMES, Feb. 9, 2007, at 7.

138 *See* Tobias Buck, *Hedge Funds and Private Equity 'Are Good for the Market,'* FIN. TIMES, Feb. 20, 2007, at 6 (interview with Charles McCreevy, EU Commissioner for Internal Market and Services). The SEC's restrictions on general solicitation by private funds contributes to the atmosphere of secrecy surrounding hedge funds. *See Hedge Funds and Systemic Risk in the Financial Markets: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 12 (2007) (statement of James Chanos, Chairman, Coalition of Private Investment Companies).

even from their investors.[139] To protect proprietary trading strategies, hedge funds typically disclose very limited information to the public and the government about their investment strategies and financial results.[140] Although hedge funds often communicate with investors through investment newsletters and password protected websites,[141] they also may decline to share even basic information about their fund with the investors.

Secrecy is further promoted by hedge funds through the substantial use of "side letter" agreements that give selected investors more favorable terms, but are not disclosed to other investors.[142] Similarly, hedge funds may hide poor performing assets in "side pocket" accounts to exclude them from affecting the funds value for purposes of calculating performance fees.[143]

Hedge funds are international in nature and are often legally domiciled offshore in a tax haven country[144] and managed in a

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139 Secrecy exists with hedge funds in order to protect proprietary trading strategies; thus, even the hedge funds' investors often receive very little information. *See* SEC STAFF, 2003 REP. *supra* note 11, at 46–47. Only in the past few years has some hedge fund data become publicly available through data vendors such as Hedge Fund Research and TASS. *See* Mila Getmansky, Andrew W. Lo & Shauna X. Mei, *Shifting Through the Wreckage: Lessons from Recent Hedge Fund Liquidations* 2 (Nov. 14, 2004), http://web.mit.edu/alo/www/Papers/fail5.pdf.

140 *See* SEC STAFF, 2003 REP., *supra* note 11, 46–47.

141 *Id.* at 45.

142 Deborah Brewster, *Hedge Fund Agreements Receive Close Scrutiny: Side Letters Which Provide Some Investors With Favorable Terms, Are an Area of Regulatory Concern*, FIN. TIMES, June 22, 2006, at 27. Side letters have become common particularly for redemption terms and fees. Pension investors might require side letters requiring more frequent pricing information and more information about investment strategies. *See Side Issues*, CAYMAN ISLANDS SUPPLEMENT, Apr. 2006, at 14, *available at* http://incisivemedia.com/hfr/specialreport/Caymans2006.pdf. Some side letters raise legal issues. For example, Goldman Sachs is alleged to have made secret agreements with hedge funds to buy Lazard stock and immediately sell it back to Goldman, creating the appearance of an active market for the stock. *See* Lazard Ltd. v. Wasserstein, 415 F. Supp. 2d 393, 395 (S.D.N.Y. 2006).

143 Roel C. Campos, Comm'r, Sec. & Exch. Comm'n, Remaiks at the SIA Hedge Funds & Alternative Investment Conference (June 14, 2006), http://www.sec.gov/news/speech/2006/spch061406rcc.htm. Some hedge funds are placing as much as twenty-five percent of their investments in side pocket accounts. *See* Gregory Zuckerman & Scott Patterson, *Street Sleuth: Side-Pocket Accounts of Hedge Funds Studied*, WALL ST. J., Aug. 4, 2006, at C3. Side pocket accounts are also used to make investments in illiquid assets. *Side Issues*, *supra* note 142, at 14.

144 SEC STAFF, 2003 REP., *supra* note 11, at 10.

different country.[145] Clients and other integral parties often come from a third country.[146] The most popular locations for offshore hedge funds are the Cayman Islands[147] and, to a lesser extent, other exotic island tax havens.[148] These islands offer sophisticated financial expertise in an attractive location. They also have excellent telecommunications infrastructures, beneficial tax laws, and strong bank secrecy laws.[149] To a lesser extent, hedge funds are located in low tax countries, such as Ireland.[150] Several countries have recently modified their laws to permit hedge funds to operate in the country and, in turn, attract investors to those countries. Outsourcing complex back operations for

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145 "Although London is a popular location for hedge fund managers, hedge funds themselves are not established in the U.K. For tax reasons, the funds locate in offshore jurisdictions .... The fund itself will have its own governance arrangements, which will operate outside the U.K." Fin. Services Auth., *Hedge Funds and the FSA* 6 (Fin. Serv. Auth, Feedback Statement on Discussion Paper No. 16, 2003), www.fsa.gov.uk/pubs/discussion/fs16.pdf. Other popular domiciles for hedge fund managers are the United States and Bermuda. *See* COTTIER, *supra* note 6, at 75.

146 ALT. INV. GROUP, *supra* note 35, at 4. For example, a particular unregistered hedge fund was domiciled in the British Virgin Islands, owned by an Austrian citizen, and managed by a hedge fund administrator in New York. *See* Fin. Asset Mgmt., Inc., *supra* note 123. The SEC charged all three parties with fraud. *Id.* In the release, the SEC accepted an offer of settlement with the prime broker that held most of the fund's securities. *Id.*

147 The Cayman Islands is currently the most popular international location for the hedge fund industry. The Cayman Islands also services several other specialized financial industries. Another major reason for the Cayman Island's popularity is its flexible regulatory environment. *See* James Eedes, *Cayman Islands - Offshore, On Target*, THE BANKER, July 3, 2006, at 106.

148 SEC STAFF, 2003 REP., *supra* note 11, at 10. Outside of the United States, the British Virgin Islands used to capture the most hedge fund business, as measured by the number of funds; the Netherlands Antilles held the greatest amount of hedge fund assets. *See* COTTIER, *supra* note 6, at 74, 101.

149 Eedes, *supra* note 147.

150 Dublin, Ireland is a major offshore financial center for the administration of alternative investment funds: firms in Ireland administer about twenty-five percent of the world's hedge fund investments. *See* Damian Neylin, PricewaterhouseCoopers, *Regulatory Frameworks – A Key Challenge for the Hedge Fund Industry*, FINANCE DUBLIN, July 2004, *available at* http://www.pwc.com/extweb/service.nsf/docid/2DAD30C1F5F5EFEF80256ED9002B2988; *see also* Mark Hutchinson, *Hedge Funds: An Irish Perspective*, 24 IRISH J. OF MGMT. 55 (2004). Ireland is considered a "quality regulator," which enables institutional investors to shorten the due diligence period they need before investing. *See* Rita Raagas de Ramos, *Singapore Market Proposes Listing of Hedge Funds*, WALL ST. J., Mar. 5, 2006, at B3.

administratively valuing hedge fund assets increases the mysteriousness and financial risk presented by hedge funds.[151]

Not only is the hedge fund industry secretive, but the accounting and financial reporting of a hedge fund's profits is also complicated[152] for four major reasons.[153] First, hedge funds usually involve extensive trading, so there are many transactions to analyze and record.[154] Second, hedge funds are subject to complicated accounting requirements that arise from a hedge fund's use of derivatives.[155] Third, hedge funds often lack the

151 ARMELLE GUIZOT, THE HEDGE FUND COMPLIANCE AND RISK MANAGEMENT GUIDE 74 (John Wiley & Sons 2007).

152 Hedge fund accounting is a significant reason for SEC investigations and a contributing factor for a significant number of financial restatements by public companies. *See* Timothy S. Kviz, Professional Accounting Fellow, Office of the Chief Accountant, Sec. & Exch. Comm'n, Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 11, 2006), http://www.sec.gov/news/speech/speecharchive/2006speech.shtml (follow "Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments" hyperlink).

153 Errors are common in the accounting for hedge fund transactions. Errors often arise because of complexities, particularly in international business transactions and the accounting for derivatives. For example, a survey conducted by the "International Swaps and Derivatives Association" revealed that twenty percent of the credit derivatives traded in 2005 were initially recorded erroneously. Richard Beales, *Equity Derivatives Face Scrutiny*, FIN. TIMES, Aug. 21, 2006, at 15. However, accounting complexity gives an advantage to those who intend to misuse the rules. *Freddie Mac: Accounting Standards Issues Raised in the Doty Report: Testimony Before the House Comm. on Energy and Commerce*, 108th Cong. 18 (2003) (statement of Baruch Lev, Professor, Stern School of Business).

154 Documentation required under International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) for hedge fund accounting should include a risk management objective and strategy, identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the entity will assess the hedging instrument's effectiveness. *See* John McDonnell, *Hedge Accounting Under International Financial Reporting Standards*, ACCOUNTANCY IRELAND, Apr. 2004, at 8, 9. The documentation required under the SEC's derivative accounting policies footnote is somewhat similar. *See* 17 C.F.R. § 210.4-08(n) (2007).

155 In the United States, the Financial Accounting Standards Board (FASB) has issued several lengthy "Financial Accounting Standards" (FAS) relating to derivatives and hedge funds. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 155: ACCOUNTING FOR CERTAIN HYBRID FINANCIAL INSTRUMENTS (2006), *available at* http://www.fasb.org/pdf/fas155.pdf; FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 149: AMENDMENT OF STATEMENT 133 ON DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

control systems to ensure proper accounting.[156] Fourth, hedge funds use intricate tax planning structures, adding to the accounting and financial reporting challenges.[157]

The financial statements of hedge funds are sometimes neither based on generally accepted accounting principles (GAAP)[158] nor audited by CPA firms. Investors should be particularly skeptical

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(2003), *available at* http://www.fasb.org/pdf/fas149.pdf; FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 138: ACCOUNTING FOR CERTAIN DERIVATIVE INSTRUMENTS AND CERTAIN HEDGING ACTIVITIES (2000), *available at* http://www.fasb.org/pdf/fas138.pdf; and FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 133: ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES (1998), *available at* http://www.fasb.org/pdf/fas133.pdf. The accounting complexity for derivatives led the European Union to ignore part of IAS 39 regarding the accounting for derivatives. *See* Council Regulation 1606/2002, 2002 O.J. (L 243) (EC), *available at* http://eur-lex.europa.eu/LexUriServ/site/en/oj/2002/l_243/l_24320020911en00010004.pdf; Commission Regulation 1725/2003, 2003 O.J. (L 261) 1 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_261/l_26120031013en00010002.pdf.

156 An SEC release prompted the FASB in 1998 to issue FAS 133 on the accounting for derivatives. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 133, *supra* note 155. The concern was that different enterprises reported similar derivative activities differently. Furthermore, results of derivative transactions were often not reported on the income statement. Under FAS 133, hedge fund accounting defers recognizing gains or losses on derivatives. However, numerous conditions are required, called hedge criteria. Hedge criteria vary depending on the nature of the risk hedged. The accounting for derivatives depends on how the hedge is designated. The concern is whether the hedge is an exposure to changes in the fair value of the recognized asset or liability, or as a hedge to exposure from variable cash flows of a forecasted transaction. *FASB Derivative Accounting Standards: Hearing Before the Subcomm. on Commerce, Trade & Consumer Protection of the Comm. on Energy & Commerce*, 108th Cong. 9-15 (2003) (statement of Leslie F. Seidman, Member, Financial Standards Accounting Board).

157 Tax planning concerns include partnership allocations, performance fees against benchmarks, and realized gains and losses on a trade date basis. Other tax concerns may arise from interest due to withdrawing partners, loss carryforwards, and trading initial placement offers. Further issues include amortization of organizational costs, interest income when earned, tax allocations, and others. Hedge Fund Center, Hedge Fund Accounting Basics, http://www.hedgefundcenter.com (follow "Basics" hyperlink; then follow "Hedge Fund Accounting Basics" hyperlink) (last visited Sept. 10, 2007).

158 *See* DOUGLAS L. HAMMER, U.S. REGULATION OF HEDGE FUNDS 269 (American Bar Association 2005). In 1997, the SEC criticized corporate "footnote disclosures" on derivatives as too general. Footnote disclosures are required by FAS 119 on the accounting policies for derivatives. General disclosures made it difficult to determine the real financial impact of derivatives on the company. Thus, the SEC took action within Regulation S-K to require public companies to provide enhanced descriptions of the accounting policies for derivatives. *See* 17 C.F.R. § 210.4-08 (2007).

of a hedge fund's financial performance.[159] Nevertheless, investors seeking to redeem an investment from a hedge fund must rely on the hedge fund's financial accounting.[160] Regulation requiring audited financial statements would provide greater reliability of the financial information and would therefore better protect individual investors.

The complex structure of hedge funds is motivated by tax, securities law, and business considerations.[161] A typical "domestic hedge fund," organized under U.S. law, is structured as a limited partnership with the fund adviser as the general partner and the passive investors as limited partners.[162] A typical "offshore hedge fund" uses a master-feeder structure that has two basic feeder

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159 Audits of hedge funds' financial statements are not subject to the Public Company Accounting Oversight Board's examination process of auditors.

160 Withdrawal of funds from a hedge fund is often difficult. Investors often have little control in when to withdraw assets from hedge funds because withdrawals generally may only be made on a quarterly or monthly basis after the hedge funds have performed their accounting. *See* CRM POLICY GROUP II, *supra* note 6, at B-15. Also, hedge funds also may have an initial two year lock-up when no redemption by an investor is allowed. This lock-up period was partly created as a response to escape the SEC's first attempt to regulate hedge funds. *See* HUW VAN STEENIS ET AL., MORGAN STANLEY, PERMANENT AND STICKIER CAPITAL FOR ALTERNATIVE ASSETS 2 (2006), http://www.morganstanley.com/institutional/primebrokerage/pdf/HVanSteenis_July_7_2006.pdf.

161 *See* KMPG L.L.P., TAXATION AND THE COMPETITIVENESS OF UK FUNDS 17 (2006), http://www.hedgeweek.com/download/36066/ Joint%20KPMG%20IMA%20TAX%20REPORT.pdf. *See generally* John W. Haskins, Comment, *The Off-Shore Hedge Fund*, 8 COLUM. J. TRANSNAT'L L. 79, 84 (1969) (indicating the funding of offshore hedge funds is substantially due to the Foreign Investors Tax Act of 1966). In the United States, hedge funds want to avoid qualifying as a retirement plan and having additional onerous fiduciary duties. *See* IRC § 404(a)(1) (2000) (enacted as part of ERISA, The Employee Retirement Income Security Act of 1974). The Pension Protection Act of 2006 liberalized the ERISA "plan assets" rule, so that pension plans can own twenty-five percent in a hedge fund, without the hedge fund becoming a retirement plan. *See* Deborah Solomon, *Congress May Let Hedge Funds Manage More Pension Money*, WALL ST. J., July 28, 2006, at A1; Arnold & Porter, LLP, Pension Legislation to Make Important Changes for Hedge Funds (Aug. 2006), http://www.arnoldandporterllp.com/pubs/files/A&PAdvisory_Pension%20Legislation%20to%20Make%20Important%20Changes%20for%20Hedge%20Funds.pdf.

162 SEC STAFF, 2003 REP., *supra* note 11, at 9. Business considerations include investor and marketing concerns. Tax issues focus primarily on pass-through possibilities to avoid double taxation. Securities law considerations include meeting the requirements for exemption to registration with the SEC. *See* COTTIER, *supra* note 6, at 71.

entities pouring their capital into an offshore master corporation.[163] One feeder entity exists for both the offshore investor and tax-exempt U.S. investor.[164] The other feeder is for the U.S. investor who wants to invest in a feeder that is taxed as a partnership – usually a limited liability company or private limited partnership is used[165] in order for the investor to avoid double tax at the entity level.[166] The master organization then makes the hedge fund investments and manages both the offshore hedge fund and the domestic hedge fund.[167]

III. Problems With Hedge Funds

Although hedge funds are generally beneficial for the international financial system, they pose risks to the public.[168] Hedge funds can create market calamities and disruptions, as discussed in Part V.a. Also, hedge funds are particularly vulnerable to money laundering[169] and terrorist financing.[170] Part

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163 *See* HAMMER, *supra* note 158, at 106.

164 *See* Managed Fund Ass'n., Survey of Selected Substantive and Technical Issues Raised in SEC Comment Letters Re: Registration of Hedge Fund Advisers 6 (Oct. 22, 2004), http://sec.gov/rules/proposed/s73004/mfa102204.pdf.

165 PHILIPS, *supra* note 83, at 4. In Australia, hedge funds are most commonly structured as trusts. However, also used are corporate structures, typically unlisted and domiciled in offshore tax havens. Scott McNally et al., *The Australian Hedge Fund Industry*, FIN. STABILITY REV., Sept. 2004, at 58.

166 Aude Thibaut de Maisieres, *Hedge Funds and Taxes: Tax Planning Strategies for U.S. Investors in Domestic and Offshore Hedge Funds*, CHAZEN WEB J. OF INT'L BUSINESS, Fall 2003, at 3. An offshore hedge fund eliminates the problem of a withholding tax on the distribution. *Id.*

167 See SEC STAFF, 2003 REP., *supra* note 11, at 9.

168 *See* Dan Waters, Director, Fin. Services Auth., Address at the AsiaHedge Conference: Regulation and Hedge Funds: An Effective and Proportionate Approach for a Dynamic, International Marketplace (Oct. 19, 2006), http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1019_dw.shtml; Fin. Services Auth., *supra* note 50, at 6-7.

169 Money laundering is the attempt to conceal the source or destination of money involved in an illegal activity. Money launderers engage in a financial transaction that "cleans" the money by making it harder to trace. In 2003, the Treasury Department proposed anti-laundering rules for unregistered investment funds. As of mid-2006, however, a final version of the money laundering rules for hedge funds still did not exist. *See* Chidem Kurdas, *New Idea for SEC Registration*, HEDGEWORLD DAILY NEWS, July 11, 2006; U.S. Dep't of the Treasury, Financial Crimes Enforcement Network, Frequently Asked Questions: Suspicious Activity Reporting Requirements for Mutual Funds (Oct. 4, 2006), http://www.fincen.gov/guidance_faqs_sar_10042006.pdf.

V.b. discusses the risk of hedge fund fraud, whether through market abuse, conflicts of interest, or tax evasion. Part V.c. explains how hedge fund problems can impact the ordinary investing public, such as through losses in pension plans from hedge fund investments.

A. Financial Shocks and Destructive Market Manipulations

Hedge funds have engaged in activities that have threatened the financial markets, currency markets, commodities markets, and real market prices for individual stocks. Hedge funds have the potential to create financial shock and disrupt the stable functioning of the financial markets more than other financial products because they involve greater leverage and risks.[171] The increased market volatility posed by hedge funds necessitates government regulation to reduce risk of market failures and fraud.

