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Rethinking Hedge Fund Regulation:

Focusing on the U.S., the U.K., and Korea

Eun Jip Kim

Submitted to the faculty of Indiana University School of Law-Bloomington

in partial fulfillment of the requirements

for the degree

Doctor of Juridical Science

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Accepted by the Graduate Faculty, Indiana University School of Law-Bloomington, in partial fulfillment of the requirements for the degree of Doctor of Juridical Science.

Sarah Jane Hughes, University Scholar and Fellow in Commercial Law

Brian Broughman, Associate Professor of Law

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Abstract

Until the global financial crisis in 2008, hedge funds had relied on various safe harbor rules to remain unregulated. Since then, various subprime mortgage crisis-driven regulatory reforms have been made worldwide. Through the implementation of registration and reporting obligations the hedge fund regulatory framework has been changed to reinforce regulations that may provide financial stability, making hedge funds more like other regulated entities.

Current hedge fund regulations are based on the policy grounds, on one hand, that macro-prudential regulations are necessary due to the potential adverse effects on the market from hedge fund size and leverage positions, and on the other hand, that conventional micro-prudential regulations are necessary due to the rising exposure of unaccredited and unsophisticated investors to the market (necessitating governmental protection).

Based on observations of the hedge fund regimes in the U.S., the U.K., and Korea, this article concludes that the current regimes have succumbed to the pressure to overregulate: It would be prudent for future regulatory efforts to focus on making the hedge fund market accessible to only accredited investors, and the role of a visible regulatory hand in this market should be refrained from to the extent necessary to promote market competition and financial innovation, while mitigating potential systemic risk from hedge fund failures.

Table of Contents

I. INTRODUCTION 1

A. Background 1

B. Purpose and Scope of the Study 4

C. Composition of This Dissertation 9

II. OVERVIEW OF HEDGE FUND REGULATION 12

A. What does The Term "Hedge Fund" Mean? 12

B. What are the Common Features of Hedge Funds? 14

C. How are Hedge Funds Distinct from Other Pooled Investment Funds? 20

1. Hedge Funds versus Mutual Funds 21

2. Hedge Funds versus Private Equity Funds 24

3. Hedge Funds versus Venture Capital Funds 28

4. Private Equity Funds versus Venture Capital Funds 30

D. What Benefits may Hedge Funds Provide to the Market? 31

III. MAIN ISSUES REGARDING HEDGE FUND REGULATION 35

A. Should Hedge Funds be Regulated or Not ? 35

B. How to Regulate Hedge Funds ? 42

1. No Direct Regulation Approach 43
2. Regulating Fund Only Approach 47
3. Regulating Manager Only Approach 50
4. Regulating Both Fund and Manager Approach 56
5. Regulating Investors Only Approach 58
6. Regulating Counterparties Only Approach 60
C. Summary and Comments 63

IV. HEDGE FUND REGULATION IN THE U.S. 69

A. Overview 69
B. Hedge Fund Regulation in the US : Before the Dodd-Frank Act 78
1. Investment Company Act of 1940 78
2. Securities Act of 1933 81
3. Securities Exchange Act of 1934 84
4. Investment Advisers Act of 1940 87
C. Hedge Fund Regulation in the US : After the Dodd-Frank Act 94
D. Summary and Comments 100

V. HEDGE FUND REGULATION IN THE U.K. 111

A. Overview 111
B. Hedge Fund Regulation in the U.K. : Before the AIFMD 112
1. Hedge Fund Manager Regulation 112
2. Hedge Fund Marketing Regulation 117

3. HEDGE FUND REGULATION 120

C. HEDGE FUND REGULATION IN THE UK : AFTERTHE AIFMD 122

1. ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE 122

2. THE IMPACT OF THE AIFMD TO THE UK HEDGE FUND REGULATION 132

D. SUMMARY AND COMMNETS 136

VI. HEDGE FUND REGULATION IN KOREA 145

A. OVERVIEW 145

B. HEDGE FUND REGULATION IN KOREA : BEFORE NEW HEDGE FUND REGIME 150

1. HEDGE FUND MANAGER REGULATION 150

2. HEDGE FUND REGULATION 155

3. HEDGE FUND MARKETING REGULATION 157

4. HEDGE FUND OFFSHORE FUND MARKETING REGULATION 157

C. HEDGE FUND REGULATION IN KOREA : NEW HEDGE FUND REGIME 160

1. HEDGE FUND MANAGER REGULATION 161

(A) LICENSING REQUIREMENT 161

(B) REPORTING REQUIREMENT 165

2. HEDGE FUND REGULATION 166

(A) REPORTING REQUIREMENT 166

(B) HEDGE FUND MARKETING REGULATION 168

(C) INVESTORS (QUALIFIED PURCHASERS) 170

(D) INVESTMENT AND MANAGEMENT REGULATION 173

(E) FUND ASSETS CUSTODY 174

(F) SUITABILITY 175

(G) PERIODIC REPORT 177

D. SUMMARY AND COMMNETS 178

VII. SIMILARITIES AND DIFFERENCES BETWEEN THE U.S., U.K., AND KOREA 183

A. OVERVIEW 183

B. SIMILARITIES BETWEEN THE U.S., THE U.K., AND KOREA 186

C. DIFFERENCES BETWEEN THE U.S., THE U.K., AND KOREA 197

D. SUMMARY AND COMMENTS 210

VIII. RECOMMENDATIONS 224

A. HOW TO REGULATE HEDGE FUNDS IN THE FUTURE ? 224

B. WHICH COUNTRY'S APPROACH IS MORE DESIRABLE ? 228

1. WHAT IF A NON-US PERSON RAISES CAPITAL IN THE US? 228
2. WHAT IF A US PRIVATE ADVISER RAISES CAPITAL IN THE US, UK, OR KOREA? 236
3. WHAT IF AN OFFSHORE MANAGER RAISES CAPITAL VIA OFFSHORE FUNDS IN THE US, UK, OR KOREA? 241
4. WHAT IF AN OFFSHORE MANAGER RAISES CAPITAL VIA ONSHORE FUNDS IN THE US, UK, OR KOREA? 247

IX. CONCLUSION 252

Bibliography 256

I. Introduction

A. Background

In late 2011, the Korean Financial Services Commission passed a set of rules for the introduction of Korea based hedge funds.[1][2] Under the new regime, Korea based hedge funds were first launched in December 2011. This was an interesting legislative development given that other major jurisdictions such as the US and the UK introduced much more stringent regulations to curtail the activities of hedge funds since the global financial crisis of 2008.[3]

Unsurprisingly, many differences can be found between the Korean hedge fund regulations and those in foreign jurisdictions. For instance, there is a clear distinction in place between private funds[4] and so-called qualified purchaser funds[5],

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[1] As illustrated *infra*, "hedge fund" is not a legally defined term, but it is a commonly used term referring to certain unregulated or lightly regulated fund or pooled investment vehicle around the world. In this article, I will use the term "hedge fund(s)" broadly to include any type of private pooled investment vehicles, regulated or not, but to exclude private equity funds and venture capital funds.

[2] *See* Jabon sijang gwa geungyung tujaeobe gwanhan beobryul sihaengryung [Enforcement Decree of the Financial Investment Services and Capital Markets Act], Presidential Decree No. 25050, Dec. 30, 2013, art. 271-2, as amended (S. Kor.) [hereinafter PD], *available at* http://www.moleg.go.kr/english/korLawEng.

[3] The Korean hedge fund regime was introduced first in Korea by amending the then-existing qualified purchaser fund provisions in the Presidential Decree of the Financial Investment Services and Capital Markets Act, and later it was codified into the FSCMA in 2013. *See* Jabon sijang gwa geungyung tujaeobe gwanhan beobryul [Financial Investment Services and Capital Markets Act], Act No. 11758, May 28, 2013, art. 249-2, as amended (S. Kor) [hereinafter FSCMA], *available at* http://www.law.go.kr/engLsSc.do?menuId=0&subMenu=5&query=자본시장법#liBgcolor0.

[4] *See* FSCMA, art. 249.

[5] *See id.* art. 249-2.

and only the qualified purchaser funds are legally classified as a category of hedge fund under the Korean regime.

Other jurisdictions, such as the US and the UK, treat both funds the same as hedge funds or unregulated funds.[6] There is a clear distinction between hedge funds and private equity funds made under the Korean regime. By contrast, both funds have remained unregulated in the US and the UK by utilizing various safe harbor rules, and as a result, have not been legally differentiated.[7]

Furthermore, private funds,[8] including hedge funds and private equity funds, and the fund managers[9] are both regulated under the Korean regime.[10]

---

[6] This regulatory difference may arise because Korea defines the two terms (*i.e.,* private fund and qualified purchaser fund) separately and differently to regulate them more lightly than mutual funds, and designate only qualified purchaser fund as hedge fund, while both the US and the UK define the terms as safe harbors for hedge funds to avoid the regulation. *See infra* Chapter VI, Part B.1, Chapter V, Part B.3; Chapter VI, Part C.2.

[7] For instance, the U.S. Investment Company Act of 1940 provides leeway for the hedge funds to avoid registration requirements. *See* 15 U.S.C. § 80a-3(c)(1), (7). The U.K. fund regime also does not require onshore or offshore hedge funds to be authorized by the Financial Services Authority (currently Financial Conduct Authority) unless these funds are offered or sold to the investing public. *See* Financial Services and Markets Act, 2000, c. 8, pt. XVII, c. 2, art. 8, 238(5) (U.K.) [hereinafter FSMA], *available at* http://www.legislation.gov.uk/ukpga/2000/8.

[8] Privately placed venture capital funds are not classified as 'collective investment schemes' (i.e., funds) under the FSCMA and are regulated under a separate statute due to special policy considerations in Korea even though those funds are still subject to certain provisions under the FSCMA to a very limited extent. *See* FSCMA, art. 6(5).

[9] The term, fund manager, is not a legal term, but it usually means investment adviser providing investment advisory services on a discretionary basis for the pooled investment vehicles. The fund manager is different from the adviser for segregated accounts in that the latter provides the advisory services to each individual account on a segregated basis while the former does so on a pooled basis. Therefore, both managers are similar in nature because the services they provide. The US and the UK regimes provide the same license and regulatory requirements on fund managers and on advisers although the fund manager is subject to additional fund-specific regulatory obligations. Korea provides separate licensing and regulatory requirements on them and treats them differently from the beginning. *See* 15 U.S.C. § 80b-2(a)(11), 3(b); FSMA, art. 19; FSCMA, art. 6(5)-(7), 12(1).

Alternatively, it is more common in the US and the UK that only the fund managers are regulated - even under the new regulatory regimes promulgated after the financial crisis of 2008[11] - and the funds can remain unregulated as long as they satisfy certain safe harbor requirements.[12]

Understanding the hedge fund regulations and underlying principles of major jurisdictions is essential to ensuring harmonious regulatory environments around the world and to minimizing the regulatory arbitrage problem. It is critically important to have a level playing field (in terms of hedge fund regulation) among these countries because certain regulations may be easily avoided by establishing the funds and the fund managers in offshore jurisdictions that provide lighter regulation, allowing those funds to be marketed to potential investors on a transnational basis through local private placement regimes.[13]

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[10] Private equity fund managers used to be exempted from direct regulation under the FSCMA until the FSCMA was amended to impose registration obligations on them from May 2013. But, they are still subject to relatively lighter regulation than hedge fund managers in Korea. *See* FSCMA, art. 272-2(1).

[11] As further discussed *infra*, the US fund regime used to provide safe harbor rules for the private fund advisers, and they are exempted from registration and other compliance requirements if they satisfy the so-called "fewer than 15 clients" threshold condition until it was repealed and replaced by the foreign private adviser exemption under the Dodd-Frank Act. *See* 15 U.S.C. § 80b-3(b)(3); Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 408, 124 Stat. 1376, 1575 (2010) [hereinafter Dodd-Frank Act].

[12] *See infra* Chapter IV, Part B, C and Chapter V, Part B, for the details of the safe harbor rules available for the hedge funds and their managers in the U.S. and in the U.K.

[13] Considering the global nature of hedge funds in particular, it is more likely that the regulatory arbitrage problem will inevitably arise if a jurisdiction puts a very stringent regulatory regime in place while other jurisdictions provide relatively lenient regulatory environments. *See e.g.,* Saeed Azhar & Parvathy Ullatil, *Seeking Less Scrutiny, Hedge Fund Flock to Asia,* REUTERS, May 17, 2010, *available at* http://www.reuters.com/article/2010/05/17/us-asia-hedgefunds-analysis-idUSTRE64G31W20100517.

For decades, there have been many discussions or debates going on in the US and in the UK on whether to and how to regulate hedge funds and their managers, culminating in mandatory registration requirements for the hedge fund managers through the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter as "Dodd-Frank Act") and the Alternative Investment Fund Managers Directive (hereinafter as "AIFMD").[14] Thus, it is worth exploring these regulatory and/or legislative developments in the US and in the UK in particular, because it would be extremely helpful for Korea in best redesigning the hedge fund regime in the future.

B. Purpose and Scope of this Study

The purpose of this dissertation is to explore and identify desirable regulatory models to consider in the future, based on a comparative analysis of the regulations and underlying rationales in the US, UK, and Korea. While each country may have different views or different regulatory frameworks relating to hedge funds and their managers, there are some issues in common, among other things, to be revisited and resolved going forward.[15]

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[14] *See generally* Dodd-Frank Act, *supra* note 11; Council Directive 2011/61, 2011 O.J. (L 174) 1 (EC) [hereinafter AIFMD], *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF.

[15] *See generally* Technical Committee of the International Organization of Securities Commissions, Final Report, *The Regulatory Environment for Hedge Funds: A Survey and Comparison* (Nov. 2006), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf.

First, given the fact that private funds are either unregulated or lightly regulated in many jurisdictions,[16] and that both retail investors and accredited investors are allowed to invest (both directly or indirectly)[17] in the funds, controversies have arisen as to what governmental or regulatory protections should be afforded to such investors. At issue is whether, from the investor protection perspective, the unaccredited investors should be treated differently from the accredited investors who are presumably in the position to "fend for themselves"[18], or if no further regulatory interventions are necessary to protect unaccredited investors, why not.[19]

It is a well-known fact that hedge funds have been unregulated or minimally regulated, based on the ground that they are offered or sold on a private placement basis, and are not marketed to the investing public.[20] As a consequence, target investors (*i.e.,* accredited investors) need to rely on their own financial

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[16] *See id.*

[17] As further discussed *infra*, for example, the U.S. securities and fund regimes (i.e., the Securities Act of 1933 and the Investment Company Act of 1940) provide that a limited number (up to 35 persons) of retail investors are able to invest in hedge funds directly with sophistication test, and non-sophisticated investors are also allowed to indirectly invest in hedge funds through fund of hedge funds. *See* 15 U.S.C. § 80a–12(d)(1); 17 C.F.R. § 230.506(b).

[18] *See S.E.C. v. Ralston Purina Co*., 346 U.S. 119, 126 (1953).

[19] Even under the pre-Dodd-Frank Act regimes, hedge fund advisers have been regulated to some extent in the U.S. That is, they owe fiduciary obligation to the fund and its beneficial owners and they are also subject to anti-fraud rules although they previously remained outside direct regulatory oversight by relying on various safe harbor provisions. *See e.g.* 15 U.S.C. § 80b–6(4); 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. Hedge fund advisers are also obligated to check the sophistication status of the unaccredited investors before accepting capital from them. *See* 17 C.F.R. § 230.506(b).

[20] *See generally* SEC Staff Report, *Protecting Investors: A Half-Century of Investment Company Regulation,* May 29, 1992, at 103-118 [hereinafter SEC Staff Report], *available at* http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

expertise or on third party professionals when making investment decision regarding the hedge funds.

Thus, it is very important issue whether those retail investors in the private funds should be treated differently from accredited investors, and whether more governmental protections should be provided, in case where retail investors is also limitedly accessible to the hedge fund market.[21] Alternatively, it is also worth exploring the feasibility of completely barring the unaccredited investors' access to the hedge funds, and allowing only indirect investment through fund of funds or other intermediating investment vehicles, such as segregated accounts or trust accounts.[22] This alternative scenario is premised on the belief that hedge funds should be lightly regulated going forward. To do so, it is necessary to make the hedge fund markets purely private market for accredited investors to ensure that no investor protection concerns are raised.[23]

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[21] Due to this controversy, there is no private fund (*i.e.* something like Section 3(c)(1) fund under the U.S. regime) exemption available to the hedge fund and no unqualified purchaser-investor is allowed to invest in such hedge fund in Korea. In other words, there are no the private fund ideas in Korea regarding hedge funds, and only qualified purchasers-investors are allowed to invest in the hedge funds albeit limited number of non-professional investors are legally permissible to invest in the hedge funds subject to a suitability test. *See* FSCMA, art. 46, 249-2.

[22] Fund of funds, segregated account, or trust account (especially unspecified trust account) are some of the examples how the retail investors should be allowed to invest in hedge funds indirectly through financial intermediaries and it is based on the belief that the financial intermediaries are deemed financially sophisticated and they are obligated to invest in the hedge fund in the best interest of the underlying retail investors as a fiduciary. *See e.g.,* FSCMA, art. 37, 79, 96, 102.

[23] Interestingly and confusedly, existing Korean hedge fund regulation provides that only qualified investors including certain wealthy individuals meeting the threshold requirement (*i.e.* minimum investment amount of 0.5 billion Korean Won or more) are permitted to invest in hedge funds, but some of the individual-qualified purchaser investors (*i.e.* wealthy individuals) are still classified unsophisticated investors and thus fall under the protections of the FSCMA suitability rule. Because of these apparently contradictory rules, as further explored *infra* Chapter VI, Part C, it is unclear

Second, another area of interest is how to best to regulate hedge funds and their managers. As aforementioned, Korea regulates both hedge funds and their managers, while the U.S. and the U.K. regulate hedge fund managers only.[24] Given the disparity in the way of regulating hedge funds and their managers between countries, it is worth exploring the policy rationales for why each jurisdiction takes different regulatory approaches in regulating hedge funds and their managers. This analysis is important because the more narrowing the regulatory gap between the countries, the more likely to minimize the possible regulatory arbitrage or regulatory shopping problem.

Further, it should be also explored the extent of the hedge fund regulation assume that it is necessary to regulate them. That is, how differently hedge funds, private equity funds, and venture capital funds should be treated is another issue to explore. While some similarities exist between them as private funds, each fund category may still retain distinct features which merit different respective levels of regulation. Accordingly, it is difficult (or perhaps impossible) to apply a uniform set of regulatory standards given that various and different types of funds are available even within the hedge fund industry itself.

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what the underlying rationale is for the government to protect some qualified purchasers-wealthy individuals and not others. *See* FSCMA, art. 47, 279-2.

[24] What is interesting and noteworthy is that, unlike hedge fund managers, private equity fund managers were exempted from registration or licensing requirement while the private equity fund itself is subject to registration and other regulatory obligations until the FSCMA was amended in 2013 to require them to register with the FSC. Accordingly, it may be concluded that Korea takes a two-tiered or phased approach in regulating hedge funds and private equity funds based on the principle of proportionality. *See* FSCMA, art. 12(1), 249-2(1), 272-2(1).

Third, another area focus should be on is how differently onshore and offshore hedge funds are regulated from country to country.[25] As a matter of fact, hedge funds are global in nature, and can very easily be moved offshore. As a result, the hedge fund market is the very market that various cross-border regulatory issues, such as licensing, marketing, and market manipulation, inevitably arise.

Without a doubt, hedge fund related transnational regulatory issues are dealt with differently from country to country. There is no reason, however, why we should not explore ways in which to apply the same regulatory standards in between jurisdictions, assume that the investment objective and target investors are same. In that regard, it is worth exploring how to promote a hedge fund regulatory regime that would treat both onshore and offshore hedge funds the same to the extent possible.[26]

In addition, I will also compare and contrast the level of regulation that existed before the global financial crisis of 2008 and how these regulations have evolved after the crisis focusing on the US, UK, and Korea respectively. As the evolution of these regulations would undoubtedly vary from country to country

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[25] For instance, the real estate funds or commodities funds are not regulated in the U.S., while such funds are typically regulated in the U.K. and Korea, among other countries. It is mainly due to the facts that U.S. fund regulation is applied only to the fund (*i.e.,* investment company) primarily investing in securities, while other countries like the U.K. and Korea regulate any pooled investment vehicles whether or not they invest in securities. *See* 15 U.S.C. § 80a–3(a)(1); FSMA, art. 235; FSCMA, art. 6(5), 9(18).

[26] EU Alternative Investment Fund Managers Directive may be one of the landmark regulatory attempts to make hedge fund regime among the jurisdictions even and consistent although it has a binding force only to EU member states. *See* AIFMD, explanatory note 4.

and from fund to fund (*i.e.* hedge fund vs. private equity fund vs. venture capital fund), I will explore their similarities and differences, and the underlying policy justifications of each.

Furthermore, based on the observations and discussions outlined above, I will make certain recommendations for a future hedge fund regulatory scheme that will bring about a more equal treatment of hedge funds regardless of whether they are domiciled onshore or offshore from a transnational regulatory perspective.

C. Composition of This Dissertation

This dissertation is composed of nine chapters. Chapter II illustrates general features about hedge funds and their managers. It is important to understand this first because it would help us have better understanding about hedge fund related regulatory concerns and policy rationales which will be discussed in the following chapters.

Chapter III explores major issues about hedge fund regulation. In this chapter, I will cover the issues of whether or not to regulate hedge funds, how and to what extent to regulate them, and the underlying policy rationales for doing so. It is critically important to understand these issues first because hedge fund regulatory regimes across countries should be implemented based on these discussions and on policy grounds in general.

Chapter IV provides an overview of hedge fund regulation in the US. In this chapter, I will explore the hedge fund related regulatory developments made

before and after the global financial crisis of 2008 and the underlying policy justificationations for the then-existing regime.

The US hedge fund regime is very important because the US used to be, and currently is, the number one country around the world in the hedge fund industry, and because the US regime used to be regarded by hedge funds as friendly because it provides various safe harbor rules for a long time. In that regard, it is worth observing how the US hedge fund regime has been changed after the 2008 global financial crisis and what made the US legislators and regulators change their regulatory philosophy.

Chapter V explores the UK hedge fund regimes. It will be demonstrated and analyzed in the order of time sequence, including before and after the AIFMD was transposed to the UK regime. As one of the two major hedge fund jurisdictions in the world, it is also important to take a close look at the UK hedge fund regimes and how the UK regulators have responded to the 2008 financial crisis, as well as how they justify the change in their regulatory position.

Chapter VI deals with Korean hedge fund regimes. Korea is a relatively young country in the global hedge fund market because it introduced its hedge fund regime just a few years ago in the wake of 2008 global financial crisis. In this chapter, I will illustrate about what the Korean hedge fund regulatory model looks like and under what policy grounds the Korean regulators justify the regulation.

Chapter VII explores the regulatory similarities and differences between the three countries, based on the observations in Chapters IV through VI. In so doing, I will point out both strong points and weak points in each jurisdiction, and

address about which country's regulatory approach is more appropriate and under what policy grounds.

In chapter VIII, I will suggest some regulatory recommendations for a future hedge fund regulation based on the foregoing discussions and observations. To do so, I will use some hypothetical situations to illustrate how the hedge fund regimes in the three countries apply, and what regulatory gaps or regulatory loopholes may exist in each jurisdiction.

Chapter IX concludes with a summary of this dissertation. I will also briefly discuss other relevant issues not thoroughly dealt with in this dissertation and potential limitations or counterarguments I may face in this dissertation.

II. Overview of Hedge Fund Regulation

A. What Does the Term "Hedge Fund" Mean?

Hedge fund has been defined in various ways and from various perspectives over the decades mainly because there has been no generally accepted definition, nor has a statutory definition been available.[27] Nonetheless, the term "hedge fund" can be generally defined, in part, as "an investment vehicle that pools the monetary contributions of multiple investors and employs a variety of investment strategies."[28]

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[27] After the global financial crisis of 2008, there have been regulatory efforts to define "hedge fund" for the purpose of having them under the regulatory purview, but the concepts of "private fund" and "alternative investment fund" are also insufficient to clearly identify who they are and what they do. *See e.g.,* Dodd-Frank Act § 402(a); 15 U.S.C. § 80b–2(a)(29) (defining private fund as "an issuer that would be a investment company, as defined in Section 3 of the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act); AIFMD, art. 4(1)(a) (defining alternative investment funds as "collective investment undertakings, including investment compartments thereof, which:

(i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

(ii) do not require authorization pursuant to Article 5 of Directive 2009/65/EC").

[28] *See* Technical Committee of the International Organization of Securities Commissions, *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds- of) Hedge Funds*, Feb. 2003, at 1 [hereinafter IOSCO Hedge Fund Report], *available at* http://hb.betterregulation.com/external/IOSCO%20PD142.pdf. Similarly, the SEC defines hedge fund as "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act." Staff Report to the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds,* Sept. 2003, at 3 [hereinafter SEC Hedge Fund Report]. The IOSCO also defines hedge fund, focusing more on its practical characteristics, as "institutions which are significant traders for their own account in financial instruments and which take on significant leverage, subject to little or no direct prudential regulation, and subject to limited disclosure requirements as they are seldom public companies." Technical Committee of the International Organization of Securities Commissions, *Hedge Funds and Other Highly Leveraged Institutions*, Nov. 1999, at 4, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD98.pdf. *See also* Erik J. Greupner, *Hedge Funds are Headed Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1559 (2003) (defining hedge fund as "privately offered, relatively unregulated pooled investment

It should be noted, however, is that it is difficult to uniformly define "hedge funds", and it is almost impossible to do considering the diverse and different nature of hedge funds. That may be the very reason why thus far there have been no recommendations or regulatory trials on how to legally define them. In that regard, it may be concluded that some current definitions of "hedge fund", such as a private fund in the US or alternative investment fund in the European Union, may be regarded as regulatory efforts to indirectly define them so that they fall under regulatory purview to some extent.[29]

As seen in its definition, hedge funds were originally devised with a view to hedging the risks inherent to the investment portfolio.[30] That is, when the first hedge fund was created in late 1940s by Alfred W. Jones, it was recognized as relatively low-risk private investment vehicle, which made use of various hedging

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vehicles in the form of limited partnership or limited liability company that have the flexibility to invest in a broad range of securities and commodities using broad range of trading techniques."); Leon M. Metzger, *Recent Market Events and the Foundation for Global Market Crises: Hedge Funds*, 4 FORDHAM FIN. SEC. & TAX L. F. 5, 6 (1999) (defining hedge fund as "private investment companies, usually in the form of limited partnership, limited liability company, or offshore corporation, that may or may not employ "hedging strategies; they are largely, but not entirely, unregulated; sometimes use leverage; use a variety of alternative investment techniques; such as such selling and derivatives, and often pay handsome compensation to those who run them."); Rory B. O'Halloran, *An Overview and Analysis of Recent Interest in Increased Hedge Fund Regulation*, 79 TUL. L. REV. 461, 464 (2004) (defining hedge fund as "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public").

[29] *See S.E.C. v. Ralston Purina Co*., *supra* note 18, at 126.

[30] Hedging typically means doing something to insure against potential loss or to mitigate the risk of loss, and accordingly the leveraged positions current hedge funds take in common is in a way deviated from the original meaning of hedging. But it has been a more familiar term in the marketplace for a long time regardless of the fact that its substance is a lot different from its name or its face, and because of that it is still commonly referred to that way. *See e.g.,* Managed Fund Association, *Comments for the SEC Roundtable on Hedge Funds*, May 6, 2003, at 2 [hereinafter MFA Comments], *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-mfa.htm.

strategies to insure the invested portfolio against any possible drop in price of the portfolio assets, albeit the derivatives contract may be also utilized for speculative purpose.[31] However, over time the hedge fund has evolved and transformed into a highly risky investment vehicle making the most of various speculative leveraged transactions.[32]

B. **What Are the Common Features of Hedge Funds?**

Hedge funds can be characterized in many different ways. Among other things, the International Organization of Securities Commissions (hereinafter as "IOSCO") summarizes the main characteristics of hedge funds as follows:[33]

> • Borrowing and leverage restrictions, which are typically included in CIS regulation, are not applied, and many (but not all) hedge funds use high levels of leverage;
>
> • Significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee;
>
> • Investors are typically permitted to redeem their interests periodically, *e.g.* quarterly, semi-annually, or annually;
>
> • Often significant 'own' funds are invested by manager;

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[31] It have been publicly known and accepted that the first hedge fund was created in 1949 by Alfred W. Jones to achieve absolute return regardless of market ups and downs. He believed the theory that "within the universe of the efficient market, there exists at any given time considerable pockets of inefficiency which can be profitably exploited without incurring unacceptable risks." Also he was the first manager to put a performance-based fee in place and make substantial commitments of his own capital to the fund he managed. *See e.g.,* Greupner, *supra* note 28, at 1560; Douglas W. Hawes, *Hedge Funds-Investment Clubs for the Rich,* 23 BUS. LAW. 576, 577 (Jan. 1968).

[32] It should be noted, however, that the original hedge fund-like investment strategy (namely, long-short equity or market neutral investment strategy) can be commonly observed in the marketplace, and they typically do not have highly leveraged positions. But it is also true that these are just part of the various hedge fund categories, and many of the hedge funds have been engaging in different types of leveraged transactions to a large extent. *See* MFA Comments, *supra* note 30.

[33] IOSCO Hedge Fund Report, *supra* note 28, at 3.

• Derivatives are used, often for speculative purposes, and there is ability to short sell securities;

• More diverse risks or complex underlying products are involved.

First and foremost, hedge funds used to remain unregulated or lightly regulated, until new regimes were implemented after the 2008 financial crisis. As pointed out above, all the aforementioned unique features of hedge fund are derived from the fact that they have been outside direct regulatory supervision. For instance, the US has provided various safe harbor rules in the securities statutes, such as private offering, private adviser, and private fund exemptions, and hedge funds used to enjoy their unregulated status by relying on those safe harbor rules.[34]

The UK also provides private placement safe harbor rules for onshore and offshore hedge funds, but not for UK based hedge fund managers, and let them stay outside the paternalistic fund regulation if they are not offered or sold to the general public.[35]

Second, hedge funds have full discretion to enter into borrowing or other leveraged transactions, and it is possible because they are free from the leverage

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[34] *See* 15 U.S.C. § 77d-(a)(2); 15 U.S.C. § 80a-3(c)(1),(7); 15 U.S.C. § 80b- 3(b)(3). Among the safe harbor rules, private adviser exemption (namely, "fewer than 15 clients" exemption) has become available only to foreign private advisers, and US based private advisers become subject to registration and other compliance requirements, subject to narrow size-based exemptions under the Dodd-Frank Act. But, what is clear is that even under the Dodd-Frank Act private fund exemptions are still available, and all the hedge fund's unique features are to be observed generally although they become subject to regulatory supervision directly (namely, hedge funds designated by the FSOC as a systematically important non-financial institution) or indirectly (through private adviser regulation) under the Dodd-Frank Act. *See* Dodd-Frank Act § 113, 403.

[35] *See* FSMA, art. 21, 238. This private fund or private offering exemption is still temporarily available for some more years to come even after the AIFMD is in force in July 2013. *See* AIFMD, explanatory note 10.

restrictions applicable to mutual funds.[36] As a result, hedge funds may have highly leveraged portfolios depending on the investment strategies they utilize.[37]As noted above, while hedge funds are allowed to take on significant leverages, hedge funds and/or their managers are subject to little or no direct prudential regulation, and opt to provide no or limited disclosure.[38]

Undoubtedly, high-leverage and low-transparency are the most commonly well-known features of hedge funds, and compared to registered and regulated mutual funds, hedge funds' portfolios are much less diversified and less

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[36] For instance, among other countries, the US provides express safe harbor rules for private fund to avoid the registration requirement and other investment restrictions including borrowing and leveraged transactions applicable to the registered investment company, and the U.K. also provides an unregulated scheme if the fund interests are not offered or sold to the general public, and offshore based funds are also free from investment restrictions applicable to the authorized scheme under the UK regime. In contrast, Korea provides no safe harbor rule for domestic hedge funds, and they are subject to certain level of borrowing and leverage restrictions. By contrast, offshore funds are free from the leverage restriction although they are subject to registration obligation under the Korean regime in connection with the offer and sale of the fund interests to certain Korean professional investors. *See infra* Chapter IV, Part B.1; Chapter V, Part B.3; Chapter VI, Part C.2.

[37] For example, fixed income arbitrage fund may have much more leverage ratio due to the unique nature of their investment strategy, while long-short equity funds are more likely to have by far less exposure in leveraged transactions. *See e.g.,* Fin. Serv. Auth., *Assessing the Possible Sources of Systemic Risk from Hedge Funds: A Report on the Findings of the FSA's Hedge Fund Survey and Hedge Fund as Counterparty Survey,* Aug. 2012, at 3 [hereinafter FSA Systemic Risk Report], *available at* http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf.

[38] For instance, in the US there used to be a private adviser exemption available for the hedge fund managers to avoid the registration requirement, as a result they are also free from prudential regulation, and at the same time they are free from mandatory disclosure requirements by relying on the private offering exemption. Korea also provides special exemptions for hedge fund managers not to be subject to the prudential regulation applicable to mutual fund managers, although they are still subject to authorization and other obligations like having internal control and risk management system in place, while they are relying on the private offering exemption to be free from the disclosure obligations. By contrast, the UK requires hedge fund managers, instead of the funds, to get authorization and be in compliance with broad principle based regulations, but it is relatively lightly applied to them compared to other regulated entities considering the fact that they carry on the business on a limited basis. *See Infra* Chapter IV, Part B.4; Chapter V, Part C; Chapter VI, Part C.1.

transparent. All of this is possible because they are basically free from any investment restrictions (*e.g.,* leverages and concentration limitations) imposed on the mutual funds relying on various safe harbor rules.[39]

This has been justified on the grounds that hedge funds are accessible only to certain accredited investors, and that they are presumed to be sophisticated enough to protect themselves vis-à-vis the managers.[40]

Third, performance based fee is a unique characteristic, commonly observed in hedge funds, that is generally unavailable to mutual fund managers.[41] What that means is that hedge fund managers typically charge 20% of the capital gain or capital appreciation of the fund portfolio as a performance fee, in addition to the general management fee (typically 1 or 2 percent of the assets under management), subject to some hurdle rate and/or high-water mark conditions.[42]

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[39] *See supra* text accompanying note 36.

[40] *See e.g*., *S.E.C. v. Ralston Purina Co*., *supra* note 18, at 125.

[41] Interestingly, Korean regime provides express rules for mutual fund managers to charge performance-based fee in addition to the basic asset management fee based on the assets under management on a limited basis. But it is practically unworkable due to very stringent threshold conditions for that. *See* FSCMA, art. 86. *See also* SEC Staff Report, *supra* note 20, at 237-48 (illustrating in detail about how the performance-based fee works in the fund industry).

[42] For instance, the US Investment Advisers Act prohibits any investment adviser from receiving performance fee from the client unless the client is limited to "qualified client". Thus, practically speaking, under the US regime hedge fund manager is allowed to charge performance fee only to qualified clients because they are now subject to the Advisers Act. *See* 15 U.S.C. § 80b-5(b)(2)(B); 15 U.S.C. § 80a-3(c)(1), (7); 17 C.F.R. § 275.205-3(d)(1). For the definition of hurdle rate and high water mark, *see e.g.,* Sangheon Shin *et al., For whom hurdle rate and high-watermark exist?*, Sept. 30, 2012, at 2, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154639.

It may be mutually beneficial for the investors and the managers as well in that it may align the economic interests between them,[43] and may provide the incentive for the managers to try to maximize the return. However, flipside here is that it may create potential conflicts of interest problem inherent in the compensation scheme particularly in terms of the valuation of portfolio assets.[44]

Fourth, hedge funds often limit the right of investors to redeem the fund shares although it is basically up to mutual agreement, and it is not completely barred. This is different from mutual funds because in principle mutual fund investors are legally guaranteed the right to redeem the fund shares at any time at their discretion.

It is also different from the private equity funds in that the private equity funds usually have lock-up periods of 2 years or longer to ensure the success of the private equity investment strategy; alternatively, hedge funds usually allow the investors the right to redeem the fund shares at intervals.[45]

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[43] Both performance fee arrangements and seeding managers' capital into the funds they manage are pointed out as two primary tools to align economic interests between the managers and the investors; this encourages the managers to exercise investment discretion that is in the best interests of the investors. *See e.g.,* Robert G. Grucht *et al.*, *No Direction: The Obama Administration's Financial Reform Proposal and Pending Legislation Proposing the Registration and Further Regulation of Hedge Funds and Private Pools of Equity are Overbroad and Fail to Address the Actual Risks That These Funds Pose to the Financial System,* 29 REV. BANKING & FIN. L. 157, 164-66 (Fall 2009).

[44] *See* SEC Staff Report, *supra* note 20.

[45] This two-year lock-up period provision has been used as a decisive indicator to distinguish private equity funds from hedge funds, and it has been used in defining investment company under the U.S. Investment Company Act. This distinction, however, has been under criticism in that hedge funds are also able to utilize this 2-year lock-up safe harbor to avoid their registration obligations if they intend to do so, and provide regulatory loophole accordingly. *See e.g.,* Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to Proposing Release No. IA-2266: Proposed Registration under the Advisers Act of Certain Hedge Fund Advisers, *available at* http://www.sec.gov/rules/proposed/ia-2266.htm#dissent.

Fifth, hedge fund is generally organized as a limited partnership or as a limited liability company to avoid burdensome corporate regulation (*e.g.* corporate governance) and double taxation onshore or offshore.[46] Special tax treatment is usually available to limited partnerships or limited liability companies, and hedge funds just make the most of the tax structure in choosing a jurisdiction as a fund base.

This minimizes the potential negative tax implications for the managers and investors, which is the primary reason why most of the hedge funds choose these offshore "tax havens".[47] That is, limited partnerships or limited liability companies help hedge funds operate as a pass-through vehicles to avoid being subject to double taxation, even if they are not registered or authorized as required by the relevant rules and regulations.[48]

Sixth, the hedge fund market could be characterized as a so-called "accredited investors" market in terms of the investor pools. It is a very important

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[46] Because of regulatory and/or tax reasons, it is very common to see hedge funds set up offshore, which typically raises no or little regulatory concern in particular because, as explained *infra*, hedge funds are free from regulation in the US and in the UK based on the private offering and/or private fund safe harbor rules. As a result, there should be no serious jurisdictional conflict or jurisdictional shopping/ regulatory evasion issues whether or not the onshore or offshore manager chooses an offshore location for the fund base. However, it is more likely that extraterritorial application issue should arise depending on the factual circumstances if there is a regime that directly regulates the funds. *See generally* Douglas Cumming & Sofia Johan, *Hedge Fund Forum Shopping*, 10 U. PA. J. BUS. & EMP. L. 783 (Summer 2008).

[47] *See id.* It should be noted, however, that it is not the only reason for hedge fund to choose offshore, but rather regulatory or privacy consideration may be also taken into account. Many times, offshore funds have been set up as a feeder fund to accommodate foreign investors' needs and raise capital from both onshore and offshore investors. *See* MARTIN CORNISH & IAN MASON, UNITED KINGDOM, IN INTERNATIONAL GUIDE TO HEDGE FUND REGULATION, (co-eds 2009), at 483.

[48] *See e.g.,* Donald J. Marples, *Taxation of Hedge Fund and Private Equity Managers,* June 20, 2013, at 2-3, *available at* https://www.fas.org/sgp/crs/misc/RS22689.pdf.

feature that vividly distinguishes hedge funds from mutual funds, and one that is closely interconnected with the private offering or private fund exemption.

Hedge funds have been able to avoid regulation primarily because of the fact that they are permitted to offer or sell their shares only to accredited investors, who are deemed financially sophisticated enough to protect themselves without regulatory intervention.[49]

These safe harbor rules remain generally unchanged in the U.S. and the U.K., and around the globe; the unique features of hedge funds illustrated above is likely to be maintained without significant fundamental change, at least in terms of the hedge fund itself.[50]

These features of hedge funds are not legally defined or legally recognized; rather these are some of the characteristics observed in common in their actual practices. Basically, all of these characteristics are the result of being unregulated, and serve to clearly distinct from more heavily regulated funds like mutual funds.

C. How are Hedge Funds Distinct from Other Pooled Investment Funds?

To understand why hedge funds should be regulated and/or how to regulate them, it is useful and important to figure out first how hedge funds are similar or different from other pooled investment vehicles, and if they should be treated same

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[49] *See infra* Chapter III, Part B.1.

[50] Some countries like Korea or Hong Kong provide regimes of directly regulating hedge funds in some degree, but offshore funds domiciled in tax haven jurisdictions are also available. In that sense, the hedge fund's feature as an unregulated investment vehicle is still valid in general. For the details of hedge fund regulation around the countries, *see* Technical Committee of the International Organization of Securities Commissions, *Hedge Funds Oversight: Consultation Report,* March 2009, at Annex 5, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf.

or differently accordingly. Below I will explore the similarities and differences between hedge funds and other pooled investment vehicles focusing on the mutual funds, private equity funds, and venture capital funds, among others.[51]

1. **Hedge Funds versus Mutual Funds**

Hedge funds and mutual funds are the same in substance in that they are pooled investment vehicles specially established for securities investment purposes on a collective basis.[52] Thus, from a functional perspective, it goes without saying that both should be subject to the same type of regulations, unless there are other sufficient justifications for regulating them differently or for not regulating one and heavily regulating the other.[53] However, as further illustrated below, hedge funds are different from mutual funds in many respects.

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[51] Hedge funds could be compared and contrasted with commodities pools or REITs (namely, Real Estate Investment Trusts) as well in that they all are also pooled investment vehicles, but the main difference between hedge funds and commodities pools or REITs is whether the invested assets are primarily composed of securities or not. This paper will not be further explored the comparison between hedge funds and commodities pool or REITs because commodities pools or REITS are also subject to securities regulation because the funds' interests should fall within the definition of securities under the securities statutes, and they are outside the fund regulation under the US Investment Company Act at the outset while they are also subject to fund regulation under the UK and Korean fund regimes respectively. *See* 15 U.S.C. § 80a–3(a)(1); FSMA, art. 238; FSCMA, art. 6(5), 9(18).

[52] *See id*.

[53] From a functional regulatory standpoint, the UK (EU) and the Korean fund regimes seem more reasonable compared to the US fund regime, because both broadly define the fund to cover every type of collective investment fund (including commodity pools and REITs), while the US fund regime (namely, the Investment Company Act) defines investment company narrowly to only cover certain pooled investment funds that have been set up primarily for a securities investment purpose. The UK and Korean regulatory approaches seem more desirable in terms of public interest and investor protection because there is little doubt that the same rules and regulations should be evenly applied to funds functioning equivalently in the market place, and investors should be protected equally under the same or comparable regime(s). *See id.*

First, hedge funds are similar to "mutual funds" (also known as regulated "investment companies" or "collective investment schemes")[54] in that both are basically collective investment vehicles that raise capital from a pool of investors by issuing securities, investing the capital in various assets such as securities or derivatives, and doing so to provide investors with ample benefits such as portfolio diversification and professional asset management by investment professionals who are responsible for the day-to-day management of the funds.[55] Some mutual funds strive to mimic the hedge fund investment strategy, further making them look similar to hedge funds.[56]

Unsurprisingly, however, hedge funds are different from mutual funds in many respects.[57] The most distinguishable feature between them is that hedge

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[54] Typically, mutual funds refer to open-ended funds only, however, sometimes the term refers more generally to regulated investment companies including closed-end funds. In this article, the more general "regulated investment companies" will be used for mutual funds.

[55] *See* 15 U.S.C. § 80a–3(a)(1); FSMA, art. 235; FSCMA, art. 6(4), 9(18).

[56] In reality, many mutual fund advisers follow or refer to hedge funds' investment strategies in order to ensure stable return regardless of market fluctuation and to attract investors' attention accordingly. For example, fixed-income arbitrage or long-short equity investment strategies are options for mutual fund advisers to pursue something comparable to absolute return or alpha strategy which hedge funds typically pursue. *See generally* Citi Fund Services Inc., *The Convergence of Traditional and Alternative Investment Products: Regulatory and Operational Considerations,* in 17 INVESTMENT LAWYER 1 (Dec. 2010), *available at* http://www.transactionservices.citigroup.com/transactionservices/home/securities_svcs/docs/71491_eprint.pdf.

[57] Alan L. Kennard, for example, summarized the differences between mutual fund and hedge fund as follows: First, hedge funds are basically unregistered and thus are unregulated investment vehicles, while mutual funds are heavily regulated. Second, investment minimums for hedge funds are very large, while investment minimums for mutual funds are small and are not legally required. Third, the number of investors is limited and certain investor eligibility tests are required for hedge funds, while there are neither investor limitations nor investor eligibility tests are required for mutual funds. Fourth, active and aggressive management through short selling and leverage is available for hedge funds, while passive and defensive management are strongly recommended for mutual funds through limitations on short selling and leverage limitation. Finally, hedge funds

funds are typically free from onerous rules and regulations by relying on the safe harbor rules while mutual funds are not.[58] What that means is that hedge fund is not typically subject to mandatory registration requirements and other regulatory requirements such as periodic reporting, valuation, conflict of interest and asset custody under the securities/fund regimes which are fully applicable to mutual funds.[59]

In addition, although it varies from jurisdiction to jurisdiction, hedge funds are different from mutual funds in terms of the manager regulation in that hedge fund managers used to be not regulated or relatively lightly regulated while mutual fund managers are to be registered with or authorized by the relevant regulatory authorities and subject to full scope of regulation.[60] Both are also different in terms of fund governance because hedge funds typically have neither board of directors nor independent directors while mutual funds are compelled to have board of directors comprising the majority of independent directors.[61]

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usually pursue absolute return strategy, while mutual funds pursue relative return strategy (*i.e.,* mutual fund advisers typically try to beat the overall market index while hedge fund advisers typically try to achieve highest return regardless of market condition). Kennard, *The Hedge Fund versus the Mutual Fund*, 57 TAX LAW. 133, 133-34 (2003).

[58] *See supra* text accompanying note 7.

[59] *See infra* Chapter IV, Part B.1; Chapter V, Part B.3.

[60] This private adviser exemption used to be the case observed in the U.S. regime before the Dodd-Frank Act has been in force since 2012, and under the Dodd-Frank Act this distinction becomes not that clear because large hedge fund managers have become subject to the Advisers Act to the full like mutual funds unless they are able to satisfy much more stringent private adviser exemptions available for the mid-sized private advisers. *See* Dodd-Frank Act § 403.

[61] *See* 15 U.S.C. § 80a–16; Collect Investment Schemes Sourcebook 6 [hereinafter COLL], *available at* http://fshandbook.info/FS/html/handbook/COLL/6; FSCMA, art. 197-99.

Additional difference can be found between them in terms of the scope of investors' pool. That is, hedge funds advisers are strictly restricted to offer or sell the funds' securities only to institutional investors or ultra-wealthy investors in order to comply with the private placement safe harbor rule, while mutual fund advisers have no problem selling the funds' interests to unsophisticated and unwealthy investing public.[62]

Based on this distinctive feature of hedge funds in terms of investor pools, as indicated above, hedge funds have been able to avoid a set of securities and fund regulation and no fundamental regulatory changes have been made even after the new financial regulatory reform measures have been taken in the wake of the global financial crisis of 2008.[63]

2. Hedge Funds versus Private Equity Funds

Both hedge funds and private equity funds are similar in that both are unregulated or lightly regulated private pooled investment vehicles.

First, both are structured in a way to avoid fund regulation by relying on various safe harbor rules.[64] The alternative investment strategies they operate

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[62] *See supra* text accompanying note 57.

[63] *See infra* Chapter IV, Part C; Chapter V, Part C.

[64] It is true that they both may be subject to fund regulation to some extent depending on the jurisdictions (*e.g.* Korea or Germany), but it is also true that both are supposed to be structured to avoid the regulation as much as possible, and as a result they are subject to much lighter regulation even where they are subject to regulation under certain jurisdictions. Furthermore, the fund managers have flexibility to choose offshore as fund bases providing regulatory friendly environments, so it should not be misleading to state that both hedge funds and private equity funds are unregulated or unregistered fund in general.

become possible just because they are not subject to the paternalistic fund regulation typically applicable to mutual funds. To do so, they make their best efforts to avoid registration or other regulatory requirements by relying on private offering or private fund safe harbor rules although it varies from country to country.[65]

Second, both are similar in that they are private funds. What that means is that they are supposed to only market the funds to certain sophisticated investors on a limited basis. That is the very reason why the regulators in many countries, such as the US and the UK, have left them free from securities and/or fund regulations, and why the regulators do not monitor the funds' investment activities. As such, they are not clearly distinguishable legally because there is no positive legal definition available for them, and because they both rely on the same safe harbor rules.[66] Because of their private nature, it is generally understood that no public advertisement or public solicitation is permitted for the funds because they both have to satisfy the registration exemption rules.[67] As a corollary, both need to

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[65] For example, both the US and the UK provide private placement and/or private fund safe harbor rules for both onshore and offshore private funds to rely on, while Korea simply provides a lighter regulatory regime in terms of onshore hedge fund regulation. *See infra* Chapter IV, Part B.1, 2; Chapter VI, Part B.2, 3; Chapter VI, Part C.2.

[66] What it implicates is that both funds are likely to become converged at some times depending on the market circumstances, and this convergence phenomenon is possible because they are outside the regulation and there is no clear and express legal distinction available for them. *See e.g.* Houman B. Shadab, *Coming Together after the Crisis: Global Convergence of Private Equity and Hedge Funds,* 29 NORTHWESTERN J. OF INT'L L. & BUS. 603 (2009) (demonstrating the trend of convergence between the two major alternative investment markets especially after the global financial crisis of 2008).

