Richmond Journal of Global Law & Business

Volume 10 | Issue 3 Article 3

2011

The Future of Hedge Fund Regulation: A Comparative Approach: United States, United Kingdom, France, Italy, and Germany

Anne Riviere
Cleary Gottlieb Steen & Hamilton

THE FUTURE OF HEDGE FUND REGULATION: A COMPARATIVE APPROACH

United States, United Kingdom, France, Italy, and Germany

*Anne Rivière**

TABLE OF CONTENTS

* LL.M (2010) Harvard Law School (International Finance); Master of Laws (2009) Institut d'Etudes Politiques de Paris (Regulation and Markets). The author is admitted to the bar in New York. She currently is an associate at Cleary Gottlieb Steen & Hamilton in Paris and is writing a doctoral thesis on hedge fund regulation in the United States and in Europe. This paper was originally published in April 2010 in conjunction with the International Finance Seminar at Harvard Law School. The author would like to express her deepest gratitude to Professor Hal Scott who supervised this paper, and thank him for his valuable comments and inputs.

INTRODUCTION

Hedge funds are important actors in the global economy. In 2009, they managed $1.7 trillion, a 13% increase compared to 2008 but still a decrease from $2.1 trillion in 2007.[1] It is estimated that 9400 hedge funds are operating worldwide, a reduction of more than 1000 funds from the 2007 peak,[2] due to the financial crisis, during which three quarters of hedge funds suffered an average 15.7% loss.[3]

Even though the industry has faced some difficulties over the past two years, hedge funds have played an important role in the global financial system. They have assured efficiency in capital markets, provided a significant source of liquidity, and absorbed financial

---

[1] INTERNATIONAL FINANCIAL SERVICES LONDON (IFSL) RESEARCH, HEDGE FUNDS 2010 1 (2010), http://www.thecityuk.com/media/2358/Hedge_Funds_2010.pdf [hereinafter IFSL RESEARCH 2010].

[2] *Id.* at 2.

[3] *See id.*

risks.[4] The benefits these investment vehicles bring to the markets are essentially made possible by flexible and light regulatory regimes. Unlike registered investment companies, they escape most of the disclosure, reporting, and leverage requirements.[5]

Though hedge funds did not cause the current crisis, there seems to be a consensus among regulators that hedge funds need stricter oversight.[6] The rationale behind this desire to take action is twofold. The first concern is systemic risk, which we define as the risk of chain reactions of failures.[7] The current crisis has shown that markets are deeply interconnected and rely on one another. The size and complexity of hedge funds may make some of them systemically significant and likely to provoke chain reactions that could lead to a generalized collapse of financial markets.[8]

In light of the failures of Long Term Capital Management in 1998 and Amaranth Advisors in 2006,[9] we must ask whether hedge funds pose a systemic risk and evaluate the potential remedies. Carrying out such assessments can be challenging for regulators who lack the necessary tools to evaluate risks. Some entities may escape their oversight, which, in turn, provides justification for more regulation. The second concern that, according to regulators, justifies hedge fund regulation is the need to achieve greater transparency and cure informational asymmetries in order to guarantee an appropriate level of investor protection.[10]

Part I of this paper examines the relevance of the systemic risk and investor protection arguments. It provides a comparative overview of legal regimes applicable to hedge funds in five jurisdictions. It focuses primarily on the United States and explores four European Union (EU) member states' hedge fund regulations. The United King-

---

[4] *See* SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 4 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter SEC STAFF REPORT].

[5] *Testimony Concerning Investor Protection Implications of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. 4-5 (2003) (statement of William H. Donaldson, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/041003tswhd.htm [hereinafter Donaldson Testimony].

[6] IFSL RESEARCH 2010, *supra* note 1, at 7.

[7] *See Systemic Risk: Examining Regulators' Ability to React to Threats in the Financial System: Hearing Before the House Comm. on Financial Services*, 112th Cong. 2 (2007) (statement of Steven L. Schwarcz, Professor of Law and Business, Duke Univ.) [hereinafter Schwarcz Testimony].

[8] *See id.* at 3.

[9] Donaldson Testimony, *supra* note 5, at 2.

[10] *Id.*

dom, France, Germany, and Italy have been chosen, for these countries represent the variety of legal frameworks that coexist within the EU. It concludes that although systemic risk may be a legitimate concern, the investor protection argument is questionable.

Part II explores what the future of hedge fund regulation could look like based on the different proposals sketched out prior to March 2010.[11] The EU[12] introduced the controversial Directive on Alternative Investment Fund Managers (AIFM) in April 2009 and the U.S. House of Representatives enacted the Private Fund Investment Advisers Registration Act of 2009 (PFIARA).[13] Part II also discusses these proposals and identifies a lack of global coordination in attempts to reform hedge funds.

Part III develops the idea that hedge funds do not simply need more regulation, but better regulation. The paper proposes a framework to assess whether more regulation is the answer and, if so, suggests what elements legislators should consider in the cost/benefit analysis that should precede any attempt to introduce regulation.

Finally, the paper develops the idea that national particularisms must be transcended in order to establish an effective legal framework on a global scale. I suggest the creation of a global database for regulators' use. This database would bring together financial information concerning all systemically sensitive financial entities, including hedge funds. This system would favor *ex-ante* monitoring, which would help reduce the likelihood of a systemic crisis.

Definition

There is no formal, legal, or universally accepted definition of the term "hedge fund."[14] The term generally refers to a broad category of pooled investment vehicles that are privately organized, administered by professional investment managers, and not widely available

---

[11] This paper was written in the middle of the legislative discussions in the E.U. and in the United States in March 2010. Therefore the data are subject to change.

[12] Although the European Union (EU) will be studied as a whole, the paper shall mention the disagreements that may exist within the member states.

[13] *See* H.R 4173, 111th Congress Title V, Subtitle A, December 11, 2009. The bill was introduced in the Senate on January 20, 2010. It is currently in the hands of the Senate Banking, Housing and Urban Affairs Committee and included in the so-called "Dodd bill." Since the House version and the Dodd version of the PFIARA are almost identical this paper refers to both versions under the term "PFIARA" and highlights differences between the two versions when necessary. [hereinafter PFIARA].

[14] *See, e.g.*, FIN. SERVS. AUTH., HEDGE FUNDS AND THE FSA 8 (2002), *available at* http://www.fsa.gov.uk/pubs/discussion/dp16.pdf at 8.

to the public, but rather to wealthy and sophisticated individuals or institutional investors.[15]

Hedge funds can be defined by their characteristics as private investment partnerships or investment corporations that use a wide variety of trading strategies in order to seek absolute returns, such as position-taking in a range of different markets.[16] They employ a variety of trading techniques and instruments, including short-selling, derivatives and leverage.[17] Strategies and instruments vary a great deal from one hedge fund to the other.[18] William Donaldson underlines that "[t]hese pools of capital may or may not utilize the sophisticated hedging and arbitrage strategies that traditional hedge funds employ, and many appear to engage in relatively simple equity strategies."[19] Another way to distinguish hedge funds from other investment vehicles is their particular compensation system, generally consisting of a 1-2% management fee and a 20% performance fee in average, which is quite unique.[20]

From a legal perspective, hedge funds in the United States are investment vehicles that are not regulated as investment companies and that rely on various federal securities laws exemptions.[21] This relative lack of regulation is also apparent in the EU, although approaches on how to deal with hedge funds vary between the United States and the EU and even among EU member states themselves.[22]

The term "hedge fund" appears to be a "catch-all classification"[23] and therefore a preliminary remark is necessary. It seems that regulating such a large range of investment vehicles, with different strategies, structures, and sizes, in a uniform manner, may be questionable. Indeed, it carries the risk of inappropriate, vague, or counterproductive regulation depending on the characteristics of each hedge fund. The heterogeneity that exists within the hedge fund industry must be kept in mind when discussing further regulations.

---

15 *Id.*

16 *Id.*

17 *Id.*

18 ASSET MANAGERS' COMM. TO THE PRESIDENT'S WORKING GROUP ON FIN. MKTS., BEST PRACTICES FOR THE HEDGE FUND INDUSTRY iv (2008), *available at* http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf [hereinafter BEST PRACTICES].

19 *See* Donaldson Testimony, *supra* note 5, at 1-2.

20 *Id.*

21 *See, eg., Id.* at 3-4.

22 *See, e.g.,* ASSOGESTIONI & EUROPEAN FUND AND ASSET MGMT. ASSOC., HEDGE FUNDS REGULATION IN EUROPE: A COMPARATIVE SURVEY 3 (2005), *available at* http://www.assogestioni.it/index.cfm/3,154,562/05_250845_efama_hdgfnd_rprt_1.pdf [hereinafter HEDGE FUNDS REGULATION IN EUROPE].

23 *See* Donaldson Testimony, *supra* note 5, at 1.

It is equally important to remember that hedge fund regulation actually designates different realities and that it may take three forms. It may refer to regulating the fund itself, regulating the fund adviser/manager, or regulating the fund's operations. The way hedge funds are regulated varies from one jurisdiction to another. Some jurisdictions regulate hedge fund advisers, whether partially (United States) or completely (United Kingdom); some regulate the funds directly (Germany), and some regulate both (France).

This paper challenges the idea that hedge funds need more regulation. It argues instead that hedge funds need more effective regulation that is flexible and tailored to their specific characteristics and risks. The development of a better regulatory framework starts with a better understanding of what hedge funds are, of their role in the financial markets, and of the risks they may entail for the stability of the global financial system, and the impact of current regulatory frameworks on hedge fund performances. This analysis is necessary in order to understand the issues at stake and to properly assess the impact of future reforms.

PART I: HEDGE FUNDS, MARKETS AND LEGAL ENVIRONMENTS: AN OVERVIEW OF CURRENT HEDGE FUND REGULATIONS IN THE UNITED STATES AND IN THE EUROPEAN UNION

It is a common assumption that hedge funds are lightly regulated investment vehicles that play an important role in financial markets. Although they tend to make markets more efficient, several criticisms have led various jurisdictions to consider reforms.

1. Hedge Funds Are Important Market Players That Are Already Regulated to a Certain Extent

1.1 The Benefits of Hedge Funds for the Financial System

Hedge funds offer investors, fund managers, and markets in general several benefits and in many respects look more attractive than traditional vehicles.[24] First, hedge funds provide investors with a potential for substantial returns, which are not necessarily correlated to the market, by using a wide range of strategies.[25] "As such, hedge funds may be an important diversification tool in an investor's overall investment portfolio because they minimize overall volatility and provide access to sectors and strategies not otherwise available."[26]

---

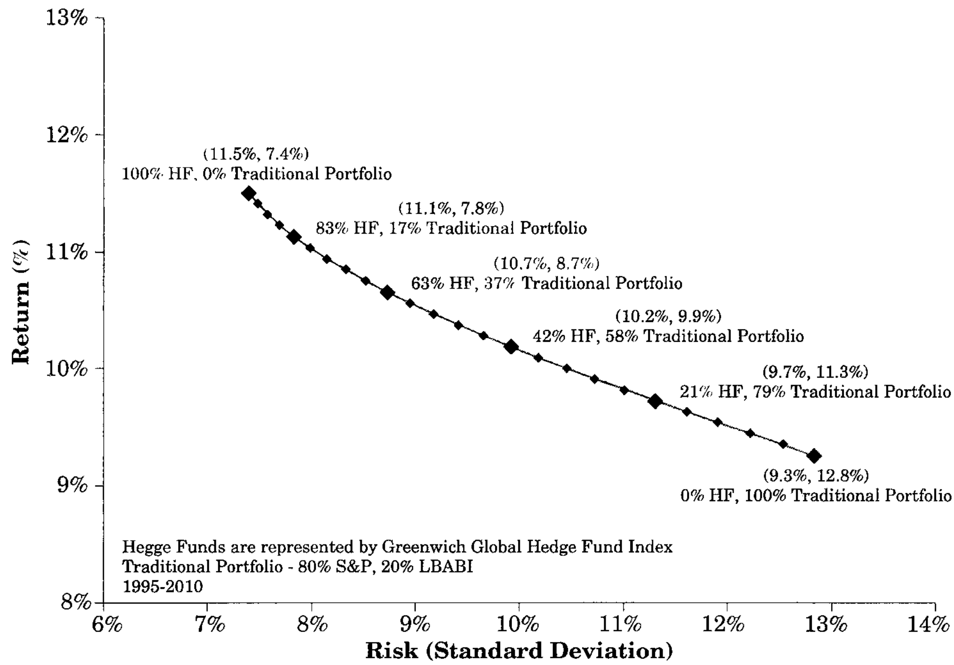
[24] *See* SEC STAFF REPORT, *supra* note 4, at viii.

[25] *Id.*

[26] Thomas Lemke et al., *Hedge Funds and Other Private Funds :Regulation and Compliance 2009-2010*, 2009.

Thus, for investors who are willing to risk large sums of money in order to get greater returns, hedge funds are an interesting alternative to traditional investment vehicles. The exhibit below illustrates this diversification benefit based on data from 1995 to 2010.[27] Overall, an investor with 100% of hedge fund interests in her portfolio had an average return of 11.5% for a 7.4% risk. This yield is substantially better than an investor with a 96% traditional portfolio whose average return was lower (9.3%) and whose percentage of risk was higher (12.8%).

DIVERSIFICATION BENEFITS OF HEDGE FUNDS



To managers, hedge funds offer an easy-to-set-up structure at minimal cost. In addition, the compensation mechanism, generally a 2% management fee and 20% performance-based allocation, is very attractive.[28] Some banks actually blame hedge funds for investment bankers' high compensation expectations. John Mack, Chairman at Morgan Stanley, believes that the reason investment bankers are overpaid is that investment banks "fear a brain drain to better-paying

[27] Greenwich Alternative Investments, Diversification Benefits of Hedge Funds, http://www.greenwichai.com/index.php/hedge-fund-essentials/diversification-benefits.
[28] *See* Donaldson Testimony, *supra* note 5, at 1-2.

hedge funds" and need to compete by raising their compensation packages.[29]

Moreover, hedge funds are structured and localized to take advantage of tax regimes.[30] In the United States, for instance, they are structured so as to benefit from a *"flow through"* tax treatment, which allows them to avoid income tax at the entity level.[31] Managers are then taxed only on their capital gains, at a 15% rate, which is substantially less than the rate for regular income taxes.[32]

Finally, hedge funds bring benefits to the financial markets. Indeed, they are said to increase liquidity and enhance efficiency.[33] For instance, hedge funds help provide efficiencies in pricing of securities in all market conditions thanks to their extensive research and willingness to make investments. Moreover, by providing a counterparty to institutions wishing to hedge their risks, hedge funds often help to disperse risk[34] and lower volatility.[35] Godeluck and Escande further argue that hedge funds have dynamized the corporate world. They claim that even activist hedge funds have accelerated the regeneration of the economic system.[36]

1.2 Legal Regimes Applicable to Hedge Funds in the United States and in the European Union[37]

Hedge funds first appeared a little more than fifty years ago and have developed in the United States and in the EU thanks to favorable legal environments.[38] They are often referred to as "unregulated" and "unsupervised" investment vehicles, but I prefer the term "lightly regulated" and I shall explain why.

---

29 *Mack Says Hedge Funds Driving Up Bank Pay*, FINALTERNATIVES, Feb. 25, 2010, http://www.finalternatives.com/node/11555.

30 *See, e.g.*, FIN. SERVS. AUTH, *supra* note 14, at 12.

31 *See* Lemke et al., *supra* note 26, at 232.

32 *See*, David Kocieniewski, *House Votes to Eliminate Hedge Fund Tax Breaks*, N.Y. TIMES, May 28, 2010. A bill to eliminate the 15% tax rate passed in the House of Representatives but failed in the Senate.

33 *See* SEC STAFF REPORT, *supra* note 4, at viii.

34 *See* Schwarcz Testimony, *supra* note 7.

35 BEST PRACTICES, *supra* note 18, at 27.

36 Solveig Godeluck & Philippe Escande, *Les Pirates du Capitalisme: Comment les Fonds d'investissement Bousculent les Marchés,* 2008, at 260.

37 Four countries have been selected for their representativeness of the variety of legal environments in the European Union: The United Kingdom, France, Germany, and Italy.

38 *E.g.*, Arindam Bandopadhyaya & James L. Grant, *A Survey of Demographics and Performance in the Hedge Fund Industry* 4-5 (Univ. of Mass. Fin. Servs. Forum, Working Paper No. 1011, 2006).

Before turning to American and European legal frameworks, the word "regulation" itself must be defined. Are we referring to the registration of the fund and its adviser with a regulatory body that exercises an active oversight or to limitations on transactions and special requirements on hedge fund activities? Indeed, in the United States, one often associates registration and regulation, which is a legitimate thing to do.

Most of the time, registration implies regulation and vice-versa. In the EU, however, hedge funds are registered almost everywhere. Yet these funds are still said to be unregulated because there are few, if any, restrictions on their activities. Conversely, the absence of registration does not mean that hedge funds are completely unregulated, as is the case in the United States.

1.2.1 The United States

The United States is the most popular on-shore location with nearly two-thirds of global on-shore hedge funds, whether structured as Limited Partnerships or Limited Liability Corporations.[39] It is also the leading center for location of management, with 68% of global assets,[40] among which 41% in the state of New York.[41] The majority of U.S.-domiciled assets are managed from New York (60%), followed by California (15%), Connecticut, Illinois, and Florida (about 6% each).[42]

The American legal framework does not offer any legal definition for a hedge fund. In its 2003 report on the implications of the growth of hedge funds, the Securities and Exchange Commission (SEC) regarded this structure as a "pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act."[43]

As Robert Jaeger points out, "hedge funds are designed to take advantage of various exemptions, exclusions, and 'safe harbors' that are explicitly provided within the regulatory framework."[44] SEC Commissioner Troy Paredes also emphasizes the fact that the resulting

---

[39] IFSL RESEARCH 2010, *supra* note 1, at 2-3.
[40] *Id.* at 1.
[41] *Id.*
[42] INTERNATIONAL FINANCIAL SERVICES LONDON (IFSL) RESEARCH, HEDGE FUNDS 2009 2 (2009), http://www.thecityuk.com/media/2207/CBS_Hedge%20Funds%202009.pdf [hereinafter IFSL RESEARCH 2009].
[43] SEC STAFF REPORT, *supra* note 4, at viii; *see also* David A. Vaughan, Selected Definitions of "Hedge Fund," Comments for the U.S. SEC Roundtable on Hedge Funds (May 14-15, 2003), *available at,* http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm.
[44] ROBERT A. JAEGER, ALL ABOUT HEDGE FUNDS: THE EASY WAY TO GET STARTED 181 (2003).

light regulation of hedge funds is not the product of "shenanigans or of the exploitation of loopholes."[45] Ironically, hedge funds must comply with many laws and regulations as described below in order to qualify for those exemptions and safe harbors.[46]

The Investment Company Act of 1940

Unlike other investment companies, hedge funds may avoid registration with the SEC if they comply with the requirements of one of the two statutory exemptions set out in the Investment Company Act of 1940 (ICA), §3(c)(1) and §3(c)(7).[47]

Under §3(c)(1), any "issuer whose outstanding securities are beneficially owned by not more than one hundred persons" and who does not hold himself out to the public is exempted from the definition of "investment company."[48] This provision actually enables hedge funds to have many more investors since beneficial ownership by a company or another fund counts as beneficial ownership of one person, provided that they are not set up to circumvent the provisions of the Act.[49]

For example, let's assume that investment company A has 50 investors, pension fund B has 150 investors and hedge fund C has 90 clients. If A, B, and C invest in hedge fund Z, hedge fund Z will be deemed to have 3 clients when really 290 investors will be exposed, provided that A, B, or C do not hold more than 10% of the outstanding voting securities of the issuer. This method, used to determine beneficial ownership for the purpose of qualifying for the 3(c)(1) exemption, has some exceptions. In a 1994 No-Action letter, the SEC stated that a defined-contribution plan could not be counted as a single investor if its participants get to make investment decisions.[50] If participants play an active role in the plan, then one must "look-through" and each plan participant must be counted as one towards the 100 investors limit.

---

[45] Troy A. Paredes, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation* 4 (Wash. Univ. Sch. of Law, Faculty Working Paper Series, Working Paper No. 07-05-01, 2007).

[46] SHARTSIS FRIESE LLP, U.S. REGULATION OF HEDGE FUNDS 87 (2005).

[47] Investment Company Act of 1940, 15 U.S.C. § 80a-1–80a-64. Exemption 3(c)(7) was introduced by the National Securities Markets Improvement Act of 1996. Pub. L. No. 104-290, § 209, 110 Stat. 3416, 3432 (1996).

[48] 15 U.S.C. § 80a-3(c)(1).

[49] Cornish and Carey Commercial, Inc., SEC No-Action Letter, 1996 WL 422641, at *3 (Jun. 21, 1996).

[50] PanAgora Group Trust, SEC No-Action Letter, 1994 WL 174138, at *6 (Apr. 29, 1994).

The second exemption, §3(c)(7), was introduced in the National Securities Markets Improvement Act of 1996 and has become popular since it allows hedge funds to offer their securities to an unlimited number of "qualified purchasers."[51]

However, one caveat should be mentioned. Even though §3(c)(7) does not set a maximum number of qualified purchasers, §12(g) of the 1934 Act imposes registration and reporting requirements if the fund has more 500 or more investors.[52] In order to benefit from the exemption, in practice, hedge funds have a maximum of 499 investors.

The look-through issue was also raised for 3(c)(7) funds in several instances. It was, for instance, raised when trying to determine whether a benefit retirement could be a qualified purchaser or if a hedge fund had to look-through to determine whether each participant was qualified. The SEC concluded that a defined benefit retirement plan is deemed a qualified purchaser if plan participants cannot make investment decisions and if the decision to invest in a 3(c)(7) fund is made solely by the plan fiduciary.[53] In this instance, if plan participants had been able to direct their investments to specific alternatives, then the 3(c)(7) fund would have had to look-through and evaluate each participant's level of sophistication.

---

[51] A "'Qualified Purchaser' means—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." 15 U.S.C. § 80a-2(a)(51)(A).

