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INCREASING INVESTOR PROTECTION THROUGH IMPROVING HEDGE FUND VALUATION

DEIRDRE FARRELL[†]

INTRODUCTION

A retired police officer makes ends meet with the pension he earned while serving his community for twenty years on the force. A first-generation American becomes the first person in her family to attend college with the help of a full scholarship from her university. A charity sends funds for much needed medical supplies after a natural disaster strikes in a foreign country. What do all of these scenarios have in common? The funds used to pay for the retired police officer's pension, the student's university tuition, and the medical supplies all derived from investments in hedge funds.

When most people think of hedge funds, they often think of a mysterious, complicated investing entity only accessible to the elite and ultra-rich. However, the industry has evolved from its exclusive beginnings. Institutional investors, such as public and private pension funds and educational and charitable endowments, now make up a sizable portion of hedge fund investors.¹ While institutional investors may benefit from access to more exotic alternative investments such as hedge funds, any losses they suffer could profoundly affect the lives of millions of everyday Americans.

Today, hedge funds manage over \$3 trillion dollars in assets worldwide.² These funds enjoyed little regulation for most of

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¹ Cary Martin Shelby, *Are Hedge Funds Still Private? Exploring Publicness in the Face of Incoherency*, 69 SMU L. REV. 405, 408 (2016).

² Melissa Karsh, *Hedge Fund Assets Pass \$3 Trillion in 2016 for First Time: Chart*, BLOOMBERG NEWS (Jan. 23, 2017, 5:00 AM), <https://www.bloomberg.com/news/articles/2017-01-23/hedge-fund-assets-pass-3-trillion-in-2016-for-first-time-chart>.

their history and the time leading up to the financial crisis of 2008.³ After the crisis, governments sought to reign in the financial services industry and used this opportunity to increase regulation of hedge funds.⁴ In the United States, the Dodd-Frank Act required hedge fund managers to register with the government for the first time.⁵ While this registration improved the transparency of the hedge fund industry in the United States,⁶ it did not go far enough to prioritize investor protection. A hedge fund's valuation of the assets it manages is particularly important for protecting investors, and the current limited oversight of the valuation process leaves room for improvement. This Note examines the current hedge fund regulations in the United States and in Europe, and proposes ways for regulators to improve hedge fund valuation in the United States to increase investor protection. Although valuation issues affect all pooled investment vehicles that invest in illiquid, difficult-to-value assets, this Note focuses only on the valuation systems of hedge funds.

Part I gives an overview of hedge funds in general—their structure and the major stakeholders involved. Part II summarizes the valuation process and its associated issues. Part III describes recent regulatory changes in the United States affecting hedge funds, including the Dodd-Frank Act of 2010 and the JOBS Act of 2012. Part III also discusses recent changes in European regulation of Hedge Funds. Finally, Part IV proposes changes to the existing framework in the United States to improve transparency and standardize the valuation process for hedge funds. Part IV also discusses cost concerns of these proposals.

³ Emily Kehoe, *Hedge Fund "Regulation" for Systemic Risk: Largely Impossible*, 14 J. BUS. & SEC. L. 35, 36 (2013).

⁴ *Id.*

⁵ Wulf Kaal & Dale Oesterle, *The History of Hedge Fund Regulation in the United States*, COLUM. L. SCH. BLUE SKY BLOG (Feb. 29, 2016), <http://clsbluesky.law.columbia.edu/2016/02/29/the-history-of-hedge-fund-regulation-in-the-united-states/>.

⁶ Mary Jo White, Chair, Sec. & Exch. Comm'n, *Hedge Funds – A New Era of Transparency and Openness*, Speech at Managed Funds Association Outlook 2013 Conference (Oct. 18, 2013) (transcript available at sec.gov).

I. HEDGE FUNDS: A BACKGROUND

A. *Defining a Hedge Fund*

Although hedge funds account for over \$3 trillion in assets worldwide,⁷ the definition of what constitutes a “hedge fund” is somewhat fluid.⁸ Generally, hedge funds are characterized as pooled alternative investment vehicles, with high minimum investment requirements, serving wealthy and sophisticated investors.⁹ For most of their history, hedge funds enjoyed little regulation and oversight from regulators across the globe, allowing them the freedom to pursue flexible investment strategies, such as investing in derivatives and short selling, through an unlimited range of investments.¹⁰ Unlike more traditional pooled investment vehicles, such as mutual funds, hedge funds use high amounts of leverage. This practice allows hedge funds to invest with borrowed money, thereby amplifying potential returns or losses.¹¹

Hedge funds have increased in popularity over the past several decades.¹² At the turn of the millennium, the hedge fund industry managed approximately \$500 billion in assets.¹³ That amount has steadily increased, breaking the three trillion dollar mark in 2015.¹⁴ During the global financial crisis of 2008, investors flocked to hedge funds because of their ability to

⁷ Karsh, *supra* note 2.

⁸ TECH. COMM. OF THE INT’L ORG. OF SEC. COMM’NS, HEDGE FUNDS OVERSIGHT FINAL REPORT 4 (2009) (“[T]here is no consistent or agreed-upon definition of the term hedge fund . . . [A]n approach for identifying these types of entities is to look at the kinds of characteristics of and strategies employed by institutions that would consider themselves to be hedge funds.”); STAFF REPORT TO THE U.S. SEC. & EXCH. COMM’N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS viii (2003) (“[A]n entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act.”).

⁹ Harry McVea, *Hedge Fund Asset Valuations and the Work of the International Organization of Securities Commissions (IOSCO)*, 57 INT’L & COMP. L.Q. 1, 4 (2008).

¹⁰ *Id.* at 5.

¹¹ *Id.*

¹² Mary Childs & Miles Johnson, *SEC’s Pursuit of Leon Cooperman Rattles Hedge Fund Industry*, FIN. TIMES (Sept. 22, 2016, 7:38 PM), <https://www.ft.com/content/d10eadba-80db-11e6-bc52-0c7211ef3198>.

¹³ *Id.*

¹⁴ *Id.*

diversify risk and beat market returns in a downturn.¹⁵ Although hedge funds have failed to beat market returns for the past several years,¹⁶ they remain popular among investors and continue to see an inflow of new investment.¹⁷

B. Hedge Fund Structure

Hedge funds consist of three major players: the fund itself, the hedge fund manager or management company, and the investors.¹⁸ Most hedge funds in the United States operate as limited partnerships,¹⁹ with the hedge fund manager serving as general partner.²⁰ As general partner, the hedge fund manager executes the investment strategy and manages the fund's operational practices.²¹ Hedge fund managers usually hire "c-suite" officers, such as a chief executive officer, a chief financial officer, and a chief compliance officer, to manage the operations of the business. Hedge fund managers also typically form committees to oversee the risk and valuation functions of the hedge fund.²²

In exchange for managing the investment portfolio and the operational aspects of a fund, hedge fund managers typically charge a "two and twenty" fee whereby managers receive annual compensation of two percent of total assets under management ("AUM") and twenty percent of profits from those assets, earned above a predetermined benchmark.²³ Additionally, most hedge funds' governing partnership agreements require the

¹⁵ See Shelby, *supra* note 1, at 430; Lawrence Delevingne & Svea Herbst-Bayliss, *Public Pensions Stick with Hedge Funds Despite Frustrations*, REUTERS, May 10, 2016, <http://www.reuters.com/article/us-usa-hedgefunds-pensionfunds-idUSKCN0Y12I0>.