A financial shock can occur when a triggering event causes both sharp declines in the prices of some types of assets and a simultaneous tightening of credit, such as when margin calls are made to repay borrowing. These events cause the market to force entities to liquidate additional holdings, which further depresses asset prices, evaporates market liquidity,[172] and potentially wipes out the capital of various entities, leaving those entities bankrupt.

With the growing size of hedge funds, one concern is that hedge funds will have a herd mentality and take similar financial positions. Such behavior has the potential to reinforce a market collapse.[173] While the financial markets and the regulators have

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170 *See* Edmund L. Andrews, *Threats and Responses: Money Trail; U.S. Proposes Hedge Fund Rules to Prevent Terrorist Financing*, N.Y. TIMES, Sept. 19, 2002, at A23. A government official specializing in money laundering reporting in the Cayman Islands noted the connection between hedge funds and terrorist financing. Especially if the administrative services are outsourced outside of the United States, a hedge fund makes it easier to avoid complying with U.S. laws that protect the financial system from association with terrorist financing. *See* Maha Khan Phillips, *How to Commit Hedge Fund Fraud*, GLOBAL INVESTOR, Oct. 2004, at 31.

171 When hedge funds unwind their leverage, the impact can exaggerate a downturn in the markets. For example, gold stocks dropped twenty-nine percent in one month, principally because of hedge fund activity. Bogdanor, *supra* note 76, at 2.

172 *Id.* at 5.

173 *See* Lars Nyberg, Deputy Governor, Sveriges Riksbank, Address at a Meeting at Nordea and the CFA Society of Sweden: Are Hedge Funds Dangerous? 5 (Nov. 24, 2006), http://www.bis.org/review/r061130d.pdf; Naoto Higashio et al., *Changes in Hedge Fund and Investment Behaviour and the Impact on the Financial Markets*, BANK

made progress in containing "financial disturbances," they are not as successful in preventing the more powerful "financial shocks" that may occur with little, if any, warning.[174]

The case of Long Term Capital Management (LTCM) first illustrated the threat to stable financial markets posed by hedge funds: "[a]lmost all of the country's major financial institutions were put at risk due to their credit exposure to LTCM."[175] LTCM was a well-regarded hedge fund with prominent fund managers. Several Nobel Prize winning economists founded LTCM in 1994.[176] Because LTCM used several aggressive trading strategies,[177] LTCM grew substantially in size, partly through leveraging to create a huge debt to equity ratio.[178]

LTCM collapsed suddenly and created a potential financial shock with the ability to affect the entire financial system. The combination of LTCM's risky trading strategies,[179] size, and leverage made it vulnerable to the market reaction from unexpected events, such as the devaluation of Russia's currency in 1998. LTCM's debt was not apparent to regulators prior to its collapse.[180] Because of the global flight to quality investments,

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OF JAPAN REV., Dec. 2006, at 3 ("There is a growing perception among market participants that the investment behavior of hedge funds is gradually becoming more homogeneous.").

174 *See* CRM POLICY GROUP II, *supra* note 6, at 6.

175 Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006) (citing ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (Random House 2000)).

176 John Meriwether, along with Nobel Prize winners Myron Scholes and Robert Merton, created LTCM as a Delaware Limited Partnership that operated a Cayman Islands partnership. ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 31, 32 (Random House 2000).

177 Aggressive trading strategies included "convergence trading" and "dynamic hedging." *Id.* at 52, 119.

178 LTCM created a debt to equity leverage ratio exceeding 25:1. U.S. GEN. ACCT. OFF., LONG-TERM CAPITAL MANAGEMENT REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK 7 (1999), *available at* http://www.gao.gov/archive/2000/gg00003.pdf. LTCM had off-balance sheet liabilities exceeding $1 trillion consisting primarily of future contracts, interest rate swaps, and over-the-counter derivatives. *Id.* at 6.

179 LTCM relied too much on theoretical market-risk models. *See* David Shirreff, Lessons from the Collapse of Hedge Fund, Long Term Capital Management: Post-Mortem, http://riskinstitute.ch/146500.htm (last visited Sept. 12, 2007).

180 Reporting of the potential financial exposure to LTCM was not apparent because

LTCM would have failed but for a $3.5 billion bailout by its investor funds,[181] a bailout that was pressed by the Federal Reserve of New York.[182]

The banking system feared that the financial collapse of LTCM could create a wider collapse in the financial markets. The concern arose because of the possibility of a chain reaction in liquidity investments, leading to a drop in prices and the need for other entities to liquidate. The LTCM episode made it clear that hedge fund failures could disrupt the financial markets on both a domestic and global level.[183] As a result, a Presidential Working Group was organized.[184] The Working Group made several recommendations, including acquiring more frequent and meaningful information on hedge funds.[185]

Fixed rate currency pressure by hedge funds was demonstrated even before LTCM.[186] Two major examples were the European Monetary System exchange rate realignments in the early 1990s[187] and the Asian financial crisis in 1997.[188] At the time of the Asian crisis, Hong Kong's financial secretary called for a coordinated

much of the transactions were with affiliates outside of regulated entities. *See* U.S. GEN. ACCT. OFF., *supra* note 178, at 16–19.

181 *See* Ibrahim Warde, *LTCM, A Hedge Fund Above Suspicion*, LE MONDE DIPLOMATIQUE, Nov. 1998, *available at* http://mondediplo.com/1998/11/05warde2.

182 U.S. GEN. ACC. OFFICE, *supra* note 178, at 1.

183 *Id.* at 29. The potential collapse of the LTCM fund prompted a review of the lack of regulatory control over hedge funds. *See id.* at 30. However, no major legal changes were made. *See id.* at 30-31.

184 *See* WORKING GROUP REPORT I, *supra* note 46, at viii.

185 *Id.*

186 Barry Eichengreen & Donald Mathieson, *Hedge Funds: What Do We Really Know?*, ECONOMIC ISSUES, Sept. 27, 1999; *see also* Sherry M. Shore, *SEC Hedge Fund Regulatory Implications on Asian Emerging Markets: Bottom Line or Bust*, 13 CARDOZO J. INT'L & COMP. L. 563, 563 (2005).

187 George Soros' Quantum Fund made $1 billion betting against the Bank of England's support of the U.K.'s currency. *See* Timothy O'Brien, *He's Seen The Enemy, It Looks Like Him*, N.Y. TIMES, Dec. 6, 1998, at M1.

188 The Asian financial crisis led to currency devaluations and stock market crashes in Thailand, Korea, Indonesia, and other Asian countries. While Westerners primarily blamed "crony capitalism" for the Asian financial crisis, hedge funds played a notable role in forcing most governments with fixed rate currencies to float the currency to reflect market realities. *See* Brian Caplen, *Where Will the Mud Stick?*, EUROMONEY, Feb. 1999, at 44.

international effort to monitor speculative hedge funds and limit their access to capital.[189] The foreign currency market has surged in volume in recent years, primarily due to trading by hedge funds.[190] As a result, the foreign currency markets have become more vulnerable to manipulation by hedge funds. Therefore, there is more need for government regulation and international coordination to monitor tactics utilized in the hedge fund industry to influence various financial markets.

Commodities manipulation is easily revealed through hedge fund failures. Although some hedge funds are regulated by the Commodity Futures Trading Commission (CFTC),[191] CFTC regulation has not prevented hedge funds from significantly affecting various commodity prices through speculative option purchases.[192] Amaranth Advisers was a hedge fund which lost about $6 billion in the natural gas industry in 2006 – about two-thirds of its capital.[193] Amaranth's attempt to monopolize oil and gas futures kept such prices artificially high until the hedge fund had to off-load its assets in distress.[194] After the Amaranth

189 *See Track the Hedge Funds*, ASIAWEEK, Oct. 23, 1998, at 60, 60-61.

190 *See* MARTIN BECK & MAREK MARCINIAK, HEDGE FUNDS ACTIVITY AND INFLUENCE ON THE FOREIGN EXCHANGE MARKET (2006), http://www.ecb.int/paym/groups/pdf/Hedge_funds_fx_market.pdf. The non-bank professional trading community now represents more than one-third of the daily trading in the spot currency market. *See* CRM POLICY GROUP II, *supra* note 6, at B-11.

191 Over seventy percent of the largest hedge funds are "commodity pool operations" (CPOs) under the Commodity Exchange Act. 7 U.S.C. § 1a(5) (2000); *see* 17 C.F.R. § 4.10(d) (2007). Registered CPOs have disclosure, record-keeping, and reporting requirements. *See* 17 C.F.R. §§ 4.21-4.26 (2007). *See generally* GUIZOT, *supra* note 151, at 5.

192 The CFTC's enforcement activities against commodity pools average ten per year. Sharon Brown-Hruska, Acting Chairman, Commodities Futures Trading Comm'n, Keynote Address at the Sec. Indus. Ass'n Hedge Funds Conferece (Nov. 30, 2004). A substantial majority of these cases involved stealing or the outright misappropriation of investor funds. *Id. See, e.g., U.S. Commodity Futures Trading Commission Charges Utah Resident William D. Perkins With USD 3.4 Million Hedge Fund Fraud*, HEDGEWEEK, Oct. 11, 2006.

193 *See* Ann Davis et al., *Hedge Fund Hardball: Amid Amaranth's Crisis, Other Players Profited*, WALL ST. J., Jan. 30, 2007, at A1. One of the big losers was the Pension Fund of San Diego which lost more than $100 million from the Amaranth hedge fund. *See Hedge Fund Loss Prompts Call for Regulation* (News Hour television broadcast Oct. 23, 2006).

194 *See* Dan White, *When Hedge Funds Falter, All Bets Are Off*, SUNDAY INDEP. (Ir.), Oct. 1, 2006. Gregory Zuckerman, *Outside Audit: How the Wreck from Amaranth*

Advisers scandal emerged,[195] the House of Representatives passed the Hedge Fund Study Act to request a federal study of the hedge fund industry.[196]

The United States Senate Judiciary Committee studied stock manipulation by hedge funds in June 2006.[197] Allegations arose that powerful hedge funds were manipulating the stock market prices of individual companies by colluding with supposedly independent securities analysts.[198] A lawyer testifying before Congress explained that hedge funds manipulate stock prices by selecting a target company (usually high tech, bio-tech, or pharmaceutical), selling the stock short, and then colluding with a stock analyst to prepare a false and negative research report on the company.[199] Once the hedge fund has accumulated a substantial short position, the analyst's report is widely disseminated.[200] These actions cause the price of the target stock to decline and

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Was Contained; J.P. Morgan and Citadel Swooped In, Assumed Risk, Proving Markets' Resilience, WALL ST. J., Oct. 5, 2006, at C3.

195 In Amaranth, financial losses were not disclosed until the final day of the redemption period for the quarter. *See* Ann Davis & Henny Sender, *Amaranth to Discuss Losses With Clients; Bid To 'Earn Back' Investors' Trust Could Also Help Alter Standards on Disclosing Hedge-Fund Data*, WALL ST. J., Sept. 22, 2006, at C1.

196 Hedge Fund Study Act, H.R. 6079, 109th Cong., (as passed by House, Sept. 27, 2006).

197 *Hedge Funds and Independent Analysts: How Independent Are Their Relationships?: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. (2006).

198 *See, e.g.*, Henny Sender, *Hedge Funds: Reward and Risk: Behind an Attack on Farmer Mac – Gotham Partners' Heavy Research Raised Questions, and the Fund Made Sure Everybody Listened*, WALL ST. J., Apr. 11, 2003, at C1. Similar allegations exist for the short-selling of stocks outside of the United States. *See, e.g.*, Jesse Westbrook, *Hedge Funds Withdraw SEC Registrations After Ruling*, BLOOMBERG, Sept. 22, 2006, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid =aK65W2d5dv2s (discussing the investigation of Aeneas Capital Management and its bets on Malaysian stocks).

199 SEC regulations, however, require analysts to certify the truthfulness of their position expressed in research reports and other media. 17 C.F.R. §§ 242.500-242.505 (2007); *see* William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice In a Time of Madness?*, 54 EMORY L.J. 843, 965–66 (2005).

200 Similarly, a lawsuit alleged that a hedge fund employed a secret agent to blackmail employees of a company that the hedge fund was short selling. Lawyers claimed that such nefarious activities are not uncommon in the world of short selling. *See* Christine Seib, *Hedge Fund Faces Lawsuit Over 'Dick Tracy' Allegations*, TIMES (London), Aug. 19, 2006, at 57.

enable the hedge fund to profit.[201] Government regulation targeting these tactics could deter hedge funds and stock analysts from colluding and manipulating stock prices for their financial gain.

The fundamental assumption of securities law – that stockholders vote in accordance with their economic interests – is undermined by techniques that some hedge funds are using to manipulate stock values of individual companies.[202] Two recently revealed techniques used by hedge funds are "empty voting"[203] and "vote morphing."[204] These techniques borrow shares to acquire added voting power, while simultaneously shorting the underlying stock so as to use the voting power to undermine the company's position and then profit when the company's stock subsequently drops. "Empty voting usually doesn't trigger current disclosure rules because these rules do not cover borrowed stock or derivatives holding" unless an investor owns more than five percent of the stock.[205] Many hedge funds remain just under that threshold level and use empty voting to enlarge and hide their voting power.

B. Fraud and Its Opportunity Through Conflicts of Interest

Fraud requires incentive, opportunity, and rationalization,

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201 *Marc E. Kasowitz Provides Details of What He Termed a 'Simple, But Frighteningly Destructive Scheme' to Manipulate the Stock Market in Testimony Before the U.S. Senate Judiciary Committee*, PR NEWSWIRE, June 28, 2006; *see also* Phyllis Feinberg, *Hedge Fund Collusion?*, MAR/HEDGE, Sept. 11, 2006, at 3.

202 *See* Paul S. Atkins, Comm'r, Sec. & Exch. Comm'n, Remarks at the Corporate Director Forum 2007 (Jan. 22, 2007), *available at* http://www.sec.gov/news/speech/2007/spch012207psa.htm.

203 Emptied voting is when the voting rights are separated or emptied from the accompanying economic ownership. Henry T. C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. L. 1011, 1014 (2006) [hereinafter Hu & Black, *Empty Voting*]; *see* Kara Scannell, *Outside Influence: How Borrowed Shares Swing Company Votes; SEC and Others Fear Hedge-Fund Strategy May Subvert Elections*, WALL ST. J., Jan. 26, 2007, at A1; *see also* Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 820 (2006) [hereinafter Hu & Black, *The New Vote Buying*].

204 Vote morphing is renting shares from other investors immediately before a shareholder vote, so that investors can plausibly deny the economic ownership that triggers disclosure requirements. Hu & Black, *Empty Voting*, *supra* note 203, at 1014.

205 *Id.*

factors that arise easily in the hedge fund industry.[206] Although hedge funds are subject to basic antifraud requirements in the Securities Exchange Act,[207] the Act failed to prevent fraud in the over ninety cases that the SEC has brought against hedge fund advisers since 2001.[208] Fraud is believed to be involved in over half of all hedge fund closures.[209] Common types of fraud have included misappropriation of assets,[210] misrepresentation of

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206 The usual incentive for hedge fund fraud is greed related to the large potential compensation available to hedge fund managers. An unregulated hedge fund manager may have an easy opportunity to engage in fraud, particularly if he possesses a strong concentration of powers over funds. This is especially true if lack of appropriate internal controls and the complexity of the transactions make it easy to hide the fraud. A hedge fund manager may rationalize his fraud by maintaining that all will work out in the long run. *See* Greg N. Gregoriou & William Kelting, *The Billion-Dollar Hedge Fund Fraud*, 12 J. OF FIN. CRIME 172, 173 (2004).

207 *See* 15 U.S.C. § 78j (2000); 17 C.F.R. § 240.10b-5 (2007).

208 *Nightly Business Report: The SEC Turns to Capitol Hill For Hedge Fund Help* (PBS television broadcast Jul. 25, 2006) (statement of Christopher Cox). *But cf. Sants Won't Go Marching In*, INSTITUTIONAL INVESTOR, Sept. 2006, at 14 (discussing the first fine imposed on the U.K.'s hedge fund industry).

209 *See* MARK JICKLING & ALISON A. RAAB, CRS REPORT FOR CONGRESS: HEDGE FUND FAILURES 4 (Congressional Research Service 2007) (citing Corentin Christory et al., *Quantification of Hedge Fund Default Risk*, J. Alternative Investments, Fall 2006, at 71, 76), *available at* http://www.abiworld.org/pdfs/June2007HedgeFundFailures.pdf. However, another study suggests that half of all hedge fund failures are attributable to operational risk. DELOITTE TOUCHE TOHMATSU, PRECAUTIONS THAT PAY OFF: RISK MANAGEMENT AND VALUATION PRACTICES IN THE GLOBAL HEDGE FUND INDUSTRY 10 (2006) (citing Stuart Feffer & Christopher Kundro, Understanding and Mitigating Operational Risk in Hedge Fund Investments § 3.1 (Mar. 2003), *available at* http://www.capco.com/assets/DFA90A4A-E6DD-4F62-9466-ACD1A05A25FF.pdf), http://www.deloitte.com/dtt/cda/doc/content/us_fsi_HedgeFundsRiskMgmt_Jan07%20%282%29.pdf. This risk includes "misrepresentation of fund investments, misappropriation of investor funds, unauthorized trading, and inadequate resources." STUART FEFFER & CHRISTOPHER KUNDRO, UNDERSTANDING AND MITIGATING OPERATIONAL RISK IN HEDGE FUND INVESTMENTS § 3.2 (Capital Markets Co. Ltd. 2003), *available at* http://www.capco.com/assets/DFA90A4A-E6DD-4F62-9466-ACD1A05A25FF.pdf; *see also* Stuart Feffer & Christopher Kundro, *Understanding and Mitigating Operational Risk in Hedge Fund Investments*, 10 J. OF FIN. TRANSFORMATION 41, 42-44 (2004), *available at* http://www.capco.com/WorkArea/showcontent.aspx?id=1712.

