DR. JONES AND THE RAIDERS OF LOST CAPITAL: HEDGE FUND REGULATION, PART II, A SELF-REGULATION PROPOSAL

BY J.W. VERRET*

ABSTRACT

Hedge funds are a fairly new asset class utilized by institutional investors and wealthy individuals. These funds can sometimes achieve remarkable returns. However, the market practice for fund managers is to charge performance fees that greatly exceed any other investment type in the financial services sector, leading some hedge fund managers to engage in illicit behavior, including fraud, that violates their duty to their investors and tempts institutional investors to violate their fiduciary duty to their principals.

This exploration examines a registration requirement, previously instituted by the Securities and Exchange Commission (SEC) to combat instances of hedge fund fraud, which was struck down during the summer of 2006. This study relies on a survey of general literature on financial regulation, specific commentary on the hedge fund regulatory reforms instituted, models of self-regulation, and analogous examples in other areas of financial regulation that have been successful. The result is a critique of the previous regulatory regime and proposals that will make it more effective.

The rapid expansion of hedge fund investments is transforming the price discovery function of the securities markets, resulting in more efficient valuation and robust flows of capital. However, these innovative strategies morph so rapidly and operationally they are so much leaner, that the simple

---

*J.D., Harvard Law School; M.P.P., Harvard Kennedy School of Government. Please send questions or comments to jayverret@gmail.com. Though written while serving as a law clerk for the Delaware Court of Chancery, I remind the reader that the opinions in this article are not expressed on behalf of, nor endorsed by, any member of the Delaware court system. I would like to thank Professors Bebchuk, Roe, and Pozen for teaching me how to think about corporate governance. This article was also written in part while serving an Olin Research Fellowship with the John M. Olin Center for Law, Economics and Business at Harvard Law School. I would like to thank the Olin Center for their generous financial support and for the guidance of the staff at the Program on Corporate Governance, and also Undersecretary Robert K. Steel of the U.S. Treasury Department for his constructive feedback. I would like to thank everyone else who helped make this project a reality, especially Troy Paredes, Howell Jackson, William Poorvu, Phil Heymann, Thomas Healey, Amy Huffman, Chris Stone, Cheryl Pusey, Bob Pozen, Steven Shavell, and the brilliant staff at the *Delaware Journal of Corporate Law*. I would also like to thank my family for their years of support, and my judge for the opportunity to clerk for a true mentor. I am responsible for all errors.

regulatory strategies of the Securities Acts of 1933, 1934, and 1940 do not lend themselves to cookie cutter application. Further, the decision makers are sharply divided. The Administration has taken a firm stance in not supporting hedge fund regulation. Congress, under Democratic control, has signaled that it is clearly interested in advancing regulation. The SEC, under its previous chairman, was 3-2 in favor of added regulation, though the United States Court of Appeals for the District of Columbia subsequently overturned the form as it was adopted. The current chairman does not support hedge fund registration.

The future consequences of this market shift are far from certain. The challenge is crafting a lasting and expensive governmental administrative structure with justification that must rest, in part, on faith in a particular regulatory philosophy or market efficiency theory. The present incarnation of the market dynamic is entirely novel. Maybe we will institute a regime that will constrain the benefits hedge funds offer. Maybe we will continue to fly blind across a cliff that will make previous financial disasters look like child's play. Risk is part of the financial regulatory game just as much as it is the essence of finance itself. The only reasonable response is to learn from what worked in the past and attempt to model the variables that will persist in the future. Therefore, I am proposing a mean between the thus far advanced regulatory philosophies, using principles we find by analogy in other areas of financial regulation.

A self-regulatory model that utilizes the inherent advantage of firms regulating each other is a major theme of the policy recommendations presented. Crafting regulatory safe harbors, permissive information access, and designing legal defenses that encourage the operation of a self-regulatory entity to monitor this industry can help to overcome the severe disadvantage that bureaucratic regulators face in this field.

TABLE OF CONTENTS

Page

I. HISTORY OF HEDGE FUNDS AND BACKGROUND 802
II. REGULATION OF HEDGE FUNDS 805
A. *The Previous Scheme for SEC Regulation of Hedge Funds* 806
B. *Legal Challenge and Subsequent Developments* 808
1. The *Goldstein* Decision: Back to the Drawing Board 809
2. The President's Working Group on Capital Markets Report 810
3. Minimum Wealth Requirement: Maybe the Rich Are Different 812
C. *Arguments and Principles of Financial Regulation in the Hedge Fund Context* 813
1. The Ethical and Economic Dilemma Posed by Hedge Funds 813
2. Observations About Financial Regulation 816
3. Self-Regulation 817
4. Regulatory Competition 824
D. *Do We Need to Regulate Hedge Funds?* 825
E. *The SEC's Stated Motives for Requiring Registration* 827
F. *Other Problems with the Previous Regulation* .. 829
G. *Lack of Coordination Between the SEC and The Commodities' Self-Regulators* 830
H. *Policy Recommendations* 833
III. CONCLUSION 840

"Risks posed by private pools of capital are best addressed through market discipline, disclosure and transparency, not through new laws, regulations or registration."[1]

Robert K. Steel
Undersecretary for Financial Institutions
United States Treasury

"I believe the announcement today by Secretary Paulson on hedge funds is a first step in addressing questions presented by the significant growth of hedge funds. . . . It is my hope that he will testify at a hearing on hedge funds the Financial Services Committee will hold this spring."[2]

Representative Barney Frank
Chairman, U.S. House Committee
on Financial Services

"[T]he industry is only 'two serious scandals away' from vigorous legislation that goes far beyond the registration drive that the agency attempted two years ago."[3]

Professor Harvey Goldschmid
Former Commissioner
Securities and Exchange Commission

I. HISTORY OF HEDGE FUNDS AND BACKGROUND

Dr. Alfred Winslow Jones is generally credited with forming the first actively managed general investment partnership, a hedge fund, to evade Securities and Exchange Commission (SEC) regulation and achieve full portfolio versatility and flexibility in 1949.[4] Dr. Jones' unique hedge

---

[1]Remarks on Private Pools of Capital (Feb. 20, 2007), http://www.ustreas.gov/press/releases/hp280.htm.

[2]Statement on Today's Announcement on Hedge Funds (Sept. 22, 2007), http://www.house.gov/apps/list/press/financialsvcs_dem/press070222.shtml.

[3]Carrie Johnson & Jeffrey H. Birnbaum, *Hedge Funds Begin to Show Up on Regulators' Radar*, WASH. POST, Feb. 9, 2007, at D1.

[4]FRANCOIS-SERGE LHABITANT, HEDGE FUNDS: MYTHS AND LIMITS 7 (MacMillian Co. 1933).

strategy combined long and short positions in equities to appreciate the value of the portfolio during any stage of the market cycle.[5] This strategy allowed him to minimize volatility, or beta in modern jargon, while maintaining a high alpha return utilizing his management expertise. In order to further maximize returns, he used enhanced leverage as well. He charged a performance fee of approximately twenty percent.[6] The 1960s saw a number of current star managers getting into the hedge fund business, including George Soros' Quantum Fund and Warren Buffet's Buffet Partners.

The term "hedge fund" is a misnomer for many funds in the industry today, as they do not necessarily engage in a traditional hedge strategy.[7] They may seek to capitalize on statistically significant divergences between two stock or commodities prices, that differ from expected past correlation, using complicated models. They may trade commodities or currency swaps based on macroeconomic data, or trade on expected results of a merger or acquisition between two companies. In short, their strategies are diverse, but many of the characteristics of Jones' creation still apply. High leverage, management expertise, performance fees, and absolute return strategies are the hallmarks of the industry. They share a belief that markets are not strongly efficient, and that adroit managers can take advantage of superior information, analysis, and minimization of trading costs to achieve absolute returns under any market conditions.[8]

These funds have always fallen under the radar of the SEC by catering to only high net worth individuals and institutions.[9] They typically charge performance fees of 20% and management fees of 2% of assets under management. A study of funds by Cumming and Que identified average

---

[5]*See* Rene M. Stultz, *Hedge Funds: Past, Present, and Future* 3 (Fisher Coll. of Bus., Working Paper No. 2007-03-003, 2007), *available at* http://ssrn.com/abstract=939629.

[6]LHABITANT, *supra* note 4, at 7.

[7]The following primers on the hedge fund industry are helpful for background: Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSP. 189 (1999); William Fung & David A. Hsieh, *A Primer on Hedge Funds*, 6 J. EMPIRICAL FIN. 309 (1999); SEC, *Implications of the Growth of Hedge Funds* (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter *SEC Report*].

[8]*See* Douglas Cumming & Li Que, *A Law and Finance Analysis of Hedge Funds* 3 (Sept. 27. 2007), *available at* http://ssrn.com/abstract=946298.

[9]Paredes provides a quick summary of the three exemptions hedge funds use. *See* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 987 n.52 (2006).

> For example, a hedge fund (1) is not subject to the Investment Company Act if the fund has a hundred or fewer investors or if all of its investors are so-called "qualified purchasers"; (2) does not have to register its securities offering under the 1933 Act if it only allows so-called "accredited investors" to invest; and (3) does not have to register under the 1934 Act if it has only engaged in private offerings and has fewer than five hundred investors in the fund.

Id. (citing 15 U.S.C. §§ 781(g)(1), 80a-3(c) (2000); 17 C.F.R. § 230.506, 240.12g-1 (2004).

alphas of 5.71% for a group of over 5,000 funds tracked from 1990 to 2005.[10] In addition to traditionally higher than average returns, hedge fund investors seek diversification from absolute return strategies.[11] Their returns do not correlate with returns from the long Standard & Poor's 500 (S&P) or other traditional benchmarks.[12] This lack of correlation brings a significant diversification advantage.[13] This explains why many large pension funds and institutions tend to invest 5-15% of their portfolios in hedge fund vehicles.

Hedge funds currently manage roughly $1 trillion, up from $400 billion just four years ago as measured by Credit Suisse First Boston and Tremont Advisers.[14] Mutual funds, by comparison, collectively manage $8 trillion.[15] Though 8,000 hedge funds are believed to operate today, only 2,500 of them were in operation ten years ago.[16] When Tremont Partners was founded in 1984 to track hedge funds, only 68 were in operation.[17] Further, hedge funds account for 40-50% of trading activity on stock markets in the United States and abroad.[18] The average hedge fund size ($87 million) and the median hedge fund size ($22 million) frame an informative but incomplete picture of the industry.[19] Two percent of funds manage more than $500 million, 15% of funds manage $100-500 million, and roughly 32% each manage categories of $5-25 million and $25-100 million.[20] So, the industry is fairly top heavy, with a few managers allocating vast sums and a throng of managers charged with small sums. Former Federal Reserve Chairman Alan Greenspan believes that the saturation of the hedge fund market will lead to significant consolidation of the industry.[21]

There are also two interesting Delaware dimensions to hedge funds. They typically form as LLCs and LLPs, sometimes offshore, but also

---

[10]Cumming & Que, *supra* note 8, at 12-14.

[11]Paredes, *supra* note 9, at 981-82.

[12]Roger G. Ibbotson & Peng Chen, *The A,B,Cs of Hedge Funds: Alphas, Betas, and Costs* 10 (Yale ICF Working Paper No. 06-10, Sept. 2006), *available at* http://ssrn.com/abstract=733264.

[13]*See* Stultz, *supra* note 5, at 15 ("Per unit of volatility, an investor who could have invested in the hedge fund index would have done about twice as well as an investor who invested in the S&P 500 [over the period 1994-2006]"). *Id.*

[14]*See* Gregory Zuckerman & Henny Sender, *Exclusive Club: Ex-Trader Creates Hot Hedge Fund, and a Traffic Jam—Big Investors Clamor to Join Mr. Mindich's Operation Despite Stringent Terms—Elsewhere Returns are Down,* WALL ST. J., Jan. 12, 2005, at A1.

[15]*Id.*

[16]*Id.*

[17]LHABITANT, *supra* note 4, at 8.

[18]Paredes, *supra* note 9, at 986 n.44 (citing CREDIT SUISSE FIRST BOSTON EQUITY RESEARCH, EUROPEAN WHOLESALE BANKS: HEDGE FUNDS AND INVESTMENT BANKS 4-5 (2005)).

[19]LHABITANT, *supra* note 4, at 12-13.