¹⁶ Childs & Johnson, *supra* note 12 (Hedge funds as a whole failed to beat the S&P 500 from 2012-2016). Several large U.S. pension funds, including plans for California's, New Jersey's, and Philadelphia's employees, have scaled back investments in hedge funds. *Id.*

¹⁷ Shelby, *supra* note 1, at 430; Delevingne & Herbst-Bayliss, *supra* note 15.

¹⁸ Houman B. Shadab, *Hedge Fund Governance*, 19 STAN. J.L., BUS. & FIN. 141, 150 (2013).

¹⁹ *Id.*; Ryan Sklar, Note, *Hedges or Thickets: Protecting Investors from Hedge Fund Managers' Conflicts of Interest*, 77 FORDHAM L. REV. 3251, 3261 (2009).

²⁰ Shadab, *supra* note 18.

²¹ *Id.*

²² *Id.* at 151.

²³ See Lindsay Fortado, *Hedge Fund Investors Question '2 and 20' Fees*, FIN. TIMES (June 6, 2017), <https://www.ft.com/content/291081ba-49df-11e7-a3f4-c742b9791d43>.

management company to invest some of its own money into the fund.²⁴ Both of these provisions, the “two and twenty” fee and the requirement that management be personally invested in the fund, seek to align the manager’s incentives with the investors’ incentives—to maximize returns.²⁵ The vast majority of hedge funds do not have a board of directors to act as a watchdog over the fund managers, as they would in a typical corporation or in many limited liability corporations.²⁶ Nevertheless, fund managers still owe fiduciary duties to the fund itself.²⁷

Investors, on the other hand, serve as limited partners in a hedge fund limited partnership, providing capital to the fund but relinquishing nearly all managerial control to the fund managers.²⁸ Investors’ only true decision-making power lies in their wallets—in the amount of capital they choose to invest with a particular fund, and in their decision whether or not to withdraw that money over time.²⁹ Unlike mutual funds and other pooled investment vehicles, hedge fund operating agreements generally require investors to lock-in their capital for a period of time, with typical lock-in periods ranging from less than a quarter to a full year.³⁰ Hedge fund operating agreements also generally only permit investors to withdraw funds on a periodic basis, such as quarterly or semi-annually.³¹ Additionally, managers often maintain discretionary power to bar withdrawals for a period of time.³² Hedge fund managers’ ability to lock-in investors’ capital for at least a short period of

²⁴ Most hedge funds require the managers to invest their own funds as a way to offset the additional risk investors take on. Sklar, *supra* note 19, at 3266. Under the “two and twenty” management fee arrangement, hedge fund managers share in a funds’ profits, but not in its losses. Shadab, *supra* note 18, at 166.

²⁵ Sklar, *supra* note 19, at 3266.

²⁶ Kehoe, *supra* note 3, at 45.

²⁷ Shadab, *supra* note 18, at 151.

²⁸ Although limited partnerships have the ability to give voting rights to limited partners, hedge fund partnership agreements usually do not give investors this power. *Id.* at 153. Therefore, investors do not have the ability to vote for or remove management, as is often the case with other forms of investment funds. *Id.*

²⁹ *Id.* at 153–54.

³⁰ Publically registered mutual funds are required to redeem shares to investors within seven calendar days. 15 U.S.C. § 80a-22(e) (2012).

³¹ Shadab, *supra* note 18, at 154.

³² *Id.* Hedge fund agreements usually require investors to “give thirty to ninety days’ notice before withdrawing” funds. *Id.* Funds may also limit the amount of capital an investor may withdraw at any one time, usually stipulated as a percentage of the value of the fund, and/or “limit redemptions to a portion of the investor’s own capital.” *Id.*

time provides management with some flexibility in pursuing its investment strategy by preventing destabilizing liquidity problems.³³

C. Accredited Investors

Another defining feature of hedge funds is that, as private funds, they are restricted to investments from “accredited investors.”³⁴ In Regulation D Rule 501 of the Securities Act of 1933, the Securities and Exchange Commission (“SEC”) defines an accredited investor, in the context of a natural person, as someone who has (1) income that exceeded \$200,000, or \$300,000 together with a spouse, in each of the prior two years, or (2) a net worth exceeding \$1,000,000, either alone or together with a spouse.³⁵ The SEC’s definition of an accredited investor also encompasses institutional investors. This category includes banks, insurance companies, and employee benefit plans, as well as charitable organizations, corporations, partnerships, and trusts with assets in excess of five million dollars.³⁶

Congress limits hedge funds to accredited investors under the theory that persons or entities who meet these criteria can bear the economic risk associated with investing in these alternative investment vehicles.³⁷ Further, since only accredited investors can invest in hedge funds, many policymakers argue against expending precious government resources to regulate or monitor hedge funds in the name of investor protection. However, these policymakers fail to recognize that average Americans provide a significant amount of the investment capital for many of these accredited institutional investors. As a result, hedge funds’ investment decisions profoundly impact the lives of countless Americans.

³³ *Id.* at 155.

³⁴ As private funds, hedge funds are excluded from the definition of an “investment company.” 15 U.S.C. § 80a-3(c)(1) (2012). Private funds may not make a public offering of their shares and, as a result, are limited to “accredited investors” in order to allow for a private offering complying with Regulation D. 17 C.F.R. § 230.506 (2017).

³⁵ 17 C.F.R. § 230.501(a)(5)–(6) (2017).

³⁶ 17 C.F.R. § 230.501(a)(1) (2017).

³⁷ OFFICE OF INV’R EDUC. & ADVOCACY, SEC. & EXCH. COMM’N, INVESTOR BULLETIN: ACCREDITED INVESTORS 1 (2013), https://www.sec.gov/investor/alerts/ib_accreditedinvestors.pdf.

For instance, millions of Americans rely on hedge fund investments to fund their pensions: forty-two percent of the 242 institutional investors that made up the “\$1 billion club,” defined as institutions that had at least \$1 billion of capital invested in hedge funds in 2016,³⁸ were either public or private pension funds.³⁹ The Public School & Education Employee Retirement Systems of Missouri invested twelve percent of its \$38 billion in hedge funds.⁴⁰ Similarly, the San Francisco City & County Employee’s Retirement System voted to increase its investment in hedge funds from five percent to fifteen percent in September 2017 and expects to have \$3.15 billion invested in hedge funds by the end of 2018.⁴¹ Essentially, the dedicated teachers of Missouri and civil servants of San Francisco, among millions of others, are relying on hedge fund investments to ensure their financial security in retirement.