[52] Securities and Exchange Act of 1934, § 12(g), 15 U.S.C § 78(l)(g).

[53] Standish, Ayer & Wood, Inc. Stable Value Group Trust, SEC No-Action Letter, 1995 WL 765406, at *5 (Dec. 28, 1995).

The Investment Advisers Act of 1940

The alternative way to regulate the hedge fund industry is to regulate hedge fund advisers. In the United States, the Investment Advisers Act of 1940 (IAA) regulates investment advisers.[54]

The IAA imposes fiduciary duties. One of the most important duties imposed, developed by the Supreme Court of the United States in 1963 in *SEC v. Capital Gains Research*, establishes an "affirmative duty of 'utmost good faith and full and fair disclosure.'"[55] Equally important is the duty of advisers to seek the best execution for their client.[56] Advisers must disclose conflicts of interest, report personal transactions,[57] keep records of their trades,[58] establish, maintain, and enforce a code of ethics,[59] and must not engage in transactions which operate fraudulently,[60] nor make untrue statements of material fact[61] to investors or in their ADV form filed with the SEC.[62]

To ensure hedge funds comply with the various legal requirements imposed upon them, the SEC introduced Rule 206(4)-7. This rule requires each investment adviser registered, or required to register with the Commission, "to adopt and implement policies and procedures reasonably designed to prevent violations of the federal securities laws, review those policies and procedures annually for their adequacy and effectiveness of their implementation, and appoint a Chief Compliance Officer (CCO) to be responsible for administering the policies and procedures."[63] Rule 206(4)-7 placed part of the compliance responsibility on the industry, along with the costs it entails, and away from the SEC, which was lacking resources to examine thousands of registered investment advisers.[64]

---

[54] Investment Advisers Act of 1940, 15 U.S.C § 80b-1–80b-21.
[55] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).
[56] NASD Notice 01-22, 2001 WL 278615 (Mar. 16, 2001).
[57] 15 U.S.C. 80a-4; SEC Books and Records to be Maintained by Investment Advisers, 17 C.F.R. § 275.204-2(a)(12) (2009).
[58] *Id.*, § 204-2.
[59] *Id.*, § 204A-1.
[60] 15 U.S.C. § 80b-1, 80b-6. Note that §206(2) does not require scienter, showing negligence is sufficient.
[61] Levinson v. Basic Inc., 786 F.2d 741 (6th Cir. 1986) (setting the standard that a fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision).
[62] 15 U.S.C. § 80b–7.
[63] Compliance Programs of Investment Companies and Investment Advisers , Investment Company Act Release No. 25,925, Investment Advisers Act Release No. 2107, 79 SEC Docket 1696 (Feb. 5, 2003), *available at* http://www.sec.gov/rules/proposed/ic-25925.htm.
[64] *Id.*

Besides additional costs, internal compliance may also lead to internal conflict of interests. For example, it is the responsibility of the CCO to establish procedures to detect and prevent violations.[65] If these procedures are too stringent, however, they may handcuff the regular course of business. One may also question the conflict of interest a CCO encounters when she detects a fraud. Should she report it at the risk of losing her position? There seems to be an incentive from a CCO's point of view to stay quiet.

In this regard, the SEC's enforcement cooperation initiative, launched on January 13, 2010, which resembles the initiative put forth by the Department of Justice. The initiative should be applauded as it "establishes incentives for individuals and companies to fully and truthfully cooperate and assist with SEC investigations and enforcement actions, and provides new tools to help investigators develop first-hand evidence to build the strongest possible cases."[66]

Hedge fund advisers meet the definition of an "Investment Adviser"[67] and should technically register[68] under the IAA and report to the SEC through Form ADV. Today, a large majority of hedge funds advisers are registered, yet some escape this regulatory oversight. Indeed, Section 203(b) of the IAA provides a list of exemptions from the registration requirement.[69] Hedge fund advisers rely on the *de minimis* exemption of Section 203(b)(3).[70] Under this provision, investment advisers who have fewer than 15 clients during the preceding 12 months, who do not hold themselves out generally to the public, and who are not advisers for a registered investment company, need not be registered, although some advisers choose to do it on voluntary basis.[71] The limit of 15 clients is often regarded as artificial. Under this exemption, for instance, 14 other funds, each representing up to 499 investors, may invest in a hedge fund without triggering a regis-

---

65 *Id.*

66 Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010), *available at* http://www.sec.gov/news/press/2010/2010-6.htm.

67 15 U.S.C. § 80b-2(a)(11) ("'Investment adviser' means 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.").

68 *Id.*, § 80b-3(c). Note that once registered with the SEC, there is no need to register under state laws. *Id.*, § 80b-3A(b).

69 *Id.*, § 80b-3(b).

70 *Id.*, § 80b-3(b)(3).

71 *Id.*

tration requirement on its adviser, because the clients would be the funds and not each individual investor behind these funds.

In 2004, the SEC challenged the term "client" and introduced §203(b)(3)-2(a), the so-called "Hedge Fund Rule."[72] It argued that "client" referred to "investor" and that one should look-through in order to calculate the number of clients.[73] In our example, if 14 funds representing 499 investors each invested in one hedge fund, 6,986 investors would be taken into account. As a result of the introduction of the Hedge Fund Rule, all hedge fund advisers had to register with the SEC by February 1, 2006. However, in June 2006, in *Goldstein v. SEC*, the Court of Appeals for the District of Columbia determined that the Hedge Fund Rule was an "arbitrary" provision.[74]

Yet, as Part II analyzes in greater detail, the mandatory registration of all hedge fund advisers is very likely to become a reality if the Private Fund Investment Adviser Registration Act is enacted. The Act eliminates the "15 client" exemption and compels all investment managers to register under the IAA.

The Securities Act of 1933

Interests in a hedge fund are securities under the definition of §2(a)(1)[75] and under the *Howey*[76] test, which technically makes hedge funds fall under the scope of the Securities Act of 1933 ("the 1933 Act").[77] As previously mentioned, hedge funds cannot hold themselves

---

72 Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

73 *Id.*

74 Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006).

75 Securities Act of 1933, 15 U.S.C. § 77b(a)(1) ("The term 'security' means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.").

76 SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946).

77 15 U.S.C. § 77a.

to the public,[78] engage in general solicitation, or advertise in the absence of a pre-existing relationship.[79]

Therefore, securities may only be offered using the private offering exemption under §4(2) of the 1933 Act.[80] Hedge funds typically use the safe harbor provision of Regulation D's Rule 506[81] to carry out their offering. Using this safe harbor is not mandatory if the conditions of §4(2) are met, although advisers usually prefer Rule 506.[82] It allows them to privately offer securities to a maximum of 35 sophisticated purchasers and an unlimited number of "accredited investors," as defined by Rule 501(a) of the 1933 Act.[83]

The Securities Exchange Act of 1934

Hedge funds typically do not need to register under the Securities Exchange Act of 1934 ("1934 Act") because they are regarded as traders.[84] If they were treated as dealers,[85] they would have to register under §15b of the 1934 Act.[86] The Exchange Act contains antifraud provisions (§10b and Rule 10b-5) that apply to all investment advisers, whether registered or not.[87] These provisions impose a fiduciary duty to disclose material facts and prohibit material misstate-

---

78 SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (establishing the test to determine if an offering is public or private. One must check if investors are able to fend for themselves to determine if the offering is private.

79 Although general solicitation is prohibited, this remark needs to be moderate as more flexible provisions exist. For instance, advertising using models for instance is not prohibited *per se* like it used to be. In its Clover Capital Management No-Action Letter, the SEC presents eleven factors that provide guidance on how to deal with models. Clover Capital Mgmt. Inc., SEC No-Action Letter, 1986 WL 67379, at *3 (Oct. 28, 1986). These models do not constitute a safe harbor. *Id.* Another example is the use of a website which destroys the private offering exemption. This is considered as general solicitation unless the website has a password restricted access available to accredited investors only and there is a quiet period long enough to establish a preexisting relationship prior to the offering.

80 15 U.S.C. § 77d(2). Rule 901 of Regulation S provides that an offer is not deemed to include offers which occurred outside the United States for the purposes of Section 5 of the 1933 Act. Regulation S, Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. 230.901 (2005).

81 Regulation D, 17 C.F.R. 230.506 (2009).

82 SEC STAFF REPORT, *supra* note 4, at 14.

83 17 C.F.R. 230.501.

84 SEC STAFF REPORT, *supra* note 4, at 18.

85 15 U.S.C. § 78c-(a)(1). The SEC stated in its 2003 staff report that some hedge funds are registered as dealers. SEC STAFF REPORT, *supra* note 4, at 18. For a definition of "dealer" under the Exchange Act, see 15 U.S.C. § 78c-(a)(5).

86 SEC STAFF REPORT, *supra* note 4, at 18.

87 15 U.S.C. § 78j-(b).

ments and omissions. Moreover, registered funds are subject to periodic requirements under §13,[88] proxy rules under §14,[89] and insider reporting requirements and short swing profits transactions rules under §16 of the 1934 Act.[90]

Other Regulatory Requirements

In addition to complying with federal securities laws, hedge funds may be required to comply with federal laws, rules, and regulations.[91] For example, a hedge fund that engages in a single commodity futures transaction is subject to the Commodity Exchange Act and the rules promulgated by the Commodity Futures Trading Commission (CFTC).[92] In addition, the National Association of Securities Dealers (NASD) requires broker-dealers selling hedge funds to comply with five sets of principles under NASD rules.[93] Furthermore, the Employment Retirement Income Security Act (ERISA) requires investment advisors to be subject to the restrictions of an ERISA fiduciary if more than 25% of the value of any class of equity interest in the hedge fund is held by an employee benefit plan.[94]

Hedge funds are also subject to several Treasury Department regulations.[95] For example, hedge funds with a large position in U.S Treasury securities or foreign currencies positions above a designated dollar equivalent threshold must be reported to Federal Reserve Bank of New York.[96] Moreover, hedge funds are financial institutions subject to the anti-money laundering requirements set out in Section 352 of the USA PATRIOT Act of 2001,[97] which compels hedge funds to develop internal control programs, to designate a compliance officer, to set an ongoing employee training program, and to have an independent audit to test the program.[98]

---

[88] 15 U.S.C. § 78m. In particular, hedge funds are subject to beneficial ownership reporting under §13(d) and 13(g) and to quarterly reporting requirements under § 13(f) when accounts exceed $100 million in fair value. *Id.*

[89] 15 U.S.C. § 78n.

[90] 15 U.S.C. § 78p.

[91] SEC STAFF REPORT, *supra* note 4, at 23.

[92] *Id.* Certain individuals providing futures advice to a hedge fund may be exempt from portions of the Commodity Exchange Act's operational requirements if they comply with the requirements of CFTC Rule 4.7. *See* 17 C.F.R. § 4.7 (2010).

[93] SEC STAFF REPORT, *supra* note 4, at 25.

[94] *Id.* at 28; *see* ERISA Rule 3-101 29 C.F.R. § 2510.3-101 (2010).

[95] SEC STAFF REPORT, *supra* note 4, at 23.

[96] *Id.* at 29-30.

[97] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56, § 352, 115 Stat. 272, 322.

[98] SEC STAFF REPORT, *supra* note 4, at 30, n. 108.

Finally, hedge funds may also be subject to state laws known as "Blue Sky" laws. Even though state laws do not regulate hedge funds' operations, states may regulate advisers, offers, and sales of interests and may impose additional and stricter antifraud provisions[99] and notice filing requirements.[100] For example, Connecticut is currently considering imposing new reporting requirements on state-based hedge funds.[101]

1.2.2 The European Union

Investment funds in the EU are classified into two categories. The first category consists of funds that meet and follow the requirements set by the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and are authorized to sell to the retail market.[102] The second category is the default category and encompasses all non-UCITS funds, including hedge funds, private equity funds, commodity funds or real estate funds.[103] These investments are regarded as entailing risk levels unsuitable for retail investors.[104] Access to these funds is therefore limited to sophisticated, professional, and institutional investors.[105] In addition, non-UCITS funds do not benefit from the EU passport that would allow them to market throughout the internal market.[106]

The graph below illustrates the evolution of the assets under management in Europe in UCITS, in non-UCITS funds, and, within the non-UCITS category, in hedge funds.[107]

At the end of 2009, the approximately 1,400 European-based hedge funds estimated that their EU managed assets amounted to $382 billion[108] (23% of the global market share) while assets domiciled

---

[99] *See* N.Y. General Business Law §§ 353, 358 (McKinney 2011). The Martin Act of 1921 empowers the New York State Attorney General to bring both civil and criminal actions for financial fraud.

[100] SEC STAFF REPORT, *supra* note 4, at at 30-31.

[101] *Connecticut Considers State Hedge Fund Regulation*, FINALTERNATIVES, Feb. 26, 2010, http://www.finalternatives.com/node/11579.

[102] Press Release, European Union, Financial Services: Commission Proposes EU Framework for Managers of Alternative Investment Funds (Apr. 29, 2009), *available at* http://europe.eu/rapid/pressReleasesAction.do?reference=IP/09/669. Directive 85/611/EEC came into force in 1987 and was amended in 2004 and 2007.

[103] *Id.*

[104] *Id.*

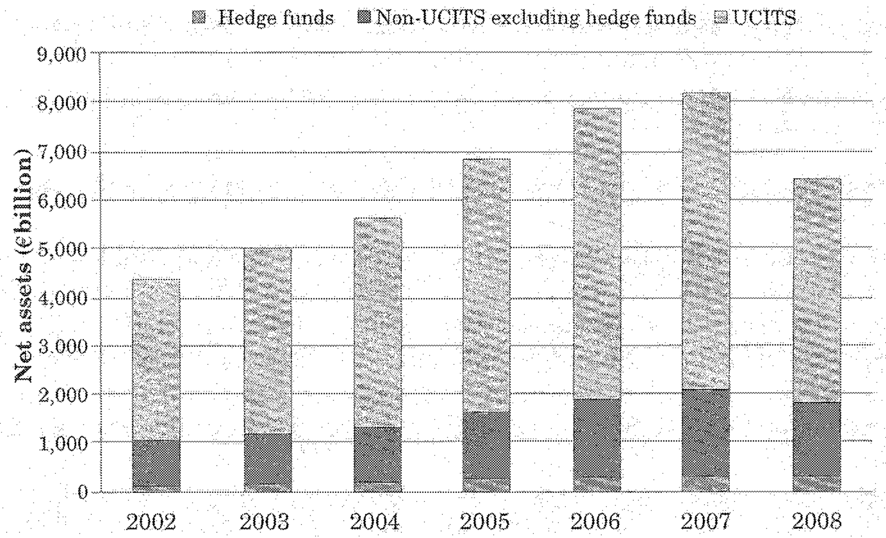
[105] *Id.*

[106] *See, e.g.*, CHARLES RIVER ASSOCS., IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE 43 (2009), *available at* http://www.crai.com/ProfessionalStaff/AuxListingDetails.aspx?id=11778&fID=34.

[107] *Id.* at 11.

[108] IFSL RESEARCH 2010, *supra* note 1, at 2-3.

FIGURE 1. VALUE OF ASSETS UNDER MANAGEMENT FOR UCITS AND NON-UCITS FUNDS MANAGED IN EUROPE



Source: European Fund and Asset Management Association (EFAMA), Hedge Fund Research (HFR) and CRA.

in the EU roughly amounted to $84 billion.[109] There is a large discrepancy between the amount of assets managed in the U.K. and the amount of assets domiciled in the U.K. Although the U.K. is a major hub for hedge fund managers, the funds themselves are often located offshore for tax reasons.[110] These figures are indicative of what regulators should target in the EU.

Because regulations are promulgated on the national level, regulation varies across EU member states. The United Kingdom approach focuses on regulation of investment advisors only.[111] Germany, on the other hand, only regulates funds, while France and Italy regulate both investment advisors and the funds themselves.[112] Although some convergences may be observed on the types of documents required,[113] many features of hedge fund regulation[114] also differ be-

---

[109] CHARLES RIVER ASSOCS., *supra* note 106, at 13. This data has been converted from Euro to USD as of October 31, 2009.

[110] *Id.* at 108. *See* IFSL RESEARCH 2010, *supra* note 1, at 8.

[111] *See* IFSL RESEARCH 2010, *supra* note 1, at 8.

[112] *See Id.*

[113] *See* HEDGE FUNDS REGULATION IN EUROPE, *supra* note 22, at 6. A survey conducted in 2005 showed that member states require the same information documents specified in Directive 85/611 for UCITS.

[114] Note that funds of hedge funds regulations ("FoHF") also vary from country to country. However, FoHFs are beyond the scope of this paper.

tween EU member states. For example, Italy imposes a minimum subscription of _500,000 for hedge fund investors, France has various monetary thresholds and qualitative requirements depending on the type of fund and its legal form, and Germany has neither monetary nor qualitative requirements for hedge fund investors.[115]

1.2.3 The United Kingdom

After the state of New York, London is the world's second largest center for hedge fund management and the leading center in Europe.[116] The U.K. hedge fund sector employed approximately 40,000 people and managed approximately $382 billion in hedge fund assets in 2009, which represented 21% of global hedge fund assets and 76% of European hedge fund assets.[117] In the U.K., hedge fund regulation focuses on the regulation of hedge fund managers who must seek the authorization of the Financial Services Authority (FSA) pursuant to § 19 of the Financial Services and Markets Act of 2000. As mentioned above, the U.K. is not a domicile of choice for hedge funds because of its tax regime,[118] although some hedge funds do exist in this jurisdiction.[119]

The FSA has a broad, principle-based and approach to regulation that is very different from the American rules-based and hedge fund-specific approach. This means that every regulated entity must follow the eleven "Principles for Business" of the FSA Handbook of

---

[115] Associazione Italiana Del Risparmio Gestito and European Fund and Asset Management Association, *Hedge Funds Regulation in Europe: A Comparative Survey*, November 2005, *available at* http://www.assogestioni.it/index.cfm/3,154,562/05_250845_efama_hdgfnd_rprt_1.pdf; HEDGE FUNDS REGULATION IN EUROPE, *supra* note 22, at 6.

[116] IFSL RESEARCH 2010, *supra* note 1, at 1-3.

[117] *Id.*

[118] PHOEBUS ATHANASSIOU, HEDGE FUND REGULATION IN THE EUROPEAN UNION: CURRENT TRENDS AND FUTURE PROSPECTS, 146, n. 104 (2009). U.K domiciled funds are liable for U.K Corporation tax on income plus chargeable capital gains.

[119] In the U.K., hedge funds may take several forms and can be broadly divided into two categories: FSA-authorized funds and unauthorized funds. Authorized funds typically fall into two legal structures: Authorized Unit Trusts ("AUTs") (Financial Services and Markets Act of 2000) and Investment Companies with Variable Capital ("ICVCs") (Open-Ended Investment Companies Regulations of 2001). Within the authorized funds category, a specific form may be chosen. Hedge fund managers may decide within one of the above-mentioned legal forms to set up a "Qualified Investor Scheme" ("QIS"), introduced in 2004 and not available to the general public, a "Futures and Options Fund" ("FOF"), or a "Geared Futures and Options Fund" ("GFOF"), which is available to the general public through the Non-UCITS Retail Scheme category. Unauthorized funds may take the form of an Unauthorized Unit Trust or of a closed-ended corporation.

Rules and Guidance.[120] These principles are not intended specifically for hedge funds but for all FSA-regulated entities. This led to the creation of the Hedge Fund Working Group, whose goal was to provide the industry guidance on what the FSA Principles should mean for hedge fund managers.[121] Provided that these principles are properly enforced, hedge fund managers are relatively free to carry out any type of strategy because there is no particular constraint on investments. Notwithstanding the above, U.K. hedge fund advisers are subject to MiFID[122] capital adequacy rules based on their activities, while hedge funds themselves are not.[123]

The FSA's approach to supervision of hedge fund managers is risk-based. It conducts periodic risk assessments through a process called ARROW II,[124] during which the FSA examines various elements such as management, governance, financial reports or the amount of capital held, or targets a specific issue.[125] Enforcement follows an outcome-based approach where the FSA assesses *ex post* the decisions made by managers, and then take enforcement action if needed.

Finally, similar to other jurisdictions, it is generally prohibited to market unregulated collective investment schemes and regulated "Qualified Investor Schemes" to the general public,[126] which may only be promoted to eligible investors after ensuring the investor's wealth and sophistication.

1.2.4 France

In France, hedge funds are known as *fonds spéculatifs* or *fonds alternatifs*. Hedge funds were introduced in France with funds investing in futures, *Fonds Communs d'Intervention sur les Marchés à Terme* (FCIMT).

---

[120] FSA, FSA Handbook,http://fsahandbook.info/FSA/html/handbook/PRIN/2/1.

[121] *See, e.g.*, Stuart J. Kaswell & Paul N. Roth, *The Changing Regulatory Framework for Hedge Funds and Managers*, *in* HEDGE FUNDS 2009, at 91, 111 (PLI Corporate Law & Practice, Course Handbook Series No. 18643 2009).

[122] Council Directive 2004/39 2004 O.J. (L 145/1).

[123] Martin Cornish, *in* INTERNATIONAL GUIDE TO HEDGE FUND REGULATION 491 (Martin Cornish & Ian Mason eds., 2009).

[124] FSA, Operating Framework, http://www.fsa.gov.uk/pages/About/What/Approach/Framework/.

[125] *Id.* at 510; Martin Cornish, *in* INTERNATIONAL GUIDE TO HEDGE FUND REGULATION 491 (Martin Cornish & Ian Mason eds., 2009).

[126] An unauthorized person acting in the course of business must not communicate an invitation or inducement to engage in investment activity in the UK unless an exemption applies. Financial Services & Markets Act (FMSA), 2000, c. 8, § 21 (Eng.). The promotion of collection investment schemes are restricted to the general public. *Id.*, § 238.