[20]*Id.*

[21]*See* Zuckerman & Sender, *supra* note 14, at A1.

frequently in Delaware.[22] Thus, the hedge fund adviser that serves as a general partner or controlling shareholder in the LLC or LLP will be subject to Delaware fiduciary duties to its investors.[23] One would expect that we should see some overlap between fiduciary duty rulemaking at the federal level and fiduciary duty suits at the Delaware level. However, a limited partner's ability to prosecute such a suit is constrained by the secretive nature of these funds. Presumably, partnership law's analogue[24] to the books and records inspections of corporations[25] would be useful in garnering information for that purpose.[26] However, the "some credible evidence standard" will limit the usefulness of that model.[27] Additionally, hedge funds are themselves frequently litigants in Delaware.[28] Some hedge funds make use of activist strategies to institute section 220 records inspections against the companies in which they invest, or they may make use of shareholder rights like appraisals and injunctions against mergers to negotiate for share buybacks or seats on a corporate board.[29] So the effects of federal hedge fund regulation will uniquely impact the salience of hedge funds growing presence in corporate law.[30]

II. REGULATION OF HEDGE FUNDS

Though hedge funds were previously exempt from registration under the Investment Advisers Act of 1940 (Advisers Act),[31] the SEC's Hedge

---

[22]*See* Paredes, *supra* note 9, at 982.

[23]*See* DEL. CODE ANN. tit. 6, § 18-1001 (2005) (stating that a member of LLC may bring a derivative action); Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., No. 15,754-NC, 1998 Del. Ch. LEXIS 226, at *16 n.14 (Del. Ch. Nov. 10, 1998) ("The derivative suit is a corporate action grafted onto the limited partnership form . . . .").

[24]DEL. CODE ANN. tit. 6, § 17-305 (2005).

[25]DEL. CODE ANN. tit. 8, § 220 (2001).

[26]For more on section 220 actions generally, see Stephen A. Radin, *Developments in the Law: The New Stage of Corporate Governance Litigation: Section 220 Demands—Reprise*, 28 CARDOZO L. REV. 1287 (2006).

[27]*See* Seinfeld v. Verizon Commc'ns, Inc., 909 A.2d 117, 118 (Del. 2006). The some credible evidence standard requires that "stockholders seeking inspection under section 220 must present 'some evidence' to suggest a 'credible basis' from which a court can infer that mismanagement, waste or wrongdoing may have occurred." *Id.*

[28]*See, e.g.*, Highland Select Equity Fund, L.P. v. Motient Corp., 906 A.2d 156 (Del. Ch. 2006); Shamrock Activist Value Fund, L.P. v. iPass Inc., No. 2462-N, 2006 Del. Ch. LEXIS 212 (Del. Ch. Dec. 15, 2006); Polygon Global Opportunities Master Fund v. West Corp., No. 2313-N, 2006 Del. Ch. LEXIS 179 (Del. Ch. Oct. 12, 2006).

[29]For more on this, see Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

[30]Also, some would suggest that companies who are the targets of hedge fund activism would support onerous regulation of these funds to hinder their efforts.

[31]15 U.S.C. § 80b-1 (2001).

Fund Registration Rule[32] required any adviser to a fund with fifteen or more "shareholders, limited partners, members, or beneficiaries"[33] to register as an investment adviser. Hedge fund general partners have always met the definition of "investment adviser" in the Advisers Act,[34] but before the Hedge Fund Registration Rule they were exempt under the "private adviser exemption" from registration in § 203(b)(3) of the Advisers Act.[35] That section exempts "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the Investment Company Act]."[36] The SEC had interpreted this provision to only count the limited partnerships themselves, and not the actual limited partners, as "clients."[37] Even the largest hedge fund managers usually ran fewer than fifteen hedge funds and were, therefore, exempt.

A. *The Previous Scheme for SEC Regulation of Hedge Funds*[38]

The SEC adopted Rule 203(b)(3)-2 and amendments to Rule 203(b)(3)-1 under the Advisers Act on October 26, 2004 to require many hedge fund managers to register as investment advisers. The rule applied to "private funds," defined as:

> 1. a fund not required to register as an investment company under the Investment Company Act of 1940 because of an exception under Sections 3(c)(1) or 3(c)(7), and
>
> 2. a fund that allows investors to redeem their investment

---

[32]Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279 (2007)).

[33]17 C.F.R. § 275.203(b)(3)-2(a) (2007).

[34]*See* 15 U.S.C. § 80b-2(11) (2001) (defining "investment adviser" as one 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"); Abrahamson v. Fleschner, 568 F.2d 862, 869-71 (2d Cir. 1977) (holding that hedge fund general partners are "investment advisers"), *overruled in part on other grounds* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

[35]15 U.S.C. § 80b-3(b)(3) (2001).

[36]*Id.*

[37]*See* 17 C.F.R. § 275.203(b)(3)-1 (2007).

[38]17 C.F.R. §§ 275, 279 (2007); Investment Advisers Act Release No. IA-2333, [2004-2005 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,316, at 81, 482 (Dec. 2, 2004), *available at* http://www.sec.gov/rules/final/ia-2333.htm. This synopsis is largely excerpted from a legal update of the Dechert Financial Services Group.

within two years,[39] and

3. a fund offered based on an adviser's expertise.[40]

The new rules required advisers to private funds to register if they advise fifteen or more investors.[41] The rules formerly allowed use of the fiction that each investment entity counted as a single client,[42] but the new rules required "looking through" each entity to count the funds' clients individually.[43] Non-U.S. investment advisers will only count U.S. clients toward the fifteen-investor limit, but have no minimum amount of assets under management to limit the registration requirement.[44] The Investment Advisers Act threshold of $25 million under management also applied and would thus technically limit the scope of the new registration requirement. As some estimate that a hedge fund needs at least $50 million under management to survive, this minimum will not have been excessively constraining. The new rules exempted the assets of advisory personnel from counting towards the minimum.[45]

Registration as an investment adviser alters the investor minimum for charging of performance fees. The minimum investor wealth standard is effectively raised to $750,000 invested with the adviser or a net worth of $1.5 million.[46] This is because clients of registered investment advisers must meet that standard in order for their advisers to be eligible to charge performance fees. Registration as an adviser would also mean that the advisers and their staff will be subject to compliance examinations by the SEC. In addition, advisers would be required to answer a revised Form ADV, which asks if the investment manager is involved in any other investment funds, and if so, the details of this other fund(s). The new requirement would also have caused some funds to hire a compliance officer, an attorney whose salary may range from $125,000 to $500,000 annually depending on the size of the fund.[47] The burden of these costs would fall most heavily on smaller funds whose management fees would be proportion-

---

[39] An exception especially crafted to exempt private equity funds and venture capital funds, which typically lockup investments for longer than two years.

[40] 17 C.F.R. § 275.203(b)(3)-1(d).

[41] 15 U.S.C. § 80b-3 (2007).

[42] *See* 17 C.F.R. § 275.203(b)(3)-1 (2003).

[43] *See id.*

[44] *See id.*

[45] *See id.*

[46] *SEC Report*, *supra* note 7, at xii.

[47] Edward Mason, *New Exposure in the Hedges: SEC Rules to Force Regulatory Burdens on Secretive Hedge Fund World*, BOSTON BUS. J., Nov. 29, 2004, http:/boston.bizjournals.com/boston/stories/2004/11/29/story1.html.

ally smaller. The SEC's intent through these requirements was to deter fraud and gather information.[48]

The rules exempted commodity trading advisers but not commodity pool operators. This incensed the Chairman of the Commodity Futures Trading Commission (CFTC), who felt that the lack of exemption duplicated regulation and encroached on her territory.[49] This change passed through the SEC on a rare 3-2 margin, with an extensive dissent included in the final report.[50]

B. *Legal Challenge and Subsequent Developments*

Fund managers immediately challenged the SEC's authority to promulgate these rules. One challenge to the constitutionality of this rule relied on the holding of *Lowe v. SEC*.[51] *Lowe* held that the definition of investment adviser requires personal investment advice, but it failed to fully define that distinction in favor of holding that mass-produced annual investment guides were exempt as being impersonal.[52] As the partnership relation in hedge funds comes with a fiduciary obligation, and hedge funds retain custody and authority over client assets, the hedge fund relationship could conceivably fit within the Court's definition of investment adviser in *Lowe*.[53] The SEC answered legal objections that it lacked the authority to alter the definition of client under section 203(b)(3) by arguing in the Final Rule

---

[48]*See generally* Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission is Appropriate?*, 80 NOTRE DAME L. REV. 909, 929-33 (2005).

[49]Sharon Brown-Hruska, Acting Chairman Commodity Futures Trading Comm'n, Keynote Address, Sec. Ind. Ass'n Hedge Funds Conference (Nov. 30, 2004), http://www.cftc.gov/opa/speeches04/opabrown-hruska-22.htm.

[50]For a broad exploration of the psychological and political factors shaping the SEC's response, see generally Paredes, *supra* note 9, at 1005-25.

[51]472 U.S. 181 (1985).

[52]Commodity Trend Serv., Inc. v. Commodity Futures Trading Comm'n, 233 F.3d 981, 988 (7th Cir. 2000) (citing *Lowe*, 472 U.S. 181 (holding that "impersonal advisors are exempt from regulation under the Investment Advisers Act ('IAA')"). The Court stated that two factors were "significant" in reaching its conclusion that the IAA applies only to those "who provide personalized advice attuned to a client's concerns." *Lowe*, 472 U.S. at 207-08. First, the Court noted that the IAA "repeatedly refers to 'clients,' not 'subscribers.'" *Id.* at 208 n.54; *see also id.* at 201 n.45. Second, the SEC did not establish that Lowe and the other petitioners had "authority over the funds of subscribers," "been delegated decisionmaking authority to handle subscribers' portfolios or accounts," or "individualized, investment-related interactions" with their subscribers. *Id.* at 210 n.57. Also, the Court concluded by stating that Lowe and his corporations were presumptively not within the IAA "as long as the communications between petitioners and their subscribers remain entirely impersonal and do not develop into the kind of fiduciary, person-to-person relationships . . . that are characteristic of investment adviser-client relationships." *Id.* at 210.

[53]*See supra* note 52.

Notice that the first hedge fund did not arise until long after the '33 Act was passed, and thus arguments over legislative intent are inherently misleading.[54] Further, *Chevron U.S.A. v. National Resources Defense Council* maintains the right of administrative agencies to interpret ambiguous statutory language as long as the interpretation is reasonably related to the ends that the legislation seeks to achieve.[55] The SEC has further promulgated numerous instances of past "look-through" provisions throughout its interpretative history.[56] Though the United States Court of Appeals for the District of Columbia was ultimately unmoved by the plaintiff's reliance on *Lowe*, the SEC's reliance on *Chevron* also ultimately proved unsuccessful.

1. The *Goldstein* Decision: Back to the Drawing Board

In June of 2006, Philip Goldstein and his hedge fund Opportunity Partners L.P. challenged the SEC's equation of "client" with "investor" in the new regulation.[57] That challenge was ultimately successful, keeping the debate alive between the now Democrat controlled Congress[58] and the Administration (with the SEC in the middle). The SEC's position was that, since the Advisers Act does not define client, it should have discretion in determining that definition.[59] The court invalidated that position, and the SEC's interpretation of the meaning of "client." First, it held that an ambiguous word in a statute does not permit an agency to utilize any definition for that word.[60] It held that the SEC's position was inconsistent

---

[54]Investment Advisers Act Release No. 2333, [2004-2005 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,316 at 81,501-02 (Dec. 2, 2004), *available at* http://www.sec.gov/rules/final/ia-2333.htm#P281_130093.

[55]467 U.S. 837, 843-44 (1984).

[56]Investment Advisers Act Release No. 2333, *supra* note 54, at 81,501 n.157 (citing Ruth Levine, SEC Staff No-Action Letter, 1976 SEC No-Act. LEXIS 2719 (Dec. 15, 1976); David Shilling, SEC Staff No-Action Letter, 1976 SEC No-Act. LEXIS 865 (Apr. 3, 1976); B.J. Smith, SEC Staff No-Action Letter, 1974 SEC No-Act. LEXIS 2642 (Dec. 25, 1975); S.S. Program Limited, SEC Staff No-Action Letter, 1974 SEC No-Act. LEXIS 599 (Oct. 17, 1974); Wofsey, Rosen, Kweskin & Kuriansky, SEC Staff No-Action Letter, SEC No-Act. LEXIS 2154 (Apr. 25, 1974); Hawkeye Bancorporation, SEC Staff No-Action Letter, SEC No-Act. LEXIS 874 (June 11, 1971)).

