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Containing Systemic Risk: New Developments in Trans-Atlantic Hedge Fund Regulation

Michael McDonald
Loyola Law School Los Angeles

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MICHAEL MCDONALD*

I. INTRODUCTION

Operating as part of the so-called "shadow banking system,"[1] hedge funds have evolved to become titans of the modern global financial industry. Not only do hedge funds attract some of the brightest minds in finance and often provide historically superior returns to their investors, but their enormous size can also provide them with tremendous influence over the course of global financial markets. Today, however, the familiar regulatory environment in which fund managers have traditionally operated is in the process of unprecedented change. The severity of the 2008 credit crisis and its aftermath have forced market regulators on both sides of the Atlantic to address the failures associated with existing regulatory standards, identify new regulatory goals, and adjust international standards accordingly. Despite the prevailing view that hedge funds played only a marginal role in facilitating the onset of the crisis, the industry's enormous size has made it too hard for policymakers to ignore.[2] As a result, there has been a renewed emphasis on removing the "cloak of secrecy" that has often surrounded hedge fund activity.[3]

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1. *See* ZOLTAN POZSAR ET AL., FED. RESERVE BANK OF N.Y., SHADOW BANKING, Staff Rep. No. 458, at 13 (2010), *available at* http://www.newyorkfed.org/research/staff_reports/sr458.pdf.

2. Adam Smith, *Should Hedge Funds Face Harsher Regulation?*, TIME, July 8, 2010, *available at* http://www.time.com/time/business/article/0,8599,1909026,00.html.

3. *Bigger, Safer but Duller: A Secretive Industry Opens Up to Meet the Demands of Investors and Regulators*, ECONOMIST, Aug. 26, 2010, *available at* http://www.economist.com /node/16891973/print [hereinafter *Bigger, Safer but Duller*].

In the United States and the European Union (EU), this trend was initially predicated upon the desire to achieve regulatory "harmonization" to prevent the harmful effects of regulatory arbitrage.[4] This process, however, has proven difficult in light of each region's individual assessment of the appropriate balance between the promotion of resilient and sustainable markets with that of economic growth and innovation.[5] For this reason, many commentators have argued throughout this process that the two regions have actually taken divergent paths.[6]

This Note will explore the question of whether the United States and the EU have achieved their respective goals of establishing an effective, unified body of financial reform measures that address hedge fund activity and its broad impact on the financial markets. In particular, this analysis will focus on these measures as they address the primary concerns regarding the relationship between hedge funds and the build-up of systemic risk within the financial system. Part II begins with a review of some of the basic characteristics that distinguish hedge funds from other types of investment vehicles and will consider the following areas: the structure of hedge funds, fund investment strategies, and fund investor pools. Part III will then identify the ways in which large hedge funds can present a systemic threat to stability of the international financial system as a whole.

Part IV will undertake a comparative analysis of both the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in the United States and the recent agreement on the Alternative Investment Fund Managers Directive in the EU ("AIFMD"). This will be accomplished by comparing the following areas: 1) the aims and background of each set of reforms; and 2) how these approaches address the regulatory concerns over systemic risk and, by extension, the suitability of these approaches in light of the unique challenges that

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4. Andreas Engert, *Transnational Hedge Fund Regulation*, 11 EUR. BUS. ORG. L. REV. 277, 362 (2010), *available at* http://journals.cambridge.org/action/displayFulltext?type=1&fid=7923084&jid=EBR&volumeId=11&issueId=03&aid=7923083 ("Regulatory arbitrage describes how participants in the hedge fund industry react to regulation if they perceive it as costly.").

5. Anthony Faiola & Brady Dennis, *U.S., Europe Fall out of Step on Global Financial Reform*, WASH. POST., May 26, 2010, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/05/25/AR2010052505316.html.

6. *Id.*; *see* Oxford Analytica, *E.U., U.S. Investing Regulations Diverge,* FORBES.COM, (Aug. 6, 2010), http://www.forbes.com/2010/08/05/united-states-european-union-investment-business-oxford.html; *see also* Martin Arnold, Brooke Masters & Nikki Tait, *Investing: Alternative Visions*, FIN. TIMES (May 13, 2010), http://www.ft.com/intl/cms/s/0/f93da592-5ec4-11df-af86-00144feab49a.html#axzz1yGyCFepS [hereinafter *Investing: Alternative Visions*].

regulation of this area entail. Ultimately, this Note takes the position that although there remain some areas of divergence, the financial reforms adopted by the United States and the EU essentially converge and represent modest, yet realistic standards for mitigating the industry's potential to inflict harmful externalities on the financial system.

II. WHAT IS A HEDGE FUND? AN "INDUSTRY" TERM

Despite its prevalence, a commonly accepted definition of a "hedge fund" does not exist.[7] Instead, hedge funds are often characterized by what they are not. In the United States, for example, hedge funds have been defined to the extent by which they fall under an exception to the federal securities laws. Before the Dodd-Frank Act, the Securities and Exchange Commission (SEC) defined a hedge fund as "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act."[8] Similarly, the EU has simply categorized hedge funds as "alternative investments" that do not require authorization as Undertakings for Collective Investment in Transferable Securities (UCITS) under Article 5 of Directive 2009/65/EC.[9] While these narrow definitions may serve legislative purposes, they fail to capture both the structure and complexity of fund investment activities and are, therefore, of limited use. For these reasons, the definition of a hedge fund as an "industry" term is more instructive.[10] According to this classification, the term "hedge fund" encompasses the three fundamental components inherent in most hedge funds: their legal organization, investment strategy, and investor profiles.[11]

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7. U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE U.S. SEC. & EXCH. COMM'N 3 (2003) [hereinafter IMPLICATIONS], *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

8. George Sami, *A Comparative Analysis of Hedge Fund Regulation in the United States and Europe*, 29 NW. J. INT'L L. & BUS. 275, 277 (2009).

9. Press Release, European Council, Directive on Alternative Investment Fund Managers ("AIFMD"): Frequently Asked Questions (Nov. 11, 2010) [hereinafter Frequently Asked Questions], *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/572&type=HTML.

10. Michael J. Schmidt, *Investor Protection in Europe and the United States: Impacting the Future of Hedge Funds*, 25 WIS. INT'L L.J. 161, 162 (2007).

11. *Id.*; *see also* Sargon Daniel, *Yesterday's Regulatory Schemes for Today's Investment Vehicles*, 27 COLUM. BUS. L. REV. 247, 251 (2007).

A. Hedge Fund Structure

A hedge fund is a pool of assets collected from both institutional and accredited investors that is administered by a fund manager.[12] In return for their investment into the fund, investors receive a share of the pooled assets and, by extension, the fund's profits.[13] Today, almost all hedge funds in the United States and the EU are organized as limited liability corporations or limited partnerships.[14] This structure provides hedge fund managers with the ability to maintain a high level of control over the fund's investment strategy and minimize tax-exposure, while also allowing them to invest their own money into the fund.[15] The majority of hedge fund entities are set up in the Cayman Islands to take advantage of the country's favorable tax incentives.[16] Most funds, however, are "managed" in the United States, followed by the United Kingdom,[17] and increasingly, Singapore and Hong Kong.[18]

B. Hedge Fund Investment Strategies

As the name suggests, fund managers often "hedge" against the inherent risks associated with their investments using a variety of techniques. A "hedge" essentially involves taking an investment position in a security while, at the same time, offsetting that position with another investment.[19] This can be done using both long and short investment strategies.[20] Although hedging is a method designed to

12. Engert, *supra* note 4, at 333.

13. *Id.*

14. *Id.* at 355.

15. *Id. See also* Dustin G. Hall, *The Elephant in the Room: Dangers of Hedge Funds in Our Financial Markets*, 60 FLA. L. REV. 183, 188 (2008).

16. Lartease Tiffith, *Hedge Fund Regulation: What the FSA Is Doing Right and Why the SEC Should Follow the FSA's Lead*, 27 NW. J. INT'L L. & BUS. 497, 500 (2007).

17. *See* Schmidt, *supra* note 10, at 162. Specifically, forty out of the fifty largest European hedge funds are currently headquartered in the United Kingdom. *See* Bill McIntosh, *Europe 50: Europe's Largest Single Managers Ranked by AUM*, HEDGE FUND J. (Sept. 2010), http://www.thehedgefundjournal.com/magazine/201009/research/the-europe-50-2010-.php [hereinafter *Europe 50*].