In 2003, the Financial Security Act[127] set up a legal framework by creating two additional legal schemes: *OPCVM ARIA*,[128] whether leveraged or unleveraged (undertaking for collective investment in transferable securities with simplified investment rules), and *OPCVM contractuels*[129] (contractual undertaking for collective investment in transferable securities). Hedge funds may operate through these legal forms[130] that are regarded as non-UCITS funds under European Law. The sales of hedge fund units or shares are subject to a general prohibition of solicitation[131] and they cannot be accessed unless various criteria are met, especially in respect to "qualified investors." These criteria are defined by decree[132] and codified in Article D.411-2 of the *Code monétaire et financier* (Monetary and Financial Code).[133]

Natural persons may invest in hedge funds whatever their legal form, if allowed to, by being registered on records by the AMF or if at least two of the following criteria are met: (i) the size of the investor's financial instruments portfolio exceeds €500,000; (ii) the investor has carried out transactions which amounted €600 each at an average frequency of at least ten per trimester over the previous year; or (iii) has worked for at least one year in the financial sector in a position that requires knowledge of securities investment.

Retail investment to hedge funds, though limited, is possible under certain circumstances.

The following chart summarizes the French legal framework and aims at providing a clearer picture of a complex environment.

---

[127] Financial Security Act (Loi de Sécurité Financière), Law No. 2003-706 of Aug. 1, 2003 [hereinafter FSA].

[128] Monetary and Financial Code (Code Monétaire et Financier), arts. L.214-34 & L.234-35-1 (2005), *available at* http://195.83.177.9/code/liste.phtml?lang=uk&c=25&r=7606 hereinafter MFC].

[129] MFC arts. L.214-35-2–234.35-6 (2005), *available at* http://195.83.177.9/code/liste.phtml?lang=uk&c=25&r=7607.

[130] *See* Jean François Adelle, *France*, *in* INTERNATIONAL GUIDE TO HEDGE FUND REGULATION, *supra* note 123, at 112.

[131] MFC Article L341-1 provides a definition of Banking and Financial Solicitation. MFC art. L341-1. Contacts with Qualified Investors qualify as exemptions from the general prohibition on solicitation.

[132] Decree n°2007-904 May, 15 2007 which came into force on November 1, 2007.

[133] MFC, art. D.411-2.

Legal form	Access	Information provided	Operations	Role of the AMF
FCIMT (funds investing in futures)	Qualified Investors MFC art. D.411-2. + non qualified individual investors whose initial subscription amounts €10,000 or more.[134] The person who signs the prospectus must ensure that these conditions are met.	Investors must acknowledge that they receive proper warning that FCIMT are to be considered as hedge funds, entail risks of significant loss and are available to a certain category of investors.[135] Investors receive a detailed note and a copy of the fund's rules upon subscription[136] as well as quarterly statement whose content is set by the AMF.[137]	Diversification 10% ceiling on securities issued by the same issuer except if the issuer is an OECD member state.	Subject to the requirement of prior AMF operational license.
Unleveraged OPCVM ARIA	Qualified Investors[138] + list set by Article 413-2 of the MFC. Non qualified investors may access if > initial subscription of €125000 or more > initial subscription of €10,000 or more when hold total of €1million or more in deposits, life insurance products and financial instruments > initial subscription of €10,000 or more and professional position for a year at least enabling to acquire sufficient knowledge.	Investors must acknowledge that they receive proper warning that OPCVMs are available to a certain category of investors[139]. Investors receive a prospectus that must be approved by the AMF. The liquidative value must be provided every month.[140]	Exemptions from the risk diversification requirement applicable to standard OPCVMs. May invest their assets in: > Up to 35% in stocks issued by the same issuer > Up to 50% in the same collective investment scheme. > Up to 20% in French or foreign alternative funds > Up to 50% in other financial instruments Leverage of two	Subject to the requirement of prior AMF operational license. Programs of operations need not be approved by the AMF

134 AMF General Regulation, Article 416-2 Autorité Des Marchés Financiers Gen. Reg., art. 416-2.
135 *Id.*, art. 416-5.
136 *Id.*, art. 411-51.
137 *Id.*, art. 416-10.
138 MFC art. D.411-2.
139 Autorité Des Marchés Financiers Gen. Reg., art. 413-6.
140 *Id.*, art. 413-10.

Leveraged OPCVM ARIA			May invest their assets in: > Up to 35% in stocks issued by the same issuer > Up to 50% in the same collective investment scheme. > Up to 50% in other financial instruments Leverage of four Counterparty ratio: 50%	Subject to the requirement of prior AMF operational license. Programs of operations need to be approved by the AMF
Contractual OPCVM	Qualified Investors[141] + non qualified investors if > initial subscription of €250000 or more > initial subscription of €30,000 or more when hold total of €1million or more in deposits, life insurance products and financial instruments > initial subscription of €30,000 or more and professional position for a year at least enabling to acquire sufficient knowledge	Investors must acknowledge that they receive proper warning that OPCVMs are available to a certain category of investors. Investors receive a prospectus that need not be authorized by the AMF. The liquidative value must be provided every three months.	May invest in any type of financial instruments, French or foreign, provided that investors are given suitable information and that a special program of operations has been approved by the AMF. No leverage limit, freely defined in prospectus	Contractual OPCVMs must register with the AMF within one month after being set up. The AMF approves the fund's programs of operations. Doesn't verify and authorize prospectuses.

In addition to these provisions, French hedge funds, like those in the United States, are subject to antifraud provisions pursuant to the European Directive 2003/6/EC on insider dealing and market manipulation.[142] They are also subject to national provisions detailed in the AMF General Regulation. The AMF also introduced Conduct of Business rules for portfolio management companies, which are enforced by its *Commission des sanctions* in the event of a breach.[143] These rules address conflicts of interest, due skill, care and diligence, and integrity of the market, to name a few examples.[144]

---

[141] MFC art. D.411-2.

[142] *See, e.g.*, CEFIC, THE CHEMICAL INDUSTRY COMMENTS ON THE COMMISSION CONSULTATION ON THE REVIEW OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE 5 (2011), *available at*http://www.cefic.org/Documents/PolicyCentre/Cefic_Comments_Markets_Financial_InstrumentI_Directive_MIFID_.pdf.

[143] Autorité Des Marchés Financiers Gen. Reg., arts. 313-10 & 313-14.

[144] *Id.*

Though they are not as regulated as other investment vehicles, French hedge funds must register and are regulated to a certain extent.[145] Although the control exercised by the AMF appears to be beneficial from an investor protection point of view, it may also be one of the reasons for the lack of competitiveness and dynamism of the French hedge fund market.

1.2.5 Italy

In Italy, hedge funds are referred to as *fondi speculativi*[146] and may be open or close-ended. Italy is a dynamic market for hedge funds and was one of the first jurisdictions to adopt specific hedge fund rules in a Treasury Ministry Decree in May 1999 that was modified in 2000, 2003, and 2005 and developed through regulations of the Bank of Italy.[147] By 2005, the Italian hedge fund market consisted of 161 funds and was worth €17 billion.[148]

A flexible legal environment, beneficial to hedge funds, may explain this dynamism. Like France, Italy requires investment advisers to be authorized by the Bank of Italy,[149] and hedge funds themselves cannot be distributed unless they have received the authorization of the market regulator, the *Commissione Nazionale per le Società e la Borsa* ("COSOB").[150] While advisers are subject to capital requirements, hedge funds themselves are not. Foreign non-UCITS funds

---

[145] *See, e.g.*, Bfinance, Hedge Fund Observer: Despite a National Regulation, the French Hedge Fund Industry is Primarily About Multimanagement, http://www.bfinance.co.uk/content/view/12007/1000242/.

[146] *See, e.g.*, ALTERNATIVE INV. MGMT. ASSOC., A SURVEY INTO THE ITALIAN HEDGE FUND MARKET, FROM A PARTICIPANT'S PERSPECTIVE 7 (2006) [hereinafter AIMA SURVEY].

[147] Regolamento recante norme per la determinazione dei criteri generali cui devono essere uniformati i fondi comuni di investimento*(adottato dal Ministro del tesoro, del bilancio e della programmazione economica con decreto del 24 maggio 1999, n. 228 e successivamente modificato con decreto del 22 maggio 2000, n. 180; con decreto del 31 gennaio 2003, n. 47 e con decreto del 14 ottobre 2005, n. 256, available at:* http://www.consob.it/main/documenti/Regolamentazione/normativa/mt228n.htm; Provvedimento della Banca d'Italia, Regolamento sulla gestione collettiva del risparmio, April 14, 2005 *available at*: http://www.bancaditalia.it/vigilanza/intermediari/normativa/sgr_oicr/provv/Regolamento.pdf.

[148] Cristina Calderoni, *Hedge Funds in Italy: An Update* (2006), *available at*: http://www.aima.org/en/knowledge_centre/education/aima-journal/past-articles/index.cfm/jid/4E211FB5-FEE2-480C-868576C66BA41EA5.

[149] AIMA SURVEY, *supra* note 146, at 7.

[150] *E.g*,, CONSOB—What It Is and What It Does, http://www.consob.it/mainen/consob/what/what.html?symblink=/Mainen/consob/what/index.html.

that want to distribute in Italy must comply with the same authorization requirements.[151]

Typically, hedge funds are managed by *Società di Gestione del Risparmio* (SGR), which, until June 2007, had to be speculative SGRs.[152] This requirement has since been removed,[153] allowing common SGRs to now manage hedge funds.[154]

In order to secure authorization, funds must disclose specific warnings and information. This includes the fund owned asset class and the procedure related to the investors' access.[155] But, unlike French regulation, this authorization, once granted, allows Italian funds to invest in any type of financial instruments and use any investment strategy, without constraints set by the Bank of Italy or portfolio diversification requirements.[156]

Italy also prohibits marketing to the general public.[157] An investor cannot invest in a hedge fund if the initial subscription is below a threshold of €500 000.[158] Until recently, Italian law also provided that hedge funds could not have more than 200 investors, but this provision has been repealed, and today there is no restriction on the maximum number of investors.[159]

Consequently, Italian hedge funds are very lightly regulated and may carry out any investments they want, provided that they find investors who can satisfy the €500,000 initial investment requirement.

1.2.6 Germany

Sondervermögen mit zusätzlichen Risiken ("Hedgefonds") (special investment schemes with additional risks) have a new legal framework since the *Investmentgesetz* (InvG),[160] which governs German collective investment schemes, came into force in 2004.

---

151 *See, e.g.*, CAPITAL MARKETS: SECURITIES MARKET REGULATION, INT'L FIN. L. REV., Apr. 8, 2002, http://www.iflr.com/Article/2027190/Channel/193438/Capital-markets-Securities-market-regulation.html.

152 KPMG, ITALY: REGULATION 1 (2010), *available at* http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/Hedge-funds-2010/Italy-HF-Regulation-2010.pdf.

153 *Id.*

154 *Id.*

155 *Id.* at 2.

156 ATHANASSIOU, *supra* note 118, at 134.

157 KPMG, *supra* note 152, at 3.

158 *Id.* at 2.

159 *Id.* at 3.

160 Investmentgesetz [Investment Act], Jan. 1, 2004 (F.R.G.), *available at* http://bundesrecht.juris.de/invg [hereinafter InvG]. The main provision on hedge fund may be fund at Section112 (Chapter 4). InvG § 112.

Unlike other jurisdictions, German law provides its own legal definition of the term hedge fund: "A fund is considered a hedge fund if it uses either leverage or short selling strategies or both and is not restricted in the choice of its assets."[161]

German hedge funds may take two legal forms. They can either be structured as investment funds (contractual form) managed by an investment management company[162] or as investment stock corporations (corporate form).[163] In Germany, hedge funds need to obtain the written license of the regulator *Bundesanstalt für Finanzdienstleistungsaufsicht* ("BaFin") prior to taking up any business.[164] Whether contractual or corporate, hedge funds may only market and distribute through private placement.[165] Additionally, they must follow the rules applicable to prospectuses, which must be written, contain the fund rules, and contain a warning for the possibility of total loss.[166] BaFin must approve the contractual terms.[167] Similarly, foreign funds can only be sold to German investors in a private placement.

German hedge funds are subject to minimum capital requirements,[168] but advisers are not. The rationale behind capital requirements is the same as for banks. It provides a "cushion against existing obligations when asset values sharply decline."[169] Like any fund, they

---

161 Harald Plewka & Barbara Schmid, *Germany*, *in* INTERNATIONAL GUIDE TO HEDGE FUND REGULATION, *supra* note 123, at 131-32 (quoting Article 112 of the InvG).

162 *See* InvG § 30. Note that in the contractual form, hedge funds are a separate estate owned by investors and which needs to be managed by an investment management company. The corporate form on the other hand is a uniform legal estate, which can manage clients' money on its own.

163 *Id.*

164 InvG §§ 7, 97.

165 *See, e.g.*, SHEARMAN & STERLING LLP, NEW GERMAN RULES FOR HEDGE FUNDS AND FOREIGN FUNDS: AMENDED PROPOSALS AFTER FINANCE COMMITTEE HEARING 3 (2003), *available at* http://www.shearman.com/files/Publication/cbf1a7ec-4622-4db3-9d61-66ba151a7aa3/Presentation/PublicationAttachment/299dbcf6-30f5-4417-9302-6ce0fc94a60a/AM_1003.pdf.

166 *Id.*

167 InvG §§ 7, 97.

168 *See* Plewka & Schmid, *supra* note 161, at 133.

169 HAL SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION 884 (16th ed. 2009). Note, however, that a distinction must be made between capital reserves and liquidity reserves. Indeed, as demonstrated in Rama Cont, Amal Moussa, & Andreea Minca, *Too Interconnected to Fail: Contagion and Systemic Risk in Financial Networks* (Columbia Ctr. for Fin. Eng'g, Working Paper, 2009). "[W]hen Bear Stearns defaulted in 2008, its capital reserve where above the minimal regulatory capital required by Basel II, but was not available (liquid) for meeting margin call." The authors argue that imposing liquidity reserves ratios

must comply with the principle of risk diversification, although no formal limits are imposed upon them. They also enjoy a very flexible legal environment in terms of investment strategies. The use of leverage and derivative-based transactions are not controlled, which is quite similar to the Italian legal framework. However, Plewka and Schmid note that the InvG empowers the Ministry of Finance to restrict the use of leverage and short-selling transactions by an executive order in order to prevent abuse and protect the integrity of capital markets.[170]

Moreover, unlike hedge fund regulation in Italy, the type of assets in which German hedge funds may invest in is restricted. For instance, hedge funds may not invest in raw materials or in real property.[171] Likewise, they may not invest more than 30% of the value of the fund in equity interests in businesses that are not listed on a stock exchange.[172] Additionally, they may not invest more than 50% of the net assets in another hedge fund in which not more than 10% are held by a single fund.[173]

Finally, in Germany there is no qualitative requirement or quantitative threshold restricting access to hedge funds, unlike other jurisdictions.

As this quick overview and the following chart demonstrate, there is no common approach between the EU and the United States. The current legal regimes applicable to hedge funds are determined on a national level, even within the EU, where one might expect a uniform approach.

Jurisdiction	Regulation[174] of hedge funds	Regulation of hedge fund advisers
United States	X *(Investment Company Act exemption)*	X *(if meet the criteria of the Investment Advisers Act exemption)*
United Kingdom	X	✓
France	✓	✓
Germany	✓	X
Italy	✓	✓

reduces the probability of large systemic losses and reduces default contagion and that it should be the tool used to regulate contagion and systemic risk. *Id.*

170 Plewka & Schmid, *supra* note 161, at 134.

171 InvG § 67(1).

172 *Id.*, § 67(4).

173 *Id.*, § 112.

174 As demonstrated in this section, the term "regulation" designates different realities and the degree to which funds or advisers are regulated varies a great deal from one country to the other.

If there is one common belief shared by regulators and politicians on both sides of the Atlantic, it is the idea that hedge funds are potentially problematic entities because they are insufficiently regulated. Still, disagreements have emerged and two factions seem to exist. On one side is the U.S.-U.K. approach, while on the other is the EU-dominant France-Germany axis. The idea that hedge funds should be regulated comes from excessive criticism as well as from valid concerns about market stability.

2. Criticisms and Concerns in the Context of the Current Crisis Have Led Governments to Take Action

2.1 Hedge Funds Are Criticized Investment Vehicles

There is a global consensus that hedge funds did not cause the recent financial crisis. According to the International Financial Services London (IFSL), only around 5% of hedge fund assets were invested in mortgage-backed securities in September 2007.[175] Although they were the victims, not the perpetrators, hedge funds were demonized and treated as scapegoats.

The industry suffers from bad press and prejudices. Misleading, but widely distributed, essays based on neither legal nor scientific facts have described hedge funds' activities as "criminal activities" based on insider trading.[176] This bad press mayalso be due to political leaders' attacks on hedge funds. Hedge funds are often associated with volatility, short selling,[177] empty voting,[178] short-termism, activism, tax avoidance,[179] and risky behaviors with the potential to affect market stability. Although some of these criticisms are not without merit, the way hedge funds function and their role in the markets are often misunderstood and reduced to the shareholder activism context.

---

[175] IFSL RESEARCH 2009, *supra* note 42, at 7; www.ifsl.org.uk

[176] JOHN R. TALBOTT, THE 86 BIGGEST LIES ON WALL STREET 202-203 (2009).

[177] Events in October 2008 provide a good example of how hedge funds use and may suffer from short selling. Hedge funds lost an estimate of $15 billion in a few hours based on their large short positions in Volkswagen's stock, which soared to more than _1000 due to a Porsche takeover attempt through cash-settled options. For more details see *e.g* A.Gennarino, R.Roman, & A.Rivière, *Investment Opportunities in Germany, France, and the U.K. in Replication of the VW/Porsche Strategy,* Harvard Law School (International Finance, Markets and Firms paper under the supervision of Professor Mihir Desai), 2009, at 10.

[178] *See, e.g.*, Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007).

[179] The tax avoidance argument that frowns upon the existence of offshore funds is not really justified, because contrary to a general belief, offshore funds are not designed to circumvent taxation but rather to provide investment opportunities to individuals who are already tax-exempt, such as foreign investors.

Indeed, the general public has become aware of the existence of hedge funds essentially through takeover attempts extensively reported in newspapers. This has contributed to the development of a generalized anti-hedge fund sentiment and has led the general public, namely voters in the United States or Europe, to call for more regulation. As a result, the industry is under heavy fire from global leaders.

Thus, this call for stricter rules to govern hedge funds may result more from a political fear of criticism than from an actual need. More generally, there seems to be a structural divergence between what political agendas dictate and what the markets and economic growth require. Politicians have a strong incentive to adopt populist measures because they increase their chances of getting reelected in the short term. Markets and growth, however, require pragmatic and long term-oriented measures that may not always look appealing from a political perspective. This is particularly true in the present context, where electors call for action and for moralization of financial markets. As John C. Coffee stated, "[h]istorically, bubbles are followed by crashes, which in turn are followed by punitive legislation."[180]

In the aftermath of the 2007 crisis, hedge funds were no exception to this statement. President Barack Obama called them "speculators" who were "refusing to sacrifice like everyone else" and who wanted "to hold out for the prospect of an unjustified taxpayer-funded bailout."[181] No hedge fund, however, was ever bailed out. The President's comments were criticized by Congressman Scott Garrett, who believed the comments revealed a fundamental misunderstanding of the clients and of the fiduciary responsibilities of hedge fund managers.[182] German Chancellor Angela Merkel and French President Nicolas Sarkozy have also joined forces combating hedge funds.[183] Given the lack of restrictions for retail investors to invest in hedge funds in Germany, one could understand the Chancellor's concerns, although hedge funds do nothing except what they are legally allowed to in this jurisdiction. President Sarkozy, who urged for more regulation in an already heavily regulated environment, said that one "can't tolerate hedge funds buying a company with debt, firing a quarter of the staff

---

[180] John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms* 46 (Columbia Law School Ctr. for Law & Econ. Studies, Working Paper No. 237, 2003), *available at* http://ssrn.com/abstract=447940.

[181] Steven Mufson & Tomoeh Murakami Tse, *In Chrysler Saga, Hedge Funds Cast As Prime Villain*, WASH. POST, May 1, 2009, at A14.

[182] *Perspectives on Hedge Rund registration: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 111th Cong. 2-4 (statement of Rep. Scott Garrett, Member, H. Comm. on Financial Services), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/111-29.pdf [hereinafter Garrett Testimony].

[183] *See, e.g.*, *UK Suffers Hedge Fund Blow*, FIN. TIMES, May 14, 2010, at 1.

and then enriching themselves by selling it in pieces. We didn't create the euro to have capitalism without ethics or morals."[184] Particularly in Europe, there seems to be a sociological pattern to regard hedge funds as a major threat, symbolizing wild capitalism and greed.

Such passionate and intransigent positions focusing only on hedge fund as activists could be avoided. The industry, along with political leaders, must properly educate the public on what hedge funds do and what their role in the financial crisis really was. As Troy Paredes noted, "the abuses and collapses that have punctuated the industry are not indicative of widespread hedge fund behavior. . . . [T]he vast number of hedge fund managers are disciplined traders who make informed, although risky, trades."[185]

In fact, according to the IFSL, hedge funds suffered from the collapse of banks in the United States. In Europe, hedge funds suffered from the falls in equity markets, from bans on short-selling, and from pressure to liquidate positions to meet margin and redemptions calls.[186]

Despite these market conditions, hedge funds outperformed many of the underlying markets, such as the S&P Index, which saw a 38% drop.[187] The 2009 global return for hedge funds is back to 19% from -13.9% in 2008.[188] Gareth Murphy from the Bank of England noted, "the sector was free of moral hazard in the sense that the crisis had not resulted in the public bailout of a single hedge fund."[189] This being said, one cannot deny that some of the criticisms and concerns addressing hedge fund industry are fair, and may, to a certain extent, justify that some action be taken.

2.2 Systemic Risk

2.2.1 Hedge Funds May Raise Concerns in Terms of Systemic Risk

Hedge funds may be a source of systemic risk and lead to chain reactions beyond the hedge fund industry, potentially creating a threat to the entire financial system. Although one often draws a parallel between the size of the fund and its potential impact in terms of systemic risk, the "absolute size of an institution is not the predicate for sys-

---

[184] Ambrose Evans-Pritchard, *Sarkozy Turns on "Predator" Hedge Funds*, DAILY TELEGRAPH, May 1, 2007, at 7.

