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IS SYSTEMIC RISK PREVENTION THE NEW PARADIGM? A PROPOSAL TO EXPAND INVESTOR PROTECTION PRINCIPLES TO THE HEDGE FUND INDUSTRY

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INTRODUCTION

The tragic events that the financial crisis yielded will haunt us for generations. In 2008, bank failures, government bailouts, and widespread foreclosures infiltrated the daily lives of every single American. The corresponding stock market losses and job lay-offs were astounding. Many of us thought that our regulators and market participants had long before absorbed the hard-earned lessons from the Great Depression. However, it became painfully clear that history may have repeated itself had the government not aggressively intervened by putting a remarkably expensive Band-Aid on the economy. As to be expected, the government has been under severe political pressure to ensure that comparable events never happen again. In response to this pressure, Congress recently passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") which subjects numerous financial institutions to sweeping regulation.[1]

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[1] Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S. Code).

The Dodd-Frank Act is largely focused on monitoring the extent to which these institutions contribute to systemic risk.[2] There are multiple definitions of this term, but it generally refers to "the risk of a broad-based breakdown in the financial system, often realized as a series of correlated defaults among financial institutions, typically banks, that occurs over a short period of time and typically caused by a single major event."[3] As a result, the Dodd-Frank Act likely targeted hedge funds because they can potentially create a systemic risk event.[4] More specifically, the failure of a particular fund could result in catastrophic effects on the entire economy because hedge funds have a symbiotic relationship with investment banks.[5] They rely on these counterparties to employ significant amounts of leverage and engage in various derivatives transactions.[6] Thus, they can expose these investment banks to excessive losses if a particular trade goes against the expectations of a hedge fund adviser.[7]

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[2] *Id.* (The stated purposes of the Dodd-Frank Act are, "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', [sic] to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."). *See generally* Roberta S. Karmel, *The Controversy over Systemic Risk Regulation*, 35 BROOK. J. INT'L L. 823 (2010) (providing an overview of the Dodd-Frank Act's focus on systemic risk).

[3] *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008: Written Testimony of Andrew W. Lo Prepared for the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 3–4 (2008) (written testimony of Andrew Lo, Harris & Harris Group Professor, MIT Sloan School of Management) [hereinafter *Written Testimony of Andrew Lo*], *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217.

[4] Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Hedge Fund Regulation on the Horizon—Don't Shoot the Messenger (June 18, 2009) [hereinafter *Commissioner Aguilar Speech*], *available at* http://www.sec.gov/news/speech/2009/spch061809laa.htm. In this speech, Commissioner Aguilar states:

> In their current form, hedge funds pose a systemic risk threat to our financial system in several ways. First, hedge funds have such significant assets under management that some fear that the loss of one or more large firms could potentially reverberate throughout the capital markets. In addition, if a counterparty fails to effectively withstand a hedge fund loss, then the failure of the counterparty could itself threaten market stability.

Id.

[5] Nicholas Chan et al., *Systemic Risk and Hedge Funds* 1 (MIT Sloan Sch. of Mgmt., Working Paper No. 4535-05, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 671443.

[6] *Commissioner Aguilar Speech*, *supra* note 4.

[7] *Id.*; *see also* Chan et al., *supra* note 5, at 2.

Accordingly, Congress used the current political climate of ensuring financial stability to pull hedge funds under the umbrella of the Securities and Exchange Commission ("SEC").

Since the Dodd-Frank Act[8] is mostly focused on monitoring systemic risk, the new legislation leaves many of the investor protection issues created by the hedge fund industry unresolved.[9] Many researchers in this area agree with this approach[10] and believe that investor protection is inapplicable since hedge funds are restricted to sophisticated investors, which are institutions or individuals who are required to maintain a certain financial net-worth.[11] This view is consistent with traditional notions of

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[8] Title IV of the Dodd-Frank Act is the section that regulates hedge funds. Dodd-Frank Act, Pub. L. No. 111-203, §§ 401–16, 124 Stat. 1376, 1570–79 (codified as amended in scattered sections of 15 U.S.C.). The formal name of Title IV is the "Private Fund Investment Advisers Registration Act of 2010." § 401, 124 Stat. at 1570 (codified at 15 U.S.C. 80b–20 (2006 & Supp. IV 2011)). However, I will simply refer to the Dodd-Frank Act throughout this Article to avoid undue confusion.

[9] *See generally infra* Part II (explaining why the Dodd-Frank Act is mostly focused on systemic risk prevention).

[10] The following articles on this topic focus on systemic risk prevention: Gregory W. Brown et al., *Are Hedge Funds Systemically Important?* (Working Paper Series, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1689079; Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks*, 5 J. FIN. STABILITY 283 (2009); Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151 (2011); *Written Testimony of Andrew Lo*, *supra* note 3; Anne Rivière, *The Future of Hedge Fund Regulation: A Comparative Approach: United States, United Kingdom, France, Italy, and Germany*, 10 RICH. J. GLOBAL L. & BUS. 263 (2011); Monica Billio et al., *Crises and Hedge Fund Risk* (Yale ICF, Working Paper No. 07-14, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1130742.

[11] The terms "sophisticated investor" and "accredited investor" will be used interchangeably within this Article. The term "accredited investor" is defined in the Securities Act of 1933, 15 U.S.C. § 77b(a)(15)(2006) and 17 C.F.R. § 230.501 (2011). The Dodd-Frank Act revised the accredited investor standard for natural persons so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than $1,000,000 and excludes the value of the primary residence of such natural person. Dodd-Frank Act, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (codified at 15 U.S.C. § 77b (2006 & Supp. IV 2011)). The SEC must also periodically review this standard every four years to take inflation into consideration. § 413(b)(2)(A), 124 Stat. at 1577 (codified at 15 U.S.C. § 77b). Knowledge is not a prerequisite for becoming an accredited investor. *See* § 413(a), 124 Stat. at 1577 (codified at 15 U.S.C. § 77b). The other federal securities law exemptions that hedge funds rely on include heightened standards for determining the qualifications of sophisticated investors (for example, the "qualified purchaser" standard in the Investment Company Act of 1940), but these specific distinctions are not necessary for purposes of this Article.

investor protection, which reject the argument that investor protection principles should be expanded to hedge fund investors, since they can presumably "fend for themselves."[12] In contrast, this Article focuses on the need for greater protection of these investors since the hedge fund industry has morphed into its own distinct marketplace that has grown increasingly complex.

As such, this Article specifically argues that the Dodd-Frank Act does not provide hedge fund investors with enough information to adequately protect themselves from the unique informational challenges associated with hedge fund investments. These unique issues encompass an overall lack of standardization within the industry, particularly with respect to its disclosure practices, risk assessments and valuation procedures. This lack of standardization, coupled with a limited public disclosure regime, makes it exceptionally difficult for investors to adequately investigate a particular hedge fund investment. In addition, investors cannot effectively choose an optimal hedge fund investment because these informational challenges make it difficult to adequately compare a large range of hedge fund opportunities. This severely limits investor choice and competition within the industry. These informational challenges deserve heightened attention since the current economic downturn resulted in the failure of approximately 1,500 hedge funds, which subsequently exposed such investors to staggering losses.[13] There are approximately 18,000 hedge funds

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[12] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). In this seminal case, the Supreme Court held that an offering to those who can "fend for themselves" is not a public offering and could therefore be exempt from federal securities regulation. *Id.*; *see also, e.g.*, Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 713–14 (2000) (arguing that hedge fund protection through federal legislation is unnecessary); Troy A. Paredes, *On the Decision To Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 990 (asserting that the government should not expand investors protection principles to hedge fund investors).

[13] David Reilly, *Hedge Funds Get To Feel Like 'Smart Guys' Again: David Reilly*, BLOOMBERG (July 1, 2009, 12:01 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aMIX3xXmjVHE; *see also* SWISS ANALYTICS, HEDGE FUND DUE DILIGENCE. . . MORE THAN JUST A BACKGROUND CHECK 1 (May 2009), *available at* http://www.barclayhedge.com/research/hedge-fund-due-diligence/2009/20090507/Due_Diligence_More_Than_Just_Background_Check.pdf (indicating that approximately "2,000 hedge funds have closed . . . their doors since the onset of the

that reported performance in 2009,[14] but this seems to be the only industry, with as many participants, which does not have an organizational or regulatory structure broadly supporting it.[15]

Furthermore, the losses of hedge fund investors could adversely impact other market participants, as well as the overall securities markets. For example, many pension plans, endowments, and insurance companies invest in hedge funds, which could expose their underlying constituents to excessive risks.[16] The SEC also uses a significant amount of its resources to monitor the hedge fund industry, even though sophisticated investors are presumed to be sufficiently capable of protecting themselves.[17] These costs could be mitigated if sophisticated investors were provided greater protections that would enable them to make better investment choices.[18] Moreover, the overall stability of the entire economy can be adversely impacted by such losses since our markets our inextricably connected.[19] The financial crisis provided a plethora of evidence on this point.[20] For these reasons, expanding investor protection principles to hedge fund investors is a pressing issue that will help to protect the overall integrity of our security markets.

This Article presents an alternative regulatory approach that seeks to create uniform and mandatory measures of valuation and risk for these investment vehicles, which would resolve many of these unique informational challenges.[21] These uniform valuation mechanisms would ensure that the fees and returns reported by hedge funds are reliable and fair. In

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financial crisis and that as many as 2,000 more may follow suit over the next 18 months"); *Commissioner Aguilar Speech*, *supra* note 4.

[14] PERTRAC FIN. SOLUTIONS, PERTRAC'S 2009 HEDGE FUND DATABASE STUDY 3 (Mar. 2010), http://www.pertrac.com/per0020/web/localdata/WEB/DATA/WEBSECTIONS]MATTACHMENT/PER0020_1368//PerTrac%202009%20Hedge%20Fund%20Database%20Study.pdf. It is difficult to track the total number of hedge funds because there is no mandatory reporting framework that would require all such funds to register.

[15] RICHARD HORWITZ, HEDGE FUND RISK FUNDAMENTALS: SOLVING THE RISK MANAGEMENT AND TRANSPARENCY CHALLENGE 143 (2004).

[16] *See infra* Part IV.B.

[17] *See infra* Part IV.A.

[18] *See infra* Part IV.A.

[19] *See infra* Part IV.C.

[20] *See infra* Part IV.C.

[21] *See generally infra* Part V.

addition, these uniform risk measures would help such investors effectively compare and aggregate risks across a number of hedge funds. They would also be tabulated and made available to interested sophisticated investors in a risk database. This risk database would be constructed so that the proprietary holdings of hedge funds are protected. This alternative framework would therefore provide more reliable and consistent disclosures to investors, while protecting the legitimate investing needs of hedge funds. Moreover, mandating standardization across the entire industry could decrease systemic risk because enhancing investor choice and transparency inevitably leads to better functioning markets.

Part I of this Article describes the basic hedge fund structure, explains the benefits that hedge funds can provide to the national securities markets and highlights the controversies that are frequently associated with these investment vehicles. Part II explains why the Dodd-Frank Act is mostly focused on systemic risk prevention as opposed to investor protection, and gives a broad overview of its relevant provisions. It also demonstrates that the Dodd-Frank Act does little to increase investor protection. For example, with respect to preventing hedge fund fraud, the exemptions provided under the act will limit the SEC's ability to detect fraud within hedge funds where fraud is most likely to occur. Part III identifies the unique investor protection issues that arise from hedge fund investments, such as the lack of standardized disclosure practices, risk calculations, and valuation mechanisms, and Part IV explains how the losses of sophisticated investors can impact other market participants, as well as the entire economy. Part V then proposes an alternative regulatory framework which would eliminate certain exemptions and exclusions from the definition of "private fund" under the Dodd-Frank Act and create a new self-regulatory organization ("SRO") that would: (1) establish certain standardized business practices for private funds so that hedge fund investors can adequately investigate and compare potential hedge fund investments; and (2) develop a risk database system that would resolve transparency issues and promote competition within the hedge fund industry, while protecting the legitimate investing needs of hedge funds.

I. BACKGROUND ON HEDGE FUNDS

This Part is designed to give a general overview of hedge funds. This section begins by describing the basic hedge fund structure and continues by explaining the various benefits that these investment vehicles can provide to its investors and to the national securities markets. It concludes with a detailed explanation of the controversies associated with these vehicles that eventually led to increased regulation under the Dodd-Frank Act.

A. *Hedge Fund Structure*

The term "hedge fund" is shrouded with mystery and obscurity, even though hedge funds account for over fifty percent of the trading volume on the New York and London stock exchanges.[22] This intrigue is partially due to the fact that hedge funds have never been officially defined by any regulatory body.[23] It is difficult to create a single definition because the actual investment strategies of hedge funds are extremely heterogeneous.[24] In their most basic form, hedge funds are investment vehicles that are formed by investment advisers who solicit money from a number of investors.[25] In this regard, hedge funds are comparable to mutual funds, but they differ with respect to their registration status, legal structures, and investment constraints.[26] Hedge fund advisers are typically experienced financial professionals who have developed a unique investment strategy that "guarantees" positive returns irrespective of market conditions.[27] Hedge fund investors must be "sophisticated," which means that each must either possess a

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[22] Greg Ip & Henny Sender, *Cash Machine: In Today's Buyouts, Payday For Firms Is Never Far Away*, WALL ST. J., July 25, 2006, at A1.

[23] *See, e.g.*, Goldstein v. SEC, 451 F.3d 873, 874–75 (D.C. Cir. 2006) (observing that securities laws do not define hedge fund); Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004) (to be codified at 17 C.F.R. 275 & 279) ("There is no statutory or regulatory definition of hedge fund . . . .").