[67] Section 506 of Regulation D under the Securities Act requires that public solicitation or public advertisement be strictly prohibited in order to satisfy the private placement exemption. It is noteworthy, however, that a new rule (*i.e.* Section 506(c) of Regulation D) provides additional and more flexible safe harbor rules under the Jumpstart Our Business Startups Act (hereinafter JOBS

offer or sell their securities by directly contacting affluent individuals or institutional investors, or through a broker-dealer who has a pre-existing relationship with the affluent investors to not violate the private offering or private fund threshold conditions.[68]

Private equity funds are, however, different from hedge funds in some respects.

First, private equity funds are more like closed-end funds, while hedge funds are more like open-ended funds. All of the structural differences between private equity funds and hedge funds may arise from this basic distinction. Open-ended funds (*i.e.,* hedge funds here in this case) are funds that have flexibility in raising capital from existing or new investors any time during the lifespan of the fund, and at the same time get ready to redeem their shares on a periodic basis upon investors' request.

Act) that general solicitation or general advertisement be permitted on the conditions that the purchase is limited to accredited investors only, and the issuer takes reasonable steps to make sure that all purchasers are accredited investors. This new rule may affect a lot about the hedge fund marketing practice because hedge funds can raise capital utilizing public media without particular legal or regulatory concern about registration requirements under Section 5 of the Securities Act. The U.S. SEC expressly confirmed that this new safe harbor provision will apply to hedge funds without any limitations and consequently they can sell or offer the funds' interests while maintaining their 3(c)(1) or 3(c)(7) based exempted fund status under the Investment Company Act if they meet this new safe harbor requirements. *See Eliminating the Prohibition against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9354 (Aug. 29, 2012) [17 C.F.R. Pts 230, 239 and 242], at 31-32, *availablea at* http://www.sec.gov/rules/final/2013/33-9415.pdf.

[68] The implication is that there should be little ground to treat them differently from an investor protection regulatory perspective because their target investors are same in scope and there is little need for direct regulatory intervention to protect them. *See infra* Chapter III.

Because of this characteristic, hedge fund portfolios are typically comprised of tradable assets and thus are more comparable to mutual funds.[69] In contrast, closed-end funds including private equity funds are funds that limit investors' right of redemption during the term of the fund to accommodate a strategy of investing primarily in illiquid assets such as private companies' securities.[70]

Second, private equity fund investors put their money into the fund for the life of the fund, and additional contributions from the investors are made only in response to the fund adviser's request (commonly known as "capital call"). By contrast, hedge fund investors, in principle, can liquidate their shares any time and put all the capital in the fund initially. This difference arises because private equity funds typically raise capital from investors each time they find a target company to invest in, while hedge fund investors are free to choose when and how much to invest in the fund.

In addition, private equity funds may distribute cash to its investors at the end of its terms by selling its portfolio assets or by sometimes distributing portfolio

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[69] There is no legal requirement for the hedge funds to be structured as open-ended funds, and in reality some of the hedge funds may have some limitation in place especially in terms of the availability of the redemption in the private placement memorandum or their constituent documents. However, hedge funds are typically structured in the form of an open-ended fund, and the structural deviations have been made intentionally to maintain an unregulated fund status by having the 2 year lock-up provision in place under the U.S. Investment Advisers Act for some while until the Dodd-Frank Act eliminated this provision. *See infra* Chapter IV, Part B.4.

[70] For the legal definition of the closed-end fund, *see* 15 U.S.C. § 80a–5(a).

securities directly to investors, while hedge funds may repurchase or redeem investors' securities at intervals during the life of the fund.[71]

3. Hedge Funds versus Venture Capital Funds

Both hedge funds and venture capital funds are of similar nature in that basically they are unregulated private pooled investment vehicles, and their target investors are limited to so-called accredited investors such as high net-worth individuals and institutional investors. Venture capital funds, unlike hedge funds, require investors to contribute capital over the life of the fund and to remain in the fund for a certain period of time. That is, hedge fund investors can receive distributions of capital at intervals by requesting that the adviser redeem their shares, or dissolve the fund and liquidate assets.

Venture capital fund investors typically need to wait until the term of the fund is due. In addition, venture capital funds have no secondary markets available for their investors due to the illiquid nature of the invested portfolio (namely, primarily investing in private and closed startup companies), and investors can receive distributions only by liquidating the assets in the portfolio.[72] By contrast, hedge funds may hold some liquid assets (*i.e.,* exchange traded securities) in

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[71] For more detailed discussions about private equity funds, *see e.g.,* Joseph W. Barlett & W. Eric Swan, *Private Equity Funds: What Counts and What Doesn't?*, 26 J. CORP. L. 393 (2001); THOMAS P. LEMKE, *ET AL.,* HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE, at 282-84 (2009-2010 ed. 2009).

[72] *See* SEC Hedge Fund Report, *supra* note 28, at 8; LEMKE, *ET AL., supra* note 71, at 284-85.

addition to illiquid assets, and thus can dispose of the assets to distribute the proceeds to investors relatively easily.[73]

Another distinguishable feature of venture capital funds is that venture capital fund advisers are often actively involved in the target companies' day-to-day operations because they sit on the board of directors of the companies they invest in.[74]

Further, under the US Dodd-Frank Act, venture capital funds have been legally defined in a way that exempts them from registration and other compliance requirements formerly required of them under the Advisers Act, making venture capital funds more clearly distinct from other private funds like hedge funds or private equity funds.[75]

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[73] *See id*.

[74] In this regard, venture capital funds are more like private equity funds, but remain different from them in that the former typically invest in small or mid-sized startup companies while the latter are more likely to invest in mature companies. *See id.*

[75] Rule 203(l)-1(a) under the Investment Advisers Act defines venture capital fund as "any private fund that:

(1) Represents to investors and potential investors that it pursues a venture capital strategy;

(2) Immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund;

(3) Does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days, except that any guarantee by the private fund of a qualifying portfolio company's obligations up to the amount of the value of the private fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit;

4. Private Equity Funds versus Venture Capital Funds

As indicated above, both venture capital funds and private equity funds are similar in nature because they are private pooled investment funds, and because they used to rely on the private fund exemptions to avoid regulation. They are also similar in that they both target private companies for investment on a long-term basis, and are actively involved in the management of the companies they invest in.[76]

On the other hand, venture capital funds are still distinguishable from private equity funds in that the former typically invest in early stage startup companies, while the latter usually invest in mature companies. Because of this distinctive investment nature, some differences can be observed between them in terms of target companies, deal structure, liquidity, and the like.[77]

As indicated above, the demarcation between hedge funds, private equity funds, and venture capital funds are not legally made – rather, it has been made from the practical business perspectives. It has been traditionally perceived that in many respects private equity funds are more like venture capital funds, than hedge

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(4) Only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata; and

(5) Is not registered under section 8 of the Investment Company Act of 1940, and has not elected to be treated as a business development company pursuant to section 54 of that Act. *See* 17 C.F.R. § 275.203(l)-1(a).

[76] Due to this nature of investment, a venture capital fund may be referred to as being part of a private equity fund in a broad sense of meaning. *See* LEMKE, *ET AL.*, *supra* note 71, at 284.

[77] For the detailed comparisons between them, *see* David M. Freedman*, The Difference between Private Equity and Venture Capital, available at* http://www.accreditedinvestormarkets.com/article/the-difference-between-private-equity-venture-capital/.

funds, although the boundary between them is not entirely clear. Also, there is a tendency for the funds to converge depending on the market situations.[78]

D. What Benefits Hedge Funds May Provide to the Market?

It has been generally acknowledged and accepted that hedge funds provide significant meaningful benefits to both investors and the financial market at large, as summarized below.[79]

From an investor' standpoint, the portfolio diversification effect, achieved through hedge fund investment, is very useful because unlike regulated mutual fund advisers, the hedge fund advisers typically pursue absolute returns regardless of whether market condition is bullish or not.

The absolute return investment strategy utilized by hedge funds has been gaining more attention from potential investors - particularly when the market is bearish and mutual fund performance is not favorable - because hedge funds

[78] Venture capital fund has been newly and legally defined under the Dodd-Frank Act intentionally for the purpose of exempting them from registration requirement under the US Advisers Act while the former two years of lock up safe harbor provision in place for the private equity fund has been eliminated, and they are also in principle subject to registration requirement. In so doing, there was a regulatory effort made intentionally to classify private equity funds into private funds, and treat private equity funds more like as hedge funds, rather than like venture capital funds, and this legislative or regulatory distinction has been justified on the ground that private equity funds have also the potential to pose systemic risk like hedge funds, while venture capital funds does not. That is, in terms of economic substance, private equity funds are more similar to venture capital funds, but legally and intentionally are treated more like hedge funds placing them under the regulatory purview similar to hedge funds. *See* Dodd-Frank Act § 403, 407, 408.

[79] *See e.g.,* SEC Hedge Fund Report, *supra note 28*, at 4-5; MFA Comments, *supra note 30*, at 4-6; PHOEBUS ATHANASSIOU, HEDGE FUND REGULATION IN THE EUROPEAN UNION: CURRENT TRENDS AND FUTURE PROSPECTS 91-99 (2009).

achieve relatively positive returns regardless of market condition. In other words, hedge funds provide the investors with the opportunity to mitigate the portfolio volatility risk by diversifying the investors' portfolio to achieve stable portfolio returns, and by actively participating in a wide variety of financially innovative products and markets typically unavailable in traditional financial markets.[80]

Another advantage to investing in hedge funds is that hedge funds advisers typically contribute their own capital into the funds they manage, and their compensation is closely linked to the funds' return via a performance-based fee. Consequently, the interest between investors and fund advisers is aligned, providing an incentive for the fund advisers to manage the fund in the best interests of the investors.[81]

From the financial market standpoint, hedge funds also play a constructive role in various ways.[82] First of all, hedge funds can function as buffer against market shock because hedge fund investment strategies such as arbitrage, hedging or other counter-market approaches help absorb market disruption.[83] In so doing, hedge funds may provide liquidity to the market irrespective of the market

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[80] *See id.*

[81] Mutual fund advisers also put their capital into the fund when they organize funds. But the amount of contribution is usually minimal and they are able to at any time redeem or resell their shares in the fund by selling the shares in the market or exercise redemption right to the fund. Additionally, their fee structure is typically flat or fixed to a certain percentage of the assets under management. Thus, it is likely that mutual fund advisers have fewer incentives to do their best in the management of the fund compared to hedge fund managers. *See supra* text accompanying note 43.

[82] *See supra* note 79.

[83] For the details of a variety of hedge fund investment strategies in general, *see e.g.,* LEMKE, *ET AL., supra* note 71, at 2-6.

condition, may play an affirmative role as market stabilizer, and may reduce the possibility of severe price fluctuation in extremely serious market conditions.

Second, hedge funds could also play a positive role in the market in that they might enhance market liquidity by actively participating in global financial markets on a continuous basis. For the same reason, they are also in the position to help improve pricing systems and to mitigate market instability by active trading based on extensive market research and capital commitment. Hedge Fund trading signals to other market participants that the price currently quoted in the marketplace may be distorted, which eventually helps narrow the price spread and mitigate the then existing pricing inefficiency and illiquidity.

Third, hedge funds are likely to take contrary positions to those taken during the herding market behavior, which drives prices down to a reasonable market price, by serving as a counterbalance to the price bubbles and inflated market prices typically created by the herding market behavior.[84]

Fourth, hedge funds can supply liquidity to illiquid markets. Hedge fund investors typically are not allowed to liquidate their investments for a certain period of time under their subscription agreement. During that time period, hedge

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[84] All these hedge funds' market activities are possible because hedge funds are flexible enough to sell or buy the portfolio assets at any time to adjust the portfolio whenever they perceive other market participants' unreasonable behavior. By contrast, mutual funds are not flexible enough to switch the fund portfolio in a timely manner because they are generally subject to buy-and-hold strategy as disclosed in the prospectus and their advisers have no discretion to change the fund investment policy without investors' advance approval. *See supra* note 79.

fund advisers are able to invest in illiquid assets such as unlisted securities, speculative securities (*e.g.,* junk bonds), or OTC derivative contracts.[85]

In sum, it has been widely acknowledged that hedge funds play positive roles in the market in various ways leading many countries to decide not to regulate the hedge funds directly or to lightly regulate them, even after the 2008 financial crisis. There has also been increasing sentiment worldwide that reinforces the position against regulating hedge funds directly.[86]

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[85] Compared to hedge funds, mutual funds are usually limited to invest in illiquid assets because they have to be always ready to redeem their shares in response to the existing investors' request. *See* 15 U.S.C. § 80a–22.

[86] It would be the best and most efficient resolution to regulate hedge funds directly and restrict their investment activities in the marketplace like regulated mutual funds if their potentially negative impacts on the market were greater than the potential benefits from them. However, major jurisdictions like the US and the UK, where many hedge fund managers are based, choose not to regulate hedge funds directly because those countries acknowledge that the benefits from hedge funds far outweigh any negative impacts on the market. *See infra* Chapter III, Part B.2.

III. Main Issues Regarding Hedge Fund Regulation

Unsurprisingly, hedge funds have been a regulatory "hot potato" over several decades partly because of their rapid growth in size and their bad reputations caused by some high-profile hedge fund episodes. But, nearly all the concerns and arguments about them have been derived from the fact that they have been outside the regulatory purview during a time when their role in the market continues to rise, and thus, when their potential impacts on the market at large have become substantial.[87] Before having a closer look at the specific hedge fund regulatory regimes of the US, UK, and Korea, it is worth first exploring some of the fundamental issues underlying hedge fund regulation.

A. Should Hedge Funds be Regulated or Not?

It has been a controversial issue whether or not hedge fund should be subject to securities or fund regulation in full or in part. Various relevant parties have expressed their views, but there has been no consensus made about this issue among the countries worldwide or even within a particular country.[88]

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[87] *See generally* Technical Committee of the International Organization of Securities Commissions, *Hedge Funds Oversight: Consultation Report* (March 2009) [hereinafter Hedge Fund Oversight], *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf; SEC Hedge Fund Report, *supra* note 28.

[88] *See e.g.,* Troy A. Paredes, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation,* Seminar on Current Developments in Monetary and Financial Law (Oct. 23-27, 2006), *available at* http://www.imf.org/external/np/seminars/eng/2006/mfl/tap.pdf; Andrew Crockett, *The Evolution and Regulation of Hedge Funds,* In Financial Stability Review – Speicial Issue on Hedge Funds 19 (April 2007).

However, in the wake of high-profile hedge fund scandals and financial crises, the trend in the recent decades is toward pro-regulation.[89] Nonetheless, major jurisdictions like the U.S. and the U.K., where most hedge fund managers are currently domiciled, have not changed their previous regulatory position that, despite the financial scandals that occurred in the past decades intermittently, hedge funds should not be directly subject to the heavy-handed securities or fund regulations applicable to mutual funds.[90]

The position in the U.S. and the U.K. against direct fund regulation is based on the fundamental belief that fund regulations should focus on protecting unaccredited and unsophisticated investors from the potential risk of frauds and on ensuring their informed investment decisions through the use of mandatory disclosure requirements.[91]

Considering the facts that hedge funds typically have been offered or sold only to sophisticated investors, such as affluent individuals and institutional investors, and that hedge funds have played an overall positive role in the global

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[89] For example, LTCM near-collapse in 1998 and financial market crises in late 1990s and late 2000s were catalysts for this debate, and pro-regulatory efforts have been made in one way or another among the jurisdictions based on these empirical observations. It was premised on the belief or observation that those incidents were possible because hedge funds have not been tightly regulated or closely monitored although it is not clearly proven whether they really caused the systemic risk or overall market instability. *See e.g.* Hedge Fund Oversight, *supra* note 87, at Annex 5; FSA Systemic Risk Report, *supra* note 37. *See also* Crockett, *supra* note 88; Robert J. Bianchi & Michael E. Drew, *Hedge Fund Regulation and Systemic Risk,* 19 GRIFFITH L. REV. 6 (2010). *See contra* Barbara Crutchfield George, *et al., The Opaque and Under-Regulated Hedge Fund Industry: Victim or Culprit in the Subprime Mortgage Crisis,* 5 N.Y.U.J.L. & BUS. 359 (Summer 2009).

[90] *See* 15 U.S.C. § 80a-3(c)(1), (7); AIFMD, explanatory note 10.

[91] *See e.g.,* Phillip A. Loomis, Jr., The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, 28 GEO. WASH. L. REV. 214, 226 (1959-1960).

marketplace, there are not many persuasive grounds for regulating hedge fund directly.[92][93]

However, there may be counter arguments in support of regulation from investor protection, functional regulation, and market stability perspectives.[94]

First, due to changes in market circumstances compared to the times when the relevant laws and regulations after the relevant laws and regulations were enacted, many substantively unaccredited investors have been exposed to the hedge fund market based on the lower accredited investor threshold conditions, or through pension funds or fund of hedge funds (commonly known as a "retailization" concern or problem).[95]

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[92] It should be noted that the private adviser exemption clause is a bit different from other safe harbor provisions under the US securities or fund regime. Other safe harbor provisions, like private offering exemption or private fund exemption, are based on the policy rationale that sophisticated investors are in a position to "fend for themselves", and accordingly that there is no practical need to regulate the fund and its offering or sale of fund interests vis-à-vis so-called accredited investors or comparable financially sophisticated investors. Private adviser exemptions are based the rationale that private adviser's client base is very limited and the size of the fund they manage is also insubstantial, and as a result they may have little impacts on the market and cause no serious concern for investor protection, although they may have a limited number of retail investors as their clients. In essence the private adviser safe harbor rule should be understood in the same way as private offering or private fund safe harbor rules in the hedge fund regulation context because it is premised on the fact that only accredited investors or comparable investors are accessible to the hedge fund market, and assumes that they engage in hedge fund business only. *See S.E.C. v. Ralston Purina Co., supra* note 40. *See also* Testimony Concerning Regulating Hedge Funds and Other Private Investment Pools Before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 111th Cong. (2009) (statement of Andrew J. Donohue, Director, Division of Investment Management, U.S. SEC), *available at* http://www.sec.gov/news/testimony/2009/ts071509ajd.htm.

[93] For more detailed discussions why not to regulate hedge funds and their managers, *see e.g.,* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission,* 2006 U. ILL. L. REV. 975, 989, 997, n. 91 (2006).

[94] *See id.* at 991-92; Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. Ill. L. Rev. 1 (2004).

[95] *See e.g.,* SEC Hedge Fund Report, *supra* note 28, at 80-82.

Based on this observation, it has been argued that the same rules and regulations applied to mutual funds should be applied to the hedge funds, at least to some extent; on the ground that hedge fund investors are not genuinely sophisticated enough to protect themselves, making direct regulatory intervention is necessary.[96] In reality, in countries such as Germany, Hong Kong, and Korea, private funds are also subject to fund regulations; however, they are lighter regulations than those applied to mutual funds.[97]

In addition, increasing hedge fund regulation may be argued from a functional regulatory standpoint as well. That is, even under the US or Korean private fund regimes, unaccredited or unsophisticated retail investors are likely to be involved in one way or another.[98]

Thus, private fund advisers should be subject to regulation because they may have unaccredited or unsophisticated investors as their clients and because they provide essentially the same investment advisory services as mutual fund managers.[99]

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[96] *See id. See also* Technical Committee of the International Organization of Securities Commissions, Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in Hedge Funds (Feb. 2003), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD142.pdf; Athanassiou, *supra* note 79, at 52-59; Wolf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28 REV. B. & FIN. L. 581, 601-11 (2008-2009).

[97] *See* CORNISH & MASON, *supra* note 47, at 131-43, 187-210; FSCMA, art. 249-2.

[98] *See* 15 U.S.C. § 80b-3(b)(3) (2007); FSCMA, art. 249-2(1).

[99] *See e.g.,* Anita K. Krug, Institutionalization, Investment Adviser Regulations, and the Hedge Fund Problem, 63 HASTINGS L. J. 1 (2011); Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COMP. L. 339 (Spring 2008) (exploring about why investment adviser regulation is necessary especially from the institutionalization perspective).

Second, from a market stability or systemic risk standpoint, there are concerns about and arguments made for more stringent and mandatory rule-based hedge fund regulations - particularly since the subprime mortgage crisis of 2008 - and these concerns and arguments have been legislatively reflected in the Dodd-Frank Act in 2010 in the US and the AIFMD in 2011 in the EU, among other countries.[100]

Interestingly, systemic risk and financial market stability issues were initially discussed in the U.S. after the near-collapse and subsequent bailouts of Long Term Capital Management (hereinafter as "LTCM") back in 1998, but regulatory concerns at that time were centered more on the investor protection or mandatory disclosure side, not on the systemic risk side.[101]

From the systemic risk control standpoint, there was a broad consensus among local U.S. regulators and market participants that reinforcing market discipline through best practices, and not through direct governmental intervention, would be a more cost-efficient resolution for mitigating the systemic risk and for preventing the reoccurrence of LTCM-like incidents going forward.[102]

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[100] *See infra* Chapter IV, Part C; Chapter V, Part C.

[101] The SEC issued a staff report about hedge fund problems in 2003, some years after LTCM episode in 1998, but the primary concern in the report was that many securities fraud cases had occurred where inadequate disclosure had been made by the hedge fund managers due to lack of regulation or safe harbor rules (*i.e.,* private adviser exemption) despite the retailization problem. *See* SEC Hedge Fund Report, *supra* note 28, at 76-88.

[102] *See e.g., Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management,* Report of the President's Working Group on Financial Markets, April 1999, at 25-26 [hereinafter PWG Report], *available at* http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf; General Accounting Office, Report to Congressional Requesters, *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk* (Oct. 1999) [hereinafter GAO Report], *available at* http://www.gao.gov/assets/230/228446.pdf; General Accounting Office, Report to Congressional Requesters, Hedge Funds: Regulators and Market Participants are Taking

However, after the subprime mortgage market collapse and the following global financial crisis of 2008, together with the securitization and regulatory gap problems with the over-the-counter derivatives market, hedge funds were pinpointed as the source of direct or indirect systemic risk despite having no clear empirical evidences for that.[103]

Legislators and regulators around the world began paying attention to the hedge funds as one of the systematically important financial institutions, and have tried to regulate hedge funds and/or their managers accordingly.[104] As a consequence, the U.S. Investment Advisers Act of 1940 was amended by the Dodd-Frank Act, and mandatory registration regime for hedge fund advisers was

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Steps to Strenghthen Market Discipline, but Continued Attention is Needed (Jan. 2008), *available at* http://www.gao.gov/products/GAO-08-200;Technical Committee of the International Organization of Securities Commissions, *Mitigating Systemic Risk: A Role for Securities Regulators* (Feb. 2011) [hereinafter IOSCO Systemic Risk Report], *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf.

[103] For example, the Amaranth Adviser's case, *i.e.* another high-profile hedge fund's collapse, took place in 2006 after the LTCM debacle in 1998. Unlike in LTCM, there was no public or private bailout occurred to deal with this incident, and the shock was absorbed by the market itself. For more information, *see* Hillary Till, *The Amaranth Case : Early Lessons From The Debacle,* EDHEC Risk & Asset Management Research Centre, October 2, 2006. Bear Sterns' affiliated two hedge funds' failures in 2007 are examples directly linked to subprime mortgage related financial product like CDOs, but it was also resolved among the relevant parties and there was no subsequent systemic risk related event resulting from this hedge fund failure. For the details about the Bear Sterns' hedge funds' failure, *see* Kate Kelly *et al., Two Big Funds at Bear Sterns Face Shutdown,* WALL ST. J., June 20, 2007, *available at* http://online.wsj.com/news/articles/SB118230204193441422.

[104] For instance, the U.S. tried to deal with hedge fund related systemic risk concerns indirectly through regulating hedge fund advisers and designating some hedge funds or their advisers as systematically important non-financial institutions, among other things. The EU also made regulatory efforts to put special regimes in place focusing on the alternative investment fund market, regulating hedge fund market indirectly by regulating the advisers. *See* Dodd-Frank Act § 113; Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, *12 C*.F.R. § 1310, Release No. 70, 70 Fed. Reg. 21637, (April 11, 2012); AIFMD, explanatory note 2, 10, 49.

introduced in the U.S., and a similar regulatory regime targeting alternative investment fund managers was also put in place in the EU.[105]

Insufficient regulatory access to the hedge fund market and a lack of regulatory monitoring tools over it were reasons why mandatory registration was necessary from the regulatory standpoint in the U.S.[106] Many arguments have been made from this regulatory perspective, and hedge fund market monitoring was perceived to be essential to proactively preventing potential market disruptions from the hedge fund failures.[107]

Third, the size of the hedge funds and their activities in the global financial market have become more notable over the recent decades, together with the institutionalization phenomenon, and there were increased concerns and pressures from both investors and legislators to more strictly regulate them than ever.[108]

The then-existing "fewer than 15 clients" safe harbor rule under the Advisers Act was considered insufficient to effectively regulate hedge funds and mitigate their potentially negative impacts on the financial market, in part, because

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[105] More precisely speaking and as further discussed in *infra* Chapter IV, the mandatory registration requirements for the hedge fund advisers in the U.S. were firstly introduced in 2004 and implemented in 2006. However, it was short-lived until the Federal circuit court invalidated SEC's amendment of the Rule under the Advisers Act based on the ground of lacking legislative authority. For more details, *see Goldstein v. S.E.C.,* 451 F.3d 873 (D.C. Cir. 2006).

[106] *See* SEC Hedge Fund Report, *supra* note 28, at 74-75, 94-95.

[107] As pointed out *supra*, systemic risk based policy consideration was not taken into account when the SEC first endeavored to introduce a mandatory hedge fund adviser registration regime in 2003. Rather, this hedge fund information access concern was raised based more on other policy grounds, such as investor protection or fraud detection. *See id.* at 92-96.

[108] For example, Professor Troy A. Paredes illustrates the reasons why SEC has continuously made an effort to regulate hedge fund advisers over decades particularly based on these observations. *See* Paredes, *supra* note 93, at 989.

the "look through" rule was no longer in force after the court's invalidation of the SEC's 2006 hedge fund rule,[109] and fund size, rather than the number of clients, became more important from the systemic risk regulatory perspective. In that regard, it seems appropriate for both legislators and regulators to seek to regulate hedge funds and their managers based on their size and/or leverage, not by their number of clients.[110]

It should be noted, however, that no one-size-fits-all approach (*i.e.* an almost all inclusive rule-based registration requirement) would be appropriate, particularly in terms of hedge fund regulation, because of the heterogeneous nature of the private fund market, and because assessing and preventing systemic risk from hedge funds by the regulators (especially securities regulators) may not be an easy mandate to undertake. Further, it is likely that high-profile financial incidents will happen occasionally even with a rigorous regime in place.[111]

B. How to Regulate Hedge Funds?

Despite many conflicting opinions and arguments raised thus far, it appears that global consensus has been made since the global financial crisis of 2008 that more stringent regulation of hedge funds is necessary, despite the hedge fund

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[109] *See Goldstein v. S.E.C.*, *supra* note 105.

[110] *See* IOSCO Systemic Risk Report, *supra* note 102.

[111] As a matter of fact, many big-sized and heavily regulated financial institutions such as Lehman Brothers, Goldman Sachs, Merrill Lynch, and AIG were bailed out or merged in the turmoil of the subprime mortgage related financial crisis of 2008 in the US. *See e.g.,* Steve Denning, *Lest We Forget: Why We Had a Financial Crisis,* FORBES, Nov. 22, 2011, *available at* http://www.forbes.com/sites/stevedenning/2011/11/22/5086/ (summarizing the background history of the crisis of 2008).

regulatory framework varying from country to country, and that this regulatory reform has been justified mainly from a macro-prudential or a systemic risk regulatory perspective.[112] That being said, at issue now is how to regulate hedge funds and to what extent they should be subject to regulation. With regard to these issues, several different regulatory approaches may be taken into consideration as follows:[113]

1. No Direct Regulation Approach

The first possible regulatory alternative is to maintain the then-existing regimes and keep hedge funds and their managers outside the regulatory purview, as observed in the U.S. before the global financial crisis of 2008, and to take no further regulatory action to directly regulate them, basically counting on market participants to be self-disciplined.

This regulatory approach used to be generally supported and was reflected into the regulatory regime in the U.S. before the Dodd-Frank Act came into effect in 2011.[114] Basically, securities regulators refrain from directly exercising their regulatory power or authority and wait see what the relevant market players do in

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[112] *See* Dodd-Frank Act, preliminary note; AIFMD, explanatory note 2, 3; IOSCO Systemic Risk Report, *supra* note 102, at 12-13.

[113] For more detailed overview about possible regulatory alternatives, *see e.g.,* Paredes, *supra* note 88, at 4-15; ATHANASSIOU, *supra* note 79, at 191-265.

[114] The U.K.'s regulatory model is somewhat similar to that of the U.S., at least from the fund regulatory perspective, in that onshore private funds are exempted from regulatory oversight provided that the fund units are not offered or sold to the general public and that their managers are subject to licensing and ongoing obligations, and offshore private funds are also outside the local regulatory purview unless they are marketed to the investing public. For more details, s*ee infra* Chapter V, Part B.

the marketplace, encouraging them to regulate themselves by relying on best practices or guidelines for the funds, fund managers, and their counterparties, made and released by (quasi) self-regulatory organizations ("SRO") in cooperation with the regulators, effectively minimizing the regulators' direct intervention.[115]

This regulatory approach is based on the premise and belief that the then-existing regulation and safe harbor rules, as well as the general anti-fraud rules, had sufficiently functioned without serious regulatory problems or concerns despite the fact that high-profile financial scandals took place occasionally.[116]

In fact, hedge funds and their managers have been regulated to some extent even under the then-existing regime in the U.S.: They have been subject to anti-fraud rules under the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934, and they owe fiduciary duties-like disclosure, avoidance of conflicts of interest, and managing the fund assets in the best interest of the funds or their beneficial owners (*i.e.,* underlying shareholders).[117] In addition, they are subject to various securities related rules and regulations such as reporting

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[115] More precisely speaking, under the then-existing US regime, hedge funds and their managers are almost completely able to avoid regulatory oversight relying on the then-available safe harbor rules, and the securities regulators were in the position to enforce them on an ex-post basis against their malpractices under the general anti-fraud rules. For the detailed U.S safe harbor rules available to the hedge funds and their managers before the Dodd-Frank Act was in force in 2011, *see infra* Chapter IV, Part B.

[116] *See supra* note 103.

[117] *See* 15 U.S.C. § 80b-6; 17 C.F.R. § 240.10b-5. Regarding the broad applicability of the anti-fraud rule (*i.e.,* Rule 10b-5), *see generally* DONNA M. NAGI *ET AL.,* SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS (MAR. 2013).

requirement for the holdings of the reporting companies and insider trading or market manipulation rules under the Securities Exchange Act. [118]

Overall, this approach is based on the conventional belief that the hedge fund market should be well-functioning even without direct governmental intervention[119] because it is a market for accredited investors only and they are legally deemed sophisticated enough to "fend for themselves". [120] Further, institutional investors like pension funds or financial institutions participate in the hedge fund market as investors, creditors and/or counterparties. There is little doubt that they are in the position to negotiate with the hedge fund managers on an arm's length basis, and that they are economically self-incentivized and best-positioned to oversee the managers' activities themselves or with the help of third party service providers such as fund rating agencies.[121]

Thus, at least in terms of a micro-prudential regulatory perspective (*i.e.,* from investor protection and/or deterrence of market fraud standpoint), it appears that existing regimes may be working relatively well and there may not be sufficient changes in factual or regulatory circumstances to the extent necessary to

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[118] *See infra* Chapter IV, Part B.

[119] *See e.g.,* Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection,* 6 BERKELEY BUS. L. J. 240, 295-97 (2009) (arguing that flexible regulation allowing financial innovation together with performance based fee and managerial co-investment would enhance investor protection even without further regulation).

[120] *See S.E.C. v. Ralston Purina Co*., *supra* note 40.

[121] *See* Paredes, *supra* note 88. *See contra* Schwarcz, *supra* note 94 (arguing that the deemed sophisticated investors are not sophisticated enough to understand certain complex financial products, and accordingly need governmental protection).

justify changing the existing rules and underlying principles for various safe harbor rules.[122]

This approach, however, may have inherent problems in that unaccredited investors can access the hedge fund markets in some ways.[123] In addition, due to the increasing complexity of innovative financial products, even accredited investors may have difficulty completely understanding about the hedge funds they invest in and their investment strategies or potential risks.[124]

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[122] Some may argue that with the institutionalization phenomenon on one hand, and the securitization phenomenon together with the increase in hedge fund exposure from retail investors on the other hand, the direct regulation of the funds and their managers may be justified. *See e.g.,* Krug, *supra* note 99. However, these phenomena may not necessarily justifying the direct regulation of the funds market because in principle these ideas may be reflected implicitly in the original legislation and dealt with even under current regulatory regime based on mandated disclosure for the general public (*i.e.,* unsophisticated investors) from investor protection standpoint. Even from a systemic risk perspective, although it has not reflected in the original securities regulation, it could be dealt with in a different way (by regulating products, counterparties, and/or investors as well as by market discipline), and accordingly it could not be concluded that the securities regulation must be shifted fundamentally to directly and fully regulate them to ensure the financial stability. *See e.g.,* Crockett, *supra* note 88, at 19 *et seq*.

[123] For instance, unaccredited investors are directly accessible to the hedge funds subject to sophistication test under the US Regulation D on a limited basis, and they are also able to invest in the hedge funds indirectly via fund of funds, trust or segregated management account. *See* 17 C.F.R. § 230.506(b)(ii). *See also supra* text accompanying note 22.

[124] This problem could be resolved by limiting unaccredited investors' direct access to hedge funds or making higher threshold conditions for accredited investors. Nobody, including institutional investors, is sophisticated enough to understand everything for sure about the hedge funds and their investment strategies as well as investment risks, but assume that current securities regime based on mandated disclosure should be maintained and it is necessary and inevitable to distinguish private market from public market, accredited investors concept is necessary and they should be deemed financially sophisticated enough to be outside direct regulatory intervention. Otherwise, it is practically impossible to comply with the rules or it is more likely very time and cost inefficient. Recent SEC's rulemaking under the JOBS Act that permits hedge funds to market to the investing public on the condition that the actual purchaser are strictly limited to accredited investors only may be regarded as one of the significant regulatory efforts made in this direction. *See infra* text accompanying note 227.

More than anything else, this regulatory option is problematic because it is not ready to answer for the systemic stability concerns raised in the wake of the global financial crisis of 2008; this is not what the then-existing securities and fund regimes had taken into consideration when they were originally enacted.[125]

2. Regulating Funds only Approach

Another option is to regulate the hedge fund directly, while leaving the managers unregulated or lightly regulated. This alternative should be based on the belief that the best way to deal with hedge fund problems in terms of investor protection, deterrence of market abuse, and market stability, is to directly regulate hedge funds' highly risky and leveraged investment activities.[126] Regulatory concerns - such as insufficient disclosure, market frauds and market instability - posed by the hedge funds may be handled more effectively and efficiently if they are regulated directly.

By imposing various disclosure and diversification requirements, business conduct rules, and leverage limitations, regulators will directly respond to the regulatory concerns raised, which is the very way that regulators deal with the mutual fund market.[127]

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[125] *See supra* note 107.

[126] Mutual fund-like regulation such as restricting leveraged transactions and/or mandating portfolio diversification would be the best way to directly regulate hedge funds, and it would be the most effective way to regulate them particularly from the systemic risk-based regulatory perspective.

[127] All these regulatory restrictions and governmental preemptive regulatory measures have been justified because the investing public may be directly exposed to the market, and they are the very persons that should be protected under the governmental regulatory umbrella. *See e.g.,* 15 U.S.C. § 80a–1(b).

This regulatory alternative cannot be commonly observed in many countries around the world, but Korea may be an example of a country adopting this approach.[128] Under the FSCMA, both private equity funds and hedge funds have been subject to direct regulatory supervision while managers of the private equity funds had been exempted from direct regulations such as licensing or registration requirement.[129] That is, on the one hand, there are some regulatory requirements about leverage, code of business conduct, valuation and reporting requirements in place governing private equity funds under the FSCMA, while, on the other hand, no registration or licensing obligation is required for the managers.

As a consequence, the managers are allowed to do almost everything themselves without regulatory concerns, such as the fund establishment, the fund marketing, and the fund assets custody on the condition that their investment activities are made in compliance with the so-called management participatory investments such as 10% or more of the target company's equity holdings with voting right and they raise capital on a private placement basis.[130]

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[128] What should be noted is that Korean regime took this fund regulation only approach vis-à-vis private equity funds, not hedge funds. But it is still somewhat meaningful in contemplating how to design hedge fund regulatory architecture in that they both are of similar nature in many respects and there is an increasing tendency to regulate them under the same regulatory regime. In accordance with this global regulatory consensus, the Korean regulator changed its position and now regulates the managers as well as the funds in terms of Private equity Fund regulation by amending the relevant rules and regulations in May 2013. *See* FSCMA, art. 272-2.

[129] As indicated in *supra* note 127, this fund only regulatory approach has been repealed in Korea, and the managers for private equity funds are now subject to registration and reporting requirements under the revised FSCMA, which took effect in May 2013, although they are subject to somewhat different and lighter regulation than hedge funds' managers. *See* FSCMA, art 249-2, 272-2.

[130] This is somewhat uncommon approach in that the manager, not the fund itself, is the very person responsible for day-to-day management of the fund's investment activities. Thus it would be a very rare and exceptional case, and not easy to take this position in general in designing the regulatory

This regulatory option, however, has somewhat inherent critical limitations and accordingly is difficult to consider as a viable regulatory option, in part because fund-focused regulation may be easily avoided by establishing the fund offshore.[131] Undoubtedly, the manager is also a more important and more relevant regulatory target in that the manager is a real entity, the very person in charge of day-to-day activities of the fund, while the fund itself is a kind of a special purpose investment vehicle utilized by the manager to achieve their goals.

In addition, A fundamental problematic part of this option is that it may confuse the distinction between the mutual funds and the private funds; also, there are few justifiable grounds to regulate them directly, at least from the micro-prudential regulatory standpoint, assuming that they are only marketed to a limited pool of accredited investors and that they are strictly prohibited from marketing to the investing public. Further, it is also problematic to only regulate the funds because doing so is likely to deter the financial innovation and market efficiency, promoted by a friendlier regulatory environment.[132]

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framework vis-à-vis private funds including hedge funds and private equity funds. *See* ganjeobtuzajasanunyongebbeob [Indirect Investment Asset Management Business Act], Act. No. 7221, Gwanbo 15811, Oct. 5, 2004, at 19.

[131] The extraterritorial application issue may arise in this situation, but it may be extremely difficult for the local regulators to detect these law evasion cases, largely because basically the funds and their managers both are out of the regulator's oversight.

[132] That is the very reason why the U.S. and the EU take regulatory positions not to regulate the private funds directly, but to regulate the managers instead. *See infra* Chapter IV, Part C; Chapter V, Part C.

3. Regulating Fund Managers Only Approach

A third regulatory alternative is to regulate the hedge fund managers, while the funds remain unregulated. This approach is predicated on the belief that it would be better to leave hedge funds unregulated, considering the overall market benefits they create are derived from the fact that they have been unregulated.[133] It is also premised on the ground that their negative impacts on the market could be controlled and manage by regulating fund managers, rather than the funds themselves, because the managers are the very persons that have unlimited direction in investing and managing the funds' assets on a continuous basis.[134]

This regulatory model has been adopted by some jurisdictions, such as the U.S. (post-Dodd-Frank Act), the EU (including the U.K., pre-AIMFD), and Singapore.[135] This approach may be assessed as a less drastic regulatory measure than direct fund regulation or fund/manager regulation because it strikes a regulatory balance. It acknowledges that hedge funds have provided many benefits to the overall market and to investors, but that the funds have done so largely by staying outside direct regulatory intervention. By regulating the managers, the potentially negative impacts that the funds may pose to the market and to investors is minimized.[136]

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[133] *See supra* Chapter II, Part D.

[134] *See e.g.,* Michael McDonald, Notes and Comments, *Containing Systemic Risks: New Developments in Trans-Atlantic Hedge Fund Regulation,* 34 LOY. L. A. INT'L & COMP. L. REV. 237, 241 (Fall 2011).

[135] *See* Hedge Fund Oversight, *supra* note 87.

[136] The U.K. used to prefer this regulatory option, and the U.S. takes the U.K.'s lead under the Dodd-Frank Act. In so doing, they expect to maintain their competitive edge against other

Regulating fund managers allow them to set up hedge funds onshore or offshore at their discretions without any legal limitation, and as a result they are in the position to pursue absolute return (*i.e.,* maximization of the fund's potential return regardless of market situation). The fund managers can them utilize various alternative investment strategies including leveraged transactions (*i.e.,* borrowing, short sale, and/or over-the-counter derivatives transactions) because they can avoid the stringent investment restrictions imposed on the mutual funds.[137]

However, highly leveraged investment activities by the hedge funds may be restricted indirectly. That is, under this scenario, hedge fund managers are under regulatory oversight and are required to implement risk management policies and procedures, and to report their holdings and highly risky leveraged transactions to the regulators periodically. Regulators can take regulatory action against fund managers if they believe it is necessary.[138]

This regulatory approach may also be justified from the investor protection, anti-market abuse, and financial market stability perspectives.

First, in terms of investor protection, hedge fund investors may be better protected than ever because the managers are directly subject to onerous regulatory

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jurisdictions, and they believe this would keep the local market efficient, competitive and financially innovative. *See e.g.,* Callum McCarthy, FSA Chairman, Speech at European Money and Finance Forum, *Hedge Funds: What Should be the Regulatory Response?*, Speech at the European Money and Finance Forum (Dec. 7, 2006), *available at* http://www.mondovisione.com/media-and-resources/news/hedge-funds-what-should-be-the-regulatory-response-speech-by-callum-mccarthy-cha/.

[137] *See e.g.,* Alexander Ineichen & Kurt Silverstein, AIMA's Roadmap to Hedge Funds (November 2008), at 30-31, *available at* http://www.tsakunov.com/lectures/aima_sroadmaptohedgefunds2008_12205.pdf.

[138] *See* 15 U.S.C. § 80b–4; AIFMD, art. 22, 24; FSCMA, art. 249-2.

requirements; such as code of conduct, code of ethics, and performance fees, in addition to the registration/authorization and reporting requirements.[139]

Investor protection may be achieved through self-regulation in the forms of market discipline by making default rules or by providing guidance, rather than by directly mandating that they comply with regulatory requirements. In this scenario, hedge fund investors have less protection because best practices and guidances are not legally binding, and also details on practices and guidances are often left unclear and managers have discretion on whether or not to adopt it internally.[140]

This may not be strong argument, however, because there are no sufficiently justifiable grounds to regulate hedge fund managers if the hedge fund investors are limited to accredited investors or qualified purchasers meeting some threshold test about their financial sophistication.[141]

Further, because the beneficial owners of the funds are deemed financially sophisticated investors, such as accredited investors or qualified purchasers, any unaccredited investors are tested for their financial sophistication before they invest in the fund, there seems no practical need to directly regulate hedge fund managers, and this accredited investor market was not originally intended to be

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[139] These rules and regulations used to be applied to mutual fund advisers. Private fund advisers were exempted in the U.S. based on the private adviser safe harbor rule under the Advisers Act until the Dodd-Frank Act has been implemented. However, hedge fund advisers have become subject to the Advisers Act in the same as mutual fund advisers under the Dodd-Frank Act. *See* 15 U.S.C. § 80b-3.

[140] *See e.g.,* Paredes, *supra* note 88, at 10-15.

[141] *See* 15 U.S.C. § 80a-2(a)(51)(A); 17 C.F.R. § 230.215, 506(b)(ii).

under direct regulatory oversight when the relevant laws and regulations was enacted.[142]

Second, regulating fund managers on an anti-market fraud policy ground is not persuasive because market fraud issue is basically a matter of law enforcement. Hedge fund managers have already been subject to anti-fraud rules and they are subject to administrative, civil, and/or criminal sanctions if found in violation of the rules.[143]

Thus, market fraud issue can be efficiently and effectively tackled if regulators are vigilant in bringing enforcement actions against hedge fund managers engaging in fraudulent market activities. Considering equal negotiation powers, many things could also be resolved between fund managers and fund investors, and regulators could further investigate the alleged frauds if necessary. Finally, it is inevitable that market fraud cases involving hedge fund managers

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[142] *See id.* Some may argue the so-called private adviser exemption is different from private offering or private fund exemptions, and it was based on the policy ground that their business is relatively small and limited in nature and in scope, and their impacts to the market or investors are not that substantial enough to governmental intervention when it was originally enacted in the U.S. It may be true in that, at the time of the legislation (*i.e.,* in 1940), the legislators had never contemplated about the hedge funds as clients because hedge funds did not emerge in the market until late 1940s. *See e.g.,* Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds,* 33 N.C.J.INT'L L. & COM. REG. 1, 51 (Fall 2007). *See also* Sec. Exch. Comm., *Registration under the Advisers Act of Certain Hedge Fund Advisers,* Release No. IA-2333, 69 Fed. Reg. 72,054, 72,069 (Dec.10, 2004). However, suppose that there is only accredited investors or qualified purchasers involved in the hedge funds, then it becomes doubtful why regulators are necessary in the market at least from the micro-prudential regulatory standpoint, and in that regard it may be more reasonable and consistent to say that hedge fund managers are not the right target for direct regulation at least in terms of investor protection.

[143] *See e.g.,* 15 U.S.C. § 80b-6(4); 17 C.F.R. § 240.10(b)-5; FSCMA, art. 178.

would occur regardless of whether there are detailed and paternalistic regulatory provisions in place.[144]

Third, the systemic risk or market stability-based policy argument might be the strongest for the direct hedge fund manager regulation. With the increase of the size of hedge funds and their role in the global financial market, it becomes crucial to keep an eye on their asset sizes, portfolios, and leveraged positions on an ongoing basis. By doing so, the regulators are able to take appropriate measures to prevent or mitigate any potential market disruption on a timely basis.[145]

However, this argument has some weak points because of the following reasons:

First, system risk may be not something the government can prevent preemptively and completely because of the technical complexity involved and because it is something that will inevitably occur even under heavily regulated market environments.[146]

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[144] *See e.g.*, Cheryl Nichols, *Addressing Inept SEC Enforcement Efforts: Lessons from Madoff, the Hedge Fund Industry, and Title IV of the Dodd-Frank Act for U.S. and Global Financial Systems*, 31 NW. J. INT'L L. & BUS. 637, 683 (Summer 2011) (arguing that the Madoff's Ponzi scheme could have been prevented, despite the fund and fund managers being unregulated, if the regulator had kept alert while examining the relevant regulated entities affiliated with the Madoff fund and its managers).

[145] *See e.g.,* Jon Danielson & Jean-Pierre Zigrand, *Regulating Hedge Funds,* in Financial Stability Review: Special Issue on Hedge Funds 29 (April 2007), *available at* http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/rsf_0407.pdf.

[146] *See e.g.,* Carl Hasselbarth, *How Should We Regulate Hedge Funds?,* 16 PIABA B.J. 233, 263-64 (2009).

Second, securities regulators may not be capable of monitoring systemic risk because of the burden in undertaking this regulatory mandate.[147] Rather, Financial Stability Oversight Council (hereinafter as "FSOC") under the Dodd-Frank Act may be a more appropriate regulatory body to undertake systemic risk oversight. As a matter of fact, the FSOC has been contemplating taking regulatory action to designate certain hedge funds and the managers as systematically important non-financial institutions.[148]

In addition, systemic risk may be avoided or minimized if relevant counterparties or creditors vis-à-vis hedge funds, such as investors, prime brokers, and/or lenders, are properly monitored because most of them are also regulated entities.[149]

In short, direct governmental direct intervention against the hedge fund managers should be minimized, even if the regulators seek to gather information and monitor hedge fund managers for systemic risk related purposes.[150]

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[147] *See e.g*., C. George Nnona, *In the Wake of the Mortgage Bubble and Financial Crisis: What Should Securities Regulation Become?*, 79 UMKC L. REV. 31, 35-41 (2010).

[148] *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, *supra* note 104.

[149] *See e.g.,* Paredes, *supra* note 93.

[150] For more detailed discussion about this, *see infra* Chapter VII, Part D.

4. Regulating Both Hedge Funds and Managers Approach

This regulatory alternative may be viewed as the most conservative and stringent in that it aims to directly respond to all possible hedge fund problems raised. It seems, however, practically difficult to be implemented in jurisdictions such as the U.S. and the U.K. because those jurisdiction have traditionally provided relatively friendly regulatory environments for hedge funds and their managers; indeed, that is the primary reason why those two countries have maintained an advantageous status as hedge fund habitats than other jurisdictions.[151]

In countries where the hedge fund markets have not been well-developed in the past, the governments play a more paternalistic role – preferring to regulate both hedge funds and managers. For example, in Germany and Korea, the hedge fund market has not come into existence for a long time; rather the governments in those two countries took initiatives and played a leading role in promoting the local hedge fund market.[152]

This regulatory alternative has strengths from a regulatory perspective because it is more likely to accommodate every possible regulatory concerns raised, such as investor protection, anti-market fraud, and market stability. The government would implement rules and regulations applicable to hedge funds and

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[151] *See* CORNISH & MASON, *supra* note 47, at 483-521; MERYL E WEINER, *UNITED STATES,* IN INTERNATIONAL GUIDE TO HEDGE FUND REGULATION (Martin Cornish & Ian Mason eds., 2009), at 525-84.

[152] *See* CORNISH & MASON, *supra* note 47, at 131-44. *See also infra* Chapter VI, Part A.

their managers, and hedge fund regulation would become more like mutual fund regulation in nature and in substance.

