I-1.14 The Future of Hedge Fund Regulation: A Comparative Approach

United States, United Kingdom, France, Italy and Germany

By Anne Rivière

Introduction

Hedge funds are important actors in the global economy that managed 1,7 trillion dollars in 2009, a 13% increase compared to 2008 and down from 2,1 trillion in 2007. It is estimated that 9 400 hedge funds are operating worldwide, a reduction of more than 1 000 funds from the 2007 peak, due to the financial crisis during which three quarters of hedge funds suffered an average 15,7% loss[1].
Although the industry has faced some difficulties over the past two years, hedge funds play an important role in the global financial system. They assure efficiency in capital markets, they are a significant source of liquidity, and they absorb financial risks. The benefits these investment vehicles bring to the markets are essentially made possible by flexible and light regulatory regimes. Unlike registered investment companies, they escape most of the disclosure, reporting and leverage requirements.

Hedge funds didn't cause the current crisis, yet there seems to be a consensus among regulators around the world for more regulation. One may wonder why that is and whether regulators are not confusing targets. The rationale behind this desire to take action is twofold. The first concern is systemic risk, which we define here as the risk of chain reactions of failures. The current crisis has shown, if it still needed to be shown, that markets are deeply interconnected and rely on one another. The size and complexity of hedge funds may make some of them systemically significant and likely to provoke chain reactions that could lead to a generalized collapse of financial markets.

In light of the failures of Long Term Capital Management in 1998 and Amaranth Advisors in 2006, the question of whether hedge funds pose a systemic risk needs to be asked and the potential remedies need to be evaluated. Carrying out such assessments can be challenging for regulators if they do not have the tools to evaluate risks. Some entities may escape their oversight, which has become a justification for more regulation. The second concern that according to regulators justifies hedge regulation is the need to achieve greater transparency and cure informational asymmetries in order to guarantee an appropriate level of investor protection.

This paper examines in its first part the relevance of these two arguments. It provides an comparative overview of legal regimes applicable to hedge funds in five jurisdictions. It focuses primarily on the United States and explores four European Union member states' hedge fund regulations. The United Kingdom, France, Germany and Italy have been chosen, for these countries are representative of the variety of legal frameworks that coexist within the European Union. It concludes that

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[1] International Financial Services London (IFSL) Research, *Hedge Funds 2009,* April 2009, *available at* http://www.ifsl.org.uk

although systemic risk may be a legitimate concern, the investor protection argument is questionable.

Part II explores what the future of hedge fund regulation could look like based on the different proposals that have been sketched out in the past few months[2].

The European Union[3] ("EU") has introduced the controversial Directive on Alternative Investment Fund Managers ("AIFM") in April 2009 and the U.S. House of Representatives has enacted the Private Fund Investment Advisers Registration Act of 2009[4] ("PFIARA").

These recent proposals introducing more regulation are presented and discussed in Part II in which a lack of global coordination in attempts to reform hedge funds is also identified.

Part III develops the idea that hedge funds do not need more but better regulation. The paper proposes a framework to assess whether more regulation is the answer and makes several suggestions as to what elements legislators should take into account in the costs/benefits analysis that should precede any attempt to introduce regulation.

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

Definition

There is no formal legal nor universally accepted definition of the term "hedge fund". It generally refers to a broad category of pooled investment vehicles, privately organized, administered by professional investment managers, and not widely available to the public but rather to wealthy and sophisticated individuals or institutional investors.
Hedge funds can be defined by their characteristics as private investment partnerships or investment corporations that use a wide variety of trading strategies in order to seek absolute returns such as position-taking in a range of different markets. They employ an assortment of trading techniques and instruments, often including short-selling, derivatives and leverage[5].

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[2] This paper was written in the middle of the legislative discussions in the EU and in the U.S. in March 2010. Therefore the data are subject to change.

[3] Although the European Union will be studied as a whole, the paper shall mention the disagreements that may exist within the member states

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

[5] Financial Services Authority, *Hedge Funds and the FSA,* Discussion paper 16, 2002, at 8

Strategies and instruments vary a great deal from one hedge fund to the other. William Donaldson underlines that "these pools of capital may or may not utilize the sophisticated hedging and arbitrage strategies that traditional hedge funds employ, and many appear to engage in relatively simple equity strategies"[6]. Another way to distinguish hedge funds from other investment vehicles is their particular compensation system, generally consisting in a management-based fee of 1 to 2% and a performance fee of 20% in average, which is quite unique.
From a legal perspective, hedge funds in the United States, are investment vehicles that are not regulated as investment companies and that rely on various exemptions offered by federal securities laws. This relative lack of regulation can also be observed in the European Union, although approaches on how to deal with hedge funds vary between the United States and the European Union, and even among European Union member states themselves.

The term hedge fund appears to be is a "catch-all classification"[7] and therefore a preliminary remark needs to be made. It seems that regulating such a large range of investment vehicles, with different strategies, different structures, different sizes in an uniform manner may be a questionable call. Indeed, it carries the risk of inappropriate, too vague or counterproductive regulation depending on the characteristics of each hedge fund. The heterogeneity that exists within the hedge fund industry must be kept in mind when discussing further regulations.
It is equally important to remember that hedge fund regulation actually designates different realities and that it may take three forms. It may refer to regulating the fund itself, regulating the fund adviser/manager or regulating the fund's operations. The way hedge funds are regulated and the degree to which they are regulated varies from one jurisdiction to another.
Some regulate hedge fund advisers, whether partially (USA) or completely (UK), some regulate the funds directly (Germany) and some regulate both (France).
This paper challenges the idea that hedge funds need more regulation. It argues instead that they need more effective regulation that is flexible and tailored to their specific characteristics and risks. Trying to develop a better regulatory framework starts with a better understanding of what hedge funds are, of what their role in the financial markets is, of what risks they may entail for the stability of the global financial system and of what the impact of current regulatory frameworks on hedge fund performances is. Such an analysis is necessary in order to understand the issues at stake and to properly assess the impact of future reforms.

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

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[6] William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, *Testimony Concerning Investor Protection Implications of Hedge Funds Before the Senate Committee on Banking, Housing and Urban Affairs*, April 10, 2003, *available at* http://www.sec.gov/news/testimony/041003tswhd.htm

[7] William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, *Testimony Concerning Investor Protection Implications of Hedge Funds Before the Senate Committee on Banking, Housing and Urban Affairs*, April 10, 2003, *available at* http://www.sec.gov/news/testimony/041003tswhd.htm

It is commonly assumption that hedge funds are lightly regulated investment vehicles that play an important role and tend to make markets more efficient (1) although they are not exempt from several critics which has led various jurisdictions to consider reforms (2).

1. Hedge funds are important market players, already regulated to a certain extent

1. 1 The benefits of hedge funds for the financial system Hedge funds offer investors, fund managers and the markets in general several benefits and in many respects look more attractive than traditional vehicles.

To investors, first of all, hedge funds provide a potential for substantial returns that are not necessarily correlated with the market by using a wide range of strategies. "As such, hedge funds may be an important diversification tool in an investor's overall investment portfolio because they minimize overall volatility and provide access to sectors and strategies not otherwise available"[8]*.* Thus, for investors who are willing to risk large sums of money in order to get greater returns, hedge funds are an interesting alternative to traditional investment vehicles. The exhibit below illustrates this diversification benefit based on data from 1995 to 2006. Overall, an investor with 100% of hedge fund interests in her portfolio had an average return of 13,6% for 7,4% risk. This yield is substantially better than an investor with a 96% traditional portfolio whose average return was lower (9,3%) and whose percentage of risk was higher (8,5%).

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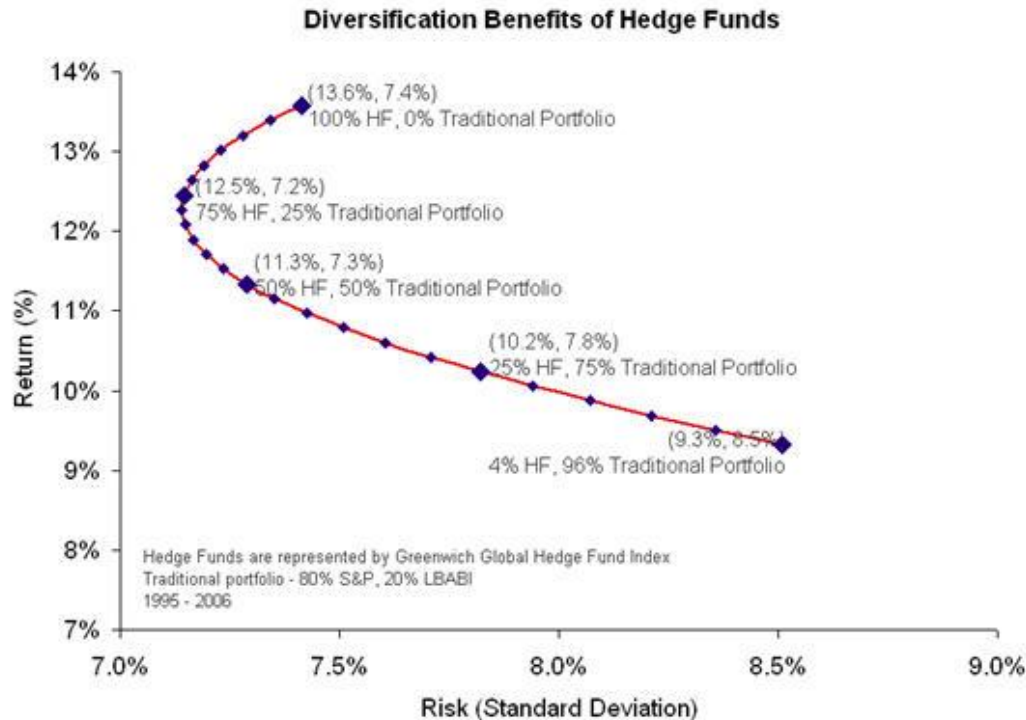
[8] Thomas Lemke, Gerald Lins, Kathryn Hoenig and Patricia Rube : *Hedge Funds and Other Private Funds :Regulation and Compliance 2009-2010*, 2009