[24] FILIPPO STEFANINI, INVESTMENT STRATEGIES OF HEDGE FUNDS 2 (2006).

[25] GERALD T. LINS ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 1.1 (2010).

[26] *Id.*

[27] *See id.* §§ 1.2, 2.2. Such returns are generally referred to as "absolute returns." *Id.* § 1.1.

certain level of financial wealth or be a certain type of institution in order to invest in such vehicles.[28] Once the investment adviser gathers enough money from sophisticated investors to form a sizable pool of assets, the adviser then invests those assets into a range of instruments to fulfill the promise of absolute returns. The term "hedge" refers to the fact that they have historically used various strategies in order to hedge, or protect, their portfolios against market losses.[29] For example, an investment adviser could simultaneously take long and short positions in the same type of instrument in order to ensure a return in both high and low markets.[30] This was essentially how Alfred Winslow Jones structured the first hedge fund in 1949.[31] He used short sales and leverage to create returns that had a low correlation to general market performance.[32] Today, however, a multitude of hedge fund strategies exist, some of which may or may not hedge their investments.[33]

Despite their prevalence in our markets, hedge funds have remained mostly unregulated prior to the passage of the Dodd-Frank Act.[34] Since hedge fund investments are securities[35] and

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[28] Securities Act of 1933, 15 U.S.C. § 77b(a)(15) (2006); 17 C.F.R § 230.501(a) (2011).

[29] *See* JOSEPH G. NICHOLAS, INVESTING IN HEDGE FUNDS 15 (2005).

[30] *See id.* at 12–15.

[31] STEFANINI, *supra* note 24.

[32] *Id.*

[33] *See What is a Hedge Fund?*, HENNESEE GRP. LLC, http://www.hennesseegroup.com/hedgefund/index.html (last visited Sept. 7, 2012).

[34] The SEC recently attempted to bring hedge funds under its umbrella by implementing the "Hedge Fund Rule" on December 10, 2004, which eliminated the "private advisers exemption" under the Advisers Act. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,055 (Dec. 10, 2004) (to be codified at 17 C.F.R. 275 & 279). This exemption was available to advisers who had fewer than fifteen clients and a single client typically included an entire hedge fund managed by an adviser as opposed to including each separate investor within such fund. *See id.* The Hedge Fund Rule rejected this interpretation of the word "client" by requiring advisers to count each individual investor within a fund, which made the private advisers exemption unavailable for many hedge fund advisers. *Id.* However, in *Goldstein v. SEC*, the court held that the Hedge Fund Rule was arbitrary and it exceeded the SEC's rulemaking authority because its interpretation of the word "client" fell "outside the bounds of reasonableness" 451 F.3d 873, 881–83 (D.C. Cir. 2006).

[35] *See* Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2006). The term "security" is defined under this section of the Securities Act. If an issuer offers securities as defined in this section, then such issuer must register its offering under the

pooled investment vehicles,[36] they fall within the regulatory framework of the four federal securities laws which are: (1) The Securities Act of 1933 ("Securities Act");[37] (2) The Securities Exchange Act of 1934 ("Exchange Act");[38] (3) The Investment Company Act of 1940 ("Company Act");[39] and (4) The Investment Advisers Act of 1940 ("Advisers Act").[40] However, most hedge funds rely on numerous exemptions provided under these laws so as to avoid the investment constraints and rigorous disclosure requirements that would result from registration.[41] In order to comply with these exemptions, hedge funds are mostly restricted to sophisticated investors.[42] This exclusion is supported by the notion that our government should not use its limited resources to protect sophisticated investors since they can use their own financial and institutional resources to gain comparable, if not superior protection.[43] As a result, hedge funds retain greater flexibility in making investments as compared to mutual funds, their registered counterparts.[44] For example, hedge funds are not

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Securities Act and file periodic disclosures under the Exchange Act, unless there is an available exemption. *See id.* § 77f(a).

[36] *See* Investment Company Act of 1940, 15 U.S.C.A. § 80a-3 (West 2011). The term "investment company" is defined in this section. If an issuer is an investment company as defined in this section, then such issues must comply with the terms under the Company Act and register under the Advisers Act, unless there is an available exemption. *Id.* at § 80a-8(a).

[37] Securities Act, 15 U.S.C.A. §§ 77a–77aa (West 2011).

[38] Exchange Act, 15 U.S.C.A. §§ 78a–78pp (West 2011).

[39] Company Act, 15 U.S.C.A. §§ 80a-1 to -64 (West 2011).

[40] Advisers Act, 15 U.S.C.A. §§ 80b-1 to -18c (West 2011).

[41] *See* SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 11–33 (2003) [hereinafter IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS], *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf (providing a detailed discussion on the exemptions that hedge funds frequently rely on).

[42] *See id.* at ix–x.

[43] *See id.* at 12–13.

[44] *The Laws that Govern the Securities Industry*, SEC, http://www.sec.gov/about/laws.shtml (last visited Sept. 7, 2012) ("The regulation is designed to minimize conflicts of interest that arise in these complex operations. The Act requires these companies to disclose their financial condition and investment policies to investors when stock is initially sold and, subsequently, on a regular basis. The focus of this Act is on disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations."). *See generally* Company Act, 15 U.S.C.A. §§ 80a-1 to -64 (West 2011) (the federal securities law that primarily regulates mutual funds).

required to adhere to any diversification policies and they can use their assets to retain large cash positions instead of maintaining actual investments.[45]

B. Benefits of Hedge Funds

Hedge funds often provide numerous benefits to the national securities markets. They can help to maintain market efficiency, facilitate capital formation, and provide liquidity to the national securities markets.[46] For example, many hedge funds seek investment opportunities from undervalued securities, which can help move the actual price of such securities closer to their true values.[47] In addition, hedge funds often make the securities markets more liquid through their significant participation in the buying and selling of securities.[48] They are also willing purchasers of several types of derivatives, which can help other counterparties to reduce their own risks.[49] Moreover, hedge funds can provide investors with a unique risk management opportunity to guarantee positive returns irrespective of market conditions.[50] Sophisticated investors have consistently taken advantage of this opportunity, which is largely unavailable in other investment company structures.[51]

C. Controversies Related to Hedge Funds

1. Leverage

Despite the proposed benefits of hedge funds, there are many corresponding controversies that have often created a public outcry for the increased regulation of these vehicles. One of the most controversial characteristics of hedge funds is their ability

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[45] LINS ET AL., *supra* note 25, § 1.1.

[46] *Testimony Concerning the Regulation of Hedge Funds, Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 109th Cong. (2006) (statement of Christopher Cox, Former Chairman, SEC) [hereinafter *Christopher Cox Testimony*], *available at* http://www.sec.gov/news/testimony/2006/ts072506cc.htm.

[47] William A. Roach, Jr., Note, *Hedge Fund Regulation: "What Side of the Hedges Are You on?"* 40 U. MEM. L. REV. 165, 173 (2009).

[48] *Id.* at 174.

[49] *Christopher Cox Testimony*, *supra* note 46.

[50] *Id.*

[51] *See id.*

to employ unlimited amounts of leverage.[52] Leverage refers to "the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment."[53] A typical leverage transaction occurs when a hedge fund adviser borrows a portion of the fund's assets from a prime broker or investment bank.[54] The use of leverage gives advisers the ability to increase returns of a particular fund, without having to increase the actual amount of capital invested.[55] Conversely, the use of excessive leverage could cause the losses of a fund to exceed the actual amounts invested, which is the contributing factor to several recent hedge fund blow-ups.[56] More importantly, the use of excessive leverage could create a situation where a hedge fund failure leads to substantial losses for the prime-brokers and investment banks since the fund will not have enough equity to pay off its creditors.[57]

The most widely-publicized hedge fund debacle occurred when Long-Term Capital Management ("LTCM"), a Connecticut based hedge fund, suffered significant losses in August 1998 when Russia devalued the ruble.[58] During this same time period, LTCM also had a balance-sheet leverage ratio that exceeded 25 to 1.[59] Thus, the primary trading counterparties, which included multiple banks and creditors, were the firms that were most

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[52] *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 11–12 (1999) [hereinafter LTCM REPORT], *available at* http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf (specifies that the amount of leverage employed by a particular hedge fund is only limited to the extent requested by its actual counterparties).

[53] *Leverage Definition*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/l/leverage.asp (last visited Sept. 7, 2012).

[54] LINS ET AL., *supra* note 25, § 2:3.

[55] *Leverage Definition*, *supra* note 53.

[56] *See* Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 30 REGULATION 36, 40 (2007).

[57] LTCM REPORT, *supra* note 52, at 13, 17.

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

[59] LTCM REPORT, *supra* note 52, at 12.

exposed to LTCM's losses.[60] This phenomenon was further explained by Roger Lowenstein, a reputable financial journalist, who stated that

> If [LTCM] defaulted, all of the banks in the room would be left holding one side of a contract for which the other side no longer existed . . . . Undoubtedly, there would be a frenzy as every bank rushed to escape its now one-sided obligations and tried to sell its collateral from [LTCM]."[61]

2. Derivatives

Hedge funds frequently rely on derivatives to ensure positive returns irrespective of market conditions.[62] However, they are often considered to be riskier financial instruments than securities.[63] By way of background, a derivative is "a financial instrument whose value derives from that of something else."[64] That "something else" could be a physical commodity, a security, or even a price index, and these instruments are referred to as the "underlier[s]" of derivatives contracts.[65] Futures are a common example of a derivatives contract where, "a party agrees to either buy or sell an underlying commodity or security at a specified price on a specified date in the future."[66] Other familiar examples of derivatives instruments include forwards, swaps, and options. Hedgers use futures contracts to protect against the risk of price fluctuations within various markets, while speculators use futures contracts to profit from inefficiencies within those same markets.[67] Essentially, speculators make a prediction of what the price of a particular commodity or instrument may be at some future date. They then use futures, or other types of derivatives, to profit from the probability of their prediction actually coming true.[68] If their predictions are

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[60] *Id.* at 13.

[61] ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT, at xix (2000).

[62] MICHAEL DURBIN, ALL ABOUT DERIVATIVES: THE EASY WAY TO GET STARTED 3–5 (2006).

[63] *See, e.g.*, *id.* at 5.

[64] *Id.* at 3.

[65] *Id.* at 1.

[66] *Id.* at 25.

[67] WILLIAM J. BAUMOL & ALAN S. BLINDER, ECONOMICS: PRINCIPLES AND POLICY 190 (11th ed. 2009).

[68] DURBIN, *supra* note 62, at 5.

accurate, then speculators earn substantial profits.[69] Conversely, if their predictions are wrong, then they suffer significant losses.[70]

Additionally, derivatives transactions usually constitute a "zero-sum game" where one party's gains depend on the other party's equivalent losses.[71] Thus, a party engaging in a derivatives transaction can either earn handsome profits or lose more than one hundred percent of their initial investment. Conversely, an investment in a security either increases or decreases in value, but rarely causes the investor to lose one hundred percent of its initial investment. Due to these heightened risks of investing in derivatives instruments, they are often associated with numerous hedge fund failures and other systemic risk events.[72] Warren Buffet's firm reiterated this view in its 2002 annual report which states that "derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."[73] Several types of complex derivatives transactions also caused the failure of several notable financial institutions during the most recent financial crisis.[74]

3. Liquidity

Hedge fund investments are also significantly less liquid than mutual fund investments. In this case, liquidity refers to the ease through which an investor can redeem its total investment from an investment vehicle. While mutual funds usually permit redemptions on a daily basis, hedge funds often require thirty to ninety day notice periods for investor

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[69] *Id.*

[70] *Id.*

[71] *Zero-Sum Game Definition*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/z/zero-sumgame.asp (last visited Sept. 7, 2012).

[72] *See, e.g.*, BAUMOL & BLINDER, *supra* note 67, at 188.

[73] BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT (2003), *available at* http://www.berkshirehathaway.com/2002ar/2002ar.pdf.

[74] *See generally The Role of Derivatives in the Financial Crisis: Hearing Before the Financial Crisis Inquiry Commission*, 111th Cong. (2010) (testimony of Prof. Michael Greenberger, Univ. of Md. Sch. of Law), *available at* http://cybercemetery.unt.edu/archive/fcic/20110310175404/http://c0182412.cdn1.cloudfiles.rackspacecloud.com/2010-0630-Greenberger.pdf.

redemptions.[75] Some hedge funds can even lock-up an investor's initial investment for one or more years.[76] Thus, if a hedge fund investor wishes to redeem their money from a particular fund, they may be subject to lengthy lock-up periods that could expose an investor to increased losses. These limited liquidity rights, combined with the sometimes riskier investment activities of hedge funds, could create undue risk for hedge fund investors.

4. Fees

The fee structures employed by hedge fund advisers are also unique because they typically receive a performance fee that is based on the actual profits earned by a fund.[77] Some critics argue that receiving a performance fee could increase the likelihood of advisers engaging in riskier investments to guarantee a profit, especially since such advisers will not incur an equivalent loss in personal earnings, if the overall fund incurs a loss.[78] However, some supporters argue that aligning the interests of the adviser with its investors reduces many of the agency problems associated with such arrangements, especially when the adviser also invests a portion of its own money into the fund.[79] These fees are generally calculated as a percentage of a fund's net asset value.[80] Furthermore, as will be discussed in Section III below, there is no standardized mechanism for calculating hedge fund valuations, which is the primary component of a fund's net asset value.[81] Thus, unscrupulous hedge fund advisers could fraudulently inflate a fund's valuations to increase their performance fees.[82]

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[75] Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 AM. J. COMP. L. 295, 311 (Supp. 2010).