210 SEC STAFF, 2003 REP., *supra* note 11, at 73. For smaller hedge fund frauds, it is more common to have outright diversion of assets; for larger frauds, failed trading strategies are more common. *See Guarding Against Hedge Fund Fraud*, TRUSTING, Mar. 2005, at 27.

portfolio performance,[211] falsification of credentials or reporting,[212] improper valuation of assets,[213] and other fraud arising from various conflicts of interest.[214]

"Private investment in public equity" (PIPE) transactions comprise another common type of fraudulent transaction involving hedge funds.[215] In a PIPE, a company sells unregistered stock at a discount because the stock is illiquid.[216] Then, the investor hedges its PIPE purchase by shorting the public stock.[217] Using the unregistered stock as a cover for the short sale is illegal.[218] In a PIPE, the effect is as if additional registered stock existed, when it did not.[219]

An opportunity for fraud arises from various conflicts of interest that exist for hedge fund advisers. For example, some hedge fund advisers oversee more than one fund, trading other types of financial investments like mutual funds. This "side by side" management enabled some advisers to favor hedge funds in order to provide the adviser more lucrative compensation.[220] This preferential treatment is at the expense of other clients, such as mutual fund shareholders.[221] Widespread hedge fund involvement

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211 SEC STAFF, 2003 REP., *supra* note 11, at 73. *See generally* Maha Khan Phillips, *How to Commit Hedge Fraud*, GLOBAL INVESTOR, Oct. 2004, at 31. Principal categories of securities law violations for hedge fund investments are antifraud violations, reporting violations, and record keeping/internal control violations. *See also* Mary Ann Gadziala, Associate Director, Office of Compliance Inspections and Examinations, Address at the International Bar Association Conference, Financial Services Section: Structured Finance Activities: The Regulatory Viewpoint (Sept 20, 2006).

212 SEC STAFF, 2003 REP., *supra* note 11, at 73.

213 *Id.*

214 Other reasons for fraud may include misleading disclosures or "pump and dump" schemes, through which untrue or misleading information about a company is disseminated. *See id.* at 74; *see also* GUIZOT, *supra* note 151, at 261.

215 *See* Kara Scannell, *Three New York Hedge Funds Settle Charges Tied to Trading*, WALL ST. J., Mar. 15, 2006, at C4.

216 *Id.*

217 *Id.*

218 *Id.*

219 For various examples of PIPES, see GUIZOT, *supra* note 151, at 260.

220 *See* Fin. Services Auth., *supra* note 50, at 62.

221 *See id.*

in "late trading"[222] and inappropriate "market timing"[223] throughout the industry[224] was discovered in 2004.[225] Hedge funds that had special deals with selected investors cost ordinary stock investors millions of dollars.[226]

Various other potential conflicts of interest arise in hedge

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222 "Late trading" is illegal. It involves profiting from market events occurring after the stock market closes at 4:00 P.M. Eastern time. The trader benefits from updated market information while taking advantage of the market's outdated closing price. *See* Kip Betz, *N.Y. AG Launches Probe of Fraud Industry: Hedge Fund Pays $40M to Resolve Claims*, SEC. L. DAILY (BNA), Sept. 4, 2003; Randall Smith & Tom Lauricella, *Law Firms Advised on Rules Governing Funds Late Trading*, WALL ST. J., Dec. 2, 2003, at C1.

223 "Market timing" involves the "rapid fire" purchase of mutual fund shares to take advantage of the fund's share price from the prior day's valuation of the underlying assets. *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Hearing on Investigations and Regulatory Actions Regarding the Mutual Fund Industry and Investors' Protection Before the Comm. on Banking, Housing & Urban Affairs*, 108th Cong. (2004) 541-43 (statement of David M. Walker, Comptroller Gen., U.S. Gen. Accounting Office). Market timing attempts to skim the profits from other investors. *Id.* For several years, the SEC failed to uncover market timing abuses in mutual funds, costing shareholders about $5 billion. *See SEC Missed Mutual Fund Abuses*, CONSUMER AFFAIRS, Apr. 2005.

224 The mutual fund scandal was estimated to cost long-term investors an additional $400 million per year. Kim Clark, *Mutual Mess: The Fund Scandal Grows and Grows*, U.S. NEWS & WORLD REP., Nov. 17, 2003, at 43. According to Morningstar, as many as forty hedge funds were implicated in the mutual fund scandal. Amey Stone, *Hedge Funds Are Everyone's Problem*, BUSINESS WEEK ONLINE, Aug. 6, 2004. At least nineteen brokerage firms have entered into a settlement with the SEC regarding this activity. *See* Harry S. Davis & Sahar Shirazi, *Funds and Misdemeanours – And How To Avoid Each When Investing in Hedge Funds*, HEDGE FUNDS REVIEW, Oct. 2006, at 27, 30, 35 n.12., *available at* http://www.srz.com/files/October%202006%20-%20HedgeArticle.pdf.

225 For example, in August 2006, Prudential entered into a $275 million settlement over its market timing practices. *See* SEC. & EXCH. COMM'N, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 10 (2006), *available at* http://www.sec.gov/about/secpar/secpar2006.pdf. This settlement occurred after the SEC alleged that four Prudential brokers defrauded more than twenty-five mutual funds of more than $2.5 billion. *See* Ellen Rosen, *Savoring a Small Victory After a Market Timing Scandal*, N.Y. TIMES, Nov. 17, 2006, at C6.

226 Steven B. Boehm & Cynthia A. Reed, *Shedding Light on Hedge Funds: The SEC Rethinks the Lack of Regulation*, BUS. L. TODAY, May/June 2004, at 53. Prudential brokers generated more than $162 million for their hedge fund clients through improper market timing practices. Walter Hamilton, *Prudential Admits Improper Trading*, L.A. TIMES, Aug. 29, 2006, at C1. The $162 million in profit generated earned the brokers involved nearly $50 million in commissions. *Id.* While the mutual funds tried to block the trading, the brokers took countermeasures to evade the monitors. *Id.*

funds. Insider trading[227] by hedge fund employees is becoming an increasing concern.[228] A hedge fund may secretly line the adviser's pockets by inappropriately charging billions of dollars' worth of expenses to investors.[229] Similarly, a fund might buy a stock near the end of a quarter or year to drive up its price in order to show a more favorable fund performance and collect higher performance fees.[230] The reliability of hedge fund asset valuations is always a concern, especially because there are no standards for hedge fund valuations.[231] Also, a lack of uniformity in the

227 "Insider trading is illegal when a person trades a security while in possession of material non-public information in violation of a duty to withhold the information or refrain from trading." Sec. & Exch. Comm'n, The Law That Governs the Securities Industry, http:www.sec.gov/about/laws.shtml (last visited Sept. 15, 2007). In fiscal year 2006, twenty percent of all SEC investigations involved insider trading. SEC Chairman Cox stated that one reason for the increase in insider trading investigations was the incidence of suspicious transactions occurring prior to takeovers, transactions that were prompted by hedge funds and private equity funds. Stephen Taub, *SEC Probing Private Equity, Hedge Funds*, CFO.COM, Oct. 19, 2006, http://www.cfo.com/article.cfm/8069819?f=search; *see also* Kara Scannell & Randall Smith, *SEC Boosts Probe for Wall Street Leaks; Mutual-Fund Complaints Help Prompt Call for Data in Insider Investigation*, WALL ST. J., Feb. 7, 2007, at C15. For an example of a hedge fund manager being sentenced for insider trading, see Press Release, Michael J. Sullivan, U.S. Att'y, Dist. of Mass., Hedge Fund Manager Sentenced for Insider Trading (Nov. 29, 2006), http://boston.fbi.gov/dojpressrel/pressrel06/insidertrading112906.pdf. Hedge fund manager Michael K. C. Tom was sentenced to three years of probation for insider trading that occurred when he traded Citizens Bank common stock and options based on an insider tip concerning Citizens Bank's impending merger with Charter One Financial. *Id.*

228 For discussion of insider trading as it relates to hedge funds, *see Examining Enforcement of Criminal Insider Trading and Hedge Fund Activity: Hearing Before the S. Comm. on the* Judiciary, 109th Cong. 1277 (2006) (statement of Linda C. Thomsen, Director of Enforcement, Sec. & Exch. Comm'n).

229 For example, a Toronto-based hedge fund management company was accused by Italian prosecutors of illegally diverting more than $87 million in commissions, referral fees, and other expenses. *See* Michael Jivkov, *Small Talk: Langbar Founder Is Interviewed as Part of Investigation Into Hedge Fund Collapse*, THE INDEP., Dec. 19, 2005, at 54.

230 *See* Whitney Tilson, *Funds Dirty Little Secrets*, THE MOTLEY FOOL, Apr. 16, 2004, http://www.fool.com/investing/general/2004/04/16/funds-dirty-little-secrets.aspx. Academics are trying to determine why hedge funds almost always perform better in December than any other month and why performance is often negative in January. *See* Floyd Norris, *How Real Are Results from Hedge Funds?* INT'L HERALD TRIB., Apr. 21, 2006, at 16.

231 SEC Hedge Fund Adviser Rule, *supra* note 40, at 72,062–63; Mohamed Gaber et al., *Funds of Hedge Funds: Ethics of This Black Box Strategy*, 9 PENSIONS: AN INT'L J.

valuation of complex assets exist,[232] and an estimated one-third of hedge fund managers do not even disclose their valuation procedures to all of their investors.[233]

Outside service providers to hedge funds sometimes engage in activities involving conflicts of interest that violate their fiduciary responsibilities. For example, pension fund consultants[234] are sometimes offered higher fees for promoting hedge fund advisers who receive fees from FOFs.[235] Can outside service providers, such as investment banks,[236] really remain independent when they

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328, 331 (2004). Spain adopted new rules to preserve the independence and reliability of the net asset valuation calculation. *See Hedge Funds in Spain*, SIMMONS & SIMMONS, May 17, 2006, at 4.

232 DELOITTE, *supra* note 209, at 15.

233 *Id.* at 12.

234 Pension fund trustees often rely on external consultants for the fund's asset allocation and on reliable external fund mangers. *See* INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: MARKET DEVELOPMENTS AND ISSUES 118 (Int'l Monetary Fund 2004), *available at* http://www.imf.org/External/Pubs/FT/GFSR/ 2004/01/index.htm (follow "Institutional Investors in Emerging Markets" hyperlink).

235 Because advising pension fund trustees on asset allocations is not a regulated activity, government rules on managing conflicts of interest do not apply. "The FSA propose[d] to open a dialogue with the Pensions Regulator to discuss appropriate risk management strategies and to keep a close eye on fund managers to ensure that they comply with the conflict of interest rules." Norton Rose, Hedge Funds: The Future of UK Regulation 3 (Sept. 2005) (on file with author). A similar concern exists in the United States, as illustrated by the Consulting Services Group (CSG), which helped to promote the Bayou Management hedge fund before it defrauded investors of more than $450 million by overstating financial results and forging audited financial statements. Yamil Berard, *City Invested in Failed Hedge Fund*, FORT WORTH STAR-TELEGRAM, Apr. 24, 2006. Because CSG had received fees from Bayou's money managers, serious questions exist as to whether CSG's inept recommendation to invest in the hedge fund was influenced by financial incentives that hedge fund managers indirectly provided. *Id.*; *see also* STAFF OF SEC. & EXCH. COMM'N, OFFICE OF COMPLIANCE AND INSPECTIONS, REPORT CONCERNING EXAMINATION OF SELECT PENSION CONSULTANTS (2005), *available at* http://www.sec.gov/news/studies/pensionexamstudy.pdf; Lori Richards, Director, Sec. & Exch. Comm'n, Office of Compliance Inspections & Examinations, Remarks at the 14th Annual Public Fund Boards Forum: Conflicts of Interest in Pension Consulting: An Update on the SEC's Examinations (Dec. 5, 2005), http://www.sec.gov/news/ speech/spch120505lr.htm.

236 Banks have direct exposure to hedge fund losses. "Banks also face indirect exposures . . . [to losses from] hedge fund counterparties and the impact of hedge fund activities in financial markets on their proprietary trading portfolios." EUROPEAN CENTRAL BANK, LARGE EU BANKS' EXPOSURES TO HEDGE FUNDS 8 (European Central Bank 2005), *available at* www.ecb.int/pub/pdf/other/ largeeubanksexposureshedgefunds200511en.pdf.

greatly benefit from the substantial business that hedge funds provide?[237] Another concern is the questionable quality of the offshore administration industry supporting hedge funds.[238] Thus, addressing hedge fund fraud and conflicts of opportunity will require a coordinated international approach.[239]

Tax fraud frequently accompanies accounting fraud.[240] Examples of tax fraud by hedge funds include the cases of Long Term Capital Management[241] and Quellos, one of the largest sellers of funds-of-funds (FOFs).[242] Quellos helped to shield $2 billion in taxes by fabricating billions of dollars of fake securities transactions to generate fake capital losses.[243] Even legal tax avoidance by tax-exempt organizations in the U.S. that invest in

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237 A recent lawsuit alleges that a powerful hedge fund group conspired to create false reports about the financial health of a company by ghostwriting negative reports. Jane Sasseen et al., *The Secret Lives of Short-Sellers; The Rise of Hedge Funds and Indie Research Raises New Questions About a Shadowy World*, BUS. WK., Apr. 10, 2006, at 50.

238 Valuation models used by administrators are often not independently derived. Instead, these models are sometimes developed by the fund managers with expertise in over-the-counter or illiquid investments markets. *See* Norton Rose, *supra* note 235. In such cases, the fund administrator does not effectively act as an independent third party. The lack of real independence is a common problem when management has the ability to fire the independent service provider.

239 Sometimes hedge fund fraud in one country gets ignored in another country. For example, a hedge fund manager who was fined by UK's financial regulator for market abuse soon reinvented himself in Switzerland and found financial backers. *See Back in Business; Hedge Funds*, ECONOMIST, Oct. 14, 2006, at 81.

240 U.K. tax authorities sought to reclaim $1.9 billion from the hedge fund industry based in London. Neil Behrmann, *UK Tax Authorities Launch Major Investigation Into Hedge Funds*, INFOVEST21 NEWS, May 22, 2006. The U.K. tax authorities alleged that hedge funds have paid inadequate taxes on fees earned from their offshore funds. Anita Raghavan, *British Tax Police Look Hard at Hedge Funds*, WALL ST. J., Sept. 19, 2006, at C1. Some hedge fund firms were sloppy in handling their tax obligations and others were engaged in questionable tax avoidance schemes. Behrmann, *supra*; *see also* Raghavan, *supra*.

241 Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004); *see also* David Cay Johnston, *A Tax Shelter, Deconstructed*, N.Y. TIMES, July 13, 2003, at C1 (discussing the Long Term Capital Management case).

242 *See* Drew DeSilver, *Probe Into Tax-Haven Abuses Names Seattle-Based Quellos; Senate Investigation into Offshore Shelters – Report Alleges Investment Firm Used Fake Deals to Help Client Shield $2 Billion from Taxes*, SEATTLE TIMES, Aug. 2, 2006, at C1.

243 *See id.*; Lynnley Browning, *Tax Shelters Under Scrutiny at Seattle Hedge Fund Firm*, N.Y. TIMES, Aug. 9, 2006, at C3.

offshore hedge funds and tax treatment of carried interest by hedge fund managers should draw Congressional attention for change.[244] Those who try to avoid having to pay U.S. taxes on unrelated business income or who benefit from capital gain treatment on their compensation deprive the public by not paying their fair share of taxes.[245]

C. Potential Losses Amplified Through Inadequate Risk Management

Potential losses from hedge fund fraud, whether related to accounting or tax fraud, are often amplified through weak risk management practices. The ordinary investing public may feel the market effects of hedge fund losses arising from leveraged and speculative transactions. The potential pain is especially great since many pension plans are investors in hedge funds. Uninformed investors are also at risk,[246] especially as stiffer competition places pressure on hedge fund managers to take even larger risks with the investors' money.[247] When hedge fund fraud occurs,[248] investors almost never recoup all the losses from the fraud.[249] Potential losses for ordinary investors arise not only

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244 Tax-exempt organizations received some scrutiny and reform in the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006); *see also The Taxation of Carried Interest: Hearing Before the S. Comm. on Finance*, 110th Cong. (2007) (statement of Peter R. Orszag, Director, Cong. Budget Office) *available at* http://www.senate.gov/~finance/hearings/testimony/2007test/071107testpo.pdf.

245 *See* Arden Dale, *Outside Audit: Hedge Fund Tax Break Raises Flags; Come April 15, the Difference Between 'Trader,' 'Investor,' Can Be a Substantial Sum*, WALL ST. J., Dec. 26, 2006, at C3.

246 Risks include the manner by which hedge funds value their hedge fund assets, lack of independent review over hedge fund accounting, incentives that may cause an adviser to inaccurately value hedge funds, and lack of access to information to acquire fair value for their interests. *See* SWISS NAT'L BANK, MONETARY POLICY REPORT: QUARTERLY BULLETIN 43 (2005), http://www.snb.ch/en/mmr/reference/quartbul_2005_1_gp/source/quartbul_2005_1_gp.en.pdf.

247 Amy Borrus, *A Guide to Hedge-Fund Maze*, BUS. WK. ONLINE, Oct. 19, 2005.

248 In 2003, the SEC staff found no evidence that fraud is more prevalent among hedge fund advisers than mutual fund advisers. *See* SEC STAFF, 2003 REP., *supra* note 11, at 73. However, hedge fund fraud is on the rise and even more cases are expected in the future, according to the SEC Enforcement Director, Linda Thomsen. *See* Phyllis Diamond, *Thomsen Defends Corporate Penalties, Expects to See More Hedge Fund Cases*, SEC. L. DAILY (BNA), Nov. 9, 2005.

249 *Hedge Funds: The New Money Men*, ECONOMIST, Feb. 17, 2005, at 13–14.

from the "retailization" of hedge funds, but also from the riskiness of the investment, the potential for inadequate management practices, and other internal control problems.[250]

In addition to the dramatic growth of hedge fund assets and the increased concern over hedge fund fraud, any future regulation of hedge funds must consider the "retailization" of hedge funds. Retailization is the increased sale of hedge funds to ordinary investors either directly or indirectly.[251] Direct sales are facilitated by the lower minimum investments required when investing in a fund of funds. Also, hedge funds started to go public in 2006,[252] although FOFs have previously been listed in Europe.[253] Indirect sale of hedge funds occurs through purchases by pension funds, university endowments, and charitable organizations – all of which are entities upon which the general public relies.[254] Indirect sale also occurs through mutual funds that attempt to imitate hedge

250 In reality, a little regulation of hedge funds exists. Regulation includes restrictions on offerings to the public, advertising prohibitions, selected compliance requirements, antifraud provisions, and insider trading restrictions. *See* Managed Funds Assoc., HF & HF Adviser FAQs, http://www.managedfunds.org/hf-hf-adviser-faqs.asp (follow "How are hedge funds regulated?" hyperlink) (last visited Sept. 15, 2007).

251 For a summary of the availability of hedge funds for purchase by individual investors in various countries, see PRICEWATERHOUSECOOPERS, THE REGULATION, TAXATION AND DISTRIBUTION OF HEDGE FUNDS IN EUROPE: CHANGES AND CHALLENGES 37-38 (4th ed. 2006), http://www.pwc.com/extweb/pwcpublications.nsf/docid/44343824ED0025ED85256EA80052D97A (follow "June 2006" hyperlink).