Hedge funds and their managers would be subject to specific regulatory obligations, like those governing mutual funds and their managers, although those regulatory obligations may be relatively lighter than those applied to the mutual funds. In that regard, hedge funds and their managers become no more unregulated entities, and they become somewhat regulated entities in nature.[153]

This regulatory approach has a fundamental weak point, however, in that it is more likely to become a government-led market, not based on the market demand and supply, and hedge funds and their managers may face many regulatory hurdles in accommodating market demands, including adapting themselves to the changes in market circumstances in a timely manner and on a continuous basis. That is, this direct regulatory intervention is more likely to prevent them from utilizing various absolute return strategies because this regulatory regime is not likely to be flexible enough to accommodate the diverse and complex nature of the hedge fund market.

Similarly, another problem with this option is that it is more likely to deter the natural development of the private market, including the hedge fund market, and make market participants more reliant on regulators. An overreliance on regulators creates increased opportunities for moral hazard, while at the same time

[153] Any issue about hedge fund regulation may be converged into this direction eventually because any regulatory efforts should be made to treat them more like mutual funds assume that there is little difference between them and same regulatory concerns exist in both industries.

giving investors the impression that they may be protected by the government in case something bad happens.[154]

Further, considering the global nature of hedge funds, a regulatory regime that governs both hedge funds and managers is likely to create serious conflict with other jurisdictions around the world. As a consequence, the market becomes more localized and force hedge funds and their managers are forced to move offshore in pursuit of friendlier regulatory environments.[155]

5. Regulating Investors Only Approach

This approach is to regulate hedge funds and their managers indirectly, relying on self-regulation and market discipline in combination with strict threshold requirements in determining who is sophisticated enough to invest in hedge funds without governmental protection.[156]

Undoubtedly, this regulatory approach is worth taking into consideration in that, provided that only sophisticated investors invest in hedge funds, it provides ample autonomy and flexibility to the market, encouraging financial innovation and encouraging self-competence. That is, under this regime hedge funds are in the position to police themselves by making and implementing best market practices

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[154] *See e.g.,* Crockett, *supra* note 88, at 25.

[155] *See e.g.,* Barney Jopson & Peter Thal Larsen, *International Watchdog to Probe Risk from Hedge Funds,* FIN. TIMES, October 6, 2005, *available at* http://www.ft.com/intl/cms/s/0/8cb5e920-3606-11da-903d-00000e2511c8.html#axzz2ngNCe3cL.

[156] *See e.g.*, Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (March 2000).

for both the managers and the counterparties, while considering changes in market circumstances.

Regulatory concerns over investor protection can be mitigated through fine-tuning of the threshold conditions to become an accredited investor.[157] Under this regulatory option, accredited investor and qualified purchaser eligibility requirements are more likely to be revised reflecting the changes in market environment and the regulators may revisit the issues of who are really financially sophisticated enough to protect themselves and whether existing criteria or threshold conditions for the accredited investor and qualified purchaser are sufficient to justify the self-regulation or market discipline.[158]

By so doing, investor protection concern may be mitigated without serious regulatory concern and systemic risk issue also may be able to be dealt with in between the hedge fund managers and their counterparties/creditors by developing and implementing appropriate internal control system including risk management policy and procedures internally.[159]

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[157] This apparently somewhat progressive regulatory approach is premised on the assumption that if the hedge fund market is entirely comprised of accredited or sophisticated investors, and all other parties involved in the market such as creditor-bank or counterparty-prime broker are regulated entities and institutional investors at the same time, then there is no practical need for the regulator to directly intervene in the market on an ex-ante basis. Because they are all sophisticated investors, deemed to be capable of making informed decisions themselves, and the regulator has the ability to monitor and intervene in the market if necessary via creditor or counterparty-regulated entities. *See generally* ATHANASSIOU, *supra* note 79, at 215-36 (neutrally illustrating about self-regulation versus external regulation, and direct regulation versus indirect regulation as well).

[158] *See id.*

[159] *See id.*

In sum, this regulatory option may be desirable - particularly from the micro-prudential or investor protection regulatory perspective - but it seems like a weak option from the macro-prudential or systemic risk regulatory perspective because it is less likely that market discipline will work properly under this scenario particularly when serious market disruptions occur because hedge funds and other relevant market participants are most likely to behave in their own best economic interests.[160]

6. Regulating Counterparties Only Approach

This counterparty oriented regulatory option is based on the idea that regulating hedge fund counterparties, like prime brokers or other financial institutions having a close business relationship with hedge funds, is sufficient and more cost-efficient in dealing with hedge fund problems. These counterparties have a good understanding of hedge funds and are in the best position to oversee the hedge fund manager's daily investment activities and to evaluate any potentially negative implications.[161]

This approach is premised on the belief that it could be implemented without direct governmental regulation of hedge funds because these counterparties are all regulated entities; hedge funds could be effectively monitored and controlled indirectly through these regulated counterparties

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[160] *See id.* at 226-36.

[161] *See id. See also* United States Government Accountability Office, Testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House of Representatives, *Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges* (Statement of Orice M. Williams, Director of Financial Markets and Community Investment), May 7, 2007, at 11-14, *available at* http://gao.gov/assets/130/122480.pdf.

accordingly.[162] In other words, counterparties' positions and risk exposures from hedge funds could be managed by mandating that they keep appropriate levels of capital, and at the same time by mandating that they put proper risk management policies and procedures in place.[163]

It is anticipated that excessive leverage by hedge funds would remain within a controllable scope.[164] With this regulatory approach, governments can minimize direct regulatory intervention into the hedge funds market by focusing on counterparties and/or creditors as a means to prevent or mitigate their negative impacts on the markets.[165]

What is problematic with this scenario is that, on the one hand, these lenders, investors, and/or transactional counterparties are well-positioned to protect themselves by conducting due diligence investigations before investing, lending, or entering into transactional agreements. However, their economic interests are so closely interconnected with the funds that they are likely to be less vigilant in

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[162] *See supra* text accompanying note 157. *See also* Noah L. Wynkoop, Note, *The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives*, 76 FORDHAM L. REV. 3095 (2008) (arguing that a system of disclosure for derivatives be implemented by emphasizing the role of traders in the derivatives market).

[163] For instance, the Volcker Rule under the Dodd-Frank Act, which strictly restricts banking entities from proprietary trading and limits the banks' stakes on the private funds such as hedge funds or private equity funds, may be regarded as a vivid example of this counterparty regulatory approach because it may substantially reduce the likelihood of the occurrence of systemic risk especially arisen from the credit channel. For more details of the text of the final common rules between the US regulatory agencies regarding Volcker Rule, *see* Commodity Futures Trading Commission, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency & Securities and Exchange Commission, Proprietary Trading and Certain Interests in and Relationships with Covered Funds, *available at* http://op.bna.com/bar.nsf/id/cbre-9e9guh/$File/Volcker%20Reg%20Text.pdf.

[164] *See supra* note 157.

[165] *See id. See also* PWG Report, *supra* note 102, at 25-26.

monitoring and evaluating the funds and their managers' investment activities because hedge funds are a primary source of their income.[166]

As illustrated above, this regulatory approach has some advantages in ensuring market stability.[167] However, a problem exists in that it is more likely to work well in ordinary situations and it is not likely operate properly during high-profile financial scandals.[168]

Additionally, this regulatory approach will likely encounter problems gathering the hedge fund related information (i.e., hedge fund activities, leveraged positions etc.) on an integrated basis because multiple service providers exist to serve hedge funds – resulting in information that may be fragmented and ultimately insufficient to measure overall risks.[169] Further, monitoring the hedge fund market from a macro-prudential regulatory perspective is not something for counterparties to do, rather it is what financial regulators need to undertake.[170]

Regulators' role becomes more important in this regulatory regime because regulators may be the only appropriate entities for gathering hedge fund information on a consolidated basis - with the help of the regulated counterparties-financial institutions, and as a result need to have a close eye on hedge funds'

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[166] *See id*.

[167] This regulatory option assumes that investor protection concerns are not critical because all of the investors in this market must be deemed sophisticated investors before participating. *See supra* Chapter III, Part B.5.

[168] *See* PWG Report, *supra* note 102.

[169] *See supra* note 161.

[170] *See e.g.,* FSA Systemic Risk Report, supra note 37, at 3-4, 20.

activities and their leverage positions to ensure market stability, and minimize the possibility of a hedge fund-led market dismantling.[171]

The success of this regulatory approach is heavily dependent on the level of cooperation between regulators and regulated counterparties-financial institutions, and may require technical support from key market players to fully understand the complex and diverse nature of hedge funds involved.

Further, self-regulatory organizations are as important as regulators in this regulatory approach for the role they play in making/implementing best practices – ensuring that regulated counterparties-financial institutions not only put proper risk management policies and procedures in place, but also rigorously implement them.[172]

C. Summary and Comments

Every regulatory option illustrated above has strong points and limitations, as illustrated *supra*. Some useful implications, however, can be garnered from each of them. First of all, it is important to acknowledge first that both investor protection concern and systemic risk concern are equally important, and should be taken into consideration simultaneously when comtemplating hedge fund regulatory architecture.[173]

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[171] *See supra* note 159.

[172] *See id.*

[173] *See e.g.,* Technical Committee of the International Organization of Securities Commissions, *Hedge Funds Oversight: Final Report,* June 2009, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf.

Among the possible scenarios, the first regulatory option (no regulation approach) and the fifth regulatory option (investor regulation approach) are difficult to recommend and may be the least viable options. The sixth regulatory option (counterparty regulation approach) is also less likely to be fully justified or supported because it does not touch the investor protection issue directly and it does not respond to the systemic risk issue in a convincing way.[174] Therefore, the second (fund regulation approach), third (manager regulation approach), and/or fourth regulatory options (both fund and manager regulation approach) are worth exploring further.

First, it should be noted that the investor protection issue has been sufficiently contemplated and incorporated into current securities and fund related statutes, and that they have arguably been functioning relatively well so far considering the fact that there has been a clear distinction made between the accredited investors market and the unaccredited investors market under each jurisdiction.

It remains unchanged until now even after the global financial crisis of 2008 and it is unlikely that this regulatory differentiation between the two investor groups will be changed in the foreseeable future, albeit some controversies do surround the criteria for the distinction and the threshold conditions, because the

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[174] In this scenario, both the government and the regulated counterparties are likely to have imperfect and incomplete hedge fund information, making it harder for the regulators to monitor hedge fund activities and leverage positions on a consolidated and continuous basis. The global nature of hedge funds' domiciles and their investment activities under this approach will make it much harder for the regulators to oversee them because local regulators are likely to have limited access to hedge funds who have transactional relationships with local regulated counterparties. *See supra* note 161.

underlying rationale behind the regime has been also well-preserved and respected.[175] Therefore, it is reasonable to conclude that merely fine tuning approach (*i.e.,* redefining the accredited investor threshold conditions) is sufficient to deal with the investor protection problem.[176]

The accredited investor standard should be periodically re-examined, and perhaps heightened in accordance with the changes in economic situations. At a minimum, the standard should be set to ensure that both institutional investors and affluent individuals have no problem understanding the complex nature of hedge funds and the accompanying risks inherent in hedge fund investments, and to ensure that they are competent to assume the risk themselves.[177]

There is no doubt that nobody (including institutional investors) can be confident in knowing everything for sure about hedge funds and their investment strategies. This regulatory concern, however, should not be heavily weighted because securities and fund regimes have been in place focusing on protecting the investing public (*i.e.,* unaccredited investors), and despite many safe harbor rules being available in private markets focusing on accredited investors, it has been functioning well without serious problems thus far.[178]

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[175] *See infra Chapter* IV, Part C; Chapter V, Part C; Chapter VI, Part C.

[176] *See e.g.,* Choi, *supra* note 156.

[177] *See e.g.,* Dodd-Frank Act § 412.

[178] The best way to ensure that only financially sophisticated investors can partake in the hedge fund market would be to require accredited investors to go through a sophistication test before investment, but it would be practically impossible and cost-inefficient in that it may entail unbearable compliance costs and a burden to both market intermediaries and investors as well. As a result, regulatory efforts to distinguish private markets from public markets, and to treat them become void. As a matter of fact, there seems to be no fundamental regulatory change needed in this regard. *See supra* note 175.

On the other hand, from a systemic risk-related information gathering perspective, it is necessary that regulators be in a position to obtain hedge fund-related information on a consolidated basis and in a timely manner. In that regard, and because hedge fund managers are responsible for the fund's day-to-day investment activities, it looks reasonable to mandate that they (and not the fund itself) either register with the regulator, or be required to be authorized by the regulator.[179]

The problem under this regime, however, is that registration or authorization requirements for hedge fund managers inevitably entails many onerous ongoing compliance burdens, and it is doubtful that those regulatory obligations are really necessary from the macro-prudential or systemic risk regulatory perspective.[180]

Thus, it is worth thinking about narrowing the scope of regulation placed on hedge fund managers. That is, provided that unaccredited and unsophisticated investors' direct exposure to hedge funds are strictly barred, regulations must ensure that hedge fund managers be treated differently from mutual fund advisers and that mandatory compliance obligations, other than registration/authorization

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[179] *See* Mcdonald, *supra* note 134.

[180] As pointed out *supra*, many rules and regulations applicable to the hedge fund managers are somewhat irrelevant to systemic risk other than registration/authorization, reporting and recordkeeping, and examination requirements, and rather are more relevant to investor protection. But, as emphasized earlier, there seems to be no strong regulatory necessity in applying those rules and regulations to the hedge fund managers, assuming that there is no investing public directly accessing the private market, because most of the rules and regulations are in place to protect the investing public. *See e.g.,* C. Edward Fletcher, III, *Sophisticated Investors under the Federal Securities Laws,* 6 DUKE L. J. 1081, 1133-34 (1988); Loomis, *supra* note 91, at 226.

and periodic reporting/recordkeeping requirements, be imposed on them as little as possible.[181]

Table 1: Comparisons between the Hedge Fund Regulatory Alternatives

	Strong Points	Weak Points
No Direct Regulation Approach	-Ensure self-regulation and market discipline -Maximize market efficiency and financial innovation	-Vulnerable to market shock -No contingency plan in place -Likely to cause a "race to the bottom" problem
Fund Only Regulation Approach	-Directly respond to the risks and problems inherent in hedge funds	-Deter market efficiency and financial innovation -Likely to cause moral hazard -Likely to make the distinction between the mutual fund market and the private fund market blurry
Fund Manager Only Regulation Approach	-Less drastic than regulating both fund and the manager -Likely mitigate overregulation concerns -Strives to take a balanced approach	-Potential overregulation problem -Likely to cause moral hazard -Likely make it look a more regulated market (*i.e.,* government-driven market)
Manager/Fund	-Directly respond to the	-Highly likelihood of

[181] This does not necessarily mean that unaccredited investors' access to the hedge fund market must be curtailed at all times. Rather, it is premised on the belief that unaccredited investors should be guided by third party fiduciaries in investing in hedge funds with suitability or sophistication tests. *See e.g.,* Choi, *supra* note 156.

Regulation Approach	risks and problems inherent in hedge funds -Most powerful approach to ensure market stability	creating an overregulation problem -Most cost-inefficient -Highly likelihood of making it look like a heavily regulated market (moral hazard problem) -No more hedge fund-led benefits to expect
Investor Only Regulation Approach	-Ensure market friendly approach -Likely to keep the market more private -Likely to encourage financial innovation	-Silent to the systemic risk concern -Likely susceptible to market shock
Counterparty Regulation Approach	-More market friendly than direct regulation -Encourage self-regulation or market discipline	-Likely inefficient for dealing with systemic risk concerns -Likely to not properly work during a period of market shock -Paying little attention to investor protection concerns

IV. Hedge Fund Regulation in the U.S.

A. Overview

Hedge funds and their advisers used to be unregulated, or minimally regulated, until the mandatory private fund adviser registration requirement was introduced by the Dodd-Frank Act in the U.S.[182] Both hedge funds and their advisers have been exempted from various securities and fund related regulations by relying on safe harbor rules under the securities or fund related statutes.

However, hedge fund advisers, not hedge funds, become subject to mandatory registration requirements under the Dodd-Frank Act (reflected into the Investment Advisers Act of 1940), and that the funds themselves will not fall under direct regulatory purview - even after the Dodd-Frank Act is in force in July 2012 - because private fund safe harbor rules under the Investment

[182] More precisely speaking, even before the Dodd-Frank Act was implemented, hedge fund managers were required to register with Securities and Exchange Commission (hereinafter SEC) in 2004 for the first time under the then existing rule from the Investment Advisers Act. *See* 17 C.F.R. § 275.203(b)(3)-2. At that time, mandatory registration requirements were enforced by amending the private adviser exemption rule relating to the method of calculation of the number of "fewer than 15 clients" (hereinafter Look-Through Rule or the Rule), and the Look-Through Rule provides that the underlying beneficial owners in the hedge fund be aggregated when counting the number of the clients in determining whether any private adviser could satisfy the threshold conditions for the exemption. As a consequence, most of the then existing hedge fund managers were forced to register with the SEC because they were deemed to have more than 15 clients under the Look-Through Rule. But the Rule was vacated by the D.C. Circuit court in 2006. *See Goldstein v. S.E.C., supra* note 105. It should be noted, however, that the then effective mandated private adviser registration requirement was a lot different from that of the Dodd-Frank Act because the Dodd-Frank Act repealed the then effective "fewer than 15 clients" private adviser exemption, and instead introduced brand-new registration requirements that depend on the assets under management the adviser has. *See* 15 U.S.C. § 80b-3(b)(3) (2010).

Company Act of 1940 have remained unchanged under the new regime (the Dodd-Frank Act).[183]

It has been indicated that the hedge fund market in the U.S. was formed and developed as an unregulated private market due to the availability of various safe harbor rules in securities related statutes. However, despite the fact that safe harbor rules were not put in place with the intent to focus on hedge funds and their advisers, hedge fund advisers have been relying on the safe harbor rules to make a special private market to avoid regulatory intervention to the extent possible for certain of their institutional investors and ultra-wealthy individuals.[184]

The hedge fund market has maintained its legal status as an unregulated private market based on the assumption, among other things, (i) that it is only accessible to a limited selection of professional investors who are presumably sophisticated enough to protect their economic interests themselves without any extensive regulatory intervention,[185] (ii) that the market conduct its business on a limited basis - in terms of the size of the funds they manage, and/or the number of clients they have in those funds,[186] and (iii) that almost

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[183] *See* 15 U.S.C. § 80a-3(c)(1), (7).

[184] For a general overview of the hedge fund market from the regulatory standpoint, *see e.g.,* SEC Hedge Fund Report, *supra* note 28, at 11-33; SEC Staff Report, *supra* note 20, at 103-118; PWG Report, *supra* note 102, at Appendix B.

[185] *See S.E.C. v. Ralston Purina Co., supra* note 18. *See also* SEC Staff Report, *supra* note 20, at 103-118.

[186] *See* 15 U.S.C. § 80b-(3)(b)(3) (2006). *See also* Registration Under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 142 (explaining that, although not entirely clear, the legislative intent of the private adviser exemption is that their impacts on the market are relatively small, and accordingly, there is no critical need for regulatory protection).

all-encompassing anti-fraud rules should be able to deter or enforce any potential market malpractices.[187]

In other words, based on the two conventional rationales for securities regulation - such as protecting investors through mandated disclosure and as deterring market frauds through anti-fraud provisions - hedge funds have been able to retain its unregulated fund status. Until the SEC raised regulatory concerns against them in 2003, and made a regulatory effort to subject them to compulsory registration requirements in 2004, there have been no serious regulatory concerns raised against hedge funds for a long time.[188]

When the SEC tried to intervene in the hedge fund market, and directly regulate hedge fund managers like general investment advisers through mandatory registration requirements in 2004,[189] there were no particular systemic risk concerns raised – despite having gone through the LTCM near-collapse scandal in 1998, and observing potential negative impacts on the overall market from a big-sized hedge fund failure.

Instead, despite the fact that the SEC paid particular attention to the rapid growth of the hedge fund industry over several decades, investor protection concerns (*i.e.,* retailization problem) and market fraud concerns were

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[187] *See* 15 U.S.C. § 80b-6 (2006).

[188] *See* SEC Hedge Fund Report, supra note 28. *See also* Registration under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 142.

[189] Mandating hedge fund advisers to register with the SEC means that they become subject to the full scope of the Advisers Act because all the substantive rules in the Act are applied to registered investment advisers. *See* 15 U.S.C. § 80b-3.

highlighted as the primary regulatory concerns.[190] What this indicates is that neither systemic risk concern nor systemic risk related rationales came into play to justify the imposition of compulsory registration and reporting requirements on the hedge fund advisers, but rather it was regarded as a matter of self-regulation or market discipline between the advisers and regulated counterparties/creditor banks.[191]

Because the SEC paid no special attention to the systemic risk issue from the LTCM failure, they made an effort to regulate hedge funds by amending the private adviser safe harbor rule, instead of by amending the relevant provision of the Advisers Act, regarding the method of the calculation of the number of clients in determining whether the private adviser satisfies the "fewer than 15 clients" threshold condition.[192] As a result, almost all of the then-existing hedge fund managers have become subject to mandatory registration requirements without sufficient legislative justifications for doing so.

The SEC's new regulatory attempt to directly regulate hedge fund advisers was invalidated by a court decision made in favor of the hedge fund advisers

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[190] *See* SEC Hedge Fund Report, *supra* note 28, *at 76-88.*

[191] *See id*. *See also* PWG Report, *supra* note 102, at 29-31; GAO Report, *supra* note 102, at 29-34 (The report emphasized the potential systemic risk from big-sized hedge fund failure, but its recommendation focused more on indirect regulatory approaches than on direct hedge fund and/or its adviser regulation).

[192] In fact, there were no arguments about the reasonableness of the SEC's new rule-making initiative, but rather at issue was whether or not the SEC had been empowered by the Advisers Act to amend the method of calculation of the number of the clients with respect to the private adviser exemption rule. For a detailed discussion about the SEC's lack of legislative authority relating to the newly amended hedge fund rules, *see Goldstein v. S.E.C., supra* note 105.

in 2006.[193] Following the court decision, it became an open question of whether or not hedge fund advisers should be regulated, and how to regulate them, until the Dodd-Frank Act set forth new hedge fund registration rules in the wake of the 2008 global financial crisis.

In response to the court decision, the SEC endeavored to regulate hedge funds indirectly by amending the anti-fraud provisions under the Advisers Act.[194] The accredited investor threshold for affluent individuals under the Securities Act was also heightened based on the conventional rationales like investor protection and deterrence of market abuse.[195]

Hedge funds have been pointed out as one of the important players that provided the momentum for the 2008 financial crisis directly and/or indirectly, based on the observations that the crisis arose primarily from the sub-prime

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[193] *See id.* at 884 (holding that the new hedge fund rules are "arbitrary" and therefore invalid).

[194] *See* 17 C.F.R. § 275.206(4)-8 (2008).

"It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business for any investment adviser to a pooled investment vehicle to:

(1) Make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

(2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

[195] It was made by defining "accredited natural person" to focus on the protection of individual investors by way of providing much higher threshold conditions for accredited investors-individuals. Accredited natural person was defined as "any natural person who meets either the net worth or income test specified in 17 C.F.R § 230.501(a) (2008) or 17 C.F.R § 230.215 (2008), as applicable, and who owns at least $2.5 million in investments individually or jointly with a spouse." However, this new "accredited natural person" idea was not reflected into the law. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 405 (proposed Jan.4, 2007).

mortgage related market collapse, and that many investment banking firms were actively involved in the market as sub-prime mortgage related financial product providers, and at the same time were involved as services providers for the hedge funds, such as prime broker or counterparty creditor, whereas hedge funds used to be there to purchase the products from the investment firms and to trade those products in the market.[196]

For this reasons, fundamental changes in hedge fund regulatory structure has been made since the global financial crisis of 2008.

Based on the macro-prudential regulatory rationale, the hedge fund managers, not the funds, should be subject to mandatory registration, reporting, and

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[196] Counter-arguments have been made from various sectors, such as academia, hedge fund market participants, and even within regulatory bodies, that the hedge fund was irrelevant in causing the collapse of the subprime mortgage market, and rather that they should be treated as a victim of the crisis. *See e.g.,* Houman B. Shadab, *Hedge Funds and the Financial Crisis* (Mercatus on Policy No. 34, January 2009), at 3, *available at* http://ssrn.com/abstract=1564847; Wulf A. Kaal, *Hedge Fund Regulation via BASEL III,* 44 VAND. J. TRANSNAT'L L. 389, 438-39 (March 2011).

It is particularly important to note that even the major regulatory bodies in the U.S. and the U.K. take similar position that hedge funds should not be blamed s a catalyst of the crisis. *See e.g.,* FSA Systemic Risk Report, *supra* note 37, at 4; Alan Greenspan, former FRB Chairman, *Risk Transfer and Financial Stability,* Remarks to the Federal Reserve Bank of Chicago's Forty-First Annual Conference on Bank Structure, May 5, 2005, *available at* http://www.federalreserve.gov/boarddocs/speeches/2005/20050505; Ben S. Bernanke, FRB Chairman, Hedge Funds and Systemic Risk, Remarks at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, May 16, 2006, *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm.

Albeit it is still a controversial issue, but there has been consensus made from the regulatory bodies around the globe that hedge funds may have the potential to adversely affect the overall market stability in an extreme market disruption due to their size, highly risky activities like leveraged transactions and lack of transparency, and accordingly direct hedge fund regulation should be in place based on these regulatory concerns ever since the sub-prime mortgage crisis of 2008. *See e.g.,* Hedge Fund Oversight*, supra* note 87. *See also* Llyod Dixon *et al., Hedge Funds and Systemic Risk* (2012), at 39-62, *available at* http://www.rand.org/content/dam/rand/pubs/monographs/2012/RAND_MG1236.pdf (illustrating how the hedge fund may contribute systemic risk in the wake of 2008 financial crisis).

recordkeeping requirements based on the size of the funds they manage, and regardless of the number of clients they have. What that means is that the long-standing private adviser exemption based on the number of clients was repealed, and instead bring a size-based compulsory registration regime come into play.[197]

The new registration requirements is that hedge fund advisers meeting the assets under management threshold condition are required to register with the SEC, while mid-sized advisers (*i.e.,* advisers with between 25 million dollars and 100 million dollars in assets under management) are required to register with a state regulator, and are not allowed to opt in registration with the SEC, subject to certain exceptions.[198] That is, the traditional private adviser exemption is no longer available under the Dodd-Frank Act, replaced by a size-based mandatory registration regime. Under the new regime, basically any private adviser with 150 million dollars or more in assets under management are forced to register with the SEC regardless of whether they have less than 15 clients.

Other private advisers with between 25 million dollars and 100 million dollars in assets under management are required to register with the applicable state regulator, instead of the SEC.[199] Mid-sized advisers and exempted reporting advisers (including private fund advisers and venture capital fund advisers) are

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[197] *See* Dodd-Frank Act § 408.

[198] *See* 17 C.F.R. § 275.203(m)-1 (2012).

[199] *See* 17 C.F.R. § 275.203A-1 (2012).

also subject to certain reporting requirement under the new regime, and are indirectly subject to SEC supervision although they are exempted from registration and other compliance obligations.[200]

All these new requirements have been implemented and justified in the name of preventing systemic risk, and most private fund advisers in the U.S. come under the regulatory purview in full or in part. Particularly, large-sized private advisers are required to comply with the paternalistic rules and regulations in the Advisers Act exactly the same as other general investment advisers carrying on business that targets the general public.[201]

However, even under the new regime the hedge fund itself is not subject to direct regulation, and the traditional private fund exemptions have been maintained without significant changes.[202]

This regulatory approach has been widely supported and justified considering the facts that (i) hedge funds have played many affirmative roles in the market - all possible because they have been unregulated or lightly regulated, (ii) the adviser manages the fund investment activities on a daily basis, and (iii) systemic risk concerns could be handled more efficiently and effectively by

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[200] As further illustrated *infra*, in addition to the mid-sized adviser exemption, among other things, more exemptions are also available under the new regime, such as a venture capital fund adviser exemption or a foreign private adviser exemption. What is also noteworthy is that the two year lock up safe harbor provision has been eliminated under the Investment Company Act, and as a consequence, private equity fund advisers become subject to mandatory registration requirements while venture capital fund advisers are still exempt from the registration requirements. *See* 15 U.S.C. § 3(b)(8) (2012); 17 C.F.R. § 202(a)(30)-1, 203(l)-1 (2012).

[201] *See e.g.*, Seth Chertok, *Detailed Analysis of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 6 VA. L. & BUS. REV. 1, 23-25 (Spring 2011).

[202] *See* 15 U.S.C. § 3(c)(1), (7) (2012).

regulating the advisers, not by regulating the funds directly.[203] This may be regarded as a regulatory effort to strike a balance in between direct regulation and indirect regulation, in that the new regime has tried to keep the market competitive and to encourage financial innovation while mitigating the potential negative impacts on the markets and while focusing on the macro-prudential regulatory perspective.[204]

In short, hedge funds and their managers have been exempted from registration and other regulatory requirements under the securities or fund related statutes for a long period of time. It has been widely accepted that they made many positive contributions to the markets through their unregulated status.[205] On the other hand, as with the rapid growth in the hedge fund industry over time, hedge fund advisers have become subject to registration and reporting requirements, among other things, depending on the size of the funds they manage and based on the new policy consideration of preventing or mitigating systemic risk.[206]

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[203] *See e.g.,* Harvey J. Goldschmid, Speech by former SEC Commissioner, *Should Hedge Funds be Regulated?* (Nov. 17, 2004), *available at* http://www.sec.gov/news/speech/spch111704hjg.htm.

[204] *Id. See also* Jenny Anderson, *Lessons from the British Way of Policing Hedge Funds,* N.Y. TIMES, July 7, 2006, at C6 (emphasizing the importance of the balanced approach done by the FSA in the U.K. that enhanced regulatory oversight is needed, while also avoiding any overregulation issue that may adversely affect the efficiency and competitiveness of the hedge fund market, and the positive effects hedge funds can have on the overall market).

[205] *See e.g.,* SEC Hedge Fund Report, *supra* note 28, at 4-5.

[206] *Id.* at 76-88. *See also* 15 U.S.C. § 80b-(3)(m), 80b-(4)(b).

B. Hedge Fund Regulation in the U.S.: Before the Dodd-Frank Act

As briefly illustrated *supra*, hedge funds and their advisers have been outside of the regulatory oversight for a long time, relying on the various safe harbor rules available under the securities related statutes. Below is a brief summary of the four major safe harbor rules that, among other things, the hedge fund industry used to rely on to maintain its unregulated status before the Dodd-Frank Act was enacted.

1. Investment Company Act of 1940

Hedge fund typically falls within the definition of "investment company" under the Investment Company Act,[207] but two safe harbor rules are available for hedge funds to avoid the application of the Investment Company Act. The first safe harbor rule is Section 3(c)(1) of the Investment Company Act. It provides hedge funds with a safe harbor to exempt them from a bunch of paternalistic regulations, such as registration and continuous reporting requirements, and specific investment restrictions.[208] Basically, it provides that hedge funds are not required to register with the SEC, and as a result they are free from regulation

[207] Section 3(a)(1)(A) of the Investment Company Act defines investment company as "an issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities", and Section 3(a)(1)(C) of the Act also defines an investment company as "an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of its total assets on an unconsolidated basis." *See* 15 U.S.C. § 80a-3(a)(1)(A), (C).

[208] *See* 15 U.S.C. § 3(c)(1) (2004).

under the Investment Company Act, provided that (i) they do not sell or offer the fund interests to the public, and (ii) the number of beneficial owners (*i.e.,* purchasers) in the fund is less than 100.[209][210]

In addition, hedge funds are exempted from ongoing periodic reporting obligations because those requirements are applied only to registered investment companies.[211] This private fund safe harbor rule was made with the legislative background that small pooled investment vehicles such as private funds are more likely to be composed of the people with "personal, familial, or similar ties", and that there is little practical need for governmental intervention.[212]

As a matter of practice, any individuals or entities who are not accredited investors under the Regulation D are not allowed to directly invest in the hedge funds because of the suitability or sophistication test concerns, despite the fact that they are not completely barred from that investment opportunity in that the Regulation D does not prohibit hedge funds from accepting any person not satisfying the accredited investor threshold conditions up to 35 persons, subject to advance sophistication test.[213]

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[209] *See id*.

[210] What is important to note is that in calculating the number of investors in 3(c)(1) fund, corporate legal entities are not counted as one person if they have 10 percent or more shares of the fund, and the underlying beneficial owners of the corporate entity are included in determining whether the fund satisfy the threshold requirements. *See* 15 U.S.C. § 3(c)(1)(A) (2004); 17 C.F.R. § 270.3c-1(b) (2004).

[211] *See* 15 U.S.C. § 80a-30 (2004).

[212] *See* SEC Staff Report, *supra* note 20, at 106.

[213] *See* 17 C.F.R. § 230.506(b)(2).

Additional exemption can be found at Section 3(c)(7) of the Investment Company Act, and it provides another safe harbor for hedge funds if they satisfy a two-prong test: (i) no public offerings are made, and (ii) they offer or sell the fund interests only to so-called "qualified purchasers".[214][215] Unlike the private fund exemption under Section 3(c)(1), the Section 3(c)(7) exemption does not provide the maximum number of investors (*i.e.,* purchasers) provided that the offer or sale is made only to the qualified purchasers.[216]

However, it has been understood that the qualified purchaser fund is indirectly required to limit the total number of the investors in the fund to 499

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[214] *See* 15 U.S.C. § 80a-3(c)(7). *See* also 15 U.S.C. § 80a-2(a)(51) for the definition of qualified purchaser (defining "qualified purchaser" as

"(i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission;

(ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;

(iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or

(iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.")

[215] For the legislative background of the qualified purchaser fund, *see* SEC Staff Report, *supra* note 20, at 110-14.

[216] Because of this advantage, Section 3(c)(7) of the Investment Company Act has been more commonly used in the market than 3(c)(1) funds. Also the fact that performance fee can be charged only to qualified clients under the Investment Advisers Act also indirectly affect this market practice. *See* 17 C.F.R. § 275.205-3(a), (d)(1) (providing that qualified purchaser under the qualified purchaser fund falls within one of the qualified clients).

persons; otherwise they may be obligated to register and comply with periodic reporting requirements under Section 12(g)(1)(a) of the Securities Exchange Act if they have assets of 10 million dollars or more and a class of equity securities is held by 500 or more shareholders.[217] Accordingly, it may be concluded that the qualified purchaser fund exemption is available only if the number of the investors in the fund is 499 or fewer, and no public offering is made.[218]

This safe harbor rule was created on the assumption that highly sophisticated investors, such as qualified purchasers, raise no particular regulatory concern in terms of investor protection because they are presumably able to protect themselves.[219]

2. Securities Act of 1933

As indicated *supra*, hedge fund falls within the definition of investment company under the Investment Company Act, and the interests it offers or sells to prospective investors are also deemed securities under the Securities Act

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[217] *See* 15 U.S.C. § 781(g)(1)(a) (2004).

[218] It should be noted, however, that the threshold conditions for the registration requirement under the Securities Exchange Act has been changed by the JOBS Act, and it has been relaxed to 2,000 equity shareholders or 500 non-accredited investors. Consequently, hedge fund now is able to rely on this newly amended safe harbor to avoid the registration and continuous reporting requirements under the Exchange Act. *See* 15 U.S.C. § 781(g)(1)(A) (2013).

[219] SEC Staff Report, *supra note 20*, at 110. It should be noted, however, that the threshold requirement for qualified purchaser is much higher than that for accredited investor threshold under the Regulation D, and as a result it is a reasonably inferred that qualified purchaser should be regarded as highly sophisticated investor who are able to protect themselves vis-à-vis hedge fund adviser in that even accredited investors are presumed to be sophisticated enough to protect themselves without the help of mandatory disclosure regime regardless of their actual sophistication. *See* 17 C.F.R. § 230.506(b)(2)(ii).

regardless of the legal form of the fund (*i.e.,* it does not matter whether or not the fund has been set up as a corporation, a business trust or a partnership because any one of them is deemed to be a legal entity under the Investment Company Act).[220] As a consequence, hedge funds are subject to registration requirements under the Securities Act when they offer or sell the fund interests to prospective investors, subject to certain limited private offering exemptions or safe harbor rules available under Section 4(2) of the Securities Act or Rule 506 thereunder.[221]

First, Section 4(2) of the Securities Act exempts any issuer, including hedge funds, from registration requirements when they sell or offer securities (*i.e.,* fund interests) on a private placement basis.[222] This private offering exemption is based on the same premise as the private fund exemptions in that private funds need to satisfy the private offering safe harbor conditions as a prerequisite to satisfy the threshold conditions for the private funds, and accordingly the investors in private offerings are limited to accredited investors who are deemed to have financial sophistication to protect themselves in terms of their knowledge, wealth, and experience.[223]

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[220] *See* 15 U.S.C. § 80a-2(a)(8), 3(a)(1).

[221] *See* 15 U.S.C. § 77d(a)(2); 17 C.F.R. § 230.506. After the JOBS Act went into effect in 2012, Section 4(2) of the Securities Act has been recodified as Section 4(a)(2). *See* Jumpstart Our Business Startups Act, Pub. L. 112-106, Sec. 201(b)(1), (c)(1), 126 Stat. 306 (2012).

[222] *See* 15 U.S.C. § 77d(a)(2).

[223] *See S.E.C. v. Ralston Purina Co.*, *supra* note 18, at 127. More precisely speaking, under the Reg D accredited investors are automatically deemed sophisticated regardless of whether they are really sophisticated or not, and up to 35 non-accredited investors are also accessible to the private offering, subject to sophistication test. Thus, based on the Reg D, it is reasonable to conclude that all the offerees in the private offering could be treated as sophisticated investors, and that there is no need to protect them through mandated disclosure. This is a precondition for the hedge fund to comply with and to satisfy the threshold conditions for the private fund, and that is the reason why private

However, this exemption is only available where the offerees, not the actual purchasers, are able to access to the kind of information required to be included in registration statement under the Securities Act at time of the investment.[224] Because of that, this exemption is, in practice, very difficult to satisfy and not that commonly relied upon by hedge funds; instead, another safe harbor rule, Rule 506 in Regulation D, is more frequently relied.

Second, Rule 506 of the Regulation D provides hedge funds with a useful safe harbor in the private offering exemption because it does not require compliance with Section 4(2). In other words, the safe harbor rule (*i.e.,* Rule 506) enables hedge funds to claim Section 4(2) exemption if they meet the conditions under the Rule.[225] However, that Rule 506 is not necessarily the only way for the hedge funds to be exempted from registration requirement under the Securities Act. Rather, hedge funds are still entitled to claim the private offering exemption if they can prove that they have done the offering in compliance with the Section 4(2) of the Securities Act.[226]

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funds can be exempted from the registration requirements as an investment company under the Investment Company Act. *See* SEC Staff Report, *supra* note 20, at 106.

[224] *See S.E.C. v. Ralston Purina Co*., *supra* note 223.

[225] Among other things, Rule 506(b)(2)(i) provides a "35-purchaser limit", so there is no problem in making an offer or sale to non-accredited investors so long as actual purchasers are within the 35-purchaser limit. The SEC takes the position that it is not a violation of the no general solicitation or advertising requirement under the Rule. It is not, however, applicable to accredited investors, so hedge funds can sell or offer the fund shares to unlimited number of investors so long as they all are accredited investors under Rule 506(e)(1)(iv). *See* 17 C.F.R. § 230.506. *See also Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales,* Securities Act Release No. 6339, Aug. 7, 1981, at n.30.

[226] *See* 17 C.F.R. § 230.500(c).

In addition, general solicitation and general advertisement are not allowed when relying on this safe harbor rule. General solicitation and general advertisement are very broadly defined to include advertisements, articles, notices or other communications published in a newspaper, magazine, or similar media, mass mailings, broadcasts over television or radio, materials contained on a website available to the public, or an email messages sent to a large number of previously unknown persons.[227]

Further, hedge funds relying on the Rule 506 safe harbor must exercise reasonable care to assure that their investors are not investing with the intent to distribute their shares in the fund to the general public; otherwise they are subject to registration obligation pursuant to Section 4(1) of the Securities Act.[228] This resale restriction is to prevent the abuse of the Rule 506 safe harbor through the resale of the exempted securities, which are originally qualified for.[229]

3. Securities Exchange Act of 1934

Under Section 15(b) of the Securities Exchange Act, dealer is defined as "any person who is engaged in the business of buying and selling securities for its own account", and dealer is required to register with the SEC. Trader, who also

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[227] *Id.* This no general solicitation or no general advertisement requirement may be avoided under the JOBS Act if (i) the purchaser is limited to accredited investors, and (ii) the issuer takes reasonable steps to ensure that the purchasers are accredited investors at time of investment. This is one way to offer securities under Regulation D, however, existing safe harbors are also available. Thus, at their discretion, private fund advisers can choose one of these two options to offer the fund shares on a private placement basis. *See Eliminating the Prohibition against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, *supra* note 67, at 35-36.

[228] *See* 17 C.F.R. § 230.502(d).

[229] *Id.*

buys and sells securities like dealer, but not as part of a regular business, however, is not required to register with the SEC.[230] Hedge funds used to rely on this trader exemption to avoid registering as a dealer.

In addition, issuers with 500 or more equity holders and assets in excess of $10 million as of its most recent fiscal year-end are required to register with the SEC, under Section 12(g) of the Securities Exchange Act and Rule 12g-1 thereunder.[231] As a result, most hedge funds seek to avoid the registration and accompanying reporting requirements by keeping fewer than 500 equity holders or less than $10 million in assets.

Further, Section 13(d) and 13(g) of the Securities Exchange Act require any person who, after acquiring beneficial ownership of any equity securities registered under Section 12 of the Securities Exchange Act, beneficially owns 5% or more of the class of equity securities, file a beneficial ownership statement.[232]

Because the hedge funds and their advisers may exercise investment discretion over the equity securities held by the fund, they will generally be deemed to beneficially own any equity securities owned by the fund. As a result, once a hedge fund or its adviser is subject to the reporting obligations under Section 13(d) or 13(g) of the Exchange Act, they must update the previously filed

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[230] *See* 15 U.S.C. § 78l(b), (g) (2004).

[231] This threshold test applies on a yearly basis, not on a permanent basis. Thus, an issuer, which is not subject to the registration requirement, can be subject to the requirement once it reaches the threshold, and vice versa. Also as indicated *supra* note 218, the threshold condition for registration under the Securities Exchange Act has been relaxed under the JOBS Act. *See supra* text accompanying note 218.

[232] *See* 15 U.S.C. § 78m(d), (g) (2004).

beneficial ownership statements when there is a change made in the statement under Rule 13d-2.[233]

Hedge fund advisers may be also subject to the quarterly reporting obligations under Section 13(f) of the Exchange Act, which apply to any "institutional investment manager" exercising investment discretion with respect to accounts having an aggregate fair market value of at least $100 million in equity securities.[234] Finally, Section 16(a) of the Exchange Act requires 10% shareholders or insiders (*e.g.,* officers or directors) of the reporting companies to report on a continuous basis the shares they hold and any change in the shares they hold on a continuous basis, and they all are also subject to a short swing profit provision under Section 16(b) of the Exchange Act.[235]

In sum, although hedge funds may be exempted from registration and accompanying reporting requirements relying on the safe harbor provision in the Securities Exchange Act, they remain subject to other reporting and insider trading regulations such as the 5% report, the 10% report, and the short swing rule; These requirements are applicable to them regardless of their status as a registered company under the Exchange Act.

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[233] *See* 17 C.F.R. § 240.13d-2.

[234] Section 13(f)(5)(A) of the Securities Exchange Act defines "institutional investment manager" as "any person other than a natural person investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the accounts of any other person." *See* 15 U.S.C. § 78m(f)(5)(A).

[235] *See* 15 U.S.C. § 78p(a), (b).

4. Investment Advisers Act of 1940

Section 202(a)(11) of the Investment Advisers Act defines investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[236] Investment advisers are subject to registration requirements unless they satisfy certain limited exemptions available under the Advisers Act. Unsurprisingly, hedge fund advisers fall within the definition of the investment adviser under the Advisers Act.

However, many hedge fund advisers avoid the registration obligations by relying on the safe harbor provision of Section 203(b), which exempts any investment adviser that (i) had 14 or fewer clients during the preceding 12 months, and that (ii) does not hold themselves out to the public as an investment adviser.[237]

What that means is that so long as it satisfies the "no hold out" requirement, and it has no registered investment company or business development company as their client, they are allowed to manage up to 14 hedge funds, regardless of the number of underlying beneficial owners, without registering as an investment adviser under the Advisers Act.[238] By relying on the safe harbor rule, hedge fund

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[236] *See* 15 U.S.C. § 80b-2(a)(11) (2004).

[237] Any investment adviser providing investment advice vis-à-vis registered investment company (*i.e.,* mutual fund) or business development company is not entitled to the Section 203(b) exemption even if they have 14 or fewer clients. *See* 15 U.S.C. § 80b-3(b)(3) (2004).

[238] This has been possible because the legislative intent and the SEC's previous interpretation about the meaning of the "client" have supported the idea that the fund, not the underlying investors,

managers are almost completely free from onerous compliance requirements, except anti-fraud provision under the Advisers Act.[239]

As demonstrated above, the private fund market has relied on various safe harbor provisions in the securities related statutes to maintain its unregulated status, and there has been no particular regulatory concerns raised against them because they used to be relatively small in size and they used to have insignificant negative impacts on the market.[240]

In addition, their client base has been limited to certain presumably sophisticated investors only (*e.g.,* accredited investors or qualified purchasers). Because the hedge fund market has been restricted to sophisticated investors and they are deemed to "fend for themselves", there had been no necessity for direct regulatory intervention into the market (indeed, until the LTCM near-failure occurred in 1998, there were few regulatory concerns raised against them for a long time). [241]

Thus, it is not that surprising to see that basically the hedge fund market has been formed and developed based on the market supply and demand - successfully settling as an unregulated private market – with the help of the safe

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should be counted as a client in terms of the private adviser exemption unless the adviser provides separate investment advice to the underlying investors. *See Goldstein v. S.E.C.*, *supra* note 105, at 883-84.

[239] Even if they are qualified for the exemption, some hedge fund advisers opt in and register as investment advisers to accommodate clients' requests or to maintain their competitiveness. *See* SEC Hedge Fund Report, *supra* note 28, at FN 76.

[240] *See id.* at Appendix A (summarizing the history of previous studies or investigations of hedge funds done by the SEC).

[241] *See S.E.C. v. Ralston Purina Co*., *supra* note 18.

harbor rules available for them, and there were few regulatory concerns raised to the market because only sophisticated investors are allowed to access the market.[242]

Even after the LTCM near-failure in 1988, which was a representative example of the potential negative impacts hedge funds could have on the overall market due to their size and highly risky nature of their excessively leveraged positions, this legislative and regulatory position has remained unchanged.[243] Instead, various indirect regulatory initiatives have been made more focusing on market self-discipline or on self-regulation, rather than on direct regulatory or governmental intervention.[244]

However, in 2003 the SEC raised some regulatory concerns about the hedge fund industry when they found, among other things, that (i) the market had grown rapidly within a relatively short period of time and that this trend was anticipated to continue going forward, while there was little information about them available to investors and regulators, and (ii) more and more substantively unsophisticated investors (albeit legally treated them as sophisticated investors) were exposed to the market, both directly through the accredited investor or qualified purchaser threshold rules and indirectly through fund of funds or pension

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[242] *See e.g.,* Michael J. Schmidt, Notes and Comments, *"Investor Protection" in Europe and the United States: Impacting the Future of Hedge Funds,* 25 WIS. INT'L L. J. 161, 166-68 (Spring 2007) (summarizing the US hedge fund regime as an "indirect regulation approach" primarily relying on mandated disclosure and investor restrictions).

[243] *See e.g.,* SEC Hedge Fund Report, supra note 28. *See also* Registration under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 140.

[244] *See e.g.,* PWG Report, *supra* note 102; GAO Report, *supra* note 102.

funds, and (iii) law enforcement tools against their potential malpractices or misconducts were only limitedly available; leaving regulators to rely on anti-fraud rules while many market malpractices continuously took place in the market.[245]

Based on these regulatory backgrounds, the SEC made an attempt to regulate hedge funds directly by making the hedge fund advisers subject to mandatory registration requirement.[246] In doing so, the SEC amended the private adviser exemption to change the method of calculating the number of the clients regarding funds in determining whether the hedge fund advisers satisfy the "fewer than 15 clients" threshold conditions.[247]

This new hedge fund rule was referred to as the "look through" rule, under which almost all the then existing hedge fund advisers became subject to mandatory registration, and consequently became subject to direct regulatory oversight because underlying investors in a fund were to be included in calculating the number of clients with respect to the private adviser exemption.[248]

The SEC strived to justify the mandatory registration regime by focusing on micro-prudential regulatory standpoints (*i.e.,* conventional rationales for

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[245] *See* SEC Hedge Fund Report, *supra* note 28, at 76-87; William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, Testimony before the Senate Committee on Banking, Housing and Urban Affairs Concerning Investor Protection Implications of Hedge Funds (April 10, 2003), *available at* http://www.sec.gov/news/testimony/041003tswhd.htm. *See also Registration Under the Advisers Act of Certain Hedge Fund Advisers, supra* note 140, at 76-88 (illustrating, among other things, that the (i) growth of the hedge fund market, (ii) increase in the hedge fund fraud cases, and (iii) retailization (*i.e.,* retail investors' broad exposure to hedge funds market) are primary concerns from a regulatory perspective, and set the grounds for the mandatory registration requirement).

[246] *See* Registration under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 140.

[247] *See* 17 C.F.R. § 275.203(b)(3)-1 (2006).

[248] *Id.*

securities regulation) such as investor protection or deterrence of market fraud, not on a systemic risk regulatory standpoint, despite the fact that they went through the LTCM episode in 2003.