[76] NICHOLAS, *supra* note 29, at 44.

[77] NICHOLAS, *supra* note 29, at 46. Hedge fund advisers also receive a fixed fee, which is based on a percentage of a fund's net asset value. Mutual fund advisers also receive these fixed fees. *Id.*

[78] Ordower, *supra* note 75, at 312.

[79] Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L. J. 240, 276–79 (2009).

[80] Ordower, *supra* note 75, at 312.

[81] *Id.* at 311–12.

[82] *Id.* at 312–13.

II. SYSTEMIC RISK FOCUS OF THE DODD-FRANK ACT

Part I highlights some, but not all, of the controversies associated with hedge fund investments. These issues can be alleviated by laws that would decrease systemic risk, as well as increase investor protection. While the Dodd-Frank Act attempts to resolve some of these issues, its primary focus is limited to preventing systemic risk.[83] This leaves many of the investor protection issues unresolved.[84] As such, this Part begins by explaining why the Dodd-Frank Act is primarily focused on systemic risk prevention and continues by giving a general overview of the Dodd-Frank Act's relevant provisions. This section concludes by explaining why the Dodd-Frank Act will have a minimal impact on the protection of hedge fund investors.

A. *Reasons for Systemic Risk Focus*

Systemic risk generally refers to "the risk of a broad-based breakdown in the financial system, often realized as a series of correlated defaults among financial institutions, typically banks, that occurs over a short period of time and typically caused by a single major event."[85] Systemic risk can be mitigated by laws that impose minimum capital requirements, leverage limits, and investment constraints on institutions whose failure would warrant government intervention. Much of the current literature on this topic analyzes how the activities of hedge funds can contribute to systemic risk.[86] Since hedge funds have a symbiotic relationship with banks, the losses of hedge funds could adversely affect the holdings of banks, and thus increase the likelihood of a systemic risk event.[87] The near failure of LTCM is an example of a systemic risk event caused by a single hedge fund.[88]

Systemic risk has recently gained widespread attention since the financial meltdown resulted in a number of bank failures and government bailouts that shattered our economic stability. In

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[83] *See infra* Part II (explaining why the Dodd-Frank Act is mostly focused on systemic risk prevention).

[84] *See infra* Part IV (discussing the need for additional investor protection).

[85] *Written Testimony of Andrew Lo*, *supra* note 3, at 3–4.

[86] *See supra* text accompanying note 10.

[87] Chan et al., *supra* note 5.

[88] *Id.* at 20, 56.

response to the financial crisis, Congress created the Congressional Oversight Panel which is "empowered to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy."[89] In January 2009, the Congressional Oversight Panel issued a special report that analyzed the current state of the regulatory system and made specific recommendations for regulatory reform.[90] Many of the recommendations within this report focused on identifying and regulating financial institutions that pose a systemic risk to the economy.[91] In September 2009, the SEC created the new Division of Risk, Strategy, and Financial Innovation to investigate and analyze issues involving systemic risk.[92] Previously, the Federal Reserve and the Treasury Department were the government entities that were primarily responsible for addressing systemic risk, while the SEC's primary focus was investor protection.[93] Since the financial meltdown brought systemic risk to the forefront of the political agenda, the Dodd-Frank Act mostly incorporates provisions that could mitigate systemic risk.

B. Overview of Dodd-Frank Act

1. Registration Under the Advisers Act

The Dodd-Frank Act will require many hedge fund advisers to register under the Advisers Act, which is the federal legislation that regulates the advisers of pooled investment vehicles.[94] The Advisers Act imposes certain disclosure

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[89] CONG. OVERSIGHT PANEL, 111TH CONG., SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY 51 (Jan. 2009), http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf [hereinafter SPECIAL REPORT ON REGULATORY REFORM].

[90] *Id.*

[91] *Id.* at 22–23.

[92] *Division of Risk, Strategy, and Financial Innovation Overview*, SEC, www.sec.gov/divisions/riskfin.shtml (last visited Sept. 17, 2012).

[93] Paredes, *supra* note 12, at 990.

[94] Dodd-Frank Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (codified at 15 U.S.C. § 80b-3(b) (2006 & Supp. IV 2011)). The Dodd-Frank Act has also created a new regulatory framework for the OTC market. §§ 701–774, 124 Stat. at 1641–802 (codified as amended in scattered sections of 7, 12, & 15 U.S.C.). This regime could

requirements on registered advisers such as descriptions of the advisory services offered, material conflicts of interest, any pending disciplinary actions, advisory fees charged, and other general business descriptions.[95] It also subjects advisers to additional fiduciary obligations and certain record-keeping requirements.[96] The SEC conducts random inspections of registered advisers to ensure that they are in compliance with the Advisers Act.[97] According to the SEC, the Advisers Act, and its corresponding regulations, are designed to protect investors, even though the SEC will likely use the information gathered from registered advisers to assess systemic risk.[98]

In effect, the Dodd-Frank Act eliminates the private-adviser exemption that hedge fund advisers previously relied on in order to avoid registration under the Advisers Act.[99] Moreover, all hedge funds that fall within the new definition of "private fund" will have to register under the Advisers Act.[100] A private fund is defined as any issuer that would be an investment company, as defined in the Company Act,[101] but for sections 3(c)(1) or 3(c)(7) of that Act.[102] Thus, if a hedge fund previously relied on the exemptions set forth in sections 3(c)(1) or 3(c)(7) of the *Company Act*, then it must register under the *Advisers Act*.[103] Under section 3(c)(1) of the Company Act, if a hedge fund has less than one hundred beneficial owners, then it is not required to register under the Company Act.[104] Under section 3(c)(7), if hedge funds

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subject hedge funds that trade OTC derivatives to additional reporting requirements and certain capitalization and leverage requirements as Swap Dealers (SDs) or Major Swap Participants (MSPs). § 727–30, 124 Stat. at 1696–702. However, the application of these standards to hedge fund advisers is unclear until the SEC issues additional guidance on the actual definitions of SDs and MSPs. §§ 721(a)(33), 721(a)(49), 124 Stat. at 1658.

[95] *See* Advisers Act, 15 U.S.C.A. § 80b-4 (c)(1)(A) (2006 & Supp. IV 2010).

[96] *Id.*

[97] *Id.*

[98] *The Laws that Govern the Securities Industry*, SEC, http://www.sec.gov/about/laws.shtml#invadvact1940 (last visited on Sept. 12, 2012).

[99] *See* Dodd-Frank Act, § 403, 124 Stat. 1376, 1571 (codified as amended at 15 U.S.C. § 80b-3(b) (2006 & Supp. IV 2010)).

[100] *Id.*

[101] Company Act, 15 U.S.C. § 80a-3(a)(1) (2006 & Supp. IV 2010).

[102] Dodd-Frank Act, § 402, 124 Stat. at 1570 (codified as amended at 15 U.S.C. § 80b-2(a)(29) (2006 & Supp. IV 2010)).

[103] *See id.*; § 403 (codified as amended at 15 U.S.C. § 80b-3(b)(1)).

[104] Company Act, 15 U.S.C.A. § 80a-3(c)(1) (West 2011).

limit their investments to "qualified purchasers," then they are also exempt from the registration requirements of the Company Act.[105] Presumably, Congress used this convoluted definition of private fund to capture the large number of hedge funds that rely on sections 3(c)(1) and 3(c)(7) of the Company Act in order to avoid the arduous requirements that normally apply to mutual funds.

2. Exemptions and Exclusions from Registration Under the Advisers Act

Under the Dodd-Frank Act, Congress also adopted various exemptions from registration under the Advisers Act for certain private funds.[106] As a result, the SEC and the investors of such funds will not receive the standard disclosures that would be mandated under the Advisers Act.[107] Congress directs the SEC to exempt advisers that only advise private funds and have assets under management in the United States of less than $150,000,000.[108] In addition, managed futures funds[109] and other funds that hold a limited amount of securities are not "private funds" under the Dodd-Frank Act, and thus are not required to be registered.[110] Family offices,[111] venture capital funds,[112] and certain foreign advisers[113] will also be exempt from registration.

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[105] § 80a-3(c)(7)(A).

[106] Dodd-Frank Act, §§ 407–410, 124 Stat. 1376, 1574–76 (codified at 15 U.S.C. § 80b-3(l)(1), -3(m)(1), -2(a)(11), -3(n) (2006 & Supp. IV 2010)).

[107] Dodd-Frank Act § 404, 124 Stat. 1376, 1571 (codified as amended at 15 U.S.C. § 80b-4(2)(b)(1) (2006 & Supp. IV 2010)).

[108] Dodd-Frank Act, § 408, 124 Stat. 1376, 1575 (codified as amended at 15 U.S.C. § 80b-3(m)(1) (2006 & Supp. IV 2010)). However, these funds are still required to maintain certain records and provide certain reports as the SEC deems necessary or appropriate in the public interest. § 408, 124 Stat. at 1575 (codified as amended at 15 US.C. § 80b-3(m)(2)).

[109] LINS ET AL., *supra* note 25, at § 11.1 (defining "managed futures fund[s]" as "funds [that] actively trade commodity futures and options on futures").

[110] § 403, 124 Stat. at 1571 (codified as amended at 15 U.S.C. § 80b-3(b)).

[111] § 409, 124 Stat. at 1575 (codified as amended at 15 U.S.C. § 80b-2(a)(11)(G)).

[112] § 407, 124 Stat. at 1574 (codified as amended at 15 U.S.C. § 80b-3(l)(1)).

[113] § 403, 124 Stat. at 1571 (codified as amended at 15 U.S.C. § 80b-3(b)(3)).

3. Collection of Systemic Risk Data

Under the Dodd Frank Act, all registered investment advisers to private funds, including certain exempt advisers, may be required to provide additional disclosures to the SEC beyond the specific disclosures requirements set forth under the Advisers Act.[114] It seems that these disclosures are designed to help the SEC identify whether certain hedge funds pose a systemic risk to the economy.[115] However, the SEC has not yet defined systemic risk or identified ways in which systemic risk can be measured. More specifically, every investment adviser may be required to file with the SEC a description of its assets under management, use of leverage, counterparty credit exposure, trading and investment positions, valuation policies and practices, types of assets held, and "such other information as the Commission . . . determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk . . ."[116] The SEC essentially has broad discretion to collect any information it deems necessary in order to protect the public interest. Yet, investors will not have access to this information. The SEC is supposed to guarantee that the information is kept in confidence and only disclosed to Congress or to other regulators.[117] However, in the Managed Funds Association's ("MFA") response to this particular provision of the Dodd-Frank Act, they stated that

> [s]uch information is highly sensitive from a competitive standpoint and advisers to private investment funds employ substantial safeguards to protect the proprietary and confidential information of the funds they manage, including

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[114] § 404, 124 Stat. at 1571 (codified as amended at 15 U.S.C. § 80b-4(b)(3)). Certain mid-sized funds, presumably including certain funds that would be exempt pursuant to section 408 of the Act (exempts advisers who have less than $150 million under management), could be subject to these additional reporting requirements if they pose a systemic risk to the economy. § 408, 124 Stat. at 1575 (codified as amended at 15 U.S.C. § 80b-3(m)(1)).

[115] *See* § 404, 124 Stat. at 1571 (codified as amended at 15 U.S.C. § 80b-4(b)(1)(A)). Hedge funds that pose a systemic risk could also be identified as "Designated Companies" by the new "Oversight Council" which would subject them to additional reporting requirements and investment constraints. *Id.* An analysis of this provision is irrelevant for purposes of this Article, which is confined to investor protection issues.

[116] § 404 (codified as amended at 15 U.S.C. § 80b-4(b)(3)(H)).

[117] § 404 (codified as amended at 15 U.S.C. § (b)(7)(B)).

> information related to their investment strategies, portfolio holdings and investor base. It is also critical that sensitive investor information that may be reported by an adviser be protected by the SEC. Public disclosure of confidential investor information could cause potential harm to those investors.[118]

Thus, the MFA, as well as many other market participants, is concerned that the improper dissemination of this information could actually harm hedge fund investors if a third party replicates the strategy of a particular hedge fund.[119]

C. *Limited Impact on Investor Protection*

The second category of the controversies associated with hedge fund investments relate to investor protection, which is the cornerstone of our federal securities laws. These laws generally seek to protect investors by giving them the necessary tools to make better investment decisions.[120] More specifically, these laws ensure investor protection by (1) deterring investment advisers from participating in fraudulent investment activities; (2) providing investors with more information and greater transparency to make better investment decisions since private actors may not have an incentive to disclose all pertinent information especially in easily compared form; and/or (3) providing regulators with more information and greater efficiency to better detect investment fraud.[121] Since hedge funds are still restricted to sophisticated investors, the Dodd-Frank Act has a limited focus on enhancing investor protection. This is consistent with traditional views on this topic, which assume that sophisticated investors are sufficiently capable of protecting themselves.[122] While the Dodd-Frank Act will require many

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[118] Letter from Richard H. Baker, President & CEO, Managed Funds Assoc., to Elizabeth M. Murphy, Sec'y, SEC (Sept. 22, 2010), *available at* http://www.managedfunds.org/downloads/MFA%20SEC%20Letter.9.22.10.pdf.

[119] *Id.*

[120] *See* Securities Act, 15 U.S.C. §§ 77b(b) (2006).

[121] *See id.* § 77q (making it unlawful to use fraud or deceit in the sale of securities); *see also id.* §§ 77k, 77l (creating civil liability for false information in registration statements and prospectuses); *id.* §§ 77j, 77e (listing the requirements for a prospectus and prohibiting the use of any means of interstate commerce in the absence of conformity with such requirements); *id.* §§ 77g, 77aa (listing disclosure requirements for registration statements).