18. *See* Netty Ismail, *Singapore's New Hedge-Fund Regulation Puts City 'Back on Map,'* BLOOMBERG (July 28, 2010, 9:01 AM), http://www.bloomberg.com/news/2010-07-28/singapore-hedge-fund-regulations-lure-managers-put-city-back-on-the-map-.html; Saeed Azhar & Parvathy Ullatil, *Seeking Less Scrutiny, Hedge Funds Flock to Asia*, REUTERS (May 17, 2010), http://www.reuters.com/article/2010/05/17/us-asia-hedgefunds-analysis-idUSTRE64G31W20100517.

19. Jennifer Ralph Oppold, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach,* 10 U. PA. J. BUS, & EMP. L. 833, 834 (2008).

20. A commonly used practice, short selling, is a procedure in which the fund manager will "borrow" a security from a lender and bet that the value of the security will decline. Upon doing so, the manager will then sell the security and buy back the lower priced security and return it to

minimize investment risk, investing in hedge funds can actually entail a higher degree of risk compared with other forms of investment, such as mutual funds, because of their tendency to pursue a more aggressive investment strategy.[21] This is due, in large part, to the fact that hedge fund managers seek to maximize absolute return to their investors rather than measure fund performance relative to a designated financial benchmark or index.[22] In doing so, many fund managers utilize highly complex, proprietary investment strategies that typically incorporate a variety of asset classes.[23] Depending on the type of fund, these asset classes often involve the use of complex financial instruments in the form of options, derivatives, and leverage.[24]

Regardless of the fund's investment philosophy, fund managers may also incorporate the use of economic leverage into their investment strategy. Defined as the practice of purchasing "stocks or other investments by using borrowed funds (on margin)," leverage can assist certain funds in providing the highest possible rate of return to its investors.[25] Typically, hedge funds obtain financial leverage through the use of repurchase agreements, short positions, and derivatives.[26] While not all hedge funds use leverage, the U.S. Government Accountability Office (GAO) has found that hedge funds "account for more than 40% of the trading volume in the U.S. leverage loan market" and more than 85% of the distressed debt market.[27]

Overall, hedge funds pursue a wide-range of investment strategies that cover essentially every corner of the financial market. Not surprisingly, direct regulation of fund manager activity is thus exceedingly difficult because of the diverse nature of fund activities and

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the lender. If timed correctly, the fund manager will have captured the "spread" between the value of the security at the time that it was sold and the value at the time that it was repurchased and replaced. Although politically unpopular, particularly in Europe, short selling can play a beneficial role in facilitating market rationalization and market liquidity. Daniel, *supra* note 11, at 252.

21. *See* Tamar Frankel, *Private Investment Funds: Hedge Funds' Regulation by Size,* 39 RUTGERS L.J. 657, 665 (2008).

22. IMPLICATIONS, *supra* note 7, at viii.

23. *See* Matthew Goldstein, *A Secret Society: Hedge Funds and Their Mysterious Success*, 6 J. INT'L BUS. & L. 111, 114 (2007).

24. *See* Schmidt, *supra* note 10, at 163.

25. WEBSTER'S NEW WORLD FINANCE AND INVESTMENT DICTIONARY 194 (1st ed. 2003).

26. HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT, REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, 4–5 (Apr. 1999), http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.

27. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-200, HEDGE FUNDS: REGULATORS AND MARKET PARTICIPANTS ARE TAKING STEPS TO STRENGTHEN MARKET DISCIPLINE, BUT CONTINUED ATTENTION IS NEEDED 1 (2008) [hereinafter GAO REPORT], *available at* http://www.gao.gov/new.items/d08200.pdf.

the ways in which their strategies straddle the boundaries of both regulated and un-regulated market activities.

C. Hedge Fund Investors and Fees

Due to the risks often associated with a more aggressive investment strategy, hedge funds have traditionally been the exclusive domain of high net-worth and institutional investors.[28] In both the United States and the EU, hedge funds are prohibited from soliciting investments from the general public, and instead must raise capital from private accredited investors via private placement offerings.[29] In order to invest in a hedge fund in the United States, for example, the investor must be an "accredited investor," which requires an individual or joint-spouse net-worth of one million dollars.[30] Similarly, EU investors must meet the criteria of a "professional investor."[31] These entry barriers are comparatively high because these investors should possess a higher degree of financial sophistication and are therefore better able to withstand the elevated risk associated with a more aggressive investment strategy.[32]

In addition to these statutory requirements, most hedge funds also maintain a minimum investment threshold of at least one million dollars and include certain time frames in which investors may not withdraw their money from the fund.[33] Today, however, institutional investors such as pension funds and insurance companies are also heavily invested in the hedge fund market—thereby allowing non-qualifying investors to participate through the back door.[34]

28. However, the recent trend is for institutional investors rather than the high net-worth, "professional" investors to dominate hedge fund investor pools. *See* Schmidt, *supra* note 10, at 163; *see also* John Horsfield-Bradbury, *Hedge Fund Self-Regulation in the U.S. and the UK* 8 (Harvard Law Sch. Victor Brudney Prize in Corporate Governance Paper, 2008), *available at* http://law.harvard.edu/programs/olin_centr/corporate_governance/papers/Brudney2008_Horsfield-Bradbury.pdf.

29. Alex Hood, *Developments in Banking and Financial Law: 2008–2009*, 28 REV. BANKING & FIN. L. 61, 63 (2009).

30. *See* 17 C.F.R. § 230.501(a)(5) (West 2011).

31. *See* Council Directive 2011/61, arts. 31(6), 32(9), 35(17), 39(11), 40(17), 2011 O.J. (L/174) 1 (EU).

32. *See* Schmidt, *supra* note 10, at 163, 166–67.

33. Matthew Lewis, *A Transatlantic Dilemma: A Comparative Review of American and British Hedge Fund Regulation*, 22 EMORY INT'L L. REV. 347, 359 (2008). From a regulatory standpoint, these traditional entry barriers are commonly referred to as the "indirect regulation approach." *See also* Schmidt, *supra* note 10, at 166–67.

34. *See* U.S. DEP'T OF THE TREASURY, AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL § 5 (2007), http://www.treasury.gov/resource-center/fin-mkts/Documents/hp272_principles.pdf [hereinafter PWG AGREEMENT].

In addition to entry barriers, the fee structure common to most hedge funds provides yet another important mechanism that limits the pool of fund investors. As one might expect, investing in a hedge fund is expensive. Typical fees include a charge of 1–3% of the assets under management, assessed on behalf of the fund advisor, as well as an additional charge of 10–30% of the fund's yearly appreciation in value.[35] These fee arrangements are based on the absolute performance of the fund, which can potentially result in a very high level of compensation for fund managers.[36] Accordingly, these fee structures can incentivize excessive risk taking.[37] Through these highly lucrative fee arrangements, hedge fund managers have become some of the highest compensated figures in the world. For example, John Paulson, advisor to the Paulson and Co. hedge fund, made a record four billion dollars in 2008 in personal compensation from fees stemming from a single trade.[38]

III. HEDGE FUNDS AND SYSTEMIC RISK

The term "systemic risk" can be roughly defined as the risk attributable to a certain market participant or segment and its corresponding negative-potential impact on another market participant, segment, or economy as a whole.[39] Correspondingly, a "systemic event" is defined as an event where "shocks to one part of the financial system lead to shocks elsewhere, impinging on the stability of the real economy."[40] These "shocks" can lead to the reduction, if not elimination, of capital market flows and liquidity needed to run everyday business activity.[41] Systemic risk is particularly problematic because individual investors and firms cannot "protect themselves at reasonable cost as long as they participate, directly or indirectly, in the financial markets."[42]

The near-collapse of the first major hedge fund, Long Term

35. Oppold, *supra* note 19 at 837.

36. *See* John Kambhu et al., *Hedge Funds, Financial Intermediation, and Systemic Risk*, 13 ECON. POL'Y REV. 1, 3 (2007).

37. *Id.* at 4.

38. GREGORY ZUCKERMAN, THE GREATEST TRADE EVER: THE BEHIND-THE-SCENES STORY OF HOW JOHN PAULSON DEFIED WALL STREET AND MADE FINANCIAL HISTORY 254 (2009).

39. *See* Kambhu et al., *supra* note 36, at 5–6.

40. *Id.* at 5 (citing Michael D. Bordo, et al, *Real Versus Pseudo-International Systemic Risk: Some Lessons from History* (National Bureau of Economic Research, Working Paper 5371, 1995).

41. Engert, *supra* note 4, at 342.

42. *See id.* at 339.