To managers, hedge funds offer an easy-to-set-up structure for minimal costs. In addition, the compensation mechanism, generally a 2% management fee and a 20% performance-based allocation is very attractive. Some banks actually blame hedge funds for investment bankers' high expectations in terms of compensation.
John Mack, Chairman at Morgan Stanley believes that the reason investment bankers are overpaid is that investment banks "fear a brain drain to better-paying hedge funds" and need to compete by raising their compensation packages"[9].
Moreover, hedge funds are structured and localized to take advantage of tax regimes. In the United States for instance, they are structured so as to benefit from a "*flow through"* tax treatment which allow them to avoid income tax at the entity level[10]. Managers are then taxed only on their capital gains, at a 15% rate, which is substantially less than for regular income taxes.

To the markets finally, they are said to increase liquidity and enhance efficiency. For instance, hedge funds help provide efficiencies in pricing of securities in all market conditions thanks to their extensive research and willingness to make investments. Moreover, it has been shown that by providing a counterparty to institutions which wish to hedge their risks, they often help dispersing risk[11] and lowering volatility[12]. Surprising and rare enough to be worth mentioning coming from a French essay, Godeluk and Escande further argue that hedge funds have dynamized the

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[9] *Mack Says Hedge Funds Driving Up Bank Pay*, FinAlternatives, February 25, 2010, *available at* http://www.finalternatives.com/node/11555

[10] Thomas Lemke, Gerald Lins, Kathryn Hoenig and Patricia Rube : *Hedge Funds and Other Private Funds :Regulation and Compliance 2009-2010*, 2009, at 232

[11] See Schwartz in *Systemic Risk: Examining Regulators' Ability to React to Threats in the Financial System*, Hearing before the Committee on Financial Services U.S. House of Representatives, October 2, 2007

[12] Best practices for the Hedge Fund Industry – Report of the Asset Managers' Committee to the President's Working Group on Financial Markets, April 2008

corporation world. Even activist hedge funds, they claim, have accelerated the regeneration of the economic system[13].

1. 2 Legal regimes applicable to hedge funds in the United States and in the European Union[14]

Hedge funds first appeared a little more than fifty years ago and have developed in the United States and in the European Union thanks to favorable legal environments. They are often referred to as “unregulated” and “unsupervised” investment vehicles but to the term “unregulated” I prefer the term “lightly regulated” and I shall explain why. Before turning to American and European legal frameworks, the word “regulation” itself needs defining. Are we referring to the registration of the fund and its adviser with a regulatory body that exercises an active oversight or to limitations on transactions and special requirements on hedge fund activities? Indeed, in the United States, one often associates registration and regulation, which is a legitimate thing to do.

Most of the time registration implies regulation and *vice-versa*. In the European Union, however, hedge funds are registered almost everywhere, yet these funds are still said to be unregulated. The reason is that there are no or very few restrictions on their activities. It is important to acknowledge that registration doesn’t necessarily mean regulation of activities.

That is the European case. Conversely, the absence of registration doesn’t necessarily mean that hedge funds are completely unregulated. This is the case of the United States.

1.2.1 The United States

The United States is both the most popular onshore location with nearly two-thirds of global onshore hedge funds whether structured as Limited Partnerships or Limited Liability Corporations. It is also the leading center for location of management, with 68% of the global assets among which 41% in the state of New York. The majority of U.S domiciled assets are managed from New York (60%), followed by California (15%), Connecticut, Illinois and Florida (about 6% each)[15].
The American legal framework doesn’t offer any legal definition of what a hedge fund is. In its 2003 report on the implications of the growth of hedge funds, the Securities and Exchange Commission (“SEC”) regards this structure as a “pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act”[16].

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[13] Solveig Godeluck and Philippe Escande, *Les pirates du capitalisme* : *Comment les fonds d’investissement bousculent les marchés,* 2008, at 260

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

[15] Based on 2008 and 2009 data. International Financial Services London (IFSL) Research, Hedge Funds 2009, April 2009 and April 2010, *available at* http://www.ifsl.org.uk

[16] Securities and Exchange Commission, *Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission, September 2003 at viii, *available at*, http://www.sec.gov/news/studies/hedgefunds0903.pdf. See also: David Vaughan, *Selected Definitions of "Hedge Fund”, Comments for the U.S. Securities and Exchange Commission !Roundtable on Hedge Funds*, May 14th and 15th, 2003, *available at,* http://www.sec.gov/spotlight/hedgefunds/hedgevaughn.htm

As Robert Jaeger points out: “hedge funds are designed to take advantage of various exemptions, exclusions and safe harbors that are explicitly provided within the regulatory framework”[17]. SEC Commissioner Troy Paredes also emphasizes the fact that the resulting light regulation of hedge funds is not the product of “shenanigans or of the exploitation of loopholes”[18]. Quite ironically, hedge funds must comply with many laws and regulations as described below in order to qualify for those exemptions and safe harbors[19].

The investment Company Act of 1940

Unlike other investment companies, hedge funds may avoid registration with the SEC if they comply with the requirements of one of the two statutory exemptions set out in the Investment Company Act of 1940 (“ICA”) known as 3(c)1 and 3(c)7[20].
Section 3(c)1 provides an exemption from the definition of an “Investment Company”[21] to an issuer whose outstanding securities are beneficially owned by not more than one hundred persons and who does not hold himself out to the public.

This provision actually enables hedge funds to have a lot more investors since beneficial ownership by a company or another fund counts as beneficial ownership of one person, provided that they are not set up to circumvent the provisions of the Act[22].

For example, let’s assume that investment company A has 50 investors, pension fund B has 150 investors and hedge fund C has 90 clients. If A, B and C invest in hedge fund Z, hedge fund Z will be deemed to have 3 clients when really 290 investors will be exposed, provided that A, B, or C do not hold more than 10% of the outstanding voting securities of the issuer.
This method used to determine beneficial ownership for the purpose of qualifying for the 3(c)(1) exemption has some exceptions. In a 1994 No-Action letter[23], the SEC stated that a defined-contribution plan cannot be counted as a single investor if its participants get to make investment decisions. If participants play an active role in the plan then one must “lookthrough” and each plan participant must be counted as one towards the 100 investors limit.

The second exemption, Section 3(c)(7) was introduced in the National Securities Markets Improvement Act of 1996 and has become very popular since it allows hedge funds to offer their securities to an unlimited number of “Qualified Purchasers”[24].

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[17] Robert A. Jaeger, *All about hedge funds: the easy way to get started*, 2003, at 181

[18] Troy Paredes : *Hedge Funds and the SEC: Observations on the How and Why of SecuritiesRegulation,* Washington University in St Louis School of Law, 2007, at 5

[19] Shartsis Friese LLP, Douglas L. Hammer et al., *U.S. regulation of hedge funds*, Chicago, Ill. : ABA Section of Business Law, 2005 at 87

[20] This exemption was introduced by the National Securities Markets Improvement Act of 1996

[21] § 3 of the Investment Company Act of 1940

[22] SEC Cornish and Carey No-Action Letter, 1996

[23] SEC PanAgora Group Trust No-Action Letter, 1994

[24] See Section 2(a)(51) (A) of the Investment Company Act of 1940 for the definition of a « Qualified purchaser ». *A “qualified purchaser means i) any natural person (including any person who holds a joint, community property, or other similar shared*

One *caveat* should however be mentioned. Even though Section 3(c)(7) doesn't set a maximum number of qualified purchasers, Section 12g of the 1934 Act imposes registration and reporting requirements if the fund has more than 500 investors. So as not to lose the benefit of the exemption, in practice, hedge funds have a maximum of 499 investors.

The look-though issue was also raised for 3(c)(7) funds, in order to determine whether a benefit retirement, for instance, could be a qualified purchaser or if a hedge fund had to lookthrough to determine whether each participant was qualified. The SEC concluded that a defined benefit retirement plan is deemed a qualified purchaser if plan participants cannot make investment decisions and if the decision to invest in a 3(c)(7) fund is made solely by the plan fiduciary[25]. In this instance, if plan participants had been able to direct their investments to specific alternatives, then the 3(c)(7) fund would have had to look-through and evaluate each participant's level of sophistication.