[122] *See infra* Part IV.A.

hedge fund advisers to register under the Advisers Act, this section explains how this new requirement has a minimal impact on investor protection. Furthermore, the various loopholes created for this new registration requirement create additional limitations.

1. Limited Effect of Advisers Act Registration

The Advisers Act subjects advisers to certain disclosure and record-keeping requirements with respect to their overall advisory businesses, but it has a limited effect on the specific activities of their respective funds.[123] In contrast, registration under the Company Act would give investors more information to make better investment choices. More specifically, it would subject registered funds to more rigorous disclosure requirements, investment constraints, and standardized business practices with respect to their actual trading activities.[124] However, the Dodd-Frank Act does not require hedge funds to register under the Company Act or impose any other comparable restrictions. As a result, the overall impact of the Dodd-Frank Act's provisions on investor protection is minimal.

Advisers Act registration will likely enhance investor protection by giving the SEC, and perhaps investors, more information to better detect fraud. It will also subject registered advisers to random SEC audits, which could serve as a deterrent to fraudulent investment activities. However, SEC Chairman Mary Schapiro recently stated that "[g]iven the SEC's limited resources, we have only been able to examine roughly 10 percent of the investment advisers registered with us in each of the last two years. The result is that many advisers registered with the SEC are not examined regularly."[125] This statement indicates

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[123] *See, e.g.*, Advisers Act, 15 U.S.C.A. §§ 80b-3 (discussing registration of investment advisers), 80b-4 (discussing reporting by investment advisers) (West 2011).

[124] *See, e.g.*, Company Act, 15 U.S.C.A. §§ 80a-8 (discussing registration of investment companies), 80a-12 (limiting functions and activities of investment companies), 80a-14 (regulating size of investment companies), 80a-29 (discussing reporting and financial statements of investment companies and their affiliated persons) (West 2011).

[125] Mary L. Schapiro, Chairman, SEC, Opening Statement at the SEC Open Meeting: Items 1 and 2—Proposals to Implement Investment Adviser Provisions of

that ensuring compliance under the Advisers Act is a costly and timely endeavor and as a result, fraudulent advisers have slipped through the cracks. The most notable example of a fraudulent adviser "slipping through the cracks" would be Bernard Madoff, who swindled over $50 billion from sophisticated investors, even though he was registered under the Advisers Act.[126] Relatedly, the various exemptions provided under the Dodd-Frank Act will probably make it difficult for the SEC to detect hedge fund fraud in funds where fraud is likely to occur.[127]

2. Smaller Funds Escape Regulatory Oversight

Hedge fund advisers with less than $150 million in assets in the United States under management will not have to register under the Advisers Act and consequently, investors within these funds will not be given the same protections.[128] The SEC will still retain its power to collect systemic risk data from these exempt funds, but this information will not be given to investors.[129] As a result, private funds that fall within this category could potentially be subject to oversight by the SEC, to the extent that they pose a systemic risk to the economy. However, it is not yet clear how the SEC intends to regulate such private funds or whether the SEC will even gather systemic risk data from any mid-sized funds that fall within this category.[130]

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the Dodd-Frank Act (Nov. 19, 2010), *available at* http://www.sec.gov/news/speech/2010/spch111910mls-items1-2.htm.

[126] David Ellis, *Congress Looks for Answers in Madoff Scandal*, CNNMONEY.COM (Jan. 5, 2009, 5:49 PM), http://money.cnn.com/2009/01/05/news/companies/madoff_hearing/index.htm. *See also* Kara Scannell, *States Will Be Hedge-Fund Police*, WALL ST. J., Aug. 19, 2010, at C3.

[127] See *infra* Part II.C.2.

[128] *See supra* note 108 and accompanying text.

[129] *See supra* note 114 and accompanying text.

[130] On November 19, 2010, the SEC issued a proposed rule that would require exempt reporting advisers to also publicly disclose basic identifying information, certain business activities that create conflicts of interest, the adviser's disciplinary history, and other information regarding the private funds that they advise. *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management, and Foreign Private Advisers, 75 Fed. Reg. 77,190, 77,206–10 (Dec. 10, 2010) (to be codified at 17 C.F.R. 275) [hereinafter *SEC Proposal*]. This new reporting requirement will not exempt such advisers from other reporting requirements mandated under their respective states. *Id.* at 77,192.

Congress probably excluded these mid-sized funds from actual registration under the Advisers Act because of its focus on systemic risk, since smaller funds are less likely to create a systemic risk event.[131]

However, with respect to investor protection issues, some studies have found that smaller funds are much more likely to commit investment adviser fraud.[132] In fact, according to the Alternative Investment Management Association ("AIMA"), most hedge fund fraud cases involved advisers with $25,000,000 under management.[133] Furthermore, smaller funds are probably more likely to commit investment adviser fraud[134] because larger hedge funds, which are more established within the hedge fund industry, are subject to heightened scrutiny from institutional investors.[135] Smaller hedge funds generally do not attract as many institutional investors as compared to their larger counterparts.[136] This is relevant because institutional investors tend to perform more due diligence on their hedge fund investments than individual high net-worth investors.[137] This heightened due diligence process inevitably holds such advisers to a higher standard since their business practices are being more closely scrutinized. In effect, if a hedge fund has a large number of institutional investors that are demanding more disclosures and greater transparency, then such advisers are less likely to commit in fraudulent investment activities.

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[131] *See* SPECIAL REPORT ON REGULATORY REFORM, *supra* note 89, at 22–24.

[132] *See* Matthew Lewis, *A Transatlantic Dilemma: A Comparative Review of American and British Hedge Fund Regulation*, 22 EMORY INT'L L. REV. 347, 372 (2008); Anuj Gangahar, *SEC Rule Ignores Highest-Risk Category of Fund Fraud*, FIN. NEWS (Oct. 31, 2005), http://www.efinancialnews.com/story/2005-10-31/sec-rule-ignores-highest-risk-category-of-fund-fraud.

[133] Gangahar, *supra* note 132.

[134] *See id.*; Scannell, *supra* note 126 (discussing how fraud is more likely to happen with small managers than with larger managers).

[135] *See* Netty Ismail, *Institutions Damp Hedge Fund 'Startup Spirit,' Citi's Roe Says*, BLOOMBERG (Feb. 20, 2011), http://www.bloomberg.com/news/2011-02-21/hedge-funds-startups-slow-as-investors-demand-track-record-citigroup-says.html (discussing institutional investors' preference for large hedge funds).

[136] *Id.*; Amanda Cantrell, *Hedge Funds: A $25 Million Loophole: The New Hedge Fund Rule Exempts Small Funds, and That Could Be Bad for Small Investors*, CNNMONEY.COM (Aug. 5, 2005, 2:20 PM), http://money.cnn.com/2005/08/05/markets/hedge_regulation/index.htm.

[137] *See* Lewis, *supra* note 132, at 368.

In addition, advisers with less than $100 million of assets under management will not qualify for federal registration and will thus be subject to regulation by each respective state.[138] However, the majority of hedge funds in existence have less than $50 million in assets.[139] Previously, advisers with less than $25 million in assets under management were delegated to the state regulation.[140] Many state regulators do not have the adequate experience and/or resources to effectively regulate such a large number of advisers.[141] This will of course further limit the likelihood of the detection of fraudulent behavior by state regulators, which is exacerbated by the fact that such smaller funds are less likely to have institutional investors that perform "internal" regulation as briefly discussed above. This can also be problematic from an investor's perspective because this will result in inconsistent disclosure for a large number of hedge funds. As a result, it will be more difficult for hedge fund investors to compare disclosures among hedge funds, even though the SEC highlighted this as being an important concern for hedge fund investors.

3. Some Futures Funds Escape Regulatory Oversight

Traditional futures funds and other funds that hold a limited amount of securities are not "private funds" under the Dodd-Frank Act, and thus are not required to register.[142] These funds are commonly referred to as "managed futures" funds and they actively trade commodity futures and options on futures.[143] Managed futures funds are excluded because they are primarily regulated by of the Commodities Futures Trade Commission

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[138] Dodd-Frank Act, Pub. L. 111-203, § 410, 124 Stat. 1376, 1576 (codified as amended at 15 U.S.C. § 80b-3a(a)(2) (2006 & Supp. IV 2010)).

[139] HORWITZ, *supra* note 15, at 168.

[140] Scannell, *supra* note 126.

[141] *Id.* (discussing how the states do not "have the budget or the manpower" to monitor newly registered advisers).

[142] Dodd-Frank Act § 403, 124 Stat. 1376, 1571 (codified as amended at 15 U.S.C. § 80b-3(b) (2006 & Supp. IV 2010)).

[143] LINS ET AL., *supra* note 25, § 11:1.

("CFTC"), which is the designated regulatory body for the futures industry.[144] Conversely, the SEC is the designated regulatory body for the securities industry.[145]

The exclusion of managed futures funds from registration under the Advisers Act was probably created in order to avoid duplicative registration of hedge fund advisers by both the CFTC and the SEC, even though the SEC previously disagreed with this position.[146] Duplicative regulation issues arise for hedge fund advisers who trade in both securities and futures markets. Despite the appropriate concerns regarding duplicative regulation, there are also exemptions that managed futures funds can rely on in order to avoid registration with both the CFTC and the SEC which would in effect, exempt such managed futures funds from any regulatory oversight. [147] The Dodd-Frank Act attempts to limit duplicative regulation by requiring the CFTC and the SEC to jointly promulgate rules governing reporting requirements for advisers that are dually-registered,

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[144] *Id.*

[145] *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC (last modified July 30, 2012), http://www.sec.gov/about/whatwedo.shtml.

[146] The SEC previously addressed this issue in its adopting release for the Hedge Fund Rule, which has since been repealed. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,065 (Dec. 10, 2004). In this release, the SEC noted:

> We disagree that our oversight of hedge fund advisers that are also commodity pool operators would be duplicative. Most hedge fund portfolios consist primarily of securities, and the CFTC's oversight necessarily focuses more on the area of futures trading, which is the activity of most concern to the CFTC. It would be inconsistent with principles of functional regulation and contrary to the design and purpose of the 2000 amendments to the Advisers Act for the Commission not to oversee hedge fund advisers whose primary business is acting as an investment adviser.

Id.

[147] 17 C.F.R. §§ 4.13(a)(3), 4.13(a)(4), 4.7 (West 2011). The CFTC has recently proposed rescinding and/or limiting certain of these CFTC exemptions, but this proposal has not yet been deemed final as of October 2011. Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Proposed Rule, 76 Fed. Reg. 7976 (Feb. 11, 2011), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-2437a.pdf.

but it does not purport to address the regulatory loopholes for hedge fund advisers that are exempt from both regulatory agencies.[148]

The exclusion of exempt futures funds from regulatory oversight can be problematic for two reasons. First, there has been exponential growth of the number of traded futures over the past ten years.[149] If the futures industry continues to follow this trajectory, then the number of managed futures funds could be expected to grow which could create a substantial loophole for such advisers. Second, futures contracts are traded using margin, which is basically another form of leverage. Margin "refers to the initial deposit of 'good faith' made into an account in order to enter into a futures contract."[150] The amount of margin required to secure a futures position is usually 5% to 10% of the actual cash value of the contract.[151] As a result, if the closing price of a futures contract moves slightly away from an adviser's expectations, this can produce enormous losses compared to such adviser's initial margin deposit.[152] This could possibly lead to a situation where a fund's losses exceed the amount of capital invested in a particular fund, which would inevitably lead to a fund's failure.[153] Since trading in the futures market subjects investors to an increased risk of losing their total investment, it seems logical that managed futures funds should be subject to increased regulatory oversight. More importantly, in the event that a fund's losses exceed the amount of capital in a futures fund, the banks that extended lines of credit to the hedge fund to let it use leverage are going to incur such loss,[154] which further increases the likelihood of systemic risk.

By and large, the Dodd-Frank Act has a limited impact on investor protection. This is made evident by the numerous loopholes that were created from the new registration

[148] Dodd-Frank Act, Pub. L. No. 111-203, § 406, 124 Stat. 1376, 1574 (codified as amended at 15 U.S.C. § 80b-11(2)(e) (2006 & Supp. IV 2010)).

[149] STEFANINI, *supra* note 24, at 224.

[150] *Futures Fundamentals: Characteristics Definition*, INVESTOPEDIA, http://www.investopedia.com/university/futures/futures4.asp (last visited Sept. 13, 2012).

[151] *Id.*

[152] *Id.*

[153] *See* LTCM REPORT, *supra* note 52, at 12.

[154] STEFANINI, *supra* note 24, at 223.

requirement, as well as the minimal effect that Advisers Act registration has on investor protection. The Dodd-Frank Act was likely focused on mitigating systemic risk, which leaves the more complicated investor protection issues unresolved.

III. UNIQUE INVESTOR PROTECTION ISSUES THAT ARE NOT CAPTURED BY THE DODD-FRANK ACT

This Part describes the unique investor protection issues that hedge fund investors typically encounter and that are not resolved by the Dodd-Frank Act. These issues involve the growing complexity of the hedge fund industry as well as the industry's overall lack of standardization with respect to its disclosure practices, risk calculations, and valuation mechanisms. These issues make it exceptionally difficult for such investors to adequately assess the risk of a particular hedge fund investment. In effect, this Part gives a detailed description of each of these issues.