[185] Paredes, *supra* note 45, at 3.

[186] IFSL RESEARCH 2009, *supra* note 42, at 1.

[187] *Id.*

[188] IFSL RESEARCH 2010, *supra* note 1, at 3-4.

[189] EU *Commission* E.U. Commission Open Hearing on Hedge Funds and Private Equity Before European Union Commission 11 (2009), *available at* http://ec.europa.eu/internal_market/investment/docs/conference/summary_en.pdf [hereinafter E.U. Commission Hearing].

temic risk; it is rather the size of its debt, its derivatives positions, and the scope and complexity of many other financial relationships running between the firm, other institutions, and the wider financial system"[190] that must be evaluated in order to determine to what extent the fund poses a systemic risk. Indeed, the failure of LTCM, a hedge fund worth $4 billion, posed a systemic risk because of its exposure to banks. On the other hand, the failure of Amaranth, which was worth more than double that of LTCM ($9.5 billion), had no systemic impact.[191]

Most of the risks that arise from hedge fund operations and strategies are hedge fund-specific,[192] such as operational risk, or fraud. One should be careful not to draw hasty conclusions, as not all risks are systemic. Indeed, "[i]f, for example, a hedge fund is pursuing a high risk contrarian strategy, then it is probably lowering systemic risk."[193]

As the Bank of France noted in a study on hedge funds in 2007, only sophisticated investors are exposed to these types of risk, and therefore strong regulation is not needed to address them from an investor protection perspective. However, in its paper on hedge funds, the European Central Bank noted that hedge funds may affect financial stability through different channels.[194]

The first of these channels is the *credit channel*, or the repercussions of hedge funds' failures on exposed banks. The LTCM debacle in 1998 illustrated this channel. A study carried out by the Bank of France estimates that 17 banks would have collectively lost three to five billion dollars if LTCM had not been bailed out.[195] Several elements may explain this hedge fund's failure. These elements include the use of derivatives, questionable investment decisions, a leverage

---

[190] *Implications of the "Volcker Rules" for Financial Stability: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 3 (2010) (statement of Hal Scott, Nomura Professor of International Finance Systems at Harvard Law School), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=files.View&FileStore_id=C372f56f-819f-4d93-bb5a-6c1802aeb18a [hereinafter Scott Testimony].

[191] Cont, Moussa & Minca, *supra* note 169.

[192] Banque de France, *Revue de la Stabilité Financière, Numéro Spécial Hedge Funds*, N° 10, (April 2007), at 51, available at http://www.banque-france.fr/archipel/publications/bdf_rsf/bdf_rsf_2007/bdf_rsf_10.pdf.

[193] CTR. FOR FIN. STUDIES, NEW FINANCIAL ORDER RECOMMENDATIONS BY THE ISSING COMMITTEE PREPARING G-20–LONDON 19 (2009).

[194] Tomas Garbaravicius & Frank Dierick, *Hedge Funds and Their Implications for Financial Stability* (European Cent. Bank, Occasional Paper Series No. 34, 2005), *available at* http://www.ecb.int/pub/pdf/scpops/ecbocp34.pdf.

[195] Banque de France, *Revue de la Stabilité Financière, Numéro Spécial Hedge Funds*, N° 10, (April 2007), at 54.

ratio of 25, and poor disclosure to its counterparties, which were not aware of the full size and the riskiness of the portfolio.[196] Often exposure and risk come from internal hedge funds, as the $3.2 billion rescue of two hedge funds owned by Bear Stearns in 2007 illustrates.[197] In such cases, the fund's failure is likely to have enormous and direct repercussions on the bank that owns it. Although one can never fully prevent a fund's failures, Charles River Associates (CRA) notes that such failures would be less likely to occur today because leverage levels are quite low and because counterparties have more information and are capable of assessing the risks.[198] CRA adds that other hedge fund failures have had a lesser impact on the markets. Amaranth, for instance, did not have a destabilizing effect because counterparties to these funds held sufficient collateral.

Hedge funds may also destabilize the markets through their *transmission and dissemination role.* In other words, by reacting to a bank failure, they may amplify the effects of a crisis and/or spread it. Although, in this assumption, they are not the source of the problem, but they may worsen its consequences by reacting to it. In the midst of the worst crisis of the century, financial stability was not affected by the hedge fund industry, whose role was limited to transmission through massive selling of shares and short-selling transactions, as Jacques de la Laroisière, Chairman of the High-Level Group on Financial Supervision in the EU, concluded in his report.[199] The Issing Committee, in charge of preparing the London G20 meeting, illustrated this statement by noting, "hedge funds played a role in crisis transmission, due to their strong reliance on bank financing and maturity mismatch. In the crisis, these characteristics contributed to procyclical behavior, in particular to deleveraging and asset sales, which both had a negative impact on market liquidity."[200]

Systemic risk may also originate from *herding* behaviors.[201] The idea is simple and may be illustrated by an example. Imagine that hedge fund A knows that a stock is overvalued, perhaps due to the existence of a bubble. The rational decision would be to short these stocks. However, hedge fund A has a strong interest in achieving tre-

---

[196] Garbaravicius & Dierick, *supra* note 194, at 29.

[197] Julie Creswell & Vikas Bajaj, *$3.2 Billion Move by Bear Stearns to Rescue Fund*, N.Y. TIMES, June 23, 2007.

[198] CHARLES RIVER ASSOCS., *supra* note 106, at 77-78.

[199] JACQUES DE LAROISIERE, HIGH-LEVEL GROUP ON FINANCIAL SUPERVISION 24 (2009), *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

[200] CTR. FOR FIN. STUDIES, *supra* note 193, at 5.

[201] *See* David Scharfstein & Jeremy Stein, *Herd Behavior and Investment* (Massachusetts Institute of Technology (MIT) Sloan School of Mgmt., Working Paper No. 2062-88, 1988).

mendous returns, especially because its compensation system is largely based on performance. Shorting a stock that is skyrocketing would carry the risk to be outperformed by other funds, which would choose to ride the bubble. Even if hedge fund A knows that the stock is overvalued, it may ultimately decide to follow the herd to take advantage of the potential returns while the bubble lasts. Being part of the herd protects the fund from suffering competitive disadvantages. It also implies that if the bubble bursts, the entire herd will suffer the same consequences. Based on this example, one can immediately identify the potential risk posed by these herding behaviors in terms of procyclicity and legitimately admit that such behaviors may be source of systemic risk.

Finally, some of the specific hedge fund features may be problematic for market stability. The first feature is the inherent conflict of interests posed by *valuation*. There is indeed a natural incentive to provide inaccurate, inflated portfolio valuation because the compensation of hedge fund managers is directly calculated based on this value. This can lead to distorted assessments by counterparties and clients, generating risk. Another feature is the *redemption system*. Hedge funds are typically structured in a way that does not allow daily liquidity. Rather, hedge funds set up quarterly or annual redemption only, usually after a lock-up period. This feature limits the impact of nervous and risk-averse behaviors that often amplify the effects of bad market conditions.

In the current crisis, hedge funds have mainly suffered from redemptions coming from risk-averse investors who brutally withdrew their money. This has caused generalized market volatility through massive selling of shares due notably to redemptions. IFSL estimates that hedge funds had to return 13.2% of investors' assets[202] in 2008, which had a procyclic effect on the generalized liquidity crisis.

Thus, it seems that some hedge funds, like many other financial institutions, may be a source of systemic risk important enough to justify that action be taken to mitigate it. The current approach to systemic risk is often an *ex post* "too big to fail"[203] bail-out policy. This can be explained by the fact that regulators experience difficulties in anticipating the impact of defaults mainly due to a lack of both visibility and relevant indicators on the structure of the financial system.[204] As discussed below, this calls for the development of tools that allow an *ex ante* monitoring.

---

[202] IFSL RESEARCH 2009, *supra* note 42, at 1.

[203] See *Statement Before the Comm. on Banking of the S. Comm. on Housing and Urban Affairs*, 111th Cong. 2 (2010) (statement of Paul A. Volcker) [hereinafter Volcker Testimony].

[204] Cont, Moussa & Minca, *supra* note 169.

2.2.2 *Mitigating Systemic Risk*

Before turning to the question of how systemic risk may be mitigated, it is worthwhile to determine whether eliminating systemic risk is even possible. The answer, I believe, is that although limiting systemic risk is feasible, it can never be entirely eradicated. Ben Bernanke similarly noted that trying to do so "would likely stifle innovation without achieving the intended goal." He specified nonetheless that "authorities should . . . try to ensure that the lapses in risk management of 1998 do not happen again."[205]

Andrew Lo wrote that "financial crisis may be an unavoidable aspect of modern capitalism, a consequence of the interactions between hardwired human behavior and the unfettered ability to innovate, compete, and evolve. But even if crises cannot be avoided, their disruptive effects can be reduced significantly."[206] This raises the interesting question of the necessary arbitrage between preserving market dynamics and mitigating systemic risk. A balance must be struck between economic efficiency considerations and arguments in favor of financial stability. Finding the right balance is one of the main challenges facing legislators. Bearing this challenge in mind, one must look for ways to improve the current situation in order to limit the contagion effect and prevent market instability.

As the proverb says, it is difficult to manage what one cannot measure, and this is particularly true for hedge funds. Indeed, hedge funds have limited obligations to disclose information that may be regarded as important by regulators in order to assess potential systemic risk. In the puzzle of trying to understand how markets and financial players are intertwined, hedge funds are often the missing piece.

Indeed, it is hard to deny that hedge funds are relatively opaque.[207] However, the amount and nature of information disclosed varies depending on whether the disclosure is made to investors, counterparties, or regulators. While unregulated advisers may not have to disclose any information to regulators, regulated advisers are subject to disclosure requirements and may be investigated by regulators at any time.

---

[205] Ben S. Bernanke, Chairman, Hedge Funds and Systemic Risk, Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006).

[206] Andrew W. Lo, *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008* : Hearing Before the H. Comm. on Oversight and Government Reform, 113th Cong. (2008) (statement of Andrew W. Lo, Professor, MIT Sloan School of Management) [hereinafter Lo Testimony].

[207] Jean-Pierre Jouyet, Président de l'AMF, *Intervention à la Conférence sur les Hedge Funds, Bruxelles* (Feb. 26, 2009), available at http://www.amf-france.org/documents/general/8776_1.pdf,.

The nature and the amount of periodic disclosure due to investors are mainly defined contractually and remain a private matter between two parties. If investors deem the amount of information they receive to be unsatisfactory, they are free not to enter into an agreement with the fund. Because hedge fund investors are qualified and sophisticated, negotiating contractually the nature of disclosure seems acceptable.[208]

Jean Pierre Jouyet, President of the French *Autorité des Marchés Financiers*, denounced the opacity with which they carry out their activities. He argued that this opacity has a cost that is too high if one looks at the risks inferred by this lack of transparence.[209]

This concern has led to the idea of setting an ongoing public disclosure requirement. As Lo pointed out, "[w]ithout more comprehensive data on hedge-fund characteristics such as assets under management, leverage, counterparty relationships, and portfolio holdings, it is virtually impossible to draw conclusive inferences about the systemic risks posed by hedge funds."[210] Although it is difficult to disagree with this statement, public disclosure is not the right answer. Indeed, as Professor Hal Scott notes, "[a]side from diminishing the overall value of hedge funds, a public disclosure regime would completely fail to address systemic risk," since a disclosure regime is primarily meant for investor protection and not for the reduction of systemic risk.[211]

Parts II and III further develop the idea that information is needed to assess systemic risk, and explain that this information should remain confidential and anonymous, only for use by regulators.

2.3 Investor Protection

The investor protection rationale is less convincing. Hedge funds are no longer unheard of. Unlike the rationale for bank regulation, which makes sense because it protects all individuals, the rationale for protecting hedge fund investors is unsatisfactory.[212]

Indeed, only sophisticated investors can enter a partnership agreement. Because they are sophisticated, they are deemed to be

---

208 *See* SEC STAFF REPORT, *supra* note 4, at 46.

209 Jouyet, *supra* note 207 (author translation of the following: "*Soit, mais le coût de cette opacité est bien trop élevé, si on le rapporte aux risques induits par ce défaut de transparence*").

210 Lo Testimony, *supra* note 206, at 3.

211 SCOTT, *supra* note 169.

212 *See, e.g.*, Kathleen E. Lange, The New Anti-Fraud Rule: Is SEC Enforcement the Most Effective Way to Protect Investors from Hedge Fund Fraud?, 77 FORDHAM L. REV. 851 (2008).

able to fend for themselves.[213] Thus, they cannot claim that they are unaware of the risk all the more since unregistered hedge funds must affix a written notice to their documents specifying they are not registered with the SEC.[214] Investors should understand that these types of investments are risky, and that the risk is the price they pay for the potential greater returns. They need to understand, as Keynes would say, "the market can stay irrational longer than you can stay solvent."[215] One should therefore be careful not to infantilize sophisticated investors by granting too much protection. In Europe, similar restrictions, both quantitative and qualitative, limit the access to this type of investment and protect retail investors.[216]

Therefore, as Demirakou writes, there is no reason to believe that hedge fund investment losses, however painful they are, have a social cost.[217] As Ben Bernanke noted, "[e]xperienced investors know, or should know, that in any given year some hedge funds lose money for their investors and some funds go out of business. Those occurrences are only normal and to be expected in a competitive market economy."[218] Congressman Kanjorski also questioned the investor protection rationale by saying that he "could care less about high-wealth individuals who want to contribute their money to a group of investors. If they want to take the shot of losing it, it does not really affect the rest of society."[219]

Shadab also demonstrated,

> A general lesson from the law and economics of hedge funds is that when a legal regime permits financial intermediaries to be flexible in their investment strategies while aligning the incentives of investors and innovators through performance fees and co-investment by managers, financial innovation is likely to complement investor protection without wide-ranging regulation.[220]

---

[213] *See* SEC STAFF REPORT, *supra* note 4, at 46.

[214] *See id.*

[215] Keynes has been attributed this comment describing his financial losses in 1920. *See e.g.*, ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 123 (2000).

[216] *See* HEDGE FUNDS REGULATION IN EUROPE, *supra* note 22, at 6.

[217] Maria G. Demirakou, *Internal and External Aspects of Hedge Fund Governance*, Harvard Law School, 2008.

[218] Bernanke, *supra* note 206.

[219] *Perspectives on Hedge Fund Registration: Hearing Before the H. Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the Comm. on Financial Servs.*, 111th Cong. 19 (2009) (statement of Chairman Paul Kanjorski).

[220] Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 240 (2009).

Moreover, it has been argued that the level of due diligence performed by sophisticated and experienced hedge fund investors might be significantly more rigorous than any registration regime would ever require.[221]

SEC Commissioner Troy Paredes goes further by underlining that the risk of loss incentivizes investors to do the kind of diligence that will protect their own interests best and that additional SEC oversight based on an investor protection rationale is not justified. He stated:

> That well-heeled, sophisticated investors choose to invest in a hedge fund that provides its investors with little information should not trigger more SEC oversight. Neither the complexity of hedge fund strategies nor the fact that hedge fund investors may lose money because of a hedge fund fraud or risky hedge fund trade is grounds for more hedge fund regulation.[222]

The European Central Bank made similar arguments, questioning the need to regulate in the EU and calling for closer investigations before considering regulation from an investor protection point of view.[223]

Two small reservations to the above must be mentioned. The first is the German legal framework, which does not provide any minimum requirement to invest in a hedge fund and which could potentially raise some investor protection issue.[224]

The second one is the growing number of investors that could potentially qualify as accredited investors[225] or its equivalent in other jurisdictions.[226] This phenomenon, which is due to inflation according to Lieder, is referred to as "retailization."[227] Some argue that hedge funds should be made available to retail investors through a fund of hedge fund, which is the approach followed by the FSA.[228] Indeed, on February 25, 2010, the FSA released a statement introducing a retail

---

[221] *See* Garrett Testimony, *supra* note 182, at 3.

[222] *See* Paredes, *supra* note 45, at 11.

[223] *See* Garbaravicius & Dierick, *supra* note 195, at 56.

[224] *See, e.g.*, HEDGE FUNDS REGULATION IN EUROPE, *supra* note 22, at 6.

[225] For definition of "accredited investors," see 15 U.S.C. § 77b(15).

[226] *See* Jan Lieder, *Regulating Hedge Funds: Investor Protection and Systemic Risk,* BUCERIUS L.J., 2009 (observing this growth of potentially qualified investors).

[227] According to Lieder, studies have shown that in 2003, 8.5% of U.S. citizens could in theory have access to hedge funds. *Id.* at 94.

[228] *See e.g.*, Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors,*11 N.Y.U. J. LEGIS. & PUB. POL'Y 251, 266 (2008).

Fund of Alternative Investment Funds.[229] Although I do not disagree with such initiatives, one should be extremely careful to guarantee the appropriate level of investor protection through stricter regulation whenever retail investors are involved.[230] However, for hedge funds themselves, this paper argues that sophistication is a key factor because it justifies the light regulatory environment that benefits hedge funds. Should more and more unsophisticated investors have access to hedge funds, investor protection could become an issue and therefore justify more regulation. An alternative solution would be to raise the standards of the definition of an "accredited investor" in the 1933 Act and its equivalent in other legal systems. This would limit the range of investors who could have access to hedge fund interests issued through a private offering exemption (Rule 506), as in the case of the United States.

A similar idea is found in the PFIARA, which requires the SEC to adjust the "qualified client" dollar amount thresholds for inflation within one year of enactment, and to repeat this process every five years.[231] The Dodd-Frank Act has a similar provision but focuses on the "accredited investor" standard. I am a bit doubtful as to using a quantitative measure of sophistication which does not guarantee that investors are indeed qualified and able to fend for themselves. Some qualitative restrictions should also be introduced to complete the existing framework. For instance, broker dealers could be in charge of assessing the client's knowledge through detailed questionnaires following the examples of the questionnaire requirement created by the Mifid Directive in the EU and of the "offering questionnaire" hedge funds often use to assess the level of sophistication in the United States.[232]

The call for more disclosure is also said to be for investors' sake. According to the SEC staff report, hedge funds "generally are not required to meet prescribed disclosure requirements."[233] However, a hedge fund is compelled to make a comprehensive disclosure to potential investors, both to satisfy fiduciary obligations under the IAA and state laws and to comply with antifraud provisions of the securities laws[234] and the requirements of the private offering exemption.[235]

---

[229] FIN. SERVS. AUTH., -POLICY STATEMENT 10/3: FUNDS OF ALTERNATIVE INVESTMENT FUNDS (FAIFS) (2010).

[230] I shall not analyze in greater details the possibility of allowing retail investors to access these complex investment vehicles, as funds of hedge funds are out of the scope of this paper.

[231] PFIARA § 418.

[232] Council Directive 2004/39/EC, 2004 O.J. (L145/1) 30 (EC).

[233] SEC STAFF REPORT, *supra* note 4, at ix.

[234] Since 2007, all investment advisers are prohibited from "mak[ing]any untrue statement of a material fact or omit[ting] to state a material fact necessary to

Moreover, as sophisticated investors become more aware of how hedge funds work, they tend to require extensive disclosure from managers. Unlike the purchase of publicly traded securities, ownership in a hedge fund comes from a contractual agreement, which may potentially be negotiated. This has a direct impact on the amount of information hedge funds disclose in their offering and private placement memoranda (PPM).[236] PPM are not mandatory under Rule 506, but result from market practice and from the need of hedge fund managers to protect themselves from liability under antifraud provisions.[237] Moreover, practice has shown that hedge funds have to disclose more and more information to more and more exigent investors without the need for formal disclosure requirements.[238]

Therefore, the investor protection argument seems questionable and does not justify additional regulation. Systemic risk, however, appears to be a legitimate source of concerns, although several doubts can be raised as to the capacity of regulation to address it in a fully satisfactory manner. Part II provides an analytical and critical overview of proposals of the U.S. Congress and the European Commission.

PART II: THE FUTURE OF HEDGE FUND REGULATION: ASSESSING THE IMPACT OF THE PRIVATE FUND INVESTMENT ADVISERS REGISTRATION ACT OF 2009 AND OF THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

As we discuss current proposals in the United States and in the EU to reform the legal regimes applicable to hedge funds, one must bear in mind that current regimes are different from one another. Since, the United States and the EU agree on the need to regulate hedge funds, it would seem like the perfect time to harmonize the various legal regimes and to set up global rules. This section examines both the European and American proposals and determines whether efforts in that direction are being made.

---

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."17 C.F.R. § 275.206(4)-8(a)(1) (2009).

235 SHARTSIS FRIESE LLP, *supra* note 46, at 4.

236 SEC STAFF REPORT, *supra* note 4, at 46-49.

237 *Id.*

238 *See id.*

1. *The Private Fund Investment Advisers Registration Act of 2009*

1.1 *Provisions of the Act*

The Private Fund Investment Advisers Registration Act of 2009 aims at regulating hedge fund advisers, not hedge funds themselves. It provides first and foremost a definition of "private fund" as an investment fund that relies on an ICA exemption, either 3(c)(1) or 3(c)(7).[239] The Act eliminates the private adviser exemption relying on Rule §203(b)(3) of the IAA and requires most hedge fund advisers above a $30 million threshold of assets under management to register with the SEC as investment advisers.[240]

In other words, hedge funds will no longer be able to rely on the 15 client exemption under the IAA and will have to be registered. The Act also empowers the SEC as a risk assessment authority, which could potentially establish new requirements if it deems it necessary, including regulating funds themselves based on their size, governance, and investment strategies.

The SEC, in consultation with the Federal Reserve, would establish the records and files keeping requirement. Hedge fund advisers would be required to keep information regarding the assets they manage, their use of leverage, and their counterparty credit risk. These records could be subject to examination at any moment. Indeed the PFIARA imposes stricter reporting and disclosure requirements that will affect the entire industry, including advisers already registered with the SEC.[241] The PFIARA provides that disclosing non-public sensitive information would not be required and that all other information would be kept confidential.[242] However, in reading between the lines, one quickly realizes that hedge funds could in fact be asked to reveal their trading practices and positions as well as any other information that the SEC or Fed deemed necessary to protect investors and assess systemic risk. This information would also be

---

[239] PFIARA § 402.