The LTCM episode was widely pointed out as a leading landmark case for demonstrating how even one big-sized hedge fund failure may negatively affect the overall market directly (through liquidity channel) and indirectly (through the counterparty credit channel).[249]

Based on traditional rationales for securities regulation, the SEC made efforts to have hedge funds under their regulatory purview by implementing the new "look through" rule in conjunction with the private adviser exemption. That is, by changing the method of calculating the number of clients targeting hedge funds, and including the beneficial owners of the funds in determining if private fund advisers meet the fewer than 15 clients threshold conditions.[250]

The SEC also paid special attention to the facts that hedge fund information was very limitedly available to investors and regulators, while the hedge fund market was rapidly growing and many unaccredited investors were being exposed

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[249] This implicates that, until the time when the new hedge fund rule was released in 2004, system risk was not been seriously taken into account as a rationale for securities regulation, rather it was regarded as a ground for regulating other entities (*e.g.,* banks or prime brokers). There has been a consensus that it is more important and efficient to regulate the counterparty or creditor banks, and through them the hedge fund default issue could be handled. In other words, it appears that systemic risk concern was not considered critical in contemplating a hedge fund regulatory framework even after the LTCM scandal, and it was broadly accepted even from the regulators' side that an indirect regulatory approach based on the best practices or market self-disciplines would be more appropriate and efficient for dealing with the systemic risk issue. *See* PWG Report, *supra* note 102, at 29-44; GAO Report, *supra* note 102, at 33-39.

[250] *See* Registration under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 140, Chapter II, Part D.

to the highly risky hedge fund market under the accredited investor thresholds or through fund of funds/pension fund schemes.[251]

The SEC also tried to justify the regulation based on the assumption that it is more likely to deter hedge fund frauds, stressing that many fraudulent market malpractices took place in the hedge fund industry such as mispricing, misappropriation, and conflicts of interest, and that it is harder for regulators to proactively take action without having proper regulation in place.[252]

These SEC's regulatory efforts ended up with success to some extent because it was reflected in the SEC Rule and in force early 2006 until it was eventually vacated by the U.S. court later in 2006 based on the ground that the SEC had no rule-making authority to amend the rule in violation of the relevant

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[251] This regulatory argument may be somewhat persuasive in the sense that even general public is able to access the hedge fund market indirectly through the fund of funds or pension funds. In that respect, mandated disclosure issue becomes relevant, and mandatory registration requirement may be justified to some extent. Despite the SEC's attention to this issue, it may be not that critical, and at the same time may be a bit misleading because there should be a fiduciary there in the fund of funds or pension fund scheme, who is obligated to make investment decision on behalf of the underlying investors and in the best interest of them. These fiduciaries are deemed accredited investors with expertise, knowledge and experience in negotiating with the hedge fund managers on an arm's length basis. More important thing is that basically they are regulated entities and subject to regulatory obligations when investing in hedge funds. Thus, it seems not that persuasive ground to justify the mandatory registration requirement in terms of the private adviser exemption. In particular, the rapid growth of the hedge fund market is more relevant to systemic risk issue, than mandated disclosure issue, and it should be more appropriate to deal with the hedge fund problem in that direction. Considering the facts that it is a private market in compliance with the private offering exemption and it is based on the assumption that all the investors in this market are composed of sophisticated investors, this regulatory approach may lose the ground to justify the regulation. Regulator's limited access problem to the market is understandable to some extent, but it may be also handled without much difficulty through regulated counterparties or creditor-financial institutions or simply imposing reporting requirement, instead of imposing full registration and other compliance obligations, is sufficient to that end. *See e.g.,* Paul S. Atkins, Statement by SEC Commissioner at Open Meeting Considering Proposed Regulation Under the Advisers Act of Certain Hedge Fund Advisers, July 14, 2004, *available at* http://www.sec.gov/news/speech/spch071404psa.htm.

[252] *See* Registration under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 140.

law (*i.e.,* Investment Advisers Act).[253] After the court's negative decision about the new hedge fund rule, the SEC tried to regulate hedge funds indirectly through the amendments of the anti-fraud rule in the Advisers Act and the accredited investor threshold conditions in Regulation D, instead of revisiting the mandatory registration issue again.[254]

In sum, a new hedge fund rule was in force in early 2006 to regulate hedge fund managers through mandatory registration and reporting requirements, based on the traditional rationales for securities regulation, not based on the systemic risk regulatory rationale. However, the rule was short-lived until late 2006 because of insufficient legislative background and was invalidated by the court's ruling. The regulatory concerns raised at that time were perhaps relevant and agreeable, but were inappropriately and disproportionately responded to because mandatory disclosure and registration requirements created an overly extensive regulatory regime that was not in line with the legislative intents for private offering or private adviser exemption.[255]

Investor protection concerns may be resolved or substantially mitigated by heightening the accredited investor threshold conditions and regulating third party fiduciaries (*e.g.,* pension funds or fund of funds managers) to behave more prudently and exercise due diligence in choosing the hedge funds they invest in the

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[253] *See Goldstein v. S.E.C.*, *supra* note 105, at 883-84.

[254] *See* 17 C.F.R. 203.207 (2007). *See also* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, *supra* note 195.

[255] For the legislative history of the Advisers Act, *see* SEC Hedge Fund Report, *supra* note 28, at 20-21.

funds they manage. By doing so, the private fund market could be distinguished more clearly from the public fund market, and this would be more consistent with the well-established rationales for securities regulation and exemptions.[256]

Hedge fund fraud issues could be also tackled without difficulty by regulators' applying the anti-fraud rules more strictly, or by leaving the fraud issues to the relevant parties to resolve through civil litigation.[257]

C. Hedge Fund Regulation in the U.S.: After the Dodd-Frank Act

As briefly indicated *supra*, in the wake of the 2008 global financial crisis, hedge funds have been pointed out for their roles in causing the crisis in one way or another.[258] The systemic risk issues, like those highlighted after the LTCM near-

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[256] *See e.g.,* Choi, *supra* note 156; Schmidt, *supra* note 242.

[257] In fact, that was advocated for and acted upon by the SEC chairman after the new hedge fund rule was invalidated by the court. The SEC revised the anti-fraud rule under the Advisers Act to prevent any loophole in enforcing any fraud cases against the hedge fund advisers. *See* Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals on Phillip Goldstein, *et al.* v. SEC (Aug. 7, 2006), *available at* http://www.sec.gov/news/press/2006/2006-135.htm. *See also* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, *supra* note 195.

[258] For instance, put aside the LTCM scandal in 1998, the Amaranth Adviser episode in 2006 (the biggest hedge fund failure in terms of the size of loss,; the U.S. based hedge fund adviser lost about 6 billion dollars due to huge bets on natural gas futures), the Bear Stearns episode where two hedge funds were bankrupted due to its heavy bet on mortgage backed securities (*i.e.,* CDOs) in 2007, and Lehman Brothers was also went bankrupt, among other things, due to unbearable loss in its sub-prime mortgage financing deals in 2008. In common in between the two large investment banking firms in big trouble was that they both had been heavily involved in the sub-prime mortgage related financial transactions, and had maintained unbearably concentrated positions on the products. *See e.g.,* Scott Hamilton & Matt Turner, *The Rise and Fall of Amaranth Advisors*, FIN. NEWS, 23 July, 2009, *available at* http://www.efinancialnews.com/story/2009-07-23/the-rise-and-fall-of-amaranth-advisors?ea9c8a2de0ee111045601ab04d673622; Vikas Bajaj & Julie Creswell, *Bear Stearns Staves*

meltdown in 1998, are the very grounds for the regulators to create a new regulatory regime, as reflected in the Dodd-Frank Act.[259] Under the new regime, private funds, including hedge funds and private equity funds, advisers become fully subject to registration, reporting, and other compliance requirements in the Advisers Act like other conventionally regulated advisers.[260]

This new hedge fund regime is different from the previous regime (*i.e.,* the new hedge fund rule of 2006) in several ways.

First, back in 2006 when the SEC amended the Advisers Act Rule to make private fund advisers under the regulatory purview, the SEC primarily relied on the traditional, long-standing rationales to justify the regulation such as investor protection and deterrence of fraud. Under the Dodd-Frank regime, systemic risk was added as an additional regulatory rationale and it is a primary factor to determine whether or not private fund managers are subject to mandatory registration and reporting requirements.[261]

Off Collapse of 2 Hedge Funds, N.Y. TIMES, June 21, 2007, *available at* http://www.nytimes.com/2007/06/21/business/21bonds.html?pagewanted=all; Andrew Ross Sorkin, *Lehman Files for Bankruptcy, Merrill is Sold,* N. Y. TIMES, Sept. 14, 2008, *available at* http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all.

[259] As a matter of fact, it has been anticipated that securities regimes would become more stringent as a result of the global financial crisis of 2008 in that IOSCO has proclaimed that systemic risk would be added as a new rationale for securities regulation in addition to the traditionally accepted rationales like protecting investors and/or ensuring market integrity, and securities regimes among the member countries should be amended in accordance with this new rationale. *See* IOSCO Systemic Risk Report, *supra* note 102, at 12-13.

[260] *See* 15 U.S.C. § 80b-3 (2012); Dodd-Frank Act § 403.

[261] *See* Dodd-Frank Act, preliminary note (stating that the legislative intent of the Act is “to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ``too big to fail'', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes”).

Second, the former private adviser exemption based on the number of clients (*i.e.,* "fewer than 15 clients" exemption) has been eliminated and replaced by a size-based exemption. It may be viewed as a fundamental change in the regulatory framework for private fund advisers because the number of clients based private adviser exemption is no more available, and instead only small-sized or mid-sized advisers can be exempted from federal regulations in the future. All these regulatory changes have been justified primarily focusing on the systemic risk or macro-prudential regulatory perspective.[262]

In short, there is no more "fewer than 15 clients" private fund adviser exemption available for the U.S. based private fund advisers, and instead size-based exemption was newly implemented.[263]

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[262]*See id.* The number of clients based exemption is still available even under the Dodd-Frank Act, but what is different from the former private adviser exemption is that it is only applicable to foreign private advisers. In that regard, it may not be viewed as a fundamental shift in regulatory architecture, but there is little doubt that there has been a dramatic change made in designing new private adviser exemption, and there has been a distinctive regulatory position shift, from the client number-based regulation to the fund size-based regulation. In addition, this regulatory position has been unchanged even in making a safe harbor rule for foreign private advisers in that they are eligible for the exemption only if they have 25 million dollars or less in assets under management and they have fewer than 15 U.S. clients or investors. All these changes have been justified in terms of the mitigation of systemic risk. It is somewhat puzzling, however, why the US based private adviser should be treated differently from the foreign private adviser because their potential impact on the U.S. market should be assessed same regardless of their location, and it should be under careful reconsideration whether or not this position should be maintained without any modification. *See supra* note 260.

[263] More precisely speaking, former 25 million dollars in assets under management threshold has been increased to 150 million dollars in assets under management (this assets under management threshold are lowered to 100 million dollars in assets under management by the SEC Rule), and consequently any private fund adviser not meeting the minimum threshold assets under management condition, in principle, is not eligible for the SEC registration. Instead, under the Dodd-Frank Act, they are subject to State regulation subject to certain limited exceptions. What it means is that these so-called mid-sized private fund advisers become generally subject to State regulation instead of Federal regulation, and no opt-in is allowed for them even though they voluntarily would like to choose to register with the SEC in order to be subject to Federal regulation rather than state regulation. *See* 17 C.F.R. § 275.203A-1.

Third, under the new hedge fund regime of 2006, private equity fund managers were placed outside the regulatory purview at the outset because of the "two-year lock up" safe harbor provision, while they now become subject to various compliance requirements such as registration and periodic reporting under the Advisers Act.[264] It is unclear why private equity fund managers are treated the same as hedge fund advisers, and are treated differently from venture capital fund advisers under the Dodd-Frank Act. It may be inferred that they have been identified as a source of potential systemic risk like hedge funds. Further, it becomes blurry to distinguish private equity fund advisers from hedge fund managers because hedge funds have become more active in raising their voices in corporate governance issues, like private equity funds typically do.[265]

Fourth, a private fund adviser exempted from mandatory registration with the SEC is nonetheless subject to reporting and recordkeeping requirements under

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[264] As indicated *supra*, it has been a controversial issue whether private equity fund advisers should be included into the private fund adviser category, and be subject to full scope of the Advisers Act under the Dodd-Frank Act. Many opponents strongly argue, among other things, that (i) private equity funds are irrelevant to the systemic risk issue in nature, (ii) most of the provisions in the Advisers Act are not fit for the private equity fund advisers, and (iii) the compliance burden is too onerous to take. *See e.g.* Joseph A. Tillman, Note, *Beyond the Crisis: Dodd-Frank and Private Equity,* 87 N.Y.U.L.REV. 1602, 1615-20 (Nov. 2012). Because of these concerns raised, new legislative consideration is under way to exempt private equity fund advisers from the Advisers Act. *See* Sarah N. Lynch, *U.S. House Passes Bill to Exempt Private Equity Funds from Rules,* REUTERS, Dec. 4, 2013, *available at* http://www.reuters.com/article/2013/12/04/house-sec-privateequity-idUSL2N0JJ26W20131204.

[265] *See* Eilis Ferran, The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis, ECGI Working Paper Series in Law, Working Paper No. 176/2011 (Feb. 2011), at 4-5, available at papers.ssrn.com/sol3/papers.cfm?abstract_id=1762119. See also David M. Freedman, The Difference between Private Equity and Venture Capital, Jan. 30, 2013, available at http://www.accreditedinvestormarkets.com/article/the-difference-between-private-equity-venture-capital (broadly explaining how the private equity funds are different from venture capital funds).

the Dodd-Frank Act, while the former hedge fund rule exempted them from any reporting or recordkeeping requirements.[266]

As indicated earlier, the Dodd-Frank Act has been in place focusing on systemic risk regulatory standpoint, and the Act has empowered the SEC to access relevant systemic risk information from the "exempt reporting advisers" even if they are exempted from the registration and other compliance requirements, due to their relatively small size (for exempted private advisers) or limited nature of the business (for venture capital fund advisers).[267]

Fifth, asset threshold for mandatory registration becomes higher from 30 million dollars to 150 million dollars in assets under management under the Dodd-Frank Act. It generally means that any private fund advisers not meeting the asset threshold would be exempted from SEC registration, and instead subject to relevant State regulation such as registration and/or examination.[268] So-called mid-sized private advisers, with assets under management of between 25 million dollars and 100 million dollars, are not allowed to opt in the SEC registration if they are eligible for the exempted private advisers and if they are subject to State registration and examination requirements.

By contrast, large-sized private fund advisers with assets under management of between 100 million dollars and 110 million dollars are eligible for

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[266] *See* 15 U.S.C. § 80b–4(a), 17 C.F.R. § 275.204-4 (b).

[267] *Id*.

[268] *See* 15 U.S.C. § 80b–3a; 17 C.F.R. 275.203A-1.

the SEC registration if they choose to do so although they are eligible for the State registration.[269]

Sixth, the Dodd-Frank Act also made an attempt to amend the qualified client standard under the Advisers Act and accredited investor standard under the Regulation D in the Securities Act respectively. Under the Rule 205-3 of the Advisers Act, the threshold for the qualified clients, among other things, has been increased to 1 million dollars from 750,000 dollars in assets under management, or to 2 million dollars from 1.5 million dollars in net-worth.[270]

The standard for accredited investors under the Rule 501 of the Regulation D becomes more stringent by excluding the natural person's primary residence from the calculation of the individual's net worth.[271]These regulatory efforts have been made in response to the rising concerns about the substantively unaccredited investors' increased accessibility to the private fund market, and these regulatory reforms can be understood as a regulatory measure to protect retail investors by placing them outside the hedge fund market.[272]

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[269] See id.

[270] The qualified client threshold has been in place to ensure that only certain qualified individuals with financial sophistication or sufficient net-worth are allowed to enter into an advisory agreement with the advisers, based on the performance-based fee. *See* 17 C.F.R. § 275.205-3(a).

[271] *See* Dodd-Frank Act § 413; 17 C.F.R. § 230.501(a)(5)(i)(A).

[272] Id.

D. Summary and Comments

As illustrated *supra*, hedge funds and their advisers remained unregulated or very lightly regulated for a long time by relying on the various safe harbor rules under the securities related statutes in the U.S.

First, the Securities Act provides private offering exemptions for hedge funds that offer or sell fund interests to accredited investors or other sophisticated investors. These private offering exemptions were justified based on the presumption that the sophisticated investors are able to protect themselves without the governmental protection.[273] There seems to be no reason to change the current regulatory framework because it has provided a clear distinction between the private securities market and the public securities market and has helped the hedge funds market remain private through the accredited investor standard.[274]

At issue in this private offering safe harbor rule is whether there are some more objective factors for setting the accredited investor threshold, and whether the deemed sophisticated investors can really make an informed decision without the help of mandatory disclosure regime or separate sophistication test.

It is understandable that having high net-worth or earning high income does not necessarily means that the relevant individual is financially sophisticated

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[273] *See e.g.,* Fletcher, III, *supra* note 180, at 1122-24.

[274] However, it is still debatable whether accredited investors, who are deemed financially sophisticated, are really financially sophisticated enough to protect themselves without paternalistic intervention by the government. *See* SEC Hedge Fund Report, *supra* note 28, at 80-83. *See also* Felicia Smith, *Madoff Ponzi Scheme Exposes "the Myth of the Sophisticated Investor",* 40 U. BALT. L. REV. 215 (Winter 2010); Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition under the 1933 Act,* 86 WASH. U. L. REV. 733 (2009); Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (Summer 1994); Choi, *supra* note 156.

enough to protect themselves. But, these objective standards may be necessary to create a distinction between the general public and sophisticated investors. Without a clear and objective standard, it would be almost impossible to raise capital from wealthy individuals because the sophistication test is very subjective and accordingly really difficult to make a judgment at time of investment. [275]

Thus, it seems reasonable that current private offering safe harbor regime based on the accredited investor standard should be maintained without substantial changes, but should be fine-tuned by redefining the accredited investor threshold. In that regard, the SEC's regulatory effort to redefine the accredited investor threshold condition by adding minimum invested amount threshold in addition to the conventional thresholds based on net-worth or income should be assessed positively.[276]

In addition, the JOBS Act has recently repealed the ban on general solicitation and general advertisement, which used to be one of the essential prerequisites for hedge funds to comply with to rely on the private offering safe harbor.[277]

The new safe harbor rule (*i.e.,* Rule 506(c) of Regulation D) may be considered a fundamental policy change in terms of securities public offering

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[275] That is the reason why we have objective safe harbor rules under the securities laws, rather than merely setting general rules in place. These safe harbor rules provide clear guidance to the market, which may positively affect market formation and development because participants in the market can be confident in the scope of the safe harbor rules. *See* 17 C.F.R. § 230.500.

[276] Net Worth Standard for Accredited Investors, 17 C.F.R. 230, 239, 270 and 275, Release Nos. 33-9287; IA-3341; IC-29891 (Dec. 21, 2011).

[277] *See* 17 C.F.R. 230.506(c). *See also* Eliminating the Prohibition against General Solicitation and General Adverting in Rule 506 and Rule 144A Offerings, *supra* note 67.

regulation because regulatory focus was shifted from offerees to purchasers, and because hedge funds are free to promote their securities without mandatory registration under the Securities Act, provided that the purchasers are accredited investors and the issuer (*i.e.,* hedge funds here in this context) takes reasonable step to verify that the purchasers are accredited investors at time of purchase.[278] Under the new safe harbor rule, hedge funds may be incentivized to market the funds utilizing various means of mass communication to attract prospective investors in the future, which may be a way to encourage hedge funds to disclose more information about them to the public.[279]

Second, the Investment Company Act provides two safe harbors for hedge funds. Accordingly, any hedge fund satisfying the private fund conditions under Section 3(c)(1), or the qualified purchaser fund conditions under Section 3(c)(7) would be exempted from the onerous regulatory requirements under the Act. These private fund related safe harbor rules in the U.S. may provide incentives for the private fund advisers to set up the hedge funds in the U.S. because hedge fund advisers have full discretion in customizing the fund investment structure to reflect market conditions and clients' needs in a timely manner, and hedge funds would retain their unregulated status even under the Dodd-Frank Act.[280]

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[278] *See supra* note 149.

[279] Under the new safe harbor rule of 506(c), unaccredited investors are strictly prohibited from investing in the hedge funds. However, there is no doubt that general advertisement or general solicitation made by the hedge funds would be beneficial for the general public because they are also exposed to the hedge funds indirectly through fund of hedge funds or pension funds, and also they may have potential to become accredited investors sometime in the future.

[280] What the new safe harbor rule implicates is that hedge funds just need to be mindful about the new accredited investor thresholds under the Regulation D to meet the private offering exemptions,

This regulatory position appears reasonable because all the benefits that hedge funds provide were possible because they are free from the paternalistic regulations originally placed on mutual funds, and they are in the position to easily avoid fund regulations by moving offshore if stringent fund regulation is in force in the U.S.[281]

As illustrated *supra*, investor protection concerns are not critical if only accredited investors have direct access to the hedge fund market, and if appropriate fiduciary and disclosure regimes, that govern market intermediaries like fund of funds or pension fund managers, are in place.

Systemic risk concerns are also controllable without difficulty through manager regulation because hedge fund managers conduct investment and management activities on a daily basis on behalf of the funds. More than anything else, direct regulation of hedge funds would end up with losing many benefits they have provided to the markets and investors.[282]

Third, the Investment Advisers Act provided a private adviser exemption based on the number of clients for the hedge fund advisers to rely on (namely, "fewer than 15 clients" exemption). Under the traditional private adviser exemption, hedge fund, not underlying investors in the funds, was treated as one

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because it is one of the threshold conditions for the private fund exemptions. *See* 15 U.S.C. § 80a–3 (c)(1), (7).

[281] *See e.g.,* Azhar & Ullatil, *supra* note 13.

[282] *See supra* Chapter III, Part B.3. *See also* Mercer Bullard, *Regulating Hedge Fund Managers: The Investment Company Act as a Regulatory Screen,* 13 STAN. J. L. BUS. & FIN. 286 (Spring 2008) (supporting the idea of having hedge fund managers under the regulatory purview of the Investment Company Act by treating them as an investment company).

client until the SEC changed the rule governing the method of calculating the number of clients.[283] The SEC's first attempt to regulate hedge funds was short-lived and ended up with failure because the D.C. Circuit vacated the rule on the ground that SEC had no legislative authority to change the rule and that doing so was in contravention of the SEC's previous interpretation of the meaning of "client" in connection with fund.[284]

With the new hedge fund rule, the SEC made an attempt to regulate hedge funds (excluding private equity funds), and tried to justify the new rule based on the traditional securities regulatory rationales, and not based on systemic risk regulation.[285] That is, retailization with intransparency and continuous occurrence of securities frauds from the hedge fund market were named as primary grounds for the justification of the mandatory registration to the managers.[286]

However, the rulemaking faced strong oppositions from the inside of the regulatory body, and from the hedge fund industry, that it was overly burdensome and cost-inefficient, and that retail investor protection issue could be easily resolved by redefining the accredited investor threshold conditions.[287]

Further, the hedge fund fraud issue is in essence a matter of law enforcement because hedge fund advisers have been already subject to very broad

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[283] *See supra* note 235.

[284] *See Goldstein v. S.E.C.*, *supra* note 253.

[285] *See* Registration under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 140.

[286] *Id*.

[287] *See supra* note 43. *See also infra* note 289.

and powerful anti-fraud rules under the securities statutes, and because mandatory registration and examination cannot guarantee that no hedge fund frauds occur.[288] This policy ground is under negative scrutiny from many commentators because under the new hedge fund rule, many small private advisers were still exempted from regulatory oversight, despite many previous market malpractices occurring at those small firms.[289]

Overall, the purpose of the new hedge fund rule was understandable, but the way of dealing with the hedge fund problems was inappropriate or went too far in terms of micro-prudential regulation.

After the global financial crisis of 2008 and accompanying failures of several big investment banks such as Bear Sterns and Lehman Brothers, the systemic risk issue became the primary concern for both the legislators and regulators. As a result, drastic changes have been made in hedge fund regulation by introducing size-based mandatory hedge fund adviser registration, and large sized private fund advisers becomes subject to full scope of regulation under the Dodd-Frank Act.[290]

Under the Dodd-Frank Act, private equity fund advisers are newly subject to mandatory registration regimes in the Advisers Act depending on the size of the assets under management, and former private adviser safe harbor rule has been

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[288] *See e.g.,* Joseph Lanzkron, The Hedge Fund Holdup: The SEC's Repeated Unnecessary Attacks on the Hedge Fund Industry, 73 BROOK. L. REV. 1509, 1530-33 (Summer 2008).

[289] *See e.g.,* Atkins, *supra* note 251; Cynthia A. Glassman, Speech by SEC Commissioner, Registration under the Advisers Act of Certain Hedge Fund Advisers, Oct. 26, 2004, *available at* http://www.sec.gov/news/speech/spch102604cag.htm.

[290] *See supra* note 258.

substituted for a foreign private adviser exemption (*i.e.,* a non-US based adviser with fewer than 15 U.S. clients or investors in the private funds and 25 million dollars in assets under management from them).[291]

All these regulatory changes are understandable in terms of macro-prudential regulation because it is difficult to deny that hedge funds could adversely affect the market directly through their trading activities in the market and/or indirectly through the counterparty financial institutions, particularly during times of severe market disruption.[292]

However, the problem in this regulatory approach is that the new hedge fund regime under the Dodd-Frank Act put too much emphasis on systemic risk and tries to regulate them in exactly the same way as other regulated advisers, and to subject them to full scope of regulations under the Advisers Act - despite the fact that there has been no clear evidence that they contribute to the global financial crisis.[293]

Further, it is also problematic that there are no special direct regulatory requirements, such as liquidity and leverage requirements, added to the Advisers Act to mitigate systemic risks from hedge funds. Rather, this mandate seems to be

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[291] *See id*.

[292] *See e.g*., Evan M. Gilbert, *Unnecessary Reform: The Fallacies with and Alternatives to SEC Regulation of Hedge Funds*, 2 J. BUS. ENTREPRENEURSHIP & L. 319, 332-35 (Spring 2009).

[293] *See supra* Chapter III, Part B.3, Part C.

handed over to the Financial Stability Oversight Council (hereinafter as "FSOC").[294]

In terms of systemic risk-based regulation, size or assets under management should not be viewed as the only one relevant factor to decide the threshold for the exempted private advisers; leverage should be also taken into account for that purpose.[295]

The FSOC was newly established to oversee and supervise systematically important financial institutions including hedge funds and their advisers, and any hedge funds and their advisers designated as systematically important financial institutions become subject to very stringent macro-prudential regulation like other regulated and FDIC insured financial institutions. In that regard, it would be prudent that the securities regulator's role be limited to gathering the relevant information from the hedge fund industry, getting ready to take any corrective regulatory measures if necessary, and strictly enforce the law against any malpractices from the hedge fund market relying on the anti-fraud rules.[296]

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[294] It is not yet determined whether or not some of the big-sized hedge funds or their advisers are designated as systematically important nonbank financial companies by the FSOC, but they become subject to some stringent prudential regulation in accordance with Title 1 of the Dodd-Frank Act once they are designated as such. *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, *supra* note 104.

[295] *See id.* at 21640 (indicating that the designation of the systematically important nonbank financial companies including hedge fund and/or its advisers should be determined considering various factors like the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company).

[296] *See e.g.,* Kathleen L. Casey, SEC Commissioner, Statement at SEC Open Meeting – Rules Implementing Amendments to the Investment Advisers Act of 1940; Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, June 22, 2011, *available at* http://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm (arguing that "these rules will needlessly harm innovation and capital formation without a demonstrated, articulable, or

The Dodd-Frank Act permits hedge funds to remain exempted from fund related regulations under the Investment Company Act. What it implicates is that the prevention of systemic risk is practically impossible and infeasible because hedge fund advisers are free to exercise highly risky or highly leveraged transactions. Unquestionably, the best way to prevent or mitigate systemic risk from potential hedge fund failures would be directly regulating them, but it is undesirable because the regulatory cost outweighs the benefits from the regulation.[297]

Thus, the more advisable regulatory approach would be to impose registration and reporting obligations on big-sized and highly leveraged hedge fund advisers, and to empower the SEC to intervene in the market to regulate them during times of emerging systemic risk.[298]

However, current hedge fund regime under the Dodd-Frank Act provides that large sized private advisers are fully subject to the Advisers Act based on the systemic risk regulation, while most of the rules in the Advisers Act are in place based on micro-prudential regulation. There seems to be insufficient grounds to apply all the paternalistic rules and regulations under the Advisers Act to the

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measurable benefit to investors or financial stability"). *See also* Eugene A. Ludwig, *Assessment of Dodd-Frank Financial Regulatory Reform: Strengths, Challenges, and Opportunities for a Stronger Regulatory System,* 29 YALE J. ON REG. 181 (2012) (generally discussing about the potential problems inherent in the Dodd-Frank Act).

[297] *See id*.

[298] It is something similar to the regulatory approach applicable to the so-called exempted reporting advisers, but the difference is that large private advisers are fully subject to the Advisers Act, including registration and business conduct regulations, while the small or mid-sized advisers are merely subject to reporting requirements, despite being exempted from the registration and other requirements. *See* 17 C.F.R. § 275.204-4.

private fund advisers because the Advisers Act was originally enacted to protect investing public, not accredited investors, and because hedge funds' target investors are all accredited investors or qualified purchasers that have been legally deemed sophisticated enough to protect themselves.[299]

On the other hand, it is also doubtful that it is necessary to regulate private equity fund advisers exactly the same as hedge fund advisers by having them fully subject to the Advisers Act. Private equity funds are less likely to pose systemic risk than hedge funds, because their business is primarily centered on private equity investments, not on short-term trading purpose.[300] As pointed out above, there are no substantial investor protection and market fraud issues in the private equity fund market in that the investors (*i.e.,* limited partners or LPs) are strictly limited to accredited investors, and they are subject to anti-fraud rules against any fraudulent or deceptive market practices. Thus, it is prudent to treat them more like venture capital funds, and to exempt them from the direct and full regulations, and instead to make them subject to reporting requirements like "exempted reporting advisers" (*i.e.,* small sized private advisers or venture capital fund advisers).

In addition, the different treatment of U.S. based private advisers from foreign private advisers is problematic in that, from a systemic risk standpoint, it

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[299] *See* Hedge Fund Rule, *supra* note 56, at 72,067 (indicating that the legislative intent of enacting the former private adviser exemption was to exempt certain advisers whose activities were "not sufficiently large or national in scope").

[300] For the legislative background on why the U.S. Congress targeted private equity funds, *see* Private Fund Investment Advisers Registration Act of 2009, H.R. Rep. No. 111-686, pt. 1 (2010), at 6, *available at* http://www.gpo.gov/fdsys/pkg/CRPT-111hrpt686/pdf/CRPT-111hrpt686-pt1.pdf. *See also* Tillman, *supra* note 264, 1615-20 (arguing that no careful considerations or discussions have been made focusing on private equity funds).

seems more reasonable and consistent to apply the same threshold requirements to both domestic and offshore private advisers. It is confusing to understand why the U.S. Congress maintained the former "fewer than 15 clients" exemption for foreign private advisers because the number of clients in the funds seems remote from the systemic risk regulatory concern.[301]

In terms of investor protection, there is no strong need to directly regulate foreign private advisers because, like US based private advisers, they must offer or sell fund shares only to sophisticated investors and they are subject to anti-fraud provisions under the US securities statutes. Therefore, it seems more prudent to have the same threshold conditions applied to both domestic private advisers and foreign private advisers.[302]

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[301] *See e.g.,* Michael I. Overmyer, Note, *The "Foreign Private Adviser" Exemption: A Potential Gap in the New Systemic Risk Regulatory Architecture,* 110 COLUM. L. REV. 2185, 2211-19 (Dec. 2010) (arguing that the same registration obligation should be imposed on foreign private advisers as is applicable to US based private advisers in terms of systemic risk based regulation).

[302] *See* 17 C.F.R. § 275.203(m)(b). It should be noted that non US-based private advisers are also able to rely on the general private adviser exemption based on the assets under management (namely, less than 150 million dollars in assets under management), but due to the foreign private adviser exemption and because of the difference in threshold conditions between the two, it is more likely that regulatory arbitrage problem arises, providing disadvantages to the US based private advisers (especially to start-up companies) and force them to choose a more regulatory favorable overseas jurisdictions. *See id.*

V. Hedge Fund Regulation in the U.K.

A. Overview

Traditionally, the U.K., and especially London, has been well-known as the center for hedge fund business in Europe. This is supported by the fact that London has been ranked as the first place venue for hedge fund managers in Europe, and as the second place venue worldwide (following the U.S.).[303] Various factors explain why most hedge fund managers in Europe and worldwide have been willing to be based in London. "Local expertise, the proximity of institutional clients and global markets, a long established financial services industry, and a generally favorable regulatory environment" are some of the factors generally discussed.[304]

Interestingly, however, most hedge funds managed by London-based managers are not domiciled in the U.K. This can be explained from both a regulatory and a tax perspective. From a regulatory perspective, there are no special rules and regulations in place for U.K. based hedge funds, while offshore domiciled funds have remained unregulated if they are offered or sold only to certain U.K. professional investors.[305] As a result, by setting up their funds

[303] As of the year-end of 2012, almost 80% of hedge fund assets in Europe are under management by U.K. based managers. *See 2013 Preqin Global Hedge Fund Report,* at 7, Fig. 2.3, *available at* https://www.preqin.com/docs/samples/The_2013_Preqin_Global_Hedge_Fund_Report_Sample_Pages.pdf.

[304] CORNISH & MASON, *supra* note 47, at 483.

[305] Onshore funds can also be exempted from regulation unless they are marketed to the general public. In that regard, it may not be a critical factor in explaining why most hedge funds managed by U.K. based managers are domiciled offshore, rather than onshore. Rather, the tax consideration may be more important in choosing the jurisdiction for the fund to be set up. *See infra* Chapter V, Part B.

offshore, it is more convenient and provides more flexibility to U.K. based managers to be able to structure a fund investment strategy reflecting investors' needs both locally and globally. From a tax perspective, unfavorable tax treatment may be applicable if a fund is established as an unregulated fund in the U.K. compared to if the fund was established in an offshore tax haven, such as the Cayman Islands or the British Virgin Islands.[306]

Overall, the U.K. has maintained its leading role in the hedge fund management business in Europe and worldwide, partly because of a flexible regulatory environment that allows offshore funds to remain unregulated[307] if they are only marketed privately to professional investors.

B. Hedge Fund Regulation in the U.K.: Before the AIFMD

1. Hedge Fund Manager Regulation

In principle, any person, including a hedge fund manager, who intends to conduct "regulated activities" in the U.K., must first be authorized by the Financial Conduct Authority (hereinafter as "FCA").[308] Even a manager domiciled outside

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[306] The tax issue is very important, especially for foreign investors, because they are concerned about the potential double taxation issue. As a result they may be more comfortable with the fund regimes located in tax haven countries. *See supra* note 304.

[307] The U.K. financial regulatory body was referred to as the Financial Services Authority until it was separated into and reorganized as the Financial Conduct Authority and the Prudential Regulation Authority (a part of the Bank of England) on April 1, 2013. The roles of the two separate regulatory bodies may be seen at their websites: http://www.bankofengland.co.uk/PRA/Pages/default.aspx, and http://fca.org.uk/about/what.

[308] *See* FSMA, art. 19, Sch. 6.

the jurisdiction of the U.K. may be subject to U.K. regulations depending on factual circumstances.[309] For instance, an offshore manager is more likely to become subject to U.K. regulations if the offshore manager contemplates conducting "regulated activities" in the U.K. market, such as marketing the offshore funds they manage to U.K. investors or trading the fund assets.[310]

Contrary to the U.S. regime, there is no license exemption available for hedge fund managers in the U.K., and they are subject to authorization and other business conduct rules like other regulated financial companies. However, the authorization requirements are relatively flexible because they are in place based on broad principles.

As a result, the U.K. regulatory authority (*i.e.,* the FCA) has discretion to apply the requirements to hedge fund managers as leniently as possible provided that they intend to conduct the business on a limited basis focusing on professional investors.[311] Schedule 6 to the Financial Services and Markets Act 2000 (hereinafter as "FSMA") provides threshold requirements for authorization, including the applicant's legal status and location of the offices, close links (*i.e.,*

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[309] *See id.* art. 21(3). ("In the case of a communication originating outside the United Kingdom, subsection (1) applies only if the communication is capable of having an effect in the United Kingdom.").

[310] *See* Cornish & Mason, *supra* note 47, at 487.

[311] *See* Hector Sants, FSA Chief Executive, *Hedge Funds – Lessons from the Recent Market Turmoil: A Supervisor's Perspective*, Nov. 20, 2007, *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/112 0_hs.shtml.

control person(s) of the applicant firm), fitness and propriety of the persons involved of the firm, and the adequacy of the financial or other resources.[312]

As authorized and regulated entities, hedge fund managers are required to have internal policies and procedures in place to monitor that their regulatory capital is adequate. It is an ongoing obligation while carrying on the authorized business to remain in compliance with the initial authorization requirements.[313] Wholesale firms like hedge fund managers are not strictly subject to examination requirements under the Senior Managements Arrangements, Systems and Controls (hereinafter as "SYSC") 5 of the FCA Handbook regarding "approved person".[314] That is, a person in the hedge fund managers may be deemed competent without a thorough examination provided that the applicants can demonstrate why they believe they are competent.[315]

Hedge fund sales agents are also subject to authorization by the FCA because fund marketing and promotion activities are also considered "regulated activities" under the FSMA.[316] In terms of ongoing examination, the U.K. financial regulator has taken an "outcome-based" approach, along with a broad "principle-based" regime.[317] What this means is that the FSA will take regulatory action

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[312] *See* FSMA, art. 41, Sch. 6 (providing broad line-by-line requirements on the threshold conditions for authorization).

[313] CORNISH & MASON, *supra* note 47, at 492.

[314] *Id.* at 493-94.

[315] *Id*.

[316] *See* FSMA, art. 19, 21-22.

[317] *See* Sants, *supra* note 311.

against regulated entities, like hedge fund managers, if they find something wrong in the actions or decisions made by the regulated firms. That evaluation is done based on the outcomes and consequences of the actions or decisions made, with reference to the general regulatory principles, and not based on the mere fact of being in compliance of any given rules.[318] For example, Principles for Businesses 3 requires regulated firms to "take reasonable care to establish and maintain such systems and controls as are appropriate to its business."[319] This high level regulatory principle is applied with broad flexibility depending on the size, nature, scope, and complexity of the business.[320]

Like other regulated entities, hedge fund managers are subject to the FCA's "risk-based" supervision. Hedge fund managers are required to have enough capital to cover any potential risks they may face while carrying on their business and to put adequate internal control and risk management systems in place to deal with the risks inherent in the business.[321] Through their "risk-based" supervision approach and their "principle and outcome-based" regulations, the U.K. seeks to ensure that any regulated firm carries on their business in compliance with the rules and regulations in place under the FSMA.[322]

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[318] *See* CORNISH & MASON, *supra* note 47, at 501.

[319] *See* Senior Managements Arrangements, Systems and Controls, art. 3.1.1R, *available at* http://www.fshandbook.info/FS/html/FCA/SYSC/3/1.

[320] *Id.* art. 3.1.2G.

[321] *See* General Prudential Sourcebook, art. 2.1, *available at* http://www.fshandbook.info/FS/html/FCA/GENPRU/2/1.

[322] For the regulatory objectives of the FSMA, *see* FSMA, art. 3-6.

Some may doubt why hedge fund managers, despite conducting business on a limited basis and only targeting certain professional investors, should be under prudential regulations. A micro-prudential regulatory perspective is insufficient to justify such prudential regulation, because unlike other regulated entities conducting business with the general public, hedge fund business is strictly limited to certain professional investors. However, there seem to be grounds to justify the application of prudential regulations to hedge fund managers in terms of a macro-prudential perspective, because the overall size and risky nature of hedge funds may pose systemic risk.[323]

Thus, there is little doubt that the current risk-based regime in the U.K. should be maintained in general. However, the current regimes should also be reconsidered in the sense that they do not take into account the size and risk level of particular hedge fund businesses in subjecting them to full regulatory supervision. That is, small-sized hedge fund managers have less of a potential to pose systemic risk to the market, so there is little necessity to subject them to the full scope of direct regulatory oversight.[324]

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[323] *See* Implementation of the Alternative Investment Fund Managers Directive, FSA Discussion Paper, DP 12/1, Jan. 2012, at 14, *available at* http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf. *See also* FSMA, art. 3A (adding financial stability as one of the regulatory objectives of the FSMA after the global financial crisis of 2008).

[324] Some may argue that small hedge fund managers may also pose systemic risk on a collective basis because of their herd behavior, particularly if they have similar investment strategies and behave in the same direction during extreme market situations. But generally speaking, it is more reasonable to say that they are less likely to cause systemic risk even in extreme market situations because they are small in size and have limited market impact (even when they go bankrupt). *See* Sants, *supra* note 311. ("We believe that these firms, with lower volumes of assets under management, are generally not large enough to have a significant systemic impact, although there

2. Hedge Fund Marketing Regulation

The FSMA forbids anyone from acting "in the course of business to communicate an invitation or inducement to engage in investment activity" unless certain conditions or exemptions are met.[325] This default rule is that only an FCA authorized or approved person is allowed to market their fund interests, but they are subject to limited exemptions. One exemption allows someone other than the authorized person to promote the funds provided that the content of the communication is approved first by the authorized or approved person.[326] Under the FSMA, "financial promotion" is defined very broadly to include any communication noted above, and the promotion rules may include communications made from outside the U.K.[327]

Thus, an unauthorized person (including an unauthorized hedge fund) is not allowed to communicate an invitation or inducement to engage in the marketing or promotional activity in the U.K. unless they rely on exemptions, because offering circulars (*e.g.,* private placement memorandum) and other marketing materials for activities of the fund may constitute financial promotion under the FSMA.[328] In particular, Article 238 of the FSMA applies in cases where the promotion of an unregulated collective investment scheme (like a hedge fund) has been made in the

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may be issues to manage where they hold concentrated positions in specific thinly traded securities.").

[325] *See* FSMA, art. 21, 238.

[326] *Id*.

[327] *See* FSMA, art. 21(3), 238(3).

[328] *See supra* note 325.

U.K., and it specifies the categories of investors that can be marketed or promoted to by hedge fund managers without being subject to regulatory supervision.[329]

The Conduct of Business Sourcebook (hereinafter as "COBS") 4.12R also provides some exemptions for the general prohibition of fund promotion under Article 238 of the FSMA. It provides a safe harbor rule that it is not a breach of Article 238 of the FSMA for hedge fund managers to market the fund shares, provided that the managers take reasonable steps to ensure that they market fund interests to only the specified categories of persons, or to any other persons reasonably regarded as being comparable to those in the specified categories.[330]

Therefore, if they wish to make use of this exemption it is critically important for hedge fund managers to only market hedge funds to certain categories of professional investors. However, because hedge funds are typically domiciled offshore they are not allowed to market to the general public; only U.K. based funds or offshore-based funds that are authorized or recognized by the FCA

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[329] *See* FSMA, art. 238(5). *See also* Conduct of Business Sourcebook, art. 4.12.1R [hereinafter COBS], *available* at http://fshandbook.info/FS/html/handbook/COBS/4/12 (providing some exemptions for an authorized person to market or promote unregulated funds like hedge funds).

[330] *See* COBS, *supra* note 329. COBS 4.12.1:

(1) A firm may communicate an invitation or inducement to participate in an unregulated collective investment scheme without breaching the restriction on promotion in section 238 of the Act if the promotion falls within an exemption in the table in (4), as explained further in the Notes.

(2) Where the left-hand column in the table in (4) refers to promotion to a category of person, this means that the invitation or inducement:

(a) is made only to recipients who the firm has taken reasonable steps to establish are persons in that category; or

(b) is directed at recipients in a way that may reasonably be regarded as designed to reduce, so far as possible, the risk of participation in the collective investment scheme by persons who are not in that category.

(3) A firm may rely on more than one exemption in relation to the same invitation or inducement.

are eligible for the exemption that allows them to market to the general public under the FSMA.[331]

The Qualified Investor Schemes established in the U.K. are not accessible to the public, even if the FCA has authorized them, because it was specially designed as a non-retail scheme authorized to market only to "qualified investors." The qualified investor schemes are also subject to financial promotion regulations and only authorized persons are permitted to market the funds.[332]

However, some exemptions are available for hedge funds to rely on in terms of marketing. One of them is called the "Professional Clients" or "Eligible Counterparties" exemption. Under this exemption hedge funds are free to market the fund shares to professional clients and eligible counterparties without engaging an authorized person in the U.K.[333]

An additional exemption is available for hedge funds where the promotion is made to a person who is (or who has been in the past 30 months) a participant in an unregulated scheme (Category 1); where a firm has made a suitability determination for an existing (or newly accepted) client (Category 2); or where the firm has made a suitability assessment of the prospective investor and has warned the investor in writing that the firm will promote an unregulated scheme to them (Category 8).[334]

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[331] *See* FSMA, art. 238, 264, 270, 272.

[332] *See supra* note 326.

[333] *See* COBS, art. 4.12, Category 7.

[334] *See* COBS, art. 4.12, Category 1, 2, 8.

3. Hedge Fund Regulation

There has been no special regime in place under the U.K. fund regime for hedge funds to rely on. However, the U.K. government introduced a Qualified Investor Scheme (hereinafter as "QIS") in 2004, and U.K. domiciled hedge funds may utilize this regime.[335] Under this regime, QIS provides more flexibility for hedge fund managers to exercise their investment strategies because, compared to other regulated funds available to the general public, relatively less stringent investment restrictions are imposed on them.

With this, hedge fund-like investment strategies can be utilized through the QIS regime provided that the hedge fund is marketed to qualified investors.[336] In contrast, the Fund of Alternative Investment Funds (hereinafter as "FAIFs")[337] scheme may be available if hedge fund managers intend to offer or sell fund interests to the general public.

In this scheme, the general public can invest in offshore hedge funds indirectly, while onshore managers are subject to tight due diligence obligations

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[335] CORNISH & MASON, *supra* note 55, at 484. *See also* Collective Investment Schemes Sourcebook, art. 8.1 (hereinafter "COLL"), *available at* https://fshandbook.info/FS/html/handbook/COLL/8/1#D2.

[336] For details about who is eligible to be Qualified Investors, *see id. art. 8,* Annex 1. Some other types of fund schemes like "Futures and Options Schemes" or "Geared Futures and Options Schemes" are also available for onshore hedge funds, but it may not work completely as applied to hedge funds because those rules were not put in place with hedge funds in mind. *See* CORNISH & MASON, *supra* note 55, at 484.

[337] FAIFs mean "a non-UCITS retail scheme, or a sub-fund of a non-UCITS retail scheme which is an umbrella whose authorised fund manager operates, or proposes to operate, it in accordance with the investment and borrowing powers in COLL 5.7 (Investment powers and borrowing limits for *NURS* operating as *FAIFs*)". *See* FCA Handbook Glossary Definition, *available at* https://fshandbook.info/FS/glossary-html/handbook/Glossary/F?definition=G2752.

under the scheme because onshore managers are allowed to invest up to 100% of the fund assets in unregulated offshore hedge funds.[338]

However, QIS and FAIFs are different from the "qualified purchaser fund" under the U.S. regime, because the former are regulated funds (despite relatively loose investment restrictions being imposed on them), while the latter is an unregulated fund.[339] The QIS and FAIFs are more comparable to Korean qualified purchaser funds and may be referred to as "quasi-regulated" or "half-regulated" funds.[340]

Unlike the authorized hedge fund-like schemes that are subject to FCA supervisory oversight, such as QIS or FAIFs, unauthorized hedge funds are generally free from onerous regulatory requirements by relying on private placement safe harbors. As a result, they can be established in whatever legal form they prefer, such as limited partnerships or closed-ended corporations. Tax treatment is also one of the primary factors in determining the legal form of the fund (as well as the favorable treatment of the offshore hedge funds over the U.K. domiciled hedge funds), and is the primary reason why there have been so few hedge funds established in the U.K.[341]

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[338] *See* COLL, art. 5.1.4, 5.7. For further details on FAIFs, *see* Fin. Serv. Auth., Fund of Alternative Investment Funds (FAIFs), Consultation Paper (CP 07/6), March 2007, *available at* http://www.fsa.gov.uk/pubs/cp/cp07_06.pdf.

[339] *Id.* For more detailed investment and borrowing restrictions applicable to Qualified Investor Schemes, *see* COLL, art. 8.4.

[340] *See* FSCMA, art. 249-2(1).

[341] *See* CORNISH & MASON, s*upra* note 55, at 486. For a broad overview of the U.K. tax regime applicable to hedge funds, *see also* CORNISH & MASON, *supra* note 55, at 516-23.

As illustrated above, non-U.K. based hedge funds are not subject to the FCA's regulatory requirements unless they are offered or sold to the general public.[342] Therefore, it is not uncommon to observe managers who are domiciled in the U.K. and are under the U.K. regulatory purview, while their funds are seldom established in the U.K. but rather are set up in offshore tax havens.[343]

C. Hedge Fund Regulation in the U.K.: After the AIFMD

1. The Alternative Investment Fund Managers Directive

In an effort to regulate the hedge fund industry in a harmonious way within the E.U. and worldwide in the wake of the 2008 global financial crisis, the European Commission (hereinafter as "EC") adopted the E.U. Alternative Investment Fund Managers Directive (hereinafter as "AIFMD" or "the Directive") in June 2011 (after long discussions and negotiations among the member states).[344] The AIFMD was partially implemented in all E.U. member states starting on July 22, 2013.

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[342] *See supra* note 331.

[343] The reasons why many hedge fund managers are based in the U.K., despite the fact that they are subject to regulatory supervision, are that there are many potential clients available in the U.K., and that the U.K. provides a more reliable and more convenient infra-structure for hedge fund managers to conduct hedge fund business, along with a relatively flexible regulatory regime. *See* Eva Pakla, *An Analysis of Regulation Governing Hedge Funds in the US and the EU from 2002 to July 2010: A Preliminary Assessment,* 2 W. MIN. L. REV. 1, 34-39 (Sept. 2012); ATHANASSIOU, *supra* note 79, at 165-81.