The Investment Advisers Act of 1940

The alternative way to regulate the hedge fund industry is to regulate hedge fund advisers. In the U.S., investment advisers are regulated by the Investment Advisers Act of 1940 ("IAA"). The IAA imposes fiduciary duties. One of the most important duty was developed by the Supreme Court in 1963 in SEC v. Capital Gains Research[26] which established an "affirmative duty of utmost faith and full and fair disclosure". Equally important is the duty of best execution. Advisers must seek the best execution for their client. They also must disclose conflicts of interest, report personal transactions[27], keep records of their trades[28], establish maintain and enforce a code of ethics[29] and must not engage in transactions which operate as a
fraud[30] nor make untrue statements of material facts[31] to investors or in their ADV form filed
with the SEC[32].
In order to make sure that hedge funds comply with the various legal requirements imposed upon them, the SEC introduced Rule 206(4)-7 which requires each investment adviser registered or required to register with the Commission "to adopt and implement policies and procedures reasonably designed to prevent violation of

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ownership interest in an issuer that is excepted under section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than $ 5,000,000 in investments, as defined by the Commission, ii) any company that owns not less than $ 5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons, iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (!iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $ 25,000,000 in investments."

[25] SEC Standish, Ayer & Wood, Inc. No-Action Letter, 1995

[26] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963)

[27] §204 and Rule 204-2(a)(12) of the IAA

[28] Rule 204-2 of the IAA

[29] Rule 204A-1 of the IAA

[30] §206 of the IAA. Note that §206(2) does not require scienter, showing negligence is sufficient.

[31] The *Basic Inc. v. Levinson* standard applies : a fact is material if there is a subtantial lieklihood that a reasonable investor would consider it important in making an investment decision.

[32] §207 of the IAA

the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and appoint a Chief Compliance Officer (CCO) to be responsible for administering the policies and procedures"[33]. Rule 206(4)-7 took part of the compliance burden off the SEC's shoulders which was lacking resources to examine thousands of registered investment advisers, to place it on the industry's with the costs that come with this responsibility.

Besides additional costs, internal compliance may lead to internal conflict of interests. For instance, it is the responsibility of the CCO to establish procedures to detect and prevent violations but if these procedures are too stringent, it may handcuff the regular course of business. One may also raise the question of the conflict of interest a CCO may be confronted with when she detects a fraud. Should she report it at the risk of losing her position? There seems to be an incentive from a CCO's point of view to stay quiet.
In this regard, the SEC's enforcement cooperation initiative launched on January 13, 2010 similar to the DOJ's should be applauded as it "establishes incentives for individuals and companies to fully and truthfully cooperate and assist with SEC investigations and enforcement actions, and provides new tools to help investigators develop first-hand evidence to build the strongest possible cases"[34].
Hedge fund advisers meet the definition of an "Investment Adviser"[35] and should technically register[36] under the IAA and report to the SEC through Form ADV.
a matter of fact, today a large majority of hedge funds advisers are registered. Yet, some escape this regulatory oversight. Indeed, Section 203(b) of the IAA provides a list of exemptions from the registration requirement. The exemption hedge fund advisers rely on is the *de minimis* exemption of Section 203(b)(3). Under this provision, investment advisers who have fewer than fifteen clients during the preceding twelve months, do not hold themselves out generally to the public and are not advisers for a registered investment company need not be registered although some advisers choose to do it on voluntary basis.

The fifteen clients limit is often regarded as artificial. Under this exemption for instance, 14 other funds each representing up to four hundred and ninety nine investors may invest in a hedge fund without triggering a registration requirement on its adviser because the clients would be the funds and not each individual investor behind these funds.
In 2004, the SEC challenged the term "client" and introduced Section 203(b)(3)-2(a), the socalled "Hedge Fund Rule". It argued that "client" referred to "investor" and that one should look-through in order to calculate the number of clients. In our example, if 14 funds representing 499 investors each invested in one hedge fund, this would imply that 6 986 investors would have to be taken into account. The consequence was that all hedge fund advisers had to register with the SEC by February 1, 2006. In

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[33] SEC Release, *Compliance Programs of Investment Companies and Investment Advisers*, 2003,*available at*, http://www.sec.gov/rules/proposed/ic-25925.htm

[34] SEC Release, *SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations*, January 13, 2010, *available at*, http://www.sec.gov/news/press/2010/2010-6.html

[35] §202(a)(11) "*Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.*

[36] §203 of the IAA. Note that once registered with the SEC, there is no need to register under state laws (§203A(b)).

June 2006, the District of Columbia Court of Appeal ruled against what it judged an "arbitrary" provision in Goldstein v. SEC[37].
Yet, as part II analyzes in greater detail, the mandatory registration of all hedge fund advisers is very likely to become a reality if the Private Fund Investment Adviser Registration Act is enacted. The Act gets rid of the fifteen clients exemption and compels all investment managers to register under the IAA.

The Securities Act of 1933

Interests in a hedge fund are securities under the definition of Section 2(a)(1)[38] and under the *Howey*[39] *test,* which technically makes hedge funds fall under the scope of the Securities Act of 1933 ("the 1933 Act").

As previously mentioned, hedge funds cannot hold themselves to the public[40], engage into general solicitation, nor advertise in the absence of a pre-existing relationship[41].
Therefore, the only way in which they may offer securities is to use the private offering exemption under Section 4(2) of the 1933 Act[42]. Hedge funds typically use Regulation D's Rule 506 safe harbor to carry out their offering.

Using this safe harbor is not mandatory provided that the conditions of Section 4(2) are met although advisers usually prefer Rule 506. It allows them to offer securities in a private offering to a maximum of 35 sophisticated purchasers and an unlimited number of "accredited investors", as defined by Rule 501(a) of the 1933 Act.

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The Securities Exchange Act of 1934

Hedge funds typically do not need to register under the Securities Exchange Act of 1934 ("The 1934 Act") because they are regarded as traders. If they were treated as

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

[38] Section 2(a)(1) of the Securities Act: *"The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing".*

[39] SEC v. W. J. Howey Co., 328 U.S. 293 (1946)

[40] The test to determine if an offering is public or private is the test established in *Ralston Purina (*SEC v. Ralston Purina Co.,346 U.S. 119, 125 (1953). One must check if investors are able to fend for themselves to determine if the offering is private.

[41] Although general solicitation is prohibited, this remark needs to be moderate as more flexible provisions exist. For instance, advertising using models for instance is not prohibited *per se* like it used to be. The SEC in its Clover Capital Management No-Action Letter provides guidance on how to deal with models in a list of 11 factors that does not constitute a safe harbor. Another example is the use of a website which destroys the private offering exemption and is considered as general solicitation unless if the website has a password restricted access available to accredited investors only and if there is a quiet period long enough to establish a preexisting relationship prior to the offering.

[42] Rule 901 of Regulation S provides that an offer is not deemed to include offers which occurred outside the United States for the purposes of Section 5 of the 1933 Act.

dealers[43] they would have to register under Section 15b of the Act. The Exchange Act is extremely important because it contains antifraud provisions (Section 10b and Rule 10b-5) that apply to all investment advisers whether registered or not which impose a fiduciary duty to disclose material facts and prohibit material misstatements and omissions. Moreover registered funds are subject to periodic requirements under Section 13[44], proxy rules under Section 14, and insider reporting requirements and short swing profits transactions rules under Section 16 of the 1934 Act.

Other regulatory requirements Hedge funds are further regulated by the Commodity Exchange Act even for a single transaction on commodity and subject to the CFTC rules[45], by the National Association of Securities Dealers ("NASD") rules and therefore must comply with five sets of principles, or by the Employment Retirement Income Security Act ("ERISA") which makes them subject to the restrictions of an ERISA fiduciary if more than 25% of the value of any class of equity is held by an employee benefit plan[46].

They are also subject to several Department of Treasury's regulations. For instance any large position in U.S Treasury securities are reportable with the Federal Reserve Bank of New York, and foreign currencies positions above certain thresholds must be disclosed.

Moreover hedge funds are financial institutions that are subject to anti money laundering requirements set out in Section 352 of the U.S. Patriot Act of 2001[47] which compels them to develop internal control programs, to designate a compliance officer, to set an ongoing employee training program and to have an independent audit function to test the program[48].
Finally, hedge funds may also be subject to state regulations also known as "Blue Sky laws".
State laws do not regulate hedge funds' operations but may regulate advisers, offers, sales of interests and may impose additional and stricter antifraud provisions[49] and notice filing requirements[50]. For instance, the state of Connecticut is currently contemplating the possibility to impose new reporting requirements on hedge funds based in the state[51].