252 European FOFs went public first. *See* Mara Der Hovanesian, *A Peek Into The Hedges*, BUS. WK., Dec. 11, 2006, at 13. U.S. FOFs followed. *See* Lynn Cowan, *IPO Outlook – Alternative Investment Twist: Fortress Plans a Stock Listing*, WALL ST. J., Nov. 20, 2006, at C5. In the U.S., the trading price of FOF Fortress rose an astonishing seventy percent during in its first trading day. *See* Eleanor Laise, *Hedge Funds Beckon Small Investors*, WALL ST. J., Feb. 14, 2007, at D1. However, the stock price of the FOF fell twenty percent from that high point later in the first week. *See* Steve Gelsi, *Fortress Investment Group Sheds Gains*, MARKETWATCH, Feb. 16, 2007, http://www.marketwatch.com/news/story/fortress-invesment-groups-share-price/story.aspx?guid=%7BF47FE139%2DE5EA%2D44CA%2DADD1%2DE8B5134EAC32%7D.

253 FOFs were listed primarily on the Irish and Luxembourg Stock Exchanges. *See* VON COTTIER, *supra* note 6, at 67.

254 Countries are concerned whether retail investors understand hedge fund activities and the risk profiles of hedge funds. Fin. Services Auth., *Hedge Funds and the FSA* ¶ 6.11 (Fin. Services Auth., Discussion Paper No. 16, 2002), http://www.fsa.gov.uk/pubs/discussion/dp16.pdf.

fund investing strategies.[255] Retailization has occurred despite SEC Chairman Cox's 2006 warning that hedge funds were too risky for 'Mom and Pop' investors.[256]

Substantial investment risks[257] are created by the manner in which hedge fund assets are invested, adding to the risks that exist in all highly leveraged instruments.[258] Hedge funds pose greater liquidity risks than other instruments because they often operate in markets that can suddenly become illiquid.[259] "Mark-to-market"[260] risk reflects the challenge of "valu[ing] some illiquid positions at market prices [when] there is no efficient market for [the financial product]."[261] Size risk reflects the idea that strategies that work in smaller environments might not work as well with larger financial positions.[262]

Other risks posed by hedge fund investments include business risk, industry sector risk, and portfolio construction risk.[263] Some risks are easy to statistically estimate,[264] while others are difficult to estimate.[265] Hedge fund complexities necessitate the use of risk management techniques by investors and creditors of hedge

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255 In 2006, mutual funds attempting to imitate hedge funds grew exponentially. *See* Eleanor Laise & Ianthe Jeanne Dugan, *The Private-Money World Opens Up*, WALL ST. J., Dec. 18, 2006, at R1.

256 Posting of Aaron C. Buser to New Jersey Law Blog, *SEC Chairman Wants More Hedge Fund Regulation*, http://www.njlawblog.com/securities-compliance-arbitration-sec-chairman-wants-more-hedge-fund-regulation.html (Aug. 10, 2006).

257 *See* Amy Friedman, *Hedge Funds: Still Risky Business*, BUS. WK. ONLINE, Oct. 17, 2006.

258 Phyllis J. Bernstein, *The Hedge Fund Mystique: Making Money With an Investment that Goes Against the Flow*, J. OF ACCT., May 2002, at 55.

259 PHILIPS, *supra* note 83, at 6.

260 "Mark-to-market" refers to recording the value of a security or account as its fair market value (as opposed to its book value) to calculate potential profits or losses. INVESTOPEDIA, http://www.investopedia.com/terms/m/marktomarket.asp (last visited Sept. 16, 2007).

261 Bernstein, *supra* note 258, at 57.

262 *Id.* at 58.

263 Pinnavaia, *supra* note 87, at 9.

264 Risks that are relatively easy to determine statistically include equity market, interest rate, credit, volatility, and liquidity risks. *Id.* at 10.

265 Risks that are difficult to determine include business risk, manager investment risk, and event risk. *Id* at 10.

funds.[266] These techniques include due diligence in the inspection of the hedge fund investment,[267] agreements to require private disclosure of financial information,[268] practices to obtain sufficient collateral for loans,[269] credit lending limits on hedge funds,[270] and regular monitoring of the hedge fund's activities.[271] A study by a private industry group notes that fund management demands for new investment strategies are growing more rapidly than risk management capabilities of many institutional investors.[272]

Effective risk management requires a culture of sound corporate governance and decision-making,[273] so that the fund manager understands the level of risk and takes action to control that risk.[274] Yet, a survey of hedge fund advisers suggests that

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266 *See* Harry M. Kat, *How to Evaluate a New Diversifier with 10 Simple Questions*, J. OF WEALTH MGMT., Spring 2007, at 29.

267 Due diligence reviews for institutional investors normally take between two to six months to complete. SEC STAFF, 2003 REP., *supra* note 11, at 59 n.206. Due diligence is a "huge issue," even for experienced financial analysts. Lawrence C. Strauss & Jack Willoughby, *Hedge-Fund Roundtable: Finding the Razor's Edge*, BARRON'S, Nov. 27, 2006, at 39, 45. *See generally* Ken Stern, *Hedge Fund Due Diligence for Retail Advisors and Brokers*, INVESTMENT PLANNING, Feb. 2006, at 1, *available at* http://www.cpfg.com/CALU_Article.pdf.

268 Private disclosure may include financial statements. However, the typical financial statement on hedge funds does not provide information about the risk profile of the trading activity. WORKING GROUP REPORT I, *supra* note 46, at 6.

269 Collateral practices require collateral from hedge funds as a risk mitigation device. The president of the Federal Reserve Bank of New York recently asked regulators to determine whether banks and securities dealers are requiring hedge funds to provide sufficient collateral, known as a margin requirement. *See* Phil Izzo, *Economists See Hedge-Fund Risks; Survey Indicates Concerns About a Lack of Oversight, Use of Borrowed Money*, WALL ST. J., Oct. 13, 2006, at C3.

270 Credit limits provide a common credit risk management tool that applies at various levels of relative returns and risks. Credit risk is probably the most important variable in determining whether financial disturbances become financial shocks posing systemic risk. *See* CRM POLICY GROUP II, *supra* note 6, at 7.

271 Monitoring of credit exposures usually includes on-going financial reporting requirements, as well as daily mark-to-market valuation of assets and potential liabilities.

272 *See* CRM POLICY GROUP II, *supra* note 6, at D-4.

273 *See* Corrigan, *supra* note 38, at 102.

274 *See generally* GUIZOT, *supra* note 151, at 105. "Even the seemingly mundane – but critically important – back-office operations of all classes of financial institutions are now enormously complex and entail sizeable elements of financial, operational and reputational risk." CRM POLICY GROUP II, *supra* note 6, at 10.

current risk management practices are often deficient.[275] One investigator explains that hedge funds generally perform risk management only on the surface as a marketing tool, rather than for true risk management purposes.[276]

Lack of integrity by a hedge fund manager substantially increases risk of loss. For example, in 2007, a court ordered major brokerage firm Bears Stearns to pay $125 million because the firm waited a year before scrutinizing the false books and records of a hedge fund.[277] This delay increased Bear Stearns' own collection of fees, while the losses to the hedge fund customers rose.[278] The same year as the court decision, two major funds operated by Bear Stearns collapsed, generating massive losses for investors.[279]

IV. SEC's Historic Lack of Oversight on Hedge Funds

Hedge funds generally seek to avoid government regulation.[280] Without restrictions from government regulation, hedge funds can better preserve any proprietary information about their trading activities.[281] Part V.a. discusses how securities regulation is generally avoided through exemptions under the U.S. securities laws. Part V.b. reviews the SEC's regulatory reinterpretation of a "client" in an attempt to force more hedge funds to register with the SEC. Part V.c. explains how the D.C. Circuit Court of

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275 DELOITTE, *supra* note 209, at 10. For example, about half the hedge fund advisors do not monitor off-balance-sheet leverage. *Id.* at 9. Few have conducted "stress tests" to determine how they will react when unexpected market events occur. *Id.* at 6.

276 GUIZOT, *supra* note 151, at 105.

277 *See* Otis Bilodeau & Thom Weidlich, *Bear Stearns Ordered to Pay $125 Million*, WASH. POST, Feb. 16, 2007, at D03.

278 *Id.*

279 *See* Kate Kelly et al., *Wall Street, Bear Stearns Hit Again By Investors Fleeing Mortgage Sector*, WALL ST. J., Aug. 1, 2007, at A1.

280 *See* John Poirier, *House Democrats Introduce Hedge Fund Bill*, REUTERS, June 9, 2006 (statement of Bruce McGuire, President, Conn. Hedge Fund Assoc.), *available at* http://www.redorbit.com/news/politics/555333/house_democrats_introduce_hedge_fund_bill/index.html.

281 "Hedge fund and mutual fund managers of portfolios of more than $100 million of public securities must file 13F forms with the Securities and Exchange Commission" on their largest stock holdings. Gregory Zuckerman, *A Peek at Moneymakers' Cards, Hedge Fund Filings on Holdings Can Clue Investors In on Strategy; Taking Joys on Bets Gone Awry*, WALL ST. J., May 19, 2006, at C1.

Appeals rejected the SEC's reinterpretation and the subsequent Congressional inaction. Following the 2007 District of Columbia Circuit Court of Appeals decision, Congress and the SEC engaged in only a limited effort to regulate hedge funds. The resulting regulations are insufficient to correct the current lack of proper government oversight of hedge funds, a major participant in the financial markets.

A. Avoidance of U.S. Securities Laws through Exemptions

After the stock market crash of 1929, Congress created two major laws regulating the securities industry: the Securities Act of 1933 and the Securities Exchange Act of 1934.[282] After the "Great Depression" of the 1930s, Congress added two more major securities laws in 1940: The Investment Company Act and the Investment Advisers Act.[283] After the corporate failures of the early 2000s, Congress enacted the Sarbanes-Oxley Act (SOX).[284] President Bush characterized SOX as the most far-reaching reform of American business practices since the securities laws of the 1930s.[285] Although SOX set a tone for a tougher enforcement environment for business entities, exemptions in the securities laws have still enabled many hedge funds to escape even light regulation that is needed for proper government oversight.[286]

The Securities Act of 1933 was designed to force truth in securities through SEC registration upon the issuance of corporate securities. As a consequence, investors had to receive financial information concerning the securities. The law also prohibited deceit, misrepresentation, and other fraud in the sale of securities.[287] However, a private placement exemption[288] exempts

282 Securities Act of 1933, 15 U.S.C. § 77a (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78a (2000).

283 Investment Company Act, 15 U.S.C. § 80a (2000); Investment Advisers Act, 15 U.S.C. § 80b (2000).

284 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

285 *See* Sec. & Exch. Comm'n, The Law, *supra* note 227, at 5.

286 This exemption of hedge funds from the heightened enforcement environment has occurred despite the concept that the SEC oversees other key participants in the financial markets, such as the stock exchanges, broker-dealers, and mutual funds.

287 *See* Sec. & Exch. Comm'n, The Law, *supra* note 227, at 5.

288 15 U.S.C. § 77d(2) (2000) (commonly known as the authority for the Regulation D exemption for private offerings). Hedge funds using the private placement exception

hedge funds' issuers when they are engaging in non-public offerings which are sold to "accredited investors."[289] Accredited investors are generally defined as either having net assets exceeding $1 million or at least $200,000 in annual income.[290] This rule assumes that those investors meeting these monetary requirements, be it wealthy individuals or qualified institutional buyers, are sophisticated investors who are capable of understanding the risks and who have the ability to withstand potential significant losses from the investment.

The Securities Exchange Act of 1934 was designed to curb speculation and market manipulation by regulating the resale of securities.[291] If a hedge fund qualifies as a "dealer," so as to be engaged in the business of "buying and selling securities for one's own account,"[292] it must register under the 1934 Act.[293] "Non-Dealer" status under the trader exception of the Securities Exchange Act of 1934 is important for hedge funds.[294]

The Investment Company Act of 1940 was designed to

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may not engage in general solicitation or advertising. *See generally* SEC STAFF, 2003 REP., *supra* note 11, at 16–17.

289 15 U.S.C. § 77d(6) (2000). See, e.g., Regulation D's Rule 506 exemption for the issuance of securities sold to accredited investors, which permits only thirty-five non-accredited investors. 17 C.F.R. § 230.506 (2007). Regulation D is the most frequently used exemption. ROBERT H. ROSENBLUM, INVESTMENT COMPANY DETERMINATION UNDER THE 1940 ACT: EXEMPTIONS AND EXCEPTIONS 861 (Am. Bar Ass'n 2003).

290 "Accredited investors" meet the income test if their income was more than $200,000 (or $300,000 for a married couple), in each of the last two years. 17 C.F.R. § 230.501(a) (2007). Accredited investors are distinguishable from "non-accredited investors" and "super accredited investors." Non-accredited investors have less income or assets than those required to qualify as "accredited investors," while "super accredited investors" have $5 million or more in assets for individuals and $25 million or more for entities.

291 *See* Elizabeth Killer and Gregory A. Gehlman, Comment, *A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 348 (1988).

292 15 U.S.C. § 78c(a)(5) (2000).

293 There is an exception, however, for persons who buy or sell securities for their own account. *Id.* § 78c(a)(5)(B).

294 A "trader" is an entity that trades solely for its own investment account and does not carry on a public securities business. *See* SEC STAFF, 2003 REP., *supra* note 11, at 18. Given the enormous profitability and business realities of hedge funds, the common assumption that this exception applies to hedge funds deserves further scrutiny by the SEC. *Id.*

increase disclosure and includes specific protections against self-dealing, conflicts of interest, misappropriations of funds, and overreaching of fees or expenses.[295] The protection of investors was needed from the abusive practices of investment companies, such as those that arise from conflicts of interest. Hedge funds often escaped application of the Investment Company Act through one of two exceptions to the definition of an investment company when no public offering is made:[296] the section 3(c)(1) "Qualified Purchaser" exemption[297] and the section 3(c)(7) "maximum 100 persons with substantial net worth" exemption.[298]

The Investment Adviser's Act was designed to reduce the abusive practices of unregulated investment advisers that Congress believed contributed to the stock market crash of 1929 and the resulting Great Depression of the 1930s.[299] The Adviser's Act is principally a reporting, disclosure, and antifraud statute.[300] It replaced the previous government philosophy of buyer beware.[301] The SEC created several rules governing the implementation of

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295 *Id.* at 127.

296 15 U.S.C. § 80a-3(a)(1) (2000).

297 15 U.S.C. § 80a-3(c)(7). Qualified purchasers are individuals who have assets of at least $5 million or, if acting for another, a qualified purchaser must have assets of at least $25 million to be recognized as an "Investment Company." 15 U.S.C. § 80a-2(a)(51) (2000). The qualified purchaser exemption was added in the National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

298 The second exemption excludes securities beneficially owned by not more than one hundred persons, each having substantial net worth (a lower amount than required to qualify as a "qualified purchaser"). 15 U.S.C. § 80a-3(c)(1) (2000). A "look through" provision exists in this exemption for certain entities that own ten percent of an issuer's stock. *Id.*

299 Richard S. Cortese, *Overview of the Adviser's Act*, *in* LIPPER HEDGEWORLD ANNUAL GUIDE 113 (2005); *see* Investor Advisers Act, 15 U.S.C. § 80b-1 et seq. (2000). Similarly, the Sarbanes-Oxley Act was passed to address the type of fraud which led to the Enron and WorldCom scandals. Annette L. Nazareth, Comm'r, Sec. & Exch. Comm'n, Remarks at the ALI-ABA Sarbanes-Oxley Institute (Oct. 12, 2006), http://www.sec.gov/news/speech/2006/spch101206aln.htm.

300 *See* 15 U.S.C. § 80b-6 (2000) (prohibiting the overstatement of assets under an adviser's management, the receipt of commission kickbacks, engagement in "cherry picking" schemes, dissemination of materially false and misleading advertising, and other misconduct).

301 The Advisers Act has registered more than 8,500 advisory firms which collectively manage over $23 trillion in assets, some of which are hedge fund advisers. SEC Hedge Fund Adviser Rule, *supra* note 40, at 72,060.

the Adviser's Act in an effort to ensure receipt of accurate financial information from advisers.[302] These rules require advisers to maintain books and records,[303] establish internal controls for proper custody,[304] and establish policies and procedures to promote compliance,[305] among other rules.[306]

Hedge fund advisers must generally register with the SEC under the Advisers Act, assuming they meet the minimum of $25 million in assets under management.[307] However, two significant

302 *See* Terrance J. O'Malley, *An Overview of Advisers Act Requirements for Hedge Fund Managers*, 5 J. OF INV. COMPLIANCE 50 (2004).

303 A "Books and Records Rule," requires registered investment advisers to maintain the books and records related to their advisory business. The records must include all accounts, internal working papers, and any documents supporting claims made about an adviser's performance, and must be maintained for a five-year period after the performance information is last used. 17 C.F.R. § 275.204-2 (2007). Hedge fund advisers would have benefited from a grandfather clause which provided them with a phase-in of the books and records rule. SEC Hedge Fund Adviser Rule, *supra* note 40, at 72,075. The Books and Records Rule for a registered hedge fund adviser encompasses the records of private funds for which the adviser acts as an investment adviser. *Id.* at 72,076.

304 A "Custody Rule," requires an adviser to maintain internal controls designed to protect client assets from being lost, misused, or misappropriated. 17 C.F.R. § 275.206(4)-2 (2007). Hedge fund advisers may satisfy custody account information delivery obligations by distributing audited financial statement to investors within 180 days of fiscal year-end. SEC Hedge Fund Adviser Rule, *supra* note 40 at 72,076.

305 The "Compliance Rule," requires hedge funds to designate a "Chief Compliance Officer" (CCO). 17 C.F.R. § 275.206(4)-7 (2007). The CCO maintains comprehensive internal policies and procedures to promote the investment adviser's compliance with SEC law. *Id.* Thus, for hedge funds, the CCO would need to adopt various policies and processes regarding portfolio management, trading practices, valuations, and recordkeeping. The CCO would also help to maintain the accuracy of disclosures, safeguarding of client assets, privacy protections of client records, and business continuity plans. *See generally* Stuart Cohen, Executive Director, Ernst & Young, SEC Adopts Registration of Hedge Fund Advisers, Global Hedge Funds Accounting & Regulatory Alert 1, 3-4 (Dec. 2004).

306 Additional SEC rules include the "Code of Ethics," the "Proxy Voting Rule," and the "Disciplinary Disclosure" rules. By adopting a Code of Ethics, a hedge fund adviser gains rules of conduct for addressing potential conflicts of interest and procedures for personal securities transactions. 17 C.F.R. § 275.204A-1 (2007). The Proxy Voting Rule ensures that the adviser votes in the best interest of the client. 17 C.F.R. § 275.206(4)-6 (2007). The Disciplinary Disclosure Rule applies when clients or potential clients are selecting an investment adviser. 17 C.F.R. § 275.206(4)-4 (2007).