[57]Goldstein v. SEC, 451 F.3d 873, 874 (D.C. Cir. 2006).

[58]*See Frank Talk on Hedge Funds, Dealbook* (Feb. 21, 2007), http://dealbook.blogs.nytimes.com/2007/02/21/frank-talk-on-hedge-funds. Some Republican members of the House Financial Services Committee and the Senate Banking Committee are also interested in exploring new regulation of hedge funds as well.

[59]*Goldstein*, 451 F.3d at 878 ("Relying on *Chevron U.S.A. Inc. v. Natural Resources Defense Council,* 467 U.S. 837, . . . (1984), the Commission believes this renders the statute 'ambiguous as to a method for counting clients.'").

[60]*Id.* The "'words of the statute should be read in context, the statute's place in the overall

with the intent of the Advisers Act as a whole,[61] and with other definitions of client in the securities regulations.[62] Further, it held that since an adviser only owes fiduciary duties to a fund under the Advisers Act, and fiduciaries are presumed to owe duties to their clients, the funds would logically be the client in the hedge fund advisory relationship.[63]

The effect of *Goldstein* was to invalidate a blanket look-through provision for counting clients. However, this does not mean that a later registration requirement that more narrowly tailors look-throughs would be invalid, as the *Goldstein* court noted.[64] So this decision does not close the door to a future registration requirement through agency rulemaking. In addition, a Congressional amendment to the Advisers Act would effectively supersede *Goldstein* and expand the range of options available to regulate this area.

2. The President's Working Group on Capital Markets Report

President Reagan issued an executive order creating the President's Working Group on Financial Markets (PWG)[65] in response to the stock market crash of 1987.[66] It consists of the Secretary of the Treasury, Chairman of the Federal Reserve, Chairman of the CFTC, and the Chairman of the SEC.[67] The PWG has since expanded its purpose to serve as a coordinating body for the evolution of financial transactions, institutions,

---

statutory scheme should be considered, and the problem Congress sought to solve should be taken into account to determine whether Congress has foreclosed the agency's interpretation.'" *Id.* (quoting PDK Labs. Inc. v. DEA, 362 F.3d 786, 796 (D.C. Cir. 2004)).

[61] *Id.* at 879.

[62] *Id.*

[63] *Goldstein*, 451 F.3d at 881.

[64] "[T]he Commission has not justified treating *all* investors in hedge funds as clients for the purpose of the rule. If there are certain characteristics present in some investor-adviser relationships that mark a 'client' relationship, then the Commission should have identified those characteristics and tailored its rule accordingly." *Id.* at 883.

[65] The PWG is also affectionately known as the "Plunge Protection Team."

[66] Its purpose was originally defined for the narrow mission of investigating the events surrounding the 1987 market crash:

> Recognizing the goals of enhancing the integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets and maintaining investor confidence, the Working Group shall identify and consider:
>
> (1) the major issues raised by the numerous studies on the events in the financial markets surrounding October 19, 1987, and any of those recommendations that have the potential to achieve the goals noted above; and
>
> (2) the actions, including governmental actions under existing laws and regulations (such as policy coordination and contingency planning), that are appropriate to carry out these recommendations.

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

[67] *Id.*

and phenomena that stretch across their various jurisdictions.[68] The PWG issues reports on major topics of interest and promulgates principles from which the various agencies can establish a coordinated administration policy.[69]

The PWG's first report on the implication of hedge funds came in response to the long-term capital management debacle in 1999.[70] It advocated guidelines to enhance disclosure of risk, and also partly resulted in an enhanced Regulation T.[71] In February 2007, the PWG issued its Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital (2007 PWG Report) concerning regulation of hedge funds (which it refers to as "private pools of capital").[72] The adopted principles are twofold: the PWG endorsed "public policies that support market discipline, participant awareness of risk, and prudent risk management" and advocated that "[s]upervisors should use their existing authorities with respect to . . . fiduciaries to foster market discipline on private pools of capital. Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors."[73]

This article will proceed in the same general direction as the 2007 PWG Report. The ability of markets to self-police will be explored and regulation of the fiduciaries who invest in hedge funds will be examined. My approach, however, will deviate from the PWG approach in two distinct ways. I will argue that the best way to encourage markets to self-police is to use financial regulatory policy to encourage self-regulation. I would call this a market-plus regulatory strategy. This could take the form of a new self-regulatory organization for hedge funds, or it could encourage more action by self-regulatory mechanisms already in place, such as the National Futures Association for those hedge funds that trade in commodities through the form of safe harbors from adviser registration. I will also argue that, despite

---

[68] *See* Brett D. Fromson, *Plunge Protection Team*, WASH. POST, February 23, 1997, at H01.

[69] *See id.*

[70] *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 232 (Random House 2000); *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management: Report of the President's Working Group on Financial Markets* viii (1999), http://www.treas.gov/press/releases/reports/hedgefund.pdf [hereinafter *1999 PWG Report*].

[71] A Federal Reserve limitation on margin lending. However, the *1999 PWG Report* advocated that further SEC regulation was not required. *See 1999 PWG Report*, *supra* note 70.

[72] The *2007 PWG Report* is found at http://www.treasury.gov/press/releases/reports/hp272_principles.pdf.

[73] *Id.* at 1.

the existence of the PWG, more coordination among regulators, both domestic and international, is essential.

Former Chairman Donaldson was the driving force behind the Hedge Fund Registration Rule, which passed by a narrow 3-2 vote. Chairman Cox, by signing onto the 2007 PWG Report and not appealing the *Goldstein* decision to the U.S. Supreme Court, is clearly signaling that the SEC will not push forward hedge fund regulation as onerous as the previous attempt any time soon.[74] However, he has already taken steps to address the retailization[75] concern that was expressed in the SEC's original Report on the Implications of the Growth of Hedge Funds[76] with a rule proposal to increase the minimum wealth level required of investors who invest in hedge funds. No one knows how future commissioners will shape this evolving area of the law, as it will depend in part on who wins the White House in 2008.

3. Minimum Wealth Requirement: Maybe the Rich Are Different

On December 27, 2006, the SEC issued for comment[77] a rule proposal

---

[74]*See* Paredes, *supra* note 9, at 1004 n.113 (stating that "a Cox-led SEC should result in a deregulatory shift at the agency") (citing Stephen Labaton, *Acting Quickly, Bush Nominates Congressman to Lead S.E.C.*, N.Y. TIMES, June 2, 2005, at A1; Deborah Solomon et al., *Cox's Nomination to Run SEC Signals a Regulatory Shift*, WALL ST. J., June 3, 2005, at A1; Deborah Solomon & John D. McKinnon, *Donaldson Ends an SEC Tenure Marked by Active Regulation*, WALL ST. J., June 2, 2005, at A1).

[75]The retailization of hedge funds refers to the problem of "the increasing ability of less qualified (or retail) investors to access hedge fund investments." Franklin R. Edwards, *Hedge Funds and Investor Protection Regulation*, at http://www.frbatlanta.org/filelegacydocs/erq406_edwards.pdf.

[76]*See SEC Report*, *supra* note 7.

[77]Some of the comments that the SEC has received thus far have been quite scathing:

"You have to be rich to be smart?" Jan A. Tubbs, *Comments on Proposed Rule: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Release No. 33-8766, File No. S7-25-06, http://www.sec.gov/comments/s7-25-06/s72506.shtml.

"I find the idea that the definition of an accredited investor is based solely on a net worth requirement to be repugnant to the principles of equality of all people. . . . The approach that you appear to be taking is short-sighted, mean-spirited and represents the easy way out." William W. Williams, *Comments on Proposed Rule: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Release No. 33-8766, File No. S7-25-06, http://www.sec.gov/comments/s7-25-06/s72506.shtml.

"The proposed rule changes are discriminatory and anti-Constitutional. We have long since done away with property qualifications for voting, and with other forms of discrimination throughout our society." Michael D. Rubin, *Comments on Proposed Rule: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Release No. 33-8766, File No. S7-25-06, http://www.sec.gov/comments/s7-25-06/s72506.shtml.

"If I gave you $2.5 Million would it make you any smarter?" Jeffrey J. Wahlgren, *Comments on Proposed Rule: Prohibition of Fraud by Advisers to Certain Pooled Investment*

to create a new recognized type of investor, termed an accredited natural person, to take the place of the accredited investor classification it previously used to determine the eligibility of investors to participate in these unregulated investments.[78] Currently, Regulation D allows unregistered sales of securities to investors, in some cases, where they meet the accredited investor standard of $1 million in net worth or $200,000 annual income.[79] The proposed change would effectively alter that exception to require unregistered hedge funds to only solicit investors who are accredited natural persons, defined as investors owning at least $2.5 million (adjusted every five years for inflation, a new concept in SEC minimum wealth tests).[80] The use of wealth as a proxy for investor sophistication,[81] and indeed the use of a paternalistic strategy of limiting access to certain investments,[82] is certainly a debatable discussion meriting exploration in other venues.[83] However, for the purposes of this article, it will allow us to minimize time exploring the retailization concern expressed in the original SEC Report on Hedge Funds, and instead focus on the prevention of fraud aspect.

Ultimately, the goal of this article is to create a regulatory regime that would be more likely to achieve consensus among the commissioners, one of the present chairman's aims, and also survive challenge to the United States Court of Appeals District of Columbia for arbitrariness like the previous attempt.

C. *Arguments and Principles of Financial Regulation in the Hedge Fund Context*

1. The Ethical and Economic Dilemma Posed by Hedge Funds

The high fees charged by hedge funds are the source of much strife for

---

Vehicles; Accredited Investors in Certain Private Investment Vehicles, Release No. 33-8766, File No. S7-25-06, http://www.sec.gov/comments/s7-25-06/s72506.shtml.

[78]SEC Release 33-8766 *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles* 4, http://www.sec.gov/rules/proposed/2006/33-8766.pdf.

[79]*Id.* at 16.

[80]*Id.* at 21.

[81]One analysis of the effect of regulation on hedge funds finds that, where governments increase the minimum wealth level required to invest in these funds, hedge fund returns remain constant but the average fees paid to hedge funds for the same returns significantly increase. *See* Cumming & Que, *supra* note 8, at 17-18. So, maybe the only difference between wealthy investors and others is that the rich are willing to pay more for exactly the same return. In which case, using wealth as a proxy for financial sophistication is suspect indeed.

[82]Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003); *see also* Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165 (2003).

[83]*See* Paredes, *supra* note 9, at 991.

regulators. Hedge fund managers get 20% of the amount by which they can make the investment grow, and with typical hedge funds running a minimum of $100-500 million, and many running $1-5 billion, those fees can become enormous.[84] With that much at stake, some less reputable fund managers are willing to share the fee with an institution that runs money on behalf of others, even if the investment is not right for the risk profile of the investor in question. In addition, this industry is highly secretive.[85] The information that hedge funds use to trade on and what trades they engage in could ruin the profitability of an investment if it got out to competitors, thus hedge funds typically disclose very little to their investors about their trading activities. Serious fee conflicts combined with secretive investment practices can be a dangerous combination for a regulator.[86] Prominent in the SEC's motives for regulation was the involvement of hedge funds in the market timing scandals that caused much consternation in the mutual fund industry.[87]

The other ethical dilemma faced in the hedge fund world is that individuals charged with managing money may have a vested financial interest contrary to that of the individuals whose money they are managing. One overarching question is whether, as in many other areas of financial regulation, proper disclosure is enough to cure an ethical conflict. If the provided documents describe the kinds of fee relationships that are involved, is that enough even if a conflict is still present? Is *caveat emptor* supplemented by mandated disclosure the approach that regulators should take to the ethical conflict?[88] Or must the financial actors further disclose particular arrangements with hedge funds? Alternatively, is it a better idea to ban access to hedge funds for certain investors altogether and prevent possible trouble? Or would audits by independent accounting firms, or perhaps regulators, be enough? Further, if you over regulate and prohibit certain groups from investing in hedge funds at all, are you really just

---

[84]*See* Stulz, *supra* note 5, at 7.

[85]*See* Paul Ali, *Hedge Fund Investments and the Prudent Investor Rule*, 17 TR. L. INT'L 74, 77 (London: Butterworths, 2003), *available at* http://shhelburne.butterworhs.co.uk/truststaxestates/articles/dataitem.asp?ID=30672&tid=7.

[86]*See* Jonathan H. Gatsik, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591, 592 (2001).