Capital Management (LTCM) in 1998, provides a prime example of the systemic problems that can result from the failure of a large hedge fund.[43] In the exceptional case of LTCM, a combination of high-amount leverage and market volatility prompted investors and counterparties alike to liquidate their holdings in the fund to the point that LTCM could not cover its liabilities and the Federal Reserve and other private banks had to bail out LTCM.[44] In the United States, the severity of the LTCM collapse prompted the first major debate concerning the need for greater oversight over hedge fund activity and led to the creation of the President's Working Group (PWG) to study the impact of the hedge fund industry on financial markets.[45] In the wake of the most recent crisis, the desire to mitigate the systemic risk associated with massive pools of lightly regulated capital has been the overriding justification for subjecting hedge funds to a higher level of regulatory scrutiny.[46]

So how does a hedge fund present a systemic risk to the "real economy?" Generally, hedge funds can pose a systemic risk to the stability of the financial system in two fundamental ways: 1) the potential for counterparties to sustain extensive losses in the event of a hedge fund failure; and, 2) the potential for disorderly market pricing in the event that a large hedge fund rapidly unwinds its investment positions.[47]

A. The Limits of Market Discipline: Hedge Funds and Counterparty Exposure

Because hedge funds invest in a wide array of financial instruments, often with the use of significant amounts of leverage, losses—like gains—are accordingly amplified.[48] In 2007, for example,

43. *See* Goldstein, *supra* note 23, at 118 ("LTCM's loss resulted from using borrowed money to purchase about $120 billion of its estimated $125 billion in assets . . . .").

44. *Id.*; *see also Private-Sector Refinancing of the Large Hedge Fund, Long-Term Capital Management*: *Hearing Before the H. Comm. on Banking and Fin. Servs.*, 105th Cong. 3–6 (1998) (testimony of Chairman Alan Greenspan), *available at* http://www.federalreserve.gov/boarddocs/testimony/1998/19981001.htm.

45. *Id.* at 5; *see also* Chairman of the High-Level Grp. on Fin. Supervision in the EU, *The High-Level Group on Financial Supervision in the EU: Report* (Feb. 25, 2009), *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (similarly, in the aftermath of the credit crisis, the EU created the so-called "High Level Group on Financial Supervision" ("Larosière Report") which recommended that hedge funds be required to disclose their strategies, use of leverage, and their "worldwide activities.").

46. *See EU Frequently Asked Questions*, *supra* note 9, at 1 ("Given the global nature of their activities, many risks posed by the AIFM have an important cross-border dimension.").

47. *See* Kambhu et al., *supra* note 36, at 7–8.

48. Timothy Geithner, President, Fed. Reserve Bank, Address at the Hong Kong Monetary Authority: Hedge Funds and Derivatives and Their Implications for the Financial System (Sept.

the average leverage ratio for the hedge fund industry as a whole was 1.7 times the value of the fund's underlying assets.[49] By utilizing economic leverage, hedge funds typically maintain relationships with a number of other financial institutions ("counterparties") that provide credit services, such as trading and execution, clearance and custody, and financing services.[50] These services are usually provided by banks or prime brokers and constitute an estimated multi-billion dollar industry.[51] In return for extending credit to a particular fund, fund managers are required to provide collateral assets that can be liquidated in the event that the fund cannot cover its investment positions.[52]

According to the GAO, hedge funds often provide collateral in the form of highly liquid securities or cash. Less often, funds will also provide collateral through lower rated or less liquid securities.[53] By extending credit to a fund, the counterparty remains directly exposed to the risk of having the value of the fund's collateral fall below the level needed to cover the fund's liabilities should it become necessary.[54] For this reason, the liquidity of the collateral and the degree to which these institutions have implemented sound risk management policies are significant factors in curtailing the potentially dangerous exposure to counterparty, and, by extension, systemic risk.[55] Commonly referred to as "market discipline,"[56] these constraints reside within each institution's policies concerning margin and collateral requirements and

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14, 2006), *available at* http://www.hkma.gov.hk/eng/key-information/speech-speakers/tfgeithner/20060915-1.shtml ("Private pools of capital have the capacity to use extensive leverage to amplify returns.").

49. *Hedge Funds Oversight: Conclusion Report,* TECHNICAL COMM'N OF THE INT'L ORG. OF SEC. COMM'NS 17 (Mar. 2009), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD288.pdf [hereinafter *IOSCO Report*] (this ratio fell to 1.4 times as of October 2008, however).

50. Kambhu et al., *supra* note 36, at 3; *see also* GAO REPORT, *supra* note 27, at 7 ("[M]ost large hedge funds use multiple prime brokers as service providers. Thus, no one broker may have all the data necessary to assess the total leverage used by a hedge fund client.").

51. *See* IMPLICATIONS, *supra* note 7, at viii. *See also* Bradley Keoun, *Morgan Stanley Speculating to Brink of Collapse Got $107 Billion from Fed*, BLOOMBERG.COM, http://www.bloomberg.com/news/2011-08-22/morgan-stanley-at-brink-of-collapse-got-107b-from-fed.html.

52. GAO REPORT, *supra* note 27, at 30.

53. *Id.*

54. *See* Engert, *supra* note 4, at 340; *see also* Kambhu, *supra* note 36, at 3.

55. Geithner, *supra* note 48.

56. *See* GAO REPORT, *supra* note 27, at 26. Additionally, the adherence to the market discipline approach stems from the free market principles, which hold that private parties have the strongest "incentives to monitor counterparties as well as the best access to the information needed to do so effectively." Nell Henderson, *Fed Urges Banks to Monitor Hedge Funds*, WASH. POST (May 17, 2006), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/05/16/AR2006051601745.html.

dictate the terms on which the counterparty will transact with a particular fund.[57]

Although market discipline comprises the "first [and most important] line of defense between unregulated hedge funds and regulated financial institutions," guarding against excessive risk-taking, a number of mitigating factors also influence this form of indirect regulation.[58] First, in order for market discipline to be effective, counterparties must have access to information regarding the fund's risk profile, as well as having the institutional mechanisms in place to limit the firm's exposure to it.[59] Traditionally, however, "the desire" for hedge funds to keep their market activities "confidential" can limit the flow of fund-specific information and has earned hedge funds a reputation for "opacity."[60]

Until the recent passage of the financial reform in the United States and the EU, hedge funds that fell under an exception to the existing securities laws have not been required by law to publicly disclose information relating to the activities of the fund.[61] The extent to which some hedge funds receive their financing from multiple counterparties compounds this problem. By maintaining relationships with several parties, each individual creditor may be exposed to only a small proportion of the hedge fund's overall position, which can affect that institution's assessment of the risk.[62] According to U.S. Treasury Secretary Timothy Geithner, "[t]his gives individual firms an incentive to free-ride on the due diligence or monitoring by others, which may render resultant collective discipline inadequate."[63] Moreover, market competition within the multi-billion dollar prime-brokerage industry helps ensure that the market standards are under constant downward pressure.[64] Overall, because these inherent limitations can only be overcome by collective action, the burden of containing systemic risk must predominantly reside at the governmental level.[65]

57. *See* Kambhu, *supra* note 36, at 3–4.

58. *Id.*

59. Ben S. Bernanke, Chairman, Fed. Reserve Bank, Speech at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference: Hedge Funds and Systemic Risk (May 16, 2006), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm.

60. *See* Geithner, *supra* note 48.

61. *See, e.g.*, Lewis, *supra* note 33, at 351–55.

62. *See* Geithner, *supra* note 48.

63. *Id.*

64. *See* IMPLICATIONS, *supra* note 7, at 40. *See also* Keoun, *supra* note 51.

65. Engert, *supra* note 4, at 332.

B. The Relationship Between Hedge Fund Size and the Build-up of Systemic Risk

In addition to the problem of free-riding, the sheer size of some of the largest hedge funds can present a systemic risk to the financial system. Although hedge funds only comprise an estimated 5 percent of all U.S. assets under management, they account for an estimated 30 percent of all U.S. equity trading volume, as well as an estimated 40-50% of the daily equity volume on major international markets.[66] The primary consequence of this inverse ratio is that hedge funds can generate "externalities," which can negatively impact not only those parties in privity with the fund, but also market participants with whom the fund shares no relationship.[67] This problem primarily occurs in two ways. First, the problem occurs where a highly leveraged fund sustains a significant loss that negatively affects the creditor counterparty's liquidity.[68] This loss can impair the transacting party's ability to provide financing to other market participants who depend on that lender's capacity to extend credit.[69] Second, and perhaps more importantly, some of the largest hedge funds have the ability to significantly alter market price movements due to their enormous size.[70]

The International Organization of Securities Commissions notes that the ability for hedge funds to take concentrated positions in certain investments (compounded by the use of leverage) can "exacerbate" market volatility and lead to "disorderly asset pricing."[71] Here, losses sustained by a large fund may result in large sell-offs ("fire sales") that can depress market prices, which, in turn, can cause other market participants to sustain significant losses.[72] According to a 2008 GAO report on the hedge fund industry, "[i]f numerous market participants establish large positions on the same side of a trade, especially in combination with a high degree of leverage, this concentration can

66. Luis Aguilar, Comm'r, Sec. Exch. Comm'n, Hedge Fund Regulation on the Horizon – Don't Shoot the Messenger (June 18, 2009) *available at* http://www.sec.gov/news/speech/2009/spch061809laa.htm [hereinafter *Aguilar*]; *see also* Lewis, *supra* note 33, at 361.