307 15 U.S.C. § 80b-2(a)(11) (2000) (defining "investment adviser"). In determining the amount of assets under a hedge fund adviser's management, the adviser must include the total value of securities portfolios in the assets under management. *Id.* § 80b-3a

loopholes allow some hedge funds to avoid the SEC Registration.[308] One loophole results from extending the lock-up period for withdrawal from the investment for at least two years. The other loophole is the "Private Adviser Exemption."[309] This exemption from registration is for investment advisers who have less than fifteen clients during the preceding twelve months. The Private Adviser Exemption was intended for small advisers whose activities were not national in scope and who provided advice to family members and friends.[310] This limited exemption was not intended to exempt advisers who serve only wealthy or sophisticated investors.[311] These wealthy or sophisticated investors often include institutional investors, such as pension funds, that serve a large number of individuals, individuals who rely on government oversight to protect their investment. Thus, using the number of clients as the only criterion for exemption creates a loophole that could leave many individuals without protection.

B. The SEC's Attempted Regulation of Hedge Fund Advisers

In 2004, the SEC voted to tighten eligibility under the Private Adviser's Exemption through new "Hedge Fund Advisers Rules."[312] The vote to adopt the new rules was an unusual three-to-two split decision among the SEC commissioners.[313] The

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(2000).

308 Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, WALL ST. J., Nov. 10, 2005, at C1.

309 15 U.S.C. § 80b-3(b)(3) (2000). This exemption is also known as the *de minimum* exemption. *See* SEC STAFF, 2003 REP., *supra* note 11, at 21.

310 SEC Hedge Fund Adviser Rule, *supra* note 40, at 72,069.

311 *Id.* at 72,054.

312 The rules that the SEC attempted to apply are provided in SEC Rule 203(b)(3)-2 and related amendments to other rules under the Investment Company Act of 1940 and the Investment Advisers Act. 17 C.F.R. § 275.203(b)(3)-2 (2007); *see also* SEC Hedge Fund Adviser Rule, *supra* note 40. However, the 2004 modifications were withdrawn.

313 *See* Judith Burns, *SEC Approves Rule on Hedge Funds*, WALL ST. J., Nov. 1, 2004, at C15; SEC Hedge Fund Adviser Rule, *supra* note 40, at 72,089. The dissent encouraged the majority to consider better alternatives, such as gathering more information on hedge funds from other sources. Hedge Fund Adviser Rule, *supra* note 40, at 72,098; Burns, *supra*. The dissent noted that the SEC lacks the resources to perform hedge fund examinations. SEC Hedge Fund Adivser Rule, *supra* note 40, at 72,073; Burns, *supra*. The dissent advocated that the SEC conduct empirical research.

dissenting commissioners wanted SEC consideration of other alternatives to hedge fund adviser regulation, such as more indirect regulation through their prime brokers.[314]

Under the Hedge Fund Advisers Rules, more hedge fund advisers had to register with the SEC under the Advisers Act before the February 2006 effective date. The new rules would effectively disqualify many advisers from using the Private Adviser Exemption to registration.[315] Registration under the Advisers Act was a form of relatively light governmental regulation.[316] Hedge funds registering with the SEC had to disclose their past financial performance, key personnel, and other information.[317] Registration would help the SEC track hedge fund operations, enable the SEC to conduct examinations of hedge funds, improve hedge fund disclosure, and bar convicted felons from hedge fund management.[318]

See Cynthia A. Glassman, Comm'r, Sec. & Exch. Comm'n, Address at the National Economists Club: Observations of an Economist Commissioner on Leaving the SEC (July 6, 2006), http://sec.gov/news/speech/2006/spch070606cag.htm.

314 *See* Paul S. Atkins, Comm'r, Sec. & Exch. Comm'n, Keynote Address at the Inaugural Edward Lane-Reticker Speaker Series sponsored by the Morin Center for Banking and Financial Law: Protecting Investors Through Hedge Fund Advisor Registration: Long on Costs, Short on Returns (March 30, 2006), *in* 25 ANN. REV. BANKING & FIN. L. 537, 539 (2006).

315 Perhaps the debate over SEC registration of hedge funds was in fact a debate over whether to enable the SEC to examine hedge funds. *See* Jeffrey B. Cobb, *Time for a Fresh Look at Advisory Registration of Hedge Fund Managers,* INVESTMENT LAW., Oct. 2006, at 3, 12 (2006).

316 Gregory Zuckermann & Ian McDonald, *The Wild West of Hedge Funds Becomes Tamer*, WALL ST. J., Jan. 24, 2005, at C1. Paul Roye, Director of the SEC's Investment Management Division, stated "'we view the hedge-fund-adviser registration requirement as a modest step.'" *Id.*

317 Regulated investment advisers must file SEC form ADV. 17 C.F.R. § 275.204-3 (2007). The first part of form ADV requires information on advisers, assets under management, compensation, disciplinary history, types of clients served, and owners of the firm. *See* Eleanor Laise & Rachel Emma Silverman, *Dissecting Hedge-Fund Secrets; Wealth-Managers Say SEC-Required Revelations Won't Replace Due Diligence*, WALL ST. J., Feb. 4, 2006, at B5. The second part of the ADV form gives details on the business background, fee schedule, education and experience of each key member of the firm's investment group. *Id.*

318 Registration of hedge fund advisers would also effectively increase the minimum investment required because registered advisers cannot charge performance fees unless an investor has at least $750,000 invested or a net worth of $1.5 million. *See* SEC STAFF, 2003 REP., *supra* note 11, at xii.

Hedge fund managers are included in the definition of "investment advisers"[319] under the Advisers Act.[320] Particularly when hedge funds do not treat all investors the same, the SEC believes that such hedge fund advisers share a key characteristic of investment advisers: the handling of separate investment accounts. The intent of the regulation was to treat hedge funds as having several separate investment accounts.[321]

The "look through rule" included in the SEC's Hedge Fund Adviser Rules changed the method of counting the number of clients for purposes of the Private Adviser Exemption. Essentially, hedge fund advisers had to "look through" a private fund and count each beneficial owner as a client to determine if the fund had fourteen or fewer clients.[322] The SEC explained that without a "look through rule," a hedge fund adviser could indirectly manage the assets of hundreds or thousands of investors. The "look through" rule even applied to offshore hedge fund advisers.[323]

The attempted regulation increased the number of registered hedge fund advisers. Prior to the SEC's attempted regulation of hedge funds, about forty percent of hedge fund operators were registered.[324] Even though the District of Columbia Circuit Court

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319 An investment adviser is defined as "any person who, for compensation, engages in the business of advising others." 15 U.S.C. § 80(b)-2(a)(11) (2000). The advising may occur either directly or through publications or writings, and may include advice as to the value of securities or whether to purchase or sell securities. *Id.*

320 The Second Circuit Court of Appeals has held that hedge fund general partners are "investment advisers." *See* Abrahamson v. Fleschner, 568 F.2d 862, 869–71 (2d Cir. 1977), *overruled on other grounds by* Transamerican Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

321 SEC Hedge Fund Adviser Rule, *supra* note 40, at 72,070.

322 Thus, for purposes of the Hedge Fund Advisers Rule, a "client" included each shareholder, limited partner, member and beneficiary of a private fund. 15 U.S.C. § 80b-3 (2000).

323 An offshore adviser is a hedge fund adviser whose principal place of business is outside the United States. 17 C.F.R. §§ 230.902, 230.903. "Offshore advisers" of hedge funds also had to look through their funds and count any U.S. residents as clients. *Id.* An offshore adviser had to register if the adviser did not qualify for the private adviser exemption. *See* 15 U.S.C. 80b-3(b)(3) (2000). Thus, the offshore adviser was subject to SEC regulation if the adviser had more than fourteen clients who were residents of the United States. *Id.*

324 Burns, *supra* note 313. About a 1,000 hedge fund advisers registered before the February 2006 registration deadline. Kara Scannell, *Making Hedge Funds Less Secret;*

of Appeals decision caused some hedge funds to de-list from SEC registration,[325] it is estimated that most of the world's hedge funds are monitored by the SEC or another regulator.[326] A substantial portion of hedge fund advisers have continued the improved business practices implemented as a result of registration.[327]

C. Judicial Inflexibility, Congressional Talk, and the SEC's Proposal

Philip Goldstein, a hedge fund manager, wanted to continue to qualify under the Private Adviser Exemption. He challenged the SEC's new Hedge Fund Adviser Rule under the Administrative Procedures Act.[328] The SEC concluded that it had the authority to adopt the challenged regulations and justified the Hedge Fund Adviser Rule primarily on policy grounds. One justification given by the SEC for the regulations was that not all hedge funds treat all investors the same.[329] The SEC cited different lock-up periods, greater access to information, lower fees, and side-pocket arrangements, and thus demonstrated that each hedge fund investor account has many characteristics of separate accounts and should be treated as comprised of separate clients.[330]

When litigated before the Circuit Court of Appeals for the District of Columbia in *Goldstein v. SEC*,[331] the court, in a

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SEC's Registration Requirement Provides a New Insiders' Look; That Old Underage-Driving Case, WALL ST. J., Feb. 3, 2006, at C1.

325 The SEC reported that over 2,500 hedge fund advisers were registered with the SEC as of June 23, 2006. *See* Doug Halonen, *Legislation Seen As Necessary to Revive Hedge Fund Registration*, PENSIONS & INVESTMENTS, Aug. 7, 2006, at 19 (2006). However, at least 275 hedge funds have delisted from SEC registration after the court invalidated the SEC's hedge fund rule. Siobhan Hughes, *More Hedge Funds Leave the Ranks of SEC's Registry*, WALL ST. J., Dec. 15, 2006, at C4.

326 *Most Hedge Funds Still Watched by Regulators – Survey*, REUTERS, Dec. 5, 2006 (a survey conducted by the Henessee hedge fund concluded that eighty-six percent of hedge funds are monitored by some entity) (on file with author).

327 *Hedge-Fund Changes Appear to Live On*, WALL ST. J., Aug. 22, 2006, at C11.

328 Brief of Petitioner-Appellant at 26, Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (No. 04-1434) (arguing that the Administrative Procedures Act, 5 U.S.C. § 706(2), requires setting aside an agency rule if it is in excess of its statutory authority).

329 *Goldstein*, 451 F.3d at 882.

330 *Id.*

331 451 F.3d 873 (D.C. Cir. 2006).

unanimous opinion on June 23, 2006, vacated the SEC's Hedge Fund Adviser Rule.[332] The court found that the SEC's rules were arbitrary and the SEC's explanation inadequate as to why investors were treated as clients for purposes of determining whether an adviser must register with the SEC.[333]

The court in *Goldstein* focused on the definition of a "client." The SEC has the authority to regulate an investment adviser with more than fifteen clients.[334] The Adviser's Act did not define "client," but since 1985 the SEC treated an entity as a single client.[335] The court noted that it presumes the same words in different parts of a statue have the same meaning.[336] Since the SEC couldn't explain why "client" should have one meaning when determining the fiduciary duties owed and another meaning when determining whether an investment adviser must register, the court concluded the SEC's change in the definition of a client for purposes of registration was arbitrary.[337] The court concluded that the SEC's interpretation of "client" fell "outside the bounds of reasonableness."[338] The court explained that reasonableness depended on the statutory language and purpose.[339] The court found the SEC's rule violated the plain language of the statute.[340]

Various proposed legislative responses have arisen after the court's decision in *Goldstein.* Rep. Barney Frank quickly co-sponsored the "SEC Authority Restoration Act of 2006" to enable the SEC to regulate hedge funds.[341] Although Rep. Frank became the chair of the House Financial Services Committee in 2007, he has since altered his position. As a result, the House Financial

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332 *Id.* at 884.

333 *Id.* at 882-84.

334 *See* 15 U.S.C. § 80b-3 (2000).

335 *Goldstein*, 451 F.3d at 879 n.5, 880.

336 *Id.* at 882 (citing Sullivan v. Stroop, 496 U.S. 478, 484 (1990)).

337 *Id.* at 882–83.

338 *Id.* at 881.

339 *Id.*

340 The court vacated and remanded the SEC's revised hedge fund rule. *Id.* at 884.

341 SEC Authority Restoration Act of 2006, H.R. 5712, 109th Cong. (2006). Rep. Barney Frank, who introduced the bill, later decided to forgo this approach and let the Federal Reserve have more oversight. Editorial, *Educating Cox*, N.Y. SUN, July 27, 2006, at 10.

Services Committee has merely pursued informational hearings and is expected to examine the investment in hedge funds by public pension funds.[342] The extent of pension fund investment in hedge funds has also raised the concern of Senator Arlen Specter. In December 2006, Sen. Specter proposed draft legislation that would require the registration of any hedge fund having more than a five percent investment from pension funds. Sen. Specter's proposal addresses the retailization issue more effectively than the SEC's proposed approach to limit individual shareholders.[343]

Even before the court's decision, Congress had discussed federal legislation to address hedge funds.[344] Especially after witnessing the damage caused by hedge fund fraud, the Connecticut Attorney General advocated federal action, or state action if needed.[345] As Senator Grassley explained in a bill known as the "Hedge Fund Registration Act," at a minimum, the SEC needs to know who is controlling the "massive pool of money in hedge funds to ensure the integrity and security of the [financial] markets."[346]

The SEC proposed new regulations affecting hedge funds in December 2006.[347] The proposal had two rules providing very

342 *See Hedge Funds and Systemic Risk in Financial Markets: Hearing Before the H. Comm. on Financial Services*, 110th Cong. (2007).

343 Ron Orol, *Specter: Hedges Need Oversight*, THE DAILY DEAL, Dec. 6, 2006.

344 After LTCM, a bill was introduced in the House called the "Hedge Fund Disclosure Act." Hedge Fund Disclosure Act, H.R. 2924, 106th Cong. (1999). This bill would have required unregulated hedge funds to report to the Federal Reserve System. *See* Scott J. Lederman, *Hedge Funds*, *in* FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS § 11-7 (Clifford E. Kirsch ed., 2006).

345 Jeremy Grant & Stephen Schurr, *Hedge Funds Face Fresh Calls for More Regulatory Scrutiny*, FIN. TIMES, June 29, 2006, at 1. Connecticut's Department of Banking created a unit overseeing hedge funds in that state after the high profile hedge fund failures of Bayou Management and Amaranth Advisers in 2006. *See* Jennifer McCandless, *Connecticut Creates Hedge Fund Oversight Unit*, FIN. NEWS, Oct. 9, 2006, http://www.financialnews-us.com/
?page=ushome&contentid=1045604943. In 2007, Connecticut is considering stricter hedge fund rules, presumably to discourage tougher action at the federal level. *Connecticut Considers Stricter Hedge Fund Rules*, N.Y.TIMES DEALBOOK, Feb. 9, 2007, http://dealbook.blogs.nytimes.com/2007/02/09/connecticut-considers-stricter-hedge-fund-rules/.

346 *Hedge Funds: Grassley Bill Would Close 'Loophole' Allowing Fund Advisers Not to Register*, SEC. L. DAILY (BNA), May 16, 2007.

347 *See* Judith Burns, *SEC Adopts Fraud Rule Affecting Hedge Funds*, WALL ST. J.

light oversight of hedge funds. In July 2007, the SEC adopted one rule, applying the anti-fraud parts of the securities laws to both investors and proposed investors in hedge funds, rather than just to the clients of hedge funds.[348] Thus, under the anti-fraud rule, a hedge fund adviser cannot make false or misleading statements to investors or proposed investors, even if the hedge fund operates under an exemption to the Investment Company Act.[349]

The other proposed SEC rule for hedge funds was a new proposed term "accredited natural person." The concept of an "accredited natural person" substantially reduces the number of individuals qualifying to invest in hedge funds.[350] After widespread public criticism,[351] the SEC is conducting further review and may be reluctant to ever adopt its second proposal. This article advocates far more stringent government regulation, such as the registration of hedge fund advisors.

ONLINE, July 11, 2007; Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 8766, Investment Advisers Act Release No. 2576, [2006-2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,736 (Dec. 27, 2006). The SEC rationalized the rule by pointing out that only 1.7% of U.S. households qualified when the accredited investor rules were first implemented in 1982; 8.5% of U.S. households qualified under the accredited investor rules prior to the adoption of the new rule. Burns, *supra*.

348 *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, *supra* note 347, at 84,042-43. Mr. Goldstein has once again threatened to challenge the new SEC rule if the SEC does not determine that his fund qualifies under an exemption. *See* Jenny Strasburg, *Goldstein Asks SEC for Hedge-Fund Filing Exemption*, BLOOMBERG.COM, Oct. 24, 2006, http://www.bloomberg.com/apps/news?pid=20601103&sid=ajWZjtcAeRUM&refer=us; *Do Hedge Funds Hold 'Trade Secrets'?*, BUSINESS WEEK ONLINE, Sept. 13, 2006.

349 Editorial, *Hedge Fund Secrets*, WALL ST. J., Dec. 21, 2006, at A16.

350 The SEC's proposed new rule adds a new category of "accredited natural person." Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, *supra* note 347, at 84,047-48. The new category adds a requirement for accredited investors to own at least $2.5 million in investments, excluding their own homes. *Id.* at 84,048.

351 For a directory of comments submitted to the SEC, see Comments on Proposed Rule: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, http://www.sec.gov/comments/s7-25-06/s72506.shtml (last visited Sept. 20, 2007).

V. Reforms for More Effective SEC Regulation of Hedge Funds

Reforms for effective financial regulation of hedge funds must consider how a regulation promotes the SEC's major strategic goals.[352] Those goals are (1) to enforce compliance with federal securities laws; (2) to promote healthy capital markets through an effective and flexible regulatory environment;[353] and (3) to foster informed decision-making by investors.[354] Effective, prudent, and non-bureaucratic SEC regulation of hedge funds is needed to acquire information on hedge fund activity necessary to prevent financial catastrophes, to deter fraud, and to assure efficient markets.

The reforms proposed in this article arise in part from international coordination needed for effective regulation of hedge funds in the global economy, as discussed in Part V.a. The need for hedge fund registration and periodic examination of hedge funds is discussed in Part V.b., and is the critical part of regulation that is needed to reduce systemic risk to the financial markets from hedge fund activity. Part V.c. proposes regulation to provide ordinary investor protection against fraud, to improve market efficiency through increased disclosure by hedge funds, and for other rules of conduct and governance for greater integrity in the market.