[344] For details about the legislative history before the AIFMD was adopted, *see* ATHANASSIOU, *supra* note 79, at 165-81.

Undoubtedly, the AIFMD will have a substantial impact on the alternative investment fund markets within the E.U. and worldwide, because it includes many aspects of the alternative investment fund industry.[345] That is, the E.U. member states are required to transpose the AIFMD into their national regimes respectively by the implementation date (July 22, 2013). There are some transitional periods available, but the AIFMD will be in force and reflected into the local regime of each E.U. member state in due course.[346]

The AIFMD provides a uniform and comprehensive regime for the first time among the E.U. member states; it includes alternative investment funds (E.U. based or not), their managers (domiciled in the EU region or not), their affiliated service providers (such as depositories), and the marketing of the funds.[347] E.U. based Alternative Investment Fund Managers (hereinafter as "AIFMs") are fully subject to the Directive, while non-E.U. based AIFMs, who intend to market the funds (E.U. based or not) to E.U. investors.

The AIFMs are partially subject to disclosure and other reporting requirements unless they apply for authorization in accordance with the Directive (which is transposed to the local member state regimes) to manage E.U. based

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[345] The EC adopted something called "Level 2" regulation on December 2012 as a Supplementing Directive to the AIFMD, and it will also become a part of the AIFMD when it is in force. For further details on the Level 2 regulation, *see* Commission Delegated Regulation (EU), O.J. L 132, 15.5.2013, Implementing Regulation 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, *available at* http://ec.europa.eu/internal_market/investment/docs/alternative_investments/2013/regulation-2013-447_en.pdf.

[346] *See* AIFMD, art. 66.

[347] *See id.* explanatory note 4.

alternative investment funds or to market the funds under the so-called "passport regime."[348]

Several noteworthy aspects of the Directive are as follows:

First, the AIFMD defines alternative investment funds (hereinafter as "AIFs") very broadly to include any "collective investment undertakings … which raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and do not require authorization pursuant to Article 5 of Directive 2009/65/EC."[349] Due to the broad definition of AIFs any pooled investment vehicles, including commodity funds, real estate funds, hedge funds, and private equity funds, become subject to the Directive.

Second, the threshold requirements for AIFMs, who are fully subject to the Directive, are somewhat different from those of the U.S. These requirements are two-tiered depending on whether leverage is utilized and on the length of the lock-up period for the funds. The default rule is that any AIFMs having 100 million euros or more in assets under management, are required to be authorized and are wholly subject to the Directive.

However, this asset under management threshold increases to 500 million euros if the AIFMs do not make use of the leveraged investment strategies for the funds and if they put a lock-up period in place of 5 years or longer.[350] This two-

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[348] *See id.* explanatory note 65, 66.

[349] *See id.* art. 4(1)(a).

[350] Those small firms having assets under management in their alternative investment funds lower than the threshold are required to register with the relevant local regulator and are subject to lighter

phased approach seems more reasonable for manager authorization than the approach utilized in the U.S. The AIFMD sets the threshold conditions based on various systemic risk relevant factors like the size of the funds they manage, the use of leverage, and the length of the lock-up period, and it tries to strike a balance to avoid an overregulation problem.[351]

Third, the Directive provides that the AIFMs must be exclusive to the fund they manage. As a result it becomes a fundamental issue of who the AIFM is, and thus who is fully subject to the Directive, especially in cases where multiple managers are involved in the management of the AIF. For instance, some controversies exist about who is the AIFM under the Directive where all or substantial parts of the core functions are delegated to third party manager(s).

The E.U. Level 2 regulation provides useful guidance about this issue by expressly stating that an original AIFM becomes the "letter-box entity" if all or substantial parts of the core functions are delegated to third party managers;

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reporting requirements instead of the authorization requirement. This is comparable to the former U.S. private fund safe harbor regime that exempted private funds from the definition of investment company on the condition that they have a 2 years or longer lock-up period in place. This exemption is primarily applicable to the private equity funds, but hedge funds are also able to rely on the safe harbor if they satisfy the threshold requirements. *See id.* explanatory note 17.

[351] Still this approach may face criticism in that, for example, private equity funds with no or low leverage strategy and a long lock-up clause in place are inappropriate targets for direct regulation, even from macro-prudential regulatory perspective, because the likelihood of their posing systemic risk is substantially lower than hedge funds (considering their private equity investment nature and their relatively small size). Because of these controversies, the U.S. Congress is considering exempting private equity fund managers from mandatory registration and ongoing reporting requirements under the Dodd-Frank Act by eliminating the distinction between private equity funds and venture capital funds, provided that outstanding debt or leverage ratios are lower than 2 times the invested capital commitments. *See* Scott E. Gluck, *United States: Legislation Would Exempt Private Equity Fund Advisers from Registration,* June 17, 2013, *available at* http://www.mondaq.com/article.asp?article_id=245222&signup=true. *See also* Lynch, *supra* note 264.

instead, the third party manager is deemed the AIFM and is subject to the full application of the Directive – despite the third party manager not being authorized under the Directive.[352]

Fourth, the AIFMD requires AIFMs to have minimum capital and to put adequate internal control policies and procedures in place based on the principle of proportionality.[353] Therefore, there is some flexibility for AIFMs about how to implement the internal control system, depending on the nature, scale, and complexity of the business they intend to carry on. The AIFMD also broadly provides moderate level of investment, valuation, and risk management requirements for AIFMs, and requires them to have proper internal investment and risk management systems in place.[354]

This proportionality-based approach, together with principle-based regulation, is more appropriate and preferable to a rule-based or one-size-fits-all regulatory approach; the AIF market is too complex and too diverse to regulate through a positive regulatory system. For example, many potential issues, including conflicts of interest between the manager and the investors and fair treatment among investors, can be resolved by providing broad rules about the manager's fiduciary duty and by strictly enforcing the rule against any violators.[355]

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[352] *See* AIFMD, art. 20(3).

[353] *See id.* art. 9.

[354] *See id.* art. 15-17, 19.

[355] The fiduciary duty itself may require the managers to disclose any preferential terms, like side letters or side agreements applicable only to certain investors in the funds.

Fifth, AIFMs must appoint a regulated credit institution as a depositary for the custody of fund assets.[356] This ensures the safe custody of fund assets and protects fund assets through the segregation of fund assets from the manager's assets. A depositary should in principle be separately appointed from the prime broker, but under the AIFMD it is not impossible for a prime broker to be designated as a depositary for the fund.

However, it is only permissible if the prime brokerage function and the depositary function of the relevant entity are functionally and hierarchically separated.[357] This requirement can be understood as a regulatory measure to minimize potential conflicts of interest between the two functions; they are in conflict with each other because the prime broker is in the position to make use of the fund assets for rehypothecation purposes.[358]

Sixth, the AIFMD defines marketing as "a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares

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[356] *See* AIFMD, art. 21.

[357] This regime is more appropriate for hedge funds, and it may not work properly for private equity funds. Basically, there is no prime brokerage concept for private equity funds, and there is no practical need to have a separate custodian appointed for asset custody of the private equity funds, in that the investment in private equity funds should be made on a capital call basis, and there are no particular assets to be under custody by a separate custodian because most of the fund assets would exist in the form of equities or some other mezzanine securities for buy-out investment purposes. However, the Directive provides that a depositary be separately appointed for the custody of private equity fund assets although it offers some flexibilities for the funds. *See id.* explanatory note 43, art. 21(3).

[358] Rehypothecation occurs when a broker, who has been hypothecated -- or pledged -- securities as collateral for a margin loan, pledges those same securities to a bank or other lender to secure a loan to cover the firm's exposure to potential margin account losses. It is a very common practice between the hedge fund and the prime broker, and because of this practice fund's assets may be at risk when the prime broker goes bankrupt. *See e.g.,* Harriet Agnew, *Rehypothecation is being redefined,* Sep. 13, 2010, *available at* *http://www.efinancialnews.com/story/2010-09-13/rehypothecation-is-being-redefined* (demonstrating that rehypothecation became an important issue in the hedge fund industry especially after the Lehman Brother's collapse in 2009).

of an AIF it managers to or with investors domiciled or with a registered office in the Union."[359] An AIFM is subject to the Directive whether or not they market the funds directly or through third party intermediaries.

What can be inferred from the statutory definition is that so-called "passive" marketing or "reverse solicitation" done at investors' initiative will not be deemed to be active marketing under the AIFMD.[360] Therefore, for the AIFM to rely on the passive marketing and reverse solicitation safe harbors they should take reasonable steps not to conduct active marketing during their follow-up communications and/or meetings, which are subject to the AIFMD. The passive marketing safe harbor is narrowly construed and is very hard to comply with accordingly. Compliance should eventually be determined by the totality of the facts and circumstances.

The AIFM may have two different options available under the Directive in terms of fund marketing. First, an AIFM may market funds in the E.U. by relying on the "passport" regime. Under the passport regime, the AIFM is free to market the funds throughout the E.U. countries without separate approval from each individual member State's regulator (once they get approval or get authorized from a home regulator).[361]

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[359] *See* AIFMD, art. 4(1)(x).

[360] *See id*. For further guidance about passive marketing, *see* Financial Conduct Authority, PS 13/5, *Implementation of the Alternative Investment Fund Managers Directive,* June 2013, *available at* http://www.fca.org.uk/your-fca/documents/policy-statements/ps13-05.

[361] This passport regime may not be a viable option for the non-E.U. AIFM to rely on because it may not be available until late 2015 at the earliest for non-E.U. AIFMs. *See* AIFMD, art. 37, 39, 40.

Second, the AIFM may market non-E.U. funds subject to each individual member state's private placement regimes. Under this route, each individual member state has the ultimate authority on whether or not to allow the AIFM to market the funds on a private placement basis.[362]

For an offshore AIFM to market funds to E.U. investors, several conditions must be met: (i) the relevant E.U. member state must have a private placement regime in place to accommodate offshore fund marketing, (ii) an offshore AIFM must comply with disclosure and transparency requirements under the AIFMD, in addition to any other local rules and regulations of the relevant member state, (iii) a cooperation or information sharing arrangement must be made between the regulators of the E.U. member state regulator, the home country regulator, and the regulator where the funds are domiciled (where the jurisdictions of the offshore AIFM and offshore fund are different), and (iv) the home country of the offshore AIFM (including the home country of the offshore funds, if applicable) must not be listed as a "Non-Cooperative Country or Territory" by the Financial Action Task Force.[363]

Thus, Non-E.U. AIFMs need not comply with AIFMD, other than the disclosure and transparency provisions, if they satisfy the member State's national private placement regimes for fund marketing (whether or not the funds are based in the EU).[364]

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[362] This national private placement regime route was only available until the end of 2008. After that, only the passport regime is available. *See id.* explanatory note 4, 69, art. 42, 67.

[363] *Id.* art. 42.

[364] *Id.* explanatory note 69.

Seventh, some disclosure and reporting obligations are imposed on both the E.U. AIFM and the non-E.U. AIFM (when the funds are marketed to E.U. investors).[365] The AIFMD requires an AIFM to disclose material terms to the investors before they make investment decisions, including side-letter or side-pocket arrangements, and any material changes to the investment after they invest.[366] The AIFMs are also subject to continuous reporting requirements to existing investors after the investment. This includes the illiquid assets' ratio in the fund portfolio, special arrangements like side pockets, the risk profile of the fund, and the amount of leverage employed.[367]

An AIFM is also subject to ongoing reporting requirements to the relevant member State regulator.[368] The frequency of the reporting may vary depending on the size of funds the AIFM manages. For example, small firms with assets under management of between 100 million euros and 1 billion euros are required to report to the relevant regulator on a half-yearly basis, while big firms with assets

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[365] *Id*.

[366] *Id.* art. 23. This mandated disclosure requirement is incompatible with the hedge fund regime in essence because it is a private market that only certain presumably sophisticated investors (who are presumably able to protect themselves) are allowed access to. That was the previous U.S. and U.K. regulatory position and there seems to be no substantial change made in market circumstances, particularly in the context of the mandatory disclosure (in that the transparency issue may be tackled easily by ensuring that only sophisticated investors are permitted into the market). Further, this mandatory disclosure requirement blurs the distinction between the private market and the public market, despite there being no clear rationale for why both markets should be treated the same. *See supra* Chapter IV, Part B; Chapter V, Part B

[367] An annual report must also be prepared and provided upon an investors' request. *Id.* art. 24.

[368] For the detailed items to be included in the report, *see* Council Directive 2013/238, 2013 O.J. (L 83) 1 (EC), Annex IV (hereinafter Level 2 Regulation), *available at* http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf.

under management of 1 billion euros or more are required to report on a quarterly basis.[369]

However, the reporting requirements are mitigated for AIFMs of private equity funds. They are required to report on a yearly basis regardless of the size of funds they manage, and when they acquire 50 percent or more of the voting rights of an E.U. non-listed company they are also subject to notice requirements to the companies, to their shareholders, and to the home member State regulator.[370]

Eighth, the AIFMD requires AIFMs to set leverage limits internally that they believe are reasonable for the funds concerned, and the home member state regulator has the authority to impose leverage limits on an ad-hoc basis "when it is deemed necessary in order to ensure the stability and integrity of the financial system."[371] As such, there is no clear and specific rule in place for leverage limits; rather, the Directive encourages AIFMs to set the limit voluntarily by considering various factors (such as the nature of the fund and the investment strategy) and the regulator is ready to intervene to set the leverage limits during market disruptions or other emergent situations.

This principle-based approach is highly advisable, particularly in terms of hedge fund regulation, in that (i) it is very difficult to measure the risk they may

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[369] *See id.* art. 110(3); AIFMD, *supra* note 14.

[370] Private equity fund managers under the AIFMD means "AIFMs in respect of each unleveraged AIF under their management which, in accordance with its core investment policy, invests in non-listed companies and issuers in order to acquire control." Thus, AIFMs who manage leveraged private equity funds may not be able to take advantage of these lighter reporting regimes, but instead are subject to the same reporting requirements as other AIFs like hedge funds. *See* Level 2 Regulation, art. 110(3)(d).

[371] *See* AIFMD, art. 15(4).

pose through the leveraged transactions; (ii) it is practically impossible to prevent risk completely even where a statutory leverage limit is in place; (iii) unitarily setting the leverage limit may adversely affect the market and make the fund structure inflexible, making it hard to achieve the fund's investment goal (*i.e.,* market neutral absolute return or alpha); and (iv) there is no or little practical need to regulate that way considering the fact that it is a private market specially designed for certain professional investors only.[372]

2. The Impacts of AIFMD on U.K. Hedge Fund Regulation

In principle, the U.K. government should take measures to implement the Directive by the implementation date (*i.e.,* July 22, 2013) by amending the relevant U.K. rules and regulations. However, U.K. domiciled managers are not required to comply with the Directive during the transition period until they are authorized by the U.K. regulator (*i.e.,* FCA), due to the one-year transition clause.[373] This transition period is applicable to U.K. based AIFMs seeking authorization under the new regime and to non-E.U. domiciled AIFMs marketing funds in the U.K.[374]

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[372] For how to apply the broad principle to hedge funds, *see generally* Fin. Serv. Auth., Hedge funds: A Discussion of Risk and Regulatory Engagement, Feedback on DP05/4, March 2006, *available at* http://www.fsa.gov.uk/pubs/discussion/fs06_02.pdf.

[373] Under the AIFMD, AIFMs have one year to comply with the new regulatory requirements under the Directive, even after the implementation date of the AIFMD. Therefore, the actual implementation date for the AIFMD is practically postponed until June of 2014. *See* AIFMD, art.61 (1).

[374] *Id*.

Some of the likely effects on the U.K. hedge fund regime from the implementation of the Directive include:[375]

First, U.K. based AIFMs are required to be newly authorized or registered during the transition period (*i.e.,* by July 21, 2014) in compliance with the requirements under the Directive and depending on the size of their firms.[376]

However, the level of regulatory compliance burden varies depending on the size of the funds and on the nature, structure, and complexity of the business the managers intend to conduct.[377] This new authorization regime seems somewhat similar to the existing regime in that U.K. based hedge fund managers were already required to be authorized by the U.K. regulator. However, it is different from the old regime in that it is much broader and more comprehensive regarding the scope of the regulated funds, their managers/ related entities, and the regulated activities.[378]

Second, AIFs are not subject to direct regulation under the Directive, which is similar to the existing U.K. fund regime.[379] Under the new regime, however,

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[375] For the details of the possible impacts of the AIFMD across Europe (including the U.K.), *see* Charles River Associates, Impact of the Proposed AIFM Directive across Europe, October 2009, *available at* http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf.

[376] For instance, an AIFM whose total size of AIF is less than 100 million euros is required to register with the regulator instead of getting authorization. Also, the assets under management threshold requirement is further lifted to 500 million euro for an AIFM who manages unleveraged AIFs only and who provides no redemption right for 5 years or longer. *See id.* explanatory note 17. *See also* The Alternative Investment Fund Managers Regulations, 2013, S.I. 2013/1773, art. 9, 10 (U.K.) (hereinafter "AIFMR"), *available at* http://www.legislation.gov.uk/uksi/2013/1773/pdfs/uksi_20131773_en.pdf .

[377] *See* AIFMD, explanatory note 17.

[378] *See id.* explanatory note 4, 5.

[379] *See id.* explanatory note 10.

AIFs may be indirectly subject to regulation because certain rules applicable to AIFMs (like liquidity management and leverage requirements) may function as de-facto regulations of the fund investment and management activities. The Directive also covers various types of AIFs including hedge funds and private equity funds, so formerly unregulated funds under the existing U.K. fund regime (*e.g.,* listed company type funds like investment trusts) also become subject to regulation indirectly through the manager regulation.[380]

Third, AIF related entities like depositaries, prime brokers, fund pricing agencies, and delegates (*e.g.,* sub-adviser or sub-custodian) are also subject to the new regime, although somewhat lighter regulations may be available depending on the types of AIFs. For example, the requirement of appointing an eligible credit institution as a depositary for the custody of fund assets is mitigated for private equity funds, venture capital funds, and real estate investment trusts considering their unique investment nature and their type of invested assets.[381]

Fourth, systemic risk-related regulations focusing on the AIF industry were introduced for the first time in the Directive.[382] Both liquidity management and leverage requirements are imposed on AIFMs, and they are subject to continuous

[380]For the meaning of AIF, *see* AIFMR, art. 3. *See also* Fin. Serv. Auth., DP 12/1, *Implementation of the Alternative Investment Fund Managers Directive,* Jan. 2012, at 10 (hereinafter AIFMD Implementation), *available at* http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf (illustrating how diverse types of funds are subject to the Directive as AIFs).

[381] *See* AIFMD, explanatory note 34.

[382] *See* AIFMD, explanatory note 2, 3; AIFMD Implementation, at 17.

reporting requirements for systemic risk-related information (like assets under management and leverage employed).[383]

In addition, the new regime makes it clear that the regulator has an obligation to monitor the AIF industry to mitigate systemic risk and that it has the authority to limit the use of leverage if necessary to ensure market stability.[384]

Fifth, U.K. domiciled AIFMs may benefit from the passport regime. Once they are authorized by the FCA, they are free to market the funds in other E.U. countries.[385] By contrast, until new authorization or passport regime is available to them, offshore managers are only allowed to market the funds by relying on the U.K. private placement regime.[386] That is, non-E.U. domiciled managers will be allowed to market the funds they manage to U.K. professional investors and eligible counterparties without authorization until the authorization or passport system for non-E.U. managers comes into effect under the Directive.[387]

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[383] *See* AIFMR, art. 68.

[384] *Id.* art. 65-69.

[385] *See* AIFMD, explanatory note 15; AIFMD Implementation, at 73-78 (illustrating various dimensions of AIF marketing issues in the E.U.).

[386] *See* AIFMD, explanatory note 19; AIFMD Implementation, at 76-78.

[387] *Id*.

D. Summary and Comments

As illustrated above, the U.K. hedge fund regimes can be summarized as follows:

First, the U.K. hedge fund regime was implemented based on broad principles, including the principle of proportionality. What this means is that U.K. based hedge fund managers are subject to the same authorization and business conduct regulations as other regulated entities, but that the rules and regulations applicable to hedge funds are general and flexible enough to apply proportionately to the hedge fund managers based on the size, type, and scope of their business.[388]

This principle-based approach is advisable in regulating the AIF market because it is very difficult to regulate it in a uniform way. The rule-based or "one-size-fits-all" approach is not appropriate for regulating the hedge fund industry due to the heterogeneous nature of the business and the complexity of their investment activities.[389]

The principle-based regime in the U.K. provides some flexibility in applying the rules to the hedge fund managers considering the fact that their target investors are strictly limited to professional investors, but also considering that they conduct relatively high-risk business compared to other general regulated entities. The U.K. regime is based on the belief that hedge fund managers should be regulated in certain ways due to the risky nature of their activities and their potential negative impacts on the market.

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[388] *See supra* Chapter V, Part B.1.

[389] *Id.*

However, there are insufficient investor protection grounds to make them fully subject to the existing regimes in that their investor base is strictly limited to professional investors. Many of the existing rules and regulations are overly burdensome for and inappropriately applied to hedge fund managers (because those rules and regulations are in place to protect the general public).[390]

This principle-based regime is likely to work more efficiently and properly if supplemented by the principle of proportionality. Based on these broad principles, the U.K. regulators would have the discretion to apply the regulatory principles to the hedge fund managers more lightly than other regulated entities, and to enforce the rules based on outcomes instead of simply relying on compliance with a specific individual rule.[391]

Thus, the principle-based hedge fund regulation in the U.K. can be positively assessed in that it is hard to deny that hedge funds should be regulated. However, it is also true that hedge funds should be more lightly regulated than other more typical regulated entities whose business is widely open to the public, because hedge fund managers conduct their business on a private placement basis focusing on professional investors.[392]

Second, hedge funds are not subject to direct regulatory oversight under both the old regime and the new regime, although hedge funds become subject to directly regulations under the new regime because hedge fund managers are

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[390] *See* FSMA, art. 5.

[391] *See supra* note 388.

[392] *See* AIFMD Implementation, at 65. It is important to recall that hedge funds used to be unregulated or lightly regulated in various jurisdictions for a long time; that is how hedge funds have emerged and evolved as an alternative private market.

subject to additional regulations on leverage, disclosure, and reporting.[393] There was formerly no hedge fund regime was in place in the U.K., so hedge funds were able to avoid regulations unless they offered or sold the fund interests to the public.[394]

The U.K. private placement or private fund regime remains unchanged under the AIFMD because it has no specific hedge fund-focused rules and regulations and does not mandate that member states make new hedge fund-focused regimes. As a result, even after the AIFMD was transposed to the various U.K. regimes, there will still be no special hedge fund-focused regime in place. Domestic and offshore hedge funds can still avoid direct regulation regarding how they structure the funds, provided that the funds are only marketed and sold to professional investors.[395]

This regulatory approach seems to be the result of efforts to strike a balance between direct regulation and indirect regulation, considering the fact that (i) there is no practical need to regulate funds directly because the general public is not permitted to access the hedge fund market directly, (ii) the benefits that hedge funds provide to the markets were possible because they are outside direct regulatory purview, (iii) it is very difficult to directly regulate hedge funds because each E.U. member state has different hedge fund regimes (and local regulation is not sufficient to reach the funds domiciled offshore), and (iv) it is more appropriate

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[393] *See supra* Chapter V, Part B.2.

[394] *See supra* Chpater V, Part B.3.

[395] *See supra* Chapter V, Part B.3, Part C.1.

to regulate hedge fund managers because they are responsible for the daily operation of the funds.[396]

Third, an all-encompassing AIF definition under the new regime is agreeable in that it could minimize the regulatory gap and regulatory arbitrage problems between the AIFs in terms of functional based regulation. However, from a manager regulatory perspective, it is somewhat doubtful if all the AIFMs should be treated equally regardless of the nature of their business. For instance, private equity fund managers are different from hedge fund managers in many ways, and both managers should be treated differently.

It is less likely for private equity funds to pose systemic risk (and there was no private equity fund generated high-profile financial market collapse so far) in that they generally have a long lock-up period in place, they utilize minimal leverage at the fund level, and they invest in target companies (typically private companies) for controlling purposes, not for short-term trading purposes. Thus, it is more reasonable to conclude that they carry on business irrelevant to systemic risk. Further, investor protection concerns are negligible because private equity fund investors are all professional investors, presumably sophisticated enough to protect themselves without governmental protection.[397]

Thus, it is unreasonable to make private equity fund managers subject to the same level of authorization requirements as other AIFMs, such as hedge fund managers. It is more prudent to exempt private equity fund managers from

[396] *See supra* Chapter III, Part B.2-4.

[397] *See supra* Chapter II, Part C.2.

authorization requirements and to impose lighter obligations like registration and reporting requirements for instances when they have the potential to pose systemic risk.[398]

Fourth, under the AIFMD, both the local private placement regime and the passport regime are available for a couple more years for onshore AIFMs who manage E.U. domiciled funds, while only the local private placement regime is available for offshore AIFMs who market offshore funds or manage E.U. domiciled funds until 2015 at the earliest (which will be eventually replaced by the passport regime).[399] The new passport regime is devised to deal with the regulatory arbitrage and regulatory competition problems among the jurisdictions by setting a uniform regime applicable not only to all the E.U. member states, but also between E.U. member states and Non-E.U. member states.

This passport regime is more likely to lower the entry barrier among the E.U. member states and for offshore managers, to help the managers raise capital more conveniently from E.U. investors or in the E.U. market, and to apply the AIF market regime in a consistently to level the playing field among market participants.

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[398] As observed in the U.S. regime, small-sized managers should be free from onerous advance authorization and registration requirements because the regulatory cost outweighs its benefits. Otherwise, small firms will disappear and new firms will be unable to emerge due to high regulatory compliance costs. Further, private equity fund managers that create only remote system risk should be exempted from the onerous authorization and registration requirements, regardless of the size of the firms, provided that they meet certain threshold requirements (like no leverage and a certain period of lock up). Instead, minimum reporting and disclosure requirements would be sufficient for ensuring market stability. *See id.*

[399] *See supra* Chapter V, Part III.

However, some doubts still remain about whether it is really necessary to subject all the AIFMs to advance authorization to rely on the passport regime. There may not be strong policy grounds to justify the regulation from a micro-prudential regulatory standpoint, assuming that it is a specially designed market for certain qualified professional investors, and that many rules and regulations are already in existence to regulate market frauds like inside trading.

It is somewhat understandable, though, that AIFMs need to be subject to regulation in terms of a systemic risk based perspective, in that they are big enough to potentially influence the market in a negative way in times of distressed market situations. Regulators are in the best position to cope with the overall systemic risk issues and should be able to access the AIF market information on a continuous basis to take timely corrective actions.

It seems acceptable that the AIFMD requires AIFMs to provide system risk related information to relevant local regulators on a regular basis, and that the AIFMD empowers the regulators to exercise discretion to limit the AIFM's high risk activities, like leveraged transactions, on an as needed basis. However, ex-ante regulation is inappropriate and is overly burdensome on small AIFMs (E.U. based or not); it is also incompatible with private offering or private fund exemptions.[400]

There are two separate regimes in place under the AIFMD in terms of fund marketing regulation; active marketing is regulated and passive marketing is not. So, in regards to fund marketing, reverse solicitation, and passive marketing

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[400] In this regard, the U.S. size-based private adviser exemptions, including the foreign private adviser exemption, seem more reasonable in principle because the U.S. regime takes a cautious approach to avoiding the overregulation problem - especially in terms of systemic risk based regulation. *See supra* Chapter IV, Part III.

initiated by E.U. investors, if the activity is not deemed to be "active marketing" initiated by the managers or their placement agents then it falls outside of the fund marketing regimes.[401]

However, the problem with this fund-marketing regime is that those two distinctions are not entirely clear, making it more likely to cause a regulatory arbitrage problem with AIFMs trying to utilize the passive marketing exemption. This problem may happen more frequently if regulatory compliance costs are too high, especially while the prospective business in the E.U. market is limited. Thus, a small adviser exemption or other private adviser exemption as observed in the U.S. regime should be taken into consideration.[402]

Fifth, the AIFMD provides extraterritorial application rules, applicable to when onshore AIFMs market the offshore funds they manage, when offshore AIFMs manage and/or market E.U. based funds, or when offshore AIFMs market offshore based fund to E.U. investors.[403] In those situations, the AIFMs are subject to a local private placement or passport regime.

Under the AIFMD, there should be minimal concerns for regulatory evasion, regulatory arbitrage, and jurisdictional shopping, in that the AIFMD provides no fund specific rules and regulations, and because the AIFMD accommodates all the possible scenarios relating to transnational fund related transactions. As a result, it makes little difference for AIFMs to choose the E.U. or

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[401] *See supra* note 361.

[402] *See supra* Chapter IV, Part C.

[403] *See supra* text accompanying note 360, 361.

other jurisdictions in terms of fund regulation. They are basically free to choose a jurisdiction for their funds.[404]

This is an interesting regulatory approach because offshore managers are not required to be based in or authorized by the relevant local E.U. regulator to manage and market the E.U. domiciled funds to E.U. investors. It is likely to help minimize the jurisdictional shopping problem and to give some incentives for offshore AIFMs to set up the funds in E.U. member states.[405]

The AIFMD does still have inherent problems worth revisiting. As stated earlier, only national private placement regimes are available until the new passport regime has replaced it. Under the current private placement regimes, both onshore managers and offshore managers are not required to get authorized by the E.U. member state regulators, provided that they only market the funds to professional investors.[406]

When the new passport regime is fully implemented, AIFMs who obtain authorization from one E.U. member state regulator will still be subject to

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[404] Still it is not entirely clear and should be determined based on factual circumstances whether or not an offshore AIFM is allowed to manage E.U. based funds and to market the funds to EU investors, supposing that the offshore AIFM chooses offshore solely for the purpose of evading the U.K. regimes applicable to U.K. based AIFMs. *See id.*

[405] As stressed *supra*, this is possible because there is no fund focused regime in place under the AIFMD; the AIFMD basically permits AIFMs to choose any jurisdiction for fund establishment purposes to help the AIFM accommodate various needs from the clients as much as possible. Also, the regulatory arbitrage or regulatory evasion issues should be handled without difficulty based on the general extraterritorial application provision. For instance, suppose that an AIFM chooses to set up a U.K. domiciled fund to raise capital from U.K. investors, and chooses to have its office offshore to avoid any U.K. manager regulation, despite most of the investment and management activities being done in the U.K. It is highly likely to be deemed illegal even under the AIFMD. *See supra* Chapter V, Part C.

[406] *See id*.

authorization requirements even though they are free to market the funds around the E.U. countries without worrying about local private placement regimes.[407]

The passport regime is also somewhat problematic in that there are insufficient grounds to justify it, in terms of investor protection and even in terms of systemic risk. It is necessary that both onshore and offshore AIFMs be subject to regulatory supervision, however, the manner of regulating the AIFMs based on their transnational deals should be done more delicately by only imposing simple registration and/or reporting requirements, together with certain minimum threshold requirements as illustrated *supra*.[408]

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[407] *Id*.

[408] *See supra* note 363.

VI. Hedge Fund Regulation in Korea

A. Overview

Hedge funds had not existed[409] in Korea because they were expressly and legally prohibited before the new hedge fund regime was introduced in September 2011 by amending the Enforcement Decree to the FSCMA.[410] Unlike the U.S., the Korean hedge fund market was not naturally formed by the demand and supply of the market participants, but rather it came into emergence by a government initiative to build up the market in Korea.[411] Before the new hedge fund regime was introduced, the then-existing Korean fund regime had not provided any safe harbor provisions to make hedge fund unique activities or strategies possible.[412]

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[409] As further explained *infra* Chapter VI, there used to be a private fund or qualified purchaser fund scheme available under the old Korean fund regime (*i.e.,* FSCMA), but it provided detailed paternalistic rules and regulations limiting the leverage and short sale, and as a consequence generally accepted hedge funds' unique investment strategies had not been available before the new hedge fund regime was implemented in 2011.

[410] When Korean hedge funds were initially launched in December 2011, total assets under management were roughly 150 billion won with 12 funds managed by 9 management companies. Over time, there were increases in both assets under management and the number of the funds. That is, as of November 2012, the total assets under management were roughly 1 trillion won with 19 funds managed by 12 management companies. Because of the relatively short track record and resulting reputational problem, there were little capital inflows from institutional investors at an initial stage, and so-called high net-worth individuals as well as prime brokers and/or affiliated companies were the primary funding sources. *See* Financial Services Commission Press Release, First Annual Status Report on the Hedge Fund Industry, Dec. 6, 2012, *available at* http://www.fsc.go.kr/eng/wn/list_qu.jsp?menu=01&bbsid=BBS0048&selQuarter=&selYear=2012&nxPage=1.

[411] *See* Financial Services Commission Legislative Release No. 2011-92 (June 20, 2011), at 1, *available at* http://fsc.go.kr/know/law_prev_view.jsp?bbsid=BBS0120&page=3&sch1=subject&sch2=&sch3=&sword=&r_url=&menu=7410100&no=25255. *See also* Interview with Seokdong KIM, former FSC Chairman, at Hedge Fund Workshop, May 23, 2011, *available at* http://www.asiatoday.co.kr/news/view.asp?seq=483850.

[412] As indicated earlier, although there were some special rules for private funds under the old fund regime, a hedge fund scheme was be practically impossible because leveraged transactions like

What that means, however, is not that hedge funds are completely unavailable in Korea: Offshore hedge funds are limitedly accessible to certain professional investors,[413] and retail investors are also accessible to offshore hedge funds indirectly via fund of funds scheme.[414] That is, under the previous Korean regime (*i.e.,* the FSCMA before the new hedge fund rules were introduced), offshore hedge funds, established and managed offshore by foreign managers, were directly available to certain professional Korean investors, and indirectly available to all types of investors including non-professional investors via Korean fund of funds scheme.[415]

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money borrowings, speculative derivative transactions, and short sales were legally barred. More precisely, those private funds used to be treated as one of the regulated funds managed by the regulated management companies although some of the rules and regulations were not applicable to the private funds on the condition that they offered or sold their securities on a private placement basis and that they were subject to certain threshold requirements such as the maximum number of the investors or eligible investor threshold (*i.e.,* qualified purchasers). *See supra* note 408.

[413] For example, National Pension Service, Korea Investment Corporation and Korea Post are some of the eligible investors to invest in the offshore hedge funds. For more details about the eligible professional investors in terms of offshore fund sale, *see* FSCMA, art. 279; PD, art. 301.

[414] For instance, diversification and no double fee rules, as well as mandated disclosure requirements (*i.e.,* securities registration statements) should be applicable to fund of funds because they were deemed to be a typical regulated funds (*i.e.,* mutual funds), and even fund of hedge funds, which were treated as private funds, would be subject to the same requirements to a large extent. *See* FSCMA, art. 249; PD, art. 271.

[415] Under the Korean regime, offshore hedge funds had also been available to Korean investors through discretionary investment management accounts or specified money trusts. Thus, four different alternatives (*i.e.,* fund of funds, fund of hedge Funds, discretionary investment management accounts, and specified money trusts), in addition to the direct sale of offshore funds to certain professional investors, have been available to Korean investors to access offshore hedge funds during the time when Korean domiciled hedge funds had been strictly prohibited. What is in common among the four alternatives is that there is a market intermediary or third party fiduciary like an investment adviser or a trustee between offshore hedge funds and Korean investors, and no direct contact between them is permitted under the FSCMA. *See supra* note 22.

Some may wonder why the Korean government (*i.e.,* Korean FSC) has determined to begin allowing Korean domiciled hedge funds and managers while many other countries around the world have tried to regulate the hedge fund industry more tightly than ever. We may find the clues or answers for this question by highlighting the unique market circumstances surrounding the Korean hedge fund market as follows:[416]

First and foremost, the push to expand the Korean hedge fund market was introduced by the government, not by market participants.[417] Meanwhile, Korean local firms have demonstrated insufficient progress and advancement in their business practices and have gained little experience or expertise in cutting-edge areas like hedge fund and prime brokerage services, because they do not have sufficiently well-experienced human resources and capital to engage in this innovative, but risky business.

With this problem in mind, the Korean government has made an effort to introduce a brand-new, high value-added market in Korea, encouraging Korean domiciled companies to try to do something more innovative businesses, and to play a more active role in investing in emerging companies with growth potential.[418] What that means is that the Korean government took the initiative to

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[416] *See supra* note 410.

[417] As illustrated *infra*, Korean domiciled hedge funds used to be unavailable because no special safe harbor rules were provided under Korean laws. That is, private funds and their managers are subject to the same rules and regulations like licensing, business conduct, and investment activities as mutual fund managers, although some provisions are exempted to apply for private fund. Thus, hedge fund-only markets were legally and practically impossible. *See infra* Chapter VI, Part B.

[418] Prime brokerage businesses, which play a very critical role with hedge funds, have not also developed yet because there have been no local hedge funds available in Korea until the new hedge

make the hedge fund market as they contemplated, and provided the management companies and securities companies with incentives to do more risky, but at the same time highly lucrative, business like hedge funds or prime brokerage businesses as a way to diversify their business portfolios.

However, especially from the demand side, there has been a great potential for institutional investors like pension funds and highly wealthy individuals to pursue innovative investment opportunities for greater, but also stable returns on an ongoing basis.[419] As with the emergence of the Korean domiciled hedge fund the Korean government has anticipated that Korean institutional investors, such as public pension funds and the high net-worth individuals, would be willing to commit their money to Korean hedge funds. In other words, Korean institutional investors and ultra-rich individuals would be given the opportunity to pursue this alternative investment opportunity in addition to the already available ones, like direct investment to offshore hedge fund or indirect investment through Korean domiciled fund of hedge funds.[420]

Second, by introducing a local hedge fund market, the Korean government also expected an incidental effect that highly value-added investment banking businesses like prime brokerage services may be able to emerge. As previously indicated, the Korean investment banking industry has fallen by far behind as

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fund regime was in place. Thus, from the Korean government perspective, by introducing the hedge fund market in Korea they anticipate incidentally that more investment bank-like business, such as prime brokerage services could emerge as the hedge fund market grows. *See supra* note 410.

[419] *See supra* note 140.

[420] *See* FSCMA, art. 81, 249, 279.

compared with the global practices in terms of business scope, and as a matter of fact, their business has been primarily oriented towards conventional brokerage businesses. In that respect, prime brokerage services are essential for the investment banking firms to diversify their business portfolio and it is critically important for hedge funds to grow sustainably. Thus, without a doubt, they are closely interdependent. It would be mutually beneficial for hedge funds and prime brokers if the hedge fund market were to grow because prime brokers provide very extensive roles related to hedge funds and they could gain a lot of profit from the services.[421] In short, the Korean government took the lead to create the hedge fund market in a way that accommodates the various needs of different market participants.

Third, the Korean government tried to attract foreign hedge fund managers to Korea to build up the local hedge fund market. To do so, the Korean government has provided incentives for foreign hedge fund managers by imposing less stringent licensing requirements as compared to local securities firms or asset management companies.[422]

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[421] Prime brokers are the very entity to supply various services for the hedge fund including the credit extention (*e.g.,* money or securities lending), asset custody, capital raising, and proprietary investment, and they are indispensable for hedge funds to operate on a daily and stable basis. *See* FSCMA, art. 8(8), 77-2, 77-3.

[422] For instance, the assets under management requirement was reduced to 1 trillion won while local Korean licensed management companies need to have 10 trillion won in assets under management to obtain the hedge fund license. Also personnel requirements are less onerous than Korean licensed advisers to accommodate foreign managers having fund management experience in foreign jurisdictions. Despite this preferential treatment of foreign advisers, so far there has been no foreign hedge fund adviser licensed in Korea. It may be partly because the Korean hedge fund market entry regulation is still quite onerous or cost inefficient compared to those of other countries (especially nearby countries like Hong Kong or Singapore) and some alternatives are available for them to do hedge fund business on a cross border basis, as indicated earlier. *See* Financial Services

It may be understood as a policy decision by the Korean government in that offshore funds have been marketed already via Korean institutional investors and have been managed by managers outside of Korea, and as a result they have little incentive to obtain the Korean adviser license and to have a commercial presence in Korea. Further, local Korean entities have little experiences, expertise, and track records to attract Korean investors at an initial stage.

B. Hedge Fund Regulation in Korea: Before the New Hedge Fund Regime

1. Hedge Fund Manager regulation

Under the FSCMA, any person is required to obtain a license in advance if he/she intends to conduct fund (including private fund) management and marketing business in Korea.[423] Unlike in the U.S., there has been no private adviser exemption for licensing purposes available in Korea even in cases where someone intends to only target professional investors for their private fund business. As a result, exactly the same licensing requirements as applicable to mutual fund advisers are applied to private fund advisers, such as major

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Commission Press Release, First Annual Status Report on the Hedge Fund Industry, December 6, 2012, *available at* http://fsc.go.kr/eng/wn/list_qu.jsp?menu=01&bbsid=BBS0048&selQuarter=&selYear=2012&nxPage=1.

[423] *See* FSCMA, art. 12.

shareholder, equity capital, and personnel requirements, although some requirements may be alleviated to some extent.[424]

In addition, private fund management companies also need to obtain a fund distribution license to market the fund units (also known as "collective investment securities") themselves, because fund units are classified as securities under the FSCMA, and are subject to securities dealing license requirements in connection with fund sales activities.[425]Interestingly, there is a clear definition of private fund (*i.e.,* private collective investment scheme) under the FSCMA, but there is no special licensing unit available for those who intend to engage in private fund business only. Thus, as a matter of practice, there is no private fund adviser license available under the old regime.[426]

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[424] More precisely and legally speaking, only equity capital and investment management expert requirements will be reduced to half of the requirements applicable to the manager for the mutual fund if target investors are limited to professional investors, and other licensing requirements like major shareholder or business plan requirements are equally applicable to private fund advisers as well. *See* FSCMA, art. 12.

[425] Under the FSCMA, fund sales activities are deemed as "regulated business" (*i.e.,* securities dealing or brokerage business), and as a consequence the private fund manager is also required to obtain a fund distribution license (namely, securities dealing license) if they intend to engage in the fund distribution activities themselves. *See* FSCMA, art. 12; PD, Annex 1.

[426] This problem happens because the licensing unit for fund business is different from the fund classification. That is, fund manager licenses are broken down simply based on the investor classification of professional investors, not by whether the fund is classified as a mutual funds or private funds. As a result, it is de facto impossible to do private fund business if targeting high net-worth individuals who are not deemed professional investors under the FSCMA, but who are eligible for the investment of private funds. More than anything else, it makes little difference and provides little incentive for the applicant to pursue private fund business only because largely the same regulatory burden is imposed on them despite the fact that they intend to do fund business focusing on professional investors or quasi-professional investors only.

However, there is an exception for private equity fund (hereinafter as "PEF") managers. Unlike hedge fund[427] managers, the PEF managers are not required to have a license provided that they engage in PEF business only.[428] Basically, PEF advisers are exempted from fund management license requirements and fund distribution license requirements.[429] In short, under the old regime private fund (including qualified purchaser fund, but excluding private equity fund) advisers need to obtain both a fund management license and a fund distribution license, while no license is required to PEF managers.

It is uncertain why the old Korean regime provided license exemptions for PEF advisers as opposed to other private fund advisers. However, it may be inferred from the fact that private funds in Korea have traditionally been regarded as a part of general fund business similar to mutual fund business, because only fully licensed companies covering mutual fund businesses have been allowed to manage private funds; also, because the PEF rule was introduced at a later stage in

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[427] For clarity, in this chapter, private funds mean both private funds and qualified purchaser funds only, to the exclusion of private equity funds, although in principle private funds may include PEF. Unlike in the U.S., the Korean regime has a separate provision for defining PEF, in addition to the private fund definition. For the definition of PEF, *see* FSCMA, art. 9(18)(vii).

[428] Private equity fund is a kind of private fund in a broad sense of meaning under the FSCMA, but are distinct from typical private fund because private equity funds are strictly limited to private equity investment only, while other private funds are flexible in investment architecture. Because of the limited nature of PEFs most of the fund rules and regulations applicable to private funds are exempted to PEFs and their managers, and instead separate set of rules are in place for them. *See* FSCMA, art. 268 *et seq.*

[429] It should be noted, however, that the PEF itself is subject to regulation to some extent despite the manager or GP being exempted from licensing requirements, and the GP is also regulated to some extent indirectly, although they are not subject to licensing requirements. For instance, the PEF is subject to registration requirements and some restrictions are also imposed on them in regard to their investment activities. *See* FSCMA, art. 270.

2004 as a special and separate form of fund business focusing only on buy-out investment business.[430]

On the other hand, venture capital fund[431] managers are expressly exempted from licensing requirements under the FSCMA provided that they offer or sell the fund units on a private offering basis.[432] It may be explained as a policy decision to avoid a regulatory overlap problem, considering the fact that they have been subject to other comparable regulatory regimes and separate regulatory bodies are in place to supervise them; thus, there is no practical need for financial regulators to regulate them directly.[433] As a consequence, PEFs are subject to the FSCMA while venture capital funds are subject to a completely separate statute – despite being functionally similar in many ways.[434]

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[430] When the PEF regime was newly introduced in 2004, the then-existing U.S. regime provided license and registration exemptions for PEF advisers. That may also have affected the Korean government's decision not to regulate the PEF advisers directly at that time.

[431] Venture capital fund is defined under a separate law, and is subject to separate rules and regulations that are quite different from the fund regime under the FSCMA. Assuming that they are subject to comparable regulation under separate regimes, venture capital funds were deemed to qualify for an exemption from fund regulation under the FSCMA, despite falling under the fund definition under the FSCMA that would make them subject to fund regulation under the FSCMA. *See* FSCMA, art. 6(5) (S. Kor.); PD, art. 6(1).

[432] *Id*.

[433] Unlike the U.S., there has been no debate whether or not to regulate venture capital funds under the FSCMA from a systemic risk perspective, both before and after the sub-prime mortgage crisis, although there was a debate about that in terms of functional regulation. Namely, in Korea venture capital funds used to be explicitly excluded from fund regulation under the FSCMA or its preceding statutes despite falling within the definition of fund. Instead, they used to be regulated by a separate governmental body and financial regulator, and separate rules and regulations were applied to them by separate statutes.

[434] For the details of the similarities and dissimilarities between the two, *see supra* Chapter II, Part C.2.

In sum, private fund (excluding PEF) managers have been subject to the same license requirements as mutual fund managers,[435] and only licensed entities are entitled to engage in private fund business in compliance with detailed rules and regulations applicable to mutual fund advisers. PEF managers, distinct from other private fund managers, are subject to no direct licensing requirements; however, they may be under regulatory supervision to some extent indirectly through the general partner regulation in the fund.[436] Also venture capital fund managers are expressly excluded from fund regulation under the FSCMA unless they raised capital from the public.[437]

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[435] Private fund manager licenses may be theoretically possible under the FSCMA, but it is practically infeasible because the only difference or benefit to private fund advisers is that less stringent capital and investment management experts requirements are applied, and other than that, every other rule and regulation for mutual fund managers is equally applied to private fund managers. More precisely speaking, there is no private fund only license is available under the former FSCMA because there is no clear license unit available to accommodate private fund only managers. Furthermore, newly licensed entities targeting professional investors may have a hard time accessing high net worth individuals who may be the primary target investors, because they are not covered by the professional investors and because they are deemed to be non-professional investors. For the new adviser, raising capital from institutional investors is practically impossible because new advisers have no track record available to attract institutional investors.

[436] *See supra* note 427.

[437] *See supra* note 430.

2. Hedge Fund Regulation

As described above, Korean private funds have been defined broadly to accommodate both general private funds and qualified purchaser funds.[438] Both are similar in nature because both funds are limited to offer or sell the units on a private placement basis only.

On the other hand, they are different in that private funds are limited to offer or sell the units to up to 99 purchasers, and up to 49 unsophisticated retail investors (*i.e.,* non-professional investors) may have access to the fund, while the latter is limited only to qualified purchasers,[439] and an unlimited number of investors can be accessible if they meet the qualified purchaser eligibility threshold requirements.[440]

Both private funds are somewhat similar to those under the U.S. regime in terms of the threshold requirements because the Korean regime benchmarked the U.S. regime in making their private fund rules. Korean private funds are a lot different from those under the U.S. regime because the Korean regime borrowed the private fund concepts to treat them a bit more favorably than mutual funds by imposing less onerous investment requirements on the assumption that they are marketed on a limited basis relying on a private placement exemption, and that

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[438] *See* FSCMA, art. 9(19).

[439] Qualified purchasers may be regarded as super accredited investors because the threshold requirements for them are much higher than that for general professional or accredited investors. It may be presumed on the belief that qualified purchaser funds are a more risky product than general securities, and should be limited to highly accredited investors. For the details about who may be eligible to become qualified purchasers, *See* FSCMA, art. 249-2(1), 271-2(1).

[440] *See* FSCMA, art. 249, 249-2.

purchasers should be limited to certain professional investors.[441] That is, the private fund concept is in place to mitigate the regulatory burden on investment activities, not to exempt them entirely from regulatory supervision in Korea. Thus, Korean private funds under the old regime are more likely classified as a sort of regulated fund like mutual funds, although they are exempted from some of the fund rules and regulations.

They are subject to various fund rules and regulations including registration requirements[442] and reporting requirements, but they are exempted from some investment and management related provisions. Because of this unique regulatory framework, under the old private fund regime, it was practically impossible for a hedge fund market to emerge in Korea.

[441] As previously indicated, theoretical non-professional investors are also accessible to private funds up to 49 persons, but they must go through a suitability test, while professional investors need not to do so. Thus in reality, non-professional investors are hard to access by private funds because the fund distributor carries the suitability obligation. It is extremely difficult to prove that fund distributors checked the suitability test and confirmed that the non-professional investors are eligible for the investment, especially from the fund distributor's standpoint. *See* FSCMA, art. 46.