[87]*See* Paredes, *supra* note 9, at 977. In market timing, a hedge fund investing in a mutual fund takes advantage of the fact that many mutual funds do not update the fair value of the fund instantaneously. Though not illegal, if a fund states in its financial statements that it does not allow market timing, but then allows it in exchange for a dedication of future investment money from the hedge fund, then the mutual fund has engaged in securities fraud.

[88]The Advisers Act was enacted by Congress to "substitute a philosophy of full disclosure for the philosophy of *caveat emptor*" in the investment advisory profession. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (emphasis added).

limiting access to a potentially highly lucrative investment? To add further complexity to the issue, a bank that acts as trustee may also run its own hedge fund, or a mutual fund may invest money on behalf of investors in both hedge funds and mutual funds, giving it an incentive to allocate profitable trades to the vehicle that offers the largest performance fee, thus conflicts arise between two competing fiduciary relationships.

On the other side, hedge funds are a vital part of the U.S. economy. They provide liquidity to U.S. markets because they take short positions in equities that other large institutions cannot engage in. (Mutual funds are prohibited from taking nearly any short positions in stocks.[89]) They are also more highly active investors than mutual funds and other players in the market, thus helping the price discovery objective of the national securities exchanges.[90] They are becoming more engaged in corporate governance, taking large positions in firms and then advocating for organizational changes to enhance efficiency and returns for investors. Any regulation that affects hedge funds should be narrowly tailored to abusive practices so that the benefits that flow from the hedge fund industry to the national economy are not eliminated.

Assuming that preventability[91] is the reason for the initiatives considered or undertaken in hedge fund and banking regulation, one question becomes readily apparent. What studies have been done to compare costs (which I measure as (1) compliance costs of hedge funds, (2) opportunity cost of trades not undertaken due to an artificial dampening of risk appetite,[92] (3) legal costs of private and governmental compliance, and (4) enforcement costs) to benefits (measured as investment appreciation due to fraud prevention, less any appreciation realized as a result of fraud that is never ultimately discovered by the market), for each provision in a reform agenda?[93] Any legislation or administrative rulemaking should be conducted

---

[89] *See* Stultz, *supra* note 5, at 11.

[90] This was also observed by Paredes, *supra* note 9, at 986.

[91] *See id.* at 1006-07.

[92] For one of the first studies to provide a robust analysis of the effect of hedge fund regulation on hedge fund returns, completed in February 2007, see Cumming & Que, *supra* note 8, at 4.

> At a broad level, the data indicate regulatory requirements in the form of minimum capitalization, restrictions on the location of key services providers and restrictions on marketing channels via private placements tend to be associated with lower fund alphas, lower manipulation proof performance measures, lower average returns, higher fixed fees and lower performance fees.

Id. They also admit, however, that there is a possible omitted variable bias in their regressions, as certain types of funds may forum select based on the regulations in that region. *Id.* at 8-9, 20-21.

[93] For an exploration of cost/benefit analysis of financial regulation generally, see John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531 (2001).

with these questions in mind in order to ensure that the costs of the reform do not outweigh the benefits. Self-regulation is most likely to minimize the cost impact, as the industry representatives making up a self-regulatory organization (SRO) would be more sensitive to the regulatory costs on the industry than a government regulator who faces no penalty for over-regulation, and indeed may have political or turf-guarding incentives to over regulate. Assuming the SRO has an incentive to properly regulate, which we will explore below, then it would be more likely to seek cost-effective strategies.

2. Observations About Financial Regulation

The relationship between an investor and the investment adviser who manages that investor's money is essentially the same principal/agent relationship that underlies most all of corporate and financial law.[94] The investor, as principal, contracts with the investment adviser, as agent, to manage the assets of the investor diligently and for a specified fee or a specified percentage of the amount by which the adviser can make the investment grow. Jensen's model of agency conflict is a discussion of investment advisory relationships.[95] Jensen described that relationship as one in which principals engage agents to perform a service which entails delegation of authority.[96] If both parties to the relationship are utility-maximizers, many situations may arise in which the agents interest will diverge from that of the principal. Principals expend to create incentives for agents to limit aberrant activities, and agents frequently expend bonding costs to ensure principal interest and maintain a profitable relationship.[97] If agents can take advantage of information asymmetries to engage in profitable aberration at the principals' expense and without the principals' knowledge, it may be rational for him to do so.[98]

Government regulation is one answer to remedy the ineffectiveness of agency models in which the cost/benefit combination of bonding, performance incentives, and asymmetries leads to aberrant agent behavior and high social losses.[99] In the case of hedge fund managers, arguments for or against

---

[94]Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301 (1983).

[95]MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS AND ORGANIZATIONAL FORMS 225-26 (Harvard University Press, 2000).

[96]*Id.*

[97]*See* Fama & Jensen, *supra* note 94, at 14.

[98]*See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932).

[99]For the unique challenges of importing cost/benefit analysis to financial regulation, see

regulation will ultimately rest on the operation of that market's agency model absent regulation compared to the operation of the model within a given regulatory regime.[100] The agency relationship inherent in the investment management situation is analogous to that of corporate managers utilizing investor wealth. For instance, the lack of disclosure of hedge funds to their investors can be viewed as an information asymmetry that minimizes monitoring by principals. The social cost from aberrant behavior by investment managers might be market instability or investor losses due to fraud.

Merton and Bodie explore the role of institutional change versus functional change in explaining the financial system.[101] Their conclusion is that the form of financial activity follows function rather than institution.[102] Entrepreneurs are not as limited by traditional forms as regulators, whose authority is traditionally defined in terms of the institutions they govern, i.e., banks or broker-dealers. This process hinders the effectiveness of institution-centric government regulators. The regulator is always a little slow to adapt to new financial products, thus market participants can frequently engage in regulatory arbitrage by adapting the function of their activities to evade the purposes of regulation. The innovation problem is particularly cogent in the hedge fund industry. Some predict that regulatory solutions will become outdated "almost instantly" due to the diverse activities and investment strategies utilized by this industry.[103]

3. Self-Regulation

Governments may impose a penalty for fraud. This would entail social cost as social resources are used to conduct compliance audits. But, as we have seen, government regulators are severely constrained in their ability to regulate rapidly innovating markets. Government regulators would not be as effective because of regulatory limitations stemming from institutional focus and the slower pace of bureaucratic change.[104] One answer to this

---

Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* (Harvard Law Sch. Discussion Paper No. 521, 2005), *available at* http://ssrn.com/abstract=839250.

[100] *See generally* Eric A. Posner, *Controlling Agencies with Cost-Benefit Analysis: A Positive Political Theory Perspective*, 68 U. CHI. L. REV. 1137 (2001) (applying cost/benefit analysis to a variety of regulatory fields).

[101] Robert C. Merton & Zvi Bodie, *Financial Infrastructure and Public Policy: A Functional Perspective* 263-75 *in* THE GLOBAL FINANCIAL SYSTEM (Harvard Bus. Sch. Press 1995).

[102] *Id.*

[103] Stephen H. Axilrod, *Comments on Public Policy Issues Raised by Rescue of a Large Hedge Fund, Long-Term Capital Management*, DOW JONES NEWSWIRES 3, http://www.financialservices.house.gov/banking/10198axi.htm.

[104] *See generally* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453

problem is to let the private market regulate itself through encouragement and support from the government oversight body.[105] Harnessing the advantages of self-regulation is one solution to the difficulties of rapid functional change. Organizations composed of financial institutions have some interest in ensuring the viability of a market for a profitable activity, such as hedge fund investing, that is harmed by those members who violate best practices. Thus, as a group, a self-regulatory organization may have many interests that coincide with those of market regulators.[106] The advantage is that the self-regulator can escape the bureaucratic morass of the administrative process and congressional review that constrains rapid adaptation to innovation. In addition, private market solutions can also solve this problem. If investors get value from a central information broker, then it may become profitable for a private firm to serve a similar role to the self-regulator. Accordingly, one underlying theme of this discussion will be to examine self-regulatory and private market solutions to regulatory concerns in this area.

From its very origins, national securities regulation utilized, in part, a self-regulatory strategy for regulation of some parties, such as broker-dealers, supplemented by SEC oversight.[107] The two justifications for this approach were that business would have a more specialized knowledge of current and abusive strategies and that the task was ultimately beyond the SEC's resources to oversee.[108] A more recent example of the SEC's embrace of self-regulation is the SEC's settlement with the National Association of Securities Dealers (NASD) in response to allegations that the NASD was engaged in price rigging.[109] The settlement, among other things, created an independent regulatory capability within the NASD that would be governed by a separate group of securities professionals and attorneys independent of the various rulemaking proposals and disputes before the body.[110]

(1997) (arguing that exchanges serve as more effective regulators than government institutions due to their ability to respond to rapid market innovation).

[105]Other professional organizations self-police, including law and medicine. For a study of the effects of self-regulation in the medical field, see James Morrison & Peter Wickesham, *Physicians Disciplined by a State Medical Board*, 279 J. AM. MED. ASS'N 1889 (1998).

[106]For more on this, and how government oversight is particularly effective in the SRO sphere, see Peter Demarzo et al., *Contracting and Enforcement with a Self-Regulatory Organization* (Aug. 2001), *available at* http://ssrn.com/abstract=297302.

[107]Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347, 1347 (2004).

[108]*Id.*

[109]HOWELL E. JACKSON & EDWARD L. SYMONS, REGULATION OF FINANCIAL INSTITUTIONS 770 (1999).

[110]*In re* Nat'l Ass'n of Sec. Dealers, Inc., Exch. Act Release No. 37,538 (Aug. 8, 1996), *cited in* JACKSON & SYMONS, *supra* note 109, at 770. The settlement included the following six strategies to create an effective SRO by providing for:

This settlement took advantage of precisely the benefits self-regulation has to offer. The SEC had neither the time nor the ability to adequately adapt its regulatory response to the complexities of securities pricing, so it decided to harness the capabilities of self-regulation by establishing a semi-independent division of an existing SRO to create a valid enforcement mechanism.

In the post-Sarbanes[111] era, criticism of the self-regulatory model is in vogue. Failures at the New York Stock Exchange (NYSE) to oversee a reasonable compensation package for Dick Grasso, former chairman and chief executive of the NYSE, signaled the end of self-regulation to some. However, agency conflicts over remuneration between the SRO executive and the board are a different animal from SRO oversight of member firms. Additionally, some version of self-regulation will remain in the financial community for some time. No one is considering abandoning the NASD.[112]

The benefits of self-regulation are frequently paired with an element of supplemental government oversight. This helps to eliminate cases of market failure and establishes a forum for firms to compete with each other in policing themselves. Harnessing the private market to create a self-regulating entity would result in a more efficient and effective solution. The SEC would be instrumental in establishing and maintaining an SRO, as its effectiveness in creating a regulatory regime that could effectively signal fiduciary duty violations to investors would require government authority. The SEC would set up a game similar to that described below by mandating the creation of an SRO, after which the entities involved would then begin voting on compliance requirements that would follow the results of Model

---

1. an independent regulatory body within the NASD that would have primary day to day responsibility for the regulation, examination, and disciplining of NASD member firms,
2. fifty percent of all boards of the organization that exercise self-regulatory function would be composed of independent members,
3. that the NASD would include participation of independent attorneys to preside over disciplinary proceedings,
4. that the NASD would provide for independence and autonomy for the NASD regulatory staff,
5. that the NASD staff would include an independent audit staff to review the activities of the NASD and report only to an audit committee composed of a majority of independent and non-industry governors, and
6. that the NASD would promulgate uniform standards for regulatory and access issues.

[111] In 2002 Congress passed the Sarbanes Oxley Act to protect investors of securities. *See* Pub. L. No. 107-204, 116 Stat. 745 (2002).

[112] Indeed, just this year the NASD's regulatory arm merged with its regulatory cousin at the NYSE to consolidate and enhance the effectiveness of its self-regulatory capability. For an earlier criticism of self-regulation, see Thomas Gehrig & Peter J. Jost, *Quacks, Lemons, and Self-Regulation: A Welfare Analysis*, 7 J. REG. ECON. 309 (1995).