A. Regulating Hedge Funds in the Global Economy

There are three basic reasons to regulate financial investments: first, to reduce systemic risk; second, to protect investors; and

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352 Similarly to the SEC, IOSCO has adopted three core objectives: protecting investors; ensuring markets are fair, efficient, and transparent; and reducing systemic risk. IOSCO, *supra* note 5, at 13.

353 "The empirical evidence strongly indicates that countries with mandatory disclosure, strong antifraud protections, [and] insider trading prohibitions . . . tend both to have stronger, more efficient capital markets and to enable companies to raise capital more efficiently." Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 778 (2006).

354 *See* SEC. & EXCH. COMM'N, IN BRIEF: FISCAL 2007 CONGRESSIONAL BUDGET REQUEST 6 (2006), *available at* http://www.sec.gov/about/secfy07budgetreq.pdf. The SEC also has an internally focused fourth strategic goal to maximize the use of SEC resources. *Id.*

third, to assure efficient markets.[355] "Prudential regulation" to reduce systemic risk should consider the extent of potential danger from the high degree of leverage which is often used in the hedge fund industry, as well as the risk management procedures of the parties involved in hedge fund financial transactions, particularly for transactions involving derivatives.[356] "Market integrity regulation" helps to protect investors from fraud. Such regulation is achieved by requiring hedge funds to register with the government to assure compliance with fiduciary duties, adviser qualification requirements,[357] proper business structures, and other appropriate regulatory measures.[358] A secondary effect of such regulation is to encourage efficient markets, usually by ensuring knowledgeable investors who have access to reliable financial information disclosure.[359] Most financial products are subject to extensive regulation for a combination of these three regulatory reasons.[360]

355 Jane Diplock, Chairman, IOSCO Executive Comm., Chairman, Sec. Comm'n of N.Z., Address at the Independent Commission Against Corruption Corporate Corruption, Integrity and Governance Symposium: IOSCO – A Global Standard Setter (May 11, 2006), http://www.seccom.govt.nz/speeches/2006/jds110506.shtml. Accurate pricing and high liquidity are characteristic of efficient markets. Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 720 (2006). Specifically, "accurate pricing is essential for achieving efficient allocation of resources in the economy." *Id.* High liquidity occurs when large sales can occur "without causing a substantial price effect." *Id.*

356 If the leading global investment banks maintain adequate counterparty risk and liquidity management systems and operation, then leverage in the hedge fund industry should only represent a marginal risk to the stability of the global financial system. SWISS NAT'L BANK, *supra* note 246, at 55.

357 Investors in small funds often entrust their money to charismatic individuals with whom they are not well-acquainted, and these managers sometimes lack the type of experience needed to trade in large sums. Peter A. McKay, *How Untested Trader Attracted Millions to Failed Hedge Fund*, WALL ST. J., Nov. 1, 2004, at C1. A small, but growing number of hedge fund managers have little or no relevant prior experience. *Wanted: Hedge Fund Manager, No Experience Necessary*, BUS. WEEK ONLINE, Mar. 6, 2006.

358 For many institutional investors, registration became an important criterion in selecting hedge funds. SWISS NAT'L BANK, *supra* note 246, at 55.

359 The hedge fund industry argues that disclosure is counter productive for an industry that helps to provide a market-based price finding mechanism. *Id.* Some also argue that the high volume of hedge fund activity makes it unrealistic for hedge funds or the custodian to compile the information on a timely basis. *Id.*

360 Regulation of mutual funds requires a degree of liquidity in the fund, redeemable

To make regulation effective, a governmental agency should consider six principles: consistency, accountability, transparency, proportionality, effectiveness, and necessity (CATPEN).[361] The SEC should consider these CATPEN principles for any potential SEC regulation of hedge funds. The principles suggest that the SEC regulation should exist only when some necessity for the regulation exists, such as concerns about systemic risk. An SEC regulation should not exist if it will not effectively achieve the SEC's goals. For such policies to be effective, the regulatory costs imposed should have some proportional relationship to the potential benefits achieved from the regulation. Finally, transparency in execution and consistency in enforcement are indispensable in implementing effective regulation. Transparency is necessary to make the regulation understandable to participants while enforcement provides consistency in application and increased accountability.

The increasingly globalized financial markets,[362] as well as the enormous size and impact of hedge funds, encourage the SEC to continue to work with major international organizations and securities regulators in other countries.[363] A coordinated

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mutual fund shares, protections against conflicts of interest, fairness in the pricing of mutual fund shares, disclosure, and limits on the use of leverage. Hedge Fund Center, The SEC's Definition of a Hedge Fund, http://www.hedgefundcenter.com (follow "Basics" hyperlink; then follow "The SEC's Definition of a Hedge Fund" hyperlink) (last visited Sept. 20, 2007).

361 *See* ROINN AN TAOISIGH, DEPARTMENT OF THE TAOISEACH, REGULATING BETTER 6 (2004), *available at* http://www.betterregulation.ie/attached_files/upload/static/RegulatingBetterGovernmentWhitePaper.pdf. Without registration, the SEC can investigate hedge funds only after an investor suspects fraud and contacts the SEC. SEC STAFF, 2003 REP., *supra* note 11, at 76. The U.S. stock exchanges are "self regulatory organizations" and perhaps fail to provide adequate investigation and enforcement when wrongdoing occurs. *See* Ron Orol & Donna Block, *SEC's Grip on Hedge Funds Reviewed*, DAILY DEAL, Oct. 30, 2006. However, the NASD imposed its largest fine to date, in excess of $2 million, on a hedge fund CEO who engaged in improper market timing. *Hedge Fund CEO Fined $2.25 Million*, HEDGE FUND STREET, Oct. 29, 2006, *available at* http://www.fundstreet.org/2006/10/hedge_fund_ceo_.html.

362 Multiple overlapping identities, such as allegiance to more than one country, exist in the global financial markets for many entities and individuals. *See* John G. Moon, *The Dangerous Territoriality of American Securities Law: A Proposal for an Integrated Global Securities Market*, 21 NW. J. INT'L L. & BUS. 131, 133 (2006).

363 *See* Christopher Cox, Chairman, Sec. & Exch. Comm'n, Address at the 34th Annual Securities Regulation Institute: Re-Thinking Regulation in the Era of Global Securities Markets (Jan. 24, 2007), http://www.sec.gov/news/speech/2007/

international regulatory approach is particularly important with countries that have major financial centers.[364] Increasingly, governments are trying to harmonize not only their accounting standards,[365] but also part of their financial regulations.[366] The reality is that achievement of regulatory goals requires a cross-jurisdictional effort.[367] Once the United States adopts necessary regulation of hedge funds, other countries are expected to follow.[368] However, significant differences in national approaches to hedge fund regulation may continue to exist, particularly regarding whether the ordinary investor should have retail access to hedge funds.[369]

Major international organizations are concerned about the risks

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spch012407cc.htm (noting that "fraudsters" now network their wrongful activities from many different countries).

364 *See* SEC. & EXCH. COMM'N, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 44-45 (2006), *available at* http://www.sec.gov/about/secpar/secpar2006.pdf.

365 *See* Annette L. Nazareth, Comm'r, Sec. & Exch. Comm'n, Remarks at the NYSE Regulation Second Annual Securities Conference (June 20, 2006); Thomas C. Pearson, *Creating Accountability: Increased Legal Status of Accounting and Auditing Authorities in the Global Capital Markets (U.S. and EU)*, 31 N.C. J. INT'L L. & COM. REG. 65, 68-69 (2005).

366 Harmonization of financial regulations is especially noticeable in Europe, which is home to approximately one-quarter of hedge fund issuances. *See generally* PRICEWATERHOUSECOOPERS, THE REGULATION AND DISTRIBUTION OF HEDGE FUNDS IN EUROPE: CHANGES AND CHALLENGES 4-8 (2005), http://www.pwc.com/extweb/pwcpublications.nsf/docid/44343824ED0025ED85256EA80052D97A (follow "June 2005" hyperlink). The European Union's "Markets in Financial Instruments Directive" (MiFID) created higher disclosure standards, responsibilities for regulators, and a "single passport" within the E.U. for financial instruments, including derivatives. *See* Ben Maiden et al., *Fifteen Trends to Expect in 2006*, INT'L FIN. L. REV., Jan. 2006, at 25.

367 *See* Neil Behrmann, *US and UK Regulators Extend Co-operation to Counter Market Abuse and Fraud*, INFOVEST21 NEWS, Nov. 22, 2006; *see also* Robert B. Ahdieh, *Dialect Regulation*, 38 CONN. L. REV. 863, 865–66 (2006); Eric J. Pan, *Harmonization of U.S.-E.U. Securities Regulation: The Case for a Single European Securities Regulator*, 34 L. & POL'Y INT'L BUS. 499, 527 (2003).

368 *See* VON COTTIER, *supra* note 6, at 10 ("Regulatory authorities of countries like the U.K., France, Japan, Luxembourg, and Ireland have based their national futures fund laws on [U.S.-based] CFTC and SEC rules.").

369 Charlie McCreevey, European Comm'r, Internal Mkt. & Services, Remarks at the Open Hearing on Retail Investment Funds, Market Efficiency, Hedge Funds and Private Equity Funds (July 19, 2006), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/465&format=HTML&aged=0&la (follow "PDF: EN" hyperlink).

posed by hedge funds. In 2007, the Group of Eight (G8) countries aim to promote hedge fund transparency.[370] Germany, which is leading the G8 in 2007, has suggested that hedge funds voluntarily adopt a code of conduct governing corporate governance and submit to voluntary ratings of investment strategies.[371] The International Organization of Securities Commissioners (IOSCO)[372] is also investigating hedge fund regulation issues. IOSCO is in the process of developing a "Code of Practice" for hedge fund valuations and prices.[373] The European Union encourages the hedge fund industry to adopt a self-regulatory approach.[374] Coordinated government regulation, however, is especially critical when industry self-regulation fails.[375] The need

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370 Andrea Thomas, *G-8 Panel Wants More Disclosure from Hedge Funds*, WALL ST. J. ONLINE, May 21, 2007; *see also* Andrea Thomas, *The Buzz: G-7 Asked to See If More Data Are Needed on Hedge-Fund Risks*, WALL ST. J., Apr. 21, 2007, at B3. The suggested regulatory baby steps will be included in an updated report on hedge fund practices and are expected to lead to discussions with the hedge fund industry about regulatory options. Jonathan Spalter, *Hedge Funds Face a Stark Choice: Revelation or Regulation*, FIN. TIMES, Feb. 14, 2007, at 15. The G-20 will also examine hedge fund regulation. *See* Stewart Bailey, *G-20 to Tackle Hedge Fund Secrecy*, BUS. REP. (S. Afr.), Nov. 22, 2006, *available at* http://www.busrep.co.za/index.php?fSectionId=561&fArticleId=3555403.

371 *See* Kara Scannell et al., *No Consensus on Regulating Hedge Funds; Officials Around the World Aim to Protect Markets But Differ on Methods*, WALL ST. J., Jan. 5, 2007, at C1, C2.

372 IOSCO consists of financial market regulators who cooperate together to promote standards of securities regulations in order to maintain stable and effective financial markets. Int'l Org. of Sec. Commissions, IOSCO Historical Background, http://www.iosco.org/about/index.cfm?section=history (last visited Sept. 21, 2007). IOSCO has over one-hundred securities agencies that regulate more than ninety-percent of the world's capital markets. *Id.* IOSCO has developed "Objectives and Principles of Securities Regulation" which promote investor protection, fairness, efficiency, and transparency in the capital markets. *Id.* IOSCO also seeks to reduce the systemic risks. *Id.* The IOSCO principles are used by the International Monetary Fund and the World Bank when conducting financial assessments. Jane Diplock, Chairman, IOSCO Executive Comm., Chairman, Sec. Comm'n of N.Z., Address at the 17th Asian Pacific Conference on Accounting Issues: IOSCO Response to Accounting Scandals (Nov. 21-22, 2005), http://www.seccom.govt.nz/speeches/2005/jds221105.shtml.

373 IOSCO's "Code of Practice" is expected by June 2007. PRICEWATERHOUSECOOPERS, *supra* note 251, at 4.

374 *See* Joe Kirwin, *Hedge Funds: Divided EU Finance Ministers Opt for Self-Regulation of Fund Industry*, SEC. L. DAILY (BNA), May 9, 2007.

375 For example, the failures of industry self-regulation of auditors led Congress to enact the Sarbanes-Oxley Act and create the "Public Company Accounting Oversight

for a harmonized international approach to financial regulation in general and to regulation of hedge funds in particular is more apparent in an age of cross-border stock exchanges.[376]

The United Kingdom's regulation of financial services,[377] including hedge funds,[378] is particularly noteworthy because the U.K. represents the largest component of European hedge fund activity.[379] The U.K.'s regulation uses a principles-based approach to financial regulation[380] in an effort to make the regulation more transparent. In contrast, the U.S. uses a rules-based approach, epitomized by the unadopted, proposed SEC regulation that introduced the regulatory term "accredited natural person" in an effort to limit the class of hedge fund investors.[381] A

Board" to regulate auditors. *See* 15 U.S.C. § 7218 (2000). Industry self-regulation has five potential disadvantages: "[c]onflicts of [i]nterest[,] . . . [i]nadequate [s]anctions[,] . . . [u]nderenforcement[,] . . . [g]lobal [c]ompetition[,] . . . [and] [i]nsufficient [r]esources." Cary Coglianese et al., *The Role of Government in Corporate Governance*, 1 N.Y.U. J. L. & BUS. 219, 225 (2004).

376 *See* Paul S. Atkins, Comm'r, Sec. & Exch. Comm'n, Remarks at the Institute of European Affairs (Sept. 29, 2006), http://www.sec.gov/news/speech/2006/spch092906psa.htm (stating that merger negotiations between the New York Stock Exchange and Euronext highlight "the need for a cooperative, mutually respecting regulatory approach" for overseeing hedge funds).

377 Although the European Union has standardized some financial regulation, countries often have their own additional laws. The U.K. has recently made progress in updating its securities laws. Fin. Services Auth., *Hedge Funds and the FSA* ¶ 2.3 (Fin. Services Auth., Discussion Paper No. 16, 2002), http://www.fsa.gov.uk/pubs/discussion/dp16.pdf. The U.K.'s Financial Services Authority has debated whether to liberalize its laws restricting the sale of hedge funds to retail investors. *Id.* ¶ 1.6.

378 Canadian hedge funds are registered with provincial regulators. *See* David Clarke, *New Hedge Fund Regulation Not Likely in Canada; In-force Regulations Seen Adequate for Alternative Investments*, INVESTMENT NEWS, Mar. 13, 2006, at 17. David Wilson, the new chairman of the Ontario Securities Commission, would like stricter rules on hedge funds.' He is seeking greater disclosure and tougher penalties for fraud and insider trading. *See* Thaddeus C. Kopinski, *CIBC Move May Spur Election Change in Canada*, GOVERNANCE WEEKLY, Jan. 6, 2006 (on file with author).

379 *Swiss Hunt U.K. Hedge Funds*, ACCOUNTANCY AGE, Apr. 19, 2007.

380 *The Wilder Side of Finance; Regulating Hedge Funds*, ECONOMIST, July 1, 2006, at 11. The U.K.'s FSA has announced a strategic shift from a prescriptive to a principles-based approach in the regulation of investment services. *See* COMM. ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 55 (2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. By the end of 2007, the FSA expects to replace its "Conduct of Business Rules" with new ones using a principles-based approach. *Id.*

381 *See supra* p. 69 and note 350 and accompanying text. Corporate governance in

principles-based approach[382] allows regulators more flexibility and places a greater burden of compliance on hedge funds in meeting the intent of a regulation.[383]

Highly developed countries like Canada, France, Japan, and Australia are increasingly establishing some type of regulation over hedge funds.[384] Australia, for example, relies heavily on the consistency principle of regulation by having a financial services law with a single code that regulates a vast variety of financial products, including hedge funds.[385] Australia's financial law achieves an efficient market through licensing, disclosure, and other methods to ensure fair conduct.[386] With these regulations in place, Australia allows the retail purchase of hedge funds by individual investors.[387]

The U.S. Congress should follow the both U.K.'s lead and require the registration of hedge fund advisers as well as

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the E.U. often adheres to a principles-based "comply or explain" process. COMM. ON CAPITAL MARKETS REGULATION, *supra* note 380, at 63.

382 The Committee on Capital Markets Regulation advocates that the SEC adopt more principles-based rules as the basis for its regulatory standards. *Id.* at 63-65. The Committee also advocates reducing the size of the primarily prescriptive rulebook. *Id.* at 64.

383 "A change in mutual-fund rules applicable across the EU, known as UCITS III, has meant that hedge-fund practices are also available to retail investors." *Rolling In It; Hedge Funds*, ECONOMIST, Nov. 18, 2006, at 75.

384 *See* David Wilson, Chair, Ontario Sec. Comm'n, Keynote Address at the Dialogue with the OSC: Momentum for Change: Providing the Regulation Canada Needs (Nov. 10, 2006), http://www.osc.gov.on.ca/Media/Speeches/sp_20061110_dw_dwo-momentum.jsp; Jérôme Sutour, *The Evolution of the Regulation of Alternative Management in France*, AIMA J., Feb. 2005, *available at* http://www.aima.org/uploads/Simmons65.pdf. In France, regulation of hedge funds is extensive, from management fees to leverage rations. *See* Matt Miller, *The European Cure*, DAILY DEAL, Feb. 5, 2007; *Japan's Hedge Funds Face Increased Scrutiny*, REUTERS, June 12, 2006, *available at* http://asia.news.yahoo.com/060612/3/2lryg.html.

385 *See* Gail Pearson, *Risk and the Consumer in Australia Financial Services Reform*, 28 SYDNEY L. REV. 99, 136 (2006). Switzerland also allows sales of FOFs to private individuals without any investor qualifications. *See* Antoinette Hunziker-Ebneter, *More Transparency for Funds of Hedge Funds: The Swiss Case*, EUROMONEY, at 5, 6-7, http://www.zhaw.ch/fileadmin/user_upload/management/zai/publikationen/pdf/fachartikel_euromoney.pdf.

386 *See* Pearson, *supra* note 385, at 99.

387 *See* Rita Raagas de Ramos, *Concerns Over Hedge Funds Rise As Market Volatility Rises Globally*, WALL ST. J., June 15, 2006, at C5. *Cf.* PRICEWATERHOUSECOOPERS, *supra* note 251, at 37.