[442] Unlike general private fund, qualified purchaser fund is subject to ex-post notice requirement, instead of ex-ante registration requirement. It may be because there is less investor protection concern for the latter in that the offerees and purchasers are limited to qualified purchasers only, while general private fund are accessible by non-professional investors on a limited basis. *See* FSCMA, art. 249-2(6).

3. Hedge Fund Marketing regulation

Contrary to fund regulation, private funds are exempted from securities registration requirements if they satisfy private offering safe harbor conditions. That is, general securities private placement exemptions are also applicable to private funds, and private funds can avoid the onerous securities registration process to promote fund securities to certain eligible prospective investors.

The policy rationale for this private offering exemption is exactly the same as that under the U.S. securities regime.[443] The Korean private fund and private offering regimes permit unsophisticated investors to invest in the funds on a limited basis (*i.e.,* up to 49 persons) subject to suitability requirements, which is similar to the U.S. regime in that unaccredited investors can access the private fund if they go through the sophistication test.[444]

Some may doubt why private funds can enjoy private placement safe harbor rules while they are subject to paternalistic fund regulations and registration requirements in Korea. The securities registration requirement is a mandated disclosure regime to help prospective unaccredited investors make informed decisions, while fund registration requirements are not a disclosure regime, but rather is in place for regulator's supervisory or information gathering purpose.[445] The fact that non-professional investors have access to private funds to some

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[443] *See S.E.C. v. Ralston Purina Co*., *supra* note 40.

[444] Only difference between the two regimes is that there is no clear rule for the sophistication test requirement in Korean private funds and private offering safe harbor rules, while the U.S. regime expressly requires it.

[445] *See e.g*., Arthur B. Laby, *S.E.C. v. Capital Gains Research Bureau and the Investment Advisers Act of 1940*, 91 BOSTON U. L. REV. 1051, 1069-70 (2011).

extent is also likely to encourage legislators and regulators to support imposing private fund registration requirements.

As illustrated above, it appears that the Korean regime takes a bit more of a paternalistic and cautious approach in regulating private funds by putting them within regulatory oversight, and that they did so primarily because of investor protection concerns. There are also counter-arguments to this approach that are worth exploring.

First of all, the investor protection issue can be handled to a large extent by strictly applying the suitability rule to non-professional investors. That is, access to the private funds by retail investors can be effectively filtered out through the suitability check process if strictly applying the rule.[446]

Second, the market may be hindered from developing into a more innovative and competent alternative investment market by regulating them directly through structuring investment portfolios and by making both the managers and investors heavily rely on the regulators, which often times will be more likely to result in a moral hazard problem or less vigilant due diligence practice in the marketplace.[447]

Finally, even from the systemic risk regulatory standpoint, the Korean regime seems to have an overregulation problem because the managers, not the funds, are the parties responsible for the day-to-day management of the funds; they should be the right targets for regulatory oversight in terms of systemic risk

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[446] *See supra* note 440.

[447] *See supra* Chapter III, Part B.2.

regulation.[448] Overall, there seem to be few grounds for supporting direct fund regulation in Korea.[449]

4. Offshore Fund Marketing Regulation

While local private funds and their advisers are subject to stringent regulation under the Korean fund regime, offshore private funds and their managers are relatively free to market the fund units if they offer or sell them fund to certain Korean institutional investors. [450] Offshore private fund managers are not subject to licensing requirements under the Korean regime if they offer or sell the fund units through locally licensed fund distributors (*e.g.,* locally licensed securities broker or dealer), and instead they are required to have the fund registered with the Korean regulator beforehand.[451]

Instead, their target offerees and purchasers should be strictly limited to certain professional investors (excluding high net-worth individuals). [452] This

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[448] *Id*.

[449] It should be noted, however, that the goal of preventing systemic risk by direct size and/or leverage regulation is almost harder to achieve and is cost-inefficient because hedge fund failure could happen even under the stringent regulatory regime. It may be an unavoidable problem we face in extremely stressful financial situations. Accordingly, direct fund regulation may be assessed as overly conservative and unreasonably burdensome. *See id.*

[450] *See* FSCMA, art. 279.

[451] *Id.* Although it is not entirely clear, there appears to be an implied safe harbor in the FSCMA for offshore fund registration, if Korean investors voluntarily invest in offshore funds without any solicitation or advertisement from the offshore funds or their sales agents. *See* FSCMA, art. 279(1); PD, art. 7(3)(vi).

[452] The permissible scope of target investors for offshore fund managers is a lot narrower than those for locally licensed entities. This difference may be explained by the fact that Korean domiciled private funds are relatively less risky and complicated than offshore hedge funds because the

Korean offshore fund sales regime indicates that offshore hedge funds have easy access to potential Korean investors, provided that the target investors are limited to certain professional investors via an offshore fund registration route.[453] Offshore fund registration requirements are imposed for the regulator only, however, not for the investors. Thus information regarding registered offshore hedge funds is not publicly available, but may be available on a limited basis only.[454]

C. Hedge Fund Regulation in Korea: After New Hedge Fund Regime

As demonstrated *supra*, hedge funds were not available under the FSCMA, except for offshore hedge funds, until the Enforcement Decree to the FSCMA was amended in 2011.[455]

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former are heavily regulated by the Korean regulator while the latter are not regulated or lightly regulated under foreign jurisdictions. Regarding the scope of professional investors for offshore hedge fund sale, *see* FSCMA, art. 279(2); PD, art. 301(2).

[453] Locally licensed fund managers may set up hedge funds offshore and offer the units to Korean investors, theoretically speaking. But it may be practically and legally problematic because of regulatory arbitrage or extraterritorial application issues. Namely, it may be rejected by the FSC if locally licensed managers apply for fund registration with FSC with a view to marketing the fund units to Korean investors because under the FSCMA there is an extraterritorial application provision that FSCMA should be applicable even to offshore funds if it may affect the Korean market or Korean investors. However, it is permissible and no extraterritorial application issues arise if Korean domiciled managers set up offshore funds for offshore investors. *See* FSCMA, art. 2.

[454] The general information about the offshore hedge fund registered with the FSC may be available to the public because the Korean FSC and a Korean SRO called KOFIA provide some information about the registered offshore funds to the public. *See* FSCMA, art. 279(3), 280(4); PD, art. 303.

[455] *See supra* note 410.

However, the hedge fund concept in Korea is not a totally brand-new one; rather it should be understood as a modified form of qualified purchaser fund regime already in place under the old regime. That is, the Korean hedge fund regime went into place by re-defining the then-existing qualified purchaser fund regime.[456]

Under the new hedge fund regime, qualified purchasers are redefined to cover the high net-worth individuals, and much more relaxed investment and management requirements are applied to accommodate the needs of the hedge funds to utilize various leveraged transactions, albeit hedge funds are still somewhat subject to investment limitations or restrictions.[457]

1. Hedge Fund Manager Regulation

(A) Licensing requirements

Under the new regime, hedge fund manager licenses have become available that focus on hedge fund business only, and the prior-existing licensed entities such as investment advisers, asset management companies, and securities firms have limited accessibility to the hedge fund business to the extent that they satisfy certain threshold requirements for hedge fund business.[458] That is, hedge fund

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[456] *See* FSCMA, art. 249-2.

[457] *Id*.

[458] Only some of the regulated entities like investment advisers, asset management companies or securities firms are eligible to apply for the hedge fund manager license because there are some threshold requirements in place. For example, one trillion won or more in equity capital is required for the securities firms, 500 billion won or more in assets under management is required for the investment advisers, and 10 trillion or more in assets under management is required for asset management companies as a prerequisite for the license application. Later on, these threshold requirements have been repealed or relaxed, but similar entry barriers are still maintained. For

managers are subject to new licensing requirements with threshold limits in place for the license.[459]

Thus, anyone who intends to carry on the hedge fund business, including previously licensed entities like investment advisers or asset management companies, should obtain the relevant license beforehand.[460] Not all persons are allowed to apply for the license; only certain licensed entities like securities firms, investment advisers, asset management companies, and foreign hedge fund managers who satisfy certain threshold requirements are eligible to apply for the license.[461]

It appears that the Korean government has taken a step-by-step approach in granting hedge fund licenses considering the fact that there was no track record and no sufficient experience in managing hedge funds among locally licensed entities; accordingly, among the licensed entities, some investment advisers, asset

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instance, the assets under management requirement for the fully licensed asset management companies has been repealed, but instead new assets under management threshold requirement (*i.e.,* 1 trillion won) is in place for the securities fund only license holders, and for securities companies or investment advisers, the threshold requirement of equity capital or assets under management has been relaxed to half of the previous ones each (*i.e.,* 0.5 trillion won for securities companies, and 250 billion won for investment advisers). *See* FSC Press Release, Private Fund Regulatory Reform, Dec. 10, 2013, *available at*
http://fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=사모펀드&r_url=&menu=7210100&no=29506.

[459] Hedge fund manager licensing requirements are exempted to the asset management companies already fully licensed because the license they already obtained covers hedge fund licenses and as a consequence they are deemed licensed entities for hedge fund business. It is because the new regime defines the hedge fund as a type of "mixed asset fund" already in existence under the FSCMA, and the fully licensed asset management companies have no need to obtain the hedge fund license in addition to the previously obtained license. But they are required, instead, to file the relevant documents with the FSC before engaging in the business to make sure that they satisfy certain additional requirements like assets under management and investment management expert requirements. *See* Regulation on the Financial Investment Business, FSC Release No. 2011-22, Nov. 22, 2011, addenda art. 2(1), as amended (S. Kor.) (hereinafter FSC Regulation).

[460] The Korean FSC announced the plan to integrate current hedge fund manager licensing requirements into registration system in the foreseeable future. *See supra* note 458.

[461] *Id.*

management companies, and securities firms were allowed to engage in hedge fund business.

Securities firms are required to have sufficient equity capital of 1 trillion won or more and to set up a separate company for their hedge fund business because of the conflict of interest concerns.[462] As a result, only certain securities firms, investment advisers and asset management companies have access to hedge fund business through the locally licensed entities.[463]

For foreign hedge fund advisers, the Korean government takes a much more flexible approach in that much less stringent assets under management, track record, and investment management expert requirements are applied. For instance, 1 billion dollars in assets under management is required for the foreign managers to apply for the Korean hedge fund manager license, while 10 trillion won in assets under management is required for Korean licensed managers.[464] Despite the

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[462] Compared to other licensed entities like investment advisers, securities firms have a higher potential to have problems with of conflicts of interest because they are the the ones doing prime brokerage business via hedge funds, and they have a proprietary trading desk actively exercising hedge fund like strategies.

[463] Because of the aforementioned threshold requirements, only big-sized regulated firms are able to participate in hedge fund business, while small-sized regulated firms or newly established firms are not. It looks a bit unreasonable because the hedge fund market should be treated as niche market focusing on private fund business only, and for that reason it should be open for everyone who is willing to do creative or innovative business. However, it may be also understood as an inevitable choice from the Korean regulator's standpoint in that while introducing the market in Korea in the wake of the financial crisis (and various concerns have been raised about their potential negative impacts on the market) the government would like to make sure that the newly established regime is safe and sound enough to deal with those concerns. The same criteria is applied to foreign hedge fund managers, and only some well-recognized and reputable managers who satisfy the threshold assets under management requirements are allowed to apply for a hedge fund manager license in Korea. The Korean FSC has announced the plan to change the hedge fund licensing regime into a simple and straightforward registration system in the near future. *See supra* note 458.

[464] It should be noted that the assets under management requirement for the Korean domiciled fully licensed asset management companies was repealed on November 22, 2012, and instead a reduced assets under management requirement (*i.e.,* one trillion won) was imposed on the securities fund only license holders. But, there are still considerable differences between domestic companies and offshore private fund managers in terms of the threshold assets under management requirement. *See* FSC Press Release, *First Annual Status Report on the Hedge Fund Industry*, *supra* note 421.

counter-discriminatory concern against locally licensed managers, this approach may be understood as a policy decision to attract reputable foreign hedge fund managers to Korea.[465]

In addition, the Korean FSC takes a different regulatory approach between investment advisers and asset management companies.[466] Different assets under management requirements are imposed on investment advisers and asset management companies, largely because of the fact that some investment advisers have experience and expertise in hedge fund-like investment strategies, while asset management companies have insufficient experience in hedge fund-like strategies.[467]

Unlike hedge fund managers, private equity fund managers are still subject to different rules and regulations than hedge funds even under the new hedge fund regime. That is, private equity fund managers are still not subject to stringent licensing requirements, but instead they are subject to registration requirement.[468]

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[465] Despite these preferential treatments of foreign hedge fund managers, there have been no foreign applicants for hedge fund business in Korea thus far. It may be explained that, from the foreign private fund manager perspective, current Korean licensing requirements is still very onerous and quite costly while the Korean hedge fund market size is relatively small (*i.e.,* cost inefficient). On the other hand, it may also affect their decision not to apply for the license that they can market their funds on a cross-border basis even under the current regime, and there is no urgent need to obtain local licenses that require them to invest lots of capital and human resources in Korea. Further, it may also be taken into account that neighboring countries like Hong Kong and Singapore provide more flexible licensing requirements for hedge fund advisers. These concerns may be mitigated or resolved if the Korean FSC implemented the registration regime in the future, instead of the current onerous authorization regime. *See supra* note 458.

[466] Briefly speaking, investment advisers provide investment advisory or discretionary investment management services on an individual and segregated account basis, while asset management companies provide discretionary investment management services via a fund or collective investment scheme. For the statutory definitions, *see* FSCMA, art. 6(4)-(7).

[467] Unlike the U.S. regime, under the Korean regime (*i.e.,* FSCMA) there is a clear distinction in licensing between investment advisers and asset management companies in that the former provides investment advisory services on a segregated account basis, while the latter provides investment management services on a collective basis targeting collective investment schemes or funds. *See id.*

[468] This registration requirement was newly introduced by the amendment of the FSCMA, and it has been in force since May 28, 2013. Before the amendment of the FSCMA, the private equity

The requirements for private equity fund manager registration are much less onerous compared to hedge fund managers.[469]

This newly introduced registration requirement for private equity fund managers may be influenced by the apparently global regulatory consensus towards regulating PEFs and hedge funds as private funds in the U.S. or as alternative investment funds in Europe. The Korean FSC, however, took a bit different approach in terms of how to regulate them. Under the FSCMA, there is a clear distinction between hedge funds and private equity funds; private equity funds are defined to carry on primarily buy-out investment activities and special rules and regulations are separately in place for them.[470]

(B) Reporting Requirements

In addition to the licensing requirements, hedge fund managers are subject to reporting requirements if there are material changes after the registration of the funds they manage. Also, they are subject to reporting requirements relating to leveraged transactions such as money borrowing and to over-the-counter derivatives transactions.[471]

These requirements are in line with the U.S. regime and are in place to monitor risky activities and to mitigate potential systemic risk, although under the

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fund only managers were exempted from licensing and registration requirements, unlike hedge fund or private fund managers. For the detailed registration requirements, *see* FSCMA, art. 272-2.

[469] As indicated earlier, under the old regime PEF managers used to not be subject to any licensing or registration requirements, but under the new regime they become subject to registration requirements. It is not clear why the Korean government takes the position to treat them differently but it appears that both are different in many ways. The PEF market was already in place in Korea while the hedge fund market is more newly established. With that in mind, it seems that the Korean government has taken a step-by-step approach to structuring the regulatory architecture for hedge funds and private equity funds for some period of time.

[470] *See* FSCMA, art. 9(18)(vii), 268 *et seq.*

[471] *See* FSCMA, art. 249-2(7), 270(9).

Korean regime there is no clear provision stating that the prevention of systemic risk is one of the goals of securities regulation.[472]

It appears that the Korean FSC takes the position that, compared to hedge funds, there are not as many systemic risk related concerns for PEFs; however, they are still subject to reporting requirements for their leveraged transactions.[473]

2. Hedge Fund Regulation

(A) Reporting Requirement

Compared to general private funds, Korean hedge funds are relatively free to establish and market to investors because they are only subject to ex-post reporting requirements, while general private funds are required to register with the FSC and cannot market the fund before registration.[474]

However, Korean hedge funds are also subject to some of the rules and regulations applicable to mutual funds to the extent necessary to protect investors and to mitigate systemic concerns.[475] For instance, leveraged transactions[476] are

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[472] Unlike the U.S. regime, the Korean regime tackles the systemic risk issue directly by providing an upper limit for leveraged transactions like borrowing and speculative derivatives transactions, in addition to the reporting requirements. In that regard, the Korean regime may be more concerned with potential systemic risks, although there is no express provision under the FSCMA asserting that preventing systemic risk is a goal. The licensing requirements applicable to hedge fund managers could be evaluated as being systemic risk focused because certain levels of capital and appropriate internal control systems should be in place to obtain the license. *See* FSCMA, art. 1.

[473] This two-tiered approach in Korea can be evaluated positively because at least in Korea there is a clear distinction between hedge funds and PEFs from a legal and practical perspective. Under the current PEF regime it is difficult to say that PEFs have great potential to pose systemic risk in that they primarily engage in private equity investments, they are not active traders in the secondary market, and there is a quantitative limit to their leveraged transactions in place. *See supra* Chapter II, Part B.3.

[474] *See* FSCMA, art. 249, 249-2.

[475] For instance, unlike the qualified purchaser fund under the U.S. regime, Korean qualified purchaser funds are accessible to only high net-worth individuals who are deemed to not be

limited to up to four times a fund's equity capital,[477] suitability rules are applicable to non-professional investors (but qualified purchasers) like high net-worth individuals, fund custody service must be provided by the licensed entity like trustee banks, and fund assets must be evaluated on a mark-to-market basis.[478]

Thus, unlike the U.S. and U.K. regimes, Korean hedge funds are subject to direct regulation, which may not work properly on unique hedge fund investment strategies that largely depend on leverage and/or short sales.[479]

Overall, the Korean hedge fund regime is unique in that Korean hedge funds are directly subject to rules and regulations like mutual funds; accordingly, it may be described as quasi-regulated funds.[480]

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professional investors, and as a result the suitability rule is applicable to them. Also, quantitative leverage restrictions are imposed and periodic reporting of leveraged transactions is required. *See* FSCMA, art. 47, 249-2.

[476] Legally leveraged transactions entail borrowing money from third party creditors, but practically it means that every transaction in essence is borrowing in substance. They may include over the counter derivative transactions, repurchase agreements, and third party debt guarantees, in addition to the money being borrowed. *See* FSCMA, art. 249-2(4), (5).

[477] This quantitative leverage limitation may adversely affect funds who find it necessary to utilize leveraged transactions a lot (*e.g.,* fixed income arbitrage fund), and may also make the local hedge fund market a bit unnatural. The Korean government takes a more conservative approach to make sure that no substantial systemic risk issues will arise and that there is no urgent need to allow unlimited leveraged transactions because most of the locally licensed managers are willing to manage traditional equity long-short fund, not fixed income arbitrage funds requiring considerable amounts of leverage at an initial stage.

[478] It should be noted that all these rules and regulations are mandatorily applied to hedge funds and hedge fund managers, and because of these rules and regulations the Korean regime may be described as taking a rule-based approach like the U.S., and not a principle-based approach like the U.K.

[478] Regulating hedge funds may have a negative impact on the market because it may give the wrong signal to potential investors that they should rely more on government (*i.e.,* moral hazard problem), and from the regulator's side they may have more pressure from the public and the political groups to be proactive or take preventive action to deal with potential hedge fund problems. To the contrary, it may also encounter criticism that the private market becomes somewhat similar to public mutual fund market, and because of that the regulator is too susceptible to political pressure when certain bad things happen. More than anything else, it may be problematic that there is no clear distinction between the private market and public mutual fund market and the regulator takes a somewhat unclear position in regulating the hedge fund market. It may also be harmful to every participant in the market because no one can have a clear understanding about what the rationale behind the regulation is.

[480] Registration or reporting may be mutually beneficial for both the manager and the investors in some respects. From the manager's standpoint, it may be helpful to market the funds because it may

(B) Hedge Fund Marketing Regulation

Under the FSCMA, any offer or sale of fund units may be deemed securities dealing or brokerage business depending on a factual assessment; no one is allowed to market the fund targeting potential investors without obtaining the relevant license first.[481]

Mandated disclosure (*i.e.,* filing securities registration statement) can be exempted if the offer or sale were done on a private placement basis in compliance with private offering rules, and if no public solicitation or advertisement is permitted then they are allowed to market to certain pre-defined qualified purchasers.[482]

Among the qualified purchasers, high net-worth individuals are not deemed professional investors under the FSCMA, but rather they are treated as non-professional-unsophisticated investors; however, they are classified as qualified purchasers under the qualified purchaser fund definition.[483] As a result, various rules and regulations applicable to securities brokers/dealers, including a suitability

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enhance their reputation or creditworthiness with counterparties and investors. At the same time, from the investors' perspective, it also may help them to access the hedge fund more comfortably because they may think it should be regulated enough to protect them by the regulatory authority. However, it is doubtful if mandatory registration or reporting requirements are really necessary in that the manager and the investors are able to choose registration on a voluntary basis if they think it is beneficial for them, and mandatory registration or direct regulatory intervention in designing their investment strategies may hinder them from pursuing financially innovative investment strategies, and may deter them from maximizing their positive roles in the marketplace. Further, considering the fact that the manager is already subject to regulatory supervision to some extent there is little practical need to regulate the fund because it may distort the market.

[481] *See* FSCMA, art. 7, 12,

[482] *See* FSCMA, art. 9(7), (8), (19), 249-2.

[483] *See* FSCMA, art. 249-2; PD, art. 271-2(1).

rule, would be applied if fund units were marketed to high net-worth individuals.[484]

That is, high net-worth individuals are treated differently from other institutional investors in the qualified purchaser funds. They have more legal protection under the suitability rule because they are deemed to be non-professional investors, requiring securities brokers or dealers to check their suitability before soliciting the fund.[485]

Hedge fund managers are able to market the fund directly, but are subject to fund distribution license requirements. It is because the Korean government would like to ensure that high net-worth individuals are sufficiently protected by the suitability rule when they are marketed by the fund manager and not by third party intermediaries like securities firms.[486]

Unlike hedge fund managers, PEF managers are eligible to market the fund units without any fund distribution license. Thus, the suitability rule, which is

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[484] This problem arises because high net-worth individuals are defined to cover non-professional investors as qualified purchasers under the hedge fund regime, but they are legally treated as non-professional investors and no opt-in clause is available under the FSCMA. What that means is that under the FSCMA high net-worth individuals are not included in the category of professional investors (i.e., deemed sophisticated investors, and no suitability rule is applied to them), but they are intentionally and statutorily included as a type of qualified purchaser in defining the qualified purchaser fund. It is a bit contradictory to the private offering or qualified purchaser fund concept in the U.S. in that typical qualified purchaser thresholds are much higher or stringent than the accredited investor threshold under the private offering safe harbor rules. However, it may be understood that the Korean government is trying to take a compromised position to accommodate the market needs to cover high net-worth individuals as a potential hedge fund investors, while making sure to protect high net-worth individuals who do not meet the professional investor threshold requirement. *See id. See also* FSCMA, art. 9(5); PD, art. 10 (defining the scope of professional investors).

[485] *See id. See also* FSCMA, art. 46.

[486] For instance, think about the situation where hedge fund managers are not required to obtain a fund distribution license. That means they do not need to be in compliance with suitability rule because they are not deemed to be a securities broker or dealer, and only securities brokers or dealers are subject to the suitability rule. It is true that under the FSCMA there is a fiduciary duty and anti-fraud rule in place for the fund manager, but these are not sufficient to protect HNWIs (*i.e.,* deemed non-professional and unsophisticated investors) proactively when they make investment decisions.

applicable to hedge fund managers when they sell the units directly, is not applicable to PEF managers if they sell the units directly to high net-worth individuals.[487]

Korea domiciled hedge funds are exempt from securities registration requirements based on the private offering safe harbor rule, but are subject to a suitability rule for high net-worth individuals when they sell or offer the units directly or indirectly through third party fund distributors. By contrast, PEF managers are free from the suitability rule if they market the units directly to high net-worth individuals.[488]

(C) Investors (Qualified Purchasers)

Interestingly, the scope of who is deemed a qualified purchaser under the new hedge fund regime is a lot wider than the former regime in that certain high net-worth individuals are allowed to directly access the hedge funds. The former qualified purchaser funds used to be inaccessible to high net-worth individuals

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[487] It should be noted that, contrary to the PEF managers, any third party intermediary is subject to fund distribution license if they sell the PEF units on behalf of the PEF managers, and accordingly they are subject to suitability rule when marketing the units to certain HNWIs who do not satisfy the professional investor threshold requirement but who are eligible for the PEF investment. Because of the regulatory difference between direct marketing and indirect marketing of the PEF, regulatory gaps and loopholes will arise, needing to be fixed legislatively.

[488] The thresholds for high net-worth individuals for hedge fund and PEF are different in Korea: 0.5 billion won of invested amount is applied for hedge fund while 1 billion won of investment amount is applied to PEF. Both HNWIs under the hedge fund and PEF regime are deemed to be non-professional investors under the FSCMA because the general professional investor threshold for the high net-worth individuals is much higher than that for hedge funds and PEFs (i.e., at least 5 billion won of invested amount is required for individuals to be treated as professional investors). This regulatory differentiation should be reconsidered and amended by either treating HNWIs as professional investors or by lowering the general threshold requirement for wealthy individuals to include high net-worth individuals under the hedge fund and PEF regulatory regime. *See* FSCMA, art. 9(5), 249-2(1), 269(6); PD, art. 10, 271-2(1), 291(3).

despite the fact that hedge funds are much riskier due to access to highly leveraged transactions than the former qualified purchaser funds.[489]

This may be interpreted as a policy decision that the Korean regulator (*i.e.,* the FSC) has taken a more affirmative position to accommodate a larger investor pool so that hedge funds can build up the market during this initial stage, despite the increased risk inherent in hedge fund investment strategies.

It seems reasonable that some professional investors, including institutional investors, are included in the qualified purchaser category. However, it is unreasonable for the threshold for high net-worth individuals for hedge funds to be much lower than the former threshold for the general qualified purchaser funds.

Generally speaking, hedge funds deal in much riskier financial products than general securities or derivatives products. In addition, the threshold for high net-worth individuals under the Korean regime is in contradiction to that of the U.S. regime in that the accredited investor threshold under Regulation D is much lower than the qualified purchaser threshold for qualified purchaser funds under the Investment Company Act of 1940.[490]

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[489] *See* FSCMA, art. 249-2.

[490] Under the FSCMA, general threshold for high net-worth individuals (i.e., professional investors) is 5 billion won of invested amount while the threshold for qualified purchasers is 0.5 billion won (*i.e.*, just one-tenth of the general high net-worth individuals threshold). The former is applicable when individual investors are willing to invest in general securities or derivatives, and it is also applicable to private offerings. On the other hand, the latter is applicable only when the high net-worth individuals are willing to invest in the hedge funds. Under the private offering regime, non-professional or unaccredited individuals are also accessible to the offering on a limited basis, and they are also accessible to the hedge funds if they meet the qualified purchaser threshold. In that respect, some may argue that the qualified purchaser threshold is a lot higher than that under the private offering regime, but it is untrue and misleading because qualified purchasers include some of the professional investors, not some of the general public. It is also consistent with the rationale that as a prerequisite the qualified purchaser fund must meet the private offering rule, and qualified purchasers should be selected from the general professional investors pool. *See* FSCMA, art. 9(5), 249-2(1); PD, art. 10, 271-2(1).

Some high net-worth individuals (*i.e.,* those in between 0.5 billion won in invested amount and 5 billion Won in invested amount) under the hedge fund regime should be treated as non-professional investors despite meeting the requirements of the qualified purchaser category, and should be treated differently under the private offering exemption as well.[491]

They are treated differently from other qualified purchasers (*e.g.,* institutional investors) who are deemed professional investors under the Korean securities regime even though they are classified the same as qualified purchasers under the new hedge fund regime. Theoretically, 49 high net-worth individuals or fewer can be marketed to and can directly invest in the hedge funds provided that they go through the suitability test in every private offering – despite not qualifying as professional investors under the Korean securities regime.[492]

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[491] Theoretically, putting those two regimes together, up to 49 high net-worth individuals are accessible to the hedge funds for a one time private offering, and the number of the them could be expanded more provided that they meet the private offering rule in every offering and also meet the qualified purchaser threshold. *See* FSCMA, art. 9(7), 249-2(1); PD, art. 11(1), 271-2(1).

[492] It is unclear whether, under the Korean private offering exemption, some high net-worth individuals, who are deemed non-professional investors, may be required to go through the sophistication test, because there is no express provision that an ex-ante sophistication test is required for the high-net worth individuals. But it should be reasonable to interpret that something like that test should be applied to high net-worth individuals even under the Korean private offering exemption because of the suitability rule applicable to them when fund distributors offer or sell the unit to them. However, the Korean private offering regime is different from the U.S. regime because no sophistication test is required for the non-professional high net-worth individuals under the Korean private offering regime, and the suitability rule is a bit different and less stringent compared to the sophistication test applicable to unaccredited investors under the U.S. private offering regime. This regulatory difference arises between the two countries because the qualified purchaser threshold under the Korean regime is a lot less stringent than the threshold for the private offering exemption under the U.S. regime. For the details of the U.S. private offering regime, *see supra* Chapter IV, Part B.2.

(D) Investment and Management Regulation

Unlike the U.S. and U.K. regimes, the Korean hedge fund rule directly regulates the investment and management of hedge fund portfolios. As indicated *supra*, the Korean regulator takes a very conservative position in directly regulating both the funds and their managers to ensure mitigating potential regulatory concerns. Leveraged transactions like cash borrowing, third party debt guaranteeing and/or speculative derivative transactions are strictly limited to 400% or less of the fund assets.[493] Also the fund managers are required to report the details of the leveraged transactions on a quarterly basis.[494]

Regulation of leverage transactions under the Korean hedge fund regime is appropriate given that there is no precedent for how to manage leveraged hedge funds in Korea, and it is difficult to imagine how the leveraged transactions may adversely affect to the market during a stressed situation, if any. Thus, it may be concluded that the Korean regulator took a wait see approach at the beginning, despite the potential harm for hedge funds in fully exercising investment strategies that utilize leveraged transactions.[495] In this regard, Korean hedge funds may still be regarded as quasi-regulated, as no full discretion is granted to the fund managers in terms of the investment activities.

However, this regulatory strategy may deter market autonomy and financial innovation, and it is more likely that the Korean hedge fund market may fall

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[493] *See* FSCMA, art. 249-2(4), (5).
[494] *See id.* art. 249-2(7).
[495] It may also be taken into consideration that at the initial stage there is no urgent market need for more flexible leverage thresholds because there is no meaningful track record or experience with managing the leveraged hedge funds like fixed-income arbitrage funds that need more leverage, and most of the Korean hedge fund managers are willing to do traditional equity long-short strategies first because it is more comfortable and familiar to them. *See supra* note 464.

behind their global competitors. It is also problematic that the government is somewhat directly involved in the hedge fund's investment activities; as a result, it is inevitable for the government to be the direct target of public blame if something bad happens from the hedge fund industry. At the same time, too much government intervention may cause a moral hazard problem from both the managers and their counterparties/investors.

Therefore, it would be advisable that direct fund regulation and direct governmental intervention in fund investment activities should be minimized or refrained from in the long run in Korea, assuming that an adequate investor protection regime and systemic risk monitoring and risk management system is in place.

(E) Fund Assets Custody

Segregation of fund assets is critically important for protecting investors, particularly against the situations of the fund or the manager's bankruptcies. Under the hedge fund regime, there is no other practical way to protect the investors' assets in the fund other than strict segregation of fund assets from others, and they are expressly required to do so under the Korean hedge fund regime.[496] The Korean regime requires the fund manager/custodian to separate fund assets from their own assets, and to have the fund assets under custody by an independent third

[496] Unlike hedge fund managers, PEF managers are not required to segregate the fund assets from others under the FSCMA, and it is probably because there exists many differences in terms of raising capital from investors, there is no daily active trading taking place in PEF, and it is more common or typical for limited partners to be involved in making important investment decisions. It may indicate that there is no practical need to require them to split fund assets from others. *See* FSCMA, art. 272(4).

parties, like regulated custodian banks or prime brokers.[497] Traditionally, commercial banks, holding trust business licenses, provide the fund custody services for funds (including hedge funds); prime brokers are recognized as primary fund custody service providers under the new hedge fund rule. The prime broker is also allowed to delegate the fund custody services to a third party service provider with relevant license.[498]

(F) Suitability

Under the FSCMA, suitability rules are applicable to non-professional investors only.[499] Thus, generally speaking, qualified purchasers such as institutional investors are not protected by the suitability rule. As explained *supra*, however, certain high net-worth individuals are deemed to be non-professional investors under the new hedge fund rule even though they are also equally classified as qualified purchasers (like institutional investors). As a result, among the hedge fund investors, certain high net-worth individuals are treated differently from institutional investors in regards to the suitability rule.

This unique phenomenon under the Korean hedge fund rule occurs because the Korean government takes the policy position that high net-worth individuals should be under the regulatory protection of the suitability rule, while classifying them as qualified purchasers under the qualified purchaser fund scheme. This

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[497] *See* FSCMA, art. 246, 249-2(1).

[498] Under the Korean hedge fund regime, the hedge fund manager is allowed to choose any prime broker as a fund custodian or to choose an independent third party custodian like a bank. In cases where the fund manager chooses a prime broker as a fund custodian, the prime broker has discretion to delegate some of the custody functions to licensed third party custodians. But it should be noted that it is not mandatorily required for the fund manager to choose prime broker as the only fund custodian, but instead they have discretion to appoint other fund custody service providers in addition to the prime broker. *See* PD, art. 50(1)(iii); FSC Regulation, art. 4-101(1).

[499] *See* FSCMA, art. 46.

approach may be possible because of the assumption that they are not sophisticated or professional investors in principle, but may be treated like quasi-professional investors by going through the suitability rule.

This regulatory approach may be understood as a somewhat inevitable one in Korea considering the fact that the hedge fund market has newly emerged. It is highly likely to expect that it is difficult to raise capital from institutional investors from the start because Korean hedge fund managers lack a track record or reputation for hedge fund management; accordingly, high net-worth individuals are the primary sources or targets for funding at the initial stage.

However, this approach may have inherent problem, from a theoretical perspective, because it is likely to confuse the nature of the accredited investors (*i.e.,* professional investors) under the private offering exemption, and the relationship between accredited investors and qualified purchasers under the hedge fund regime.

Under the private offering exemption in Korea, non-professional investors (certain high net-worth individuals) can be directly marketed and exposed to hedge funds, subject to the suitability rule. As pointed out *supra*, the problem here is that the threshold for high net-worth individuals who are deemed professional investors under the private offering rule is much higher than that for qualified purchaser high net-worth individuals.

It is questionable, though, whether this two-tiered approach regarding high net-worth individuals as qualified purchasers is reasonable. The fact of qualifying high net-worth individuals as qualified purchasers should indicate that they are

presumably sophisticated enough to protect themselves without paternalistic governmental intervention.

Given that the rationales of the accredited investor standard under the private offering exemption and qualified purchaser standard under the hedge fund regime are similar between the U.S. and Korea, it would be a more reasonable conclusion that qualified purchasers (including high net-worth individuals) should be treated as professional investors because that is the reason why they are defined as qualified purchasers.[500]

(G) Periodic report

Under the new hedge fund rule and private offering exemption, there is no mandated disclosure required to hedge fund managers regarding investors at the time of purchase of the fund securities. However, hedge fund managers are subject to periodic (*i.e.,* quarterly) reporting requirement to both the investors and the regulators.

Unlike the U.S. and the U.K., under the Korean regime the information in the fund related document, including the periodic report, is not legally accessible by fund investors, and it is only accessible to the regulators; instead, under the new

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[500] Some may counter-argue that non-professional investors should be allowed to access hedge funds directly as a matter of policy considering the fact that they are already accessible to hedge funds through fund of funds or pension schemes. This view may have some grounds to support it, but it is also true that defining high net-worth individuals as qualified purchasers, but treating them as non-professional investors, is a very uncommon regulatory approach that may cause unnecessary concern or confusion about the underlying rationale of why they are included to the qualified purchaser category for hedge funds. Thus I believe it is a more prudent and consistent regulatory approach to treat them as professional investors, or alternatively to lower the threshold requirement for accredited investors under the private offering exemption, so that high net-worth individuals are included under the qualified purchaser fund scheme. *See* SEC Staff Report, *supra* text accompanying note 223.

hedge fund regime, there is a special provision to force the fund manager to provide quarterly performance reports to investors.[501] This periodic disclosure requirement is equally applicable to both institutional investors and high net-worth individuals to ensure the equal treatment of information access among the qualified purchasers in the fund.[502]

D. Summary and Comments

As explained above, Korean hedge fund regime has been introduced in the wake of the financial crisis in 2008, and because of that it was considered to be an audacious and a counter-intuitive decision, because as with the financial crisis there was an international consensus made to regulate the hedge fund industry more stringently than ever.[503]

Because of these unfavorable or even hostile circumstances worldwide relating to the hedge fund industry, Korean regulators have taken a very cautious approach. They have sought to make the local hedge fund market available by introducing a new hedge fund regime while, on the other hand, it placed a more stringent regime in place under which hedge funds and their managers are both

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[501] In principle, under the Korean private offering rule it is legally impermissible to disclose fund related information to the public because it would be in violation of the private offering safe harbor rule. Thus, a mandated disclosure idea may not be feasible under the Korean private offering regime even though some of the general information of the funds may be distributed by the regulator and accessible by the general public. It should be noted, however, that this general information disclosure can only be made by the regulator, not by the manager or distributors, so there is no law violation issue here relating to the private offering safe harbor rule. *See* FSCMA, art. 249-2(1).

[502] This periodic disclosure requirement is also confusing and seems inconsistent in terms of private offering and private fund exemptions, because a mandated disclosure rule is in force in regard to periodic disclosure while it is not applicable from the private offering exemption or suitability perspective. Thus it should be advisable to make it clear that mandated disclosure rule is not applicable to professional investors or to qualified purchasers.

[503] *See* IOSCO Systemic Risk Report, *supra* note 102.

subject to regulatory purview. This is generally in line with the global consensus and at the same time may help mitigate investor protection concerns and/or systemic risk concerns.[504]

However, this regulatory approach may have some potential problems calling for careful reconsideration.

First, direct fund regulation is inadvisable because it is more likely to impair the competitiveness and efficiency of the local Korean hedge fund market, and at the same time it may also deter financial innovation. It would be less likely for the local hedge fund market to be fully functioning and it may influence the market in an abnormal way.[505]

There is no doubt that proper control of the highly risky leveraged transactions by hedge funds is essential to ensuring market stability. However, direct fund size or leverage regulation are less viable options because there are more cost-efficient ways to deal with the problems – by regulating the fund managers, counterparties-financial institutions, and by enhancing market discipline through establishing best-practices.

Moreover, it is less likely to promote all the possible benefits and simultaneously it may deter the market autonomy and creativeness, which should be the hallmark of this market if they are directly regulated.[506] Given these problems, the new hedge fund regime in Korea is less likely to be free from the

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[504] *See id.*
[505] *See supra* Chapter III, Part B.2.
[506] *See id.*

overregulation issue, and should be revised to enhance market flexibility to the extent possible in the long run.[507]

Second, as for the manager regulation, the Korean hedge fund regime has also had problems because it requires close to the same (or even more stringent) licensing requirements for those who intend to carry on hedge fund business only as mutual fund managers.[508]

Assume that hedge fund business should be done on a very limited basis with sophisticated investors including ultra-rich individuals, it is doubtful if such onerous licensing requirements are really necessary. Investor protection concerns become irrelevant or insignificant if all the investors are strictly limited to professional/qualified investors (*i.e.,* deemed sophisticated investors), and systemic risk concerns can be effectively handled without creating an onerous licensing regime. Lighter registration and reporting requirements should be sufficient.

In that regard, barriers to entry such as licensing requirements should be lowered to reflect the business nature and potential investors pool, while ensuring that an appropriate ex-post risk monitoring system in place.[509]

Third, the definition of accredited investor under the private offering exemption regime and qualified purchasers under the new hedge fund regime

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[507] As discussed *supra* and observed in the U.S. and the U.K. regimes, it would be more advisable not to directly regulate the fund, instead but to eventually regulate the manager only. *See id.*
[508] Any entity could apply to be a mutual fund manager if they satisfy the relevant licensing requirements, but there is a prerequisite for the hedge fund manager applicants in addition to the general licensing requirements (such as assets under management or equity capital). It may be considered an unreasonable or a disproportionately excessive regulation because the hedge fund market is a niche market like the investment advisory market in Korea, and the participants in the market are restricted to certain qualified purchasers. *See supra* Chapter VI, Part B.1.
[509] The Korean FSC recently announced its plan to lower the entry regulation in regard to hedge fund management business in the near future, and it should be assessed as a positive regulatory policy change. *See supra* text accompanying note 458.

should be revised. The current qualified purchaser threshold should be higher than it is now and the general accredited investor (*i.e.,* professional investor) threshold should be lowered to include high net-worth individuals, who are eligible to be qualified purchasers under the qualified purchaser fund scheme as professional investors. Because hedge funds are a much more complex and riskier product than other financial investment products the target investors (*i.e.,* qualified purchasers) should be more limited than accredited investors under the private offering regime.

Assuming that qualified purchasers are composed of institutional investors or ultra-rich individuals meeting the professional investor threshold conditions, there should be no serious investor protection concern raised and there is no practical need to have a stringent paternalistic regime in place.

Fourth, as noted *supra*, under the Korean regime, it is unclear why there is a clear regulatory distinction between hedge funds and private equity funds, and why they are regulated separately and differently. Hedge funds have been treated more like mutual funds, not like hedge funds in offshore jurisdictions, and hedge funds and their managers both are heavily regulated in Korea. Private equity funds and their managers have been treated a lot differently from hedge funds and their managers. The private equity fund managers have been exempted from direct regulations, like licensing requirements, although the funds are subject to direct regulation in the form of registration and restrictions on investment activities.

This PEF regime is very uncommon in other jurisdictions, and it may be understood as the result of the Korea unique regulatory consideration of the "Chaebeol" or conglomerate issue. That is, Korean regulators are concerned about

the possible misuse of the private equity fund scheme as a buy-out vehicle to expand the affiliates of the Chaebeol firms in Korea.[510] However, this regulatory approach may be viewed negatively in terms of regulatory architecture because there are no crystal clear rationales to justify the different regulatory approach between hedge funds and private equity funds, and many regulatory inconsistencies exist between the two regimes. Thus it should be revised to minimize the regulatory disparities between the two regimes in the long run.

Fifth, it is worth noting that there are considerable regulatory differences in regulating local private funds and offshore hedge funds. As pointed out *supra*, Korea based hedge funds and their managers are subject to onerous regulatory requirements in Korea, while offshore hedge funds are readily accessible to Korean investors by relying on offshore fund sales regime or fund of funds schemes. There is no doubt that this creates significant regulatory arbitrage problems for Korea based hedge funds and their managers, and it is likely to drive them offshore to carry on hedge fund business targeting Korean investors.

In sum, the Korean hedge fund regime has insufficient legal justifications for its structure and it should be re-designed with reference to the major jurisdictions like the U.S. and the U.K. Korea needs to have clearer rationales for regulating hedge funds and to act consistently with those rationales moving forward.

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[510] *See* ganjeob tuja jasan woonyongeob beob [Indirect Investment Asset Management Business Act], Legislative Release, Act No. 7221, Oct. 5, 2004, as amended (S. Kor.), *available at* http://www.law.go.kr/lsInfoP.do?lsiSeq=62375&lsId=&efYd=20041206&chrClsCd=010202&urlMode=lsEfInfoR&viewCls=lsRvsDocInfoR#0000.

VII. Similarities and Differences between the U.S., the U.K., and Korea

A. Overview

The unprecedented worldwide financial crisis in 2008 occurred primarily due to sub-prime mortgage related financial market failures, and it had substantial negative impacts on the global market as it lead to some big-sized financial firms' failures. Some examples of the crisis driven failures include Bear Sterns affiliated hedge fund adviser's failure and Lehman Brother's demise in the U.S., and Northern Rock's bailout in the U.K.[511][512] Unsurprisingly, powerful and stringent regulatory reforms followed around the world after the crisis, and they have been justified primarily based on the macro-prudential regulatory rationale (namely, preventing or mitigating the systemic risk or ensuring the market stability).[513]

Hedge funds have been pointed out as one of the major players that caused the subprime mortgage market failure and subsequent worldwide financial crisis, among other things, while remaining unregulated or lightly regulated.[514] As a

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[511] For the details of the Northern Rock failure, *see* THE ECONOMIST, *Northern Rock: Lessons of the fall*, Oct. 18, 2007, *available at* http://www.economist.com/node/9988865/print.

[512] Korea was relatively safe from the crisis in the wake of the 2008 global financial crisis and it demonstrated no big failures in the financial market primarily because they had limited exposure to sub-prime mortgage related financial products. *See* THE HANKYOREH, *US subprime crisis likely to have limited impact on S. Korea,* Aug. 14, 2007, *available at* http://english.hani.co.kr/popups/print.hani?ksn=228595.

[513] *See e.g.,* IOSCO Systemic Risk Report, *supra* note 102 (discussing generally the securities regulator's role regarding systemic risk).

[514] *See e.g.,* Sants, *supra* note 311. *See also* Rebecca Christie & Ian Katz, *Hedge Funds May Pose Systemic Risk in Crisis, U.S. Report Says*, BLOOMBERG, Feb 17, 2011, *available at* http://www.bloomberg.com/news/2011-02-17/hedge-funds-may-pose-systemic-risk-in-crisis-u-s-

result, regulatory efforts have been made to have them be subject to mandatory registration and authorization, as well as periodic reporting requirements based on the size and amount of leverage the hedge funds utilize.[515] In other words, large sized hedge funds are presumed to be systemically important enough to negatively affect the markets when they fail or are in a seriously distressed market condition. Registration and reporting requirements are implemented to prevent or mitigate the market disruption created by hedge fund failures by monitoring their activities in the markets on a continuous basis, helping the relevant regulators be ready to take appropriate corrective measures in a timely manner when necessary.[516]

In addition, rules and regulations are in place to address the traditionally well-recognized micro-prudential regulatory rationale of investor protection. Mandated disclosure to the investors in the U.K. and various business conduct regulations are some of the examples to that end.[517] These regulatory measures have been justified based on the fact that the hedge fund market has been growing quickly and continuously over recent decades, that there has been a significant increase in unsophisticated investors' access to the hedge fund market, and that

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report-says.html (reporting on the FSOC report indicating that hedge funds may pose a threat to market stability, especially in a time of crisis).

[515] *See supra* Chapter IV, Part C; Chapter V, Part C.

[516] *See e.g.,* Tim Geithner, U.S. Treasury Secretary, *Written Testimony for the House Financial Services Committee Hearing*, March 26, 2009, *available* at http://www.treasury.gov/press-center/press-releases/Pages/tg71.aspx.

[517] *See supra* note 515.

many market malpractices have been executed by hedge fund advisers while they were outside of the regulatory umbrella.[518]

Because of these changes in the regulatory landscape around the world and the global consensus among local regulators,[519] the newly adopted hedge fund regulatory regime is similar to a large extent, but some differences in regulating the hedge fund industry can be observed between the countries. Below is the brief summary of the regulatory similarities and differences observed in the hedge fund regimes of the three different countries (namely, the U.S., the U.K., and Korea).

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[518] *See e.g.,* SEC Hedge Fund Report, *supra* note 245.

[519] *See* IOSCO Systemic Risk Report, *supra* note 102. For a general illustration of the relationship of between hedge funds and systemic risk, s*ee* Ferran*, supra* note 265. *See also* Andrew W. Lo, *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Written Testimony for the House Oversight Committee Hearing on Hedge Funds,* November 13, 2008, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217; and Shadab, *Hedge Funds and the Financial Crisis, supra* note 196.

B. Similarities Between the U.S., the U.K., and Korea

First and foremost, what can be observed in common among the three countries is that hedge funds and/or their managers have come under direct regulatory oversight with the new regulatory framework in one way or another.[520] As illustrated *supra*, hedge funds and/or their advisers were unregulated or lightly regulated in the U.S. and the U.K. until the recent regulatory reform driven by the global financial crisis, while they were completely prohibited from carrying on hedge fund business in Korea. But the global financial crisis arising from sub-prime mortgage related financial market bubble urged the regulators around the world to regulate hedge funds and/or their managers more directly. As a result, the U.S. and the U.K. regulators have finally taken the position to regulate the fund managers directly, leaving the hedge funds outside the direct regulatory supervision, and focusing on the rationale of prevention or mitigating of systemic risk.[521]

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[520] As indicated *supra*, Korea is a bit of a unique example, and may be seen to take a relaxed position in terms of hedge fund regulation in that Korea has newly introduced a hedge fund regime in Korea to institutionally develop the market amid the global financial crisis and the global consensus to reinforce direct regulation against hedge funds and/or their managers. But what is important to note about the Korean example is that they are also trying to go in parallel with global regulatory consensus and exercise their legislative or regulatory authority within the scope of global consensus. That is, on one side, the Korean regime may be regarded as an example of a deregulatory effort because the local hedge fund market has been completely barred in Korea until the new hedge fund regime became available in late 2011. But, on the other side, it may be regarded as an example of relatively stringent hedge fund regime compared to the U.S. and the U.K. regimes because the Korean regime basically provides more stringent rules and regulations against both hedge funds and their managers. *See supra* Chapter VI, Part C.