Additionally, endowments and foundations made up another significant portion of the “\$1 billion club,” accounting for fifteen percent of these heavy-hitter institutional investors.⁴² These same endowments and foundations fund charities and educational institutions in the U.S. and around the world. Combined, public and private pension funds, foundations, and endowments, account for over *fifty percent* of hedge funds’ largest institutional investors. In other words, how hedge funds invest these organizations’ capital significantly affects millions of Americans from all socioeconomic statuses.⁴³

These institutional investors are fueling much of the growth the hedge fund industry is experiencing. The number of public pensions that invest in hedge funds grew from 234 in 2010 to 282 in 2016, and “[t]he average percentage of pension portfolios in

³⁸ Prequin, *The \$1Bn Club: Largest Investors in Hedge Funds*, 9 HEDGE FUND SPOTLIGHT, no. 1, 2017, at 1, 5, <http://docs.prequin.com/newsletters/hf/Prequin-Hedge-Fund-Spotlight-May-2017.pdf>. “The \$1Bn Club” institutional investors account for \$805 billion dollars invested in hedge funds. *Id.*

³⁹ *Id.*

⁴⁰ Delevingne & Herbst-Bayliss, *supra* note 15.

⁴¹ Randy Diamond, *San Francisco Allocates \$250 Million to 3 Managers, Proposes Hedge Fund Ramp Up*, PENSIONS & INVESTMENTS (Oct. 10, 2017), <http://www.pionline.com/article/20171010/ONLINE/171019982/san-francisco-allocates-250-million-to-3-managers-proposes-hedge-fund-ramp-up-searches-and-hires?template=print>.

⁴² Prequin, *supra* note 38, at 6.

⁴³ *Id.*

hedge funds has also r[isen] to nearly ten percent.”⁴⁴ While it is true that institutional investors generally enjoy a higher level of sophistication than a typical individual investor, the level of sophistication across institutional investors varies,⁴⁵ and even the most sophisticated institutional investor cannot overcome incomplete or bad data, both of which can arise from a lack of regulation or oversight.⁴⁶

II. INVESTOR PROTECTION: VALUATION OVERVIEW

With this structure in mind, there are several areas of concern regarding investor protection under the current hedge fund governance and regulatory model. Chief among these concerns are how hedge fund managers value a fund's investments and the potential conflicts of interest that exist in this process.

A. Fair Value Accounting and Valuation

After the passage of the Dodd-Frank Act, the Financial Accounting Standards Board (“FASB”), which is responsible for developing the Generally Accepted Accounting Principles (“GAAP”) in the United States, clarified existing rules for

⁴⁴ Delevingne & Herbst-Bayliss, *supra* note 15.

⁴⁵ See Jongho Kim, *Can Risks Be Reduced in the Derivatives Market? Lessons from the Deal Structure Analysis of Modern Financial Engineering Debacles*, 6 DEPAUL BUS. & COM. L.J. 29, 45–48 (2007) (describing the bankruptcy of Orange County, CA caused by the municipality's investments in risky derivatives, and explaining that “the main cause of Orange Country's failure in the use of derivatives lay . . . in the people who acted without knowledge of them”); Saul Hansell, *Bankers Trust Settles Suit with P.&G.*, N.Y. TIMES (May 10, 1996), <http://www.nytimes.com/1996/05/10/business/bankers-trust-settles-suit-with-p-g.html> (“Procter & Gamble was perhaps the most prominent corporation to contend that it did not understand the risk of derivatives after its two deals with Bankers Trust lost value very rapidly in 1994.”).

⁴⁶ See Tom Loftus, *Lawsuit: Retirement Systems Gambled on Hedge Funds, Concealed Its Financial Mess*, LOUISVILLE COURIER J. (Dec. 27, 2017, 2:25 PM), <https://www.courier-journal.com/story/news/politics/2017/12/27/lawsuit-kentucky-retirement-systems-gambled-hedge-funds/982740001/>. In December 2017, Kentucky state employees sued retirement system officials and three hedge fund managers, alleging breach of fiduciary duties when the managers “lur[ed]” the retirement system into making investments in the funds “without fully disclosing the high risks, massive fees and lack of transparency.” *Id.* These investments failed to pay off, leaving the retirement system that services 360,000 state employees with a deficit of billions. *Id.*

measuring and accounting for an asset's fair value.⁴⁷ Fair value is defined as the price that would be received to sell an asset between market participants at the measurement date.⁴⁸ Under the new rules, assets are classified into three levels based on their liquidity,⁴⁹ or the relative ease with which the asset can be converted into cash.⁵⁰ On one end of the spectrum, level one assets, such as stocks and bonds, have observable quoted prices for identical assets in active markets.⁵¹ On the other end, level three assets, such as derivatives and distressed debt, are generally highly illiquid assets for which there is no observable market pricing.⁵² Level two assets lie somewhere in the middle.⁵³

In an ideal valuation scenario, an asset is freely traded in a deep, liquid market (level one) and, therefore, the asset's fair value is easily identified on any given day as its current exchange-traded price.⁵⁴ However, for more illiquid assets (levels two and three), accurately valuing the asset is far less straightforward. A number of variables must be considered, including the "[v]alue of similar financial instruments," the "[r]eliability of estimates," the reliability of financial modeling used, and the "[r]easonableness of assumptions," among others.⁵⁵ As a result, "[d]etermining [f]air [v]alue where no exchange-traded price exists *is more of an art than a science*, as a number of assumptions and estimates must be made."⁵⁶ As alternative investment vehicles, almost half of a hedge fund's assets typically fall within the difficult-to-value asset categories, levels two and

⁴⁷ Daisy Maxey, *If a Security Isn't Trading, What Is It Really Worth?*, WALL ST. J. (Feb. 4, 2014, 1:39 PM), <https://www.wsj.com/articles/sec-looking-at-how-alternative-funds-value-investments-1391096281?tesla=y>.

⁴⁸ FAIR VALUE MEASUREMENT, Accounting Standards Codification No. 820, § 10-20 (Fin. Accounting Standards Bd. 2015).

⁴⁹ *Id.* § 10-50-2.

⁵⁰ *Accounting Liquidity*, NASDAQ, <http://www.nasdaq.com/investing/glossary/a/accounting-liquidity> (last visited Mar. 26, 2018).

⁵¹ FAIR VALUE MEASUREMENT, Accounting Standards Codification No. 820, § 10-20 (Fin. Accounting Standards Bd. 2015).

⁵² *Id.*

⁵³ *Id.* § 10-35-48. Level 2 assets include assets with (1) "quoted [market] prices for similar assets or liabilities in active markets"; (2) quoted prices for identical or similar assets in inactive markets; or (3) "inputs other than quoted prices that are observable for the asset." *Id.*

⁵⁴ ALT. INV. MGMT. ASS'N (AIMA), AIMA'S GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION 45 (2013).