67. Kambhu et al., *supra* note 36, at 11 ("An externality is the impact of one party's action on others who are not directly involved in the transaction.").

68. *See id*. at 7.

69. *See id.*

70. *See id.* at 11.

71. Geithner, *supra* note 48; *see also* GAO REPORT, *supra* note 27, at 35 (noting that the concentration of large positions on the same side of a trade can contribute to a liquidity crisis if traders are compelled to simultaneously unwind their positions).

72. *See* Engert, *supra* note 4, at 341–42.

contribute to a liquidity crisis if market conditions compel traders to simultaneously unwind their positions."[73] This problem is particularly apparent when this covariance involves short-selling. At the height of the credit crisis in September of 2008, for example, artificially negative price movements, largely the result of "naked" short-selling by institutional investors, helped facilitate the rapid deterioration of market conditions.[74] This decline was so severe that the SEC took the extraordinary measure of issuing an emergency order prohibiting fund managers from engaging in the practice of "naked" short-selling.[75] As this episode highlighted, in the absence of tighter regulatory controls, institutions may lack the incentive to "internalize" the effects of this unwinding on the market because fund managers have a greater incentive to minimize financial losses.[76] Consequently, some observers have argued that the direct regulation of hedge funds should be enacted to limit the size of the hedge fund's assets under management.[77]

In addition to the systemic risks that some of the largest funds can present, the increasing number of hedge funds may also have a destabilizing effect on market pricing as fund positions become increasingly concentrated.[78] Since Alfred Jones established the first hedge fund with one hundred thousand dollars in 1949, the number of hedge funds has grown exponentially, particularly since the 1990s.[79] In 1990, an estimated three hundred hedge funds managed a total of thirty-nine billion dollars in combined assets.[80] As of 2007, the number of hedge funds grew to an estimated ten thousand, with a total value of assets under management of $2.079 trillion.[81] The industry's remarkable

73. GAO REPORT, *supra* note 27, at 35.

74. *Id.*

75. *See* Exchange Act Release No. 34-58592, at 2.

76. *See* Geithner, *supra* note 48; *see also* Kambhu et al., *supra* note 36, at 7 ("If a bank has a large exposure to a hedge fund that defaults or operates in markets where prices are falling rapidly, the bank's . . . exposure may reduce its ability or willingness to extend credit to worthy borrowers.").

77. *See* Frankel, *supra* note 21, at 659.

78. Tobias Adrian, *Measuring Risk in the Hedge Fund Sector: Current Issues in Economics and Finance*, 13 FED. RES. BANK 3, Mar.–Apr. 2007, at 1, http://www.ny.frb.org/research/current_issues/ci13-3.pdf ("A key determinant of hedge fund risk is the degree of similarity between the trading strategies of different funds.").

79. Aguilar, *supra* note 66.

80. Daniel, *supra* note 11, at 253.

81. Oppold, *supra* note 19, at 840; KYLA MALCOLM, ET AL., IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE 15 (2009), http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf. At the time of writing, hedge fund assets under management totaled $1.917 trillion. Margot Patrick, *Hedge-Fund Assets Hit $1.917 Trillion*, WALL ST. J., Jan. 19, 2011, http://online.wsj.com/article/SB10001424052748704590704576091872684789648.html. Ironically, as a result of the Dodd-Frank Act's creation of

growth, however, has produced a growing body of evidence that suggests that greater levels of hedge fund "covariance" often precede higher levels of hedge fund volatility.[82] This hedge fund covariance is primarily because continued growth of the industry may negatively impact a fund's level of return as market positions become "saturated."[83] As fund positions become concentrated in certain market areas, fund managers may decide to incorporate a greater degree of leverage into their investment strategies in order to provide a competitive rate of return.[84]

IV. THE CURRENT STATUS OF HEDGE FUND REGULATION IN THE UNITED STATES AND THE EUROPEAN UNION

The first half of this Note has provided both an overview of the defining characteristics of the term "hedge fund" and the inherent challenges that these funds present to the stability of the financial system. Focus will now shift to the most recent regulatory measures passed in both the United States and the EU as these reforms relate to the relationship between hedge funds and systemic risk. The following comparative analysis will consider the respective reforms in the following areas: 1) the aims and structure of each set of reforms; and, 2) how effectively these reforms address the concerns over systemic risk.

A. The Dodd-Frank Wall Street Reform and Consumer Protection Act

1. The Dodd-Frank Act: Aims and Background

According to the preamble of the Dodd-Frank Act, the act is intended "[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', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."[85]

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the Volker Rule, which bans proprietary trading on behalf of bank holding companies, the number of hedge funds, and presumably the amount of assets under management, is expected to increase as a greater number of former "prop traders" enter into the industry. Murray Coleman, *Financial Reforms Expected to Boost Number of Hedge Funds*, BARRON'S (Oct. 15, 2010, 2:38 PM), http://blogs.barrons.com/focusonfunds/2010/10/15/financial-reforms-expected-to-boost number-of-hedge-funds/.

82. Adrian, *supra* note 78, at 6.

83. Schmidt, *supra* note 10, at 170.

84. *Id.*; *see* MALCOLM, *supra* note 81, at 85.

85. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203,

The Dodd-Frank Act, which became effective on July 21, 2011, has been described as the most comprehensive financial reform legislation passed in the United States since the federal securities laws established in the 1930s.[86] While the legislation itself is new, the act's proscriptions are not.

As it relates to hedge funds, the act builds upon the PWG's recommendations set forth in the aftermath of the LTCM meltdown.[87] In its 2007 final report entitled, "Principles and Guidelines Regarding Private Pools of Capital," the PWG called for a principle-based regulatory approach that "affirms that 'market discipline,' supplemented by compliance with 'industry sound practice,' is the touchstone of hedge-fund regulatory policy."[88] Although the report stressed the need for greater transparency at the investor level, it did not specifically address the more important relationship between hedge funds and their trading counterparties.[89] Moreover, the report's integrity suffered from the fact that the implementation of its recommendations remained purely voluntary.[90]

The Dodd-Frank Act's call for hedge fund registration and increased disclosure can also trace its roots to the SEC's short-lived "hedge fund rule" implemented in late 2004.[91] Intended to eliminate the "Investment Advisor exemption," the hedge fund rule modified the definition of a "client" under the Investment Advisers Act of 1940 (IAA) by allowing regulators to "look through" the fund and count each investor as a "client" rather than only counting the fund itself.[92] The latter system allowed fund managers to escape SEC registration by relying on the IAA's exemption for advisors with less than fifteen clients.[93] In a controversial 2006 opinion, the D.C. Circuit in *Goldstein v. Sec. & Exch. Comm'n* struck down the existing rule on the grounds that the term "client" under the IAA only applied to the investment

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124 Stat. 1376, 1376 (2010) [hereinafter Dodd-Frank Act].

86. VIRAL V. ACHARYA, ET AL., REGULATING WALL STREET 359 (2010).

87. *See* PWG AGREEMENT, *supra* note 34, at 25 (noting that market discipline by creditors, counterparties, and investors is the most effective mechanism for limiting systemic risk from private pools of capital).

88. John P. Hunt, *Hedge Fund Regulation: The President's Working Group Committees' Best Practices Reports – Raising the Bar but Missing Risks* 5 (Berkeley Ctr. for Law, Bus. & the Econ., Working Paper, 2008) [hereinafter *Hunt*], *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1279870.

89. *See id.* at 9–10, 16; *see also* PWG AGREEMENT, *supra* note 34, at 32.

90. *See Hunt*, *supra* note 88, at 6.