[521] *See supra* Chapter IV, Part C and Chapter V, Part C. It should be noted, however, that systemic risk is not the only base for mandatory registration/authorization; rather it has also been grounded on the conventional rationale for securities regulation (*i.e.,* investor protection and deterrence of market abuse). *See e.g.,* Andrew J. Donohue, U.S. SEC director, *Regulating Hedge Funds and Other Private Investment Pools,* Feb. 19, 2010, *available at* http://www.sec.gov/news/speech/2010/spch021910ajd.htm.

The Korean example is basically same as that of the U.S. or the U.K. in that the Korean regulator would like to ensure that both hedge funds and their managers are within their direct regulatory purview, giving them a close watch over hedge fund investment activities and the potential impacts on the Korean financial market. The flip side here is that the Korean regulator has strived to build up the Korean hedge fund market, and has relaxed the then-existing rules and regulations that made the local hedge fund business practically impossible.[522]

It is reasonable to conclude that hedge funds and/or their managers have become somewhat regulated entities, and that they are subject to onerous reporting and compliance obligations under the new regimes of the three countries.

The private adviser exemption (namely, "fewer than 15 clients" exemption) is no longer available in the U.S., and they are required to comply with registration, reporting, and business conduct rules, as well as the SEC's examinations under the Advisers Act.[523] The U.K. regime also requires hedge fund managers to be authorized, and hedge fund managers are subject to broad business conduct rules (although those rules may be applied a bit lightly to the hedge fund managers considering the nature of their limited business based on the proportionality

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[522] In that regard, it may be more accurate to say that Korea takes a relatively more conservative position than the U.S. or the U.K. in regulating the Korean hedge fund market considering the fact that it has been newly introduced in late 2011, while the global financial market turmoil had not been cleared yet, and they may need some time to wait and see how the hedge fund market goes locally and globally.

[523] *See supra* Chapter IV, Part C.

principle).[524] Both countries take position not to directly regulate the hedge funds provided that they are marketed only to certain eligible investors.[525]

The Korean regime provides a comparable regulatory framework to that of the U.S. and the U.K. in principle in that any hedge fund adviser carrying on hedge fund business in Korea is required to be authorized in advance like other regulated entities. It is different from the U.S. and U.K. regimes because hedge funds are also subject to direct regulatory requirements such as leverage limits or other investment restrictions, and in that regard the Korean regime may be viewed as a more stringent regulatory regime than that of the U.S. or U.K.[526]

Second, regulatory focus has been shifted more to macro-prudential regulation (namely, systemic risk control or ensuring market stability) from micro-prudential regulation (namely, investor protection), and many rules and regulations have been implemented from that perspective in the three countries in response to the mortgage bubble and accompanying financial crisis.[527]

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[524] *See supra* Chapter V, Part C. *See also* Dan Waters, U.K. FSA Asset Management Sector Leader, Hedge Fund Regulation 2009 Forum Speech, *The European Regulatory Agenda for Hedge Funds,* Sept. 30, 2009, *available at* http://www.fsa.gov.uk/library/communication/speeches/2009/0930_dw.shtml.

[525] *See supra* note 521. The U.K. private placement exemption is no longer available to hedge funds after 2018, and the uniform European passport regime will replace it. All hedge funds will be subject to approval or reporting requirements under the AIFMD starting in 2019. *See* AIFMD, explanatory note 4, 69; art. 42, 67.

[526] It should be noted, however, that the U.K. regime may be viewed as being more similar to the Korean regime, and thus different from the U.S. regime, in that both the funds and the managers are required to register to or be authorized by the relevant local regulatory authorities under the AIFMD, while the U.S. hedge fund regime still provides safe harbors for hedge funds to avoid many of the paternalistic regulations. *See supra* note 521.

[527] *See supra* Chapter IV, Part C; Chapter V, Part C; Chapter VI, Part C.

It does not necessarily mean that the conventional micro-prudential regulatory rationale has been disregarded or treated lightly, but it is more accurate to say that the then-existing regulatory regime based on the micro-prudential rationale has been supplemented by the new rationale of macro-prudential regulation. For instance, redefining the threshold conditions for accredited investors in the U.S., and having hedge fund advisers subject to mandatory registration/authorization, reporting/disclosure, and examination obligations in the three countries, among other things, are some of the regulatory measures taken in terms of investor protection or deter fraud from private fund advisers.[528]

There was a consensus among the regulators to redesign the regulatory framework to prevent or mitigate the systemic risk from the hedge fund market and to have a close watch over them.[529] A few of the new hedge fund regimes changes made to address systemic risk regulation include imposing authorization and registration requirements on the private fund manager and/or the fund, mandatory reporting, and compulsory implementation of appropriate compliance and risk management systems.[530]

In the U.S., the then-existing private adviser exemption based on the number of clients has been repealed and replaced by a new size-based exemption

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[528] *See e.g.,* Donohue, *supra* note 521; Waters, *supra* note 524.

[529] *See e.g.,* Eilis Ferran, *supra* note 265, at 9-14 (summarizing the regulatory initiatives among the regulators from the global level in response to the global financial crisis).

[530] These rules may be also viewed as a regulatory regime with a micro-prudential regulatory perspective because it is in some ways connected with a mandated disclosure regulatory philosophy in that the information contained in the registration statement or periodic report are publicly available in whole or in part. *See supra* note 525.

(except for foreign private advisers) and new continuous reporting requirements based on this rationale.[531] A new uniform alternative investment fund manager authorization regime has been transposed into the U.K. regime reflecting the AIFMD, and periodic reporting requirements are in place to monitor the systemic risk from the hedge fund market. The Korean regime also requires hedge fund managers to be authorized like other regulated entities and to report relevant information regarding system risk periodically such as cash borrowing or other leveraged transactions (*e.g.,* OTC derivatives transaction).[532]

Needless to say, regulating the fund's leveraged activities is the most safe, easy and efficient way to deal with systemic risk concern from the regulator's standpoint.[533] The problem with this regulatory option, however, is that regulatory costs may outweigh the regulatory benefits in that it is more likely to deter financial innovation and prevent hedge funds from providing many benefits to the market, like supplying liquidity, portfolio diversification, price discovery, and market shock smoothing.[534]

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[531] What is noteworthy particularly in the U.S. is that big-sized hedge funds and/or their managers designated by the FSOC may be subject to macro-prudential based regulatory requirements like liquidity, capital, and leverage requirements, in addition to the general private adviser regulation under the Advisers Act. *See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, supra* note 104.

[532] *See supra* Chapter V, Part C; Chapter VI, Part C.

[533] *See e.g*., Cary Martin, Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investors Exemption, 37 DEL. J. CORP. L. 49, 110 (2012) (suggesting, as one of the possible alternative regulatory options, that direct regulation of hedge fund's leveraged transactions should be taken into consideration).

[534] *See e.g.,* Goldschmid, *supra* note 203.

Therefore, the U.S. and U.K. approaches would be a more reasonable and less drastic regulatory approach than the Korean regulatory option because (i) systemic risk issue is something ex-post in nature that is difficult to deal with on a proactive basis, (ii) it is very rare and exceptional to observe the really high profile hedge fund failures, sufficient to pose systemic risk, and (iii) other viable alternative regulatory options are available by regulating the counterparties or institutional investors as well as the managers, most of whom are regulated entities.[535]

Third, disclosure requirements for investors and the public are heightened in these three countries to enhance the transparency about the hedge funds and minimize informational asymmetry between the managers and investors. In the U.S., regulatory efforts to make the private fund industry more transparent have been made in the form of making the registration statement and periodic report publicly available, not in the form of mandating that the manager to provide the documents directly to the investors.[536]

The Korean regime provides that all the Korean domiciled hedge fund managers be subject to periodic reporting obligations with the regulator, but there is no express provision that requires the hedge fund or its manager to provide its

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[535] *See e.g.,* Tamar Frankel, *Private Investment Funds: Hedge Funds' Regulation by Size,* 39 RUTGERS L. J. 657 (Spring 2008) (arguing that not regulating hedge fund directly, but regulating the sources of hedge funds' leverage is more appropriate). *See also* supra Chapter III, Part B.

[536] The information in the registration statement of the registered investment adviser is publicly available in part, and other information in the periodic report filed with SEC is also available to the public in case of the exempted reporting advisers. That is, they are exempted from the registration requirement, but still subject to recordkeeping and ongoing reporting obligations. *See supra* Chapter IV, Part C.

investors with private placement memorandum or periodic reports.[537] In contrast, the U.K. regime (namely, AIFMD) explicitly requires hedge fund managers to provide periodic reports for the investors on a continuous basis in addition to the filing requirements with relevant local regulator.[538] Basically, the Korean disclosure regime is more like the U.S. regime than the U.K. regime.[539]

Fourth, private equity fund managers, not to mention hedge fund managers, become subject to authorization/registration in the three countries. This new regulatory approach has been justified in the name of systemic risk control because like hedge funds, private equity fund managers also have the potential to disrupt market stability.[540]

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[537] As illustrated *supra*, any information filed by the manager in the authorization process or in the periodic report is not publicly available including the investors in Korea, and no private placement memorandum delivery is required at time of offering or selling the funds. But some high net-worth individuals in the hedge funds are indirectly protected through suitability and product guidance rules because they are treated as non-professional investors (non-sophisticated investors). It is still doubtful, though, if these rules are really in line with the legislative background for defining qualified purchaser to include high net-worth individuals. *See supra* Chapter VI, Part C.

[538] It may be a confusing regulatory approach because the investors in the fund are deemed sophisticated, and they are in the position to request relevant information from the adviser if necessary. Also it seems inconsistent with the idea that no mandated disclosure is required if the offer or sale is limited to certain professional investors. It is likely that express disclosure requirements may dilute the disclosure issue because it may give them the impression that they are free from liability if they merely comply with the disclosure obligation set forth in the statute. *See supra* Chapter V, Part C.

[539] It should be noted, however, that the Korean disclosure regime is somewhat different from the U.S. regime in that even the information in the fund registration statement or periodic report filed with the regulator is not publicly available under the Korean regime, while some of the hedge fund information filed with the regulator are publicly available in the U.S. *See supra* Chapter IV, Part C; Chapter VI, Part C.

[540] For the relationship of PEF and systemic risk, *see generally* Ferran, *supra* note 265; Tillman, *supra* note 264.

The U.S. regime treats PEF managers exactly the same as hedge fund advisers, while the U.K. and Korean regimes have tried to regulate them differently based on a proportionality principle. For instance, some rules regarding fund custody are relaxed for private equity fund managers considering the difference in their investment process and the assets they invest and hold in the U.K. Korea also provides lighter regulatory treatment for PEF managers by subjecting them to a more simplified registration.[541] But the three countries take the same regulatory position in imposing periodic reporting requirements on both hedge fund managers and private equity fund managers for the purpose of monitoring their systemic risk.[542]

Fifth, these countries take similar approaches in regulating offshore-based hedge fund managers. Under the U.S. regime, offshore hedge fund managers are subject to registration requirements under the Advisers Act if they conduct the business in the U.S. or with U.S. investors, unless they satisfy the private adviser or foreign private adviser exemption.[543] Foreign hedge fund advisers, like U.S. based hedge fund advisers, used to rely on the then-existing "fewer than 15 clients"

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[541] *See supra* note 525.

[542] It is not entirely clear if private equity funds are more likely to pose systemic risk and many academics support the idea that there is a lot less likelihood that they pose systemic risk because their investment strategies are by far different from those of hedge funds. The leverage concern is also not as critical in the private equity fund industry because the leveraged transaction typically takes place in the level of the acquired target companies, not the fund level. *See e.g.,* Tillman, *supra* note 264. *See contra* Ferran, *supra* note 265 (supporting the idea of regulating the PEF market like the hedge fund market from the standpoint that they are also big enough to pose systemic risk in the event they go bankrupt, and the leverage they take in the acquired portfolio company level could also negatively affect the market in the event of their collapse).

[543] *See supra* Chapter IV, Part C.1.

private adviser exemption to avoid the registration obligation under the Advisers Act.[544]

Even under the Dodd-Frank Act, the same private adviser exemption is still available to foreign private advisers despite no longer being available to U.S. based private fund advisers. The "fewer than 15 clients" exemption remains unchanged in connection with foreign private advisers; U.S. domiciled private advisers no longer have access to the "number of clients" based exemption, but are now subject to new size-based safe harbor rules.[545] Consequently, two separate safe harbor rules are in place under the Dodd-Frank Act for U.S. based private advisers and foreign private advisers respectively.[546]

Under the U.K. regime, foreign based advisers have not been legally required to be authorized unless substantial parts of their conduct takes place in the U.K. or with U.K. investors, but the U.K. regime does not provide clear safe

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[544] For the general overview of the extraterritorial reach of the Advisers Act before the Dodd-Frank Act, *See* SEC Staff Report, *supra* note 20, at 221-236.

[545] *See supra* note 541.

[546] More precisely and legally speaking, the old "fewer than 15 clients" exemption has been officially repealed and a new registration regime has been implemented based on the size of the fund and the manager, and new safe harbor rules have been put in place including the foreign private adviser exemption under the Dodd-Frank Act. But in substance, the new foreign private adviser exemption is exactly the same as the old private adviser exemption, because the former exemption was narrowed down to only provide a foreign private adviser exemption. This U.S. regulatory approach may be understood as a way for regulators to measure and clarify the scope of the extraterritorial application for foreign based private advisers, and at the same time this safe harbor condition is in place to minimize the negative regulatory impact on U.S. based private advisers (with a goal of discouraging them from moving to an offshore regulatory friendly location to avoid onerous U.S. regulations). *See* Overmyer, *supra* note 301, at 2208-10. *See also* Registration under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 140, at 72,071.

harbor rules for foreign private advisers, and it has been typically been dealt with in the context of offshore fund marketing.[547]

Likewise, the Korean regime does not provide express safe harbor rules for foreign-based private advisers, and instead provides a general extraterritorial application provision and offshore fund sales rules.[548] Based on those rules, it has been understood that offshore private advisers are not subject to authorization requirements under the Korean regime if they market the offshore funds in compliance with the offshore fund sales rules, and unless there are any special factual circumstances to apply the general extraterritorial provision.[549] Overall, the three countries provide some safe harbors expressly or impliedly for the offshore hedge fund managers in different ways.

Sixth, the three countries take similar regulatory approaches in general relating to offshore hedge funds marketing to their local investors. That is, offshore hedge funds are not subject to registration requirements if the fund interests are offered or sold to certain eligible professional investors. The U.S. regime provides express safe harbor rules for the private offering of hedge fund interests,[550] the U.K. regime provides that offshore hedge funds are not subject to the U.K. fund regime if not offered and sold to the general public,[551] and the Korean regime provides

[547] *See supra* Chapter V, Part B, C.

[548] *See supra* Chapter VI, Part C.

[549] *Id*.

[550] *See supra* Chapter IV, Part B.2.

[551] It should be noted, however, that offshore funds become subject to approval requirements under the new U.K. regime (*i.e.,* AIFMD) starting in 2019, although until that time the current private placement safe harbor regime is still available. *See supra* Chapter V, Part C.

similar safe harbor rules to that of the US in terms of private offerings.[552] Until the new U.K. offshore fund marketing regime is implemented under the AIFMD in 2019, the U.K. regime provides for a private placement safe harbor regime and offshore hedge funds have been outside of regulatory oversight as long as they are not marketed to the general public. The U.S. regime provides similar private offering safe harbors.[553]

The Korean regime is positioned in between the two regimes. It is somewhat similar to the U.S. and U.K. regimes in that offshore hedge funds are exempted from securities registration requirements (in terms of the private offering exemption), but it is different from the U.S. and U.K. regimes (before the AIFMD is fully in force in 2019) in that they are subject to fund registration requirements even when they intend to sell the funds only to certain eligible professional investors.[554]

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[552] *See supra* Chapter VI, Part C.2.

[553] *See supra* Chapter IV, Part B.2; Chapter V, Part B.2.

[554] *See supra* Chapter VI, Part C.2.

C. Differences between the U.S., the U.K., and Korea

Overall, in principle, there is no substantial difference in the hedge fund regulatory framework because hedge fund regimes have been modified or newly introduced in the same direction – to reinforce regulations after the global financial crisis of 2008 by focusing on preventing or mitigating systemic risk from hedge funds. Nonetheless, some meaningful regulatory differences can be observed.

First, the U.S. basically follows a rule-based approach, regulating hedge fund advisers with the Advisers Act (exactly the same as the mutual fund advisers); while the U.K. maintains its previous broad principle-based regime and provides the flexibility to loosely apply the rules considering the limited nature and scope of their business.[555] In contrast, the Korean regulatory model goes between the two regimes in that Korean hedge fund managers are required to be authorized in addition to having many rules and regulations applicable to mutual fund managers being equally applied to them.[556]

In terms of a micro-prudential regulatory perspective, it is disputable that hedge fund managers should be subject to the full scope of the Advisers Act in the U.S. like other mutual fund advisers, as they focus only on accredited investors. The current mandatory registration regime for private advisers is somewhat

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[555] *See supra* Chapter V, Part C; Chapter V, Part C.

[556] The Korean model looks somewhat similar to the U.K. regime because Korea based hedge fund managers are subject to authorization requirements. However, some of them may be applied to hedge fund managers more lightly than other regulated entities including mutual fund managers, and some of the rules applicable to mutual fund advisers are exempted from applying to hedge fund managers. But, on the other hand, it also looks like the U.S. regime because the Korean regime is in place on a rule basis, not on a principle basis, and there is no flexibility to apply the rules differently or more lightly to hedge fund managers other than through the licensing requirements. *See supra* Chapter VI, Part C.1.

inconsistent with the legislative intent or history that distinguishes the private market from the public market and from all the rules and regulations in place that focus on the public market.[557] Even from a macro-prudential regulatory perspective, it is still doubtful that the current regulations are appropriate and that all the rules in the Advisers Act are relevant to addressing systemic risk.[558]

The Korean hedge fund regime is also problematic. It treats the hedge fund market as a regulated market in principle, at least for Korea based funds and their managers, because many of the rules applicable to mutual fund advisers are equally applied to hedge fund managers. Korean regulators meticulously define hedge fund and bar the investing public from accessing the market directly, and also keep them distinct from other heavily regulated markets such as the mutual fund market (and even from the general private fund where the general public can access on a limited basis).[559] Furthermore, it tried to directly regulate hedge funds and to impose investment limitations on the fund's leveraged transactions.[560]

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[557] *See supra* Chapter IV, Part D.

[558] This doubt is based on the observation that hedge fund counterparties or creditors should be regulated to control potential systemic risks in terms of credit channel regulation, while direct regulation of hedge fund's risky investments (e.g., highly leveraged transactions like borrowing or speculative OTC derivative transaction) are more effective in terms of market channel regulation, and should be a matter of Investment Company Act, not the Advisers Act. As a matter of fact, most of the rules in the Advisers Act are in place to protect the general public and are more relevant to micro-prudential regulation. Therefore there is a mismatch between the rationale for private adviser regulation and the implemented rules to a large extent, assuming that there are no unaccredited investors involved directly in the hedge fund market and that there are no critical concerns for investor protection. *See id.*

[559] *See supra* Chapter VI, Part D.

[560] *See supra* Chapter VI, Part C.2.

Second, the three countries demonstrate differences in regulating the hedge fund itself. The U.S. regime remains unchanged in terms of the private fund exemption and allows hedge funds to avoid fund regulation while their advisers come under regulatory purview; the U.K. takes a similar position, even under the new regime (*i.e.,* AIFMD).[561] Both countries, take a bit different of an approach in designing the regulatory framework for hedge funds in that the U.S. provides express safe harbor rules while the U.K. does not. The U.K. achieves the same regulatory goal by providing not creating rules applicable to hedge funds unless they offer or sell the fund interests to the public.[562]

Korea demonstrates vivid contrast from the other two countries in terms of hedge fund regulation in that they try to regulate the fund investment activities directly. For instance, leveraged transactions like money borrowing and speculative OTC derivative transaction are allowed on a limited basis.[563] This difference may arise because the Korean regime treats hedge funds like quasi-regulated funds, and only some of the rules applicable to mutual funds are exempted to from applying to hedge funds.[564] This approach may be working to some extent to mitigate the occurrence of market disruption from the Korea based hedge funds because the amount of leverage they may utilize is capped at the

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[561] *See supra* Chapter IV, Part C; Chapter V, Part C.

[562] *See id.*

[563] *See* FSCMA, art. 249-2(3), (4).

[564] *See* FSCMA, art. 249-2(1).

outset. However, it is likely working incompletely and is easily avoidable by choosing an offshore jurisdiction not covered by the Korean regime.[565]

Therefore, the U.S. or the U.K. approach seems more appropriate in that direct fund regulation cannot completely ensure the market stability, in part because most of the funds are based offshore giving them more power to influence the local market. Also, they are generally free from local regulation inevitably resulting in a regulatory arbitrage problem.[566]

Third, the three countries take a somewhat different approach in regards to the disclosure requirement to the investors. The U.S. regime provides no specific direct mandatory disclosure regime for the purpose of investor protection. That is, the U.S. Securities Act provides hedge funds with a safe harbor rule that exempts them from registration requirements, and the U.S. Advisers Act also provides no rule to force the hedge fund advisers to provide disclosure documents for the investors.[567]

Further, under the U.S. regime certain information in the registration statement or other reports filed by registered investment advisers is not publicly

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[565] This regulatory loophole may be curtailed or minimized if all the offshore funds were subject to registration and reporting requirements, but it is practically impossible and undesirable because a regulatory overlap or regulatory conflict problem may arise. *See* SEC Staff Report, *supra* note 544.

[566] *See* AIFMD, explanatory note 4. It would be best and ideal if we can make the hedge fund regime uniform and consistent to level the playing field between the countries around the world, and the E.U. AIFMD would be an example to that end. However, this is almost impossible for various reasons. Thus it is more prudent and more feasible for local regulators to coordinate in regulating the local hedge fund market and to share information relevant to systemic risk. *See e.g.,* Anne Riviere, *The Future of Hedge Fund Regulation: A Comparative Approach,* 10 RICH. J. GLOBAL L. & BUS. 263, 328-31 (Summer 2011).

[567] Some of the information in the Form ADV filed with the SEC may be publicly available, but still it is different from direct disclosure to the investors. *See supra* Chapter IV, Part C.

available, while the information contained in the report filed by the "exempt reporting company" (namely, mid-sized private adviser or venture capital fund adviser) may be publicly available.[568]

Korea takes a similar position to the U.S. in that there is no mandatory disclosure and prospectus delivery requirement for hedge funds.[569] Instead, Korean hedge fund managers and their sales agents are required to comply with suitability rules and product guidance obligations for non-professional individual investors among the qualified purchasers when they market the fund interests to them.[570]

In contrast, the UK regime (namely, AIFMD) expressly provides that hedge fund managers disclose material terms to the investors before investment

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[568] The reporting requirement imposed on the "exempt reporting adviser" may be justified on the ground that the mid-sized private advisers or venture capital fund advisers may also have potential to pose systemic risk on a collective basis because of their possible herd behavior. The regulator should be able to monitor their activities and be ready to take action if necessary. *See* Seth Chertok, *supra* note 201, at 24 (2011). However, it may be counter-argued that the distinction between registered private advisers and exempt reporting advisers becomes blurry, and treating them basically the same as registered hedge fund advisers would be appropriate. Even exempted private advisers are subject to same recordkeeping and reporting requirements as registered private fund advisers, and it undoubtedly entails a lot of disproportionate compliance burdens for the mid-sized private advisers or venture capital fund advisers, and impairs their business operation considering the relatively small size of their business. *See e.g.* Kathleen L. Casey, SEC Commissioner, Statement at SEC Open Meeting, *Rules Implementing Amendments to the Investment Advisers Act of 1940: Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with less than $ 150 Million in Assets under Management, and Foreign Private Advisers,* June 22, 2011, *available at* http://www.sec.gov/news/speech/2011/spch062211klc-items1-2.htm. *See also* Eisner Amper, *Dodd-Frank Bill: A Year and a Half Later*, at 25-28 (March 2012), *available at* http://www.hofstra.edu/pdf/academics/colleges/zarb/zarb_paper_doddfrank.pdf (observing that due to the heightened reporting and compliance burden small private advisers are particularly required to reorganize their management system in one way or another).

[569] *See supra* Chapter VI, Part C.2

[570] These suitability and product guidance rules are different from prospectus delivery or mandated disclosure rules, but it may be functioning indirectly as a regulatory tool to urge the managers to provide disclosure documents (like private placement memorandums) for the non-professional qualified purchasers in the hedge funds. *See id.*

and that they update any material changes made after the investment.[571] It also provides that the manager is subject to continuous reporting obligation to the investors.[572] That seems a bit confusing and in contradiction with the rationale for private offering exemption, though, because mandatory disclosure obligations are imposed on the hedge fund managers despite the fact that the investors in the fund are strictly limited only to professional investors.[573]

There is no doubt that certain types of information should be provided before investment to the investors, and as a matter of market practice it is very common to provide certain disclosure documents called private placement memorandums to meet the investors' due diligence requests, and at the same time to avoid the possible breach of fiduciary duty or anti-fraud rule. Thus, it may be more advisable not to expressly set forth rules for mandatory disclosure requirements.

Fourth, the three countries also have taken slightly different approaches in regards to the coverage of the regime and the way to deal with private fund advisers (including hedge fund advisers). The U.S. private fund regime is applicable only to private funds, and it includes general private funds and qualified purchaser funds only under Section 3(c)(1) and 3(c)(7) of the Investment Company Act. Other private funds (e.g., real estate funds or commodity funds) not falling

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[571] *See* AIFMD, art. 23.

[572] *See id.* art. 24

[573] *See e.g.,* Sants, *supra* note 311.

within the definition of investment company under the Investment Company Act will remain outside the regime even under the Dodd-Frank Act.[574]

In contrast, the U.K. and Korea take a quite different position based on the principle of functional regulation that any private pooled investment vehicles are subject to the private fund regime unless they can rely on the exemption clauses.[575] As a result, REITs or commodity funds are also subject to the new private fund regime.[576] In addition, some differences can be observed in the way that different types of private funds (including hedge funds and private equity funds) are regulated between the three countries.

The U.S. takes a very simple and straightforward position in regulating private funds, including hedge funds and private equity funds, and the default rule is that all private funds should be subject to same rules and regulations under the Advisers Act; despite the diverse nature of the private fund market and despite the fact that the original legislative intent of the Act was to protect the general public from the managers.[577] As a consequence, there is no different regulatory treatment

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[574] It may be assessed as an inevitable regulatory measure because the Investment Company Act has been in place to cover the pooled investment vehicles set up mainly for the securities investment purposes, and the private fund safe harbor rules were implemented to exclude those private funds from the reach of the Investment Company Act. Thus any other pooled investment vehicles primarily investing in something other than securities would be outside the regulatory purview under the Investment Company Act at the outset. *See* supra Chapter IV, Part C.

[575] *See* AIFMD, explanatory note (2), (4) and (6); FSCMA, art. 9(18), (19) and 249-2.

[576] Private funds, such as REITs or commodity funds, have been subject to the U.K. and the Korean private fund regime even before the new regimes were implemented. Nonetheless, the new hedge fund regimes in the U.K. and Korea are meaningful to some extent in that a new uniform regulatory regime is in place focusing on hedge funds (or more broadly the alternative investment fund market). *See supra* Chapter V, Part B; Chapter VI, Part B.

[577] *See SEC v. Capital Gains Research Bureau, Inc., et al*., 375 U.S. 180, 186 (1963).

made between hedge funds and private equity funds based on the assumption that private equity funds may also have potential to pose systemic risk.[578]

In contrast, the U.K. and Korean regimes take a proportionate approach in regulating hedge funds and private equity funds. Some of the rules applicable to hedge fund managers may be exempted or loosely applied to private equity fund managers. For instance, among other things, capital requirements are reduced for private equity fund managers who do not utilize leverage and for those who have 5 years or longer lock-up period in place in the fund. Disclosure and reporting requirements are also more lightly applied to private equity fund managers than hedge fund managers under the U.K. regime (*i.e.,* AIFMD).[579]

Korea also takes a two-tiered approach in regulating hedge funds and private equity funds, with much lighter regulatory oversight on the private equity fund market. Simplified registration, instead of authorization, is required for the private equity fund managers and most of the rules and regulations applicable to hedge funds and their managers are exempted from applying to private equity fund managers under the Korean regime.[580] The size, the level of leverage they utilize, the investment strategy and investment portfolio, the frequency of trading in the market, and the frequency of redemption are, among other things, different to a large extent between hedge funds and private equity funds; although there has been no clear legal distinction made between them in the past, there has also

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[578] *See* Tillman, *supra* accompanying text note 264.

[579] *See* AIFMD, explanatory note 17; Level 2 Regulation, art. 110(3)(d).

[580] *See* FSCMA, art. 268 *et seq.*

occasionally been convergence between them depending on the market circumstances.[581]

Therefore it is reasonable to conclude that the private equity fund market should be treated differently from the hedge fund market, as observed in the U.K. and Korean regimes. Lighter regulatory oversight is needed in the private equity market than in the hedge fund market. For instance, simple registration and/or reporting and recordkeeping requirements would be sufficient for the regulator's oversight of the systemic risk posed by private equity funds.[582]

Fifth, there are some differences found in regulating offshore private advisers between the three countries. The U.S. provides an express safe harbor rule that offshore fund advisers can rely on to avoid registration and other regulatory obligations under the Advisers Act. To do so, the U.S. has utilized the former "fewer than 15 clients" safe harbor rule as a new foreign private adviser exemption.[583] Relying on this new safe harbor rule, offshore private advisers are able to avoid the registration requirement under the Advisers Act to the extent that they satisfy such threshold conditions for "foreign private adviser" who: (i) have no place of business in the U.S., (ii) have, in total, fewer than 15 clients or investors in the U.S. in private funds advised by the adviser, (iii) have aggregate

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[581] For the distinctions between hedge funds and private equity funds, *see* supra Chapter II, Part C.2. For the convergence tendency between hedge funds and private equity funds, *See e.g.* Shadab, *supra* note 64.

[582] This may be comparable to the U.S. "exempt reporting company" under the Dodd-Frank Act, and it may be acceptable for the systemic risk monitoring purpose from the regulator's standpoint. *See supra* Chapter IV, Part C.

[583] *Id*.

assets under management attributable to clients in the U.S. of less than 25 million dollars, and (iv) neither holds itself out generally to the public in the U.S. as an investment adviser, nor acts as an investment adviser to any registered investment company under the Investment Company Act or as a business development company.[584]

That may be assessed as a regulatory effort to demarcate the line for whether or not offshore private advisers are required to register with the SEC in accordance with the Adviser Act, and it may have positive effects to some extent in that it makes a clear distinction between regulated non-U.S. based private advisers and unregulated non-U.S. based private advisers in terms of the outer reach of the Advisers Act.

However, in some respects it is more likely to cause some problems. First, it fails to clearly explain why different safe harbor rules are necessary between U.S. based private advisers and non-US based private advisers, and why different threshold conditions are provided for them.[585] From the macro-prudential regulatory perspective, both onshore and offshore private advisers (conducting hedge fund management business in the U.S. or with U.S. investors) should be under the U.S. regulator's oversight because they both have the potential to pose

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[584] *See* Dodd-Frank Act, § 402, 124 Stat. 1376, 1570 (2010); 15 U.S.C. § 80b-3(b)(3).

[585] As illustrated *supra*, US based private advisers are exempted from registration requirements depending on the size of the funds they manage, while foreign private advisers are exempted from the registration requirement based on the size and the number of the U.S. clients or investors in the funds they manage. Furthermore, the threshold conditions are also different in terms of the size between them. *See supra* Chapter IV, Part C.

systemic risk in the U.S.[586] Furthermore, it may provide private advisers (especially startup companies) with the incentive to choose to be offshore to avoid onerous regulatory requirements under the Advisers Act if they intend to carry on the business on a limited basis in the U.S. or with U.S. investors. Thus at least from the systemic risk regulatory standpoint, it would be more prudent to set forth comparable safe harbor threshold conditions between them.[587]

In contrast, the U.K. takes a much different position in regulating offshore private advisers. They are not subject to the authorization requirements of the U.K. regime unless there is special circumstances to treat them like a U.K. based adviser, depending on the factual circumstances (e.g., if they choose offshore merely to avoid the UK regulation).[588] They are also free to choose the U.K. as a base for fund establishment.[589]

Korea takes a more unique position in regulating offshore private fund managers. Offshore private fund managers are not allowed to set up the fund in Korea to raise capital from Korean investors, unless they are based in Korea and authorized by the Korean regulator.[590] It is partly because private advisers and

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[586] *See* Overmyer, *supra* note 301.

[587] There are not any serious investor protection issues here because foreign private advisers are also subject to private offering safe harbor conditions, and only accredited investors would be allowed to invest in the funds they manage. Also, a regulatory overlap issue would be easily avoidable by limitedly applying the rules under the Advisers Act to the extent necessary to gather relevant systemic risk information from them. *See supra* accompanying text note 580.

[588] *See supra* Chapter V, Part C.

[589] This implies that the private adviser is allowed to carry on the private fund business on a cross border basis without having a commercial presence in the U.K. and without obtaining authorization under the U.K. regime. *See id.*

[590] *See supra* Chapter VI, Part C.

private funds are both subject to regulation in Korea, and because only Korea based and Korea licensed advisers can set up Korea based funds.[591]

It is not easy to clearly judge which regime is more appropriate and desirable. But what is clear here is that offshore private advisers should be subject to certain types of regulatory supervisions if they intend to carry on the business in foreign jurisdictions. Regulatory obligations for them should be mitigated provided that their business in a certain jurisdiction is done on a limited and private placement basis.[592]

The U.K. approach seems more reasonable in that they provide implied safe harbor rules for foreign private advisers, and provide flexibility for offshore advisers to choose onshore or offshore as their fund base (subject to approval or reporting requirements when they intend to sell the funds to the investors in their territory).[593] This is a private market available only to certain sophisticated investors and there is no serious concern for investor protection accordingly, and systemic risk concerns from the offshore private advisers may be easily handled by imposing registration and reporting requirements on them if necessary.[594]

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[591] *See id*.

[592] It is because it is too disproportionate and cost-inefficient from the foreign private advisers' perspective if they are subject to the full scope of regulation in certain jurisdictions, especially if their business is very limited in that jurisdiction. Unbearable regulatory burdens may discourage them from carrying on the contemplated business and may encourage them to try and find other loopholes to avoid the regulation. *See supra* Chapter VI, Part D.

[593] *See supra* Chapter V, Part C.

[594] As emphasized *supra*, investor protection concerns should not be a sufficient ground to directly regulate hedge fund advisers because we have many other alternatives available to filter unsophisticated investors out from the so-called sophisticated investor market, and most rules and regulations already in place under the fund regimes are irrelevant to systemic risk. *See supra* Chapter III, Part C.

Sixth, these countries also take a bit different approach in regulating offshore fund marketing. The U.S. traditionally has handled this issue with their private placement or private fund regime. No mandatory registration is required where offshore funds are offered and sold to U.S. accredited investors, and no fund registration is required if the offshore funds satisfy the private fund threshold conditions.[595]

The U.K. and Korea take a different approach from the U.S. The U.K. has a similar private placement regime in place and offshore private advisers are not required to be authorized by the U.K. regulator provided that they offer or sell the fund to certain professional investors only in the U.K.[596] This U.K. private placement regime, however, will no longer be available starting in 2019, and only the passport regime will be available under the AIFMD. Under the passport regime, offshore private advisers would be required to get approval from the U.K. regulator before selling the fund interests to U.K. investors, together with reporting and disclosure obligations.[597]

Korea takes a similar position to the UK in terms of offshore fund marketing regulation. That is, offshore funds are required be registered in advance

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[595] *See supra* Chapter IV, Part B.

[596] *See supra* Chapter V, Part B.2.

[597] *See supra* Chapter V, Part C.

before selling the fund interests to certain Korean professional investors, along with periodic reporting requirements.[598]

D. Summary and Comments

There has been a tendency to reinforce hedge fund regulation around the globe after the global financial crisis of 2008, and based on the global consensus,[599] these three countries show similar patterns in designing the regulatory architecture for the hedge fund market in the big picture, while some differences are observed in the details.

First, the 2008 financial crisis has urged regulators to take appropriate regulatory measures to oversee the hedge fund market, paying special attention to the systemic risk they may pose. Both the U.S. and the U.K. have taken regulatory actions, among other things, focusing on the potential systemic risk from hedge fund industry and emphasizing the need to ensure market stability as a new and supplemental rationale for securities regulation.[600] All three countries have taken similar actions to that end.

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[598] This Korean regime is somewhat confusing because there is no disclosure requirement at all at the time of purchase, while ongoing disclosure is required for existing investors. *See supra* Chapter VI, Part C.2.

[599] *See* IOSCO Systemic Risk Report, *supra* note 102.

[600] *See supra* Chapter IV, Part C; Chapter V, Part C. Korea also takes similar regulatory posture to the U.S. and the U.K. by imposing authorization requirements on the managers, registration requirements, and express leverage restrictions on the funds, as well as continuous reporting requirements. However, they do not expressly declare that prevention of systemic risk is an additional rationale for securities regulation. *See supra* Chapter VI, Part C.

For instance, the U.S. has introduced a new registration and periodic reporting regime for hedge fund managers[601] and the U.K. has maintained its authorization regime for hedge fund managers and simultaneously has reinforced the periodic reporting/disclosure regimes.[602] Korea also has taken regulatory initiative to build up the new local hedge fund market, while ensuring market stability by imposing authorization and reporting requirements for the managers and imposing registration and quantitative limitations on leveraged transactions for the funds as well.[603]

These regulatory approaches by the three countries should be positively assessed in principle because there is little doubt that hedge funds have become more important as active players in the financial market locally and globally, and from the regulators' standpoint, there should be ways for the regulators to oversee their activities on an ongoing basis for systemic risk so that they may take appropriate regulatory action if necessary.[604]

However, the current crisis-driven regimes in the three countries seem to have problems with overregulation, based on the belief that private markets (like the hedge fund market) should be carefully handled and that direct ex-ante

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[601] *See supra* Chapter IV, Part C.

[602] *See supra* Chapter V, Part C.

[603] *See supra* Chapter VI, Part C.

[604] Regardless of the possibility of their posing systemic risk, the regulator should be in a position to get the information about the private fund market because their activities in the market may directly or indirectly affect market stability in various ways. *See supra* Chapter III, Part A.

regulatory intervention should be refrained from to the extent possible to avoid adverse impacts on the market.[605]

That is the very reason why the private market is distinct from the public market – by relying on the various safe harbor rules. Considering the heterogeneous nature among them and their positive roles in the market, it is very important to implement a flexible regime that provides them with sufficient discretion in designing investment structure and the accompanying investment activities, while keeping them under regulatory oversight (from a macro-prudential regulatory standpoint).[606]

The hedge fund market was formed and developed on a voluntary basis by relying on the various safe harbor rules. Hedge funds have played a constructive role in part because they have remained lightly regulated on the ground that it is a special market for accredited investors and because there is no need to heavily regulate the market like public market for the investing public.[607] The systemic risk issue is critical for regulators and other market participants (including investors or counterparties), but it is still doubtful that direct government intervention into the market is a panacea to resolve the issue.[608]

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[605] For instance, paternalistic government intervention in the private market may give the wrong signal to the market as well as to investors that it is a quasi-regulated market, which may give rise to a moral hazard problem. *See supra* note 202.

[606] *See supra* Chapter III, Part C.

[607] *See id*.

[608] As pointed out *supra*, the regulator's role is to mitigate the risk before and after crisis, but we have seen many cases of regulator failure in preventing occurrences of crisis, from even heavily regulated entities. The mere fact that the regulator is closely watching the market may itself have a smoothing effect by urging market participants to reinforce self-regulation and market discipline. *See supra* note 109.

Without a doubt, the most powerful and effective way to deal with the systemic risk concern is to regulate hedge funds and their managers directly like mutual funds and their managers, but it makes little sense because it means that there would no longer be a private fund market that parallels the public mutual fund market. It also becomes much harder to expect them to have a positive impact on the market.[609] Furthermore, it is in contradiction with the fundamental regulatory framework that has intentionally segregated the private market from public market, and leaving much of the things to be determined by the relevant parties on a negotiated basis.[610]

Regulatory differentiation and lighter regulatory intervention have been justified based on the belief that there is no practical need to directly regulate the market if the counterparties and investors are institutional investors or highly wealthy individuals who are deemed sophisticated enough to protect themselves without government protection.[611] This position for securities regulation is still valid and most of the rules and regulations based on this rationale remain unchanged.[612]

The fundamental problem in the hedge fund regimes in those three countries is that there are too many specific rules in place for the managers to

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[609] *See supra* Chapter III, Part B.4.

[610] *See supra* Chapter IV, Part D.

[611] *See id*.

[612] For example, the private offering, private fund exemption, and accredited investor or qualified purchaser concepts are a few of the regulatory efforts to distinguish the private market from the public market at the outset. These different regulatory treatments have been justified based on the assumption that there is no need to protect them like there is with the general public. *See id.*

comply with, and consequently, the distinction between the public fund market and private fund market becomes blurry.[613]

As indicated earlier, most of the existing rules and regulations have been in place to regulate the advisers providing investment advisory services to the investing public, and this investor protection concern could be easily handled by limiting the general public's access to the market. So, even under the conventional securities and/or fund regime investor protection concerns could be effectively managed without the regulator's visible hand. For example, the accredited investor and qualified purchaser threshold in the U.S., the professional investor and qualified purchaser threshold in Korea, and the eligible counterparty threshold in the U.K. may be regarded as regulatory initiatives to make the hedge fund market really private.[614]

The systemic risk issue could be dealt with in a different and a less drastic way by imposing relatively simple authorization, registration, and continuous reporting obligations for information relevant to monitoring systemic risk, rather than having them subject to the full scope of regulations applicable to mutual fund

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[613] *See* Atkins, *supra* accompanying text note 251.

[614] At issue here is whether the investors are really sophisticated enough to make an informed decision without the help of a mandatory disclosure regime, or wealthy enough to assume the risks from the investment, and whether the current net worth threshold is really relevant for the sophisticated investor threshold. But it has been working relatively well for a long time and, without the objective or quantitative threshold condition, there could be no hedge fund market due to uncertainty and hardship in screening the investor's eligibility for the investment. For example, unaccredited investors are not typically marketed to by the hedge fund managers and their sales representatives because of the difficulty in going through the sophistication test, although they are legally allowed to invest in the fund on a limited basis. *See supra* Chapter IV, Part B.

advisers.[615] The hedge fund market is supposed to be a financially innovative and self-evolving market, mutually beneficial for investors and counterparties as well as the managers who pursue alternative investments and absolute return opportunities.[616]

The government's role in the market should be as a whistle blower in cases where market fraud and market failure happen, and to be ready to take proactive action to reduce the possibility of the occurrence of the failure in normal situations. In that regard, it seems that current hedge fund regimes in the three countries go too far by striving to heavily regulate the hedge fund market based on the rationale of systemic risk prevention, while many of the rules in place are more relevant to the rationale of investor protection, despite little need for the protection of investors in this market.[617]

Second, the three countries have taken additional regulatory measures in response to the retailization concern (i.e., the increase in direct and indirect access to the hedge fund market from the investing public). The U.S. has leveraged the retailization phenomenon as a legislative background to subject private fund advisers to mandatory registration under the Advisers Act as a way to enhance their transparency.[618]

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[615] *See supra* Chapter III, Part C.

[616] *See supra* Chapter II, Part D.

[617] *See supra* Chapter III, Part C.

[618] *See supra* Chapter IV, Part B.4.

But in the U.S. regime, the new mandatory registration requirements are in place primarily for the purpose of gathering relevant information on systemic risk and not for the protection of investors. This is clear because it is not legally and explicitly provided that the information in the registration statement should be provided to investors.[619]

This approach seems reasonable in that the transparency issue in this market is more relevant to the regulator than to the investors because the investors in this market are sophisticated and do not need the mandated disclosure to protect themselves.[620] Instead, the investor protection concern has been dealt with by way of redefining the accredited investor threshold condition, particularly focusing on wealthy individuals.[621] In addition, retail investors' indirect exposure to the hedge fund market through fund of funds or pension funds would not be a serious concern for investor protection because they have a third party fiduciary, and they are subject to regulation directly or indirectly by relevant authorities.[622] Thus, this retailization concern is an insufficiently justifiable ground to have hedge funds subject to full scope of the Advisers Act.

The U.K. takes a similar approach to the U.S. in that it mandates that hedge fund managers be authorized and subject to continuous reporting requirements. But

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[619] *See supra* Chapter IV, Part C.

[620] *See supra* Chapter IV, Part B.2.

[621] *See* Net Worth Standard for Accredited Investors, *supra* note 274.

[622] For example, fund of hedge funds should be subject to the Investment Company Act as a type of mutual fund if the adviser offers or sells the fund interests to the investing public. *See* 15 U.S.C. § 80a- 12(d)(1).

at the same time, they differ slightly from the U.S. in that they impose additional disclosure obligations on the manager requiring that certain information be provided to investors before investment.[623] However, this mandatory disclosure regime is inconsistent with the private placement regime under which only certain professional investors are permitted to invest in the fund.[624]

By contrast, Korea's approach is somewhat unique in that even non-professional individuals are allowed to directly participate in the hedge fund market as qualified purchasers. The Korean hedge fund regime tries to deal with investor protection concerns indirectly with suitability rules.[625] This regulatory approach should be reconsidered and revised to make the threshold for the wealthy individuals as qualified purchasers a lot higher than it currently is, and to treat them as professional investors without requiring suitability test. Also, non-professional investors should be indirectly exposed to the hedge fund market through fund of funds.[626]

Third, the three countries also demonstrate slight differences in regulating offshore fund marketing. Based on the U.S. private placement regime, offshore

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[623] *See supra* Chapter V, Part C.

[624] *See supra* Chapter III, Part A.

[625] It is somewhat similar to the U.S. in that, theoretically, even unaccredited investors are allowed to invest in the hedge funds (up to 35 persons and up to 100 persons in total) after a sophistication test under the U.S. private placement and private fund regime. Under the Korean private placement and qualified purchaser fund regime, non-professional individual investors are allowed to participate in the fund (up to 49 persons) while there is no limitation in the number of the qualified purchasers under the qualified purchaser fund regime. *See supra* Chapter IV, Part B.1, 2; Chapter VI, Part C.2.

[626] *See supra* Chapter VI, Part C.2(C).

funds are exempted from registration requirements under the Securities Act,[627] and at the same time they can also avoid registration requirements under the Investment Company Act under the private fund exemptions.[628] Thus there are no particular rules or regulations applied from an offshore fund level other than anti-fraud provisions under the securities related statutes.

The U.K. has taken a similar regulatory position in that offshore funds are free from approval requirements, and as a result are exempted from the onerous fund related rules and regulations, if the fund interests are offered or sold to certain professional investors on a private placement basis.[629] It should be noted, however, that this U.K. private placement regime will be no longer available after 2019 in terms of offshore fund marketing, and it will be replaced by a uniform fund passport regime. Offshore funds will be required to get advance approval from the local regulator in order to promote the fund interests to U.K. investors.[630] This regulatory change in the U.K. private placement regime has been made in an effort to regulate the alternative investment fund market in a consistent way between European countries and between European countries and other countries.[631]

This approach seems reasonable in terms of functional regulation, and it may help local regulators oversee offshore hedge funds' activities in the local

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[627] *See supra* Chapter IV, Part B.2.

[628] *See supra* Chapter IV, Part B.1.

[629] *See supra* Chapter V, Part B.2.

[630] *See supra* Chapter V, Part C.

[631] *See id*.

market because this would be the only way for local regulators to monitor the offshore fund activities in the local market. It may also help deter any regulatory arbitrage effort from the offshore private fund managers.[632]

The Korean approach is more like the U.K. regime in that offshore funds are required to register with the Korean regulator before they market the fund interests to certain eligible professional investors in Korea.[633] This Korean offshore fund promotion regime may be regarded as an implied safe harbor rule for offshore private advisers to conduct hedge fund business on a cross-border basis, because they do not need to obtain a local license in Korea if they satisfy the offshore fund promotion rules.[634] At the same time, this offshore fund registration regime may be functioning as an invisible hand to fill in the regulatory gaps between local hedge fund regimes and offshore fund promotion regimes.[635]

Fourth, the three countries take similar positions in general in regulating offshore fund advisers, but there are some differences observed in the details. The U.S. provides express safe harbor rules for foreign private advisers that exempt them from registration requirements if they meet certain threshold conditions, such as fewer than 15 U.S. clients or investors and less than 25 million dollars in assets under management from U.S. investors or clients.[636]

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[632] *See supra* Chapter V, Part D.

[633] *See supra* Chapter VI, Part C.2(B).

[634] *See id.*

[635] *See supra* Chapter VI, Part D.

[636] *See supra* Chapter IV, Part C.

Unlike the private adviser exemption based on the size of the adviser and primarily available to U.S. based advisers, the foreign private adviser exemption is based on both the size of the adviser and the number of U.S. clients or investors in the fund.[637] It seems to take into account the systemic risk concern as well as the U.S. investor protection concern in determining the threshold conditions for the outer reach of the Advisers Act on foreign private advisers.[638]

This exemption may provide clear guidance as to whether foreign private advisers are required to register with the SEC. On the one hand, it is more likely to include too many foreign advisers under the U.S. regime, leading to an overregulation or regulatory overlap problem between the home jurisdiction and the U.S., because foreign private advisers become fully subject to the US Advisers Act unless they satisfy threshold conditions (even if they carry on business in the U.S. on a very limited basis with U.S. accredited investors).[639] On the other hand, it is likely to cause a regulatory loophole in terms of systemic risk regulation because some foreign private advisers are missing from the regulatory oversight despite conducting private fund business in the U.S.[640]

It would be worth amending the threshold condition to make the same threshold conditions applicable to the extent possible between U.S. based private

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[637] *See id.*

[638] *See supra* Chapter IV, Part C.

[639] *See supra* Chapter IV, Part D.