⁵⁵ *Id.*

⁵⁶ *Id.* at 47 (emphasis added).

three.⁵⁷ Therefore, a significant portion of most hedge funds' valuations of their assets depends on judgment calls about how to accurately and consistently account for these variables. Such judgment calls are "susceptible to abuse."⁵⁸

B. Valuation Concerns

An accurate valuation of a hedge fund's assets is critical for several reasons. First, funds measure and report their performance to investors based on how the fair value of their portfolio assets change over time.⁵⁹ Current investors look to a fund's performance when deciding whether to keep their capital with the fund, and potential new investors consider a fund's past performance⁶⁰ when deciding whether or not to invest with the fund.⁶¹ Within the past several years, regulators at the SEC have expressed concern that some managers might be exaggerating the performance of holdings to entice new investors.⁶²

Second, hedge fund managers are compensated based on the net asset valuation and the performance of the fund.⁶³ While this form of compensation is intended to align the hedge fund managers' interests with the investors' interests, it also creates a conflict of interest by possibly incentivizing managers to mark up the fund's valuation to increase their compensation.⁶⁴ Since many of a hedge fund's assets are categorized as level two and

⁵⁷ *Id.* at 8 (reporting that a representative sample of AIMA's hedge fund members had thirty percent level two investments and thirteen percent level three investments).

⁵⁸ Maxey, *supra* note 47.

⁵⁹ *See supra* Part II.B.

⁶⁰ Although past performance of a fund is not an accurate indicator of future outcomes, investors continue to weigh heavily a fund's past performance when choosing where to invest their capital. McGraw Hill Fin., *Does Past Performance Matter? The Persistence Scorecard*, S&P DOW JONES INDICES 1, 2 (2015), <https://us.spindices.com/documents/spiva/persistence-scorecard-june-2015.pdf>.

⁶¹ ALT. INV. MGMT. ASS'N (AIMA), *supra* note 54, at 17. "From the [*i*]nvestor's perspective, fair valuation is the foundation on which analysis of the portfolio's performance and volatility of returns is based . . . [A]n [*i*]nvestor would normally expect that the amount of cash paid to take an equity interest in the portfolio and the amount of cash received on withdrawal of an equity interest is based on a formal and fair valuation of the portfolio's assets and liabilities." *Id.*

⁶² Maxey, *supra* note 47.

⁶³ Sklar, *supra* note 19, at 3265.

⁶⁴ *Id.* at 3269.

three assets, their valuation is dependent on a number of variables and judgment calls, making them more vulnerable to manipulation by a fund's management.⁶⁵

Finally, under the current U.S. hedge fund regulatory scheme, no single organization has the authority to develop and enforce mandatory valuation standards.⁶⁶ Although various organizations have produced valuation guidelines, none carry the force of law in the United States.⁶⁷ Therefore, there is little standardization and oversight of the valuation process even though valuation plays a key role in the hedge fund business, making it difficult for investors to comprehend and compare fund valuations.⁶⁸

III. RECENT CHANGES IN HEDGE FUND REGULATION AND CURRENT INDUSTRY VALUATION PRACTICES

A. *United States Hedge Fund Regulation – Dodd-Frank Wall Street Reform and Consumer Protection Act*

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was the single most sweeping piece of legislation affecting hedge funds in the United States in the past several decades.⁶⁹ Passed in the wake of the 2008 global financial crisis, the Dodd-Frank Act sought to improve all aspects of the financial services industry by preventing fraud, increasing

⁶⁵ See *supra* Part III.A.

⁶⁶ See generally Hossein Nabilou & Alessio M. Paces, *The Hedge Fund Regulation Dilemma: Direct vs. Indirect Regulation*, 6 WM. & MARY BUS. L. REV. 183 (2015).

⁶⁷ Competing authorities include the Alternative Investment Management Association, which published its *Guide to Sound Practices for Hedge Fund Valuation* (ALT. INV. MGMT. ASS'N (AIMA), *supra* note 54); the Hedge Fund Standards Board, which issued principles in 2015 (THE HEDGE FUND STANDARDS (HEDGE FUND STANDARDS BD. 2015)); the Chartered Financial Analyst Institute's *Global Performance Investment Standards* (GLOBAL PERFORMANCE INVESTMENT STANDARDS (CFA INST. 2010)); and the International Organization of Securities Commission's ("IOSCO") *Hedge Fund Principles* (TECH. COMM. OF THE INT'L ORG. OF SEC. COMM'NS, *supra* note 8).

⁶⁸ See generally Joshua Rogers, *All Hedge Funds May Not Be Bad – Here's How to Suss Yours Out*, FORBES (Apr. 1, 2013), <https://www.forbes.com/sites/joshuarogers/2013/04/01/all-hedge-funds-may-be-bad-heres-how-to-suss-yours-out/#72c5e9a65a89>.

⁶⁹ Cecilia C. Lee, *Reframing Complexity: Hedge Fund Policy Paradigm for the Way Forward*, 9 BROOK. J. CORP. FIN. & COM. L. 478, 480 (2015).

investor protection, and limiting systemic risk.⁷⁰ Although experts disagree as to the level of involvement hedge funds had in the global financial crisis,⁷¹ legislators viewed the Dodd-Frank financial services reform bill as an opportunity to close regulatory loopholes that persisted after previous failed attempts to register hedge funds with the federal government.⁷²

Prior to Dodd-Frank, many hedge fund managers escaped registration through a series of exemptions included in the Investment Advisers Act of 1940.⁷³ However, Title IV of Dodd-Frank, entitled the Private Fund Investment Advisers Registration Act of 2010 (“PFIARA”), removed most of these exemptions, forcing hedge fund managers to register with the government.⁷⁴ Under the provisions in PFIARA and rules issued by the SEC in 2011, hedge fund managers with more than \$150 million in assets under management are required to register as investment advisers with the SEC.⁷⁵ Dodd-Frank also authorized the SEC to promulgate rules requiring enhanced disclosure for hedge fund managers.⁷⁶

Under the new Dodd-Frank registration rules, hedge fund managers, as investment advisers, are required to maintain and

⁷⁰ Wulf A. Kaal, *Hedge Fund Manager Registration Under the Dodd-Frank Act*, 50 SAN DIEGO L. REV. 243, 262 (2013).

⁷¹ See Reint Gropp, *How Important Are Hedge Funds in a Crisis?*, FED. RES. BANK OF S.F. ECON. LETTER (Apr. 14, 2014), <https://www.frbsf.org/economic-research/files/el2014-11.pdf> (arguing that hedge funds play a prominent role in transmitting shocks to the rest of the financial market and, thus, may amplify systemic risk more than previously thought). *But see* Kaal, *supra* note 70, at 248 (“[H]edge funds were not identifiable as the culprits for the financial crisis.”).

⁷² In 2004, “the SEC, using its rulemaking authority under the Investment Advisers Act, issued a [formal] rule requiring hedge fund [managers] to register under that [A]ct.” Kaal & Oesterle, *supra* note 5. The rule spurred significant resistance from the hedge fund industry. *Id.* In July 2006, the D.C. Circuit vacated the hedge fund rule in *Goldstein v. SEC*, calling the rule arbitrary rulemaking. *Id.* Most hedge fund advisers who had registered under the 2004 registration rule promptly deregistered. *Id.*

⁷³ Most relied on the “small firm” exception. *Id.* 15 U.S.C.A. § 80a-3(c)(1) (2010).