[240] *Id.* The PFIARA created an exemption from the registration requirement for an adviser if this latter acts solely as an adviser to private funds and has less than $150 million under management. These managers will not be exempt from the providing the SEC with an annual report and any document that the SEC will deem necessary. The "Dodd bill" contains a similar exemption for adviser with less than $100 million of assets under management. Between $25 million and $100 million, the adviser would need to register with state regulators. This diverges from the House approach under which these advisers would remain subject to federal regulation but would be exempt from the registration requirements.

[241] *Id.*, § 404.

[242] *Id.*

shared with any other entity aiming to control systemic risk, including the newly established Financial Stability Oversight Council.[243]

As explained further in Part III, this forced disclosure may be extremely problematic because hedge funds distinguish themselves from one another by their setting their own strategies. They create value using their unique models. Publicly disclosing this type of information would harm both hedge funds and their clients. It will be very interesting to see how the Senate will approach the disclosure requirements and whether it will require public disclosure or keep the confidential reporting adopted by the House. The Dodd-Frank Bill seems to follow the PFIARA's path and provides that "proprietary information" such as trading data or strategies should not be made publicly available. However both versions allow this information to be shared with courts, agencies or federal departments which still raises questions in terms of confidentiality and protection of business strategies.

In this regard, this paper supports the recommendation made by the Committee on Capital Markets Regulation (CCMR) to create a confidential reporting requirement, provided that the information collected remain confidential and is not accessible by other hedge funds.[244] Rather, the regulator should only use the data to assess potential threats to financial stability, and should only take action if it is needed to prevent failures and chain reactions. This information should also remain anonymous in order to avoid information leakage. The CCMR Report suggests that information about the fund's liquidity needs, leverage use, risk concentrations, and connectedness, should be disclosed to others.[245] It further suggests, and I completely share this analysis, that "the regulator would bear the burden of demonstrating its need for the required information as well as its ability to use that information effectively."[246]

The PFIARA has been well received by the industry, as most of hedge funds have already registered voluntarily with the SEC. Todd Groome, Chairman of the Alternative Investment Management Association (AIMA) declared that the AIMA supported the registration of managers. Richard Baker of the Managed Funds Association (MFA)acknowledged that the mandatory registration of investment advisers was "the right approach" although not a "panacea," in particular because of the costs registration will entail.[247]

---

243 *Id.*

244 COMM. ON CAPITAL MKTS. REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 13 (2009).

245 *Id.*

246 *Id.*

247 *Perspectives on Hedge Fund Registration: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the Comm.*

Additionally, shortly after the adoption of the Hedge Fund Rule, Chris Kentouris wrote that "the SEC's initial estimate of $50,000 a year" in compliance costs "was quickly debunked."[248] Kentouris further stated that "there is just too much to do and too few who know how to do it, with some citing a figure of at least double that amount."[249]

The approach chosen by the SEC resembles the U.K's approach, which also requires that advisers be registered with the FSA. This is a significant and encouraging step toward greater harmonization of the legal regimes of the two main platforms for hedge fund managers in the United States and the United Kingdom.[250]

1.2 Assessing the PFIARA

To assess the utility and the potential effectiveness of this proposal, two questions come to mind. First, does the PFIARA provide a real improvement and is likely to generate substantial changes in the hedge funds' course of business? Second, does it effectively address the issue of systemic risk?

Registration

First of all, was the PFIARA really necessary? The main provision is the mandatory registration of all investment advisers who manage more than $30 million of assets.[251] Many within the industry have expressed doubts as to what registration would really accomplish for investors, for hedge fund managers, and for the markets.[252] I tend to believe that registration is beneficial because it provides the SEC with the opportunity to exercise its oversight on the activities of hedge funds themselves through the oversight on hedge fund advisers. However, Congress's attempt to make this registration mandatory is puzzling.

From a hedge fund manager's point of view, there is a natural incentive to register because it gives them a competitive edge. It is

---

on Financial Servs., 11th Cong. 11 (2009) (statement of Richard Baker, Managed Funds Assoc.) [hereinafter Baker Testimony].

248 Chris Kentouris, *The Cost to Comply*, SECURITIES INDUSTRY NEWS, Dec. 6, 2004.

249 *Id.*

250 Hedge funds themselves are not U.K.-based because of an unfavorable tax regime that deters from incorporation in the UK.

251 PFIARA, § 402. Advisers managing less than $25 million in assets under management are prohibited from registering with the SEC and are subject to state law.

252 Eric Jackson, *The Good, the Bad and Ugly in Hedge Funds: A Manager's View*, BUS. WK., Mar. 5, 2009.

particularly true in this economy that when an investor is faced with a choice between a registered fund and an unregistered one, the investor will naturally favor the one that is registered. Some even declared that registration for registration's sake seems like a waste of time because a growing number of hedge funds, (70% according to the Managed Funds Association, representing a majority of assets) have voluntarily registered and already provide a list of holdings on a quarterly basis.[253] The MFA further argues that having hedge funds register was no guarantee that no incident would ever occur.[254]

After all, the current crisis was caused by regulated investment banks, and one of the biggest frauds of the century was committed by Madoff, an SEC-registered broker-dealer. Raising this particular issue, Juraj, in quite a humoristic way, questioned the effectiveness of regulation. He quoted one sentence from George Soros, "I am having a good crisis,"[255] and then the word "guilty,"[256] which was declared by Bernard Madoff at his trial. He then explained that the main difference between these two men was that Madoff was subject to the SEC's oversight, whereas Soros was not.[257]

Finally, Groome expressed concerns as to the implications of the PFIARA for non-U.S. managers who could face dual registration. He therefore called for a full exemption for non-U.S. managers who are already registered in an OECD country or others where domestic regulators cooperate and share information with the SEC.[258]

This concern, although legitimate, is addressed in the PFIARA. If not modified by the Senate, the PFIARA would include a foreign private advisers exemption. Provided that (1) the adviser does not have her place of business in the United States' (2) has had 15 or fewer clients in the preceding year; (3) has less than $25 million of assets under management; and (4) does not hold herself out to the public or advises a registered investment company, she would not need to register with the SEC.[259] The exemption seems a bit artificial because of

---

[253] *Id.*

[254] *Id.*

[255] *"I'm Having a Very Good Crisis," Says Soros as Hedge Fund Managers Make Billions off Recession*, DAILY MAIL, Mar. 25, 2009.

[256] Diana B. Henriques & Jack Healy, *Madoff Goes to Jail After Guilty Pleas*, N.Y. TIMES, Mar. 12, 2009.

[257] Alexander Juraj, *New Governance and Hedge Fund Regulation: Shorting Federalism or Bernie's Nightmare?* HEDGE FUND REGULATION 2 (2009). For a similar argument see also Garrett Testimony, *supra* note 182, at 3.

[258] AIMA, *AIMA Reiterates Support for Registration of Hedge Fund Managers in the U.S.*, http://www.aima.org/en/media_centre/press-releases.cfm/id/40F01E5D-3F04-4184-9B4E087C8FF502CD.

[259] PFIARA, § 402. The SEC would have the authority to set a higher threshold if it deems it appropriate based on a investors' protection rationale.

the low $25 million threshold. As a result, this exemption will be limited to a few investment advisers whose involvement with U.S investors is low.

Transparency

Another concern is transparency. As previously discussed, hedge funds are often criticized for their opacity. However, stricter disclosure requirements to investors may not be needed. Managers, whether registered or not, have fiduciary duties, are subject to anti-fraud provisions, and must fulfill the requirements of private offerings under §4(2) of the Securities Act. They must make true, accurate, and comprehensive disclosures in their PPMs, their Partnership Agreements, and their Subscription Agreements, which typically contain the kind of information that would be required in a registration statement.[260] Moreover, as investors become more and more comfortable with hedge funds and their practices, their disclosure expectations grow, which leads managers to disclose more information on the risks they take, on their compensation arrangements, or on the type of strategies used.

However, it is difficult in practice to grasp the risks that are taken. Often, to shield the manager and the fund from liability, PPM provides a list of the types of potential risks without being too specific, which fails to give an accurate picture of the risks at stake.

As far as the investor protection rationale is concerned, some argue that because pension and mutual funds invest in hedge funds, additional protections should be created. However, such protections already exist. Mutual funds are subject to diversification requirements under the Investment Company Act. Additionally, both pension funds' and mutual funds' interests in a hedge fund cannot exceed 30%.

The second concern is the disclosure to counterparties. I do not believe that regulations need to be passed in order for broker-dealers or banks to assess risks. These counterparties have the expertise and the tools to carry out their due diligence, and they remain free not to enter into agreement if they determine that the level of disclosure is not satisfactory. Therefore, the opacity between hedge funds and counterparties can be resolved by contractual agreements between parties without any regulatory intervention.

Leverage

Regulation T already indirectly limits the amount of leverage hedge fund can undertake.[261] Indeed, Regulation T regulates the ex-

---

260 Shadab, *supra* note 220, at 286.
261 12 CFR § 220.12 (1998).

tension of credit provided by broker-dealers and imposes a 50% cap for securities bought on margin.[262] This means that hedge funds may be required at any time to satisfy margin calls and to deposit additional money or stocks to meet these requirements. This indirectly limits hedge funds' use of leverage as margin calls may occur at any time, especially when markets depreciate.

However, Jonna points out that broker-dealers typically arrange financing through foreign affiliates that are not registered with the SEC.[263] Leverage can be a real issue in terms of systemic risk. However, it seems that the industry spontaneously limits its leverage use. The chairman of the FSA recently said that the average leverage of hedge funds was two or three to one, which Congressman Edward Royce called a "staggeringly low amount of leverage if you consider that our most heavily regulated institutions like the Government Sponsored Enterprises Fannie Mae and Freddie Mac, were leveraged here in the United States by 100 to 1."[264] The exhibit below, provided by the Charles River Associates Report, on the impact of the AIFM Directive, illustrates this relatively low use of leverage on a global level. The report explains that the amount of leverage depends on the strategies carried out by hedge funds, and varies accordingly. For instance, arbitrage funds are more leveraged than distressed securities-based investments.[265]

The Fed also acknowledged that overall, the industry showed a lack of leverage. This explains why the losses hedge funds suffered did not threaten the stability of the financial system. Richard Baker, CEO of the Managed Funds Association, reported that a recent study found that 26.9% of hedge funds used zero leverage.[266]

The main reason explaining this relative lack of leverage is the fear of its disappearance. Leveraged funds run the risk of being wiped out. Indeed, hedge funds often invest in products that are already intrinsically leveraged and prone to illiquidity, such as junk bonds. Moreover, because of redemption rights, investors may withdraw their money at any time, creating a potential danger for the fund if it is over-leveraged. As a result, there is a strong natural incentive for hedge fund managers to be spontaneously cautious about leverage. This incentive may be more effective at preventing irresponsible be-

---

[262] *Id.*

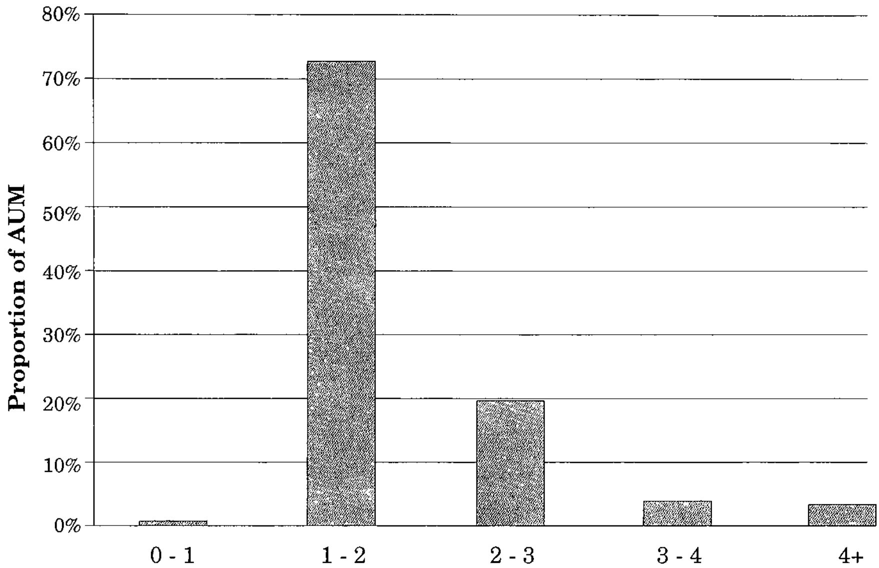
[263] Paul M. Jonna, *In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation*, 45 SAN DIEGO L. REV. 989, 1026 (2008).

[264] *Perspectives on Hedge Fund Registration: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Servs.*, 111th Cong. 1 , 7 (2009) (statement of Edward Royce).

[265] CHARLES RIVER ASSOCS., *supra* note 106, at 23.

[266] Baker Testimony, *supra* note 247, at 11.

FIGURE 11. GLOBAL ASSETS UNDER MANAGEMENT BY LEVERAGE



Source: Information provided to CRA by the Centre for Hedge Fund Research at Imperial College London.
Analysis based on data available as of early September 2008.

haviors than formal rules. The market acts as the best arbitrator between well-managed and poorly-managed funds and operates as natural selection. Well-managed, low-leveraged funds are less likely to disappear, incentivizing hedge fund managers to follow this type of "best practice."

Risk

Although one should not over-generalize, the risks managers take may not be as dangerous as they appear, especially if one takes into account the fact that most hedge funds have so-called "high water mark" provisions. Under these provisions, the manager only receives performance fees when the assets' value is greater than its previous greatest value.[267] Studies have shown that funds with high water marks perform better than those without high water marks.[268] According to Shadab, this demonstrates that managers react positively to this incentive.[269]

---

[267] *See* Shadab, *supra* note 220, at 277-78.
[268] *Id.* at 278.
[269] *Id.* at 278.

Role of the SEC

One may question the relevance of the PFIARA. Indeed, one should be extremely careful when trying to prevent these vehicles from being overly aggressive, but rather pushing them to favor flexibility. This does not mean that hedge funds should be allowed to engage in any type of fraud or any other risky activity that would pose a real threat to the financial system. This simply means that the current legal framework does not need to be changed. Preventing reckless behaviors and enforcing current rules may be achieved by reinforcing the powers of the SEC. In this regard, the recent trends and evolutions within the SEC must be applauded. Indeed, the SEC recently established five new units within its enforcement division, including one for hedge funds and private equity firms, which the SEC regarded as one of its priority areas.[270]

The newly appointed SEC's N.Y. Chief George Canellos also confirmed that hedge funds were a big area of emphasis and that the SEC conducted a number of significant sweeps of investment advisers in the last year or two. He further explained that they moved towards cause and risk-based exams rather than more routine checks.[271] Finally, there seems to be a trend to include more industry participants within the SEC's staff, which is an interesting and encouraging evolution that could lead to a better understanding and control over hedge fund activities.

Based on the above, it is unclear what the additional regulation could bring that market discipline and better-tailored SEC oversight could not achieve on its own. If the sole purpose of the PFIARA is to make registration mandatory, the impact will be marginal compared to the time and costs this reform will generate. It seems that the PFIARA fails to provide a sufficient benefit in terms of systemic risk reduction compared to its potential costs.

The Obama / Volcker Proposal

The PFIARA is not the only proposal that would have an impact on the hedge fund world. More problematic and potentially harmful is the so-called Obama Proposal[272] introduced on January 21, 2010, which would bar bank holding companies from owning or investing in hedge funds and private equity funds. The rationale behind this pro-

---

[270] *New SEC Unit To Cover Hedge Fund, P.E. Probes*, FINALTERNATIVES, Jan. 14, 2010, http://www.finalternatives.com/node/10232.

[271] *SEC's New N.Y. Chief Turns Spotlight On Hedge Funds*, FINALTERNATIVES Jan. 4, 2010, http://www.finalternatives.com/node/10105.

[272] Volcker Testimony, *supra* note 201, at 2. This proposal was first introduced by former Federal Reserve Chairman Paul Volcker before Senate on February 2, 2010.

posal is to reduce systemic risk by limiting the interconnectedness of financial institutions. Yet, it is not clear that the rule would really have the effect it predicts. According to Professor Scott, the Volcker Rules are both "*over-inclusive* because not all banks, and not even all large banks, pose chain-reaction risks to the financial system" and "also potentially *under-inclusive*, because many interconnected financial institutions which do pose systemic risks are not deposit-taking banks."[273]

Besides potentially failing to address the systemic risk issue, the proposal would harm the hedge fund industry. There are also concerns about the "possibility of liquidity in markets being reduced and the prime broker relationship being adversely affected."[274] This situation is even more preoccupying because the U.K. has explicitly ruled out such a proposal, and because the EU is not likely to adopt such provisions. One can easily imagine what the lack of coordination might do to the U.S. hedge fund industry should this proposal be adopted.

2. The Alternative Investment Fund Managers Directive

2.1 Provisions of the Directive

In April 2009, the European Commission released a draft of the Alternative Investment Funds Managers Directive (AIFM) aiming at the goal of regulating the non-UCITS fund managers who have more than €100 million of assets under management. There are two exemptions in this provision.

First, fund managers whose assets under management consist of less than €500 million, whose portfolios are unleveraged, and whose funds offer no redemption rights during five years may be out of the scope of this Directive. So would an alternative investment manager who wouldn't manage an EU-domiciled hedge fund and who wouldn't market in the European Union.

The AIFM Directive would require all alternative investment fund managers to be authorized in the member state in which its registered office is located and subject to harmonized regulatory standards on an ongoing basis. By alternative investment fund (AIF), the Commission means "any collective investment undertaking, including investment compartments thereof whose object is the collective investment in assets and which does not require authorization" under the UCITS Directive.[275] This definition is extremely broad and gener-

---

[273] Scott Testimony, *supra* note 190, at 5.

[274] *Obama Proposal Would Block Banks From Hedge Funds, Private Equity*, FINALTERNATIVES, Jan. 21, 2010, http://www.finalternatives.com/node/11031.

[275] Proposal for Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and

ally includes hedge funds. Once authorized, fund managers may market anywhere throughout the European Union, thus benefititng from the European passport, which would significantly reduce their costs.[276]

Articles 19 through 21 impose transparency requirements relating to the funds,[277] such as the need to provide an audited annual report and to disclose information to investors and regulators about the fund's investment strategy, the identity of depositary, the valuation procedure, and how liquidity risk is managed.[278] According to CRA's impact report, the rationale behind this requirement is that "[d]isclosure to investors is expected to reduce asymmetric information and increase investor confidence about investing in the fund," and "[d]isclosure to competent authorities is expected to bring about improved regulatory oversight of AIF including with respect to systemic risk."[279]

Funds domiciled outside of the EU ("third country funds") would also gain access to the European market provided they meet EU regulatory and supervisory requirements after a transitional period of three to five years.[280] In other words, third country funds could be marketed in the EU if their legislations are equivalent to the provisions of the Directive, if there were reciprocal market access, and if they complied with the OECD Model Tax Convention standards.[281] The provision relating to third country funds has raised criticism, albeit only 5.8% of global hedge funds are domiciled in the EU, mainly in Ireland, Luxembourg, and France.[282]

Finally, the AIFM Directive would further impose minimum capital requirements,[283] as well as conflicts of interest, risk and liquidity management requirements,[284] an independent valuation of assets,[285] threshold disclosure,[286] and would limit the fund's use of leverage.

2009/. . ./EC, 31-33 COM (2009) 207 final (Apr. 30, 2009) [hereinafter AIFM Directive]. Please note that AIFM Directive refers to the draft as of April 2010. The final version is discussed in the Recent Developments section.

276 AIFM Directive, art. 32; CHARLES RIVER ASSOCS., *supra* note 106, at 46.

277 AIFM Directive, arts. 19-21.

278 *Id.*

279 CHARLES RIVER ASSOCS., *supra* note 106, at 36-37.

280 AIFM Directive, art. 3.5.8.

281 For further explanation, see CHARLES RIVER ASSOCS., *supra* note 106, at 38.

282 *Id.* at 18, 58.

283 AIFM Directive, art. 14.

284 *Id.*, arts 10-12 and 16.

285 *Id.*, arts. 10-12 and 16.

286 *Id.*, arts. 26-27; CHARLES RIVER ASSOCS., *supra* note 106, at 37. Hedge funds would be required to disclose their positions when they reach 30% of voting rights.

2.2 Assessing the AIFM Directive

On February 1st, 2010, the Spanish government, which currently holds the rotating presidency of the Union, published the third draft of the AIFM.[287] These proposed rules have been heavily criticized, particularly by the Bank of England, the Financial Services Authority and the House of Lords. The House of Lords recently warned that the rules could have disastrous consequences for the European economy and could "sap European competitiveness."[288] On March 16, 2010, Spain announced that the vote of the Union's finance ministers on the AIFM Directive would be postponed to the beginning of the summer, provoking strong reactions among members of the European Union Parliament and from some member states, such as Germany.[289]

Several provisions of the AIFM draft are problematic. The best illustration of the controversial nature of the European Commission language is the number of proposed amendments by members of European parliament and the Alternative Investment Management Association (AIMA), more than 1000 so far[290] and 80 introduced by the AIMA,[291] as well as the arguments the proposed rules have raised among member states and even within the European institutions.

Leverage

The same reasoning developed in the assessment of the PFIARA applies to the leverage requirements that the Directive would develop and impose on hedge funds. It seems like there is a natural incentive to limit leverage in order to avoid potential failures. Moreover, as the CRA impact study demonstrates, "it unclear that the AIFMD will be effective in preventing the transmission of systemic risk associated with leverage."[292] Additionally, leverage limits "could add to procyclicity at a time of crisis by forcing hedge funds to sell to stay within the prescribed regulatory limit. In addition, investors

---

287 The previous directive was introduced by the Swedish Presidency of the E.U. and was abandoned largely because of the criticism raised by the U.K.

288 *British Lords Join In Savaging Proposed European Hedge Fund Rules*, FINALTERNATIVES, (Feb. 10, 2010, 12:00 PM), http://www.finalternatives.com/node/11360.