2.[113] The government's role would be to make membership in the SRO mandatory, or at least desirable, because only in that event will the equilibrium forces come into effect.[114]

In theory, a self-regulatory strategy would utilize many of the advantages of a consolidated market structure while sidestepping many of its disadvantages. In effect, a part of the governance of the financial firm is outsourced to a central SRO, while the firms output for financial services is still determined based on free market outcomes. This central organization is an effective solution to the free rider problem of industry reputability and could help foster a healthy Nash equilibrium[115] to deter fraud in the hedge fund management industry.[116]

Model 1: No Information Asymmetry

First, assume that there is no information asymmetry to manager fiduciary violations. Fiduciary duty violations (FDV) are defined in this model as investment managers profiting at the expense of investors absent contractual agreement (i.e., not fees). There may not necessarily be a direct correlation between firms that engage in fraudulent activity and reputation costs. A single firm may find it profitable to engage in fraudulent behavior, where the profit (P(1)) exceeds its allocation of industry reputation cost (C(1)).

Assume two options for the SRO, allow FDV or stop FDV. If the SRO decided to allow FDV, the firms making up an SRO will experience profit of Σ P and reputation costs of Σ C. The organization would allow fraud where $\Sigma P > \Sigma C$. But, where fraud allows managers to profit at the

---

[113] *See infra* Model 2: Information Asymmetry.

[114] SROs, in some circumstances, can become subject to regulatory capture if the market power within the industry becomes sufficiently consolidated. For an interesting exploration of how SROs are most effective when they operate under the threat of more onerous government enforcement if they fail to adequately police fraud, see generally Peter M. Demarzo et al., *Self-Regulation and Government Oversight*, 72 REV. ECON. STUD. 687 (2005).

[115] The following succinct introduction to Nash equilibrium is instructive:

> The central solution concept in game theory. It is based on the principle that the combination of strategies that players are likely to choose is one in which no player could do better by choosing a different strategy given the ones the others choose. A pair of strategies will form a Nash equilibrium if each strategy is one that cannot be improved upon given the other strategy.

DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 310 (Harvard Univ. Press, 1995).

[116] "Self regulation [sic] has played a key role in protecting investors for a very long time. Most observers agree that the SRO system has functioned effectively, and has served the government, the securities industry, and investors well." Christopher Cox, Chairman, SEC, Statement at News Conference Announcing NYSE-NASD Regulatory Merger (Nov. 28, 2006), http://www.sec.gov/news/speech/2006/spch112806cc.htm.

expense of investors, reputation costs have to at least equal profits from fraud. In such an instance, it would not be profitable for an SRO to allow fraud.

This model would require no regulation, but is not realistic in the financial services world. Information asymmetries do exist; firms have access to data that consumers will never see. Thus, the next model will form our understanding of this issue more clearly.

Model 2: Information Asymmetry

It is possible that Σ P from FDV does not correlate with Σ C. This could be due to an information asymmetry between managers and investors. Hedge funds are highly secretive and utilize hazy valuation measures. Thus, investors may not be aware of fraud if it occurs, resulting in a case where $\Sigma P > \Sigma C$ and the SRO would seem to want to allow FDV.

Even if the reputation costs do not correlate with profits from fraud, an SRO could help lead to an optimal outcome.[117] The SRO could be viewed as an effective forum for establishing a Nash equilibrium where firms would not violate individually where they might all profit from allowing fraud together.[118]

Profits from investment advising are denoted P. P_1 equals profits including FDV when there is no mechanism in place to signal FDV to investors. P_2 equals profit with FDV when there is a signal to investors. P_3 equals profit without FDV when there is a signal to investors and the other half is also not engaging in FDV. P_4 equals profit without FDV when the other half of the industry is engaged in FDV and there is a signal. Assume that $P_4 > P_1 > P_3 > P_2$. P_4 is greatest because it results in market share taken from the firms exposed as engaging in FDV by firms not engaged in FDV. The following delineates outcomes in a simplified game in which the funds making up the SRO are divided into two halves and are allowed to make independent decisions of whether or not to vote to allow FDV in the hedge fund market. Assume for simplicity that half of firms voting for no FDV will result in creation of a self-regulatory regime in which investors will be able to determine whether or not a firm is conforming to established best practices and thus whether or not the fund is engaging in FDV.

---

[117] For a more robust analysis of how equilibria can be achieved in financial self-regulation, see Arnoud W.A. Boot & Anjan V. Thakor, *Self-Interested Bank Regulation*, 83 AM. ECON. REV. 206 (1993).

[118] John Nash, *Non-Cooperative Games*, 54 ANNALS OF MATHEMATICS 286, 295 (1951); *cf.* B. Douglas Bernheim et al., *Coalition-Proof Nash Equilibria*, 42 J. ECON. THEORY 1 (1987).

Voting Outcomes, each group represents half of the industry, one vote for No FDV installs monitoring		***Fund Group B***	
		Vote for FDV	*Vote for No FDV*
Fund Group A	*Vote for FDV*	P_1, P_1	P_2, P_4
	Vote for No FDV	P_4, P_2	P_3, P_3

The initial position is firms deciding whether or not to engage in FDV. This will decide how a firm will vote, since it would be irrational for a firm to vote to create the signal if it would lose in so doing.[119] If either group of firms decides not to engage in FDV, and votes accordingly, it will benefit because it will expose the other firms and thus profit from the additional investments it can now secure from investors. Further, if one group of firms votes not to allow FDV, then the other must not engage in FDV and will vote to create the signal as well. Thus, the dominant strategy for both groups of firms will be not to engage in FDV and not vote to allow FDV. In terms of the model above, firms might begin at the decision in the upper left quadrant. But, each firm would anticipate that the other firm would vote to create the signal, because it could profit by taking market share.[120] The Nash equilibrium model is really all about damage control. This results in both firms voting not to allow FDV. So the SRO functions to create a Nash equilibrium because it gives firms an opportunity to create a signaling mechanism to overcome the information asymmetry.[121] The two concepts

[119]For more on how economic signals can be created and will be used in legal situations, see BAIRD ET AL., *supra* note 115, at 122-58; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 280-85 (Harvard Univ. Press 1991); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1786-91 (2000); Michael Spence, *Competitive and Optimal Responses to Signals: An Analysis of Efficiency and Distribution*, 7 J. ECON. THEORY 296 (1974) (cites collected in Paredes, *supra* note 9, at 994 n.76).

[120]For example, the lower left quadrant would be preferable to the A group of funds and the upper right quadrant would be preferable to the B group. But, when each of them vote according to their individual best interest, they end up with an outcome in the lower right quadrant, creation of a regime that allows no one to engage in FDV but also gives no one a market advantage for being honest.

[121]The standard response to equilibria models is: why would not each firm, knowing how the other would respond, vote to collude. Thus, we are back to the upper left quadrant above. But that is why Nash equilibria are so effectively taught with the example of the Prisoner's Dilemma. (Two suspects in different rooms, the first one to talk gets five years and the other gets 10, but if

are linked. The Nash outcome is a vote to create a signal that gets rid of a profitable information asymmetry. Collusion is not a concern because both halves would have an incentive to cheat no matter what agreement they came to before voting. Expanding the number of voters should fit with the model; it would simply make it more difficult for firms to collude because they would be less able to agree to vote to allow FDV.

This model assumes that the market for investors is static, which is, of course, not the case in the real world. Perception of the hedge fund industry will affect the willingness of investors to put money in hedge funds as opposed to, say, private equity or index funds. However, thankfully, removing that assumption only helps the case for self-regulation. A hedge fund SRO would have an interest in creating signals to the general market of investors that the operational risk of fraud in hedge funds is minimal, as it would give them a competitive edge in acquiring investment capital flows over the other asset classes with which it competes. In effect, not only will individual fund managers want a signal about their low operational risk vis-à-vis their internal competition for capital, they will have an added incentive to create such a signal to aid in their external competition for capital with other asset classes.

Doubtless, every model of complex economic activity will have its flaws, especially when it is as simplistic as this one. For instance, one drawback to the Nash equilibrium model is that multiple Nash equilibria may be possible in a game. In other words, there may be more than one outcome that represents the dominant strategy, taking the other players' strategies into account. In this case, it is unlikely that the multiple Nash equilibria drawback is present, as long as the assumption is that firms can take market share from each other if they can manage to expose fraudulent players. Other failures to the Nash game might also creep up. However, with the presence of mild SEC oversight,[122] as we have seen with the NASD

---

they both stay silent they both walk free. However, acting in their individual self-interest, they both talk and get a result that is detrimental to their collective self-interest. Take out scratch paper and play it with a friend, you will see.) So, the response to that question is, that as soon as you agree to collude with your other partner, it is still in each's self-interest to cheat on the collusion agreement, and we are back to the Nash equilibrium. My apologies for the amateur economics, but the basic theory holds. Supplement that with government agency review of the SRO's decisions, and you have an effective governance alternative to full oversight.

[122] According to Cox,

> [O]ne of the fundamental precepts that has characterized the SRO model since its inception in 1930s: the notion that regulation of the markets works best when the front-line regulator is close to the markets. The SEC and other government regulators would continue to benefit by being able to leverage their resources through an oversight role, and the securities markets would continue to be supervised by organizations familiar with the nuances of their operations.

Cox, *supra* note 116.

and the NYSE,[123] we can steer the SRO in the right direction in the event that it becomes subject to regulatory capture and design its charter to prevent that from happening.[124] The proposal explored in the final section of this article will precisely outline the SEC's oversight role in designing an SRO, taking into account previous flaws in the design of the other financial SROs since the advent of federal securities regulation.

4. Regulatory Competition

A frequently highlighted debate in corporate governance is the usefulness of regulatory competition in state oversight of corporations.[125] Many scholars point out that such competition develops into a "race to the bottom" in which states compete to form the most liberal regime to attract chartering. A classic view is that states compete to develop superior competency through efficient and effective regulatory regimes, the so-called "race to the top." Jackson points out that a similar line of thinking has emerged in the field of financial regulation.[126] Proponents of regulatory competition argue that investors are able to take into account the value added by investing in companies that are listed in well-regulated regimes.[127]

This third concept fits nicely into the previous two. Where governments act to solve the agency problem of investment management, they are frequently at their best when they compete but also coordinate[128] with other agencies of the government, insomuch as such competition encourages them to innovate to attract chartering. The rapidly changing

---

[123]The NASD and NYSE's regulatory arms have recently merged, with the SEC's blessing, in order to join forces and enhance the effectiveness of the self-regulatory advantage.

[124]For more on the effectiveness of SROs when backed up by government oversight, see Howell E. Jackson & Stavros Gkantinis, *Markets as Regulators, A Survey* (Harvard Law and Econ. Discussion Paper No. 579, Jan. 2007), *available at* http://ssrn.com/abstract=960168.

[125]*See* Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEORETICAL INQUIRIES INTO LAW 1, 4-5 (2001) (citing Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992)). *See also* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998) (arguing that Delaware keeps its corporate law artificially vague, at the expense of its effectiveness, in order to maintain its dominance as a state of incorporation). For a recent continuation of this line of argument, see Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999); Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001).

[126]*See* Jackson, *supra* note 125, at 12. His analysis focuses on competition in the global financial marketplace. *See id.*

[127]*See id.* at 13.

[128]For a good primer on this idea, see Robert B. Ahdieh, *Dialectical Regulation*, 38 CONN. L. REV. 863 (2006).

function of financial activity, described by Merton,[129] would be met by multiple regulators able to specialize in different types of institutions within that same industry. In the same way that banks charter under different regulators to meet their idiosyncratic needs, investment managers could do the same in a regulatory competition environment.[130]

D. *Do We Need to Regulate Hedge Funds?*

Some market regulators, such as former Federal Reserve Chairman Alan Greenspan, are concerned that regulation of hedge funds could harm market liquidity.[131] Many hedge funds add liquidity by engaging in short selling as part of their hedging operations, thus making them an effective counter party to long traders. The dearth of long trades in the market comes in part from the fact that some institutions, such as mutual funds, are prohibited from short selling. Thus anything that hinders hedge funds ability to operate could hinder market liquidity.[132] This liquidity makes the flow of funds more efficient, reducing cost to all participants.[133]

A registration requirement is constructive in that it would give regulators more information about an active market participant that is especially secretive.[134] Absolute return requirements can put more pressure on managers when returns are low, as their watermark requirements will severely limit management compensation.[135] Regulators are concerned that this will encourage engagement in excessive operational risk or fraudulent activity, similar to the market timing and late trading scandals.[136] Regulators hope to anticipate such activities using information gathered through a registration compliance process and analyzed by entities such as the SEC's new Office of Risk Assessment.[137] The antifraud provisions of the Securities

---

[129]*See* Merton & Bodie, *supra* note 101.

[130]*See* Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 121-26 (2005).