⁷⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403 124 Stat. 1376, 1571 (2010) (amending 15 U.S.C. § 80b-3 (2006)) (striking the private adviser exemption under section 203(b)(3) of the Advisers Act, thereby precluding many private fund advisers from avoiding registration).

⁷⁵ Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, 76 Fed. Reg. 39646-01, 39666-67 (July 6, 2011) (codified at 17 C.F.R. § 275.203(m)-1).

⁷⁶ Kaal & Oesterle, *supra* note 5.

file records and reports with the SEC containing information such as the hedge fund's total assets under management, its use of leverage, valuation methodologies, types of assets held, and other information deemed "necessary . . . for the protection of investors or for the assessment of systemic risk."⁷⁷ Additionally, as part of registration, hedge fund managers must make such records available for periodic inspections by the SEC.⁷⁸

The Dodd-Frank Act also created the Financial Stability Oversight Council ("FSOC") to monitor systemic risk to the U.S. financial system.⁷⁹ The SEC and Commodities Futures Trading Commission ("CFTC") together created the Form PF to collect the information proscribed in Title IV of Dodd-Frank and to assist the FSOC "in monitoring [hedge funds'] risk to the U.S. financial system."⁸⁰ Information reported on the Form PF is kept confidential once filed with the government; however, the government may use information reported in its examinations and enforcement actions.⁸¹ Funds with assets under management exceeding \$150 million, but less than \$1.5 billion, are required to file the Form PF annually, and funds with assets exceeding \$1.5 billion are required to file quarterly.⁸²

Under post-Dodd-Frank regulations, many hedge fund managers now must also complete the Form ADV.⁸³ Part One of Form ADV requires funds to disclose general information about the investment adviser, including information about its employees, clients, compensation, the value of assets under management, custodians, and ownership and control.⁸⁴ Responses to Part One are publicly available.⁸⁵ Part Two of Form ADV is only distributed to the government and investors and contains

⁷⁷ 15 U.S.C. § 80b-4(2), (3)(H) (2012).

⁷⁸ *Id.* § 404(b)(6).

⁷⁹ *Id.* § 111.

⁸⁰ SEC. & FUND SERV. PRIME FIN., *Form PF The Impact on Private Advisers*, CITIBANK 1, 1 (2012), https://www.citibank.com/mss/docs/Impact_on_Private_Fund.pdf.

⁸¹ BINGHAM MCCUTCHEN LLP, GUIDE TO SEC INVESTMENT ADVISER REGISTRATION FOR HEDGE FUND AND PRIVATE EQUITY FUND MANAGERS 18–19 (2012), <https://www.morganlewis.com/alerts/2011/02/~media/e87b98c6bc794d3fb2e1dd629dc5de11.ashx>.

⁸² SEC. & EXCH. COMM'N, FORM PF 1–2, <https://www.sec.gov/rules/final/2011/ia-3308-formpf.pdf> [hereinafter FORM PF].

⁸³ Kehoe, *supra* note 3, at 46; SEC. & EXCH. COMM'N, FORM ADV, <https://www.sec.gov/files/formadv.pdf>.

⁸⁴ BINGHAM MCCUTCHEN LLP, *supra* note 81, at 9; Kehoe, *supra* note 3, at 45.

⁸⁵ BINGHAM MCCUTCHEN LLP, *supra* note 81, at 9.

information regarding an investment advisers' business and funds managed, conflicts of interest, and advisory personnel.⁸⁶

B. *United States Hedge Fund Regulation - JOBS Act of 2012*

In addition to Dodd-Frank, the Jumpstart Our Business Startups ("JOBS") Act of 2012 shaped the hedge fund regulatory landscape by ending the solicitation ban for private companies relying on Rule 506 of Regulation D.⁸⁷ Before the JOBS Act, hedge funds and other private issuers were largely prohibited from engaging in any form of advertising for their investments.⁸⁸ However, hedge funds can now market themselves to a broader audience.⁸⁹ While many view the removal of the solicitation ban under the JOBS Act as a positive step towards transparency, critics see it as an opportunity to "lure unsophisticated investors," including less sophisticated institutional investors,⁹⁰ into a world of complicated investments "they do not fully understand and cannot easily leave."⁹¹

C. *Changes in Regulation Outside of the United States – AIFMD European Approach*

The United States was not the only country propelled by the global financial crisis to reexamine regulation and oversight of the hedge fund industry. The European Union responded by creating the Alternative Investment Fund Managers' Directive ("AIFMD") in 2011.⁹² The AIFMD is a regulatory framework requiring registration and enhanced reporting for alternative

⁸⁶ *Id.*

⁸⁷ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–314 (2012).

⁸⁸ Cary Martin, *One Step Forward for Hedge Fund Investors: The Removal of the Solicitation Ban and the Challenges that Lie Ahead*, 16 U. PA. J. BUS. L. 1143, 1145 (2014). Prior to the JOBS Act, private issuers, including hedge funds, were allowed to raise unlimited capital but only from accredited investors, and, in doing so, were largely restricted from advertising to the general public as to preserve the private nature of the investments. *Id.*

⁸⁹ Alexandra Stevenson, *With Ban on Ads Removed, Hedge Funds Test Waters*, N.Y. TIMES (Feb. 20, 2014), http://dealbook.nytimes.com/2014/02/20/with-ban-on-ads-lifted-hedge-funds-test-waters/?_r=1.

⁹⁰ See *supra* Part II.C and notes 45–46.

⁹¹ Stevenson, *supra* note 89.

⁹² Kehoe, *supra* note 3, at 36; Directive 2011/61, of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 O.J. (L 174) 1.

investment fund managers (“AIFMs”), including managers of hedge funds and private equity firms.⁹³ The aims of the AIFMD include (1) preventing market instability and the buildup of systemic risk in the European financial market; (2) improving investor protection through increased investor disclosure and mandatory reporting; and (3) harmonizing rules across member states to improve efficiency and level playing fields.⁹⁴ Entities affected by the directive were given until July 22, 2014 to comply with the directive’s mandates.⁹⁵ The directive applies generally to AIFMs who are based in the European Union, to AIFMs who manage alternative investment funds (“AIFs”) based in the European Union, and to AIFMs who market AIFs within the European Union.⁹⁶

Similar to the Form PF, the AIFMD grants exceptions to registration for AIFMs with assets below a certain threshold.⁹⁷ If the fund is leveraged and has less than €100 million in assets under management, or unleveraged and less than €500 million in assets, the fund’s advisors are exempt from registration altogether.⁹⁸

In terms of valuation, the AIFMD regulates the processes and procedures that AIFMs must follow, rather than prescribing substantive rules. AIFMs must either hire an external valuation expert to value its portfolio performance and assets under management, or they must create an in-house valuation team that is functionally independent from the portfolio managers.⁹⁹ Under the directive, if a fund chooses to use in-house valuation staff, the AIFM must ensure that it takes proper measures to mitigate any potential conflicts of interest and disclose them

⁹³ AIFMD, FINANCIAL CONDUCT AUTHORITY (Apr. 13, 2017), <https://www.fca.org.uk/firms/aifmd>.