A. *Inability To Properly Assess Risk*

Some academics have assumed that investor protection principles should not be expanded to hedge fund investors since many sophisticated investors spend anywhere from two to over six months performing due diligence on a particular hedge fund.[155] Through this due diligence process, such investors receive information that would otherwise be disclosed if such hedge fund were registered. However, in a study that was

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[155] Paredes, *supra* note 12, at 992–93. This article also specifies that,

> [a] 2004 study by Deutsche Bank found that nearly 40% of the hedge fund investors surveyed spend an average of three to six months doing diligence before investing, with 20% of those surveyed spending an average of six months or more on diligence. Merely 3% of investors surveyed said they spend less than one month doing diligence. Only 21% of Deutsche Bank's respondents said that they normally invest in a fund at its inception, with the remaining 79% presumably waiting for the fund to develop a track record to gauge performance. Pension plans reported, on average, that they annually meet with about forty hedge fund managers in making only one to three allocations, and the average for endowments was to interview about ninety hedge fund managers a year to make just four to six allocations. Managers of so-called "funds of hedge funds" reported that they sometimes interview over 400 hedge fund managers to make just fifteen or so allocations.

Id.

conducted by the United States Government Accountability Office on May 7, 2009, "some market participants suggested that not all prospective investors have the capacity or retain the expertise to analyze the information they receive from hedge funds."[156]

Many of the underlying financial instruments that are traded by hedge funds have also become increasingly complex. While some hedge funds employ low-risk trading strategies that are relatively straightforward, other funds depend on high-risk trading strategies that rely on complex derivatives to ensure positive returns. For instance, a computer program could take days to value certain collateralized debt obligations ("CDO"),[157] which are investment vehicles that offer securitized interests in a pool of loan or debt instruments.[158] Similarly, collateralized mortgage obligations, which are investment vehicles that offer securitized interests in a pool of mortgages,[159] are so complex that counterparties within a CMO transaction could yield different values for the same CMO interest.[160]

Also, since trading strategies of hedge funds tend to be dynamic, it can be challenging for sophisticated investors to properly assess the corresponding risk of these strategies. More specifically, hedge funds can employ highly active strategies where they are allowed to trade varying quantities of instruments and leverage on a daily basis, and can alter their investment strategies with minimal notification to investors.[161] Accordingly, it is difficult for sophisticated investors to adequately assess their risk exposure to hedge fund investments

[156] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-677T, HEDGE FUNDS: OVERVIEW OF REGULATORY OVERSIGHT, COUNTERPARTY RISKS, AND INVESTMENT CHALLENGES 11 (2009) [hereinafter GAO STUDY], *available at* http://www.gao.gov/new.items/d09677t.pdf.

[157] Jennifer S. Taub, *Enablers of Exuberance: Legal Acts and Omissions that Facilitated the Global Financial Crisis* 2 (Vt. Law Sch., Working Paper Series, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1472190.

[158] *Collateralized Debt Obligations Definition,* RISKGLOSSARY.COM, http://www.riskglossary.com/link/collateralized_debt_obligation.htm (last visited Sept. 13, 2012).

[159] *Collateralized Mortgage Obligations*, SEC, http://www.sec.gov/answers/tcmos.htm (last modified Sept. 2, 2011).

[160] *See* CHARLES R. MORRIS, THE TWO TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH 39–40 (2008).

[161] *See id.*

that employ dynamic trading strategies, even if they spend a significant amount of time performing due diligence on a particular fund.

B. Limited Transparency

Hedge funds are not required to provide extensive disclosures to their investors, while mutual funds are required to deliver a prospectus to all investors under the Company Act.[162] A prospectus contains "valuable information, such as the fund's investment objectives or goals, principal strategies for achieving those goals, principal risks of investing in the fund, fees and expenses, and past performance."[163] Many hedge funds do provide certain disclosures in order to comply with the anti-fraud provisions under the Securities Act,[164] Exchange Act[165] and Advisers Act.[166] Such anti-fraud provisions apply even when issuers are exempt from registration.[167] Many funds also voluntarily provide additional disclosures to their investors because a number of sophisticated investors have started to demand greater transparency.[168] However, the level and degree of such disclosure varies among funds and most do not disclose the specific investment positions within their portfolios due to the proprietary nature of their investments.[169] This concern arises from the possibility of third parties replicating their strategies which could lead to significant losses for current hedge fund investors.[170] In addition, smaller hedge funds are not bound

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[162] *Implications of the Growth of Hedge Funds*, *supra* note 41, at 43; OFFICE OF INVESTOR EDUC. & ADVOCACY, SEC, MUTUAL FUNDS: A GUIDE FOR INVESTORS 18 (2007) [hereinafter *Mutual Fund Guide*], *available at* http://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf.

[163] *Id.*

[164] Securities Act, 15 U.S.C.A. § 77q (West 2011).

[165] Exchange Act, 15 U.S.C.A. § 78j (West 2011); 17 C.F.R. § 240.10b-5 (West 2011).

[166] Advisers Act, 15 U.S.C.A. § 80b-6 (West 2011); 17 C.F.R. § 275.206(4)-8 (West 2011); Shadab, *supra* note 79, at 286.

[167] Shadab, *supra* note 79, at 286–87.

[168] Greg MacSweeney, *Investors Demand Hedge Fund Transparency*, WALL STREET & TECH. (Nov. 23, 2009), http://www.wallstreetandtech.com/asset-management/showArticle.jhtml?articleID=221600610.

[169] Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 315–16 (2007).

[170] *Id.* at 316.

by comparable demands for transparency because they are less likely to attract larger institutional investors that have greater bargaining power.[171] Thus, while some larger institutional investors are able to bargain for greater transparency, other smaller investors are left to fend for themselves in a marketplace that has grown increasingly complex.

C. Inability To Adequately Compare Various Hedge Fund Investments

Regulators often rely on mandatory disclosure, or other comparable reporting mechanisms, as a tool for optimizing investor protection. A mandatory disclosure regime forces a firm to provide relevant information to its regulators, which would help them to better detect investment adviser fraud. It also ensures that investors have access to more reliable information regarding their investments so that they can make more informed investment decisions.[172] The arguments in favor of a mandatory disclosure regime often focus on the limitations of a voluntary disclosure regime. For example, firms may not have a great incentive to disclose relevant information voluntarily if such information would shed a negative light on the firm's business.[173] Even if information is disclosed voluntarily, they may have a self interest in only providing disclosure that would enhance their insider trading opportunities.[174] In a similar vein, voluntary disclosures may not encompass pertinent information "coming from outside the disclosing firm."[175] Due to these reasons, mandatory disclosure is thought to improve investor welfare.[176]

However, one of the least discussed benefits of mandatory disclosure, or other comparable reporting mechanisms, is the ability for investors to compare the financial and risk data among

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[171] Cantrell, *supra* note 136.

[172] SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 27 (1981).

[173] STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 26 (2d ed. 2008).

[174] *Id.*

[175] *Id.*

[176] *Id.*

various firms.[177] The ability to compare firms is repeatedly stressed by the literature on financial statements analysis[178] and as indicated by Professor Sharon Hannes, is arguably one of the most important aspects of a mandatory disclosure regime.[179] As she accurately points out, if investors are not able to adequately compare the performance data and risk control practices of multiple firms, then it is difficult to ascertain whether a particular firm is competitive and whether it conforms to industry standards.[180] For example, a return of 10% may appear favorable on its face, but if other comparable firms are earning returns of 15%, then the 10% return may not be optimal. In order for this benefit of mandatory disclosure to accrue to investors, there of course needs to be a standardized format for calculating data as well as a public disclosure system, or some other comparable reporting mechanism, which would provide investors and other analysts with access to such data.[181] Moreover, the financial statements that are provided by hedge funds are not required to comply with generally accepted accounting principles or to be reviewed by a CPA.[182]

With respect to public companies, Congress delegated authority to the SEC to promulgate finance reporting rules.[183] The SEC in turn has delegated this function to the Financial Accounting Standards Board ("FASB"), which is the agency that

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[177] Sharon Hannes, *Comparisons Among Firms: (When) Do They Justify Mandatory Disclosure?*, 29 J. CORP. L. 699, 702 (2004).

[178] *See* MARY BUFFET & DAVID CLARK, WARREN BUFFETT AND THE INTERPRETATION OF FINANCIAL STATEMENTS: THE SEARCH FOR THE COMPANY WITH A DURABLE COMPETITIVE ADVANTAGE 73–74 (2008) (indicating that the financial statements of a company provide whether it offers a competitive advantage that will make for a good investment); ROBERT C. HIGGINS, ANALYSIS FOR FINANCIAL MANAGEMENT 6–11 (9th ed. 2009) (explaining the mechanism of financial statement analysis which is used by finance professionals to forecast performance and assess future opportunities); *see generally* MARK E. HASKINS, THE SECRET LANGUAGE OF FINANCIAL REPORTS: THE BACK STORIES THAT CAN ENHANCE YOUR INVESTMENT DECISIONS 171–87 (2008) (providing detailed guidance on how to engage in financial statement analysis to make better investment decisions).

[179] Hannes, *supra* note 177.

[180] *Id.*

[181] *Id.*

[182] Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C. J. INT'L L. & COM. REG. 1, 29 (2007).

[183] MARK E. HASKINS, THE SECRET LANGUAGE OF FINANCIAL REPORTS: THE BACK STORIES THAT CAN ENHANCE YOUR INVESTMENT DECISIONS 5 (2008).

issues specific guidelines on how to report specific financial statement line items as well as any corresponding disclosures within any applicable footnotes.[184] The FASB has also highlighted that uniform reporting standards contribute to better functioning markets.[185] The FASB specifically stated that, "[Uniform] standards are important to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information."[186]

With respect to hedge fund industry, there is no standardized mechanism for managers to calculate valuations or to assess risk, which makes hedge fund comparisons extremely difficult for investors. There is also no public disclosure regime, or other reporting mechanism, that would require all hedge funds to report such information. This point is further exacerbated by the fact that hedge fund managers are prohibited from advertising, which means that they are forbidden from voluntarily disclosing relevant information to the public marketplace.[187] Hedge fund investors primarily rely on hedge fund marketing activities, limited index reports, and extensive due diligence inspections as the main sources of information regarding these investments.[188] As a result, the process for determining whether a hedge fund investment is optimal is expensive and unreliable. This creates inefficiencies with respect to the value and quality of hedge fund investments, which is problematic since many institutional investors, such as pension plans, insurance companies, and endowments, see hedge funds as a valuable component of their underlying investment strategies. This is also problematic to the extent that hedge funds are

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[184] *Id.*

[185] *See Facts About FASB*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495 (last visited Sept. 13, 2012).

[186] *Id.*

[187] 17 C.F.R. § 230.502(c) (2008). *See* Roel C. Campos, SEC Comm'r, Remarks Before the Hedge Fund Institutional Forum Corporate Funds Roundtable (Mar. 5, 2007), *available at* http://www.sec.gov/news/speech/2007/spch030507rcc.htm (discussing the possibility of eliminating prohibition on advertising to promote transparency in hedge fund industry).

[188] *See generally* PRINCIPLES AND BEST PRACTICES FOR HEDGE FUND INVESTORS: REPORT OF THE INVESTORS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS (2009), *available at* http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf.

actually providing benefits to the overall marketplace by eradicating price inefficiencies, providing liquidity for various financial instruments, and by providing capital for new companies and industries.[189] This issue deserves heightened attention since there are approximately 18,000 hedge funds in existence; although this number cannot be verified since there is no public disclosure regime, or other reporting mechanism, that will require all hedge funds to register.[190] Overall, the hedge fund industry seems to be the only industry, with as many participants, that does not have an organizational or regulatory structure broadly supporting it.[191]

In February 2007, the President's Working Group on Financial Markets ("PWG") released a set of principles and guidelines that were designed to assist regulators in the development of hedge fund regulations.[192] The following "Investor Protection Principle" was included in this agreement: "Sophisticated investors that determine to invest in a private pool of capital should ensure that the size of their investment is consistent with their investment objectives and the principle of portfolio diversification."[193] However, this principle cannot be fully realized if sophisticated investors cannot adequately compare various hedge fund investments. Since the Dodd-Frank Act does not include standardized valuation and risk practices, and will exempt many advisers from registration, investors will be limited in their abilities to optimize their hedge fund investments.

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189 GAO STUDY, *supra* note 156, at 13–14.

190 PERTRAC'S 2009 HEDGE FUND DATABASE STUDY, *supra* note 14.

191 HORWITZ, *supra* note 15.

192 Press Release, U.S. Dep't of Treasury, President's Working Group Releases Agreement Detailing Common Approach to Private Pools of Capital (Feb. 22, 2007), *available at* http://www.treasury.gov/press-center/press-releases/Pages/20072221434566971.aspx.

193 *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, U.S. DEP'T OF TREASURY 1–2, http://www.treasury.gov/resource-center/fin-mkts/Documents/hp272_principles.pdf (last visited Sept. 13, 2012) [hereinafter *PWG Agreement*].

D. *Lack of Standardized Valuation Mechanisms*

Valuation generally refers to the mechanisms through which a firm determines the current value of its assets.[194] Since hedge fund managers are compensated based on the overall value of the fund's assets, which in turn affects the performance results of a fund, there is a general concern that such managers have an incentive to inflate valuations.[195] This issue is even more problematic with respect to hedge fund investments because they often trade illiquid assets for which there is no readily available market quotation.[196] Moreover, hedge fund managers have great discretion to utilize their own valuation policies, as they are not required to use a third-party valuation agent or adhere to a standardized set of valuation policies.[197] Most hedge fund offering materials do contain provisions that explain the manager's valuation policies. However, these provisions generally lack the specificity that investors need in order to effectively evaluate such policies.[198] In addition, the hedge fund manager usually has discretion to deviate from the provided valuation policies when deemed necessary, making the disclosures even more ineffective.[199]

Many academics, industry groups and even regulators have recognized the need for better hedge fund valuation policies and procedures.[200] For example, the MFA, which is a leading advocate for sound business practices within the hedge fund industry, issued a best practices manual for hedge funds in

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[194] *Valuation Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/v/valuation.asp (last visited Sept. 13, 2012).