1.2.2 The European Union

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[43] According to the SEC in its 2003 staff report, some hedge funds are registered as dealers. See definition of §3(a)(5) of the Exchange Act.
[44] In particular hedge funds are subject to beneficial ownership reporting under §13(d) and 13(g) and to quarterly reporting requirements under §13(f) when accounts exceed $100 million in fair value.
[45] Unless they comply with the requirements of CFTC Rule 4.7
[46] Rule 3-101 of the ERISA
[47] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept andObstruct Terrorism Act of 2001
[48] Securities and Exchange Commission, *Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission, September 2003 at 30, *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf
[49] In the state of New York, the Martin Act of 1921 (Article 23-A of the New York General Business Law) empowers the New York State Attorney General to bring both civil and criminal actions for financial fraud.
[50] Securities and Exchange Commission, *Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission, September 2003 at 31, *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf
[51] *Connecticut Considers State Hedge Fund Regulation*, FinAlternatives, February 26, 2010 *available at* http://www.finalternatives.com/node/11579

Investment funds in the European Union are classified within two categories. The first one is the so-called UCITS funds (Undertakings for Collective Investment in Transferable Securities) that meet and follow the requirements set by the UCITS Directive[52] and are authorized to sell to the retail market. The second category is a broad and default category encompassing all non-UCITS funds including hedge funds, private equity funds, commodity funds or real estate funds that are regarded as entailing a level of risk that makes them
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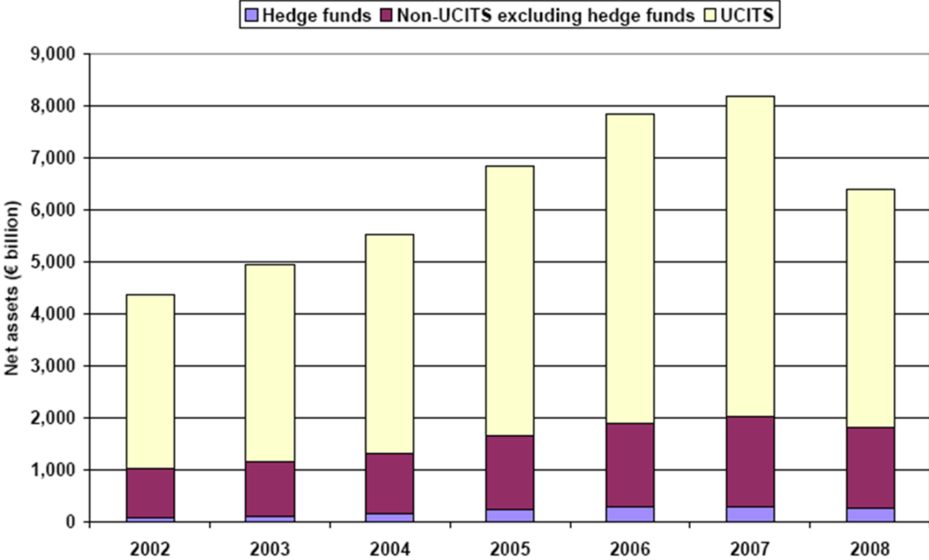
unsuitable for retail investors. Access to these funds is therefore limited to sophisticated,
professional and institutional investors[53]. In addition, they do not benefit from the EU passport that would allow them to market throughout the internal market.

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

Figure 1: Value of assets under management for UCITS and non-UCITS funds managed in Europe



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

With 1 400 hedge funds, it is estimated that hedge funds' assets managed in the European Union amount $382 billion[54] (23% of the global market share) while assets

[52] Directive 85/611/EEC which came into force in 1987 and was amended in 2004 and in 2007.
[53] European Union Press Release, *Financial services: Commission proposes EU framework for managers of alternative investment funds*, Brussels, April 29, 2009, *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/669
[54] International Financial Services London (IFSL) Research, *Hedge Funds 2010,* April 2010, *available at* www.ifsl.org.uk

domiciled in the EU roughly amount $75billion[55]. This can be explained by the fact that the U.K. is a major hub for hedge fund managers but that their funds themselves are often located offshore, for tax reasons. These figures give indications as to what regulation should target in the EU.

Hedge funds are regulated on a national level, and the way hedge fund regulation is dealt with varies a great deal from one country to the other. The United Kingdom approach focuses on regulation of investment advisers only. Germany on the other hand only regulates funds, while France and Italy regulate both investment advisers and the funds themselves. Although some convergences may be observed on the types of documents required[56], for instance, the features of hedge fund regulation[57] itself differ from one EU member state to another.
In terms of investor access, for example, Italy imposes a minimum subscription of !500,000, France has various thresholds depending on the type of fund as well as on qualitative considerations[58], and Germany has no such requirements.

1.2.3 The United Kingdom

London is the second largest center for hedge fund management after New York and the leading center in Europe. In 2009, the sector employed around 40,000 people and managed 21% of global hedge fund assets and 76% of European hedge fund assets totaling around $382billion[59].
Hedge fund regulation in the U.K refers mainly to the regulation of hedge fund managers who must, prior to commencement of business, seek the authorization of the Financial Services Authority ("FSA") pursuant to Section 19 of the Financial Services and Markets Act of 2000.

As mentioned above, the U.K is not a domicile of choice for hedge funds themselves because of its tax regime[60], although hedge funds are not inexistent in this jurisdiction[61].
Very different from the American rules-based and hedge fund-specific approach, the Financial Services Authority has a principles-based and wide scope approach to regulation.

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[55] Charles River Associates (CRA), *Impact of the proposed AIFM Directive across Europe*, October 2009, at 11. This data has been converted from Euro to USD.

[56] A survey conducted in 2005, showed that member states require the same information documents specified in Directive 85/611 for UCITS.

[57] Note that funds of hedge funds regulations (FoHF) also vary from country to country but that FoHFs are not addressed in this paper.

[58] Associazione Italiana Del Risparmio Gestito and European Fund and Asset Management Association, *Hedge Funds Regulation in Europe: A comparative survey*, November 2005, *available at* http://www.assogestioni.it/index.cfm/3,154,562/05_250845_efama_hdgfnd_rprt_1.pdf

[59] International Financial Services London (IFSL) Research, *Hedge Funds 2010,* April 2010, *available at* www.ifsl.org.uk

[60] Phoebus Athanassiou, *Hedge fund regulation in the European Union : Current trends, and future prospects*, 2009 at 146 note 104. U.K domiciled funds are liable for U.K Corporation tax on income plus chargeable capital gains.

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

Simply put this means that every regulated entity must follow the eleven “Principles for Business” of the FSA Handbook of Rules and Guidance. These principles are not intended specifically for hedge funds but for all FSA-regulated entities. This has led to the creation of the Hedge Fund Working Group whose goal was to provide guidance to the industry on what the FSA Principles should mean for hedge fund managers. Provided that these principles are properly enforced, hedge fund managers are relatively free to carry out any type of strategy as there is no particular constraint on investments.
Notwithstanding the above, U.K hedge fund advisers are however subject to Mifid[62] capital adequacy rules based on its activities while hedge funds themselves are not[63].

The FSA’s approach to supervision of hedge fund managers is risk-based. It consists in periodic risk assessments through a process called ARROW II during which the FSA examines various elements such as management, governance, financial reports or the amount of capital held, or targets a specific issue[64]. Enforcement follows an outcome-based approach where the FSA assesses *ex post* the decisions made by managers and take enforcement action if needed.
Finally, like in other jurisdictions, there is a general prohibition on the marketing of unregulated collective investment schemes and regulated “Qualified Investor Schemes” to the general public[65] which may only be promoted to eligible investors after making sure of the investor’s wealth and sophistication.

1.2.4 France

In France, hedge funds are known as *fonds spéculatifs* or *fonds alternatifs*. Hedge funds were introduced in France with funds investing in futures, *Fonds Communs d’Intervention sur les Marchés à Terme (*FCIMT).
In 2003, the Financial Security Act[66] set up a legal framework by creating two additional legal schemes: *OPCVM ARIA*[67] whether leveraged or unleveraged (undertaking for collective investment in transferable securities with simplified investment rules) and *OPCVM contractuels*[68] *(*contractual undertaking for collective investment in transferable securities).

Hedge funds may operate through these legal forms[69], that are regarded as non-UCITS funds under European Law. The sale of hedge fund units or shares are

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62 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC

63 Martin Cornish *in* Martin Cornish and Ian Mason *International guide to hedge fund regulation*, 2009, at 491

64 Martin Cornish *in* Martin Cornish and Ian Mason *International guide to hedge fund regulation*, 2009, at 510

65 Section 21 of the FSMA provides that an unauthorized person acting in the course of business must not communicate an invitation or inducement to engage in investment activity in the UK unless an exemption applies. Section 238 of the FMSA further establishes a restriction of the promotion of collection investment schemes to the general public.

66 Loi de Sécurité Financière n°2003-706 of August 1, 2003

67 Articles L.214-35 and L.234-35-1 of the Monetary and Financial Code, available in English at http://195.83.177.9/code/liste.phtml?lang=uk&c=25&r=7606

68 Articles L.214-35-2 to L.234-35-6 of the Monetary and Financial Code, available in English at http://195.83.177.9/code/liste.phtml?lang=uk&c=25&r=7607

69 See Jean François Adelle *in* Martin Cornish and Ian Mason *International guide to hedge fund*

subject to a general prohibition of solicitation[70] and they cannot be accessed unless various criteria are met, especially in respect to "qualified investors". These criteria are defined by decree[71] and codified in Article D.411-2 of the *Code monétaire et financier* (Monetary and Financial Code).