⁹⁴ *Id.*

⁹⁵ DUFF & PHELPS, *Enhancing Independence: How Can Fund Managers Comply with AIFMD Valuation Requirements*, VALUATION INSIGHTS, 1, 4 (2015), <https://www.duffandphelps.com/-/media/assets/pdfs/publications/valuation/valuation-insights/q2-2015-valuation-insights.ashx>.

⁹⁶ The directive applies to (1) “EU[-based] AIFMs which manage one or more AIFs” (whether EU or non-EU AIFs); (2) “non-EU AIFMs, which manage one or more EU AIFs;” and (3) “non-EU AIFMs which market one or more AIFs in the [European] Union” (whether EU or non-EU AIFs). Council Directive 2011/61, art. 2(1), 2011 O.J. (L 174) 1.

⁹⁷ *Id.* at art. 3(2).

⁹⁸ *Id.*

⁹⁹ AIFMD Factsheet: Valuation, MATHESON 1 (2016), http://www.matheson.com/images/uploads/publications/AIFMD_Factsheet_Valuation.pdf.

where they exist.¹⁰⁰ In instances where the AIFM elects to use in-house valuation staff, regulators retain the power to require the AIFM to undergo verification of valuation by an external valuation expert or auditor.¹⁰¹ If an AIFM chooses to appoint an external valuation expert, the AIFM must demonstrate that the external party is professionally recognized and can furnish professional guarantees.¹⁰² Regardless of whether the AIFM appoints an external valuation expert or utilizes in-house valuation staff, the AIFM retains ultimate responsibility and liability for the calculation of the fund's net asset value and the proper valuation of the fund's assets.¹⁰³

The directive prescribes that an AIFM determine the valuation methodologies that will be used for each type of asset in which the AIFM will invest.¹⁰⁴ These methodologies must be applied consistently, and the policies and procedures for valuation must be reviewed at least annually.¹⁰⁵ Additionally, the directive requires AIFMs to provide investors with a description of these valuation methodologies, including "the methods used in valuing hard-to-value assets."¹⁰⁶

The directive further requires the AIFM to file an annual report with their home state regulators and to distribute the report to investors upon request.¹⁰⁷ Unlike the Form PF, information contained in the AIFM annual report includes the fund's investment strategies, trading techniques, leverage sources, and kinds of assets held.¹⁰⁸

D. Current Valuation Practices in the United States

Although Europe's regulations provide substantial detail for the process of hedge fund valuation, regulations in the United States have left this area untouched.¹⁰⁹ As a result, hedge fund

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² "[W]hat constitutes as 'professional guarantee' is not defined under the AIFMD." *Id.*

¹⁰³ *Id.* at 2.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ Directive 2011/61, art. 23(1)(g), 2011 O.J. (L 174) 1.

¹⁰⁷ Kehoe, *supra* note 3, at 53.

¹⁰⁸ *Id.*

¹⁰⁹ *See generally* Nabilou & Paccès, *supra* note 66.

managers are self-policing when it comes to the valuation of a fund's assets.¹¹⁰

In the field of public accounting in the U.S., the Financial Accounting Standards Board ("FASB") produces the Generally Accepted Accounting principles ("GAAP"), which all public companies must adhere to in their accounting methods and preparation of financial statements.¹¹¹ However, no analogous authoritative body exists in the U.S. for alternative investment valuation.¹¹² Instead, in hedge fund valuation, competing authorities issue guidance and principles, none of which carry the force of law in the United States.¹¹³ Therefore, even the most sophisticated investors find themselves at a disadvantage when performing due diligence on prospective hedge fund investments because they have no guarantee that the information they are comparing is actually comparable. As discussed previously in this Note, the SEC officially has the authority to demand inspection of any registered hedge fund's records at any time.¹¹⁴ However, in reality, the SEC lacks the person-power to use this as a meaningful enforcement mechanism for valuation.¹¹⁵ Practically speaking, this leaves a large gap in investor protection.

E. Recent Hedge Fund Valuation Cases and Enforcement Actions

Recent cases brought by the SEC and DOJ against hedge fund managers highlight weaknesses in the current valuation process that are most ripe for improvement through regulation. The first weakness is the possibility of direct manipulation of a funds' assets by the hedge fund managers. In December 2016, the SEC charged the founder and managers of Platinum Partners, a one billion dollar hedge fund, with "conducting a

¹¹⁰ Hedge funds are still subject to general prohibitions against fraud and managers owe a fiduciary duty to the funds they manage. OFFICE OF INV'R EDUC. & ADVOCACY, SEC. & EXCH. COMM'N, INVESTOR BULLETIN: HEDGE FUNDS 1 (2013), https://www.sec.gov/investor/alerts/ib_hedgefunds.pdf.

¹¹¹ *About the FASB*, FIN. ACCOUNTING STANDARDS BD., <http://www.fasb.org/facts/> (last visited Mar. 26, 2018).

¹¹² *See supra* Part III.B and note 67.

¹¹³ *See supra* Part III.B and note 67.

¹¹⁴ *See supra* Part IV.A.

¹¹⁵ Francis J. Facciolo, *Do I Have a Bridge for You: Fiduciary Duties and Investment Advice*, 17 U. PA. J. BUS. L. 101, 149 (2014).

fraudulent scheme to inflate asset values and illicitly move investor money to cover...liquidity problems.”¹¹⁶

By the end of 2014, eighty percent of Platinum’s assets were illiquid “level three” assets.¹¹⁷ Management touted its use of an independent valuation agent to investors.¹¹⁸ In reality, the fund’s founder and Chief Investment Officer, Mark Nordlicht, often instructed his staff to adjust the values of various positions up or down, leaving the staff to flesh out the rationales for the adjustments.¹¹⁹ Although the fund’s auditor in 2015 reported that a “material weakness” existed in the fund’s valuation process of level three assets, management never disclosed these findings to investors, and subsequently terminated the auditor.¹²⁰ Platinum’s control over valuations allowed the managers to substantially overstate the value of the fund’s largest assets.¹²¹ Platinum’s managers began operating the fund like a Ponzi scheme by misrepresenting the fund’s performance to lure in new investors, and then using the new investors’ capital to pay out redemptions to old investors.¹²²

The second observable weakness from recent cases is the possibility of a lack of independence of third parties offering comparable price inputs. In November 2015, former portfolio manager Michael Balboa was convicted and sentenced to four years in prison for manipulating the valuation of Nigerian debt held by his fund, Millennium Global Investments (“Millennium”).¹²³ The fund held positions in thinly traded,

¹¹⁶ Press Release, Sec. & Exch. Comm’n, SEC Charges Platinum Funds and Founder with Defrauding Investors (Dec. 19, 2016), <https://www.sec.gov/news/pressrelease/2016-267.html#>.