91. Lewis, *supra* note 33, at 370.

92. *Id.*

93. *See* Investment Advisers Act of 1940, 15 U.S.C. § 80B-3 (2012).

entity itself and not the number of actual investors in the fund.[94] Consequently, until Dodd-Frank was passed, hedge fund managers were not required to register with the SEC as long as they managed fewer than fifteen "entities."[95]

More recently, the magnitude of the financial crisis helped forge a general consensus to increase disclosure as a necessary predicate for establishing a more stable financial system.[96] As a result, with the aim of strengthening investor confidence, U.S. policy makers began the process of reforming the hedge fund industry by making fund manager activity more transparent at both the investor and counterparty levels.[97] It was clear from the beginning, however, that the market-based regulatory approach would remain as the cornerstone of U.S. regulatory policy and that the main focus would be on identifying the segment of funds that should be subject to greater regulatory oversight.[98] In narrowing their focus, lawmakers rejected proposals to impose tighter restrictions on trade activity or to impose a tax on systemic risk—a clear manifestation of Congress's desire to achieve a "balance" between the need for greater transparency and the desire to maintain U.S. preeminence within the industry.[99]

2. The Dodd-Frank Act: Regulatory Approach

In the United States, regulatory reforms related to the hedge fund industry are contained in Title IV of the Dodd-Frank Act.[100] According to Section 402 of Title IV, a hedge fund is essentially characterized as a "private fund" under the Investment Company Act of 1940.[101] Consequently, a hedge fund will now be considered an investment company that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."[102] Structurally, Title IV modifies the IAA by

94. Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 882 (D.C. Cir. 2006).

95. *Id*.

96. *See Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before H. Comm. on Financial Services*, 111th Cong. 42 (2009) (statement of Stuart Kaswell, Executive Vice President, Managed Funds Association) [hereinafter *Kaswell Statement*].

97. *See Perspectives on Hedge Fund Registration: Hearing Before H. Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, of the H. Committee on Financial Services*, 111th Cong. 1–3 (2009).

98. *See id.*

99. *See id.* at 5–6.

100. Dodd-Frank Act §§ 401 *et seq*.

101. *Id.* § 402(b).

102. Investment Company Act, 15 U.S.C. § 80a-3(a)(1)(A) (2004).

using the size of the fund's assets under management as the determining factor regarding whether the fund manager will be required to register with the SEC.[103] By implementing this "tiered" approach, the Dodd-Frank Act reflects the industry's prevailing view that only the largest hedge funds can present the types of systemic risk that the Act is intended to prevent.[104]

3. Addressing the Concerns Regarding Counterparty Risk and Disorderly Market Pricing

The Dodd-Frank Act intends to mitigate counterparty risk by addressing hedge fund manager activity rather than directly regulating the fund itself.[105] Central to the Act's approach is the requirement that, for the first time, managers who oversee the largest hedge funds must register with the SEC.[106] Section 408, however, specifies that hedge fund managers who act solely as an advisor to "private funds"[107] will be subject to federal registration only if their assets under management exceed $150 million.[108] Consequently, Section 408 will exclude approximately 82 percent of U.S. managed hedge funds from increased federal oversight.[109] For those funds whose assets exceed the $150 million threshold, the Act effectively eliminates the "private investment advisor exemption" in the IAA (and *Goldstein* opinion), which allowed funds to evade disclosure if the fund had less than fifteen "clients."[110] By closing this regulatory loophole, Section 404 now requires these fund managers to provide information (using a revised Form ADV) to the SEC on an annual basis regarding:

(A) the amount of assets under management and use of leverage, including off-balance-sheet leverage;
(B) counterparty credit risk exposure;
(C) trading and investment positions;

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103. *See* Dodd-Frank Act §§ 401, 408.

104. *See* Mary L. Schapiro, Chairman, U.S. Sec. and Exch. Comm'n, Opening Statement - SEC Open Meeting: Private Fund Systemic Risk Reporting (Jan. 25, 2011).

105. MARK JICKLING & KATHLEEN ANN RUANE, CONG. RESEARCH SERV., R41398, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: TITLE VII, DERIVATIVES 2 (2010*), available at* www.llsdc.org/attachments/files/239/CRS-R41398.pdf.

106. *See* Dodd-Frank Act § 408.

107. Under § 402 of the Dodd-Frank Act, "private fund" is defined as "an issuer that would be an investment company under Section 3 of the Investment Company Act of 1940 (15 U.S.C. § 80a-3)."

108. Dodd-Frank Act § 408. In addition, § 410 of the Dodd-Frank Act raises the threshold for federal registration of all investment advisors from $25 million to $100 million.

109. *See* ACHARYA, *supra* note 86, at 359.

110. Investment Company Act § 80b-3(b)(3).

(D) valuation policies and practices of the fund;
(E) types of assets held;
(F) side arrangements [(side pocket agreements)] . . . ; [and]
(G) [the fund's] trading practices[.][111]

In addition, registration pursuant to the IAA requires the implementation of, among other things, a compliance program, an insider trading policy, and a code of ethics.[112]

As a complement to Section 404's informational requirements, the section also provides the SEC with the authority to require fund managers to provide additional information that the Commission may consider to be of public interest.[113] Currently, the SEC is proposing that "large" hedge fund managers with over $1 billion in assets under management provide quarterly reports using a newly proposed reporting form (Form PF).[114] As it stands, the rule would apply to an estimated two hundred funds, which, in the aggregate, manage about 80 percent of all hedge fund assets.[115]

The prospect of forced disclosure was met with concerns from many fund managers over the confidentiality of the fund's proprietary investment information.[116] In particular, the ability to compile and disseminate asymmetrical information is a key component in maintaining a competitive advantage for those funds whose investment strategies rely upon the theory of market inefficiency.[117] This is because these funds' investment strategies are often predicated on exploiting market price discrepancies to secure short-term gains.[118] Accordingly, public disclosure of this information would essentially neutralize the fund manager's ability (and incentive) to realize gains using this type of investment approach. For this reason, Section 404 exempts "proprietary information" from public disclosure even though the SEC and the FSOC will review this information.[119]

Disclosure will have an effect on the extent to which counterparties are willing to transact with a particular fund in addition

111. Dodd-Frank Act § 404.
112. *See* Investment Advisers Act of 1940, 15 U.S.C. § 80B-3(c) (2012).
113. Dodd-Frank Act § 413.
114. *See SEC Proposes Private Fund Systemic Risk Reporting Rule*, U.S. SEC. & EXCHANGE COMMISSION (Jan. 25, 2011), http://www.sec.gov/news/press/2011/2011-23.htm.
115. *Id.*
116. *See Kaswell Statement, supra* note 96, at 42.
117. *See* Lewis, *supra* note 33, at 357.
118. *Id.*
119. Dodd-Frank Act § 404 (characterizing "proprietary information" as including investment strategies, analytical and research methodologies, trading data, and computer software containing intellectual property).

to its effects on fund managers from monetary costs associated with compliance.[120] The most obvious advantage of Title IV's approach is that this information can be used to make each fund's market activity significantly more transparent, thereby allowing investors and counterparties to more accurately ascribe the fund's level of risk. From this standpoint, mandatory disclosure is intended to protect other, more systemically important, market participants, such as prime brokerages (some of which were bailed out at the height of the credit crisis), by bolstering the effectiveness of market discipline.[121] Of course, greater transparency will also have the added benefit of enhancing investor protection by preventing investment manager fraud.[122]

While there is a tendency to view "smaller funds" as systemically non-important, Section 408 includes a provision for the registration of "mid-size" funds that do not meet the $150 million threshold.[123] Registration of these funds will not be automatic, however, and will only be required on an ad-hoc basis where the SEC determines that the fund may pose a systemic risk.[124] Because Section 408 does not define a "mid-size" fund, the impact of Section 408 on this segment of the industry is not immediately clear. Moreover, the Act also does not specifically address smaller funds that may incorporate high leverage amounts.[125] Currently, there remains the distinct possibility that this class of funds will be spared the burdens of increased disclosure.[126]

Title IV's focus on disclosure provides market participants with the information necessary to enhance market discipline while providing regulators with a better insight into the build-up of systemic risk within the financial system.[127] Perhaps U.S. Deputy Secretary Neal Wolin stated it best when he remarked that, "to constrain systemic risk effectively, the Council [FSOC] and its members must be able to monitor systemic risk effectively."[128] In this way, disclosure helps

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120. IMPLICATIONS, *supra* note 7, 46–47.

121. *See Perspectives on Hedge Fund Registration: Hearing Before H. Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, of the H. Committee on Financial Services*, 111th Cong. 12–14 (2009) (statement of W. Todd Groome, Chairman, Alternative Inv. Mgmt. Ass'n (AIMA)).

122. *See* ACHARYA, *supra* note 86, at 357.

123. *See* Dodd-Frank Act § 408.

124. *Id.*

125. *See id.*

126. *See id.*

127. Neal S. Wolin, Deputy Secretary, Dep't of the Treasury, Remarks at the Georgetown University McDonough School of Business (Oct. 25, 2010), *available at* http://www.benzinga.com/life/politics/10/10/550287/deputy-secretary-neal-s-wolin-remarks-at-georgetown-university-mcdonough-.