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

Retail investment to hedge funds, though limited is not impossible under certain circumstances.

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

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regulation, 2009, at 112

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

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

[72] AMF General Regulation, Article 416-2

[73] AMF General Regulation, Article 416-5

[74] AMF General Regulation, Article 411-51

[75] AMF General Regulation, Article 416-10

[76] Article D.411-2 of the MFC

[77] AMF General Regulation, Article 413-6

[78] AMF General Regulation, Article 413-10

[79] Article D.411-2 of the MFC

Legal form	Access	Information provided	Operations	Role of the AMF
FCIMT (funds investing in futures)	Qualified Investors (Article D.411-2 of the MFC) + non qualified individual investors whose initial subscription amounts €10,000 or more[72]. The person who signs the prospectus must ensure that these conditions are met.	Investors must acknowledge that they receive proper warning that FCIMT are to be considered as hedge funds, entail risks of significant loss and are available to a certain category of investors.[73] Investors receive a detailed note and a copy of the fund's rules upon subscription[74] as well as quarterly statement whose content is set by the AMF[75].	Diversification 10% ceiling on securities issued by the same issuer except if the issuer is an OECD member state.	Subject to the requirement of **prior** AMF operational license.
Unleveraged OPCVM ARIA	Qualified Investors[76] + list set by Article 413-2 of the MFC. Non qualified investors may access if > initial subscription of €125000 or more > initial subscription of €10,000 or more when hold total of €1million or more in deposits, life insurance products and financial instruments > initial subscription of €10,000 or more and professional position for a year at least enabling to acquire sufficient knowledge	Investors must acknowledge that they receive proper warning that OPCVMs are available to a certain category of investors[77]. Investors receive a prospectus that must be approved by the AMF. The liquidative value must be provided every month[78]	Exemptions from the risk diversification requirement applicable to standard OPCVMs. May invest their assets in: > Up to 35% in stocks issued by the same issuer > Up to 50% in the same collective investment scheme. > Up to 20% in French or foreign alternative funds > Up to 50% in other financial instruments Leverage of **two**	Subject to the requirement of **prior** AMF operational license. Programs of operations need not be approved by the AMF
Leveraged OPCVM ARIA			May invest their assets in: > Up to 35% in stocks issued by the same issuer > Up to 50% in the same collective investment scheme. > Up to 50% in other financial instruments Leverage of **four** Counterparty ratio: 50%	Subject to the requirement of **prior** AMF operational license. Programs of operations need to be approved by the AMF
Contractual OPCVM	Qualified Investors[79] + non qualified investors if > initial subscription of €250000 or more > initial subscription of €30,000 or more when hold total of €1million or more in deposits, life insurance products and financial instruments > initial subscription of €30,000 or more and professional position for a year at least enabling to acquire sufficient knowledge	Investors must acknowledge that they receive proper warning that OPCVMs are available to a certain category of investors. Investors receive a prospectus that **need not be authorized by** the AMF. The liquidative value must be provided every three months.	May invest in any type of financial instruments, French or foreign, provided that investors are given suitable information and that a special program of operations has been approved by the AMF. No leverage limit, freely defined in prospectus	Contractual OPCVMs must register with the AMF **within one month** after being set up. The AMF approves the fund's programs of operations. Doesn't verify and authorize prospectuses.

In addition to these provisions, French hedge funds, like those in the United States, are subject to antifraud provisions, pursuant to the European Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation. They are also subject to national provisions detailed in the AMF General Regulation. The AMF also introduced Conduct of Business rules for portfolio management companies which are enforced by its *Commission des sanctions* whenever a breach occurs. Such rules address conflicts of interests, due skill, care and diligence, and integrity of the market, to name a few examples.

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

1.2.5 Italy

In Italy, hedge funds are referred to as *fondi speculativi* and may be open or close-ended. Italy is a dynamic market for hedge funds and was one of the first jurisdictions to adopt specific hedge fund rules in a Treasury Ministry Decree in May 1999 that was modified in 2000, 2003, and 2005[80] and developed through regulations of the Bank of Italy. By 2005, the Italian hedge fund market consisted in 161 funds and was worth € 17,5 billion[81].

This dynamism may be explained by the flexible legal environment hedge funds benefit from.

As in France, Italy requires investment advisers to be authorized by the Bank of Italy, and hedge funds themselves cannot be distributed unless they have received the authorization of the market regulator, the *Commissione Nazionale per le Società e la Borsa ("*CONSOB").

While advisers are subject to capital requirements, hedge funds themselves are not. Foreign non-UCITS funds that want to distribute in Italy must comply with the same authorization requirements.

Typically, hedge funds are managed by *Società di Gestione del Risparmio* ("SGR"), which until June 2007 had to be speculative SGRs. This requirement has been removed.

Consequently common SGRs may now manage hedge funds.
In order to secure authorization, funds are required to disclose specific warnings and information such as the class of asset which will be owned by the fund and the procedure related to the investors' access. But unlike France, once this authorization is granted, they are free to invest in any type of financial instruments and use any investment strategy and are not subject to the supervision of the Bank of Italy nor to portfolio diversification requirements[82].

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

[81] Cristina Calderoni, *Hedge funds in Italy: An update*, 2006 *available at*: http://www.aima.org/en/knowledge_centre/education/aima-journal/pastarticles/index.cfm/jid/4E211FB5-FEE2-480C-868576C66BA41EA5

[82] Phoebus Athanassiou, *Hedge fund regulation in the European Union : Current trends, and future prospects*, 2009 at 134

Italy also imposes a prohibition on marketing to the general public. An investor cannot invest in a hedge fund if her initial subscription is below a threshold of !500 000. Up until recently, Italian law also provided that hedge funds could not have more than two hundred investors but this provision has been repealed. Therefore, as of today there is no restriction on the maximum number of investors[83].

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

1.2.6 Germany

Sondervermögen mit zusätzlichen Risiken ("hedgefonds") (special investment schemes with additional risks*)* have a new legal framework since the *Investmentgesetz* (InvG)[84] which governs German collective investment schemes came into force in 2004.

German law, unlike any other jurisdiction, provides its own legal definition of the term hedge fund: "a fund is considered a hedge fund if it uses either leverage or short selling strategies or both and is not restricted in the choice of its assets"[85].
German hedge funds may take two legal forms. They can either be structured as investment funds (contractual form) managed by an investment management company[86] or as investment stock corporations (corporate form). In Germany, hedge funds need to obtain the written license of the regulator *Bundesanstalt für Finanzdienstleistungsaufsicht ("*BaFin"*)* prior to taking up any business[87].
Whether contractual or using the corporate form, hedge funds may only market and distribute through a private placement and they must follow the rules applicable to prospectuses which must be written and contain the fund rules and a warning for the possible total loss.

The terms of contract must be approved by the BaFin. Similarly, foreign funds can only be sold to German investors in a private placement.

German hedge funds are subject to minimum capital requirements[88] but advisers are not. The rationale behind capital requirements is the same as for banks. It provides a "cushion against existing obligations when asset values sharply decline"[89]. Like any

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[83] KPMG *Regulation Italy, Hedge fund 2009,* 2009 *available at*: http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/Hedge-fundssurvey/Italy-HF-Regulation-2009.pdf

[84] InvestmentGesetz, *available at* http://bundesrecht.juris.de/invg : the main provision on hedge fund may be fund at Article 112 (Chapter 4).

[85] Harald Plewka and Dr Barbara Schmid in Martin Cornish and Ian Mason *International guide to hedge fund regulation*, 2009, at 132 quoting Article 112 of the InvG

[86] See Article 30 of the InvG, available at http://bundesrecht.juris.de/invg/__30.html. Note that in the contractual form, hedge funds are a separate estate owned by investors and which needs to be managed by an investment management company. The corporate form on the other hand is a uniform legal estate which can manage clients' money on its own.

[87] Article 7 (1) s.1 and Article 97 (1) S.1 of the InvG

[88] See, Harald Plewka and Dr Barbara Schmid in Martin Cornish and Ian Mason *International guide to hedge fund regulation*, 2009, at 133

[89] Hal Scott, International Finance : *Transactions, Policy and Regulation* 16th edition, 2009 at 884. Note however that a distinction must be made between capital reserves and liquidity reserves. Indeed, as demonstrated in Rama Cont, Amal Moussa, Andreea Minca, *Too interconnected to fail: Contagion and Systemic Risk in Financial Networks,* Working Paper,

fund they must comply with the principle of risk diversification, although no formal limits are imposed upon them, like it is the case in France for instance.

They also enjoy a very flexible legal environment in terms of investment strategies, the use of leverage is not controlled, nor is derivatives-based transactions, which is quite similar to the Italian legal framework. Plewka and Schmid note however that the InvG empowers the Ministry of Finance to restrict the use of leverage and short-selling transactions by an executive order to prevent abuse and protect the integrity of capital markets[90].