289 *British Block European Hedge Fund Rules*, FINALTERNATIVES, Mar. 16, 2010, http://www.finalternatives.com/node/11781.

290 *Avalanche of Amendments Inundate EU Hedge Fund Rules*, FINALTERNATIVES, Jan. 28, 2010, http: //www.finalternatives.com/node/11098/.

291 Tony Griffiths, *Aima Releases its List of Amendments to Directive*, HFMWEEK, (Jan. 13, 2010), http://www.hfmweek.com/news/427003/aima-releases-its-list-of-amendments-to-directive.thtml.

292 CHARLES RIVER ASSOCS., *supra* note 106, at 4-5.

would no longer have access to particular strategies with high leverage, further reducing choice and returns."[293]

Finally, it should be noted that specific rules on leverage would be adopted through implementing measures after the Directive comes into force. This additional factor creates uncertainty and makes leverage limitations provisions difficult to assess at the current stage of the legislative process.

Third Country

The main criticism targets the provision applicable to foreign funds. Under the current draft, foreign funds would not be allowed to market in the EU unless they meet EU standards—which that are stricter than most of their home jurisdictions—and only if cooperation arrangements are in place between the regulator of the manager's jurisdiction and that of the EU member state in which investors are located.[294] This proposal would bar funds whose home jurisdiction rules are not as strict as that of the European Union, which, according to the head of FSA's asset management division, represents 40% of the world's hedge funds.[295]

In addition, the third country provision creates a blurry framework and is a source of legal uncertainty. CRA's report points out that the current draft of the Directive "indicates that the EC will determine whether or not third countries are considered to have equivalent regulation to that in the Directive. This decision will occur after the adoption of the Directive and therefore, at present, no non-EU country can be assumed to have met the equivalence test."[296]

Under such circumstances, the U.K.'s House of Lords has urged the British government to veto the proposed rules, unless it is made "compatible with equivalent legislation with regulatory regimes in third countries and in particular in the United States."[297] The HFSB also issued a statement expressing its concerns.

> The draft directive has not been discussed with the key interested parties nor is it consistent with the analysis and recommendations of the Commission's own experts as outlined in the well received De Larosière Report. The Directive also ignores the efforts already underway to develop global proposals such as those taking place under

[293] *Id.* at 4.
[294] *Id.* at 38.
[295] *Avalanche of Amendments Inundate EU Hedge Fund Rules,* FINALTERNATIVES, Jan. 28, 2010, http://www.finalternatives.com/node/11098/.
[296] CHARLES RIVER ASSOCS., *supra* note 106, at 40.
[297] *British Lords Join In Savaging Proposed European Hedge Fund Rules,* FINALTERNATIVES, Feb. 10, 2010, http://www.finalternatives.com/node/11360.

> the G20 process. We are particularly concerned that the draft Directive opts for prescriptive norms, in contrast with the principles-based approach under which the industry developed in the U.K. It would empower the Commission to issue detailed regulations, in effect sidelining national regulators. It would also force non-E.U. countries to approve equivalent regulation if they want to maintain access to the European market.[298]

Jacques de Larosière himself acknowledged in a conference in June 2009, "the directive went much further than his report recommended."[299]

Finally, the United States Secretary of Treasury expressed his concerns in a letter addressed to EU Commissioner for Internal Market and Services Michel Barnier.[300] Geithner asserts that the "U.S-E.U. relationship is absolutely vital for achieving effective regulation of financial markets" and that both markets should "fulfill our G-20 commitment to avoid discrimination and maintain a level playing field."[301] He further explained that the United States is worried about "various proposals that would discriminate against U.S. firms and deny them the access to the E.U. market."[302] It is unclear whether the United States would fail the equivalence test since the criteria are not yet defined, although the differences in tax regimes could very well become an issue. Indeed, the concerns expressed by third countries, such as the United States, are mainly derived from the lack of certainty regarding the criteria that would be used to determine whether a country's regulatory framework is equivalent, since these criteria are believed to potentially bar non-EU hedge funds from the European market.

The draft also gave rise to much criticism within the hedge fund industry, particularly afraid that the Directive would put the hedge funds out of business in the EU. Hedge fund lawyers also expressed concerns about the potential outcome of such draconian measures and warned that should the Directive come into force, one would witness a hedge fund exodus. Soon, no hedge fund would operate from

---

[298] Hedge Fund Standards Board, *Statement on Alternative Investment Fund Managers Directive* (Apr. 29, 2009).

[299] Alternative Investment Management Association, *AIMA Welcomes de Larosiere, Turner, Myners, Sassoon Comments on Draft Directive* (June 24, 2009), *available at* http://www.aima.org/en/media_centre/press-releases.cfm/id/9E633F0A-915B-474E-8C3BBA83090E6466.

[300] Letter from Timothy Geithner, U.S. Treasury Sec'y, to Michel Barnier, European Commissioner for Internal Market and Services (Mar. 1, 2010), *available at* http://www.ft.com/cms/b102c1be-2d31-11df-9c5b-00144feabdc0.pdf.

[301] *Id.*

[302] *Id.*

within the EU, since hedge funds are much more mobile than banks and would have no trouble relocating in more friendly jurisdictions.[303]

Potential Impact on Investors

In the end, EU-based investors may suffer as well. European institutional investors are currently free to seek out the best managers globally, but it seems that this freedom will soon cease to exist. Indeed, the quantity and variety of funds available would diminish a great deal, because investors will not have access to funds managed by a non-registered manager.

Article 3(d) of the AIFM Directive defines marketing as "any general offering or placement of units or shares in an AIF to or with investors domiciled in the Community,[304] regardless of at whose initiative the offer or placement takes place." Marketing would be prohibited for funds that do not comply with the Directive's provisions. This is a different approach to that taken in the UCITS Directive, which allows investors to purchase securities that are not marketed in the EU.[305] Since many funds will be unable to comply with the AIFM Directive requirements and will not be allowed to market in the EU, investors will lose investment opportunities evaluated as a reduction in the annual returns to EU investors of around €1.4 billion.[306] As Andrew Baker from the AIMA explains, "[a]ny restrictions imposed on European investors would also hit asset managers in financial centers such as the United States, Canada, Switzerland, Hong Kong, Singapore, Japan, Australia and South Africa."[307]

This paper supports the position taken by the U.K. and by the industry itself. The Directive does not benefit European member states' legal environments and may harm the industry. Its vagueness on disclosure issues and capital requirements, for instance, would make it either dangerous or ineffective. Moreover, the third country provision would be a disaster for hedge funds and for investors. Although some argue that the EU does not want to discriminate against EU managers and, "it is a matter of level playing field,"[308] the markets

---

303 *All Hedge Funds Will Leave European Union, Lawyer Warns,* FINALTERNATIVES, Dec. 14, 2009, http://www.finalternatives.com/node/9962.

304 AIFM Directive, art. 3(e). Note that checking each investor's domiciliation could be challenging from a practical point of view as well as costly.

305 Council Directive 2009/65, 2009 O.J. (L 302/32) (EC).

306 CHARLES RIVER ASSOCS., *supra* note 106, at 62.

307 *Spain Re-introduces "Protectionist" Measure to European AIFM Directive,* ALTASSETS, Feb. 18, 2010, http://www.altassets.com/private-equity-news/article/nz17956.html.

308 *Foreign Funds Take Center Stage In EU Hedge Fund Debate,* FINALTERNATIVES, Feb. 6, 2010, http://www.finalternatives.com/node/11338 (citing Becher).

should not be regarded only at the European level, but rather on a global scale.

Therefore, this paper concludes that the AIFM draft is inadequate at best because it fails to improve the current system and remains vague, if not dangerous and protectionist.

PART III: HOW TO REGULATE HEDGE FUNDS: SEVERAL ELEMENTS THAT SHOULD BE TAKEN INTO ACCOUNT BEFORE CONSIDERING IMPOSING MORE REGULATION ON HEDGE FUNDS.

The debate of whether or not to regulate one player of the financial system is crucial, and requires a legal and economic analysis of financial regulation. Part III of this paper offers general remarks on financial regulation and how these comments apply to the hedge fund situation. Additionally, in following a cost/benefit approach, I conclude that the current regulatory trends are misdirected and fail to propose a better alternative to present legal regimes. Finally, Part III advocates for the creation of a global database of financial information that will allow regulators to monitor systemic risk without impairing hedge funds' activities and performances and discusses the challenge of developing global standards.

1. General Remarks on Hedge Fund Regulation: Factors to Take Into Account When Considering More Regulation

1.1 Questions to Be Asked and Remarks to Be Made Before Considering Changes in Legal Frameworks Applicable to Hedge Funds

Know What You Want to Regulate

When trying to regulate hedge funds, addressing the subject of the regulation itself is a major challenge. Indeed, regulating hedge funds as a homogeneous entity may turn out to be a "fruitless exercise" because hedge funds are heterogeneous to the point that they are "the entire investment world less the small subset of traditional investment strategies," from arbitrage to event driven or macro strategies.[309] According to Bookstaber, "with so broad a classification, seeking a uniform approach would be like developing a single set of traffic rules to apply for all modes of transportation, from pedestrians to commercial jets."[310] Juraj makes a similar point, stating that there is no single regulatory framework that can be imposed on all hedge

309 RICHARD BOOKSTABER, A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION 244, 247 (2007).
310 *Id.* at 248.

funds because the variety of fund structure, strategies, and their social positions require a varied approach.[311]

Though this is true, a distinction has to be made between regulation as it is often regarded and the hybrid rules-based approach and a principles-based approach of regulation. Trying to regulate such a heterogeneous group with stringent rules may be challenging, impossible, and even dangerous. A principles-based regulation like the British Financial Services Authority's or the Dubai Financial Services Authority's (DFSA)[312] provides a general framework that the industry must follow and adapt to its own business. This approach is more flexible, thus making regulation better suited to the industry's needs and more likely to be properly enforced by hedge funds. This statement is illustrated by the forewords of the DFSA in its Hedge Fund Code of Practice:

> Instead of rules, we have adopted a principles based approach for developing best practice standards. We believe this will promote certainty while allowing industry participants a degree of flexibility to adapt these standards to suit their particular businesses in light of changing market conditions and emerging issues.[313]

The heterogeneity argument can also be applied to the size of these investment vehicles. It is quite intuitive to say that smaller funds are less likely to pose a systemic risk problem and thus need less supervision.[314]

In the United States, for instance, 213 hedge funds are in the so-called "billion dollar club" and hold more than $1 billion of assets under management, while only 34 manage more than $10 billion.[315]

---

[311] Juraj, *supra* note 257, at 24.

[312] In Dubai, hedge funds are required to comply with the Collective Investment Law. Collective Investment Law, DIFC Law No. 1 of 2006, *available at* http://www.complinet.com/file_store/pdf/rulebooks/DFSA_8387.pdf. This law was enacted and came into force on 18 April 2006 and was amended in 2006 and 2007. These rules are broad and do not apply to hedge funds directly. Therefore, the DFSA has chosen to follow a U.K-like approach. In 2007, a non-biding Hedge Fund Code of Practice was launched. It aims at addressing issues and risks that are specific to hedge funds. Dubai Financial Services Authority, Hedge Fund Code of Practice, 2007.

[313] Dubai Financial Services Authority, Hedge Fund Code of Practice, 2007 at 2.

[314] *Perspectives on Hedge Fund Registration: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. On Financial Servs.*, 111th Cong. 8 (2009) (statement of Brad Sherman, Congressman) (stating that small entities should not have to bear excessive regulation in order to preserve "cowboy capitalism").

[315] Hedge Fund Intelligence, *Global Review 2010 Report*, 2010 *available at* http://www.hedgefundintelligence.com/Article/2455359/Issue/74948/Global-hedge-fund-

This is a modest number compared to the 9400 hedge funds that exist worldwide. This also means that the majority of funds are probably too small to raise concerns of systemic risk. In that respect, it should be noted and appreciated that both the PFIARA and the AIFM address this concern by exempting small funds from registration, therefore providing them a way out of complying and supporting the costs that registration and on-going disclosure would entail. Under the PFIARA, funds with less than $30 million of assets under management are exempted from registration.[316] The AIFM Directive does not require registration for funds under €100 million of managed portfolio. Should the Directive be adopted, 90% of assets of EU domiciled hedge funds would fall under the scope of the Directive and would have to register.[317] The draft also sets a higher exemption threshold of €500 million for funds, which do not use leverage and have a five year lock-in period since they are deemed to not present a systemic risk.[318]

Introducing more regulation can have several drawbacks that must be carefully examined prior to considering imposing new rules on one part of the financial industry. This analysis can be carried out by asking a set of questions described below.

Are the Potential Benefits Really Worth the Costs?

One cannot prevent what one cannot predict. In this regard, regulation may be justified if more transparency is needed or when a financial entity poses a systemic risk, which is more problematic in the case of hedge funds.

Because the term "regulation" encompasses the regulation of structure, reporting and activities, one must be extremely careful not to draw too general a conclusion. Although some types of regulation seem necessary, some are unnecessary. Regulation consisting of data collection, for instance, allows risk anticipation to mitigate them and avoid potential chain reactions. Allowing regulators to exercise deeper oversight over the sector and to have access, under certain aforementioned conditions, to hedge fund data brings a certain benefit to the financial system. Yet is this benefit really worth the costs and the energy governments are devoting to it at the moment?

One should never forget that introducing more regulation is costly for governments, regulators, and the industry itself. It is esti-

---

assets-rebound-to-just-over-18-trillion.html?Task=report. The top 10 hedge funds manage between $20 billion to $50.4 billion as of January 2010.

[316] PFIARA, § 402.

[317] Press Release, Europa, Financial Services: Commission Proposes EU Framework for Managers of Alternative Investment Funds (Apr. 29, 2009), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/669.

[318] *Id.*

mated that the AIFM Directive would cost €3.2 billion[319] to the hedge fund/private equity industry due to rules on delegation and changes to legal structures which may require the reorganization of the business models, and around €27 million in ongoing compliance costs.[320] Studies have also shown that the SEC's estimates are understated.[321]

The term "costs" goes beyond the simple issue of compliance. Here, costs refer to a broad category. The term encompasses the time devoted to discuss, evaluate, vote for, enforce the new registration process, audit and investigate, fill out forms, answer the regulator's demands, set out new compliance procedures, and provide extensive disclosures. It also refers to the above-mentioned compliance costs for hedge funds and to a lesser extent to regulators, as well as to reduced investment opportunities for investors.[322]

Costs in terms of personnel needs, especially the ones borne by regulators, are often forgotten. Competent economists and analysts are needed to process the information provided by hedge funds to properly assess systemic risk and anticipate potential crisis. This is particularly true for the SEC, which is essentially composed of lawyers. The SEC would need to hire economists and experts in statistics to exercise an effective oversight on hedge funds.

One must be extremely careful not to impose an excessive or potentially harmful financial burden on hedge funds. This last remark is particularly addressed to the "third country" provision of the AIFM Directive. If this provision were to come into force, it would likely have a disastrous financial impact on those funds and deter them and their managers from doing business from and with the European Union.[323] However, the argument is less relevant in the PFIARA case, which does not impose excessive requirements prone to financially destabilize hedge funds.

Finally, introducing new regulations can ultimately carry negative costs for the home country as it may impair its competitiveness. For instance, London, the EU's main hub for investment manage-

---

[319] *La Proposition de Directive AIFM Pourrait Coûter 3,2 Milliards d'euros*, L'AGEFI, Oct. 16, 2009, *available at* http://www.agefi.fr/articles/La-proposition-directive-AIFM-pourrait-couter-3-2-milliards-deuros-1111558.html.

[320] For a detailed analysis of the impact of the Directive on costs, see Table 2 in CHARLES RIVER ASSOCS., *supra* note 106, at 3.

[321] Kentouris, *supra* note 248.

[322] According to CRA, investment opportunities in hedge funds would be reduced by 40% if the Directive were adopted. CHARLES RIVER ASSOCS., *supra* note 106, at 1.

[323] *See, e.g., AIFM 'Third Country' Threat Stirs Wide Concern*, PRIVATEEQUITYONLINE, Mar. 15, 2010, http://www.allbusiness.com/banking-finance/financial-markets-investing-securities/14107035-1.html.

ment,[324] could lose a huge part of its business if the Directive were enacted as it is drafted today. More generally, one should think twice before passing regulations that could put a $1.7 trillion industry employing 150,000 people worldwide out of business.[325]

What Effect Could Direct Regulation Have on Hedge Funds and Financial Markets?

Introducing more regulation may also impair performances of hedge funds and harm the financial markets. Empirical studies[326] demonstrate that there is causal link between the amount of regulation and hedge fund performance and the fact that the current legal regime in the United States is a source of Alpha.[327] According to Cumming,

> [T]he data indicate regulatory requirements in the form of restrictions on the location of key service providers and marketing channels that permit wrappers tend to be associated with lower MPPMs [Manipulation-Proof Performance Measures],[328] lower alphas, lower average returns, higher fixed fees and lower performance fees. The standard deviation of returns is lower among jurisdictions with restrictions on the location of key service providers and higher minimum capitalization requirements.[329]

The current regime also has advantages on the market itself since hedge funds must constantly innovate to maintain their competitive edge, which the current legal framework allows because of its absence of constraints. Although some argue that innovation tends to develop more complex products that carry more risks, innovation is first and foremost a key component of financial dynamism. Stifling financial innovation may result in stifling growth. There are also concerns that over-regulating hedge funds "may reduce liquidity, which

---

[324] IFSL RESEARCH 2010, *supra* note 1, at 1, 3.

[325] IFSL RESEARCH 2009, *supra* note 42, at 2.

[326] For an empirical study on the impact of hedge fund regulation on performance, see Douglas Cumming, *A Law and Finance Analysis of Hedge Funds*, Apr. 5, 2008. The paper is based on an empirical analysis of a cross country dataset of 2137 hedge funds from twenty-four countries from January 2003 to December 2005.

[327] Shadab, *supra* note 220.

[328] Manipulation-Proof Performance Measure.

[329] Cumming, *supra* note 326, at 4.

would have a large negative effect on the markets," as Alan Greenspan pointed out.[330]

Is the Proposed Regulation Flexible Enough to Meet Hedge Funds' Characteristics?

Hedge funds are flexible investment vehicles tailored to meet the requirements of various exemption regimes. When dealing with investment management funds, one must keep in mind that imposing strict regulations on them and/or on their advisers might not only drive them away but may also be counterproductive and encourage them to find loopholes.

New techniques and products could potentially be even more dangerous for market stability because they would escape the regulatory scope. Lo's comment on what regulation should be is interesting when he writes, "[n]ew regulations should be adaptive and focused on financial functions rather than institutions, making them more flexible and dynamic."[331]

Christian de Boissieu, comparing the tension between financial innovation and regulation to a "hide and seek game," concluded that direct control of hedge funds would fail because the controlled instrument would reappear elsewhere under a new name and a new form. According to de Boissieu, it would better to rely on an indirect regulation of those funds, consisting in reinforcing controls on counterparties.[332] This is also the opinion of CESR Chairman Eddy Wymeersch, who suggested that systemic risk-related information be gathered from prime brokers.[333] Hellgardt also agrees, stating, "since it is not warranted to destroy the hedge fund industry through heavy regulatory measures but rather to cultivate its beneficial impact on the financial markets, while monitoring the dangers for systemic stability, it is preferable to employ indirect regulatory techniques instead of reforming direct hedge fund regulation,"[334] and to employ banks as gatekeepers for minimal interference with hedge funds operations.

---

[330] *See* John Horsfield-Bradbury, *Hedge Fund Self-Regulation in the US and the UK*, Apr. 28, 2008, *available at* http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/Brudney2008_Horsfield-Bradbury.pdf.
[331] Lo Testimony, *supra* note 206, at 3.
[332] Christian de Boissieu, L'articulation entre régulation et crise dans le secteur bancaire et financier, in Marie Anne Frison-Roche (sous la direction de), Les risques de la régulation *Volume 3*, Presses de Sciences Po et Dalloz, 2005, at 25.
[333] E.U. Commission open hearing on hedge funds and private equity, February 26 and 27, 2009, *available at* E.U. Commission Hearing, *supra* note 189, at 17.
[334] Alexander Hellgardt, *Hedge Funds, the Financial Crisis, and Regulatory Competition: How to Maintain U.S. Supremacy in Hedge Fund Incorporations*, Harvard Law School, 2010.

These recommendations underline the need for strong enough regulation to prevent hedge funds from becoming a threat to financial stability, but not too much in order to avoid the counterproductive effects mentioned above. The challenge lies in finding the right balance and appropriate measures that will provide benefits without creating a burden on hedge funds' competitiveness and operations. This comes down to determining whether regulation is always the best alternative to reach the objectives sought and if similar goals are feasible otherwise.

The hedge fund industry praises self-regulation, also known as market discipline, which is organized by so-called SROs (self-regulatory organizations).[335] Primary examples include the Hedge Fund Working Group in the United Kingdom, as well as the AIMA, MFA, and the Asset Managers' Committee to the President's Working Group on Financial Markets in the United States.

These SROs are well-established authorities. In Europe, the Hedge Fund Standards Board (HFSB), set in 2008, aims at codifying best practices.[336] Managers representing 60% of the European hedge fund industry and $350 billion in assets follow the voluntary code of conduct of the HFSB.[337]

In 2006, Federal Reserve Chairman Ben Bernanke argued that "[d]irect regulation may be justified when market discipline is ineffective at constraining excessive leverage and risk-taking but, in the case of hedge funds, the reasonable presumption is that market discipline can work."[338] He further underlined the costs in terms of moral hazards and the loss of private market discipline that direct regulation would imply and well as the possible limits on funds' ability to provide market liquidity.[339] SROs tend to establish rules that are better tailored to the realities and needs of the market and of the relevant activity.[340] One of the main criticisms of the SEC was that its staff was mainly composed of lawyers who may be disconnected from the reali-

---

335 *See, e.g.*, David Weidner, *Hedging the Feds: It's Time for Hedge Fund SRO*, MARKETWATCH, Apr. 20, 2006, http://www.marketwatch.com/story/its-time-for-a-hedge-fund-sro.