128. *Id.*

ensure that market regulators are not fighting yesterday's battles. Because a large amount of the most important fund information will not be made public, however, the effectiveness of this approach as a regulatory instrument will likely be determined by the extent to which regulators are able to proficiently wield it.[129]

Aside from its impact on transparency, it does not appear that Title IV will directly impact a fund's ability to generate unwanted market externalities resulting from concentrated investment positions. To be sure, while stronger market discipline may reduce the extent to which the use of leverage can promote market concentration, the Act does not prohibit fund managers from engaging in high-risk strategies, nor does it impose any direct form of leverage restriction or liquidity requirements.[130] At this time, the Act only instructs the SEC to conduct a study regarding the feasibility of requiring hedge funds to report, in real-time, their short-sale positions.[131]

4. The Role of the Financial Stability Oversight Council (FSOC)

What is surely one of the most significant, if not most controversial, means by which the Act addresses the build of systemic risk is through the creation of the Financial Stability Oversight Council (FSOC) under Section 111.[132] The Act envisions the FSOC, which will be chaired by the U.S. Treasury Secretary and will include members of the Federal Reserve Board, will play a vital role in determining which market participants are systematically important enough to warrant increased federal oversight.[133] The creation of the FSOC is an important step in containing the build-up of systemic risk because the FSOC can overcome the inherent collective action problem that can undermine the effectiveness of market discipline. Due to the potential for the disorderly unwinding of concentrated market positions under certain conditions, it may not be enough to know about a counterparty's position *vis-à-vis* a particular fund.[134] Consequently, the FSOC's ability to compile information about the aggregate exposure of all market participants who may be forced to unwind their positions significantly enhances the traditional, market-based, regulatory system.

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129. *See* John Carney, *Hedge Funds: The Next Too Big To Fail Monsters*, CNBC.COM (Jan. 13, 2011), http://www.cnbc.com/id/41056905.

130. *See* Dodd-Frank Act §§ 115, 619.

131. *Id.* § 727. At the time of writing, the SEC was still in the preliminary stages of conducting its investigation on this very significant topic.

132. *Id.* § 111.

133. *See* Wolin, *supra* note 127.

134. *See* Engert, *supra* note 4, at 345.

Undoubtedly, determining which hedge funds should be considered systemically important is complicated by the fact that hedge funds are heterogeneous; not all funds pursue the same strategy or operate in the same markets. Consequently, many hedge funds may not be systemically important at all.[135] In considering which funds to deem systemically important, the FSOC proposes a comprehensive list of eleven "considerations" it will follow in identifying important funds to be subject to the FSOC's supervision.[136] These considerations include: "the extent of . . . leverage of the [fund][;]" the fund's "off-balance-sheet exposures[;]" the "interconnectedness" of the fund; and the fund's relationships with other market participants.[137]

Of course, the ability for the FSOC to oversee, and potentially intrude upon, fund manager activity under certain conditions is highly controversial.[138] To some in the industry, the competitiveness of U.S. financial institutions "will, under this new structure, inevitably be subordinated to supervisory judgments about what these firms can safely be allowed to do."[139] There also remains the question of whether a fund that comes under the supervision of the FSOC will be allowed to fail.[140] However, when construed against the other alternatives, namely, to exclude any form of final oversight, the creation of the FSOC represents the most effective option for providing a last line of defense absent more direct forms of regulation.[141] Furthermore, at this time, the concerns surrounding the FSOC's authority in this area may prove to be unfounded because it is unclear that the FSOC is even convinced that hedge funds can present a systemic risk.[142]

While it is certainly difficult to make the argument that increased disclosure is a step in the wrong direction, there are some early indications that suggest that enhanced disclosure may entail some

135. *See* Ronald D. Orol, *SEC Defends Tighter Rules for Some Hedge Funds* MARKETWATCH (Oct. 26, 2010), *available at* http://www.marketwatch.com/story/sec-defends-tighter-rules-for-some-hedge-funds-2010-10-26.

136. FINANCIAL STABILITY OVERSIGHT COUNCIL, 12 CFR CHAPTER XII: ADVANCE NOTICE OF PROPOSED RULEMAKING AUTHORITY TO REQUIRE SUPERVISION AND REGULATION OF CERTAIN NONBANK FINANCIAL COMPANIES, FR Doc. 2010-2532, *available at* http://www.treasury.gov/initiatives/documents/2010-25321_PI.pdf [hereinafter *FSOC Proposal*].

137. *Id.*

138. *See* Rachelle Younglai and Dave Clarke, *Hedge Funds May Skirt Direct Fed Scrutiny,* REUTERS (Dec. 20, 2010, 3:00PM), http://www.reuters.com/article/2010/12/20/us-fed-hedgefunds-idUSTRE6BJ4O220101220.

139. Peter Wallison, *The Dodd-Frank Act: Creative Action, Destroyed*, AM. ENTERPRISE INST. (Aug. 30, 2010), *available at* http://www.aei.org/outlook/100983.

140. *Id.*

141. *Id.*

142. Younglai & Clark, *supra* note 138.

unintended consequences. Most notably, the cost of complying with the new rules is predicted to be a major consideration in determining the economic viability of many smaller funds.[143] Due to the predicted cost of compliance, many smaller funds that will be subject to registration may be forced to merge with larger funds that are generally viewed by investors as more stable.[144] Moreover, there is also the fear that the continued consolidation of the industry will inspire "money managers[,] who might otherwise [establish] their own [funds]," to work for the larger, more established funds.[145] Consequently, the act may have the effect of moving the industry in the direction of increasingly larger funds, which could present the same systemic problems that the legislation was intended to reduce.[146]

B. The Alternative Investment Fund Manager Directive (AIFMD)

1. The AIFMD: Aims and Background

In accordance with the European Union's pre-existing regulatory regime, investment funds have been categorized as either UCITS or non-UCITS.[147] The former includes pension and mutual funds that are available on the retail market and are strictly regulated under the UCITS Directive (85/611/EEC).[148] The latter, also known as "alternative investment funds," encompasses private equity and hedge funds—which will now fall under the auspices of the AIFMD.[149] Prior to the creation of the directive, the regulation of non-UCITS solely resided with the regulatory body of the fund's home member-state.[150] In fact, prior to the passage of the AIFMD, there was not a single European community law that specifically addressed hedge fund manager activity.[151] As the financial crisis demonstrated, this patchwork regulation did not effectively manage the inherent cross-border risks associated with hedge fund activities. In its assessment of the key impacts of the AIFMD, the EU Commission Staff reported that, "the inability to piece together a comprehensive picture of AIFM leverage

143. *See, e.g.*, Carney, *supra* note 129.
144. *E.g., Bigger, Safer but Duller*, *supra* note 3.
145. Carney, *supra* note 129.
146. *Id.*
147. *Commission Staff Working Document Accompanying the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers: Impact Assessment*, at 4, COM (2009) 207 (Apr. 30, 2009).
148. *Id.*
149. *See id.*
150. *See id.* at 44.
151. *See generally id.* (proposing AIFMD in the absence of other EU law).

and activities in all major European markets is a major flaw in existing systems[.]"[152] As a result, the AIFMD was established independently for the specific purpose of regulating private pools of capital.[153] According to the directive's text, "the Directive aims at establishing a framework capable of addressing the potential risks that might arise from the activities of AIFMs and ensuring the effective monitoring of those risks by the competent authorities within the Union."[154]

Passed by the European Parliament and European Council in the fall of 2010, the AIFMD represents the most aggressive and comprehensive measure taken by the EU to establish unified standards for regulating hedge fund activity within the Union. Although, as recently as 2006 the European Commission conducted a study on the European hedge fund industry that called for regulators to further a policy of allowing fund managers to pursue a strategy of "enlightened self interest."[155] The initial draft of the current directive was notable for being far more extreme than its U.S. counterpart.[156] The lack of an existing framework also made the drafting of the directive a painstakingly slow process that consumed over two years, largely because of member state disagreements over the scope of the proposed reforms.[157] Most prominent among these disputes was the issue of the so-called European "passport," which involved the question of whether a fund's compliance with the provisions of the directive would allow that fund to solicit investors in all member states.[158]

A number of influential members, particularly France and Germany, opposed the creation of a passport system, arguing that member states should be able to enact their own domestic regulations in

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152. *Id.* at 18.

153. This process was not lost on some industry leaders during the drafting of Dodd-Frank, who argued that the EU's tailored approach—which distinguished hedge funds from other types of private investments—was superior to the American "patchwork" approach, which did not. *See Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. 45–46 (2009) (statement of James S. Chanos, Chairman, The Coalition of Private Investment Companies).

154. *See* Council Directive 2011/16, *supra* note 31, at 14.