Moreover, unlike Italy, there are restrictions as to the type of assets German hedge funds may invest in. For instance they may not invest in raw materials nor in real property. They may not invest more than 30% of the value of the fund in equity interests in business which are not listed on a stock exchange and more than 50% of its net assets in another hedge fund in which not more than 10% are held by a single fund[91].

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

As this quick overview and the following chart demonstrate, there is no common approach between the European Union and the United States. The current legal regimes applying to hedge funds are determined on a national level, even within the European Union from which one could expect an uniform approach.

Columbia Center for Financial Engineering, 2009, "when Bear Stearns defaulted in 2008, its capital reserve where above the minimal regulatory capital required by Basel II, but was not available (liquid) for meeting margin call". The authors argue that imposing liquidity reserves ratios reduces the probability of large systemic losses and reduces default contagion and that it should be the tool used to regulate contagion and systemic risk.

[90] Harald Plewka and Dr Barbara Schmid in Martin Cornish and Ian Mason *International guide to hedge fund regulation*, 2009, at 134

[91] Article 112 of the InvG

Jurisdiction	Regulation[92] of hedge funds	Regulation of hedge fund advisers
United States	✗ *(Investment Company Act exemption)*	✗ *(if meet the criteria of the Investment Advisers Act exemption)*
United Kingdom	✗	✔
France	✔	✔
Germany	✔	✗
Italy	✔	✔

If there is one common feature of regulators and politicians on each side of the Atlantic it is the idea that hedge funds are potentially problematic entities because they are not regulated enough.

Yet even in this trend, disagreements have emerged and two blocks seem to exist. The USUK approach on the one hand and the France-Germany axis that is dominant in the European Union on the other hand.

The idea that hedge funds should be regulated comes, in my view, from critics that may be excessive as well as from valid concerns about market stability.

2. Critics and concerns in the context of the current crisis have led governments to take Action

2.1 Hedge funds are criticized investment vehicles

There is a global consensus to acknowledge that hedge funds didn't cause the recent financial crisis. According to the IFSL only around 5% of hedge fund assets were invested in mortgage-backed securities in September 2007[93]. But although they were the victims, not the perpetrators, hedge funds are often demonized and end up being treated as scapegoats.

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

[93] International Financial Services London (IFSL) Research, *Hedge Funds 2009,* April 2009, *available at* http://www.ifsl.org.uk

From misleading but widely distributed undocumented essays based on no legal nor scientific facts describing hedge fund's activities as "criminal activities" based on insider trading[94], to political leaders incriminating hedge funds, the industry suffers from bad press and prejudices.

Hedge funds are often associated with volatility, short selling[95], empty voting[96], shorttermism, activism, tax avoidance[97] and risky behaviors that potentially affect market stability.
Although some of the above-mentioned critics are not unfounded, the way hedge funds work and their role in the markets are often misunderstood and reduced to their shareholder activism role. Indeed, the general public has become aware of the existence of hedge funds essentially through their takeover attempts extensively reported in newspapers.
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This contributed to the development of a generalized anti-hedge fund sentiment and has led the general public in other words voters in the United States or in Europe to call for more regulation. As a result, the industry is under heavy fire from global leaders.

Thus, this call for stricter rules to govern hedge funds may result more from a political fear of being criticized than from an actual need. More generally, there seems to be a structural divergence between what political agendas dictate and what the markets and economic growth require. Politicians have a strong incentive to adopt populist measures because by doing so, they increase their chances of getting reelected in the short term. Markets and growth however, require pragmatic and long term-oriented measures that may not always look appealing from a political perspective. This is particularly true in the present context where electors call for action and for moralization of financial markets. As John C. Coffee identified "historically, bubbles are followed by crashes, which in turn are followed by punitive legislation"[98].

In the aftermath of the 2007 crisis, hedge funds are no exception to this statement. President Barack Obama called them "speculators" who were "refusing to sacrifice like everyone else" and who wanted "to hold out for the prospect of an unjustified taxpayer-funded bailout"[99] when it is known that not a single hedge fund was bailed out.

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[94] John R. Talbott, *The 86 Biggest Lies on Wall Street*, New York, 2009 at 202-203

[95] A good example of how hedge funds use short selling and may suffer such activities is what happened in October 2008. Hedge funds lost an estimate of 15 billions of dollars in few hours, based on their large short positions in Volkswagen's stock which soared to more than 1000! due to Porsche takeover attempt through cash-settled options. For more details see *e.g* A.Gennarino, R.Roman and A.Rivière, *Investment opportunities in Germany, France and the UK in replication of the VW/Porsche strategy,* Harvard Law School (International Finance, Markets and Firms paper under the supervision of Professor Mihir Desai), 2009, at 10

[96] See Hu & Black, *Hedge Funds, Insiders, and Empty Voting: Decoupling of Economic and Voting Ownership in Public Companies*, Journal of Corporate Finance, 2007

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

[98] John C. Coffee, Jr, *Gatekeeper failure and reform : The challenge of fashioning relevant reforms*, Working paper n°237, Columbia Law School, September 2003

[99] Steven Mufson and Tomoeh Murakami Tse In Chrysler Saga, *Hedge Funds Cast As Prime Villain*, The Washington Post, May 1, 2009

The President's comments were criticized, by Congressman Scott Garrett, for instance, for whom it showed a fundamental misunderstanding of just who hedge fund managers represent as well as the fiduciary responsibilities these managers have to their investors[100]. German Chancellor Angela Merkel and French President Nicolas Sarkozy have also joined forces combating these "predators".

Given the lack of restrictions for retail investors to invest in hedge funds in Germany, one could understand the Chancellor's concerns, although hedge funds do nothing else but what they are legally allowed to in this jurisdiction. Nicolas Sarkozy who urged for more regulation in an already heavily regulated environment, said that one "can't tolerate hedge funds buying a company with debt, firing a quarter of the staff and then enriching themselves by selling it in pieces. We didn't create the euro to have capitalism without ethics or morals"[101].

Particularly in Europe, there seem to be a sociological pattern to regard hedge funds as a major threat, as the symbol of wild capitalism and greed. Such passionate and intransigeant positions focusing only on hedge fund as activists could be avoided if the industry along with political leaders properly educated the public to understand what hedge funds do and what their role in the financial crisis really was. As Troy Paredes well noted "the abuses and collapses that have punctuated the industry are not indicative of widespread hedge fund behavior, (…) the vast number of hedge fund managers are disciplined traders who make informed, although risky, trades*"[102].*

In fact, according to International Financial Services London Research hedge funds suffered from the collapse of banks in the United and in Europe, from the falls in equity markets, from bans on short-selling and pressure to liquidate positions to meet margin and redemptions calls.

Yet, despite these market conditions, they outperformed many of the underlying markets such as the S&P index which saw a 38% drop and the 2009 global return is back to 19% from -13,9% in 2008[103].

Gareth Murphy from the Bank of England noted that the sector was free of moral hazard in the sense that the crisis had not resulted in the public bailout of a single hedge fund[104].

This being said, one cannot deny that some of the critics and concerns addressed to the hedge
fund industry are fair and may, to a certain extent, justify that some action be taken.

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[100] Scott Garrett in Perspectives on hedge fund registration: hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, U.S. House of Representatives, One Hundred Eleventh Congress, first session, May 7, 2009

[101] Ambrose Evans-Pritchard, *Sarkozy turns on "predator" hedge funds*, The Telegraph, May 1, 2007

[102] Troy Paredes : *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation,* Washington University in St Louis School of Law, 2007, at 4

[103] International Financial Services London (IFSL) Research, *Hedge Funds 2009 and 2010,* April 2009 and April 2010, *available at* http://www.ifsl.org.uk

[104] EU Commission open hearing on hedge funds and private equity, February 26 and 27, 2009

2.2 Systemic risk

Hedge funds may raise concerns in terms of systemic risk

The first of these concerns is that some hedge funds may be a source of systemic risk and lead to chain reactions beyond the hedge fund industry, potentially creating a threat to the entire financial system. Although one often draws a parallel between the size of the fund and its potential impact in terms of systemic risk, it should be kept in mind that "the absolute size of an institution is not the predicate for systemic risk; it is rather the size of its debt, its derivatives positions, and the scope and complexity of many other financial relationships running between the firm, other institutions, and the wider financial system"[105] that must be evaluated in order to determine to what extent the fund poses a systemic risk. Indeed, the failure of LTCM, a hedge fund worth $4 billion posed a systemic risk because of its exposure to banks, while the failure of Amaranth, which was worth more than the double ($9,5billion) had no systemic impact[106].

Most of the risks that arise from hedge fund operations and strategies are hedge fund-specific[107] such as operational risk, or fraud. It should be careful not to draw hasty conclusions as not all risks present systemic risk characteristics. Indeed, "if, for example, a hedge fund is pursuing a high risk contrarian strategy, then it is probably lowering systemic risk"[108].

As the Bank of France noted in a study on hedge funds in 2007, since only sophisticated investors are exposed to these types of risk, strong regulation is not needed to address them from an investor protection perspective. However, hedge funds may affect financial stability through different channels, as the European Central Bank analyzed in its occasional paper on hedge funds[109].