[131]Nomination of Alan Greenspan: Hearing Before the Committee on Banking, Housing, and Urban Affairs, 108th Cong. 25-26 (2004) (statement of Alan Greenspan, Fed. Reserve Chairman), http://www.access.gpo.gov/congress/senate/senate05sh.html.

[132]*See* Cumming & Que, *supra* note 8, at 3.

[133]Axilrod, *supra* note 103.

[134]Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 709 (2000) ("Under existing laws, financial regulators are somewhat handicapped in their ability to identify the potential risks posed by hedge funds.").

[135]*See generally* William N. Goetzmann et al., *High-Water Marks and Hedge Fund Management Contracts*, 58 J. FIN. 1685 (2003).

[136]"By keeping a census of advisers, the Commission can better respond to, initiate, and take remedial action on complaints against fraudulent advisers." Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006).

[137]*See* Paredes, *supra* note 9, at 1010 n.133 (citing SEC, 2004-2009 Strategic Plan,

Act already apply to hedge fund operators, but regulators complain that their secretive nature makes unfortunate post-event prosecution their only current tool to combat fraud.[138] Critics question whether the SEC can anticipate hedge fund malfeasance if it could not anticipate such problems through its oversight of mutual funds.[139]

Hedge funds often use extraordinary degrees of leverage in comparison to other vehicles. Excessive leverage brings in issues of systematic risk, as evidenced by the Long-Term Capital Portfolio, L.P. (LTCM) debacle.[140] The system runs the risk that the insolvency of a large enough market participant could unwind and significantly affect the perception of market participants, rippling out into the economy at vast cost. Regulation T[141] (a Federal Reserve borrowing limitation) already limits the leverage that a broker-dealer can provide, but the lack of transparency in the firms' positions makes accurate measurement of the firms' leverage ratio difficult for the primary brokers to measure. The leverage concern is not as prescient if one

---

available at http://www.sec.gov/about/secstratplan0409; Lori A. Richards, Director of the Office of Compliance Inspections and Examinations, SEC, The Need for More Proactive Risk Assessment, Remarks at NRS Annual Spring Compliance Conference (Apr. 14, 2004), http://www.sec.gov/news/speech/spch041404lar.htm).

[138]For examples of the SEC's recent enforcement actions against hedge funds, see, e.g., SEC v. Wright, Litigation Release No. 19,581 (Feb. 28, 2006); SEC v. Wood River Capital Mgmt., LLC, Litigation Release No. 19,428 (Oct. 13, 2005); SEC v. Israel, Litigation Release No. 19,406 (Sept. 29, 2005); SEC v. Beacon Hill Asset Mgmt. LLC, Litigation Release No. 18,745A (June 16, 2004).

[139]*See also* John C. Coffee, Jr., *A Course of Inaction: Where Was the SEC When the Mutual Fund Scandal Happened?*, 2004 LEGAL AFF. 46 (arguing that the SEC was ineffective in anticipating the mutual fund scandals of 2002-2004, despite the presence of a massive compliance and inspection regime).

[140]Gibson provides a summary of the LTCM debacle:

> The most widely publicized being the difficulties encountered by Long Term Capital Management, L.P., operating Long Term Capital Portfolio, L.P. ("LTCM"). The LTCM fund employed various trading strategies, with the majority of its trading positions in government bonds of the G-7 countries. In summer 1998, conditions caused by financial problems in Russia and other emerging markets caused LTCM to incur substantial losses. The enormous size of the LTCM hedge fund placed its trading counterparties and creditors in a position to lose substantial amounts because they had extended excessive credit to LTCM, either through trading counterparty or lending relationships. Since LTCM's creditors and counterparties had allowed LTCM to build up dangerous levels of leverage, they faced the real possibility that LTCM would default on the credit obligations it owed them. To protect themselves from an LTCM default, some of the fund's creditors and counterparties created a consortium, which injected $3.6 billion in equity into LTCM in return for receiving ninety-percent equity stake in the fund. Banking regulators assisted LTCM creditors and counterparties in creating the consortium because they feared that LTCM's losses could cause financial shock to the markets if LTCM's seventy-five counterparties sought to liquidate their positions simultaneously in response to an LTCM default.

Gibson, *supra* note 134, at 682.

[141]*See* 12 C.F.R. § 220.1 (2007).

believes that the firms generally properly value their hedged positions to minimize risk. Nevertheless, an institution that adds systemic risk to the market and is by its very nature secretive in its movements and strategies is a difficult combination for a regulator. The information gathered through registration could be used to aid the Federal Reserve in its mission to ensure the stability of the payment system.[142] Systemic risk was not a goal mentioned in the SEC Report growth and will therefore be largely set aside for the remainder of this examination.

Excessive regulation may also make it worthwhile for hedge funds to move to offshore jurisdictions.[143] This would mean that funds still pose the same risk to U.S. markets, but escape any government oversight. Offshore flight would be especially easy to achieve for funds already running mirror offshore entities.[144] But will all funds seek to move in response to heightened regulation? The bonding hypothesis for exchange listing holds that foreign companies list in the United States to signal to investors that they are well-governed companies with nothing to fear from regulation.[145] Perhaps hedge funds will also wish to use domestic registration under heightened regulation to signal the same to institutional investors. Many of the larger funds already registered voluntarily before the current regulations to do just that.

E. *The SEC's Stated Motives for Requiring Registration*

The SEC is concerned about fraud in the industry.[146] It has initiated roughly forty enforcement actions involving fraud in the last five years involving hedge funds.[147] Though these numbers are not proportionally significant, the losses involved in each case were far higher than most because the SEC was unable to act until long after the fraud occurred, due to the lack of information about the industry.[148] The SEC has justified the registration requirement on the grounds that information gained through registration and compliance will increase the probability that it can detect

---

[142]For a summary of how systemic risk is usually left off the SEC agenda, see Paredes, *supra* note 9, at 983-84.

[143]*See* Cumming & Que, *supra* note 8, at 21.

[144]*See* Stultz, *supra* note 5, at 6.

[145]Ugur Lel & Darius P. Miller, *International Cross-Listing, Firm Performance and Top Management Turnover: A Test of the Bonding Hypothesis* 3 (Fed. Reserve Bd. Int'l Fin. Discussion Paper No. 877), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=926606.#PaperDownload.

[146]For a summary of the over-regulation and under-regulation by the SEC driven by bias and political factors, see Paredes, *supra* note 9, at 1025-26.

[147]Steven B. Boehm & Cynthia A. Reid, *Shedding Light on Hedge Funds*, BUS. L. TODAY, June 13, 2004, at 53.

[148]*Id.*

fraud in the future in this rapidly growing industry.[149]

Another significant concern is the retailization of hedge funds.[150] The hedge fund exception to registration requirements was based on limiting investment in the fund to individuals meeting a wealth threshold.[151] One of the justifications for a past lack of regulation has been the assumption that wealth is a proxy for sophistication and sophisticated investors are able to look after themselves. However, the advent of funds of hedge funds (FOHF) and pension fund investment in hedge funds increases the exposure of "unsophisticated" investors.[152] There are no limitations on an investor's wealth in a FOHF.[153] However, as previously mentioned, the increase in minimum wealth requirements should take care of most of that issue for now.

Surprisingly though, the SEC was also concerned about the lack of disclosure to sophisticated investors.[154] Valuation methods for hedging operations are tricky, and investor sophistication may not be sufficient to protect their investments from fraud. The SEC was also concerned that disclosure about conflicts of interest with other investment management activities of the general partners were not being sufficiently disclosed.[155] The traditional prophylaxis for avoiding conflict has been a market norm that hedge fund management invest nearly all of their personal wealth in the fund.[156] The theory is that their motives will align with their investors and conflict will be avoided. Valuation issues nevertheless remain when investors cash in and cash out. An unethical manager could game the valuation of the funds holdings, which often lack comparables, to ensure that management receives more than their fair share of the pooled funds.

The SEC has also expressed concern over the role of advisers running mutual funds and hedge funds simultaneously.[157] Mutual funds have recently suffered from an inability to compete for professional talent with

---

[149] *Id.*

[150] *SEC Report*, *supra* note 7, at 80-83.

[151] *See id.*

[152] *See* Ali, *supra* note 85, at 74.

[153] An interesting phenomenon that will turn this entire question on its head, and indeed shows just how the structure of securities products follows function rather than form, is the advent of hedge fund IPOs, where the hedge fund adviser will subject itself to registration under the '33 and '34 Acts. *See, e.g.*, Matt Krantz, *Hedge Fund IPO Jumps*, USA TODAY, Feb. 9, 2007, *available at* http://www.usatoday.com/money/markets/us/2007-02-08-hedge-fund-ipo-usat_x.htm ("Fortress, which priced 34.3 million shares at $18.50 to raise $634 million, is the first alternative investment firm to go public in the USA and the second-biggest IPO so far in 2007."). Whether this remedies the issues discussed in this article, I leave to further examination.

[154] *SEC Report*, *supra* note 7, at 83.

[155] *See id.*

[156] *See* Ali, *supra* note 85, at 76.

[157] *SEC Report*, *supra* note 7, at 83-84.

hedge funds.[158] The fees hedge funds offer are no match for fees in mutual funds.[159] In addition, management at mutual fund advisory companies are themselves interested in a piece of the action. This has resulted in many mutual fund advisers starting their own hedge fund operations.[160] A significant conflict of interest faces firms that operate both mutual funds and hedge funds. The fact that the investment manager would have a fiduciary duty to investors on both sides, through an investment adviser obligation to the mutual fund and fiduciary obligation to the partners in the hedge fund partnership, makes the issue especially complex. There are two instances in which the conflict is readily apparent. There is a danger that firms will allocate a trading opportunity to the hedge fund over the mutual fund in order to take advantage of the higher performance fee. There is also a possibility that the firm will use the long investing in the mutual fund to mirror and support the shorting activities in the hedge fund.[161] Even if the mutual fund trades result in a loss, management's take of the performance fee in the hedge fund more than compensates for the loss. Greupner argues that the proper arena for reform should be on the Investment Company Act of 1940 side, to enhance the regulations so that mutual fund managers are prevented from engaging in such activity.[162] The information asymmetry between the fund and investors would still remain. Without statutory requirements for the hedge fund to submit to a compliance audit, there would be no way for the SEC to ascertain whether a conflict of interest was being exploited by the mutual fund management through their activities in a hedge fund they also managed.

F. *Other Problems with the Previous Regulation*

In order to exempt private equity funds from registration, the SEC's previous attempt exempted funds that did not permit their investors to withdraw their investments within the first two years, a requirement common in private equity investment contracts.[163] However, in order to avoid registration, many hedge funds simply increased their lockup requirement. If hedge funds were to move to two-year lockup periods in order to exempt themselves from a future registration requirement, it will become more

---

[158]Eric J. Greupner, *Hedge Funds are Headed Down Market, A Call for Increased Regulation*, 40 SAN DIEGO L. REV. 1555, 1560 (2003).

[159]*See* Stultz, *supra* note 5, at 7.

[160]*See* Greupner, *supra* note 158.

[161]*See* Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L., ECON. & ORG. 245 (2003).

[162]Greupner, *supra* note 158.

[163]For more on lockups, see Paredes, *supra* note 9, at 1016-17.

difficult for FOHFs (funds that pool investment in different hedge funds together for smaller investors[164]) to move between funds. This result will mean that smaller investors in the FOHFs will lose some of the advantages of having a manager select hedge funds for them. Smaller investors gain access to the privileged world of hedge funds through FOHFs, but with added diversification and fund picking expertise. This buffer helps to protect the downstream investors that are brought in through retailization of this investment vehicle. It could be that the two-year lockup exception will have the ironic effect of harming downstream, smaller investors. With a two-year lock up, a FOHF will lose its ability to exit poorly performing funds and enter well-managed funds. It is still possible that some funds will not institute the lockup provisions in order to attract FOHF money. Smaller hedge funds will be the harder hit by registration expenses, so they are more likely to make use of the lockup exception. So at the very least, we should expect that FOHFs will have access to fewer small hedge funds as a result of the SEC's new rule.

Registration may also send the wrong signal to investors that a hedge fund is completely safe when registration only means that minimal compliance audits of some especially risky firms have been conducted. This implied seal of approval may further increase the exposure of retail investors to hedge funds as smaller investors demand access. One effective result of registration will be an enhanced review of conflicts for dual mutual fund/hedge fund operators. Previously, the SEC only had access to compliance audits of the mutual fund's operations. They will now be able to compare the activities of both funds to police for violations of fiduciary duties.