[640] *See id.*

advisers and foreign private advisers, and at the same time to mitigate the regulatory compliance burdens for registered foreign private advisers.[641]

Unlike the U.S., the U.K. provides no clear safe harbor rule for foreign-based private managers, and instead provides an offshore fund promotion regime with a general extraterritorial application clause.[642] What this means is that offshore private managers are not required to obtain licenses from the U.K. regulator unless there is a special factual circumstances evidencing that they chose offshore to avoid the U.K. licensing regime.[643] Instead, offshore-based private managers are required to get approval before marketing the funds (offshore or not) to U.K. investors under the new regime (i.e. AIFMD).[644]

Therefore, it appears that the U.K. provides a less stringent regime than the U.S. in terms of licensing or other compliance requirements in general, and that the U.K. effectively deals with the regulatory loophole issue in that any private funds managed by foreign private advisers are subject to requiring advanced approval from local regulators when an offer or sale is made to local investors.[645]

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[641] For instance, it would be one of the possible ideas that foreign private advisers relying on the exemption be subject to reporting and recordkeeping requirements on a continuous basis like the U.S. based exempted private advisers. Instead most of the rules in the Advisers Act are exempted from applying to them. This idea is more like the offshore fund promotion regimes observed in the U.K. and Korea. It would be sufficient for gathering systemic risk related information, and the investor protection issue would be minimal here because only a limited number of US accredited investors have access to the offshore funds. *See id.*

[642] *See supra* Chapter V, Part C.

[643] *See id.*

[644] *See id*.

[645] *See id*.

The Korean regime is similar to the U.K. regime. In Korea foreign private fund managers do not need to obtain licenses from the Korean regulator in principle, subject to a general extraterritorial application clause, and instead are subject to registration requirements in regards to the offshore fund marketing to certain eligible Korean professional investors.[646]

Each of the three countries' regimes has good points and weak points in regulating foreign-based private advisers. The U.K. and Korean offshore fund promotion regime seems more reasonable than the U.S. foreign private adviser regime, in that it is more likely that an indirect approach minimizes the overregulation issue; this ensures that local regulators have the necessary regulatory tools to oversee the foreign private adviser's activities in the local market.

Table 2: Comparisons of Hedge Fund Regimes between the U.S., the U.K., and Korea

	U.S.	**U.K. (AIFMD)**	**Korea**
Manager Regulation	- AUM based Registration - Small & Mid-sized Adviser/Venture Capital Fund Adviser exemption	-Authorization -No exemption	-Authorization -No exemption
Fund Regulation	-Private Fund exemption (3(c)(1)	-Unregulated if sold to certain	-No exemption, but lightly regulated

[646] *See supra* Chapter VI, Part C.2(B).

	& 3(c)(7) Fund) • No direct leverage regulation -Private offering Exemption (4(a)(2) & Reg D Rule 506)	professional investors (pre-AIFMD) • No direct leverage regulation -Authorization or Report under Passport regime (AIFMD)	• Leverage regulated to some extent -Registration
Disclosure & Reporting	-Periodic Report to regulator required -No mandatory disclosure to investors required	-Periodic Report to regulator required -Mandatory disclosure to investors required	-Periodic Report to regulator required -No mandatory disclosure to investors required
Offshore Manager Regulation	-Foreign private adviser exemption -Cross border license practically impossible	-No direct regulation subject to extra-territorial application clause -No cross border license required	-No direct regulation subject to extra-territorial application clause -Cross border license impossible
Offshore Fund Sale Regulation	-Private offering exemption (Reg S)	-Private offering exemption (Pre AIFMD) -Authorization or report under passport regime (AIFMD)	-Registration
Investor Eligibility	-Accredited investors & unaccredited investors with sophistication test (up to 35 persons)	-Professional investors	-Professional investors & non-professional investors with suitability test (up to 50 persons)

. **VIII. Recommendations**

A. Regulating Hedge Funds in the Future

With their rapid growth in size and the negative potential impact created by market disruptions, hedge funds have been highlighted as a target for stricter regulation for several reasons.[647]

First, in terms of investor protection, no direct regulatory intervention can be justified provided that the investors are wealthy and sophisticated enough to make informed decisions themselves.[648] This position should be maintained despite the tendency for retailization (both direct and indirect), unless there is a consensus that the regulatory distinction between the private fund market and the public fund market is no longer necessary.[649]

The individual's wealth itself does not necessarily mean that they are financially sophisticated enough to protect themselves, considering the increasing complexity of new financial products (e.g., hedge funds) and the risks inherent in the investment.[650] But sophistication should be one of the criteria in judging whether a particular individual is in the position to protect themselves at the time of investment because they have the financial resources to ask for assistance from financial intermediaries and to absorb the possible loss from the investment.[651] The existing regime for sophisticated investor eligibility is not fundamentally flawed and should be maintained by redefining the threshold conditions in terms of assets,

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[647] *See supra* Chapter III, Part A.
[648] *See supra* Chapter IV, Part B.2.
[649] *See supra* Chapter III, Part A.
[650] *See supra* note 272.
[651] *See S.E.C. v. Ralston Purina Co.*, *supra* note 223.

income and/or invested amount to reflect the changes in market circumstances over time.[652]

In addition, the concern about retail investors' participation in the hedge fund market through fund of funds or pension funds should not be treated as a critical one because (i) third party intermediaries (i.e., fund of funds managers or pension fund managers) should be between the hedge funds and retail investors, (ii) they are obligated to play a fiduciary role (e.g., conduct due diligence) for the fund investors and they are financially sophisticated enough to evaluate investments in hedge funds, and (iii) they are in the position to negotiate on an equal basis with hedge fund managers.[653]

Furthermore, managers are subject to regulatory requirements such as diversification and asset quality, and accordingly hedge funds can be indirectly and sufficiently controlled by regulating the investor-third party intermediaries – not by regulating hedge funds directly.[654]

The investor protection concern could be handled well by making the hedge fund market truly private, denying direct access to unaccredited investors, and regulating intermediaries if necessary.

Second, the ensuring market integrity issue should also be handled under the existing anti-fraud, inside trading, and price manipulation rules.[655] Hedge fund fraud cases are likely to occur occasionally under the existing regimes, but it is not

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[652] *See e.g.*, Net Worth Standard for Accredited Investors, *supra* note 274.
[653] *See supra* Chapter III, Part A.
[654] *See id.*
[655] *See id.*

a problem unique to hedge funds; rather, it is a universal problem observable even in other heavily regulated entities like mutual fund advisers or broker/dealers.[656]

What matters more is how to enforce the law against violators. Placing them under direct regulatory oversight cannot guarantee that no hedge fund frauds will occur in the future, rather more rigorous and strict law enforcement efforts may be a strong and effective enough regulatory tool to deter potential hedge fund frauds.[657]

Third, unlike the micro-prudential regulatory concerns, current market consensus is that large leveraged hedge funds may have the potential to negatively affect the market in extreme situations and accordingly that they should fall under regulatory oversight. However, it is still debatable whether hedge funds really do pose systemic risk to the market.[658]

Therefore, it is a more relevant and compelling issue of how to regulate them than whether to regulate them. Possible regulatory frameworks worth considering for the future include direct regulation, indirect regulation, or a market discipline based approach.

First, a purely market discipline based approach is less plausible and is unsustainable because self-regulation cannot guarantee market stability in cases where high-profile hedge fund failures occur. Investors, creditors, and counterparties cannot efficiently and effectively handle the systemic risk issue when emergent market crisis happens because they are commercially self-

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[656] *See e.g.,* Nichols, *supra* text accompanying note 144.
[657] *See supra* Chapter III, Part B.1.
[658] *See supra* Chapter III, Part A.

interested and because it is unlikely that they have sufficient information about the funds on a consolidated basis.[659]

Second, the direct fund regulation approach is apparently reasonable in that the restriction of hedge funds' leveraged activities may be the best way to prevent the potential negative impacts on the market from hedge fund failures.[660] But the problem with this regulatory option is that it may overshadow the many positive roles that hedge funds play in the market, such as promoting financial innovation, providing market liquidity, and encouraging market stability during ordinary market situations.[661] Thus the idea of direct fund regulation is not easily advocated for.

Third, an indirect regulatory approach via investors, creditors, and counterparties may come into play because they of their self-interest in closely monitoring hedge fund activities on a continuous basis. Also, they are such a heavily regulated entity that they are legally required to have sufficient capital and proper risk management policies and procedures in place.[662] The problem with this regulatory option, however, is that the systemic risk issue is not something that can be easily dealt with among market participants because each one of them is economically self-interested and because hedge fund counterparties have no effective tool to handle the overall market stability issue. Rather, it is something for the regulators to undertake.[663]

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[659] *See supra* Chapter III, Part B.1.
[660] *See supra* Chapter III, Part B.2.
[661] *See id.*
[662] *See supra* Chapter III, Part B.5-6.
[663] *See id.*

Fourth, regulating hedge fund managers and not hedge funds may be a more realistic and more feasible regulatory option, especially from the systemic risk regulatory standpoint, because they are the people in charge of the funds' day-to-day investment and management activities.[664] Imposing mandatory registration or licensing obligations, together with periodic reporting, recordkeeping, and examination requirements, is understandable to that end.[665]

Hedge fund manager regulation should be minimized to the extent necessary to deal with systemic risk matters because many of the current rules and regulations are irrelevant to systemic risk. Further, investor protection concerns may be tackled without much difficulty by redefining "accredited investors," by reinforcing the creditor and counterparty regulations, and by encouraging heightened market discipline and self-regulation among the market participants.[666]

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[664] *See supra* Chapter III, Part B.3.
[665] *See id.*
[666] *See supra* Chapter III, Part C.

B. Which Country's Approach is More Desirable?

With the global nature of hedge funds in mind, and considering the discussions *supra*,[667] it is worth exploring which country's regulatory approach is the most reasonable, as evidenced with hypothetical situations below.

1. What If a non-US person raises capital in the U.S.?

The first possible scenario is a situation where a non-U.S. person intends to carry on the hedge fund business as a start-up company with prospective investors in the U.S., U.K., and Korea, with fewer than 15 U.S. investors and less than 25 million dollars in assets under management from the U.S. investors.

First of all, as for the fund jurisdiction, unlike Korea, both the U.S. and the U.K. provide safe harbor rules for hedge funds to avoid regulations unless they offer or sell the fund interests to the investing public.[668] In that regard, it is more likely that a person would be relatively free to choose whatever jurisdiction they want with little regulatory differences whether or not they choose an onshore jurisdiction as a fund domicile.

By contrast, Korea provides no safe harbor rules for onshore or offshore hedge funds. Korea-based hedge funds are directly subject to onerous fund rules and regulations including registration, reporting, and leveraged position cap

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[667] What it implicates is that hedge funds and their managers are quite flexible in choosing the relevant jurisdictions for the funds and their managers, and easily move offshore providing more regulatory-friendly environment assume that regulatory gap exists between the jurisdictions. *See* Azhar & Ullatil, *supra* note 13.

[668] As noted *supra*, the UK provides no specific hedge fund safe harbor rules, but UK based hedge fund may be free from the onerous fund investment restrictions relying on the UK private placement regime until the AIFMD replace it from 2019 and mandatory approval or report is required. *See* FSMA, art. 238(5); COBS, art. 4.12.1R. In contrast, the US provides express safe harbor rules for hedge fund, in addition to the general private offering exemption. *See* 15 U.S.C. 80a-3(c)(1),(7); 17 C.F.R. § 230.506.

requirements, while non-Korea-based funds are relatively free from fund related regulation.[669] Thus, it goes without saying that the non-US person is highly likely to choose the U.S., U.K., or other jurisdiction that provides a more flexible regulatory regime for fund regulation than to choose Korea for their fund establishment purposes, unless there are no serious regulatory evasion or fund jurisdictional shopping concerns raised under the Korean extraterritorial application regime.[670]

There is no doubt that Korea is less likely to be considered as an attractive jurisdiction in terms of fund regulation from both onshore and offshore managers if they intend to raise capital and invest in assets on a transnational basis. As a result, Korea is likely to lose its ground as a competitive venue for global hedge funds when you compare it to other jurisdictions that provide a more flexible regulatory environment for fund regulation. The regulatory arbitrage problem may inevitably arise due to the significant regulatory differences between Korea-based hedge funds and offshore-based hedge funds under the Korean regime.[671]

The huge regulatory gap that exists between Korea and other jurisdictions is likely to unintentionally encourage Korea-domiciled managers and offshore

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[669] *See* FSCMA, art. 249-2.
[670] As explained *supra*, Korea provides no express safe harbor rules for Korea-domiciled hedge funds while offshore-based hedge funds are merely required to register with Korean regulator with no substantive regulation. During the offshore fund registration process, however, certain offshore funds are less likely to be registered based on the general extraterritorial application clause depending on the factual circumstances. For example, it is more likely that the application for the registration will be rejected on the ground that it is in violation of the general extraterritorial application rule if a Korean person intentionally or recklessly set up the fund offshore merely to avoid the onerous Korean hedge fund regulations, while primarily targeting Korean investors. *See* FSCMA, art. 2, 279.
[671] *See* FSCMA, art. 249-2, 279.

managers to choose offshore locations to set up their funds.[672] This is a problem for Korean investors and regulators because it is less likely to ensure a level playing field between onshore funds and offshore funds.[673] Accordingly it is likely to adversely affect the Korean hedge fund market and Korea-domiciled managers in the long run in that it makes it difficult for Korea-domiciled hedge fund managers to raise capital from offshore investors and to accommodate investors' needs.

Based on these observations, it may be strongly inferred that hedge funds should be left unregulated or minimally regulated if local regulators are unable to totally bar offshore fund managers from raising capital from local investors. Instead, it would be more advisable to regulate hedge fund managers to ensure the regulatory parity between onshore funds and offshore funds.

Suppose that hedge funds (onshore or offshore) were to remain unregulated, the systemic risk issue could still be handled by imposing registration or authorization requirements on locally based managers and by mandating registration and approval obligations in connection with offshore fund promotion with local investors, regardless of whether the managers are domiciled onshore or not.[674] Also, the investor protection concern under this regime could be handled by redefining the accredited investor threshold conditions and by prohibiting unsophisticated-unaccredited investors from directly partaking in the hedge fund

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[672] It should be noted that it is practically impossible for the regulators to prevent hedge fund managers from choosing offshore as a hedge fund domicile regardless of whether a local regulator put stringent fund regime in place, and it may be one of the primary reasons why the US and UK choose not to directly regulate local hedge fund. *See e.g.* Waters, *supra* note 524.
[673] *See supra* Chapter VI, Part D.
[674] *See e.g.,* AIFMD, art. 31 et seq.; Sants, *supra* note 311.

market.[675] In this regard, the Korean regulatory approach seems inadvisable in that some presumably non-professional or unaccredited investors are also permitted to directly invest in the Korea-domiciled hedge fund.[676]

Second, in terms of fund manager regulation, all three countries currently have some type of licensing requirements (such as registration or authorization) in place, although there are some limited exemptions available under the current U.S. regime. There also used to be a more general private adviser safe harbor rule applicable to hedge fund managers before the Dodd-Frank Act was enacted in 2010.[677]

Concerning this factual scenario, the U.S. regime provides two express safe harbor rules for start-up companies. One is a small private adviser exemption (i.e., less than 25 million dollars in assets under management regardless of the number of clients or investors in the funds under management), and the other is a foreign private adviser exemption (namely, fewer than 15 U.S. clients or investors and 25 million dollars in assets under management from the U.S. clients or investors).[678]

In contrast, the U.K. and Korea impliedly provide safe harbors for offshore managers and leave them free from advance authorization unless there are special factual circumstances to indicate that they are domiciled offshore to avoid the relevant local authorization regimes.[679] The U.K. and Korea provide similar

[675] *See supra* Chapter III, Part A.
[676] *See supra* Chapter VI, Part C.2(C).
[677] As indicated *supra*, the U.S. used to provide a private adviser safe harbor rule (namely, the "fewer than 15 clients" exemption) for both onshore and offshore hedge fund advisers under the Advisers Act, while the U.K. has consistently provided a uniform authorization regime to U.K. based hedge fund advisers only. Korea also introduced new authorization regime for hedge fund managers in late 2011. *See supra* Chapter IV, Part B.4; Chapter V, Part B.1; Chapter VI, Part C.1.
[678] *See* 15 U.S.C. § 80b-3, 4(a); 17 C.F.R. § 275.204-4(b).
[679] *See* AIFMD, art. 37-42; FSCMA, art. 2, 279(1); FSMA, art. 2.

offshore fund promotion regimes; under the regimes offshore hedge funds and their managers are subject to approval and registration requirements when they sell or offer fund interests to U.K. or Korean investors. Also, the target investors are strictly restricted to certain professional investors only.[680]

Based on the facts and the relevant rules and regulations illustrated above, the U.S. person is more likely to choose the U.S. as a jurisdiction for their fund management business because they have no legal barriers to doing business by relying on the (foreign) private adviser exemptions. There is no incentive for them to apply for a license in the U.K. or Korea either, because those jurisdictions provide less favorable regulatory environments compared to the U.S., and because they can raise capital from investors in the U.K. and Korean via an offshore fund marketing regime, even without obtaining local licenses under the U.K. or Korean regime.[681]

What the three countries' regimes implicate for a U.S. person seeking to set up a company to conduct hedge fund business on a transnational basis is that the person (namely, the hedge fund manager) will be inclined to choose a more favorable regulatory jurisdiction to avoid onerous manager regulations to the extent possible. They can do that by satisfying the safe harbor rules under the U.S. regime and offshore fund promotion requirements under the U.K. and Korean regimes.[682]

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[680] What should be noted, however, is that under the U.K. regime offshore funds and their managers may be able to avoid the approval requirement for the coming years until the AIFMD will be fully in force in 2019. *See* AIFMD*,* explanatory note 67.
[681] *See supra* Chapter V, Part C; Chapter VI, Part C.2(B).
[682] What is also noteworthy is that, unlike the U.S. or U.K., Korea provides no licensing exemption for offshore managers who seek to set up an onshore fund to market onshore investors. *See* FSCMA, art. 12, 279.

Overall, in terms of manager regulation, the U.K. and Korean regulatory models seem more desirable, especially from the macro-prudential regulatory perspective. Under the U.K. and Korean regimes, all onshore managers are subject to authorization requirements without exception, regardless of the size of the funds they manage or the number of investors they have. At the same time, all the offshore managers are subject to approval and registration requirements under the U.K. and Korean offshore fund promotion regimes.

What that means is that the UK and Korean regulators would be in the position to oversee how many funds are active in the local market, how the funds are operated, and how much potential they have to adversely affect the local market. The U.S. regime provides insufficient regulatory tools for effectively monitoring the foreign private adviser's activity in the U.S. market by allowing the foreign private adviser exemption and by choosing to impose onerous registration and reporting requirements on firms who go over the foreign private adviser threshold conditions.[683]

The U.K. and Korean regimes also seem more advisable than the U.S. regime in that the U.K. and Korean regulators are more likely to be able to deter

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[683] This all or nothing approach under the U.S. regime is less advisable because it may inevitably entail overregulation and regulatory loophole problems. Some offshore managers are subject to overly burdensome compliance obligations, even if they contemplate carrying on the hedge fund business on a limited basis in the U.S. and focusing on marketing to U.S. accredited investors only. By contrast, the U.K. regime seem more effective and efficient in dealing with this overregulation and regulatory loophole concern by requiring onshore based managers to obtain local licenses with less stringent compliance obligations, and by imposing an approval and registration obligation in connection with the sale or offer of the offshore fund interests (in lieu of a more burdensome licensing obligation). *See supra* Chapter IV, Part C; Chapter V, Part C.

regulatory arbitrage efforts while reviewing the offshore fund approval and registration application, depending on the totality of the factual circumstances.[684]

In terms of offshore fund marketing regulation, the U.S. and U.K. regimes seem more desirable and more consistent than the Korean regime. The U.S. and U.K. regimes treat onshore and offshore funds equally based on a micro-prudential policy rationale; unless the fund interests are marketed to unaccredited or unsophisticated investors it allows them to operate free from paternalistic fund regulation.[685] The Korean regime treats onshore hedge funds a lot differently from offshore hedge funds, and only onshore hedge funds are subject to fund regulation.[686]

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[684] The flipside is that, in terms of onshore hedge fund manager regulation in particular, there seems little difference in principle between the three countries because they all require onshore hedge fund managers to register and be authorized. But the U.K. and Korean regimes seem more appropriate in that they regulate the onshore hedge fund managers less stringently than they do mutual fund managers based on the principle of proportionality. The U.S. regime treats them the same as mutual fund managers under the Advisers Act. There is little doubt that, from the micro-prudential regulatory perspective, hedge fund managers should be subject to a lighter regulation than mutual fund managers because it is a private market open to the accredited investors only, and systemic risk and macro- prudential concerns may be effectively handled with registration and reporting requirements – not by subjecting them to the full scope of the Advisers Act. In that regard, it appears that the U.S. regime has somewhat of an overregulation problem. *See supra* Chapter IV, Part C; Chapter V, Part C; Chapter VI, Part C.

[685] Both countries' approach in regulating hedge funds (onshore and offshore) may be viewed as slightly different in that under the AIFMD, onshore and offshore hedge funds will be required to be approved or reported while the U.S. regime completely lets them fall outside the fund regulation if they meet the private fund safe harbor conditions. What should be noted, however, is that both countries basically take the same regulatory position to not regulate hedge funds directly unless there is an exceptional situation where the regulator believes they may pose systemic risk to the overall market. *See supra* Chapter IV, Part C; Chapter V, Part C.

[686] This may be an inappropriate and disproportionate regulatory approach because under the Korean regime, Korean institutional investors are exposed to both onshore and offshore hedge funds. There is no legal barrier for them to choose offshore hedge funds instead of onshore hedge funds, based on whichever is pursuing a more attractive alternative investment opportunity. In that sense, the disparate regulatory treatment between the two is unreasonable and is likely to have an unexpected, and negative effect by driving the fund/managers offshore in the long run. *See* FSCMA, art. 249-2, 279.

2. What if a US Private Adviser raises capital in the US, UK, or Korea?

The second scenario is the situation where a new U.S. based Private Adviser, who remains unregulated based on the Private Adviser Exemption, intends to raise capital of more than 150 million dollars from investors in the U.S., U.K., and Korea, among other countries.

First of all, from the U.S. fund regulatory perspective, U.S. based private fund advisers have no legal problem with raising capital from U.S., U.K., and Korean investors of more than 150 million dollars in assets under management based on the private offering and private fund exemptions.[687] It also makes no legal difference whether the U.S. based private adviser chooses an onshore or offshore fund to raise capital, or if they utilize both funds at the same time. Onshore and offshore funds are treated the same, allowing funds to avoid registration requirements by relying on the safe harbor rules under the relevant securities and fund statutes.[688]

Thus, under the U.S. regime, both onshore and offshore private fund information may not be available to the U.S. regulator other than through the Form D report, unless the manager is required to register with the SEC.[689] From the U.K. fund regulatory perspective, U.S. based private advisers are obligated to be approved by (or report to) the U.K. regulator before they offer or sell fund interests to U.K. investors, regardless of whether the fund is based in the U.K. or not.[690]

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[687] It is because there are no offering size limitations and no limitation on the number of investors if offered or sold to accredited investors only under Reg D. *See* 15 U.S.C. § 80a-3(c)(1), (7); 17 C.F.R. § 230.506.
[688] *See id.*
[689] *See* 15 U.S.C. § 80b-3; 17 C.F.R. § 230.503(a).
[690] As noted *supra*, however, the same analyses, applied under the U.S. regime, are also applied under the U.K. regime before the AIFMD comes into force in 2019, effectively ending the local

The same conclusion may be reached if the U.S. based private adviser determines to move to the U.K., or to set up a new company for hedge fund business in the U.K., because under the AIFMD U.K. based private advisers are also subject to same approval and reporting requirement regardless of whether the fund is located in the U.K. or not.[691]

A similar analysis is possible under the Korean regime. That is, the U.S. based private adviser is required to register the fund with the Korean regulator before marketing the fund interests to certain Korean professional investors.[692] U.S. private advisers are allowed to market offshore funds only, and it is strictly prohibited for them to set up onshore funds and to market them to Korean investors.[693]

Second, from the manager regulatory standpoint, the three countries demonstrate differences in some respects. Under the U.S. regime the formerly unregulated private adviser becomes subject to registration requirements under the Advisers Act because it no longer satisfies the mid-sized private adviser threshold

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private placement exemption. Meanwhile, the U.S. based private adviser is able to freely market the fund interests to certain U.K. professional investors without being subject to approval requirements by relying on the existing U.K. private placement safe harbor rule, which is equally available to U.K. based funds and non-U.K. based funds. *See* AIFMD, explanatory note 65, 66; art. 37-42.

[691] What is noteworthy, though, is that under the new U.K. regime (*i.e.,* the AIFMD), U.K. based private advisers are subject to authorization requirements in addition to the fund (onshore or offshore) approval and reporting requirements. Non-U.K. based private advisers are only subject to fund approval and reporting requirements. *See* AIFMD, art. 31 *et seq.*

[692] The offshore fund would be exempted from the securities registration requirement under the Korean private placement regime, but is still subject to fund registration requirements. In that regard, the Korean regime is uniquely positioned and different from the U.S. and U.K. regimes. *See* FSCMA, art. 9(8), 119(1), 279(1).

[693] The same conclusion may be reached in a situation where a Korea based private adviser intends to set up offshore funds to market them to Korean investors, because the offshore fund registration regime is available only to offshore advisers. Doing so may be viewed as a violation of the extraterritorial application rule under the Korean regime. *See* FSCMA, art. 2, 12(1), 279(1).

conditions. It does not matter whether the funds are domiciled in the U.S. or if the private adviser is based in the U.S.[694]

The flipside here is that U.S. based private advisers are likely to think about setting up affiliated companies offshore to raise capital from the three countries' investors, so that the U.S. based adviser can remain unregulated. This is unlikely to be a viable option for them, however, because the foreign private adviser exemption is by far narrower and a lot more stringent than the mid-sized private adviser exemption available to U.S. based private advisers.[695]

Therefore, under these factual circumstances, U.S. based private advisers are more likely to choose to register with the U.S. regulator, and to market the fund interests to the investors from the three countries based on the private offering safe harbor rules available to them under each countries' regimes.[696]

In contrast, under the U.K. regime, U.S. based private advisers are required to be approved by the U.K. regulator before marketing the fund interests to U.K. investors, and it does not matter whether or not the fund is domiciled in the U.K. Also, U.S. private advisers are not required to obtain a private adviser license from

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[694] *See* 15 U.S.C. § 80b-3.

[695] It may provide incentive for U.S. based private advisers to establish an offshore affiliated company to avoid the onerous U.S. registration requirements if they intend to focus more on offshore investors, to limit the number of U.S. investors, and to ensure that the amount of capital raised from U.S. clients complies with the foreign private adviser threshold conditions. *See* 15 U.S.C. § 80b-2(a)(30).

[696] As illustrated *infra*, It should be noted that the U.S. private adviser is subject to registration and approval requirements under the Korean and U.K. regimes in connection with the sale or offer of the fund interests to Korean and U.K. investors, because the two countries provide no private fund exemptions to offshore based private advisers. However, the U.S. based private adviser is not obligated to be authorized under the Korean or the U.K. regime. *See* FSCMA, art. 279(1); AIFMD, art. 42.

the U.K. regulator if they meet certain fund promotion requirements.[697] Therefore the U.S. based private adviser should only need to be mindful about the offshore fund promotion rules under the U.K. regime.[698] Korea takes a similar regulatory approach to the U.K. in that offshore private fund advisers are required to register with Korean regulators in connection with the purchase or sale of fund interests to certain Korean professional investors. However, they are exempted from licensing requirements.[699]

The only difference between the two countries is that the U.S. private adviser is not allowed to set up the fund in Korea to raise capital from Korean investors under the Korean regime, while the U.S. private fund adviser is free to choose the U.K. as a fund domicile for marketing to U.K. investors.[700]

In terms of manager regulation, the U.S. regime provides private adviser safe harbor rules for both onshore and offshore private fund advisers, although different threshold conditions apply to them. Both the U.K. and Korean regimes subject onshore advisers to licensing obligations without an exception, while providing offshore fund promotion regimes and exempting offshore private fund advisers from licensing requirements.[701] The primary difference, in terms of private adviser regulation, between the U.S. and the U.K./Korea is that the U.S.

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[697] As indicated *supra*, a non-U.K. based private adviser is completely free from licensing and approval obligations in regards to the offshore fund marketing based on the U.K. private placement regime (until the AIFMD is fully in force in 2019). *See supra* Chapter V, Part C.

[698] Extraterritorial application issues regarding the U.K. licensing requirement may be ignorable under this situation provided that the U.S. based private adviser has been doing business in the U.S. for some period of time, and has some U.S. investors in the funds they manage prior to marketing the fund interests to U.K. investors. *See* FSMA, art. 2.

[699] Extraterritorial application issues regarding the U.K. licensing requirement may also be ignorable in this situation because of the reasons mentioned *supra* in note 624. *See* FSCMA, art. 2, 279(1).

[700] *See* FSCMA, art. 279(1); AIFMD, art. 42.

[701] *See supra* Chapter IV, Part C; Chapter V, Part C; Chapter VI, Part C.

excludes certain private advisers (onshore/offshore) from regulatory oversight while the U.K. and Korea place every private adviser (onshore/offshore) under their regulatory purview in some way.

As noted *supra*, the U.K. and Korean regimes (especially the U.K. regime) seem more appropriate than the U.S. regime in terms of systemic risk and macro-prudential regulation because the U.K. and Korean regimes include all the onshore and offshore managers in one way or another. As a result, the U.K. and Korean are better positioned to monitor all private adviser activities in the local market while imposing less burdensome regulatory requirements.

On the other hand, both the U.S. and the U.K. take the regulatory position not to regulate the fund directly and to let private fund advisers choose onshore or offshore as a fund domicile. Korea takes a more conservative regulatory approach to only allow locally licensed private advisers to set up funds onshore to market fund interests to Korean investors.[702] It is obvious that the U.S. and U.K. regulatory approach is advisable because hedge fund related regulatory concerns can be properly controlled through adviser regulation and because the fund itself can easily move offshore to avoid fund regulation if necessary.[703]

It is likely that the Korean regime provides less incentive to offshore advisers to be domiciled in Korea due to their relatively strict fund regulation. At the same time the Korean regime may even force onshore advisers to move offshore or to set up offshore based affiliated companies to market offshore funds to Korean investors by relying on the offshore fund promotion regime. In that

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[702] *See id.*
[703] *See supra* Chapter III, Part B.2.

regard, it is more likely that the Korean regime produces less productive results than the U.S. or U.K. regimes.

3. What if an offshore manager raises capital via offshore funds in the US, UK, or Korea?

The third scenario is the situation where a non-U.S., U.K., or Korea based hedge fund manager set up a hedge fund offshore to raise capital from U.S., U.K., or Korean investors.

First, from the manager regulatory standpoint, offshore managers are in principle not subject to local regulation, including licensing requirements, if they satisfy the safe harbor conditions or the offshore fund promotion rules under the U.S., U.K., and Korean regimes.

Under the Dodd-Frank Act, the U.S. expressly provides a foreign private adviser exemption for non-U.S. based private advisers, and unlike "exempted reporting advisers,"[704] they are free from the U.S. private adviser regulations (such as registration, reporting, recordkeeping, and examination requirements) by relying

[704] This includes U.S. based mid-sized private advisers and venture capital fund advisers exempted from the registration requirements. *See* 17 C.F.R. § 275.204-4.

on the threshold conditions available for foreign private advisers;[705] also because they do not fall within the definition of "exempted reporting adviser."[706]

By contrast, the U.K. and Korea take a slightly different approach from the U.S. by basically relying on their offshore fund promotion regimes. Under the U.K. and Korean regimes, offshore managers do not need to obtain a license from the local regulatory authority and as a result are not obligated under the same rules and regulations as locally licensed entities (as long as they comply with the offshore fund promotion rules and regulations).[707]

The U.K. regime (namely, AIFMD) provides a kind of indirect safe harbor rule for offshore managers and exempts them from licensing and other compliance requirements if they meet certain threshold conditions under the U.K. private placement regime (*i.e.,* restricting the investors to certain professional investors or equivalent).[708] Under the AIFMD offshore managers are subject to disclosure obligations to investors both before and after investment and have reporting

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[705] To rely on the foreign private adviser exemption, any foreign private adviser need to show that (i) it has no place of business in the U.S., (ii) it has, in total, fewer than 15 clients and investors in the U.S. in private funds advised by the investment adviser, (iii) it has less than $25 million in aggregate assets under management that are attributable to clients in the U.S. and investors in the U.S. in private funds advised by the investment adviser, and (iv) it neither holds itself out generally to the public in the U.S. as an investment adviser nor act as an investment adviser to any registered investment company or business development company. *See* 15 U.S.C. § 80b-2(a)(30).

[706] *See* 15 U.S.C. § 80b-2(a)(30); 17 C.F.R. § 275.204-4. *See also* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets under Management, and Foreign Private Advisers, Release No. IA-3222 (July 2011), at note 5, 21, *available at* http://www.sec.gov/rules/final/2011/ia-3222.pdf.

[707] *See* FSMA, art. 238(5); FSCMA, art. 279; COBS, art. 4.12.1R.

[708] For the detailed threshold conditions for private placement, *see supra* Chapter V, Part 2.B(1).

obligations to the U.K. regulator, even though the offshore fund is strictly limited to certain professional investors.[709]

This U.K. regulatory approach is different from the U.S. and Korea, where there is no express provision to force the managers or the funds to disclose relevant information to investors before or after investment, although some of the information in the registration statement may be available to the public under the U.S. and Korean regimes.[710]

The regulatory approach in the U.K. seems inconsistent with the rationale for the private placement exemption. It is likely to cause duplicate regulation and an overregulation problem because the distinction between public offerings and private placements becomes blurry due to the mandatory disclosure obligations, which are supposed to be applied during public offerings. It may also be viewed as an unnecessary and overly paternalistic regulatory intervention into the private market, which is presumably available only to accredited and sophisticated investors.[711]

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[709] *See id*.

[710] Under the Korean offshore fund sales regime, periodic (quarterly) performance reports should be provided to existing investors and offshore fund managers are obligated to supply fund related information to existing investors upon their request. This is different from the mandatory disclosure requirement under the U.K. regime in substance and in nature. In addition, under the U.S. regime, foreign private advisers are completely free from direct mandatory disclosure obligations to investors if they meet the threshold conditions for the foreign private adviser, private fund, and private offering exemptions. However, there is an implied obligation to disclose relevant information to the investors at the time of investment and thereafter based on the general anti-fraud rules in the securities laws. *See* FSCMA, art. 280(2), (3); AIFMD, art. 23. *See also supra* Chapter IV, Part C.

[711] Regardless of the controversy of whether sophisticated investors are really financially savvy enough to understand every potential risk entailed in the investment and the complex investment strategy to be utilized by the manager, they are presumed to be sophisticated enough to protect themselves from the managers. Sophisticated investors are also in a position to request relevant

Korea takes a similar regulatory position to the U.K. in regulating offshore fund managers in that they regulate offshore fund managers indirectly through offshore fund sales regulation. Korea takes a different position from the U.K., however, regarding the mandatory disclosure obligation. Like the U.S., Korea imposes no mandatory disclosure obligation against offshore funds or their managers if they meet the private offering safe harbor conditions.[712]

Korea takes a somewhat unique position by putting rules in place regarding disclosure to investors by imposing a periodic reporting obligation and a fund information provision on offshore fund managers.[713] In addition, the Korean regime seeks to deal with the investor protection concern by applying the suitability and financial product guidance rule to certain non-professional and unsophisticated investors who are categorized as qualified purchasers under the hedge fund rule (i.e., some high net-worth individuals not satisfying the threshold conditions for professional investors), and by eliminating any differential treatment between the investors when providing relevant fund information.[714] However, this Korean regulatory approach is problematic because it makes it hard to understand the rationale for the rule and it shows inconsistency in regulating hedge funds (also known as qualified purchaser funds) despite the fact that hedge funds are supposed

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information from the manager if necessary. Considering the fact that the current regime is still in place based on this rationale, a likely conclusion is that it is a somewhat strange and disproportionate regulatory intervention into the private market. *See supra* text accompanying note 612.

[712] *See supra* Chapter VI, Part C.2.

[713] *See id*.

[714] *See* FSCMA, 46, 47, 249-2(1).

to be treated specially and that only certain qualified purchasers and sophisticated investors are allowed to directly invest in the fund.[715]

Second, in terms of the fund regulation, the U.S. exhibits certain differences when compared to the U.K. and Korea. The U.S. regime provides that offshore funds are not subject to mandatory registration or disclosure requirements if they meet the private offering safe harbor conditions and are not subject to fund regulation if they satisfy the private fund (or qualified fund) exemption.[716]

In contrast, both the U.K. and Korean regimes provide that the offshore fund (or its manager) is subject to approval and registration requirements before selling the fund interests to local investors, although the offering must be made strictly in compliance with the private placement rules.[717] By doing so, the local regulator is able to gather fund information being used to actively advertise to investors in the local market.

The primary distinction between the U.S. and the U.K./Korea in terms of offshore fund marketing regulation is that the U.S. aims to regulate offshore fund managers directly by mandating that foreign private advisers register with the U.S. regulator (subject to limited exemptions), while the U.K. and Korea endeavors to regulate the fund managers indirectly via an offshore fund approval/registration

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[715] This explanation is what qualified purchaser should mean. It is more in line with the private offering exemption and the accredited investor definition under the private offering exemption because it is one of the prerequisites that the hedge fund must satisfy to be entitled to special treatment under the hedge fund rule. *See* 15 U.S.C. § 80a-3(c)(1), (7).

[716] *See id*.

[717] *See supra* Chapter V, Part C; Chapter VI, Part C.2.

regime. Both the U.K. and Korean regimes avoid regulating offshore managers directly.[718]

The basic regulatory positions between the U.S. and the U.K./Korea are totally opposite, and unfortunately, it is not entirely certain which regulatory approach is more effective or efficient. But, at least from macro-prudential regulatory perspective, the U.K. and Korean example seems more desirable in that it is more cost-effective (i.e., less burdensome for offshore managers to comply with) and it is more likely to minimize regulatory loopholes. The U.K. and Korean regulators are more likely to be in a position to take regulatory action against offshore fund managers in a timely manner, if necessary, while the U.S. regulator has few measures to take against foreign private advisers who meet the safe harbor conditions. Also, the direct regulation of foreign private advisers is likely to create an overregulation problem considering the fact that they merely market the funds on a limited basis to accredited investors (by relying on the private offering or private fund exemptions).[719]

Although still debatable, it seems like the offshore fund sale regulatory regimes in the U.K. and Korea are more reasonable and more cost-efficient than the approach in the U.S., both from a systemic risk and a macro-prudential regulatory perspective.

However, the mandatory disclosure requirements in the U.K. offshore fund promotion regime should be reconsidered. It would be better to let the disclosure

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[718] *See* 15 U.S.C. § 80b-2(a)(30), 3; AIFMD, art. 42; FSCMA, art. 279.

[719] *See id. See also* Overmyer, *supra* note 301, at 2211-19.

issue be resolved between the parties considering the fact that hedge fund investors are strictly limited to certain professional and sophisticated investors.[720] In this regard, the U.S. and Korean regulatory approaches seem better.

4. What if an offshore manager raises capital via onshore funds in the U.S., the U.K., or Korea?

The last scenario is the situation where a non-U.S., -U.K., or -Korea domiciled hedge fund manager set up a hedge fund in the U.S., the U.K., or Korea to raise capital from U.S., U.K., or Korean investors.

The U.S. and U.K. regimes do not prohibit offshore managers who do not obtain relevant licenses in the U.S. or U.K. from establishing locally domiciled hedge funds to raise capital from local investors. The U.S. regime even provides several safe harbor rules for offshore managers to establish U.S. domiciled funds for that purpose.

First, offshore managers can avoid registration requirements under the Advisers Act by relying on the "foreign private adviser" exemption, allowing them to raise capital from 14 or fewer U.S. clients and investors, and up to 25 million dollars in assets under management.[721] In addition, offshore managers are able to avoid registration obligations under the Advisers Act if they satisfy the general mid-sized private adviser exemption. Under the mid-sized private adviser exemption they are only permitted to raise capital from U.S. clients and investors

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[720] *See supra* Chapter V, Part D.

[721] See 15 U.S.C. § 80b-2(a)(30).

through "qualifying private fund(s)" of up to 150 million dollars in assets under management.[722] The offshore managers are also able to avoid fund and securities registration requirements under the Investment Company Act or Securities Act if they meet the private fund or private offering exemption.[723]

In short, the offshore managers are allowed to raise capital from U.S. clients or investors directly or indirectly through qualifying private funds, and to some extent without worrying about the adviser or fund registration requirements. This is possible because the U.S. provides clear and express safe harbor rules for offshore managers and the private funds they manage.

The U.K. regime indirectly removes the legal barriers from offshore managers who set up U.K. domiciled funds to raise capital from U.K. investors on a private placement basis. This is done by stipulating that the offshore managers are required to get approval from the U.K. regulator for the onshore funds they intend to manage, before they can promote the fund interests to professional investors.[724]

Thus, at least from a legal point of view, the offshore managers have full discretion on whether to choose an onshore or offshore fund jurisdiction. This regulatory framework may be justified based on the belief that there is no regulatory difference between onshore funds and offshore funds, because both

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[722] What should be noted is that, unlike the "foreign private adviser" exemption, under this mid-sized adviser exemption the offshore managers have no limitation on the number of the U.S. clients provided that their clients invest "qualifying private funds." Only the size of the funds they manage matters here. *See* 17 C.F.R. §275.203(m)-1(b).

[723] *See* 15 U.S.C. § 80a-3(c)(1), (7); 17 C.F.R. § 230.506.

[724] *See supra* Chapter V, Part C. *See also* AIFMD, explanatory note 66, art. 42.

funds are basically free from local fund regulation under the U.K. private placement regime. Instead, onshore and offshore funds they both are subject to approval requirements for fund promotion.[725]

This regulatory approach, however, may have regulatory arbitrage and regulatory gap problems in that U.K. domiciled private fund managers are required to get authorization from the U.K. regulator, while offshore managers are not.[726] That may create an unintended adverse effect by inducing onshore managers to move offshore to avoid authorization obligations under the U.K. regime. With this regulatory concern in mind, the U.K. regime provides general rules that prohibit any evasive regulatory avoidance, and it may be filtered out or prevented by the fund approval and offshore manager authorization processes.[727]

Unlike the U.S. or the U.K. regime, this scenario may be concluded to be totally infeasible or legally impermissible under the Korean regime, because the Korean regime provides no rules relevant to this situation. In other words, Korea domiciled hedge funds must report to the Korean regulator, and the Korea domiciled fund must be managed by a Korea domiciled and licensed entity.[728]

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[725] *See* AIFMD, explanatory note 10.

[726] *See supra* Chapter V, Part C.

[727] For instance, the local regulator that reviews the relevant fund application documents may be able to block this regulatory arbitrage attempt, depending on the factual circumstances, by identifying cases where the offshore manager chose to be based outside the U.K. just to avoid the authorization process. *See* FSMA, art. 2.

[728] *See* FSCMA, art. 12, 249-2.

Offshore managers are allowed to market offshore based funds to Korean investors on a limited basis, but not Korea domiciled funds.[729]

Other than those two scenarios, there are no other alternatives like this available under the Korean regime. There is no cross-border or transnational fund management business is allowed in Korea from the offshore fund manager perspective. The only thing offshore fund managers can do is to market the offshore fund to certain Korean institutional investors.[730] Otherwise, if they intend to set up a Korea domiciled fund to raise capital from Korean investors they need to obtain the relevant fund management business license under the current Korean regime. Undoubtedly, it is overly burdensome and very difficult for them to choose to do so because they need to be fully subject to Korean hedge fund regulation for their limited business in Korea, and there are other options for them to market the offshore funds to Korean investors without the heavy regulatory burdens under the offshore fund sales regime.[731]

The U.S. and U.K. regimes seem more reasonable than the Korean regime regarding this scenario because they provide both express and implied safe harbor rules for offshore managers to set up onshore funds to raise capital from onshore

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[729] *See* FSCMA, art 279.

[730] *See* FSCMA, art. 279(2).

[731] In fact, there is little incentive for them to set up locally licensed entities to engage in hedge fund business in Korea in that their track record or expertise must be primarily on offshore investments, not local investments, and they may be more interested in raising capital from certain Korean institutional investors. Thus the offshore fund sales regime may be the only feasible option for them to accommodate their business needs in Korea, unless there are significant deregulatory measures taken by the Korean regulator. In this regard, the Korean regulator's announcement to deregulate the licensing regime in the foreseeable future would be positive. *See supra* text accompanying note 458.

investors, while the Korean regime provides no safe harbor rules for this scenario. This regulatory difference between the three countries arises primarily because hedge funds are subject to direct regulation in Korea while they are not in the U.S. or the U.K.[732]

> Considering the fact that Korean managers are allowed to set up offshore funds to raise capital from offshore investors, that offshore managers are already allowed to market their funds to certain Korean institutional investors (in accordance with the offshore fund sales regime), and that offshore hedge fund businesses operating in Korea already focus more on marketing than on fund investment and management, it would be prudent and reasonable to adopt the offshore fund sales regime utilized in the U.K.[733]

[732] It is unlikely cause serious regulatory concerns if offshore managers set up onshore funds and raise capital from Korean investors, assuming that onshore hedge funds are exempted from registration and reporting requirements (besides having to market the fund interests through a Korean licensed entity and to obtain the fund distribution license themselves). This inference is possible because offshore managers likely do not intend to manage onshore funds in Korea (as most of the investment and management functions are operated offshore), allowing offshore managers to rely on the private securities offering exemption and the private fund exemption.

[733] *See* AIFMD, explanatory note 13.

IX. Conclusion

Five years have elapsed since the global financial crisis struck the financial markets, and a couple of years have passed since the unprecedented, draconian, crisis-driven financial regulatory reforms and hedge fund regulations made their way around the world.

There is no doubt that it is too early to assess whether or not the current crisis-driven hedge fund regime is necessary (or sufficient) to prevent another high profile financial market failure in the future. Therefore, it would be prudent to wait and see how effectively and efficiently the paternalistic hedge fund regimes in the major jurisdictions deal with the hedge fund problems raised during the crisis.[734]

It is worth thinking about whether the current hedge fund regulations are reasonable or if they go too far, because we may not have had enough time to think about the cumulative scope of the regulations while undergoing the crisis, and because identifying the appropriate level of regulation will ensure sustainable growth in the marketplace and will minimize potential negative impacts on local and global markets.

Consensus has built around the idea that hedge funds provide a positive effect on the financial markets, but the regulations imposed on hedge funds should be legally and practically distinct from the other types of funds available to the investing public.[735] However, the policy rationales behind regulating hedge funds,

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[734] *See supra* Chapter III, Part A.

[735] *See supra* Chapter II, Part B, C.1.

i.e., investor protection, deterrence of market fraud, and ensuring financial market stability, are still valid and should be fully respected.

The question now is whether those rationales are appropriately reflected in the current hedge fund regulatory regimes. It appears, in terms of micro-prudential regulation, that the regimes in the U.S., the U.K., and Korea have overregulation problems. All three countries were overly responsive to investor protection and/or market fraud concerns by subjecting hedge funds managers (and hedge funds in Korea) to a broad array of mandatory regulations that used to only be applicable to mutual fund managers.[736]

The autonomy of the accredited investor hedge fund market should be respected to the extent possible, assuming that all the participants in this market are sufficiently sophisticated to make informed investment decisions and to protect their own interests. Redefining accredited investor threshold conditions, mandating that hedge funds comply with broad principles of business conduct, and enforcing regulations in cases where fraudulent or deceptive practices take place should serve the minimize the need for regulatory intervention.[737]

From a macro-prudential regulatory perspective, there is little doubt that hedge funds should be subject to stronger regulatory oversight than ever. It seems reasonable and desirable to subject hedge fund managers to licensing/registration and reporting requirements, because it is hardly deniable that they have the potential to pose systemic risk during extreme market situations; regulators should

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[736] *See supra* Chapter III, Part C.

[737] *See id*.

be able to take appropriate corrective measures in a timely manner when necessary.[738]

The problem under the current hedge fund regimes though is that detailed, paternalistic, line-by-line rules and regulations have been implemented and justified under the policy rationale of preventing systemic risk and ensuring market stability. There are other more delicate, more responsive, and more flexible regulatory alternatives available[739] that should be pursued if we can agree that the hedge fund market should exist as a private market, clearly distinct from the public market. The hedge fund market would also be more likely to survive and to stay financially innovative if lighter regulatory oversight is allowed.[740]

It should be noted that, in this dissertation, I do not take into consideration such other hedge fund related issues as hedge fund activism,[741] money laundering, insider trading or market manipulation, and unethical or illegal investments, among other things. Instead, what I have endeavored to cover is how to efficiently and effectively deal with hedge fund problems from the securities or fund regulatory perspective, and how to regulate the hedge fund market accordingly under the relevant local securities and/or fund regimes.

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[738] *See id*.

[739] As briefly mentioned in *supra* note 163, the Volcker Rule may be a good example of an indirect regulatory alternative that may be utilized as a powerful and effective regulatory tool to control the hedge fund market, because the Volcker Rule directly and significantly limits the banking industries' exposure to private funds. As a consequence it may also adversely affect the growth of the hedge fund market. *See supra* Chapter III, Part B.

[740] *See supra* Chapter VIII, Part A.

[741] *See e.g.,* ATHANASSIOU, *supra* note 79, at 84-90.

Therefore, I do not believe my arguments or recommendations in this dissertation are absolutely correct or infallible in every situation. Undoubtedly the aforementioned issues need to be dealt with separately and from different regulatory perspectives. Some regulatory issues and concerns have already been touched on by the regimes covered here, and others may be dealt with through statutes or by regulators not included in this dissertation.

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