The first of these channels is the *credit channel*, in other words the repercussions of hedge funds' failures on exposed banks. This was illustrated by the LTCM debacle in 1998. A study carried out by the Bank of France estimates that 17 banks would have collectively lost 3 to 5 billion dollars if LTCM hadn't been bailed out[110]. Several elements may explain the failure of this hedge fund among which derivatives use, questionable investment decisions, a leverage ratio of 25, and poor disclosure to its counterparties which weren't aware of the full size and the riskiness of the portfolio[111].

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[105] Hal Scott, *Prepared written testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, February 4, 2010, at 3,

[106] Rama Cont, Amal Moussa, Andreea Minca, *Too interconnected to fail: Contagion and Systemic Risk in Financial Networks,* Working Paper, Columbia Center for Financial Engineering, 2009

[107] Banque de France, *Revue de la stabilité financière, Numéro spécial hedge funds*, N° 10, April 2007 at 51

[108] *New Financial Order Recommendations by the Issing Committee Preparing G-20* – London, April 2, 2009 Version: February 2, 2009, at 19

[109] Tomas Garbaravicius and Frank Dierick, *Hedge funds and their implications for financial stability,* European Central Bank, Occasional paper n°34, 2005, available at http://www.ecb.int/pub/pdf/scpops/ecbocp34.pdf

[110] Banque de France, Revue de la stabilité financière, Numéro spécial hedge funds, N° 10, April 2007 at 54

[111] Tomas Garbaravicius and Frank Dierick, *Hedge funds and their implications for financial stability,* European Central Bank, Occasional paper n°34, 2005, *available at* http://www.ecb.int/pub/pdf/scpops/ecbocp34.pdf, at 29

Sometimes such an exposure and risk come from internal hedge funds as the $3,2 billion rescue of two hedge funds owned by Bear Stearns in 2007 illustrates[112]. In such cases, the failure of the fund is likely to have enormous and direct repercussions on the bank that owns it. If such event may always occur, some, like CRA, note such a failure would be less likely to occur today because leverage levels are quite low and because counterparties consider that they have more information and are capable of assessing the risks[113]. CRA adds that other hedge fund failures have had a lesser impact on the markets.
112
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Amaranth, for instance, did not have a destabilizing effect because counterparties to these funds held sufficient collateral.

Hedge funds may also destabilize the markets through is their *transmission and dissemination role*. In other words, by reacting to a bank failure for instance, they may amplify the effects of a crisis and/or spread it.

Although in this assumption, they are not the source of the problem, they may worsen its consequences by reacting to it. In the midst of the worst crisis of the century, financial stability was not affected by the hedge fund industry, whose role was limited to transmission through massive selling of shares and short-selling transactions as Jacques de la Laroisière, Chairman of the High-Level Group on Financial Supervision in the EU concluded in his report[114].

The Issing Committee in charge of preparing the London G20 meeting illustrated this statement in its report by noting that "hedge funds played a role in crisis transmission, due to their strong reliance on bank financing and maturity mismatch. In the crisis, these characteristics contributed to pro-cyclical behaviors, in particular to deleveraging and asset sales, which had a negative impact on market liquidity"[115].

Systemic risk may also originate from *herding*[116] behaviors. The idea is simple and may be illustrated by an example. Let's imagine that hedge fund A knows that a stock is overvalued, due to a bubble for instance. The rational decision to make would be to short these stocks.

However, hedge fund A has a strong interest in achieving tremendous returns, especially because of its compensation system that is largely based on performance. Shorting a stock that is skyrocketing would carry the risk to be outperformed by other funds which would choose to ride the bubble. Even if hedge fund A knows that the stock is overvalued, it may ultimately decide to follow the herd to take advantage of the potential returns while the bubble lasts.

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[112] Julie Creswell and Vikas Bajaj, *$3.2 Billion Move by Bear Stearns to Rescue Fund*, The New York Time, June 23, 2007

[113] Charles River Associates(CRA), *Impact of the proposed AIFM Directive across Europe*, October 2009 at 78

[114] High-Level Group on Financial Supervision (De Laroisière Report), Brussels, February 25, 2009, at 24, available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

[115] New Financial Order Recommendations by the Issing Committee Preparing G-20 – London, April 2, 2009 Version: February 2, 2009, at 5

[116] See David Scharfstein and Jeremy Stein, *Herd behavior and Investment,* Working papers with number WP 2062-88, Massachusetts Institute of Technology (MIT), Sloan School of Management, 1988

Being part of the herd protects the fund from suffering competitive disadvantages and also imply that if the bubble bursts the entire herd will suffer from the same consequences. Based on that example, one can immediately identify the potential risk posed these herding behaviors in terms of procyclicity and legitimately admit that such behaviors may be source of systemic risk.

Finally, some of the specific hedge fund features may be problematic for markets stability. ! 117

The first one that needs to be mentioned is this inherent the conflict of interests that is posed by *valuation*. There is indeed a natural incentive to provide inaccurate, inflated valuation of the portfolio because the compensation of hedge fund managers are directly calculated based on this value. This can lead to distorted assessments by counterparties and clients and generate risk. Another feature is the *redemption system*. Hedge funds are typically structured in a way that doesn't allow daily liquidity by setting up quarterly or annually redemption only, usually after a lock-up period. This feature limits the impact of nervous and risk averse behaviors that often amplify the effects of bad market conditions.

In the current crisis, hedge funds have mainly suffered from redemptions coming from risk-averse investors who brutally withdrew their money. This has led to a generalized market volatility through massive selling of shares due notably to redemptions. IFSL estimates that hedge funds had to return 13,2% of investors' assets[117] in 2008, which had a procyclic effect on the generalized liquidity crisis.

Thus, it seems that some hedge funds, like many other financial institutions, may be a source of systemic risk important enough to justify that action be taken to mitigate it. The current approach to systemic risk is often an *ex post* "too big to fail" bail-out policy. This can be explained by the fact that regulators experience difficulties in anticipating the impact of defaults mainly because of a lack of visibility and lack of relevant indicators on the structure of the financial system[118]. This calls, as it shall be discussed below, for the development of tools to allow an *ex ante* monitoring.

2.2.2 Mitigating systemic risk

Before turning to the question of how systemic risk may be mitigated, one should first and foremost seek to determine whether getting rid of systemic risk is even possible. The answer, I believe, is that although limiting systemic risk is feasible, it can never be entirely eradicated.
Ben Bernanke made a similar statement and noted that trying to do so "would stifle innovation without achieving the intended goal". He specified nonetheless that "authorities should try to ensure that the lapses in risk management of 1998 do not happen again"[119].

[117] International Financial Services London (IFSL) Research, *Hedge Funds 2009,* April 2009, available at www.ifsl.org.uk

[118] Rama Cont, Amal Moussa, Andreea Minca, *Too interconnected to fail: Contagion and Systemic Risk in Financial Networks,* Working Paper, Columbia Center for Financial Engineering, 2009

[119] Chairman Ben S. Bernanke At the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, Sea Island, Georgia May 16, 2006

Andrew Lo wrote that “financial crisis may be an unavoidable aspect of modern capitalism, a consequence of the interactions between hardwired human behavior and the unfettered ability to innovate, compete, and evolve. But even if crises cannot be avoided, their disruptive effects can be reduced significantly[120]. This raises the interesting question of the arbitrage that needs to be made between preserving market dynamics and mitigating systemic risk. Differently put, a balance has to be struck between economic efficiency considerations and arguments in favor of financial stability. Finding this right balance is one of the main challenges legislators must confront.

Bearing this challenge in mind, one must look for ways to improve the current situation in order to limit the contagion effect and prevent market instability.

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

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

The nature and the amount of periodic disclosure due to investors is mainly defined contractually and remain a private matter between two parties. If investors deem the amount of information they are presented with unsatisfactory, they remain free not to enter into an agreement with the fund. Because hedge fund investors are qualified and sophisticated, negotiating contractually the nature of disclosure seems acceptable. Jean Pierre Jouyet, President of the French *Autorité des Marchés Financiers* speaking about this topic in a conference on hedge funds denounced the opacity with which they carry out their activities. He argued that this opacity has a cost that is too high if one looks at the risks inferred by this lack of transparence[121].

This concern has led to the idea of setting an ongoing public disclosure requirement. As Lo pointed out, “without more comprehensive data on hedge-fund characteristics such as assets under management, leverage, counterparty relationships, and portfolio holdings, it is virtually impossible to draw conclusive inferences about the systemic risks posed by hedge funds”[122].

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[120] Andrew W. Lo, *Hedge funds, systemic Risk, and the financial crisis of 2007-2008* : Hearing on hedge funds, written testimony prepared for the U.S. House of Representatives Committee on oversight and government reform November 13, 2008.

[121] Jean-Pierre Jouyet, Président de l’AMF *Intervention à la Conférence sur les Hedge Funds, Bruxelles*, February 26, 2009

[122] Andrew W. Lo, *Hedge funds, systemic Risk, and the financial crisis of 2007-2008* : Hearing on hedge funds, written testimony prepared for the U.S. House of Representatives Committee on oversight and government reform November 13, 2008.