¹¹⁷ Complaint at 16, SEC v. Platinum Management (NY) LLC, 2017 WL 5634983 (E.D.N.Y. Dec. 19, 2016) (No. 16-CV-06848).

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ In one instance, Platinum’s overstatement of an oil company, Golden Gate LLC, resulted in an overstatement of thirteen percent of the fund’s total assets under management in 2014. *Id.* at 3.

¹²² Alexandra Stevenson, *Platinum Hedge Fund Executives Charged with \$1 Billion Fraud*, N.Y. TIMES, Dec. 19, 2016, <http://www.nytimes.com/2016/12/19/business/dealbook/platinum-partners-hedge-fund-founder-and-6-others-charged-with-fraud.html>.

¹²³ United States v. Balboa, 622 F. App’x 31, 32–33 (2d Cir. 2015); Nate Raymond, *Ex-Millennium Global Fund Manager Loses U.S. Fraud Appeal*, REUTERS, Nov. 18, 2015, 11:40 AM, <http://www.reuters.com/article/us-usa-crime-balboa-idUSKCN0T72ES20151118>.

illiquid Nigerian debt.¹²⁴ Pursuant to Millennium's Valuation Service Agreement, Millennium engaged GlobeOp Financial Services ("GlobeOp"), an independent valuation services firm, to act as the firm's valuation agent and calculate the Fund's net asset value each month.¹²⁵ For illiquid assets with no observable trading market to compare prices, GlobeOp solicited opinions of brokers or counterparties trading similar securities to determine the most accurate valuation.¹²⁶ Balboa suggested GlobeOp consult Gilles De Charsonville, a counterparty working in emerging market debt at a broker-dealer, to provide valuations on fifteen to twenty of Millenniums' difficult-to-value securities.¹²⁷ GlobeOp used De Charsonville because Balboa and De Charsonville held De Charsonville out as an independent source.¹²⁸ However, unknown to GlobeOp, De Charsonville agreed to provide GlobeOp with prices supplied by Balboa and present them as his own findings.¹²⁹ The scheme lasted for over a year and caused the fund's value to be overstated by eighty million dollars in August 2008.¹³⁰

In addition to these cases, in the past several years, the SEC has launched a series of investigations into other hedge funds related to their valuation process.¹³¹ According to SEC Enforcement Director Andrew Ceresney, the SEC considers valuation a "core issue[]" when looking for hedge fund manager misconduct.¹³²

¹²⁴ Raymond, *supra* note 123.

¹²⁵ SEC v. Balboa, No. 11 Civ. 8731 PAC, 2015 WL 4092328, at *1 (S.D.N.Y. July 6, 2015).

¹²⁶ *Id.*

¹²⁷ *Id.* at 2.

¹²⁸ *Id.* at 1.

¹²⁹ *Id.* at 2.

¹³⁰ Raymond, *supra* note 123. In a similar case, the SEC fined Alphabridge Capital Management and its owners five million dollars for inflating the value of its holdings of mortgage-backed securities by colluding with broker-dealers to supply favorable price quotes to the fund's auditors. Carmin Germaine, *SEC Fines Alphabridge Capital \$5M Over Inflated MBS Prices*, LAW360, (July 1, 2015), <https://www.law360.com/articles/674630/sec-fines-alphabridge-capital-5m-over-inflated-mbs-prices>.

¹³¹ In May 2016, the SEC was investigating RD Legal Capital LLC, Platinum Partners LP, and Visium Asset Management, LP. Rob Copeland and Aruna Viswanatha, *Wall Street Cops to Hedge Funds: Treat Investors Better; Regulators Ramp Up Scrutiny, with Investigations Focusing on How Thinly Traded Investments Are Valued*, WALL ST. J. (May 9, 2016), <http://www.wsj.com/articles/hedge-funds-treatment-of-investors-gets-new-scrutiny-1462808155>.

¹³² *Id.*

IV. PROPOSED CHANGES TO IMPROVE UNITED STATES REGULATIONS FOR HEDGE FUNDS

Registration of hedge funds under the Dodd-Frank Act was a step in the right direction, helping to shed light on this mysterious, shadowy industry. The increased reporting has provided the government with a clearer picture of the industry¹³³ and allowed regulators to better analyze the systemic risk associated with the industry.¹³⁴ However, the registration requirements under Dodd-Frank leave room for improvement in the area of investor protection. With billions of dollars from pension funds, charitable foundations, and educational endowments tied up in hedge funds, the SEC should prioritize investor protection in its efforts to regulate the industry going forward. This Note argues that the best way to do so is through focusing on hedge fund valuation practices and mitigating related conflicts of interest.

First, the SEC should follow the lead of the AIFMD and promulgate rules that would require hedge funds to establish transparent independent valuation functions. Similar to under the AIFMD, funds could achieve this independent valuation function through two methods: either by (1) outsourcing all of valuation calculations to a qualified external valuation expert, or (2) creating an internal valuation function that is functionally independent of the portfolio managers.¹³⁵ If funds chose to retain the valuation function in-house, they should be required to produce written valuation policies and procedures, detailing the segregation of duties and internal controls in place to ensure the highest level of independence and separation from portfolio managers.¹³⁶ These written procedures should be kept current, distributed to the government on at least an annual basis, and made available to investors upon request.

¹³³ In her speech to the Managed Funds Association Outlook conference in 2013, SEC Chair Mary Jo White stated “We knew that there was a gap in our knowledge. But, we did not know how many hedge fund managers existed Until [Dodd-Frank], we did not know that we had not accounted for one-third of the industry.” Speech by Mary Jo White, *supra* note 6.

¹³⁴ SEC Chair Mary Jo White stated that the non-public data on hedge funds’ risk profiles reported in the Form PF allows regulators to monitor the industry’s systemic risk. *Id.* “Using this information, regulators can then assess trends over time and identify risks as they are emerging.” *Id.*

¹³⁵ DUFF & PHELPS, *supra* note 95.

¹³⁶ ALT. INV. MGMT. ASS’N, *supra* note 54, at 15.

Further, the SEC should distinguish between larger funds, which account for the majority of the hedge fund industry and can afford to shoulder greater regulatory costs, and smaller funds for which additional reporting requirements would constitute a significant burden. Specifically, the SEC should require large funds, with at least \$150 million in AUM that choose to perform valuations in-house, to have those valuations reviewed periodically by an external third-party valuation expert.¹³⁷ This \$150 million threshold aligns with the SEC's current threshold for private funds that are required to register with the SEC and file a Form PF.¹³⁸ Also like the Form PF requirements, funds with greater than \$150 million in AUM should be required to undergo this external review annually, while funds with greater than \$1.5 billion in AUM should be required to undergo this review quarterly.¹³⁹ The results of these external reviews should be filed with the SEC and made available to current investors.