336 *BlueCrest, Winton Sign Up For Voluntary Hedge Fund Code*, FINALTERNATIVES, February 11, 2010, *available at* http://www.finalternatives.com/node/11391.

337 *Id.*

338 Bernanke, *supra* note 206.

339 *Id.*

340 Philipp Fischer, *Self-Regulation in the Financial Sector - Status Quo and Future Outlook*, 7 (Harvard Law School, 2009), *available at* http://www.law.harvard.edu/programs/about/pifs/llm/select-papers-from-the-seminar-in-international-finance/llm-papers-2008_2009/fischer.pdf.

ties of the industry they aim at regulating.[341] Self-regulation, through a code of best practices, enjoys a higher degree of acceptance by the governed. This, as Fischer noted, leads to a greater degree of compliance by leveraging the industry's expertise and shifting at least part of the regulatory burden from the public authority to the industry.[342]

Critics of self-regulation have voiced concerns about possible conflicts of interests and how these codes of conduct could be enforced.[343] The HFSB, for instance, specified in its response to an International Organization of Securities Commissions (IOSCO) consultation, "it is important to highlight that, while HFSB monitors the Standards, it does not serve as a regulator and does not enforce them."[344]

Therefore, I do not believe in control exercised solely by the industry but rather in a coordinated approach and in stronger cooperation between regulators and SROs to create rules that are flexible enough to adapt to this fast-paced changing financial environment. By including SROs in the rule-making process, one may also achieve greater compliance and limit by-pass behaviors. One way of appropriately combining SROs and regulators would be to require mandatory membership in industry associations, as proposed by Jiri Krol, Minister of Finance of the Czech Republic.[345] Juraj has gone further by suggesting that legislators should set basic goals and require regulators to ensure that each category of funds adequately pursues these goals, while assessments of adequacy should be matters of negotiation and, in case of controversy, judicial determination.[346] However, this model raises many issues in terms of legal certainty, and even more so in terms of how the SEC would treat funds that bridge several strategies and do not fall into just one category.

Also interesting is the initiative of the Asset Managers' Committee to the President's Working Group on Financial Markets, which

---

[341] *See, e.g.*, Adam Peter & Michael D. Kinsman, *Quest to Regulate Hedge Funds Hits Speed Bump,* 10 GRAZIADIO BUS. REV. (2007) *available at* http://gbr.pepperdine.edu/2010/08/sec-quest-to-regulate-hedge-funds-hits-speed-bump/.

[342] Fischer, *supra* note 340, at 7.

[343] E.U. Commission Hearing, *supra* note 189, at 18. Panelists John Gaine (of MFA), Florence Lombard (of AIMA), and Dan Waters (of FSA) viewed industry codes as a useful complement to regulation but pointed out the main problem with the self-regulatory approach is enforcement.

[344] Press Release, Hedge Fund Standards Board, HFSB Public Response to the IOSCO Consultation Report on Hedge Fund Oversight 8 (Apr. 30, 2009) *available at* http://www.hfsb.org/sites/10109/files/hfsb_response_iosco_hf_oversight_30_04_2009.pdf.

[345] EU Commission open hearing on hedge funds and private equity, February 26 and 27, 2009 E.U. Commission Hearing, *supra* note 189, at 19.

[346] Juraj, *supra* note 257, at 23.

released its "Best Practices" report, together with a separate "Investors' Report," to increase accountability for hedge fund managers.[347] The President's Working Group believes that a large part of the responsibility of investment assessment should be on investors themselves.[348] A market regulatory system that sanctions managers who do not comply with best practices principles, while also educating investors, could ensure that rules are effectively enforced without additional costs on regulators and managers.

At that point, a general recommendation can be made. When contemplating more regulation, legislators should keep in mind that if their interests and the industry's interests coincide, then rules will be more effective and better enforced. Regulation is often seen as a punishment on certain activities or market players. This view, however, is remedied by attempting to align all parties' interests.

1.2 Proposal for the Creation of a Global Database of Systemic Risk

The Dangers of Mandatory Public Disclosure

Legislators and regulators must understand hedge funds and the impact any regulation may have on the industry, to achieve a reasonable legal framework that will not jeopardize hedge fund activities or their very existence. In that respect, initiatives such as the studies of the AIFM Directive must be encouraged and developed.[349]

To illustrate how regulators' goals can directly conflict with hedge funds activities, one can consider the provisions of both the PFIARA and the AIFM Directive, which require disclosure of positions and strategies. While there is a legitimate rationale in trying to assess the risks posed by each hedge fund to limit systemic risk, it is not clear that this information will remain confidential. If the purpose of these provisions is to disclose this information to the public, there could be dreadful consequences on the industry.

First, it raises an intellectual property issue. Hedge funds distinguish themselves from other funds by their investment strategies. According to Lo, hedge funds are "among the most secretive of financial institutions because their franchise value is almost entirely based

---

[347] BEST PRACTICES, *supra* note 18.
[348] Horsfield-Bradbury, *supra* note 330, at 36.
[349] *See* PFIARA. The PFIARA also includes a provision on cost study to be carried out by the Comptroller General assessing the costs borne by investors and advisers due to new requirements within two years of the enactment of PFIARA. PFIARA, § 929Z. The Dodd version includes impact studies on the feasibility of a self-regulatory organization to oversee private funds, on the accredited investor standard and on short selling practices. Although this is a good initiative, carrying such a study prior the enactment would be preferable in order to anticipate rather than to adapt ex post.

on the performance of their investment strategies, and this type of intellectual property is perhaps the most difficult to patent."[350] If forced to disclose such strategies, funds may not be able to maintain their competitive edge, thus affecting their competitiveness and diminishing their contributions to market liquidity.[351] Lo warned about the disastrous effects forced disclosure would entail.[352] According to him, the most intellectually innovative funds would cease to exist or move to less intrusive regulatory jurisdictions, generating a major loss to the American capital markets.[353] This argument is easily applied to the EU, where this provision could have a procyclic effect, increasing systemic risk. Indeed, if rules have a negative impact on hedge funds and lead them to fail, this will certainly not be an improvement for systemic risk prevention.

Second, full disclosure could entail moral hazard issues, which the Issing Committee highlighted in its report.[354] According to the Committee, full disclosure could lead hedge fund advisers to feel "wrongfully safe" and therefore less cautious.[355]

Third, making positions and strategies available to other funds could lead to herding behaviors, which, as previously discussed, is source of systemic risk.[356]

Finally, there is a practical concern based on the ongoing collection of hedge fund information. The Issing Committee called it "unrealistic, because of the fast changes in fund exposures . . . and the enormous data collection and analytical requirements involved."[357] Bernanke also rejected day-to-day hedge fund monitoring, stating:

> A system in which hedge funds and other highly leveraged market participants submit position information to an authority that aggregates that information and reveals it to the market would probably not be able to address the concern about liquidity risk. Protection of proprietary information would require so much aggregation that the value of the information to market participants would be substantially reduced.[358]

---

[350] Lo Testimony, *supra* note 206.

[351] *Id.*

[352] *Id.*

[353] *Id.*

[354] CTR. FOR FIN. STUDIES, *supra* note 193, at 20.

[355] *Id.*

[356] *Id.*

[357] *Id.*

[358] Bernanke, *supra* note 206.

Preliminary remarks

Therefore, this paper advocates for a cautious approach to data collection. It supports the idea that all information gathered be kept anonymous and confidential, accessible for the sole purpose of assessing risks and for the use of regulators. To do so will guarantee that hedge funds will be able to carry out their strategies while allowing regulators to properly exercise their control. This paper also supports the idea that the burden of proving that information is necessary to assess systemic risk should be placed upon regulators,[359] to avoid excessive requests. It also argues that the day-to-day collection of data is irrelevant, excessive, and costly. Information should be collected on a monthly basis, or more frequently only in volatile markets, and only if regulators prove it to be necessary.

Finally, this monitoring will only be effective if information is shared on a global scale, through an alert system for instance. When a regulator would detect a significant risk, the alert system would send an alert to regulators of jurisdictions in which the fund is a potential threat. There is no longer national systemic risk due to the interconnectedness of economies. Only by achieving effective global cooperation can risks be properly mitigated. And, therefore, cooperation among regulators is key.

For a Global Database of Financial Information

Taking into account all the arguments developed above, this paper recommends the creation of a global database of financial information.[360] The term "financial information" would include all useful and relevant information necessary to carry out a proper assessment of systemic risk, such as information on leverage, value-at risk (VaR),[361] collateral, liquidity needs, use of financial instruments (espe-

---

[359] This recommendation was made by the Committee on Capital Markets Regulation. *See* COMM. ON CAPITAL MKTS. REGULATION, *supra* note 245, at 13.

[360] This recommendation was developed in the report prepared by the think-tank Club Praxis. *See Club Praxis Rapport Flash sur la Régulation Financière Systémique,* New York, Dec. 9, 2009, *available at* http://www.clubpraxis.com/en/rapports/rapport-flash-sur-le-risque-systemique/. (Please note that the English version provided is for information only. The author used the original, French version.) The report recommends that this database be a G20 initiative placed under the supervision of the Forum of Financial Stability. *Id.*

[361] The Value at Risk "measures how much the institution can be harmed by market moves: it is concerned with the marginal loss distribution of the institutions portfolio." *See* Cont, Moussa & Minca, *supra* note 169. The VaR may be an interesting indicator but measuring systemic risk implies that one understands how much the financial system can be harmed by the failure of an institution. Therefore, additional indicators may be needed. The paper mentioned in this footnote

cially complex financial instruments such as over-the-counter derivatives), and information about the interconnectedness to other large financial institutions.

Hedge funds would disclose such data but any other financial entity that is potentially systemically significant would be required to do so as well.[362] To do so would allow regulators to understand the structures and dynamics of interconnections between financial institutions and to develop an *ex-ante* approach to regulation of systemic risk. This approach is probably the most effective way to deal with such complex financial networks. The information gathered on hedge funds would remain confidential and anonymous in order to avoid the intellectual property issues already discussed.

On February 25, 2010, IOSCO, whose membership includes 95% of the world's securities markets, released a template for the global collection of hedge fund information to be disclosed every six months that "will assist in assessing possible systemic risks arising from the sector."[363] Even though the organization has no formal authority to impose these disclosure requirements on hedge funds, its members are committed to follow its guidelines. This initiative is certainly a first step toward international cooperation, but several reservations may be mentioned. This template diverges from the above proposal in several respects.

First, this provision is insufficient as it only targets hedge funds. Therefore, it fails to make this global database a true systemic risk monitoring tool that would encompass other financial institutions and allow a complete assessment to account for mutual exposures. Second, it is not clear that this information will be kept confidential from public view, which is problematic. The third concern has to do with enforcement, as IOSCO does not have any direct authority on hedge funds.

---

proposes two new measures of systemic risk which this author finds compelling: the "default impact" which measures the connectivity with other market participants and the magnitude of exposures, and the "expected systemic loss" measure.

[362] In this respect, a proportionate approach like the FSA's which requires only the U.K.'s larger hedge fund managers to report systemically-relevant data would be desirable, as not all hedge funds are likely to pose a systemic risk.

[363] International regulators publish systemic risk data requirements for hedge funds, *see e.g.*, Press Release, International Organization of Securities Commissions (Feb. 25, 2010), *available at* http://www.iosco.org/news/pdf/IOSCONEWS179.pdf.

2. *The Challenge of Developing a Global Approach to Hedge Fund Regulation*

2.1 *The Difficulties of Developing Global Standards*

In today's world, markets are interconnected and finance ignores borders. On the other hand, the law is confined within a defined territory, creating a disjunction between territorial regulation and global activities. This general remark applies to hedge funds and might be one of the greatest challenges facing financial law.

Indeed, the financial market is faced with operations and investors in different jurisdictions in addition to the potential conflicting regulations issues and high costs of compliance. There also exists the risk of forum shopping since the absence of a coordinated approach at the international level allows hedge funds to move to less stringent jurisdictions out of the reach of regulatory oversight—which is hardly good news for the efforts to mitigate systemic risk.

Florence Lombard, Executive Director of the AIMA, called for a system of mutual recognition of international standards even from offshore jurisdictions.[364] A coordinated approach to regulation is much more effective and less costly.

Achieving a globally harmonized legal framework for hedge funds appears utopian, at least for now. As Part I demonstrated, there is no common regulatory approach in the United States or within the EU. As Part II conveyed, the current reform proposals did not seize the opportunity to promote a coordinated approach.

There still is no consensus on what form regulation should take or on what material should be regulated. Even within the EU, member states fight among themselves to impose their own visions of financial regulation and do not seem to be willing to compromise and move toward greater harmonization.

This paper does not support the idea that international financial regulation is unatainable. It only acknowledges the structural and cultural elements that must be considered by those willing to overcome those difficulties and promote an international framework.

Deep philosophical and cultural differences have shaped different conceptions of regulation in general, and of regulation of investment vehicles in particular. On one side, the U.K., the U.S., and to a lesser extent Italy, favor a flexible approach to hedge fund regulation. On the other hand, France and Germany continue to push for further regulation. Understanding these divergences is the first step to overcoming them and developing an international legal framework.

These differences may, first of all, be rooted in the very conception of the role of the state. France and Germany have a strong state

---

[364] E.U. Commission Hearing, *supra* note 189, at 17.

intervention tradition while the U.S. has traditionally taken a more liberal approach. This may also come from the role of the law itself in each country. France has always been a highly regulated country with frantic legislative activity, while the United States regulates more lightly and only when necessary.

The way each of the countries discussed regard hedge funds is also influenced by the importance of the industry in these countries. For instance, France and Germany may not be so concerned about the impact of hedge fund regulation on their economies because this impact would not be so significant. On the other hand, the U.K. and the U.S. have a strong incentive to preserve their competitiveness as the two main financial centers for hedge funds.

Finally, despite the efforts of the G20, there seems to be a competition between the jurisdictions mentioned in this paper to impose their own vision of regulation in a very chauvinistic way, which is arguably prejudicial.[365]

In today's financial world, one can no longer afford this nationalism for another age. It is regrettable that regulators and politicians have made statements jeopardizing efforts to build effective international cooperation. For instance, when asked what should be done at the European level to deal with hedge funds, the President of the French AMF said, "setting the example and not be subject to a regulation that would be strictly American."[366] Also consider EU Commissioner Michel Barnier, who declared he would not be bullied by "Paris or London and certainly not by Washington."[367] Likewise, FSA officials publicly stated that the U.K. would not make any compromise on the current draft of the AIFM Directive, and Angela Merkel verbally attacked Gordon Brown over his refusal to move forward with the Directive.[368]

Beyond philosophical and cultural differences, there is a competitiveness issue that slows the internationalization of financial regulation. Indeed, although achieving a level-playing field seems compelling in many respects, many countries fight to keep their com-

---

[365] Some actually see the absence of harmonization as a good thing. Indeed, regulatory competition may be seen as a stimulating element that motivates attempts to reach better legal systems which ultimately brings benefits and contributes to the improvement of legal frameworks. This idea, although unpractical from a hedge fund regulation point of view, is nonetheless interesting.

[366] Intervention de Jean-Pierre Jouyet, Président de l'AMF, Conférence sur les Hedge Funds, Bruxelles, February 26, 2009.

[367] *British Block Euro. Hedge Fund Rules*, FINALTERNATIVES, Mar. 16, 2010, *available at* http://www.finalternatives.com/node/11781.

[368] Tony Czuczka & Patrick Donahue, *Merkel Berates U.K. Over Hedge-Funds*, BUS. WK., Mar. 17, 2010.

petitive edge in sometimes protectionist ways. This is what Joseph Stiglitz developed in a recent article when he stated:

> [E]ach country looks at each proposal and assesses how it affects the competitiveness of its financial system; the objective too often is to find a regulatory regime that crimps competitors more than one's own companies. As the saying goes, all politics is local, and, at least in the US and many other jurisdictions, finance is a big political player.[369]

2.2 Overcoming Divergences and Differences to Effectively Mitigate Systemic Risk on a Global Scale

If I do agree with Stiglitz's above statement, which identifies a real issue, I do not agree with the remedy he advocates. He claims that since achieving global coordination seems difficult, there is no time to lose in trying to do so. According to Stiglitz, because each country is responsible for "ensuring the safety and stability of its financial system and economy . . . [i]t is far better to have strong action now and then harmonize the regulatory structures later. It may be 'second best' but far better than the third-best alternative of delayed and ineffective regulation."[370]

Given the nature of systemic risk and the interconnectedness of the financial markets, delaying efforts to develop a coherent global framework for entities with global operations is hardly conceivable and is certainly not the best alternative. Since the PFIARA and the AIFM are simultaneously discussed, one can deplore that the opportunity to promote a global approach to hedge fund regulation was not seized despite the recommendations of the G20, of many committees, think tanks, and academics publications.

Failure to achieve global standards in current reform proposals does not mean that efforts in that sense do not exist. Examples of these efforts to develop global cooperation may be illustrated by the existence of bilateral agreements between regulators such as the "Memorandum of Understanding on Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms" between the FSA in the U.K. and the SEC in the United States.[371] The "strategic dialogue" between the two regulators was initiated in 2006, and the fifth meeting in Feb-

---

[369] Joseph Stiglitz, *Watchdogs Need Not Bark Together,* FIN. TIMES, Feb. 10, 2010.

[370] *Id.*

[371] SEC & FSA, Memorandum of Understanding on Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms (2006), *available at* http://www.fsa.gov.uk/pubs/mou/fsa_sec.pdf.

ruary 2010 discussed, among other things, the regulation of hedge funds and investment advisers.[372] Efforts have also been made within the G20, IOSCO, the CESR, and various *fora* and committees to develop international standards, which should be encouraged. Yet, if such initiatives exist, they are often more formal and rarely lead to legal harmonization, often because they are confronted with legislators who are not willing to go down that path.

The most advanced example of global cooperation to this date remains at the level of the SROs. They indeed easily generate consensus within the industry. The guidelines they provide the industry are flexible and easily transposable on a global level. Andrew J. Donohue, Director of the Division on Investment Management at the SEC, referred to such rules as "an excellent model for the way in which industry can work together with regulators around the globe to develop smart and sensible solutions to hedge fund regulatory issues and to strengthen and enhance confidence in all of our markets."[373]

In other words, it seems the hedge fund industry is ready for an international legal framework, but governments and regulators still struggle to overcome their national particularisms. This leads to deadlock. Harmonization of legal frameworks appears illusory since regulators continue to contemplate national-based reforms when an effective prevention of systemic risk calls for international cooperation.

The proposal presented in this paper takes this structural difficulty into account. It acknowledges the natural tendency of jurisdictions to handle regulation on a national basis. The creation of a global database of systemic risk does not negate national prerogatives to regulate as each country sees fit, but promotes a framework for global cooperation via an information sharing system superimposed on national regulations.

PART IV: CONCLUSION

This paper has reviewed existing legal frameworks applicable to hedge funds in the United States, the United Kingdom, France, Germany, and Italy. It concludes that additional regulation is not necessary, and in certain cases would potentially be counterproductive or even dangerous if improperly tailored to this industry's needs and characteristics.

---

[372] *See* Press Release, FSA, SEC and UK FSA Hold Fifth Meeting of the SEC-FSA Strategic Dialogue (Feb. 1, 2010), *available at* http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/021.shtml; *SEC, FSA To Boost Cooperation On Hedge Funds*, FINALTERNATIVES, Feb. 2, 2010, http://www.finalternatives.com/node/11207.

[373] Andrew J. Donohue, Dir., SEC Div. of Inv. Mgmt., Keynote Address at the 9th Annual International Conference on Private Investment Funds, (Mar. 10, 2008).

The paper deplores the lack of global coordination and convergence in current efforts to reform the hedge fund legal framework. It recommends hedge funds remain lightly regulated and that increased harmonization be reached through private initiatives that have demonstrated their success in developing international best practice standards, which are now widely accepted by the industry and implemented.

Nonetheless, this paper acknowledges that hedge funds raise legitimate concerns about systemic risk, and that action should be taken in order to mitigate potential threats to financial stability. Systemic risk is neither national nor limited to one player. It must be treated using a coordinated and global approach. As a report of the British Academy very well noted, "[r]isk calculations were most often confined to slices of financial activity, using some of the best mathematical minds in our country and abroad. But they frequently lost sight of the bigger picture."[374] In order to reach this "bigger picture," this paper recommends the creation of an international database that would collect all the financial positions and the counterparts of all the major financial institutions and monitor systemic risk on a global scale through increased cooperation efforts.

PART V: RECENT DEVELOPMENTS

Since this paper was written in April 2010, the United States and in the European Union enacted major legislative developments.

In the United States, the Wall Street Reform and Consumer Protection Act of 2009, also known as Dodd-Frank Act ("The Act"),[375] was enacted on July 21, 2010 and more than 200 implementing measures are expected to be issued by various agencies by July 2011, by the time the Act becomes effective.

On the other side of the Atlantic, on November 11, 2010, the European Parliament adopted the controversial Alternative Investment Fund Managers ("AIFM") Directive (collectively, the "Directive") after months of disagreements and intense debates. The Directive shall be published in 2011, and it will come into force on January 1, 2013.

This section provides a short overview [376] of the main provisions of Title IV of the Act (Part 1) and of the AIFM Directive (Part 2), while keeping in mind that both reforms will be implemented progres-

---

[374] Letter from British Academyto Her Majesty The Queen (July 22, 2009), *available at* http://media.ft.com/cms/3e3b6ca8-7a08-11de-b86f-00144feabdc0.pdf.

[375] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376-2223 (2010) [hereinafter Dodd-Frank Act].

[376] Under no circumstances should this additional section be considered as an exhaustive summary of two long and complex statutes.

sively, through a process which will involve regulators and market participants and entail many consultations, discussions and the drafting of many rules. The paper underlines, when relevant, the various elements for which the industry still awaits precision and offers some comments about both reforms.