Australia's example and place all financial investments on a level playing field. Individuals often rely upon advisers for financial sophistication.[388] Hedge fund advisers should not escape basic regulation applicable to other investment advisers. One reasonable alternative to achieve a level playing field among financial investments is modifying the application of mutual fund regulations as appropriate to hedge funds. Although it is not surprising that registration of hedge funds is supported by the leading trade group for mutual funds, it is helpful to point out that these investments are not currently on a level playing field.[389]

The U.S. President's Working Group has attempted to preempt potential regulation by calling for more market discipline by hedge fund creditors, counterparties, and investors.[390] The Working Group advocates the adoption of non-binding guidelines by hedge funds and their lenders in order to make hedge funds more transparent to investors and make creditors more vigilant.[391]

B. Reducing Market Failures and Fraud Through Prudential Regulation

Financial market failures arise because of systemic threats, market misconduct, information asymmetry, and anticompetitive behavior.[392] Systemic risks can jeopardize the complex but fragile international financial system.[393] Market misconduct can reduce

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388 For example, several professional football players with limited financial knowledge invested more than $15 million in a hedge fund with a scam-artist manager. Ian McDonald & Valerie Bauerlein, *Hedge Fund's Assets Hard to Find; Bench Warrant for Arrest of Atlanta Firm's Chief Is Issued in Fraud Inquiry*, WALL ST. J., Feb. 27, 2006, at C3. SEC registration of hedge fund advisers might have prevented that manager from operating a hedge fund. *See id.*

389 *See* Burns, *supra* note 313.

390 *See* Press Release, U.S. Dep't of the Treasury, President's Working Group Releases Common Approach to Private Pools of Capital; Guidance on Hedge Fund Issues Focuses on Systemic Risk, Investor Protection (Feb. 22, 2007), http://www.treas.gov/press/releases/hp272.htm; *see also* Deborah Solomon, *Regulators' Hedge Fund Approach: Hands Off*, WALL ST. J. Feb. 23, 2007, at C1.

391 *See* Timothy Spangler, *Working Group Guidance*, DAILY DEAL, Mar. 1, 2007.

392 *See* JEFFREY CARMICHAEL & MICHAEL POMERLEANO, DEVELOPMENT AND REGULATION OF NON-BANK FINANCIAL INSTITUTIONS 23 (World Bank 2002).

393 Systemic risk describes the possibility of a series of correlated defaults among financial institutions that occurs over a short time-horizon, often caused by a single major event. *See* Chan et al., *supra* note 64, at 1.

investor confidence to participate in the financial markets. Information asymmetry arises when disclosure by itself is insufficient to enable consumers to make informed choices. Anticompetitive behavior can arise when hedge funds act together. "Prudential regulation," such as requiring hedge funds to register with the SEC, attempts to prevent these market failures.

While systemic risks associated with hedge funds are reducible through government regulation, they cannot fully disappear.[394] Except for initial lock-up limitations and periodic redemption restrictions, hedge funds are vulnerable to "runs on the bank" when investors are worried and demand withdrawal all at once.[395] Regulatory policy should seek to reduce systemic threats and prevent the type of financial crisis that almost occurred with LTCM.[396] Relying on the risk management systems of financial institutions is not always adequate protection.[397]

Regulators should worry that financial institutions and managers underestimate the likelihood of severe events and overestimate their ability to take needed corrective action that is both effective and timely.[398] Regulators have a role to play in reducing the risk that the private sector's risk management processes have eroded. Regulations should help assure that hedge funds implement proper internal controls.[399] It is desirable to have

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394 *See Hong Kong HKMA Says Hedge Funds Need Close Monitoring*, XINHUA FIN. NETWORK NEWS, Jan. 30, 2007 (discussing the concerns of the Hong Kong Monetary Authority regarding hedge funds and systemic risk).

395 *See* Henny Sender, *Hedge Funds Hit Rough Weather But Stay Course*, WALL ST. J., June 22, 2006, at C1.

396 In the last twenty-five years, the LTCM crisis, combined with the Asian and Russian crises of 1998, is considered one of three major financial shocks in the "red zone" of systemic risk. CRM POLICY GROUP II, *supra* note 6, at 5-6. The other two dangerous financial shocks were the developing economies debt and banking crisis of the early 1980s and the stock market crash of 1987. *Id.*

397 Int'l Org. of Sec. Commissions, Technical Comm., Hedge Funds and Other Highly Leveraged Institutions 6 (1999), http://www.iosco.org//library/pubdocs/pdf/IOSCOPD98.pdf. An example of inadequate protection occurred in the case of a hedge fund manager suffering from severe depression. *See* Susanne Craig, *When Hedge-Fund Selling Bites Wall Street*, WALL ST. J., Aug. 3, 2006, at C1. The hedge fund manager stopped monitoring the funds and significant losses for investors resulted. *Id.*

398 *What Keeps Bankers Awake at Night?*, ECONOMIST, Feb. 3, 2007, at 73 (referencing the Financial Services Authority in its latest Financial Risk Outlook).

399 *Cf.* 15 U.S.C. § 7262 (2000) (setting forth the statutory authority for such

clear regulatory expectations, diligently enforced, and, ideally, couple those expectations with regulatory incentives. A combination of regulatory expectations and incentives will help improve risk management and reduce the likelihood of systemic risk.

Systemic risks arise from a new "triangle of vulnerability" connecting hedge funds,[400] credit derivatives,[401] and the credit cycle.[402] Particularly in the derivatives market, financial regulators know that more regulatory effort is needed to avert systemic threats to the capital markets.[403] Thus, the SEC along with other leading organizations issued a warning in Fall 2006 that countries must join forces to help contain the risk presented by the global expansion of derivatives,[404] even though derivatives often

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regulations).

400 Survey information suggests hedge funds have improved their risk management capabilities since 1999. *See* CRM POLICY GROUP II, *supra* note 6, at B-1. While more derivatives are traded on regulated futures and option exchanges, some are traded in over the counter markets that have little regulation. *Id.* at D-3.

401 Credit derivatives are privately negotiated agreements that shift credit risk from one party to another so as to act as insurance policies against corporate defaults. *See Hedge Funds and Systemic Risk in the Financial Markets*, *supra* note 78, at 126; Greg Ip, *Geithner's Balancing Act: The Fund's Go-To Man for Financial Crises Takes on Hedge Funds*, WALL ST. J., Feb. 20, 2007, at C1, C2. Since their introduction in the mid-1990s, credit derivatives have grown dramatically. At the end of 2005, $17 trillion of credit derivative contracts were estimated to exist. *See Role of Hedge Funds in Our Capital Markets: Hearing Before the Subcomm. on Securities and Investment of the S. Comm. on Banking Housing and Urban Affairs*, 109th Cong. 10 (2006) (statement of the Managed Fund Assoc.), *available at* http://banking.senate.gov/_files/gaine.pdf. While financial institutions, mainly banks, used to handle credit risk, that activity is now frequently outsourced through credit derivatives to highly leveraged hedge funds as counterparties. *See* Tim Reason, *Who's Holding the Bag?*, CFO, Oct. 2005, at 40, 42-43; *see also* Letter from Joerg Schroeder to Senator Christopher Dodd (Jan. 2, 2007) (on file with author).

402 *See* Joellen Perry & Alistair MacDonald, *European Banker Urges Disclosure on Hedge Funds*, WALL ST. J., Dec. 12, 2006, at C4.

403 The primary goal of most regulatory bodies is to better understand hedge fund operations and their potential impact on systemic risk. INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: MARKET DEVELOPMENTS AND ISSUES 45-58 (Int'l Monetary Fund 2004), *available at* http://www.imf.org/External/Pubs/FT/GFSR/2004/02/index.htm (follow "Global Financial Market Developments" hyperlink).

404 *See World Finance Watchdogs Focus on Opaque Derivatives Market*, AGENCE FRANCE PRESSE, Sept. 30, 2006 (other organizations included the U.K.'s Financial Services Authority and the Federal Reserve Bank of N.Y.).

serve a valuable purpose in the financial markets.[405]

Systemic risks are minimized by having hedge fund advisers register with the SEC. Registration helps policymakers acquire necessary information about hedge funds to make more effective policy decisions.[406] Regulators need the ability to assess the possibilities of systemic losses and financial market disruptions due to hedge fund losses from complex financial instruments. Given the tremendous size of hedge funds, systemic risk is a real concern.

Market misconduct is more likely if hedge funds remain able to use non-transparent, offshore entities while still benefiting from favorable U.S. tax law. The U.S. government should also be concerned about the integrity of the offshore financial centers and tax havens which provide administrative services to hedge funds. Tax havens often have secrecy laws that help both to hide the activities of hedge funds and to distort the information that policymakers need and revenue authorities depend upon.[407] The President's Working Group recognized that the U.S. Treasury Department needs a comprehensive solution to the tax haven problem so it can address the related concerns posed by offshore hedge funds.[408]

Information asymmetry becomes a more important concern as the financial markets use sophisticated technology to exploit small differences in information.[409] Some argue that by allowing the stock markets in the world's major financial centers to integrate, governments could track a substantial portion of the hedge funds'

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405 After studying the financial fiascos during the last two decades, a noted securities law professor advocates treating derivatives like other financial products. *See* FRANK PARTNOY, INFECTIOUS GREED 397 (Times Books 2003).

406 Registration not only helps the SEC acquire census information from hedge funds, but also facilitates detection and deterrence of hedge funds involved in fraud and prevents investment in those hedge funds. *See Hedge Funds and Systemic Risk in the Financial Markets*, *supra* note 78, at 64-67 (statement of Kenneth D. Brody, Co-Founder & Principal, Taconic Capital Advisors, LP).

407 Offshore tax havens or "Offshore Financial Centers," also have little or no tax on investment income derived in the tax haven. *See* Prem Sikka, *The Role of Offshore Financial Centres in Globalization*, 27 ACCT. FORUM 365, 366 (2003).

408 WORKING GROUP REPORT I, *supra* note 46, at 41.

409 Information asymmetry requires regulating insider trading.

financial flows.[410] Although this would help the SEC make a more appropriate determination as to whether leverage or other restrictions are needed to prevent hedge funds from potentially overwhelming a financial market, it is not enough. Further prudential regulation by the U.S. is needed for hedge funds.

Anticompetitive behavior exhibited by hedge funds is demonstrated by empty voting practices. Empty voting involves separating voting rights from economic ownership to undermine a company's economic position, and then profiting by short-selling when the resulting vote is announced. Corporate governance reforms are needed at least to disclose such practices.[411] Professors Hu and Black, in their seminal analysis of empty voting, provide a proposal for "integrated ownership disclosure rules," so that empty voting is properly disclosed.[412] While their proposal is a logical first step, other proposals deserve consideration.[413]

C. Ensuring Efficient Markets Through Enhanced Market Integrity Regulation

"Market integrity regulation" focuses on increased disclosure of relevant information and other rules for proper conduct of business.[414] Market integrity regulation helps to protect economic growth.[415] SOX provided market integrity regulation for public

410 *Track the Hedge Funds: Hong Kong's Finance Czar Takes on the Hot Money*, ASIAWEEK, Oct. 23, 1998.

411 The Justice Department is examining the anticompetitive behavior of private equity and hedge funds. Dennis K. Berman & Henny Sender, *Private-Equity Firms Face Anticompetitive Probe*, WALL ST. J., Oct. 10, 2006, at A3.

412 *See* Hu & Black, *The New Vote Buying*, *supra* note 203, at 820. Their proposal replaces, simplifies, and modernizes the SEC's five sets of disclosure rules for large shareholders (mutual fund reporting, insider disclosure, institutional money manager reporting, and large shareholder reporting on Schedules 13D and 13G). *See id.*

413 *See, e.g.*, Charles M. Nathan, *"Empty Voting" and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds*, M&A DEAL COMMENTARY, Sept. 2006, http://lathamandwatkins.com/upload/pubContent/_pdf/pub1689_1.pdf (proposing a time-phased voting system where voting is keyed to duration of ownership).

414 CARMICHAEL & POMERLEANO, *supra* note 392, at 26.

415 *See* Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721, 747 (2005) (citing Ross Levine & Sara Zervos, *Stock Market Development and Long-Run Growth*, 10 WORLD BANK ECON. REV. 323 (1996)).

companies, but not for hedge funds. A major reason for SOX was the collapse of Enron.[416] Before its collapse, Enron had converted itself into an energy trading company and was acting similarly to a hedge fund trading in derivatives.[417] Despite the hedge-fund-like behavior exhibited by Enron, SOX failed to extend its regulatory coverage to hedge funds.

1. Meaningful, But Reasonable Disclosures Needed

Disclosure of information is necessary to encourage more due diligence by the investors, creditors, and other parties in a financial or business transaction.[418] Market discipline is effective when creditors and private counter-parties have both the incentives and the abilities to evaluate the true riskiness of hedge funds investments, investment strategies, management abilities, and recent financial results.[419] Clear disclosure allows investors to make better, more informed judgments.[420] Fair evaluation requires accurate accounting, reporting, and disclosure. More frequent and meaningful disclosure of material financial information from hedge funds is needed.[421]

Opinions differ on the type of information hedge funds should

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416 For a discussion of the activities of Enron that led to passage of the Sarbanes-Oxley Act, see *Collapse of Enron: Hearing Before the S. Comm. on Commerce, Science, & Transportation*, 107th Cong. 29-40 (2002) (statement of William C. Powers, Member, Enron Board of Directors, Chairman, Special Investigation Committee).

417 *See The Fall of Enron: How Could It Have Happened?: Hearing Before the S. Comm. on Governmental Affairs*, 107th Cong. 103-34 (2002) (statement of Frank Partnoy, Professor, Univ. of San Diego Sch. of Law).

418 Ironically, some disclosure of confidential information may occur unexpectedly through the private sector. *See* Ianthe Jeanne Dugan, *Hedge Fund Managers Are Furious Over Effort to Sell Trading Histories*, WALL ST. J., Dec. 12, 2006, at C1.

419 In 2005, The Counterparty Risk Management Policy Group called for more disclosure by hedge funds to banks and prime brokers. *See* CRM POLICY GROUP II, *supra* note 6, at 13-18. The Group wants disclosure of details of hedge funds' trading philosophies, risk management systems, and market positions. *See id.*; Pierre Paulden, *Corrigan Goes on Blow-up Patrol*, INSTITUTIONAL INVESTOR, Sept. 2005, at 9.

420 In 2005, the SEC began to require funds to disclose other types of accounts run by any registered investment adviser. Eleanor Laise, *Is Your Hedge Fund Manager Two-Timing You?; As Hedge and Mutual Funds Increasingly Share Overseers, Critics Fret About Small Investors*, WALL ST. J., Nov. 1, 2006, at D1. The disclosure occurs in a "Statement of Additional Information." *Id.* This information is designed to enable the investor to determine what conflicts of interest might exist. *Id.*

421 WORKING GROUP REPORT I, *supra* note 46, at 32–33.

disclose through registration. One securities industry expert has suggested that every hedge fund provide investors with a standardized chart of its annual performance, as well as the fees for each hedge fund in the portfolio.[422] The hedge fund advisers' professional qualifications, any material conflicts of interest, the fund's investment strategies, and any redemption restrictions on the underlying hedge funds should also be disclosed.[423] Some advocate the disclosure by hedge funds of monthly returns, the extent of leverage, assets under management, instruments traded, and all brokerage, financing, and credit relationships.[424] Arguably, smaller hedge funds should not have to reveal their portfolio holdings, while larger ones might have to provide basic information about their assets because they are more likely to present systemic risk to the financial markets.[425] Thus, the regulation requirements could vary based on the size of the hedge fund investments, their potential impact on the market, and international agreements on disclosure of hedge fund investment risks.[426]

A system of disclosure for hedge funds could be implemented through a statement similar to an abbreviated "management's discussion and analysis" (MD&A), as required by the SEC for public companies.[427] The purpose of this additional disclosure is to enable the investor to assess the quality of the earnings, the profitability of the fund, and whether previous operating results can fairly predict future performance.[428] Included in the MD&A

422 The U.K. requires that hedge fund managers complete forms detailing their business plans and describing the capital that they hold to cover liabilities. Managers must also disclose personal information, such as whether they have criminal records. *See* Scannell et al., *supra* note 371, at C2.

423 *See* Roel C. Campos, Comm'r, Sec. & Exch. Comm'n, Remarks at the Managed Funds Association (July 12, 2005), http://www.sec.gov/news/speech/spch071205rcc.htm.

424 *See* Getmansky et al., *supra* note 139, at 30.

425 E.g., FOFs often disclose only their ten top holdings to potential investors. *See* Gaber et al., *supra* note 231, at 330.

426 The United States has a "multi-jurisdictional disclosure system" with Canada. Ruth O. Kuras, *Harmonization of Securities Regulation Standards Between Canada and the United States*, 81 U. DET. MERCY L. REV. 465, 468–70 (2004).

427 17 C.F.R. § 229.303 (2007).

428 SEC Guidance on MD&A, Securities Act Release No. 8350, Exchange Act Release No. 48,960, Financial Reporting Release No. 72 [2003-2004 Transfer Binder]

of public companies is also a "statement of risks." Hedge funds could supply a similar statement of risks, beyond the initial offering,[429] to provide better transparency of their trading philosophies, activities, and risks taken.[430]

Critics of disclosure are properly concerned that the extent of required disclosure of regulated investments is often excessive, creating "an acute information overload problem."[431] While the management of any entity generally prefers little disclosure so as not to limit managerial discretion,[432] the management of hedge funds will adjust to new disclosure requirements, as have management of other entities. Yet, the SEC should review the information that it requires the investor to disclose to determine if all the information is really necessary. Hopefully, the SEC can scale back some of the unnecessary disclosure required of all entities and refocus on maximizing the transparency and understandability of the financial information made available to the ordinary investor.

Consider the desired disclosure of compensation paid to hedge

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Fed. Sec. L. Rep. (CCH) ¶ 87,127, at 88,888-89 (Dec. 19, 2003).

429 A private placement memorandum is given to investors before an investment is made, and that memorandum generally includes a brief statement of risks. *See* SEC STAFF, 2003 REP., *supra* note 11, at 47–48.

430 It is time to implement the Federal Reserve Bank of New York's recommendation of a new financial statement that provides quantitative information about the overall market risk of an entity. *Cf.* Disclosure of Accounting Policies For Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments, Securities Act Release No. 7386, Exchange Act Release No. 38,223, Investment Company Act Release No. 22,487, Financial Reporting Release No. 48, Fed. Sec. L. Rep. (CCH) ¶ 72,448 (Jan. 31, 1997). A private industry study group believes that investment managers and fiduciaries need to form generally accepted techniques for supplying risk characterization data. *See* CRM POLICY GROUP II, *supra* note 6, at D-4. The goal is to provide sufficient information for an independent analysis of credit and market risk undertaken by the institutional investors. *See id.*

431 *See* CRM POLICY GROUP II, *supra* note 6, at C-1. Also, more harmonization of disclosure requirements is needed. *Id.* at C-3. Some believe the SEC registration form asks for everything and is "onerous and intrusive." Jesse Eisinger, *Long & Short: A David Toppled Hedge-Fund Rule, But Was Goliath Really So Bad?*, WALL ST. J., June 28, 2006, at C1.