[195] *See* Kent Oz, Note, *Independent Fund Administrators as a Solution for Hedge Fund Fraud*, 15 FORDHAM J. CORP. & FIN. L. 329, 350 n.166 (2009).

[196] *See id.* at 335.

[197] *See* Ryan Sklar, Note, *Hedges or Thickets: Protecting Investors from Hedge Fund Managers' Conflicts of Interest*, 77 FORDHAM L. REV. 3251, 3268 (2009).

[198] *Id.*

[199] *Id.* at 3268–69.

[200] *See* IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 41, at viii; Susan M. Mangiero, *Hedge Fund Valuation: What Pension Fiduciaries Need to Know*, J. COMPENSATION & BENEFITS, Aug. 2006, at 20, *available at* http://www.bvallc.com/pdf/hedgefund2006.pdf (stressing the importance of pension plans becoming familiar with hedge fund valuation procedures); *The SEC Isn't Finished with Hedge Funds*, BLOOMBERG BUSINESSWEEK (July 17, 2006), http://www.businessweek.com/magazine/content/06_29/b3993055.htm (discussing the difficulties associated with the subjective valuation procedures for certain assets traded by hedge funds). *See generally* Sklar, *supra* note 197.

2009.[201] This manual includes recommendations that fund valuations be "fair, consistent, and verifiable."[202] The Asset Managers' Committee, under the direction of the President's Working Group, even issued a best practices report on January 15, 2009, which recommends "[r]obust valuation procedures that call for a segregation of responsibilities, thorough written policies, oversight and other measures for the valuation of assets, including a specific focus on hard-to-value assets."[203] Despite these numerous recommendations, the Dodd-Frank Act does not address the valuation issue.[204] While it is difficult to create a uniform standard for all hedge fund investments since the strategies employed by hedge funds are heterogeneous and distinct from traditional investments, it is vital that certain standards are developed and applied consistently. This can perhaps be achieved by requiring third-party oversight for valuation procedures, by creating separate valuation procedures for different types of instruments, or by adopting the models proposed by the MFA or other similar organizations.

E. Lack of Standardized Risk Management Practices

In addition to evaluating the returns of hedge fund investments, sophisticated investors are also looking for ways to compare and aggregate risks across a number of portfolios.[205] The four components of risk that sophisticated investors

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[201] MANAGED FUNDS ASS'N, SOUND PRACTICES FOR HEDGE FUND MANAGERS 1 (2009), *available at* http://www.managedfunds.org/files/pdf's/MFA_Sound_Practices_2009.pdf [hereinafter MFA BEST PRACTICES GUIDE].

[202] *Id.* at 7.

[203] BEST PRACTICES FOR THE HEDGE FUND INDUSTRY: REPORT OF THE ASSET MANAGERS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS iii (2009), *available at* http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf.

[204] It should be noted that under the SEC Proposal, the SEC mandates a uniform method for calculating "regulatory assets under management" for purposes of determining whether advisers can rely on certain exemptions. However, advisers can deviate from this method for purposes of calculating their fees and returns, which is how investors typically measure the success of a particular fund. In addition, this uniform measure is not required for other disclosures that are voluntarily given to investors. As a clarification, "assets under management" generally includes all assets that a particular adviser manages, which could encompass multiple funds. As a result, this proposal does not create a uniform measure on a fund-by-fund basis.

[205] *See* HORWITZ, *supra* note 15, at 2.

generally evaluate include volatility, diversification, leverage, and liquidity.[206] Volatility refers to the amount of uncertainty associated with the value of a particular investment, while diversification refers to the extent to which a portfolio includes a wide variety of investments.[207] Leverage refers to the ratio of a firm's debt to its equity capital,[208] while illiquidity refers to whether an investment could be easily sold or exchanged for cash without a substantial loss in value.[209] Another category of risk that is not subject to quantitative analysis is "operational risk[ ]" which "include[s] organizational aspects such as the reliability of back-office operations, legal infrastructure, accounting and trade reconciliation, personnel issues, and the day-to-day management of the business."[210] Operational risks have recently gained more attention since most hedge fund failures result from operational inefficiencies.[211]

Various models can be used to measure each of these risk components. However, with respect to the hedge fund industry, there is no standardized format for measuring or reporting the various types of risks created by hedge fund investments.[212] Moreover, hedge funds are not required to disclose specific information with respect to their specific risk calculations or

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[206] *Id.* at 3.

[207] *Volatility Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/v/volatility.asp (last visited Sept. 13, 2012); *Diversification Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/d/diversification.asp (last visited Sept. 13, 2012).

[208] *See supra* note 53 and accompanying text.

[209] *Illiquid Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/i/illiqu*id.*asp (last visited Sept. 13, 2012).

[210] Andrew W. Lo, Risk Management for Hedge Funds: Introduction and Overview 31 (Working Paper Series 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=283308.

[211] *See* Gareth Jones, *Operational Due Diligence: Increased Demands for Hedge Fund Managers and Investors*, THE HEDGE FUND J. (June 2010), http://www.thehedgefundjournal.com/magazine/201006/opinion/operational-due-diligence.php.

[212] *See* Pearson & Pearson, *supra* note 182, at 47–48. This point is reiterated by Mark J.P. Anson, a senior investment officer with CalPERS, a prominent institutional investor. He states that "there is no standard platform for measuring risk and no standard format for reporting it. . . . Consequently, the risks of several hedge fund managers cannot be combined." Mark J.P. Anson, *Hedge Fund Risk Management for Institutions*, *in* MANAGING HEDGE FUND RISK: FROM THE SEAT OF THE PRACTITIONER—VIEWS FROM INVESTORS, COUNTERPARTIES, HEDGE FUNDS AND CONSULTANTS 19, 21 (Virginia Reynolds Parker ed., 2000).

methodologies.[213] As a result, it is difficult for hedge fund investors to compare a variety of hedge fund risk exposures, which makes harder to achieve optimal risk allocations. While the PWG recognized that "[i]nvestors should understand their investments and the corresponding risks, and should not expose themselves to risk levels they cannot tolerate,"[214] the Dodd-Frank Act does little to ensure that investors are given the appropriate tools to properly assess risk.

F. Information Asymmetries Create a "Lemons" Market

The above investor protection issues create distinct information asymmetries between advisers and investors. These asymmetries have possibly created a "market for lemons" within the hedge fund industry.[215] Essentially, a "market for lemons" is created when individuals within a particular market buy goods or services without knowing the true quality of such goods or services.[216] The sellers within these markets have more knowledge about the quality of their goods than the buyers.[217] As a result, the high quality goods and the low quality goods will inevitably end up selling at the same price since the buyer cannot tell the difference between a high quality good and a low quality good.[218] This would in turn push out the higher quality goods since they would not be rewarded for their superiority.[219]

With respect to the hedge fund industry, the lack of standardized valuation and risk reporting mechanisms make it difficult for investors to know the true value of such investments. As a result, it is possible that certain hedge funds with different qualities will have the same price, because investors are not aware of the true value of a hedge fund investment.[220] The value of a hedge fund is frequently measured by the extent to which a

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[213] *See id.*

[214] *PWG Agreement*, *supra* note 193, at 2.

[215] George A. Akerlof, *The Market For "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. OF ECON. 488, 488 (1970).

[216] *Id.*

[217] *Id.* at 488–89.

[218] *Id.* at 489.

[219] *Id.* at 489–90.

[220] Martin Wolf, *Why Today's Hedge Fund Industry May Not Survive*, FINANCIAL TIMES (Mar. 18, 2008), http://www.ft.com/cms/s/0/c8941ad4-f503-11dc-a21b-000077b07658.html#axzz1ahuRDXfA.

manager's skill or talent contributes to the actual returns exhibited by a particular fund.[221] However, it is possible for a hedge fund manager to temporarily earn high returns by using a probability analysis to place bets on certain market events, without developing a long-term and legitimate investment plan.[222] For example, if a manager with no investment talent uses a probability analysis to determine that it is highly unlikely that the S&P 500 index will fall more than 20%, the manager could write options on this unlikely S&P event and sell them in the marketplace.[223] Thus, if the S&P 500 does not tank, the manager will be able to keep the money earned from selling the options and this will increase the fund's returns.[224] On the other hand, in the rare event that the S&P 500 tanks, the manager will have to use the fund's assets to pay the option-holders who were on the opposite end of the bet.[225] If this happens, the investors will have lost the total value of their initial investments.[226]

Since investors often evaluate hedge funds by comparing their returns, without having the tools to effectively evaluate and/or compare hedge funds' valuation and risk policies, it is difficult to differentiate a talented manager from an unscrupulous one. These issues could be partially addressed through implementing standardized business practices and improving the transparency of all hedge funds, regardless of their asset sizes. The Dodd-Frank Act does little to address these issues since it seems to be primarily focused on mitigating systemic risk, as opposed to enhancing investor protection.

IV. THE BROADER IMPACT OF HEDGE FUND INVESTMENTS

This Part explains why hedge fund investors should be entitled to greater investor protection under our federal securities laws. While Part III supports this view by explaining

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[221] STEFANINI, *supra* note 24, at 12.

[222] *Gaming the System: Are Hedge Fund Managers Talented, or Just Good at Fooling Investors?*, KNOWLEDGE@WHARTON (Apr. 2, 2008), http://knowledge.wharton.upenn.edu/article.cfm?articleid=1931&jsessionid=9a3077a90249657e225f.

[223] Dean P. Foster & H. Peyton Young, *Hedge Fund Wizards*, ECONOMISTS' VOICE, Feb. 2008, at 1.

[224] *Id.* at 1–2.

[225] *Id.* at 2.

[226] *Id.*

how the hedge fund industry can create undue risk for sophisticated investors, this Part explains how the losses of such investors can extend to other market participants, such as retail investors, as well as to the general public. For example, many pension plans that invest in hedge funds could expose their underlying investors to excessive risks. In addition, the SEC uses a significant amount of its resources to monitor the hedge fund industry, even though sophisticated investors are presumed to be sufficiently capable of protecting themselves. These costs could be mitigated if sophisticated investors were provided greater protections that would enable them to make better investment choices. More importantly, since our markets are inextricably connected, the overall stability of the entire economy can be adversely impacted by such losses. For these reasons, expanding investor protection principles to hedge fund investors will help to protect the overall integrity of our security markets. This Part further explains each of these issues.

A. Hedge Fund Fraud

The SEC uses a significant portion of its resources investigating and prosecuting fraudulent hedge fund advisers.[227] While hedge funds are subject to the anti-fraud provisions under the federal securities laws,[228] these laws failed to prevent the occurrence of multiple instances of hedge fund fraud. For example, from 1999 to 2004, the SEC investigated fifty-one cases involving hedge fund fraud, which caused investors to lose over $1.1 billion.[229] More recently, from 2006 to the first four months of 2009, the SEC investigated eighty-four cases of hedge fund fraud.[230] Thus, the number of these investigations has actually increased in recent years. A current example of hedge fund fraud occurred during the financial crisis, when the SEC charged two former Bear Stearns Hedge Fund managers with fraud for

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[227] *See, e.g.*, Linda Chatman Thomsen et al., *Hedge Funds: An Enforcement Perspective*, 39 RUTGERS L. J. 541, 542 (2008). This article is authored by members of the SEC's Division of Enforcement. *Id.* at 1. It provides a detailed analysis of the various kinds of SEC enforcement cases that have been brought against hedge fund advisers. *See generally id.*

[228] *See supra* note 146 and accompanying text.

[229] *See* Jane J. Kim, *Digging for Hedge-Fund Dirt*, WALL ST. J., Aug. 8, 2005, at C1.

[230] *Commissioner Aguilar Speech*, *supra* note 4.

misleading investors about the funds' financial state.[231] In this case, the investors suffered approximately $1.8 billion in losses after these funds took highly leveraged trades within the subprime mortgage backed securities markets.[232] The SEC further alleges that

> when the hedge funds took increasing hits to the value of their portfolios during the first five months of 2007 and faced escalating redemptions and margin calls, then-[Bear Stern Asset Management] senior managing directors Ralph R. Cioffi and Matthew M. Tannin deceived their own investors and certain institutional counterparties about the funds' growing troubles.[233]

Andrew J. Donohue reiterated the limitations of relying on these anti-fraud provisions to adequately protect investors by stating: "It is not uncommon that our first contact with a [hedge fund] manager of a significant amount of assets is during an investigation by our Enforcement Division."[234] Thus, the anti-fraud provisions within the securities laws fail to adequately protect sophisticated investors. If these investors had greater protections at the outset of the transaction, then they might be able to better detect fraudulent hedge fund activities before disaster hits. This would in turn preserve the resources that the SEC uses to investigate these claims.

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[231] Press Release, SEC, SEC Charges Two Former Bear Stearns Hedge Fund Managers with Fraud (June 19, 2008), *available at* http://www.sec.gov/news/press/2008/2008-115.htm.

[232] *Id.*

[233] *Id.*

[234] *Testimony Concerning Regulating Hedge Funds and Other Private Investment Pools, Hearing Before the Subcomm. on Sec., Ins., and Inv. of the S. Comm. on Banking, Hous., and Urban Affairs* (July 15, 2009) (statement of Andrew J. Donohue, Director, Division of Investment Management, SEC), *available at* http://www.sec.gov/news/testimony/2009/ts071509ajd.htm.