1. The Dodd Frank Act

Title IV of the Act,[377] entirely devoted to private fund advisers, amends the Investment Advisers Act of 1940. It starts with a definition of the term "private fund." Rather than defining a private fund, which would have been a nearly impossible task and would not have had the breadth to encompass all types of funds,[378] structures or strategies, Congress compromised and drafted the following wording "a private fund means an issuer that would be an investment company, as defined in §3 of the Investment Company Act of 1940, but for §3(c)(1) and 3(c)(7) of that Act."[379]

The Act was marketed as the statute that would finally regulate hedge funds. Often depicted as unregulated investment vehicles, hedge funds were never completely unregulated and thus, the Act does not create a framework for hedge fund regulation. Rather, the Act increases the level of scrutiny and requirements to which hedge funds are subject, both through the mandatory registration of private fund advisers with the SEC and through tougher standards regulating some of the operations they carry out.[380]

Title IV eliminates the private adviser exemption and amends §203(b)(3) of the IAA.[381] Effective July 2011, private fund advisers including hedge fund advisers will be required to register with the SEC unless they fall into one of the following exemptions[382] in which case they become exempt from registration with the SEC.[383]

---

377 The PFIARA mentioned throughout the paper was incorporated into the Dodd Frank Act and is now known both as the Private Fund Investment Advisers Registration Act of 2010 and as Title IV of the Dodd Frank Act: "Regulation of Advisers to Hedge Funds and Others."

378 *See supra*, Part III, 1.1.

379 Dodd-Frank Act § 402.

380 E.g. proprietary trading, use of derivatives, etc. *See* Dodd-Frank Act.

381 Dodd-Frank Act §§ 401-416.

382 Exempt advisers may be required to maintain records and provides reports to the SEC should the SEC deem it *"necessary and appropriate."*

383 Exempt advisers are not prohibited from registering with the SEC, even if they fall within the scope of one of the above mentioned exemptions. They may decide to register on a voluntary basis provided that they hold at least $100 million in assets under management.

(1) Advisers that act solely as investment advisers to one or more venture capital fund;[384]
(2) Investment advisers acting solely as advisers to private funds whose assets under management in the United States do not exceed $150 million;[385]
(3) "Family offices;"[386]
(4) Foreign private advisers that have no place of business in the United States, have fewer than 15 clients and investors and whose aggregate assets under management from such clients and investors are less than $25 million, or such higher amount as the SEC may by rule determine;[387]
(5) Advisers to small business investment companies.[388]

Title IV reallocates the responsibility for oversight of investment advisers at the state and at the federal level. It requires private fund advisers with assets between $25 million and $100 million of assets under management to register with the state. According to the SEC, approximately 4100 investment advisers would switch from SEC to state registration as a result of the enactment of the Act.[389] However, it should be noted that the minimum assets threshold for SEC registration may be lowered to $25 million in certain cases. If an adviser is neither subject to nor required to register with the securities commissioner of the state where its principal office or place of business is located, or when the adviser would otherwise be required to register with 15 or more states, then the minimum asset threshold may be lowered.

The Act also redefines the articulation between the SEC and the CFTC. Advisers that are already registered with the CFTC for purposes of trading in commodities are exempt from SEC registration so long as they do not become predominantly involved with securities related advice.

---

[384] Dodd-Frank Act § 407. The SEC shall adopt rules to define the term "venture capital" within one year of the enactment of the Act.

[385] *Id.* § 408. It should be noted that Section 408 further provides in respect of mid-sized funds (term to be defined) that the SEC "shall take into account the size, governance and investment strategy of such funds to determine whether they pose systemic risk, and shall provide for registration and examination procedures with respect to the investment advisers of such funds which reflect the level of systemic risk posed by such funds."

[386] *Id.* § 409. The section provides guidelines for the SEC to define this term.

[387] *Id.* § 403.

[388] Dodd-Frank Act § 403.

[389] Securities and Exchange Commission, 17CFR Part 275 Release n° IA-3110; File S7-36-10 *"Rules Implementing Amendments to the Investment Advisers Act of 1940,"* at 9.

Mandatory registration entails many requirements for reporting,[390] recordkeeping, disclosures, or collection of systemic risk data. Under Section 404 of the Act, private fund advisers will be required to provide extensive information and data regarding the amount of assets under management, the use of leverage, the counterparty credit risk exposure, trading and investment positions, valuation policies and practices, or the types of assets held.[391] Beyond the list provided by the Act, the SEC will be given a broad discretion and authority to request any information "necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk by the Financial Stability Oversight Council" *(FSOC)*.[392]

This wording raises several concerns already discussed in greater detail in this paper. The first of these concerns is the heavy burden such requirements inflicts upon private advisers. The formulation of the provision extends the SEC extensive powers to request a tremendous amount of information that advisers will need to collect, process, and file. Such increased duties will increase the costs of compliance and will most likely be extremely prejudicial to small hedge funds.

Another critical issue, as explained earlier in this paper is confidentiality. The Act provides that the SEC should maintain a high level of confidentiality of the reports and information with which it is provided. However, the Act also provides that the SEC share this information with the FSOC, and doesn't withhold any information from Congress, courts, federal departments, or self-regulated organizations if they require access to these documents. These institutions must maintain a level of confidentiality consistent with the level established by the SEC. Even with such standards prescribed by the SEC, one may fear that confidential information, confidential strategies or valuation models shared among two, three or ten different bodies may not stay confidential very long. The manner in which the SEC and the FSOC handle confidentiality will have an undoubtedly significant impact on hedge fund operations and must therefore be treated with great caution.

Finally, the Act reinforces the supervision of the SEC over private fund advisers by granting a wide array of powers and authority. However, the question of the budget of the SEC is troublesome because it has not increased as in relation to its responsibilities. Indeed, the

---

390 Rules Implementing Amendments to the Investment Advisers Act of 1940, 75 Fed. Reg. 77052, 77054 (Dec. 10, 2010)(to be codified at 17 C.F.R. pts. 275 and 279). The SEC and the CFTC are currently working on additional changes to Form ADV.

391 Dodd-Frank Act.

392 Id.

task that awaits the SEC is daunting and many have expressed concerned about the quality and the fairness of the rulemaking process.[393] In less than a year, the SEC needs to adopt and implement hundreds of rules, create new offices, redefine standards such as the accredited investor standard,[394] or carry out studies. As Chairman Schapiro points out, the SEC will soon have to process the data of an additional 750 private fund advisers registering for the first time with roughly the same resources and with few economists to analyze the data.[395] Although collecting data is important and may help to prevent a crisis, data collection is pointless without analysis to carry out satisfactory *ex-ante* monitoring.

In addition to closer scrutiny by the SEC, hedge funds may also be subject to supervision by the newly created FSOC.[396] This new supervision may require a;

> [n]onbank financial company[to] become subject to consolidated, prudential supervision by the Board if the Council determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company['s] activities, could pose a threat to the financial stability of the United States.[397]

In addition, hedge funds and other organizations will be required to file a form on a quarterly basis, the content of which is currently being discussed between the SEC and the CFTC, aimed at assessing which funds are systemically important.[398] As of today, it may still be too early to comment on the implication of systemic risk monitoring for hedge funds because too many terms still require definition. For example: 1) What does being "predominantly engaged in financial activities" mean?; and 2) How can one measure if a fund is a "significant nonbank financial company"?

---

[393] *See, e.g.*, Implementation of Dodd-Frank : Hearing before the S. Comm. On Banking, House and Urban Affairs, 112th Cong. (2011) (opening statement of Sen. Richard C. Shelby, Ranking Member, S. Comm. On Banking).

[394] Net Worth Standard for Accredited Investors, SEC, (proposed Jan. 25, 2011) (to be codified at 17 C.F.R. pts. 230, 239, 270, 275).

[395] Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Hearing on the Oversight of Dodd-Frank Implementation: A Progress Report by the Regulators at the Half-Year Mark (Feb. 17, 2011).

[396] Press release, U.S. Sec. * Exch. Comm'n, SEC Proposes Private Fund Systemic Risk Reporting Rule (Jan. 25, 2011), *available* at http://www.sec.gov/news/press/2011/2011-23.htm.

[397] Definitions of «Predominantly Engaged in Financial Activities» and «Significant» Nonbank Financial Company and Bank Holding Company, 76 Fed. Reg. 7732 (Feb 11, 2011) (to be codified at 12 CFR pt. 225).

[398] *Id.*

The Board of Governors of the Federal Reserve has yet to choose a method for determining whether a fund is significant. The Board could adopt an objective quantitative method by setting a threshold of assets under management above which a nonbank financial company will be deemed "significant" or the Board could favor a case-by-case approach, which may seem fairer, but may generate more legal uncertainty.

The creation of the FSOC may be an interesting first step towards the creation of a global database of systemic risk information. It will be extremely interesting to see how the FSOC will operate and to see whether it will be a relevant forum, effectively gathering data from all systemically important entities and effectively interacting with foreign regulators.

Thus, the Act extends the scope of the IAA but does not significantly modify the general philosophy under which the United States regulates hedge funds. Although the Act demands more transparency and greater oversight, the extent to which it will impact the industry is unknown and will ultimately be determined at the implementation. Through implementing measures, regulators could either be quite permissive towards hedge funds rendering a minimal impact on their business or could seek to regulate these investment vehicles in a detailed and stringent fashion that would resemble the European approach.

2. The Alternative Investment Fund Managers Directive

In November 2010, after months of controversy and several drafts, the European Parliament adopted one of the most controversial European Directives. The directive aimed at laying down the rules for the authorization, ongoing operations and transparency of AIFM, which, until then, were regulated at the national level.

Under the Directive, AIFM means any legal person whose regular business is managing one or more alternative investment fund (AIF).[399] An AIF means, "any collective investment undertaking which raises 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," which does not require authorization pursuant to the UCITS Directive[400] and which shall have a single AIFM.[401]

---

[399] Alternative Investment Fund Managers Directive, P7_TA-PROV(2010) 0393, European Parliament Legislative resolution of 11 November 2010 on the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/. . ./EC. [hereinafter AIFMD] Please note that, while it has been voted on, the Directive has not yet been published.

[400] AIFMD, Art. 3(b) and (c) [hereinafter AIFMD]. The UCITS Directive refers to the Directive 2009/65/EC of the European Parliament and of the Council of July

Like the Dodd Frank Act, the Directive will come into force at the end of an implementation process which will be carried out at different levels[402] by the European Commission, the newly created European Securities and Markets Authority ("ESMA"),[403] national market authorities and the law of each Member state.[404] Although the Directive creates a harmonized regulatory framework for all Member states, each Member state will be able to apply stricter standards at their discretion, as long as these standards do not discriminate against AIFM of other Member states. Therefore, despite a desire to coordinate hedge fund regulation within the EU, a fragmented regulatory landscape with slight differences from one Member state to another may still persist.

The Directive applies[405] to (1) all EU AIFM who manage one or more AIFs whether or not in the EU, (2) all non-EU AIFM who manage one or more EU AIF and (3) all non-EU AIFM who market one or more AIFs whether an EU AIF or a non-EU AIF in the EU.

13, 2009 on the coordination of laws, regulations, and administrative provisions relating to undertakings for collective investment in transferable securities.

401 AIFMD, Art. 3a.

402 The implementation of the AIFMD will follow a classical Lamfalussy process. Level 1: the Commission adopts a formal proposal for Directive and the European Parliament and Council reach an agreement on framework principles of implementing powers in the Directive. Level 2: the Commission requests advice from the ESRC (now ESMA) on technical implementing measures. The ESMA prepares advice in consultation with market participants and submits it to the Commission, which examines it and makes a proposal to the European Securities Committee. This committee votes on the proposal and the Commission adopts the measures. Level 3: the ESMA works on joint recommendations, consistent guidelines and common standards. Level 4: Member states implement the legislation and the Commission verifies that they are in compliance" *Commission Staff Working Document The Application Of The Lamfalussy Process To Eu Securities Markets Legislation A preliminary assessment by the Commission servicesAnnex 1: The four-level regulatory approach under the Lamfalussy process available* at http://ec.europa.eu/internal_market/securities/docs/lamfalussy/sec-2004-1459_en.pdf.

403 The ESMA has replaced the Committee of European Securities Regulators on January 1, 2011.

404 It is expected that nearly 100 implementing measures will need to be taken before 2013. See European Commission, Directorate General Internal Market and Services, *Provisional Request for Technical Advice on the Directive for Alternative Investment Managers (AIFM) Level 2 Measures*, December 2, 2010.

405 *See* AIFMD, Art. 2. Note that the Directive applies to these three categories regardless of the AIFM legal form, of whether the AIF is open or closed-ended and of whether the AIF is constituted under the law of contract or under trust law.

The Directive provides a list of entities that fall outside the scope of the Directive[406] as well as a list of exemptions.[407] AIFM who manage one or more AIFs whose only investors are the AIFM or the parent's undertakings or the subsidiaries of the AIFM or other subsidiaries of those parent undertakings, provided that none of those investors itself is an AIF are exempt from the provisions of the Directive. AIFM who manage portfolios of AIFs whose assets under management, including any assets acquired through use of leverage do not exceed €100 million, or do not exceed €500 million when the portfolio consists of AIF that are unleveraged and have no redemption right exercisable during a period of five years following the initial investment are subject to limited provisions[408] although they may decide to opt-in and seek full authorization under the Directive in order to benefit from the rights granted thereunder.

To manage an AIF, an AIFM must apply for authorization in its home Member state and provide extensive information about the AIFM, on how it complies with the requirements of the Directive, and about each AIF it manages including information regarding investment strategies, remuneration policies, leverage, and risk profiles.[409] Once granted, and only if the conditions for authorization are met,[410] the authorization is valid in every Member state and the AIFM must notify the competent authorities of any material changes to the conditions for initial authorization.[411]

Unlike Title IV of the Act, which is quite concise and does not fundamentally change the U.S approach to hedge fund regulation, the Directive is a long and complex statute, comprised of 56 articles and more than 130 pages, dealing with nearly every possible aspects of hedge fund regulation ranging from initial capital requirements,[412] to

---

406 *See Id.* Holding companies, institutions covered by the 2003 Directive on the activities and supervision of institutions for occupational retirement provision, supranational institutions such as the World Bank, the IMF, the ECB, the EIB etc., national central banks, national, regional and local governments and bodies, including those supporting social security or pension systems, employee participation or savings schemes, and securitization special purpose entities.

407 *Id.* Art. 2a.

408 They must be registered with the competent authorities in their home Member state and identity itself and the AIF managed, provide information on the investment strategies of the AIF managed and on the main instruments in which they are trading, on exposures and on the most important concentrations of AIF they manageEU, and notify the competent authority if they cross the applicable threshold in which case they should seek full authorization within 30 days.

409 AIFMD, Art. 5.

410 *Id.* Art. 6 and 6a.

411 *Id.* Art. 7.

412 *Id.* Art. 6a.

the appointment of a single depositary,[413] remuneration policies,[414] risk management,[415] conflicts of interests,[416] liquidity management,[417] investment in securitization positions,[418] valuation,[419] disclosure and reporting obligations,[420] leverage,[421] or organizational requirements.

Such substantive and heavy requirements bring a fundamental change to the hedge fund industry that will require fund managers to rethink and potentially restructure the way they operate as well as causing hedge fund managers to spend large amounts of capital in compliance costs. In this context and facing such draconian measures, it is likely that some AIFM will choose to leave the European market for jurisdictions with lighter regulation.

While implementing the Directive, the Commission, the ESMA and Member states should refrain from adopting measures that would be too stringent and seek flexibility as much as possible. As developed earlier in this paper, overburdening these investment vehicles with too many rules that may not be relevant may be counterproductive. Moreover, the manner in which confidential information will be processed by the competent authorities is still unclear and one may fear that this issue may not be given the level of caution required.

The heart most controversial part of the Directive lies in Chapters VI and VII, which are devoted to the right to market to professional investors[422] throughout the EU under what is commonly known as the EU "passport." Under national private placement regimes, AIFM had to seek authorization in each of the countries in which they wanted to market. From 2013 for EU AIFM and 2015 for third countries AIFM, hedge funds will be allowed to market fund interests anywhere throughout the EU once authorized in one Member state.

This is a major step forward, but also was a bone of contention. Indeed, while the Directive was under discussion, a group of countries, France among them, expressed concerns regarding the subjection of

---

413 *Id.* Art. 18a.
414 AIFMD, Art. 9a.
415 *Id.* Art. 11.
416 *Id.* Art. 10.
417 *Id.* Art. 12.
418 *Id.* Art. 13.
419 *Id.* Art. 16.
420 AIFMD, Art. 19-21.
421 *Id.* Art. 25.
422 Article 35j provides that Member states may allow AIFM to market to retail investors on their territory and impose stricter requirements on AIFM. They may not however impose stricter requirements or additional requirements on EU AIF established in another Member state and marketed on a cross border basis than on AIF marketed domestically, in order to avoid protectionism issues.

non-EU AIFM to lighter regulatory requirements or the possibility that "unsupervised" AIFM would be granted the right to market in the EU In a protectionist fashion, these countries pushed for a proposal allowing some Member states to opt-out of the passport or delay a decision on the passport. U.S Secretary of Treasury Geithner qualified such a proposal as "discriminatory" and "damaging to our shared interest in maintaining an open global financial system."[423] The final version of the Directive allows third countries to access the internal market with the passport.

However, the implementing measures must be seen, in particular those regarding cooperation agreements (see table below), in order to assess whether protectionism definitively belongs to the past or, if through these measures, the ESMA and Member states will conduct a screening process that would knowingly exclude AIFM and AIF from certain jurisdictions. The following table summarizes the key provisions applicable to domestic funds and fund managers as well as "third country" funds and managers.

	EU AIF	***Non-EU AIF***
EU AIFM	The passport will be available to EU AIFM marketing EU AIF in the European Union in 2013, provided that they meet the requirements of the Directive and provided that a notification[424] is submitted with the competent authorities of the AIFM's home Member state in respect to each EU AIF that it intends to market.	From 2015, EU AIFM managing non-EU AIF will be able to market to professional investors in the EU with the European passport[425] provided that they comply with the requirements of the Directive. They must notify the competent authorities, that "*appropriate cooperation arrangements are in place between the competent authorities of the home Member state of the AIFM and the supervisory authorities of the third country where the non-EU AIF is established in order to ensure at least an efficient exchange of information*", that the third country is not "listed as a Non Cooperative Country and Territory by the Financial Action Task Force on anti money laundering and terrorist financing" and that the third country where the AIF is based has signed an agreement with the home Member State of the AIFM and with each other Member state in which the AIF is to be marketed that fully complies with the OECD Model Tax Convention standards.[426]

---

[423] T.Geithner, Letters to C.Largarde, G.Osborne and W. Schaüble, October 5, 2010.

[424] AIFD, Art. 31. The content of such notification is set forth in Annex III of the AIFMD.

[425] The passport is not mandatory and that the Directive also sets forth the conditions for an EU AIFM managing a non EU AIF to market in the European Union without a passport in Article 35c.

[426] AIFD, Art. 35a.

Non-EU AIFM	In order to manage and market EU AIF under the European passport,[427] available in 2015, a non-EU AIFM must comply with the provisions of the Directive,[428] obtain authorization and have a legal representative established in the Member state of reference[429] who shall be the contact point of the AIFM in the European Union for the investors, for the ESMA and for competent authorities.[430] Requirements in terms of cooperation agreement, anti money laundering regulations and OECD model tax agreements also apply to non AIFM managing/marketing EU AIF and as for all AIFM, a notification is required prior to marketing the AIF.[431]	Non-EU AIFM may also market to non-EU AIF under the passport. To be able to do so, after 2015, AIFM will have to comply with the provisions of the Directive, and submit a notification to the competent authorities of its Member state of reference. Appropriate cooperation arrangements should be in place between the competent authorities of the Member state of reference and the supervisory authority of the third country where the non-EU AIF is established, the third country complies with anti-money laundering regulations and the Member state of reference and each other member state in which the non-EU fund is proposed to be marketed and the third country should have signed an agreement that complies with the OECD Model Tax Convention[432]

The global financial crisis led to major legislative efforts in both the United States and in the EU to anticipate and prevent future crises. The common idea behind both legislative initiatives was to increase both the depth and breadth of regulation, that is, more regulations and more financial institutions regulated. This postulate, as this entire paper demonstrated, is highly questionable; the benefits of such reforms for investors and for the financial system altogether will not likely outweigh the costs entailed.

It is premature to provide a conclusive assessment because implementing measures will greatly influence the actual impact that the reforms will have on hedge funds and on the markets, but two elements may be deplored.

First, even though both sets of reforms were discussed and adopted simultaneously, they fall short of achieving a global convergence of regulatory frameworks. The lack of coordination combined

---

[427] The passport is not compulsory and the conditions for marketing in the European Union without a passport are set forth in Article 35i.

[428] Unless they can demonstrate that it is impossible to combine compliance with a provision of the Directive with compliance with a mandatory provision in the law to which the non EU AIFM or the non EU AIF marketed in the European Union is submitted, that the law to which they are submitted provides for an equivalent rule having the same regulatory purpose and offering the same level of protection to investors and that they are in compliance with this equivalent rule. AIFD, Art. 35d (2).

[429] The Member state of reference is determined by several factors, as set forth in Article 35d (4) and the conditions for managing AIF established in Member states other than the Member state of reference by non EU AIFM are laid down in Article 35h.

[430] AIFD, Art. 35d.

[431] *Id.* Art. 35f.

[432] *Id.* Art. 35g.

with other increased requirements may prove an even larger challenge for AIFM operating and marketing both in the United States and throughout the EU.

Second, regulators missed the opportunity to coordinate their efforts to create the global database of financial information for which this paper advocates. Such coordination would gather data from all major financial institutions on a confidential basis and assess interconnectedness in order to monitor systemic risk. Although the creation of the FSOC in the United States and the European Systemic Risk Board in the EU demonstrates efforts in the right direction, systemic risk needs to be appreciated on a global scale and a regional approach, though encouraging, is unsatisfactory.

Finally, and in addition to the comments made above, this paper advocates for the adoption of implementing measures only after thorough cost/benefits analysis accounts for the impact of these measures on the hedge fund industry, on investors, *and* on the global financial system. Regulators must consider each of these constituencies since impeding hedge fund operations could have a tremendous and detrimental effect on financial markets and the stability of the entire financial system.