432 Robert Prentice, *Whether Securities Regulation! Some Behavioral Observations Regarding Proposals for its Future*, 51 DUKE L. J. 1397, 1423 (2002).

fund advisors.[433] The huge financial incentives for highly paid hedge fund managers provide great pressure for business or accounting manipulations.[434] These financial incentives are similar to the problematic fees paid to the auditors who failed to remain independent, perform proper audits, and detect the corporate wrongdoing that led to the corporate scandals of the early 2000s.[435] One chief executive officer has characterized the exorbitant fees paid to hedge fund advisers as creating an investment business scam.[436] The excessive compensation paid to hedge fund advisers has contributed to the illegal secret deals involving inappropriate market timing and late trading that stole profits from other mutual fund investors. Further disclosures can help the market effectively reduce the outrageous fees paid to hedge funds.[437]

Congress and the SEC should take measures that help to deter inappropriate practices from reoccurring in hedge funds in the future.[438] Requiring the disclosure of securities owned personally by hedge fund advisers, as is currently required of mutual fund

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433 E.g., the United States requires that fund managers make a good faith determination that the commissions paid are reasonable relative to the value of the products and services provided by the broker-dealers and relative to the fund manager's responsibilities. *See* Soft Dollar Advice, Exchange Act Release No. 54,165 [2006 Transfer Binder] Fed. Sec. L. Rep. ¶ 87,616, at 83,355 (July 18, 2006). Where compensation to the manager is based on performance of the fund, the compensation is limited to the "fulcrum fees." *See* 17 C.F.R. § 275.205-2 (2007). *Cf.* Ron Orol, *Senate Comm. Approves Limit on Executive Comp. Plans*, DAILY DEAL, Jan. 18, 2007 (discussing the Senate Finance Committee's proposal of limiting executives to $1 million of tax-free compensation per year).

434 An academic study of companies with chief executive officers who received ninety-two percent or more of their pay in stock options found that approximately twenty percent of these companies had misstated financial statements within the previous five years. Floyd Norris, *Stock Options: Do They Make Bosses Cheat?*, N.Y. TIMES, Aug. 5, 2005, at C1 (discussing a study by Jared Harris and Philip Bromley of the University of Minnesota that was presented at the Academy of Management).

435 *See* David Skeel, *The Ghost of a Crisis in Equity Funds Hides Real Benefit*, FIN. TIMES, Sept. 5, 2006, at 19.

436 William C. Symonds, *Husbanding That $27 Billion*, BUSINESS WEEK, Dec. 27, 2004, at 119.

437 For example, the world's largest hedge fund, the Man Group, has cut its performance fees in half. *See* GUIZOT, *supra* note 151, at 32.

438 Selva Ozelli, *Taxing Mutual Fund Scandal Fines and Penalties*, ACCT. TODAY, Oct. 11, 2004, at 13.

advisers,[439] could help make some potential conflicts of interest more apparent and less likely to create problems for investors.

2. *Other Needed Rules of Conduct, Governance, and Tax Reform*

Market integrity regulation provides rules for conducting business. It involves creating reasonable entry restrictions, such as licensing, improving governance, and enhancing fiduciary responsibilities.[440] Proper tax reform can also reinforce more market integrity in the hedge fund industry and the financial markets they affect.

Proper conduct of business should require hedge funds to produce audited financial statements. Before 2006, many hedge funds did not have audited financial statements which complied with GAAP, despite the huge sums of money invested in hedge funds.[441] "Responsibility for ensuring that financial reports comply with accounting standards [primarily] rests with the officers and directors of the reporting enterprise."[442] Just as chief executive officers and chief financial officers of public companies have to certify financial statements of public companies,[443] so should hedge fund managers have to certify their financial statements. If the financial statements provided to investors are significantly distorted, investors are more likely to misallocate capital from worthy investments to other, less secure investments with distorted financial statements. Both investors and society

439 Mutual funds must disclose how many of their managers own fund shares and their stake in fund performance. *See* Portfolio Manager Disclosures, Securities Act Release No. 8458, Exchange Act Release No. 50,227, Investment Company Act Release No. 26,533 [2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,250, at 80,861-63 (Aug. 23, 2004).

440 CARMICHAEL & POMERLEANO, *supra* note 392, at 26.

441 Even when audits of hedge funds have occurred, the auditing is not as reliable because hedge fund transactions present extensive challenges for auditors. Barbara Davison, *An Audit View of Hedge Funds*, INTERNAL AUDITOR, Dec. 2006, at 75.

442 *FASB Derivative Accounting Standards, Hearing Before the Subcomm. on Commerce, Trade, and Consumer Protection of the H. Comm. on Energy and Commerce*, 108th Cong. 12 (2003) (statement of Leslie F. Seidman, Member, Fin. Accounting Standards Bd.). Auditors of financial statements have secondary responsibility. *Id.* For public enterprises, the SEC is ultimately responsible. *Id.*

443 15 U.S.C. § 7241 (2000).

suffer from disregarding the real opportunity costs of capital.[444]

Reasonable entry restrictions on hedge fund managers should exist to ensure that hedge fund advisers understand their legal requirements and have the minimum acceptable professional credentials needed to understand the financial products they might use. Although this entry restriction regulation cannot detect all scam-artists and incompetent hedge fund managers, it should help to eliminate some of the worst managers and further professionalize other hedge fund advisers.

Various governance reforms are needed for hedge funds, including some reforms similar to those in SOX.[445] Governance reforms could create greater integrity in the financial reporting by hedge funds and, in turn, more efficient capital markets.[446] Arnelle Guizot, a former hedge fund insider, advocates three corporate governance reforms for every hedge fund: (1) an independent board chairman[447] and a board comprised of at least two-thirds independent directors, (2) a chief compliance officer (CCO) who reports directly to the board, and (3) an independent audit committee.[448] Other major governance changes that are needed for hedge funds include requiring hedge funds to report and disclose the hedge fund side-letters to preferred investors.[449]

444 *See* Cynthia A. Glassman, Comm'r, Sec. & Exch. Comm'n, Remarks at the 25th Annual USC Leventhal School of Accounting SEC and Financial Reporting Institute Conference: Complexity in Financial Reporting and Disclosure Regulation (June 8, 2006), http://www.sec.gov/news/speech/2006/spch060806cag.htm.

445 One low-cost governance concept is to require hedge funds to publish their codes of ethics. *See* 15 U.S.C. § 7264 (2000); 17 C.F.R. § 229.406 (2007); Disclosure Required By Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, Exchange Act Release No. 47,235 [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,818, at 86,894-98 (Jan. 23, 2003).

446 Thomas C. Pearson & Gideon Mark, *Investigations, Inspections and Audits in the Post-SOX Environment*, 86 NEB. L. REV. (forthcoming fall 2007).

447 A board chair is important in setting the agenda and establishing a culture of enhanced independence between the fund manager and the board. Investment Company Governance, Exchange Act Release No. 26,520 [2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,243, at 80,803 (July 27, 2004).

448 GUIZOT, *supra* note 151.

449 In 2006, the United Kingdom required hedge funds to report side agreements that give preferential treatment to selected clients. Neil Behrmann, *Hedge Funds Must Report Side Letters to UK Regulators by October 31*, INFOVEST21 NEWS, Sept. 28, 2006. In a survey of hedge fund executives, Ernst & Young found that two-thirds provide side letters to their investors and one-third were increasing the disclosure of such letters. *See*

Also, the SEC should restrict voting in companies to beneficial owners, so that hedge funds cannot engage in "empty voting."[450]

Fiduciary responsibilities are more likely fulfilled when there are proper compliance controls. Insufficient compliance controls for hedge funds is one problem institutional investors frequently cite.[451] Once registered, hedge fund advisers must institute comprehensive compliance procedures and designate a CCO. However, the SEC asserts that these internal compliance measures are just the first line of defense in protecting investors against an adviser's misconduct.[452] Fulfillment of fiduciary responsibilities among hedge funds and their institutional investors can help manage potential conflicts of interest.

Hedge-fund-specific penalties for fraudulent conduct are needed to deter wrongful conduct from hedge fund managers.[453] Because hedge funds hold such substantial assets, the penalties created under Sarbanes-Oxley Act of 2002 (SOX)[454] for fraud or

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Chidam Kurdas, *Side Letters Become More Popular*, HEDGEWORLD DAILY NEWS, Dec. 12, 2006. Side letters generally ease withdrawal rights, give preferential pricing, reduce fees, or give the investor the ability to add funds when new investors are prohibited to do so. *Id.*

450 *See* Hu & Black, *Empty Voting*, *supra* note 203, at 1049.

451 SEC Hedge Fund Adviser Rule, *supra* note 40, at 72,064.

452 *Id.* at 72,079. Congress should imitate the whistle-blowing protection provisions of SOX for individuals who supply important information about hedge fund fraud, insider trading, or investment advisers who engage in other illegal activities. *See Examining Enforcement of Criminal Insider Trading and Hedge Fund Activity*, *supra* note 228, at 1247 (statement of Richard Blumenthal, Att'y Gen., State of Conn.). *Cf.* 18 U.S.C. § 1514A (2000) (protecting whistleblowers in publicly traded companies). Because hedge fund firms are small, hedge fund auditors should have the responsibility of overseeing the process by which whistleblower complaints about accounting or auditing matters are addressed. *Cf.* 15 U.S.C. § 78j-1(k) (2000) (setting forth current auditor responsibilities).

453 Meaningful penalties help to create a tougher enforcement environment for the SEC. Thus, enhanced penalties were created under SOX to deter wrongdoing. These penalties also provided a basis for more governmental investigatory staff with accounting and auditing expertise. *See* Cynthia A. Glassman, Comm'r, Sec. & Exch. Comm'n, Remarks at the European Corporate Governance Summit: An SEC Commissioner's View: The Post-Sarbanes-Oxley Environment for Foreign Issuers (Mar. 2, 2005), http://www.sec.gov/news/speech/spch030205cag.htm.

454 While SOX and its penalty structure for misleading financial statements has raised the level of compliance, problems within auditing firms continue to exist. *See, e.g.*, Christopher Byron, *Two Faces for PWC – Firm Has One Schtick for Clients, Another for the Lawyers*, N.Y. POST, Jan. 3, 2005, at 31.

interference in an audit are not sufficiently severe to effectively deter the illegal conduct associated with hedge funds, their employees, and cozy outside service providers.[455] For example, outside service providers for hedge funds may need additional incentives to ensure that their independence remains firm.[456]

Closing the tax loopholes and incentives that tax exempt organizations in the United States have to invest in offshore hedge funds could also help reduce some of the opportunities for hedge fund fraud.[457] Congress could take action against tax schemes by changing the burden of proof when income is earned from a trust or corporation in a tax haven.[458] Congress could also change the tax treatment of hedge fund entities, currently similar to that of "publicly traded partnerships," so that hedge funds are no longer treated as flow through entities. For such proposed tax changes to be effective, however, Congress must also modify the tax consequences for offshore investment[459] and limit the amount of tax-deferred compensation allowed.[460] Otherwise, the change

455 *See* Diamond, *supra* note 248. For example, a Director of Investments, who was an unregulated investment adviser to three hedge funds, defrauded investors. Press Release, Sec. & Exch. Comm'n, SEC Brings First Failure To Supervise Action Against Principal of an Unregistered Investment Adviser to a Hedge Fund; Also Charges Hedge Fund Director of Investments With Fraud (Dec. 15, 2003), http://www.sec.gov/news/press/2003-172.htm. The SEC imposed only a $15,000 fine on this hedge fund employee, beyond requiring reimbursement to hedge fund investors. *Id.* Such a miniscule penalty will not deter wrongful conduct by other hedge funds.

456 *Cf.* Gregory Zuckerman & Peter Lattman, *Research Firms' Consultant Ties Draw Scrutiny; New York, SEC Examine Information Disclosures To Hedge Funds, Others*, WALL ST. J., Jan. 16, 2007, at C1 (discussing the investigation of whether research firms Gerson Lehrman Group and Vista Research possibly shared non-public information with hedge funds).

457 For example, Congress could require tax-exempt organizations which invest abroad to gross-up the unrelated business income tax by the tax that would have been paid if the investment occurred within the United States.

458 *See generally* MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE § 7B.11[2] (rev. 2d ed. 2002).

459 Senator Carl Levin "has proposed making it easier for the [U.S.] government to crack down on tax schemes." Editorial, *Billionaire Tax Cheats Beyond the Reach of Law*, NEWS TRIBUNE (Tacoma, Wash.), Aug. 14, 2006, at B5. He proposes to "[place] the burden on taxpayers to prove that income from trusts or corporations in tax havens is not taxable." *Id.* Senator Levin "also wants to force financial institutions to report to the IRS when the beneficiary of [a] foreign compan[y] [or entity] is an American citizen." *Id.*

460 *See* Howard Leventhal & Joseph Bianco, *Senate Passes Deferred Compensation*

would simply push more hedge funds to relocate offshore.[461]

Regulation that either limits the tax deductibility of fees paid to an investment adviser (including any hedge fund adviser) or adopts restrictions similar to those placed on mutual fund adviser compensation is advisable.[462] Such regulation could reduce the financial incentive for hedge fund managers to engage in fraudulent activities, help create a more reasonable level of compensation, and thus lessen the burden on the taxpayers who indirectly subsidize tax loopholes for hedge funds and their employees.[463]

With increased disclosure and other responsibilities, costs rise for both the private sector and government.[464] Hedge funds could generally absorb the costs, given the exorbitant fees they are collecting from their clients. Governments also have additional costs from the need to examine periodically the information disclosed. While the SEC may need more money from Congress to handle the increased responsibilities of examining the

Limits, HEDGEWORLD DAILY NEWS, Feb. 5, 2007.

461 *See* Kenard, *supra* note 9, at 139–40.

462 *See* Hal Lux, *Rich, Offshore, Taxable?*, INSTITUTIONAL INVESTOR, Sept. 2002, at 13. Similarly, the U.S. Senate is reviewing the tax treatment of interest carried by fund managers, which is currently taxed at capital gains rates. Instead, where "carried interest" represents the underlying income for services, it could be taxed at the higher ordinary income tax rates. Sarah Lueck, *Senate Aides Weigh Hedge-Fund Tax Changes*, WALL ST. J., Mar. 9, 2007, at C2.

463 If an investment adviser is registered, then (s)he is prohibited under the Investment Advisers Act from charging a performance fee to clients who are not "qualified clients." 17 C.F.R. § 275.205-3 (2007). A qualified client must have a net worth of more than $1.5 million or "at least $750,000 under the management of the investment adviser." *Id.* Investment advisors must look through a fund to determine that all investors are qualified clients before they charge a performance fee. *Id.*

464 The SEC underestimated the private costs of increased disclosure under the Advisers Act, characterizing them as significant, but reasonable. The SEC had estimated the added costs created for hedge fund advisers as "$20,000 in professional fees and $25,000 in internal costs, including staff time." SEC Hedge Fund Adviser Rule, *supra* note 40, at 72,063 n.112. However, the SEC noted that "several hedge fund advisers estimated the costs to be in the range of $300,000." *Id.* at 72,081. The higher cost was mostly attributable to "compensation costs for hiring a dedicated chief compliance officer (CCO)." *Id.* at 72,081. Total costs for all hedge funds was estimated at $44 million. Letter from Kathleen E. Wannisky, Managing Assoc. Gen. Counsel, U.S. Gov't Accountability Office, to Sen. Richard C. Shelby, Sen. Paul S. Sarbanes, Rep. Michael G. Oxley & Rep. Barney Frank (Dec. 20, 2004) (enclosure), http://www.gao.gov/decisions/majrule/d05222r.pdf.

disclosures by hedge funds,[465] SEC Commissioner Atkins' argument that hedge fund registration would unduly divert resources from the oversight of mutual funds, which benefits investors who are less wealthy,[466] is specious. Pension plans are investing in both hedge funds and mutual funds, and thus both require SEC examination.[467]

VI. Conclusion

Hedge funds are a vital part of the financial system, but they pose substantial risks to both the stability of the financial markets and the capital preservation of investors. While the financial markets have radically changed in the last sixty-five years with increased globalization and technological sophistication, the laws governing securities have not. Our market continues to operate under securities laws primarily drafted during the Great Depression. The SEC must abandon its Depression-era mentality and propose meaningful regulations for hedge funds. The SEC's anti-fraud regulation does not go far enough to ensure that all individual and institutional investors receive government help at a level sufficient to maintain the integrity of, and attract capital investment in, the global financial markets.[468] Properly regulated markets help to maintain stability in the financial markets, provide safety for all investors, and provide access to relevant information for greater market efficiency.

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465 Bloomberg News, *SEC Plans Database on Hedge Trading*, AMERICAN BANKER, Dec. 6, 2006, at 18. Precedent exists from SOX for giving the SEC additional funding when its responsibilities are increased. Thus, funding decisions should not drive the debate about whether the SEC should have the power to examine hedge funds.

466 *See* Paul S. Atkins, Comm'r, Sec. & Exch. Comm'n, Remarks at the 9th Annual Alternative Investment Roundup (Jan. 29, 2007), http://www.sec.gov/news/speech/2007/spch012907psa.htm (discussing his dissent to the SEC's rule requiring registration of hedge fund managers).

467 Opponents to hedge fund regulation apparently also assume that the SEC will not acquire added resources for additional responsibilities, unlike the precedent set under SOX.

468 "Investors increasingly are trading in other countries besides their own." Christopher Cox, Chairman, Sec. & Exch. Comm'n, Keynote address at the International Organization of Securities Commissioners Technical Committee Conference: 'The Hunters and the Stag': Why National Securities Regulators Must Collaborate In the Era of Global Investing (Nov. 16, 2005), http://www.sec.gov/news/speech/2006/spch111606cc.htm.

More effective SEC regulation of hedge funds can reduce systemic risk, protect investors, and ensure market efficiency. Prudential regulation is needed to prevent market failures. Market integrity regulation is essential to reduce the opportunity for fraud from complex hedge fund financial transactions. Any additional regulation should also require hedge funds to register with the government to ensure compliance with fiduciary duties, adviser qualification requirements, and increased disclosure to create more efficient markets. SEC registration of hedge funds provides several benefits, such as requiring that all hedge funds use GAAP and audited financial statements. A coordinated international approach in regulating hedge funds will best enable the SEC to protect global financial market stability and promote integrity in the global financial markets.