Involving external valuation experts will help add transparency and independence to the complicated valuation process. In fact, many hedge funds already engage external valuation experts in some form for these very reasons.¹⁴⁰ However, currently, these experts are engaged by hedge funds voluntarily, and no mechanism exists to provide a check on the valuations conducted by external valuation experts. Therefore, concerns persist as to the expert's independence and power, as with Platinum Partners and Millennium Global Investments.¹⁴¹

To add credibility to the work of external valuation experts, Congress should create a private fund industry governing body. This body would act under the power and oversight of the SEC and would be responsible for periodically reviewing the work of the external valuation experts (essentially a review of the reviewers). The organization could mimic the structure of the Public Company Auditing Oversight Board ("PCAOB"), a similar governing body that oversees the public accounting industry.¹⁴²

¹³⁷ *Id.*

¹³⁸ FORM PF, *supra* note 82.

¹³⁹ *Id.*

¹⁴⁰ Maxey, *supra* note 47.

¹⁴¹ *See supra* Part IV.E.

¹⁴² The PCAOB is responsible for regulating accounting auditors of public companies. *About the PCAOB*, <https://pcaobus.org/About> (last visited Mar. 26, 2018). Members are appointed by the SEC and the SEC maintains oversight of the board's rules, standards, and budget. *Id.*

This new, private fund governing body would be responsible for registering qualified external valuation experts; periodically reviewing the work of these experts; and issuing valuation standards. This would promote investor protection and transparency by instilling confidence in investors and eliminating problematic competing valuation standards.¹⁴³ Investors could be confident that when they compared valuation and performance of various funds, the funds were using the same standards and metrics. The governing body should also follow the lead of the PCAOB by requiring external valuation experts to periodically change the partner or managing director leading the external valuation, thereby increasing the likelihood that any material misstatements would be identified over time as the partners leading the external valuation rotated.¹⁴⁴

Although these proposed changes in regulation would provide greater transparency and confidence to investors and the government, hedge funds will likely express concern over implementation and compliance costs. This is a legitimate concern, particularly at a time when hedge funds have seen a dip in investment returns.¹⁴⁵ The discussion of costs should be broken into two sections: (1) the cost of creating independent valuation functions at the fund level, and (2) the creation of an industry governing body to oversee valuation at an industry level.

First, the proposals relating to the creation of an independent valuation function at the fund level essentially proposes to use what is already considered industry best practices and mandate them.¹⁴⁶ Additionally, the valuation proposals closely align with the valuation requirements found in the AIFMD.¹⁴⁷ Therefore, hedge funds that fall within the scope of the AIFMD have, at least partially, already complied with

¹⁴³ See *supra* note 67.

¹⁴⁴ The PCAOB requires public accounting firms to rotate audit partners and engagement quality review partners every five years to aid in the detection of any material misstatements in the financial statements. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 203, 116 Stat. 745, (2002) (codified as amended at 15 U.S.C. § 78j-1)

¹⁴⁵ Several large U.S. pension funds, including plans for California's, New Jersey's, and Philadelphia's employees have scaled back investments in hedge funds as returns have declined in recent years. Childs & Johnson, *supra* note 12.

¹⁴⁶ Maxey, *supra* note 47.

¹⁴⁷ See *generally* Council Directive 2011/61, 2011 O.J. (L 174) 1 (EC).

these standards since July 2014.¹⁴⁸ Further, the majority of hedge funds already engage external valuation experts in some form because investors demand it.¹⁴⁹

Second, the creation of an industry governing body could follow the lead of the PCAOB and be financed by its members.¹⁵⁰ The PCAOB requires all publicly traded companies to share the cost of the accounting support fee that funds the PCAOB.¹⁵¹ The proposed private fund governing body could do the same, requiring all hedge funds with net asset valuation above \$150 million to contribute. Despite severe criticism, the PCAOB has remained intact since its creation by the Sarbanes-Oxley Act of 2002.¹⁵² A recent study concluded the PCAOB increased the overall credibility of financial reporting.¹⁵³

The benefits of increased investor protection are difficult to quantify since they only become apparent when a hedge fund fails and investors are left empty-handed. However, since these proposals build on existing widespread industry practices and regulatory framework implemented elsewhere, the costs are not so great as to outweigh the benefits.

CONCLUSION

Hedge funds provide an alternative method of investment for high net worth individuals and institutional investors. After years of operating largely without regulation, governments around the world used the fallout of the financial crisis of 2008 to introduce new regulation for the hedge fund industry. In the United States, the Dodd-Frank Act of 2010 required most hedge funds to register with the SEC and provide information about the funds' investment strategy, trading practices, leverage, assets

¹⁴⁸ DUFF & PHELPS, *supra* note 95.

¹⁴⁹ Rogers, *supra* note 68; Maxey, *supra* note 47.

¹⁵⁰ *About the PCAOB*, *supra* note 142.

¹⁵¹ *Id.*

¹⁵² The Sarbanes-Oxley Act continues to face hostility despite "acquiescence or even mild praise by those most directly affected" by it. John C. Coates & Suraj Srinivasan, *SOX After Ten Years: A Multidisciplinary Review*, 28 ACCT. HORIZONS 627, 628–29 (2014).

¹⁵³ The study concluded the introduction of the PCAOB and its inspection regime increased capital-market responses to firms' earnings surprises, indicating the audit oversight regime enhanced the credibility of reported earnings. Brandon Gipper et al., *Public Audit Oversight and Reporting Credibility: Evidence from the PCAOB Inspection Regime* 39–40 (Nat'l Bureau of Econ. Research, Working Paper No. 21530, 2016).

under management, and valuation practices. This information assisted the U.S. government in learning more about the industry and in monitoring for systemic risk. However, the legislation left more to be desired in its aim to increase investor protection.

Shortly after the passage of Dodd-Frank, the JOBS Act of 2012 removed the solicitation ban, allowing hedge funds to reach a broader base of potential investors through advertising. This change, along with the general "retailization" of hedge funds, increased the number of institutional investors in hedge funds, such as public and private pension funds and charitable and educational endowments.

In Europe, the European Council approved the AIFMD, a sweeping piece of legislation that aimed to increase investor protection, monitor systemic risk, and provide common standards for hedge funds doing business in Europe. Among its directives, the AIFMD provided detailed requirements for independent hedge fund valuation.

The U.S. government should follow the AIFMD's lead in requiring greater standardization and transparency of hedge fund valuation. The United States should require hedge funds to either engage external valuation experts to value their assets or at least require that funds create and document valuation functions that are as independent as possible from the portfolio managers. This would increase investor protection by providing investors with confidence in the valuations they see and also by providing common metrics to compare funds. To ensure that the external valuation experts are truly independent, Congress should also create an industry governing body that would have the power to inspect the external valuation expert's reports, accredit valuation experts, and issue valuation standards for the industry. Together, these measures would strengthen confidence in hedge fund valuations and improve investor protection for the millions of Americans who rely on hedge funds for their financial security.