B. *Increased Exposure to Retail Investors and Other Constituents*

Many academics, as well as the SEC, have highlighted the risk of retail investors[235] being indirectly exposed to hedge funds since pension plans, insurance companies, charitable trusts, and other institutional investors have been increasingly investing into these vehicles.[236] A 2007 study revealed that institutional investors account for over 50% of hedge fund investments.[237] However, a more recent study revealed that institutional investors account for over 61% of total hedge fund investments, and will continue to increase in upcoming years.[238] Additionally, one source found that fund-of-funds accounted for 30% of the total amount of assets in the hedge fund industry.[239] As background, fund-of-funds are investment vehicle structures that are available to retail investors, even though they directly invest into a large number of underlying hedge funds.[240] Furthermore, two-thirds of endowments[241] have significant hedge fund

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[235] Retail investors are individuals who purchase small amounts of securities for themselves, as opposed to institutional investors. *Retail Investor Definition*, INVESTOR WORDS, http://www.investorwords.com/4231/retail_investor.html (last visited Sept. 15, 2012).

[236] *Testimony Concerning Investor Protection and the Regulation of Hedge Funds Advisers, Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs* (July 15, 2004) (statement of William H. Donaldson, Former Chairman, SEC), *available at* http://www.sec.gov/news/testimony/ts071504whd.htm; *Christopher Cox Testimony*, *supra* note 46 (specifying that "the investor protection issues that stem from the increasing exposure of retail investors to hedge fund investment opportunities"); Alexander R. Roche, *The Regulator Strikes Back: A Look at the SEC's Most Recent Attempt To Regulate Hedge Funds and What It Missed*, 33 U. DAYTON L. REV. 145, 153 (2007).

[237] Press Release, U.S. Dep't of the Treasury, Remarks of Under Secretary for Domestic Finance Robert K. Steel on Private Pools of Capital (Feb. 27, 2007), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp280.aspx.

[238] Madison Marriage, *Institutional Investors Driving Investment in Hedge Funds*, HEDGE FUND REV. (Feb. 12, 2011), http://www.hedgefundsreview.com/hedge-funds-review/news/2025856/institutional-investors-driving-investment-hedge-funds.

[239] Jane J. Kim, *Hedge Funds Target Smaller Investors: As Cheaper Options Proliferate, Some Doubt the Gains Can Last*, WALL ST. J., Apr. 27, 2005, at D1.

[240] Ryan Barnes, *Hedge Funds Go Retail*, INVESTOPEDIA, http://www.investopedia.com/articles/mutualfund/07/mutual_fund_retail.asp (last visited on Sept.. 15, 2012).

[241] *Endowment Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/e/endowment.asp (last visited Sept. 15, 2012) (defining endowment as "[a] financial asset donation made to a non-profit group or institution in the form of investment funds or other property that has a stated

investments.[242] Many non-profit groups, academic institutions, and other organizations rely on endowments to support their various functions.[243] Overall, these institutional investors, as opposed to wealthy individuals, are becoming the dominant investor class within the hedge fund industry.[244]

While the overall impact on retail investors is not entirely clear, it goes without question that they are increasingly being exposed to hedge fund investments. Moreover, some analysts predict that losses incurred by these institutional investors "could eventually lead to reduced payouts to retirees, higher taxes so state governments can fulfill their promises, or less cash available for colleges to give out as financial aid."[245] For example, in April 2006, San Diego's pension fund incurred significant losses when its underlying hedge fund investments were overexposed to losses in the natural gas industry.[246] The pension plan's strategy included a group of hedge funds, which initially helped the plan to achieve higher returns than the rest of its portfolio.[247] However, the subsequent losses of those hedge funds caused the pension fund to incur corresponding losses that adversely impacted its 33,000 county workers.[248] Those county workers were all retail investors, who had no control over the underlying investments of the pension fund, which of course, was deemed a sophisticated investor. The pension fund may not have had sufficient knowledge of the hedge funds' overexposure to certain natural gas trades since the hedge funds were not required to fully disclose their trading positions or leverage

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purpose at the bequest of the donor. Most endowments are designed to keep the principal amount intact while using the investment income from dividends for charitable efforts").

[242] *Christopher Cox Testimony*, *supra* note 46.

[243] DIANA S. NEWMAN, NONPROFIT ESSENTIALS: ENDOWMENT BUILDING xiv (2005).

[244] Barnes, *supra* note 240.

[245] Rachel Beck & Joe Bel Bruno, *College, State Pension Funds, Endowments Are Hurting*, USA TODAY (Dec. 3, 2008, 9:01 PM), http://www.usatoday.com/money/perfi/retirement/2008-12-03-pension-funds-endowments_N.htm.

[246] Mary Williams Walsh, *Pension Fund Tallies Losses and Rethinks Its Strategy*, N.Y. TIMES, Sept. 20, 2006, at C4.

[247] *Id.*

[248] *Id.*; *see also* Rami Grunbaum, *Offshore Hedge Fund Is Trouble for Seattle's Pension Fund*, SEATTLE TIMES (Apr. 10, 2010, 10:02 PM), http://seattletimes.nwsource.com/html/businesstechnology/2011570587_sundaybuzz11.html.

exposure. If the pension fund and/or fund's underlying investors were privy to this information, the subsequent losses could have been prevented. In effect, you cannot increase protection to retail investors, without directly protecting sophisticated investors, since the sophisticated investors—which include pensions plans and other institutions—are, in essence, controlling the investment of the retail investor.

C. Increased Exposure to the Entire Economy

Sophisticated investors have a history of suffering significant losses and those losses can have an adverse impact on the entire economy. The losses of several notable sophisticated investors also facilitated and magnified the most recent financial crisis. For instance, multiple sophisticated investors were exposed to the severe losses incurred by AIG,[249] which is a prominent global insurance company that was overextended in the credit default swap ("CDS") market. A CDS is a derivative instrument where a protection party—in this case, AIG—insures against the losses of a purchasing party who engages in certain debt transactions.[250] The purchasing party pays the protection party a periodic premium, while the protection party promises to pay the purchasing party's debt in the event of a default.[251] Protection parties collect a stream of premiums from multiple counterparties, with the hope that such parties do not simultaneously default on their underlying debts.[252] However, AIG issued $440 billion in CDS while the real estate market suffered unprecedented losses.[253] As a result, many of these CDS holders began to demand payment by AIG, but AIG could not fulfill their end of the bargain.[254] When AIG subsequently collapsed, many of the primary CDS holders, which included prominent investment banks, hedge funds, and other insurance

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[249] Lynn Stout, *How Deregulating Derivatives Led to Disaster, and Why Re-regulating Them Can Prevent Another*, LOMBARD ST., July 6, 2009, at 4, 4.
[250] DURBIN, *supra* note 62, at 64.
[251] *Id.*
[252] *Id.* at 73.
[253] Christopher Cox, Op-Ed., *Swapping Secrecy for Transparency*, N.Y. TIMES, Oct. 19, 2008, at WK.12.
[254] *Id.*

companies, were exposed to severe financial distress.[255] The government had to employ a $180 billion bailout plan to prevent a severe systemic risk event.[256]

While the CDS market is currently being subject to a new regulatory framework under the Dodd-Frank Act,[257] the AIG example highlights the impact that the aggregate losses of sophisticated investors can have on the entire economy. By and large, the recent financial crisis was exacerbated by the losses of sophisticated investors.[258] These losses had a monumental effect on the integrity of our markets and the general public felt its devastating effects. Yet, retail investors did not have access to many of the markets and/or transactions that facilitated the crisis because they were excluded from this sector of the economy. While it is arguable that greed motivated the poor decisions of sophisticated investors, it is clear that many of these investors did not fully understand the risks entailed within these complex transactions. Thus, removing the assumption that sophisticated investors can fend for themselves is an essential step towards creating a more efficient regulatory regime. As proposed in this Article, a regulatory approach that improves investor protection for sophisticated investors would inevitably lead to better functioning markets.

V. ALTERNATIVE REGULATORY FRAMEWORK

This Part proposes an alternative regulatory framework that begins with the retooling of certain private fund exemptions under the Dodd-Frank Act. As further explained in this section, this framework would also necessitate the creation of an SRO that would be primarily responsible for the development of uniform and mandatory measures of valuation and risk. This section continues by exposing the limitations associated with this proposal and provides a brief cost-benefit analysis. It concludes by addressing the counterarguments that would likely follow this framework.

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[255] Stout, *supra* note 249.

[256] *Id.*

[257] *See supra* note 12 and accompanying text.

[258] *See* Carl Hulse, *House Approves Tougher Rules on Wall Street*, N.Y. TIMES, Dec. 12, 2009, at A1.

A. *Retooling Private Fund Exemptions*

Since investor protection issues apply to all hedge funds, each hedge fund should be subject to heightened regulation regardless of its asset size. Accordingly, the exemption of advisers with less than $150 million of assets under management should be repealed. Advisers who manage between $25 million and $100 million in assets should also remain subject to federal registration, as opposed to being regulated by the states. This would essentially revert to the previous standard where the states regulated advisers who had less than $25 million in assets under management.[259] Also, futures funds that are exempt from registration with the CFTC should at least be subject to regulation by the SEC, or another regulatory body. Thus, the definition of private fund under the Dodd-Frank Act should be revised so that it captures such exempt funds.

B. *Creation of an SRO for Hedge Funds*

An SRO is "a non-governmental organization that has the power to create and enforce industry regulations and standards. The priority is to protect investors through the establishment of rules that promote ethics and equality."[260] The federal securities laws were designed to incorporate self-regulation as a primary component of securities regulation because it is more cost effective.[261] The SEC also found SRO's to be more cost effective because the complexities of securities trading practices made it more practical for private industry participants to be directly involved with rulemaking.[262] Relatedly, since the SRO members are more familiar with their own business practices, they would likely set heightened business conduct standards that exceeded

[259] *See General Information on the Regulation of Investment Advisers*, SEC, http://www.sec.gov/divisions/investment/iaregulation/memoia.htm (last visited Sept. 15, 2012); *see also* James E. Bedar et al., *Alert: SEC Announces New Rules Regulating Private-Fund Advisers*, BROWN RUDNICK (June 30, 2011), http://www.brownrudnick.com/uploads/114/doc/Brown_Rudnick_SEC_Announces_New_Rules_Regulating_Private-Fund_Advisers_6-11.pdf.

[260] *Self-Regulatory Organization Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/s/sro.asp (last visited Sept. 15, 2012).

[261] Concept Release Concerning Self-Regulation, Release No. 34-50700, 17 C.F.R. § 240 (Mar. 8, 2005), *available at* http://www.sec.gov/rules/concept/34-50700.htm#P73_6136.

[262] *Id.*

those that would have been imposed by the SEC.[263] Furthermore, since the final SRO decisions are subject to final approval by the SEC, it is the perfect combination of federal and private oversight.[264] Due to the unique investor protection issues that arise from hedge fund investments, an SRO should be created, which would be primarily responsible for establishing various rules and standards within the hedge fund industry.[265] Under the Dodd-Frank Act, Congress has already instructed the SEC to prepare a study to evaluate whether the creation of a SRO for private advisers would be beneficial to investors.[266]

The first task of this SRO would be to establish standardized valuation mechanisms and risk measurements that would be mandatory for all registered private funds. Of course, the standards created by this SRO would remain subject to final approval by the SEC.[267] Industry participants are probably in a better position to create these standards since the hedge fund industry is heterogeneous and entails risks that are distinguishable from traditional investments. The creation of an SRO would give industry participants an opportunity to implement some of the various models that have already been developed. This SRO could also assist the CFTC and the SEC with resolving the inefficiencies that result from the dual regulation of certain funds.

This new SRO would probably be similar to the industry-wide organizations that already exist. For example, many of the larger and more prominent funds have become members of organizations such as the MFA and the AIMA. The MFA's members "include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies" and are "the leading advocate[s] for sound business

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[263] *Id.*

[264] *See* Joel Seligman, *Should Investment Companies Be Subject to a New Statutory Self-Regulatory Organization?*, 83 WASH. U. L. Q. 1115, 1120 (2005).

[265] *See also* J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 814 (2007) (discussing the additional benefits of implementing an SRO for hedge funds).

[266] Dodd-Frank Act, Pub. L. 111-203, § 416, 124 Stat. 1376, 1579 (codified at 15 U.S.C. § 80b-18c (2006 & Supp. IV 2010)).

[267] *See id.*

practices and industry growth."[268] The AIMA's members include "hedge fund manager members [who] manage in excess of 75% of global hedge fund assets and 70% of global fund of hedge funds assets."[269] These organizations have already created education, regulation, policy development, and sound practices that can be used by institutional investors, policymakers, and supervisors.[270]

C. *Develop a Risk Database for Hedge Funds*

Once the SRO creates standardized valuation and risk measures, it should create a risk database that would include the new standardized risk measures that will have been adopted and implemented by all registered private funds. Such risk measures would be tabulated and made available to interested investors in some general form. The database would not be publicly available on the SEC's website since retail investors are prohibited from investing directly into hedge funds, which are private investment vehicles. Additionally, this risk database should be constructed so that the proprietary holdings of hedge funds are protected. This would also prevent "herding" behavior of hedge fund advisers since the additional disclosures would be primarily focused on risk and valuations.