G. *Lack of Coordination Between the SEC and the Commodities' Self-Regulators*

The global nature of the financial market system is a component of policymaking in this area that one cannot afford to forget. Financial intermediaries work across multiple borders; payments flow digitally over oceans instantaneously. Ideally, financial regulation should take into account global effects and would be composed with an eye for what other countries are doing so that global regulation of financial intermediation works in unified harmony. The U.K. Financial Services Authority (FSA) already has a regulatory regime for hedge funds that the U.S. should at least consider in crafting its own. The FSA and SEC processes are typically very

[164] *See* Stultz, *supra* note 5, at 10.

different, with the SEC having more expansive disclosure requirements and the FSA having a more onerous application process. This compounds the expense of regulatory compliance for cross-border funds. The risk that cross-border hedge funds will have inconsistent rules across jurisdictions is even worse. The globalization of finance is a net benefit to all concerned. Regulators need to be more careful to coordinate their rulemaking efforts so that they do not accidentally hinder cross-border investment. If accumulating market intelligence is truly one of the SEC's goals in creating this rule, cooperation with the FSA is vital. Information sharing, combined with cooperatively designed regulatory regimes, would help both countries to maintain market stability and achieve investor protection. The SEC mentioned in a footnote to the final rule release that it will seek such information sharing, a marginal accommodation that seems to lack substance in light of its failure to coordinate the registration requirement.[165]

Many allege that the SEC was also guilty of failing to cooperate fully with its fellow domestic regulators.[166] The CFTC Chairman was particularly incensed by the registration rule. Many funds that would have been forced to register as investment advisers were already registered with the CFTC as commodities trading advisers or commodities pool operators.[167] Even many funds exempt from CFTC registration voluntarily registered for supervision by the National Futures Association (NFA).[168] The NFA promulgated best practices guidelines and conducted periodic audits to the satisfaction of the CFTC Commissioner.[169] Many were concerned that the registration

---

[165]The Commission marginally observed:

> So that our oversight of offshore advisers can be conducted effectively and efficiently in light of potential overlap with foreign regimes, we have asked our Division of Investment Management, our Office of Compliance Inspections and Examinations, and our Office of International Affairs to explore ways to obtain and share information with foreign authorities with oversight of hedge advisers that may register with the SEC.

Investment Advisers Act Release No. 2333, *supra* note 54, at 81,501 n.200.

[166]Then again, this is nothing new. *See generally* J.B. Ruhl & James Salzman, *Mozart and the Red Queen: The Problem of Regulatory Accretion in the Administrative State*, 91 GEO. L.J. 757 (2003) (exploring some of the burdens created by a lack of coherent structure in the body of federal administrative law stemming from the numerous decentralized agencies responsible for its promulgation).

[167]Brown-Hruska, *supra* note 49.

[168]The NFA is a self-regulatory body under the jurisdiction of the CFTC.

[169]Sharon Brown-Hruska's arguments in favor of an exemption were quite forceful.

> Pursuant to our delegated authority to the NFA, elective registration with the CFTC results in an independent and expert review that includes periodic examinations, evaluation of internal controls, and review of required disclosure documents and financial statements. In our review of the NFA's audit and compliance program, the NFA has demonstrated the necessary understanding of the complexities of the firms they examine, and a willingness to be tough when problems are uncovered.

requirement may have encouraged firms already voluntarily registered with the CFTC and the NFA to keep only their mandated SEC registration as a cost-saving measure.[170]

Self-regulatory strategies, as previously examined, are particularly effective in the area of finance. The Financial Accounting Standards Board (FASB), NFA, NASD, and to some extent the Federal Reserve are all examples of self-regulatory organizations sponsored by federal regulators. The advantage of these institutions is their flexibility in accommodating to rapid financial innovation. Though a self-regulator faces more conflicts of interest, it is also more capable of preventing regulatory arbitrage and fostering innovation. Further, conflicts of interest are constrained by the optimal voting models explored in Part I of this article. If NFA oversight of hedge fund activity is jeopardized, the SEC runs the risk of limiting the effectiveness of hedge fund oversight. Accordingly, Chairman Brown-Hruska sought an exemption from the SEC for those funds already registered with the CFTC.[171]

The SEC specifically rejected the proposal to exempt CFTC registered entities, claiming that the Section 203(b)(6) exemption from registration for any firm registered under the Commodities Exchange Act whose business "does not consist primarily of acting as an investment adviser" should be sufficient.[172] The SEC has failed to give much comment on its definition of investment adviser, thus the exemption is largely moot. The SEC also felt that firms would begin to take advantage of recent CFTC exemptions to withdraw from registration, but failed to address the significance of voluntary compliance through the NFA. Indeed, even if firms would have withdrawn from CFTC oversight, that says nothing about an exemption for those firms that would have remained.

If the SEC approved the exemption for funds registered with the

---

Id.

[170]For a summary of the CFTC regulations affecting hedge funds that invest in commodities, see Gibson, *supra* note 134, at 699-704.

[171]Sharon Brown-Hruska's remarks in a 2004 keynote address to the Securities Industry Association Hedge Fund Conference summarize her position.

> In my comment to the SEC, I requested that the SEC provide a registration exemption for CFTC-registered CPOs and CTAs that sponsor, operate or advise privately-offered commodity pools and that do not hold themselves out to the general public as investment advisers. It is my view that such a registration exemption would avoid duplicative regulation and would be consistent with good government, the principle of functional regulation, and current exclusions and exemptions in the Advisers Act for regulated financial institutions. This exemption for CFTC-registered CPOs and CTAs would be complemented by a formal information sharing agreement between the CFTC and SEC related to CFTC registrants.

Brown-Hruska, *supra* note 49.

[172] Investment Advisers Act Release No. 2333, *supra* note 54, at 81,502 n.130.

CFTC, it would give funds a choice of regulators. This would be similar to the multi-regulator architecture in banking. Banks have the option to charter under either the Federal Reserve, Comptroller, or state regulators. As previously explored, many would assert that this competition between regulators has made them more innovative, encouraging them to both streamline the cost of regulation to attract registrants and maintain tight oversight so that other regulators do not outshine them before Congressional oversight. It has also allowed the multiple regulators to specialize. Hedge fund oversight could benefit from such a multi-regulatory structure, but only if the overlap forged by the SEC's previous rule is not renewed.

H. *Policy Recommendations*

I will now examine a variety of alternative regulatory strategies and structures through which the SEC can make a second, more narrowly tailored attempt at regulating hedge funds. Perhaps, if future rulemaking in this area were more narrowly tailored, it would survive challenge in the United States Court of Appeals for the District of Columbia.[173] The lack of overlap between the registration requirement imposed and the concerns addressed by the SEC in their report calls for some additional effort to address those concerns. The general line of analysis explored here, the least cost and highest efficiency alternative, is an extension of the self-regulatory thesis previously explored. There are three entities that the SEC can use, the NFA, Managed Funds Association (MFA), and NASD (all examples of SROs or quasi-SROs) to enhance the self-regulatory form of governance over this market.[174] I examine these supplements to SEC central regulation as they might resolve some of the problems inherent in the previous regime. Government regulation has a historical tendency to grow outward beyond the intent of current thinking, I merely hope to provide some alternative lines of analysis through the remainder of this article.

Recommendation #1. The SEC should take steps to encourage creation of a private market intermediary. One step might be to make information gathered through a compliance process available to a select few officially chartered private rating agencies. The idea is admittedly tricky, the

---

[173]"If there are certain characteristics present in some investor-adviser relationships that mark a 'client' relationship, then the Commission should have identified those characteristics and tailored its rule accordingly." Goldstein v. SEC, 451 F.3d 873, 883 (D.C. Cir. 2006).

[174]R.M. Philips, *Overview, The Multi-Layered Securities Enforcement System*, *in* THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES (R.W. Philips ed., Chi. Am. Bar Ass'n, 1997).

confidentiality of firms' proprietary data would have to be assured, but the possibility deserves exploration. The analysis explored above of agency problems created by asymmetries, and the use of SROs to overcome these, could be sidestepped with a method to eliminate the information asymmetry itself. A private information intermediary could at least minimize the agency conflict by providing more information to hedge fund investors. Dr. Harvey Westbrook, an economist for the SEC, recently published a paper exploring the capabilities of such an intermediary that are particularly insightful.[175]

Dr. Westbrook proposes harnessing the growing institutional investor interest in hedge funds to encourage a private certification process.[176] He asserts that institutional market power can be used to negotiate for fund participation in a verification process to assure fund management operates within independently established operating procedures.[177] Institutional investors are a future source of enormous funding for the industry. Many chase absolute return strategies to meet dramatic funding shortfalls.[178] Their market power has been demonstrated in their ability to force funds into voluntary registration as investment advisers before the previous regulations were promulgated. Nevertheless, their bargaining capability is not unlimited, and so this recommendation is not intended to stand alone.

The efficacy of the institutional investor's market power has already been tested in the arena of corporate governance. The California Public Employees' Retirement System (Calpers) has achieved some success, especially in the use of "moral suasion." Nevertheless, many firms face a collective action problem. The profits from acting are exceeded by the individual cost of activism. It is cheaper to sell holdings and take the "Wall Street walk" (to simply sell the investment). This situation may be analogous to the hedge fund world. The positive externality that Dr. Westbrook aptly identifies, that institutional investors monitoring firms spill over into individual investor protection, is a case in point.[179] The institutions have no way of internalizing that profit, and will act only where the cost/benefit analysis makes the decision to certify a rational one.[180]

A private hedge fund certification entity may be possible if it can become a self-sustaining and profitable venture, as in the case of RiskMetrics[181] for corporate governance. Perhaps the entity will not be

---

[175]Harvey Westbrook, *Hedge Fund Industry Structure and Regulatory Alternatives*, Office of Economic Analysis, SEC, http://www.q-group.org/conf/Westbrook.pdf.

[176]*Id.*

[177]*Id.*

[178]*See* Ali, *supra* note 85, at 74.

[179]Westbrook, *supra* note 175.

[180]*See id.*

[181]Formerly Institutional Shareholders Services (ISS). Further information about this is

created by the institutions as much as it will be an intermediary earning a profit for its owners. If that entity can achieve economies of scale such that the cost of the service to each institutional investor customer is exceeded by their value attributed to monitoring, then intermediary certification can be achieved. If hedge funds are to cooperate with the certification body, assurances of the confidentiality of proprietary data will certainly be required. Though many hedge fund informational services exist, and some are able to obtain access to internal controls and trading data, the industry standard of strict confidentiality limits their effectiveness. I offer one possibility, affording access to SEC, NFA, or hedge fund SRO audit results to a limited number of certified intermediaries, as one idea the SEC could use to encourage the creation of a valid information intermediary.

Adding a new intermediary into the flow of financial funds can help to alleviate operational risk. Still, adding a new principal-agent relationship to the system of investment flow also creates more potential conflicts of interest. Also analogous to RiskMetrics, an independent intermediary would run the risk of attending to its own interests at the expense of investors. It could sell consulting services to hedge funds. It could game the certification process and play both sides against the middle. The efficacy of the intermediary would depend on its market power, the ability of competitors to challenge it (whether certification is a natural monopoly), and the regulatory environment facing certification providers. Even if a certification intermediary is established, it is also unlikely that it will fully internalize the negative externality of systematic risk that the hedge fund's use of leverage may engender. The intermediary will still face the same difficulty as regulators in measuring leverage, and it will never have as high an incentive as a regulator to limit such risk.

Recommendation #2. The SEC should request the MFA to put together a proposal for a disclosure statement requirement in accordance with an original suggestion of the SEC staff SEC Report.[182] The MFA is a private lobbying and research organization that serves the hedge fund industry. At the very least, it could make use of the "moral suasion" frequently cited by academics as a vital element of financial regulatory policy. A regulatory body can encourage private sector action through the implicit threat of added regulation.

---

available on the company's website http://www.riskmetrics.com/issgovernance.html.