155. EUROPEAN COMMISSION INTERNAL MARKET AND SERVICES DG, REPORT OF THE ALTERNATIVE INVESTMENT GROUP TO THE EUROPEAN COMMISSION: MANAGING, SERVICING, AND MARKETING HEDGE FUNDS IN EUROPE 4 (July 2006).

156. *See generally* Council Directive 2011/16, *supra* note 31.

157. Georges A. Boivin, *Cayman Islands: EU Directive on Alternative Investment Fund Managers: Uncertainty and More Delays – Prospective from a Swiss Point of View*, MONDAQ (Aug. 8, 2010), http://www.mondaq.in/article.asp?articleid=107528.

158. *See EU Agrees "Imperfect" Deal to Regulate Hedge Funds*, EURACTIV.COM (Oct. 27, 2010), http://www.euractiv.com/euro-finance/eu-agrees-imperfect-deal-regulat-news-499194.

addition to those contained in the AIFMD.[159] In the end, however, the reality of squandering an opportunity to reform this important industry—helped in no small part by the extensive lobbying efforts of the UK and the hedge fund industry—was too high a political cost, and the passport system prevailed.[160] The AIFMD, however, has not been without its detractors. Indeed, one of the most prevalent critiques of this process is that regulators have placed "the cart before the horse" by not addressing more immediate systemic concerns, such as the size of large financial institutions, short selling, and the use of derivatives—areas that played a more visible role in the onset of the financial crisis.[161]

2. The AIFMD: Regulatory Approach

The AIFMD prohibits fund managers from managing or marketing a hedge fund to professional investors in the EU unless the fund manager has been authorized in accordance with the terms of the directive.[162] The primary advantage of this "passport" system is that authorized fund managers will be allowed to market and solicit funds in every member country without having to receive regulatory authorization on an individualized basis. According to Article 4 of the directive, hedge funds will be classified as "Alternative Investment Funds" (AIF), defined as any "collective investment . . . which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy" and is not authorized pursuant to Article 5 of the Directive 2009/65/EC.[163] Like its U.S. counterpart, the AIFMD restricts investor access to hedge funds to only those individuals and institutions qualified as a "professional investor."[164]

Encompassing the so-called "passport" provision, Article 32 provides that any EU authorized fund may market shares to professional investors in any member state.[165] Correspondingly, hedge funds managed outside of the EU must comply with the provisions of the directive, in accordance with Article 39, in order to gain access to EU

159. *Id.*; *see also* Stephen Fidler, *Hedge Fund Talks: The End Game?* WALL ST. J., Sept. 28, 2010, *available at* http://blogs.wsj.com/brussels/2010/09/28/hedge-fund-directive-the-end-game/.

160. *See EU Agrees "Imperfect" Deal to Regulate Hedge Funds, supra* note 158.

161. Andrew Baker, *The Long*, HFMWEEKONLINE (Dec. 13, 2010), http://www.hfmweek.com/blogs/the-long/650977/comment-andrew-baker.thtml.

162. Council Directive 2011/16, *supra* note 31, art. 6.

163. *Id.* art. 4(a).

164. *See id.* art. 4(af)-(ag).

165. *Id.* art. 32(1).

community investors.[166] In addition, the foreign fund must also ensure that arrangements are made to coordinate the flow of information between the regulatory authority of the fund's home country and the appropriate authorities in the member state.[167] Initially, the passport regime was the cause of much consternation in the United States due to the fear that U.S. managed funds would have to comply with the directive or else risk being locked out of the European market.[168] However, this fear appears to have dissipated recently as it is widely suspected that the directive will consider the U.S. regulatory requirements to satisfy the directive's prerequisites.[169] Ironically, for reasons discussed below, it may now be less expensive for U.S. based hedge funds to solicit funds from investors in member states than it is for union countries.

Currently, the implementation of the AIFMD is planned to consist of at least three phases.[170] Phase One covers the authorization of, and the operating conditions for, the AIFM Directive.[171] The second phase will establish provisions regarding "depository requirements."[172] The third, phase will address provisions relating to transparency requirements and the use of leverage.[173] At the time of writing, however, only Phase One has been passed with the subsequent phases to be drafted and voted on in the coming months. Consequently, although the basic regulatory framework is now in place, the detail of the directive's provisions will become more apparent in the months ahead.

Structurally, the AIFMD, like the Dodd-Frank Act, targets the investment manager rather than the fund itself.[174] Moreover, the size of the fund's assets under management is also the determining factor in classifying which funds will be subject to the directive's requirements.[175] In accordance with Article 3, two classes of hedge fund managers will now be subject to heightened regulatory scrutiny.[176] The

166. *Id.* art. 39(1).

167. *Id.* art. 39(2).

168. *See Investing: Alternative Visions*, *supra* note 6.

169. Hester Plumridge, *Hedge Funds Win Big in Brussels*, WALL ST. J. (Oct. 20, 2010), *available at* http://online.wsj.com/article/SB10001424052702304741404575564133358359888.html.

170. *Provisional Request to CESR for Technical Advice on Possible Level 2 Measures Concerning the Future Directive on Alternative Investment Fund Managers* § I.1, COM (2010) 892960 final (Dec. 2, 2010).

171. *Id.*

172. *Id.*

173. *Id.*

174. *See generally* Council Directive 2011/16, *supra* note 31.

175. *See id.* art. 26.

176. *See id.* art. 3(2).

first class will be comprised of those fund managers using leverage with over €100 million in assets under management.[177] The second class will broadly consist of managers with total assets of over €500 million, regardless of the use of leverage.[178] By triggering registration at a lower figure for those funds using leverage, Article 3 directly addresses a category of funds that Dodd-Frank does not—smaller funds that incorporate significant amounts of leverage into their investment portfolios.[179] For those funds that do meet the Directive's threshold, Article 6 still requires the fund manager to register with the regulatory authority of their home Member State.[180] These smaller funds, however, may "opt-in" under Article 32 to avail themselves of access to professional investors in other union member states.[181] Under the AIFMD, member states will have two years to establish the domestic legislation necessary to implement the Directive before it becomes effective in January 2013.[182] After that date, fund managers will have up to one year to comply with the Directive's requirements.[183] For those funds managed outside of the EU, the wait will be considerably longer because the directive will not become effective until 2015.[184]

3. The AIFMD: Addressing the Concerns Regarding Counterparty Risk and Disorderly Market Pricing

The most salient feature of the AIFMD is the transfer of national regulatory control over alternative investments to EU standards, at least with respect to systemically important funds. While the Directive establishes trans-national standards, the primary responsibility for ensuring fund manager compliance with the Directive will reside not with EU authorities but with regulators in the fund's home member state.[185] The European Securities and Markets Agency (ESMA), the financial regulatory authority of the EU, will retain primary responsibility for regulating foreign hedge funds and may coordinate with member states to establish protective measures for member-state

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177. *Id.* art. 3(2)(a)
178. *Id.* art. 3(2)(b).
179. *Id.* art. 3.
180. Council Directive 2011/16, *supra* note 31, art. 6.
181. *Id*. art. 32.
182. Nikki Tait & Martin Arnold, *Brussles Agrees to Hedge Fund Rules*, FIN. TIMES (Oct. 26, 2010), *available at* http://www.ft.com/intl/cms/s/0/74a47cf8-e0f5-11df-87da-00144feabdc0.html#axzz1Z5WEgRXy.
183. Council Directive 2011/16, *supra* note 31 arts. 32(2), 51.
184. Tait, *supra* note 182.
185. *See* Council Directive 2011/16, *supra* note 31 arts. 5–6.

funds.[186]

Although the AIFMD and the Dodd-Frank Act promote fund manager disclosure as the cornerstone of their respective frameworks, it is clear that regulators under the AIFMD will retain a significantly greater degree of direct regulatory control over fund manager activity than those in the United States. Specifically, the AIFMD addresses the relationship between hedge fund activity and systemic risk in two ways. First, Chapter IV of the Directive requires fund managers to make comprehensive disclosures to both investors and to the regulatory body of home member state.[187] Second, Chapter V of the Directive grants both the member state and the ESMA the power to monitor, and even limit, the degree to which fund managers may incorporate leverage.[188]

Like the Dodd-Frank Act, the most salient feature of the AIFMD is the degree to which fund managers will be required to disclose their investment activities. Once the Directive becomes effective, fund managers will be required to submit annual reports to investors disclosing, among other things: a current balance sheet, the fund's investment strategy, and the circumstances in which the fund may incorporate leverage into its investment strategy.[189] Under Article 24, fund managers will also be required to provide a more detailed annual report to regulators in the fund's home member state.[190] Specifically, the report must include information regarding the instruments and markets in which the fund is invested, the main categories of assets in which the fund is invested, and the percentage of the fund's illiquid assets.[191] In addition, the Directive takes the remarkable step of requiring each fund manager to establish a maximum level of leverage that the fund may incorporate into its strategy.[192]

The Directive's disclosure requirements seek to limit systemic risk in two important ways. First, as discussed above, disclosure enhances market discipline by providing counterparties and other market participants with the information necessary to implement effective risk management policies. In doing so, the Directive, like the Dodd-Frank Act, aims to protect other systemically important institutions that maintain relationships with hedge funds by enhancing market discipline.