While it would admittedly be difficult to develop uniform measures of risk for the multiple types of hedge fund investments that currently exist, it is certainly feasible. One example of a risk-reporting model was developed by Kenmar, a global investment management and fund of hedge funds firm.[271] This model is called the "Risk Fundamentals Solution" and it described as follows:

> The system is a sophisticated risk management application that uses a standard template to create a comprehensive risk profile of the fund without disclosing any position data. The system automatically tracks the fundamental risk measures over time

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[268] *About Managed Funds Association*, MANAGEDFUNDS.ORG, http://www.managedfunds.org/forum2011/about-mfa-forum-2011.asp (last visited Sept. 15, 2012).

[269] *Global Hedge Fund Industry Employs 300,000 People*, AIMA (Dec. 10, 2010), http://www.aima.org/en/media/press-releases.cfm/id/5A158030-55AA-4D8E-BEE0E03BC0379A0F.

[270] *See id.*

[271] HORWITZ, *supra* note 15, at 250–51.

> and compares each measure to those of the fund's peer group and the universe of hedge funds. The risk profile includes measures of: [r]eturns[,] [l]iquidity[,] [l]everage[,] [r]isk-factor sensitivity[,] [v]olatility[,] [d]iversification[,] [r]isk-adjusted return[,] [v]alue at [r]isk[,] [s]tress tests[, and p]erformance attribution[.] The system can automatically distribute these risk profiles electronically. These risk profiles can be compared and aggregated across funds to analyze the risks of a portfolio of funds.[272]

The Risk Fundamentals Solution model is an example of a reporting framework that creates consistent and reliable measures of risks for various categories of hedge fund investments. While it is noted that the effectiveness of this model warrants additional research that is outside the scope of this Article, this example demonstrates that a risk reporting framework, which does not expose the positions of hedge funds, is feasible. It also proves that regulators can work with industry participants to explore and develop unique solutions that partially eradicate these unique investor protection issues that the hedge fund industry has created.

By and large, this risk database system would ensure that sophisticated investors can adequately compare various hedge fund investments. It would allow such investors to compare a specific fund with the overall distribution of risk for all hedge funds, or for subsets of funds that employ a particular investment strategy. In addition, giving this information to the SEC would allow it to see if there was a more general systemic risk issue with respect to a single hedge fund or subset of funds. This framework would also allow analysts and other industry specialists that represent the interests of sophisticated investors to better monitor hedge fund activities and assist with the prevention of investment adviser fraud and systemic risk. Moreover, it could reduce the information asymmetries that have led to the creation of a "lemons market" and limit the ability of hedge fund managers to control the marketplace.[273] Essentially,

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[272] *Id.*

[273] *See* Barry W. Rashkover & Laurin Blumenthal Kleiman, *SEC Enforcement and Examinations Concerning Hedge Funds*, 52 N.Y.L. SCH. L. REV. 599 (2008). This article specifically states that

> [SEC] Examiners also have recently shown interest in how portfolio managers share information and ideas with non-affiliated portfolio

this reporting system would lower the search costs associated with finding an optimal hedge fund investment. This would increase the capacity of investors to make informed decisions, which should in turn improve the overall process of marketing such funds.

D. Limitations

Since the hedge fund industry is heterogeneous, and thus engages in a large range of trading activities and strategies, it will admittedly be difficult to create standardized mechanisms for valuation and risk. However, most hedge funds fall within certain identifiable categories, so different mechanisms can be developed for each particular investment strategy. Different mechanisms can also apply to certain asset classes that are frequently traded by hedge funds. With respect to risk measures, hedge funds should be able to produce consistent numbers that reflect its leverage exposure, volatility, and diversification, despite the fact that the industry is heterogeneous.

It will also be difficult to determine the ideal methodologies for the reporting framework since hedge fund advisers have various preferences for measuring risk and calculating valuations. However, this is a necessary task that has been undertaken by other notable organizations. For example, FASB issues specific guidelines on how to report specific financial statement line items as well as any corresponding disclosures within any applicable footnotes.[274] Actual industry participants are in the best position to develop these methodologies, since the SEC has limited expertise in these areas. While the final methodologies will remain subject to SEC approval, the SRO will maintain responsibility for developing the initial framework.

> managers. The concern appears to be that due to the size of the hedge fund industry in general and the magnitude of assets controlled by certain funds in particular, hedge funds are now in a position not only to control companies but to move markets—especially if two or more funds comprise a "group" working together to maximize return with respect to a specific issuer or strategy.

Id. at 620–21.

[274] *Id.* at 624 n.175.

E. Cost-Benefit Analysis

The proposed alternative framework, which includes the creation of an SRO, should be subject to a detailed cost-benefit analysis to ensure that the marginal costs of implementing this system do not exceed the marginal benefits. Professor Howell E. Jackson from Harvard Law School gives helpful guidance on how to implement this analysis in his article, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*.[275] He also exposes some of the inherent challenges of implementing a cost-benefit analysis for financial regulation.[276] For example, it is difficult to measure the private costs of regulation with respect to the "incremental costs that financial institutions incur beyond the levels of effort they would expend in the absence of regulation" and the "transactions that regulatory intervention unintentionally deters."[277] As Professor Jackson further notes, it is difficult to measure the benefits of protecting the general public and eliminating externalities from financial failure.[278] Despite these challenges, it is still important to analyze these issues when developing a new framework for financial regulation. Thus, this section will analyze the extent to which the benefits of developing this system outweigh the actual costs.

1. Costs

There would be significant costs associated with the creation of a new SRO for hedge funds. However, the SEC is already set to incur significant costs in monitoring newly registered advisers and collecting and analyzing systemic risk data from registered hedge fund advisers. In addition, the SEC will have to use its resources to create reliable measures of systemic risk and to determine which hedge funds pose a systemic threat to the economy. A new SRO could actually help the SEC to undertake

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[275] Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253 (2007).

[276] *Id.* at 255.

[277] *Id.* at 261.

[278] *Id.* at 259–60.

these newly created tasks under the Dodd-Frank Act. SROs are in fact intended to be a cost-effective solution for problems in which the SEC has limited expertise.[279]

There would also be costs associated with developing a standardized reporting framework. However, the SRO could use the systemic risk data, which the SEC is already authorized to collect, to compile the risk database system that is proposed herein. Essentially, the SEC would be putting this data into the hands of the actual investors, instead of keeping it to themselves. Furthermore, the MFA and AIFMA are already incurring private costs in developing best practices models and other recommendations for standardized operating functions, valuation mechanisms, and risk assessments.[280] In effect, this solution corresponds to the increasing demands of private actors within the industry. As a result, the costs of developing such standards could be minimal if these standards are considered ideal by the newly created SRO.

2. Benefits

The primary benefit of creating this alternative framework is that it gives sophisticated investors more information to make better investment choices. It would resolve many of the unique investor protection issues discussed herein by mandating certain business practices within the hedge fund industry and creating a risk database that would allow investors to adequately investigate and compare a larger range of hedge fund investments. This would give such investors more reliable data to ensure that they fully understand the corresponding risks of investing in hedge funds.

Overall, this new framework would help to preserve the integrity of our capital markets by creating a more transparent hedge fund marketplace. Transparency is typically the best mechanism for exposing deficiencies that could lead to various market failures. Before our recent financial crises, this benefit was probably thought to be somewhat vague and arbitrary. Yet,

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[279] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-623, PRIVATE FUND ADVISERS: ALTHOUGH A SELF-REGULATORY ORGANIZATION COULD SUPPLEMENT SEC OVERSIGHT, IT WOULD PRESENT CHALLENGES AND TRADE-OFFS 20 (2011), *available at* http://www.gao.gov/new.items/d11623.pdf.

[280] *See* Jackson, *supra* note 275, at 260.

after our economy has lost trillions of dollars in recovering from the worst economic downturn since the Great Depression, it is essential that our regulators play a more vital role in implementing ex ante regulation to enhance transparency, which would subsequently improve the integrity of our markets.

Furthermore, this reporting framework would help the regulators to better understand the hedge fund industry. It would also open the door to more meaningful empirical research opportunities to better understand the complexities of the industry. Several empirical research studies have been completed, but they are severely limited in scope because there is no existing reporting framework that tracks all hedge funds. While many hedge funds do report their returns to various reporting indexes, such reporting is not mandatory. The most prominent hedge fund index is the Dow Jones Credit Suisse Hedge Fund Index℠—formerly known as the Credit Suisse/Tremont Hedge Fund Index—and it tracks approximately 8,000 funds.[281] This number includes offshore funds, and excludes fund-of-funds.[282] In addition, the index only includes funds that have a minimum of $50 million assets under management, a minimum one-year track record, and current audited financial statements.[283] Overall, there are about 18,000 hedge funds in existence, but it is difficult to verify this number since there is no mandatory reporting framework that tracks all hedge funds.[284]

F. Counterarguments to Alternative Approach

1. Deterrence of Hedge Fund Activity

Some commenters believe that this proposed framework may deter hedge funds from operating in the United States. However, this proposed framework seeks to protect the proprietary position data of hedge funds, which is often the primary hurdle towards achieving better transparency practices within the industry. In

[281] *Dow Jones Credit Suisse Hedge Fund Indexes: FAQ's*, HEDGEINDEX.COM, http://www.hedgeindex.com/hedgeindex/en/faq.aspx?cy=USD&indexname=HEDG (last visited Sept. 16, 2012).
[282] *Id.*
[283] *Id.*
[284] PERTRAC FIN. SOLUTIONS, *supra* note 14.

fact, many hedge funds are already disclosing comparable information to investors, who are starting to demand more information in response to the recent financial crisis. For example, one study enacted by PricewaterhouseCoopers found that following the financial crisis, "[Hedge fund] [i]nvestors are requiring far higher standards of governance and more robust operations, combined with greater transparency into operational controls, investment portfolio construction and performance."[285] In addition, the development of this reporting framework will include the perspectives of industry participants through the creation of an SRO. As a result, the industry will have a voice in discussing the extent to which the disclosure of certain information would cause harm to its investors.

2. Political Hurdles

Some commenters also believe that the proposed alternative framework would be too difficult to implement from a political standpoint, especially since it would directly contradict long-standing notions of investor protection principles. In effect, this framework would single-handedly dismantle the sophisticated investor doctrine, which asserts that sophisticated investors are fully capable of protecting themselves, without government intervention. However, the Dodd-Frank Act has already indirectly limited the effectiveness of this doctrine. Essentially, by bringing hedge funds under the SEC's umbrella, Congress has sent a signal that such investors are no longer capable of monitoring the markets. The ensuing regulations under the Dodd-Frank Act will likely further dismantle the sophisticated

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[285] *From Black Box to Open Book: Hedge Fund Trust and Transparency*, PRICEWATERHOUSECOOPERS (2010), *available at* http://www.pwc.com/en_GX/gx/asset-management/assets/pwc-hf-trust-and-transparency.pdf. This view was reiterated in a report published by Ernst & Young, which stated that, "The global hedge fund industry . . . is responding readily to investor requests for greater transparency[.]" *Hedge Funds Rebound Amid Calls for Greater Transparency*, ERNST & YOUNG (Nov. 9, 2010), http://www.ey.com/GL/en/Newsroom/News-releases/Hedge_funds-rebound-amid-calls-for-greater-transparency. *See also* Stephan Thollot, *Push for Transparency Puts Spotlight on Valuation for Alternative Asset Managers*, ERNST & YOUNG (Oct. 2011), *available at* https://eyaprimo.ey.com/natlmktgaprimoey/Attachments/AMCenter_Valuation_J00370.pdf.

investor doctrine. Thus, implementing a framework that explicitly acknowledges this proposition may not be as difficult to accomplish given the passage of the Dodd-Frank Act.

3. Cost Limitations

Some commenters may think that this system is too costly to implement. There is definitely merit to this argument since the SEC has publicly admitted that its limited resources make it difficult to effectively monitor registered advisers.[286] However, this may be an indication that the existing regulatory framework is ineffective, especially given the multiple market failures that have occurred in recent years. The federal government has expended trillions of dollars in correcting these failures, in which hedge funds play a significant role. Perhaps a better use of the government's resources would be to creating ex ante regulation that would prevent comparable market failures. It is clear that the existing regulation did little to prevent these failures and for the most part, the Dodd-Frank Act does little to reinvent the wheel.

CONCLUSION

This Article presents an alternative regulatory framework for the increased regulation of hedge funds, which focuses on the unique investor protection issues created by the hedge fund industry. It would supplement the new regulation provided under the Dodd-Frank Act, which seems to primarily focus on preventing systemic risk. This framework would enhance investor protection by standardizing certain business practices within the overall hedge fund industry and creating a risk database that would allow investors to adequately compare a larger range of hedge fund investments. Furthermore, this reporting framework would open the door to more meaningful empirical research opportunities to better understand the hedge fund market and give investors more reliable data without exposing hedge funds' positions.

In addition, it could potentially decrease the likelihood of systemic risk since it would create more transparency within the hedge fund industry. Mary Schapiro, the Chairman of the SEC,

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[286] *See supra* note 108.

stated that systemic risk could be mitigated by "the traditional oversight, regulation, market transparency and enforcement provided by primary regulators that helps keep systemic risk from developing in the first place."[287] While it is arguable that greed motivated the poor decisions of sophisticated investors, it is clear that many of these investors did not fully understand the risks entailed within these complex transactions. Thus, removing the assumption that sophisticated investors can fend for themselves is an essential step towards creating a more efficient regulatory regime. In effect, by focusing on investor protection and implementing ex ante regulation,[288] our regulators, as well as actual hedge fund investors, might be in a better position to stop systemic risk before it actually occurs.

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[287] *Testimony Concerning Regulation of Systemic Risk, Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 111th Cong. (2009) (statement of Mary L. Schapiro, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/2009/ts072309mls.htm.

[288] RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 31 (2009) (proposing implementing ex ante regulation as regulating the financial industry before a catastrophic event occurs).