[182]This point is also a component of the recent statement of principles of the President's Working Group on Financial Markets. *See 2007 PWG Report*, *supra* note 72, at 5. "Managers of private pools of capital should have information, valuation, and risk management systems that meet sound industry practices and enable them to provide accurate information to creditors, counterparties, and investors with appropriate frequency, breadth, and detail." *Id.*

In addition, the SEC should go a step further and consider a grant of authority to an SRO organization it creates to license members. It could then extend an exemption for registrants with the SRO from any future registration requirement.[183] The five basic functions of this SRO would be registration, standards of practice, inspection, investigations and discipline, and budgetary and operational decision making.[184] It could use the MFA (a hedge fund organization), or it could start from scratch. However, it would need to take an active role in the process of creating the SRO. If the arrangement could be properly designed, with independent regulatory authority and power vested within the private organization, the result could be a self-regulatory capability somewhat similar to that used in broker-dealer regulation on the National Association of Securities Dealers Automated Quotations (NASDAQ), facilitated by an opt-over provision from SEC registration.[185] One particular advantage to this structure, over that of the NASD or NYSE, would be that the SRO would be a single private regulator for an entire regulated industry, more akin to the Public Company Accounting Oversight Board.[186]

The SEC's oversight role would play out in four unique ways. First, its encouragement would be required to establish the necessity for an SRO. The majority of individual hedge funds face a collective action problem in coming together to form the SRO, and even the larger funds that might benefit most from regulation to enhance the industry's reputation could not force the others to join. However, once each has a motive to submit to regulation by the SRO (for instance, to avoid more onerous regulation by the SEC by taking advantage of a registration exemption for SRO members) then the Nash equilibria can begin.[187]

Second, the SEC would be required to establish the rules by which the game would play out. The architecture of other SROs like the NYSE, NASD, NFA, and FASB are all laid out in their charters, but amendments to the charter require SEC approval. This would also have to be the case for

---

[183]This follows in line with the PWG's overarching guideline that "[t]he vitality, stability and integrity of our capital markets are a shared responsibility between the private and public sectors . . . . Investor protection concerns can be addressed most effectively through . . . market discipline." *Id.* at 1.

[184]Joel Seligman, *Should Investment Companies be Subject to a New Statutory Self-Regulatory Organization?*, 83 WASH. U. L.Q. 1115, 1124 (2005).

[185]Some have argued the case for rules for which one can opt out in corporate law. *See* Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489 (2002). This would be an opt-over provision.

[186]Seligman argues that such a structure is optimal. Seligman, *supra* note 107, at 1348.

[187]In the words of one of the more notable SEC Chairmen, William O. Douglass, "'Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.'" *Id.* at 1361.

the hedge fund SRO. Otherwise, the players may be able to change the rules of the game to alter its results.

Third, the representatives of the rulemaking body would need to be approved by the SEC to ensure that they encompassed a representative sample of the hedge fund industry. If, for instance, the representative body were composed of representatives of only large funds, then the regulations may work to the advantage of larger funds over smaller ones.[188] Additionally, it would need to encompass representatives that engage in a variety of fund strategies.[189] This may require that the group be larger than the typical board of directors, more of a small assembly similar to the NYSE board. SEC approval could also ensure that, through pass-through entities and client relationships, one large fund did not possess influence over the other funds' member representatives, such that, the Nash outcome would be endangered (i.e., if Goldman Sachs had significant banking relationships with most of the other funds on the board). SEC approval would also ensure that, as the landscape of the hedge fund industry changed, the SRO rulemaking body membership continued to represent the disparate players well.

Fourth, the SEC would need to establish in the SRO's charter that, though the rulemaking body could be composed of individuals with industry ties, a separate body within the organization would need independent authority to enforce violations of the SRO's rules. The NASD settlement establishing the same thing is ample justification for such a requirement.[190] The decision making body of the hedge fund SRO would need to be composed of individuals with a working knowledge of the hedge fund world, but independent of industry ties. Veto authority for the SEC over appointments to the SRO's regulatory wing would help to achieve this result. Additionally, there should be a chief regulatory officer reporting directly to this body, a reform that was adopted at the NYSE in 2003.[191]

As an informative example, the SEC's settlement with the NASD in response to allegations that the NASD was engaged in price rigging, reviewed in the self-regulatory section of this article would be analogous to this recommendation.[192] If the SEC could persuade the MFA to create a similar enforcement body within its ranks, and offer the extension of an

---

[188]For more on circumstances in which an SRO can devolve into anti-competitive rulemaking, see *id.* at 1363-64.

[189]A similar reform was instituted at the NYSE in 1961, limiting the membership of specialists to eliminate problems caused by their over-representation on the NYSE board. *See id.* at 1362.

[190]*See* Seligman, *supra* note 107, at 1370-71.

[191]*Id.* at 1378.

[192]JACKSON & SYMONS, *supra* note 109, at 770.

exemption for firms registered with the MFA regulators, then it would allow a forum for a Nash regulatory equilibrium to ensue.

The NASD may also be able to aid in regulating primary brokers in the area of hedge funds to look for conflicts. Hedge funds typically use a primary broker who acts not only as their main securities broker but also provides accounting and custodial services to the fund.[193] Those brokers are already regulated by SROs, including the NASD. For example, the SROs and the SEC already enforce their own liquidity requirements, promulgated by the Federal Reserve or the SRO, for broker-dealers to ensure minimization of counter-party risk.[194] They could add enhanced oversight of conflicts through this established vehicle as well. Through the SEC's leadership, these established self-regulatory forums could be used to create the kind of regulatory Nash equilibrium described in the previous section.

It is important to note that the self-regulatory model is probably insufficient to regulate systematic risk, or the risk that over leverage in the industry will lead to a domino effect of loan defaults resulting in financial meltdown, especially if the larger institutions believe they are too big to fail. This risk forms a negative externality that consumers and suppliers of financial services do not take into account in their economic decisions. Therefore, the Federal Reserve should maintain vigilance in this area. But since this is largely a response to the non-liquidity concerns of hedge funds, rather than the fraud and self-dealing occurrences in the industry, I will leave exploration of that problem to more qualified experts.

Recommendation #3. The SEC should enhance coordination with other regulators. It should also exempt CFTC registrants from any future registration requirement. This would continue to encourage funds to register with the NFA, thus continuing the benefits of self-regulation in this exceptionally complex and rapidly changing environment.[195] This would also eliminate the high cost and redundancy in dual regulation from both commissions and help to foster a competitive regulatory environment.

The CFTC Chairman's request for an exemption was an olive branch from the CFTC to prevent a turf war overregulation of a $1.5 trillion industry and could lead to enhanced information sharing between the two regulators. The SEC should also create a working group to coordinate information gathering with the U.K. FSA,[196] and find ways to make

---

[193] *1999 PWG Report*, *supra* note 70, at B-4.

[194] *Id.* at B-4 to B-5.

[195] *See* Garth Saloner, *The Self-Regulating Commodity Futures Exchanges*, *in* THE INDUSTRIAL ORGANIZATION OF FUTURES MARKETS (R.W. Anderson ed., 1984).

[196] The International Organization of Securities Commissions makes some headway in this

registration easier for offshore registrants. International cooperation would help to minimize the impact of regulatory costs.[197] As part of this initiative, the SEC should consider an exemption for entities registered in the U.K.[198] The same arguments justifying a similar exemption under Rule 144A for Canadian issuers selling securities would apply.[199] Regulatory competition is frequently cited as creating a "race to the top" in corporate and banking law and the same principle would apply in this forum.[200]

Recommendation #4. The SEC should establish some statutory recognition to hedge fund best practices through safe harbor rulemaking to encourage registration with a self-regulatory body. It could provide a defense to regulatory enforcement action to any hedge fund that follows guidelines promulgated by such a body, in much the same way it recognizes such for firms that follow Generally Accepted Accounting Principles (GAAP), accounting rules promulgated by the FASB or broker-dealer best practices promulgated by the NASD.

Admittedly, there should already be some impetus for following these kinds of rules, as following best practices promulgated by an industry group should provide some common law defense for the reasonableness of a firm's activities. But statutory protection would be better defined and coordination preferable to a patchwork of legal decisions in this area.[201]

Recommendation #5. The Martin Act should be amended by the New York legislature to limit the powers of the New York Attorney General,[202] so that activities in compliance with SEC regulations are statutorily exempt from the definition of fraud. This will help ensure

---

area. *See* Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133 (1999). However, formal, one-on-one coordination directly between the FSA and the SEC would be advisable, since those two jurisdictions contain the overwhelming majority of hedge fund operations.

[197] *See* Kellye Y. Testy, *Comity and Cooperation: Securities Regulation in a Global Marketplace*, 45 ALA. L. REV. 927 (1994).

[198] *See* Ahdieh, *supra* note 128, at 883.

[199] *See* Jackson, *supra* note 99, at 10 (citing Anna T. Drummon, *Internationalization of Securities Regulation: Multijurisdictional Disclosures System for Canada and the U.S.*, 36 VILL. L. REV. 775 (1991)).

[200] *Id.*

[201] Paredes argues that mere promulgation of best practices is enough, citing literature on the expressive function of corporate law. *See* Paredes, *supra* note 9, at 1028 (citing Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227 (2003); Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998)). Going a step further to give statutory power to the best practices would only enhance their salience.

[202] N.Y. GEN. BUS. LAW § 352 (2006). *See also* Jonathan R. Macey, *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Preemption of the Martin Act*, 80 NOTRE DAME L. REV. 951, 960-61 (2005).

that the priorities and activities of the Attorney General's Office and the SEC do not provide inconsistent guidance to the financial community generally and the hedge fund world in particular.[203]

Recommendation #6. The SEC should adopt the other recommendations issued by the SEC staff. The SEC staff made a number of recommendations in the SEC Report requested by the SEC members in anticipation of rulemaking that were noticeably absent from the previous rule change.[204] Among those were:

> 1. The SEC staff should consider addressing certain valuation, suitability, and fee disclosure issues relating to registered FOHFs.
>
> 2. The SEC should consider permitting general solicitation in fund offerings limited to qualified purchasers.
> 3. The staffs of the SEC and the NASD should monitor capital introduction services provided by broker-dealers.
>
> 4. The SEC should encourage the hedge fund industry to embrace and further develop best practices.[205]

The SEC's previous rule failed to address many of these recommendations. Encouraging best practices would be an especially useful tool that the SEC failed to address at all. Best practices are a weak form of SRO regulation that could effectively supplement the SEC's efforts. Without any carrots or sticks to encourage funds to abide by best practices, or a dialogue with the MFA to maintain best practices guidelines, that avenue will remain unexplored.

III. CONCLUSION

There is a marked discrepancy between the SEC's stated goals in SEC Report and their previous registration rule. They set up a basic reporting regimen, but did little to establish controls on things like retailization,

---

[203] *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance, Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003) (discussing the relationship between state and federal securities laws).

[204] *See SEC Report*, *supra* note 7.

[205] *Id.* The need for best practices is also indicated in *2007 PWG Report*, *supra* note 72, at 5.

manager conflict between mutual and hedge funds, the disclosure problem, or establish incentives for the fostering of best practices. It is likely that regulatory activities will expand to address these issues. When it does, this article suggests that the regulatory strategies incorporate significant elements of self-regulation and regulatory competition.

Any future attempts at hedge fund regulation can be enhanced by the effectiveness of the self-regulatory model. Information collected during a compliance process, for instance, will be available to the agency. For any hedge fund to misrepresent itself to a party in connection with the sale of securities would be securities fraud, so the incentive to hedge fund operators to lie to a central information advisory agency would be reduced. Further, information collected during the SRO compliance process could be shared with the SEC. With that information available, the wide array of ethical conflicts posed here can be minimized.

One danger is that, caught up in the regulatory zeal, the SEC and banking regulators will burden the nimble traders of the hedge fund world with regulation akin to the mutual fund industry and seek to limit access for institutional investors like trusts and pension funds to this useful asset class. This is where the self-regulatory argument is most cogent and should be utilized to frame any future rulemaking in this area. Additionally, the growing presence of hedge funds in political lobbying calls for a measured and final rule on this issue before Congress becomes subject to regulatory capture.[206]

If Dr. Jones's legacy, this source of liquidity that has risen up to dominate our financial system in the last ten years, is to survive intact, then the SEC must maintain a coordinated and creative regulatory response that harnesses the capabilities of other regulators including federal, international, and SRO organizations. Otherwise, it risks constraining the growth of funds through unnecessary expense and limiting the effectiveness of its regulatory action. As its regulatory capability in this area grows and develops, the SEC should consider adding an element of self-regulation into the arena as a supplement to its own efforts.

---

[206]The MFA intends to "double the size of its political action committee" in 2007. Carrie Johnson & Jeffrey H. Birnbaum, *Hedge Funds Begin to Show Up on Regulators' Radar*, WASH. POST, Feb. 9, 2007, at D01-D02, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/02/08/AR2007020801829_2.html.