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186. *See* Frequently Asked Questions, *supra* note 9.

187. Council Directive 2011/16, *supra* note 31, arts. 22–24.

188. *Id*. art. 25.

189. *Id.* art. 19.

190. *Id.* art. 24.

191. *Id.* art. 21. Furthermore, the directive grants the appropriate authorities the ability to request further information on an *ad hoc* basis. *Id.* art. 47.

192. Council Directive 2011/16, *supra* note 31, art. 22.

Of course, the degree to which the Directive's disclosure requirements will enhance market discipline depends in large part on the actions of individual counterparties, as well as future industry reforms aimed at the fund-creditor relationship.

Second, the Directive also addresses the problem of systemic risk by providing regulators in both the home Member State and the ESMA with detailed fund information that can help these authorities identify the extent to which the fund's use of leverage contributes to the build up of systemic risk.[193] According to one analysis of the directive's impact, although there is no clear evidence that proves that disclosure of the fund's use of leverage to investors reduces systemic risk, such disclosure is "necessary in order to improve macro-prudential oversight."[194] As mentioned earlier, the extent to which regulators under the AIFMD can exercise direct control over fund manager activity represents the most significant divergence with the Dodd-Frank Act. Nowhere is this departure more apparent than in the enormous power granted to the regulatory authorities of the fund's home member state under Article 7. Specifically, the Article provides individual state regulators with the authority to restrict the scope of the fund manager's authorization by placing limitations directly on the fund's investment strategy.[195]

4. The Role of European Securities and Markets Authority (ESMA)

So what happens in the event that regulators determine that a hedge fund presents an unacceptable systemic risk? Article 25 provides that home-State regulators, under advisement with the ESMA and the newly created European Systemic Risk Board (ESRB), can restrict the fund's use of leverage as well as place "restrictions" on the management of the fund.[196] Moreover, the ability for regulators to restrict the use of leverage is not necessarily fund-specific, as restrictions can be placed on particular groups of funds.[197] Similarly, Article 45 affords ESMA with the power not only to prohibit the marketing of non-member funds within the union, but also to impose restrictions on non-member fund managers where their activities are believed to present a systemic or counterparty risk.[198] In this way, the role of the ESMA as a fund

193. *Id.* art. 25(1).
194. MALCOLM, *supra* note 81, at 88.
195. Council Directive 2011/16, *supra* note 31, art. 7.
196. *Id.* art. 25.
197. *Id.* art. 42.
198. *See id.* art. 45.

overseer may be much like the Financial Services Oversight Committee in the United States.[199]

A closer inspection of Article 45 reveals that home-State regulators, under Article 25, will have broader authority to impose restrictions than the EU-level ESMA. This is because Article 45 delineates the particular circumstances that will trigger the exercise of the ESMA's authority. Specifically, the ESMA may take action where a "substantial threat" exists with respect to the cross-border financial system *and* where home-State authorities have not taken sufficient measures to address the threat.[200] The scope of the ESMA's authority to act, however, is severely limited under the same Article because of the mandate that the organization's actions must not create the risk of regulatory arbitrage or hamper the efficiency of the financial markets in a disproportionate manner.[201] Consequently, the narrow parameters in which the ESMA may act could have a chilling effect on the organization's incentive to take immediate action. Furthermore, the Directive does not provide an explanation of what a "substantial threat" constitutes, making it unclear whether such a threat would relate solely to the build-up of systemic risk or threats to other areas of the market in which the fund does not transact.

The effectiveness of the Directive's ability to constrain systemic risk will significantly depend on a number of variables, not the least of which will include the ability of home-State authorities and the ESMA to seamlessly cooperate, as well as the timeliness of imposing leverage restrictions. As to the former, although Article 48 of the Directive obligates home-State authorities and the ESMA to cooperate, the Directive conspicuously fails to provide the ESMA with final decision-making authority.[202] In the event of a disagreement between these parties, the Directive will instead require ESMA mediation.[203] Of course, while the likelihood of a significant disagreement may ultimately be non-existent, the European Union's ongoing solvency problems have demonstrated that collective action amongst Member States is not necessarily a given when it comes to economic policy

199. At this stage, however, the scope of ESMA's authority is much more defined than the American FSOC.

200. Council Directive 2011/16, *supra* note 31, art. 47.

201. *Id.*

202. *Id.* art. 48; *see* Mirzha de Manuel, *Why Passport Flexibility Comes at a Price* FIN. TIMES (Dec. 12, 2010), http://www.ft.com/intl/cms/s/0/3277e83e-048f-11e0-a99c-00144feabdc0.html#axzz1Z69q3lTo.

203. *See* Council Directive 2011/16, *supra* note 31, art. 48.

matters.[204] Furthermore, the lack of overriding decision-making authority could also mean that coordination in times of crisis could be dangerously slow.

Regarding the latter, according to one impact assessment, the ability for regulators to restrict the use of leverage in extraordinary circumstances may not even address the actual build-up of systemic risk.[205] In fact, one of the most prevalent concerns regarding the use of leverage restrictions is that the limitations themselves may actually intensify the ability for hedge funds to generate externalities.[206] According to the same study, the imposition of leverage restrictions will likely result in an environment in which fund managers will operate close to the designated leverage limitations.[207] Consequently, in the event that market conditions deteriorate, these funds may be forced to sell assets "beyond what might be necessary from the perspective of retaining sufficient collateral with brokers" to stay within the leverage limitations.[208] Another inherent limitation on the Directive's impact is the modest size of the European hedge fund industry itself. As of late 2009, only 5 percent of the global hedge fund industry was based in the EU, with only an estimated 26 percent of all hedge fund assets managed within the European community.[209] Thus, the effectiveness of actions taken by the relevant European authorities may be quite limited where the conditions giving rise to financial instability reside outside of the EU.

V. CONCLUSION

So, have the United States and the EU fallen out of step on hedge fund reform? Although this remained a distinct possibility in early 2010, the final legislation passed on both sides of the Atlantic shows that the two sides have largely ended up in the same place. In being the first member of the G-20 to pass financial reform in this area, U.S. policy makers hoped that the Dodd-Frank Act would provide the model the rest of world would adopt.[210] Thus far, however, this goal has failed to

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204. *See, e.g.,* Mohamed El-Erian, *Europe Is Running Fast to Stand Still,* FIN. TIMES (Jan. 17, 2011), http://www.ft.com/intl/cms/s/0/89c3e2bc-222d-11e0-b91a-00144feab49a.html#axzz1ZHzkF2Ze.

205. MALCOLM, *supra* note 81, at 4.

206. *Id.* at 90.

207. *Id.*

208. *Id.*

209. *Id.* at 90–91.

210. Tom Braithwaite & Francesco Guerrera, *Financial Regulation: A Garden to Tame* FIN. TIMES (Nov. 11, 2010), http://cachef.ft.com/cms/s/0/90873016-f016-11df-88db-

materialize. Both sides have rightly decided to make disclosure the centerpiece of their respective reform agendas without implementing measures that will make compliance too onerous from a competitive standpoint.[211] The financial reforms adopted by the United States and the EU do show that differences remain, however. Without question, fund managers in the EU will face a greater level of regulatory scrutiny than their American competitors. By contrast, in the United States, there still remains the question of what form the FSOC will take, if one will ever take form at all. What is sure is that even with these reforms in place the global hedge fund industry will likely consolidate, albeit while continuing to grow. Amidst all this uncertainty, only time will reveal the true measure of whether policy makers on both sides of the Atlantic have achieved their goals of implementing a more stable industry—or, conversely, whether these recent reforms will have planted the seeds from which the next major crisis will grow.

00144feab49a.html.

211. Sam Jones, *Investors Seek Transparancy in Hedge Funds*, FIN. TIMES (Nov. 8, 2010), http://www.ft.com/intl/cms/s/0/ee29d874-eb5f-11df-b482-00144feab49a.html#axzz1ZZFTV0Cp (noting that "[t]ransparency is the leading concern investors share about the publicity-shy $1,800bn global hedge fund industry . . . .").