Although it is difficult to disagree with this statement, public disclosure is not the right answer. Indeed, “aside from diminishing the overall value of hedge funds, would completely fail to address systemic risk”, as Professor Hal Scott notes[123], since disclosure regime is primarily meant for investor protection and not for the reduction of systemic risk.

Parts II and III develop in greater details the idea that information is needed to assess systemic risk but that this information should be used by regulators only and remain confidential and anonymous.

2.3 Investor protection

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

Indeed, only sophisticated investors can enter a partnership agreement and because they are sophisticated, they are deemed to be able to fend for themselves. Thus, they cannot claim that they are unaware of the risk all the more since hedge funds must put a written notice specifying that they are not registered with the SEC on their documents. Investors should understand that these types of investments are risky and that it is a price to pay for the potential greater returns they will get. They need to understand, as Keynes would say, that “the market can stay irrational longer than you can stay solvent”. One should therefore be careful not to infantilize them by granting too much protection.

In Europe, similar restrictions both quantitative and qualitative exist which limits the access to this type of investments and protect retail investors.
There is therefore as Demirakou writes it no reason to believe that hedge fund investment losses however painful they are, have a social cost[124]. As Ben Bernanke noted “experienced investors know, or should know, that in any given year some hedge funds lose money for their investors and some funds go out of business. Those occurrences are only normal and to be expected in a competitive market economy”[125]. Congressman Kanjorski also questioned the investor protection rationale by saying that he “could care less about high-wealth individuals who want to contribute their money to a group of investors. If they want to take the shot of losing it, it does not really affect the rest of society”[126].

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[123] Hal Scott, International Finance : *Transactions, Policy and Regulation* 16th edition, 2009

[124] Maria G. Demirakou, *Internal and external aspects of hedge fund governance*, Harvard Law School, 2008

[125] Chairman Ben S. Bernanke At the Federal Reserve Bank of Atlanta’s 2006 Financial Markets Conference, Sea Island, Georgia May 16, 2006

[126] Chairman Paul Kanjorski in *Perspectives on hedge fund registration: Hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services*, U.S. House of Representatives, 111th Congress, first session, May 7, 2009 at 19.

Shabab also demonstrated that "a general lesson from the law and economics of hedge funds is that when a legal regime permits financial intermediaries to be flexible in their investment strategies and aligns the incentives of investors and innovators through performance fees and co-investment by managers, financial innovation is likely to complement investor protection without wide- ranging regulation*"*[127]

Moreover, it has been argued that the level of due diligence performed by hedge fund investors, who because they are sophisticated know what they are doing might be significantly more rigorous than any registration regime would ever require[128].
SEC Commissioner Troy Paredes goes further by underlining that the risk of loss incentivizes investors to do the kind of diligence that will protect their own interests best and that additional SEC oversight based on an investor protection rationale is not justified. "That wellheeled, sophisticated investors choose to invest in a hedge fund that provides its investors with little information should not trigger more SEC oversight. Neither the complexity of hedge fund strategies nor the fact that hedge fund investors may lose money because of a hedge fund fraud or risky hedge fund trade is grounds for more hedge fund regulation*"*[129]*.*

Similar arguments were made by the European Central Bank which questioned the need to regulate in the European Union and called for investigating more closely before considering regulation from an investor protection point of view[130]. Two small reservations to the above needs to be mentioned. The first one is the German legal framework which does not provide any minimum requirement to invest in a hedge fund and which could potentially raise some investor protection issue.

The second one is the fact that, as some people have observed[131], a growing number of investors could potentially qualify as accredited investors[132] or its equivalent in other jurisdictions. This phenomenon, which according to Lieder is due to inflation is referred to as "retailization"[133]. Some argue that hedge funds should be made available to retail investor through a fund of hedge fund[134] which is the approach followed by the FSA. Indeed on February 25, 2010, the FSA released a statement introducing a retail Fund of Alternative Investment Funds[135].

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[127] Houman B. Shadad, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, Berkeley Business Law Journal, August 2009

[128] Scott Garrett in *Perspectives on hedge fund registration: hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services*, U.S. House of Representatives, One Hundred Eleventh Congress, first session, May 7, 2009 at 3.

[129] Troy Paredes : *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation,* Washington University in St Louis School of Law, 2007, at 11

[130] Tomas Garbaravicius and Frank Dierick, *Hedge funds and their implications for financial stability,* European Central Bank, Occasional paper n°34, 2005, available at http://www.ecb.int/pub/pdf/scpops/ecbocp34.pdf, at 56

[131] Jan Lieder*, Regulating Hedge Funds : Investor Protection and Systemic Risk,* Harvard Law School, 2009

[132] Defined by Rule 501(a) of the Securities Act of 1933

[133] According to Lieder, studies have shown that in 2003, 8,5% of U.S. citizens could in theory have access to hedge funds.

[134] Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, New York University Journal of Legislation and Public Policy, Vol. 11, No. 2, Winter 2008

[135] Financial Services Authority -Policy Statement 10/3, Funds of Alternative Investment Funds (FAIFs) Including feedback on CP08/4, February 2010

I personally do not disagree with such initiatives although I believe that one should be extremely careful to guarantee the appropriate level of investor protection through stricter regulation whenever retail investors are involved[136].

For hedge funds themselves however, this paper argues that sophistication is a key factor because it justifies the light regulatory environment they benefit from. Should more and more unsophisticated investors have access to hedge funds, investor protection could become an issue and therefore justify more regulation. An alternative issue would be to raise the standards of the definition of an "accredited investor" in the 1933 Act and its equivalent in other legal systems in order to limit the range of investors who could have access to hedge fund interests issued through a private offering exemption (Rule 506), in the case of the United States.

A similar idea can be found in the PFIARA. It requires the SEC to reconsider within one year of enactment the thresholds in dollar amount to adjust the "qualified client" standard to inflation and to repeat this process every five years. The Dodd bill has a similar provision but focuses on the "accredited investor" standard. I am a bit doubtful as to using a quantitative measure of sophistication which do not guarantee that investors are indeed qualified and able to fend for themselves. Some qualitative restrictions should also be introduced to complete the existing framework. Broker dealers could for instance be in charge of assessing the client's knowledge through detailed questionnaires following the examples of the questionnaire requirement created by the Mifid Directive[137] in the European Union and of the "offering questionnaire" hedge funds often use to assess the level of sophistication in the United States.

The call for more disclosure is also said to be for investors' sake. The SEC staff report made the comment that hedge funds "generally are not required to meet prescribed disclosure requirements". However, a hedge fund is compelled to make a comprehensive disclosure to potential investors, both to satisfy fiduciary obligations under the Advisers Act and state laws and to comply with antifraud provisions of the securities laws[138]and the requirements of the private offering exemption"[139].
Moreover, as sophisticated investors more and more aware of how hedge funds work, they tend to require extensive disclosure from managers. Unlike the purchase of publicly traded securities, ownership in a hedge fund comes from a contractual agreement, which may potentially be negotiated. This has a direct impact on the amount of information hedge funds disclose in their offering and private placement memoranda (PPM). The PPM is not mandatory under Rule 506 but results from market practice and from the need hedge fund managers have to protect themselves from liability under antifraud provisions.

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

[137] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC amended in 2008.

[138] Since 2007, all investment advisers are prohibited from « *making any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle » (*Rule 206(4)-8(a)(1) of the IAA.

[139] Shartsis Friese LLP, Douglas L. Hammer et al., *U.S. regulation of hedge funds*, Chicago, Ill. : ABA Section of Business Law, 2005 at 4

Moreover, practice has shown that hedge funds have to disclose more and more information to more and more exigent investors and this, without the need for formal disclosure requirements.
Therefore, in my view the investor protection argument is questionable and does not justify additional regulation.

Systemic risk, however, seems to be a legitimate source of concerns although several doubts can be raised as to the capacity of regulation to address it in a fully satisfactory manner. Part II provides an analytical and critical overview of the U.S. Congress' and of the European Commission's proposals.

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

As we discuss current proposals in the U.S. (1) and in the European Union (2), to reform the legal regimes applicable to hedge funds, one must bear in mind that current regimes are very different from one another. Since, the U.S. and the EU agree on the need to regulate hedge funds, it would seem like the perfect time to try to harmonize the various legal regimes and to set up global rules. This section examines both the European and American proposals and determines whether or not efforts in that direction are being made.

1. The Private Fund Investment Advisers Registration Act of 2009

1.1 Provisions of the Act

The Private Fund Investment Advisers Registration of 2009 aims at regulating hedge fund advisers, not hedge funds themselves. It provides first and foremost a definition of "private fund" as investment fund that rely on an ICA exemption, either 3(c)(1) or 3(c)(7). The Act gets rid of the private adviser exemption relying on Rule §203(b)(3) of the IAA and requires most hedge fund advisers above a $30 million threshold of assets under management to register with the SEC as investment advisers[140].

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

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

Among the requirements that will be established by the SEC in consultation with the Federal Reserve, will be the records and files keeping one. Hedge fund advisers would be required to keep information regarding the assets they manage, their use of leverage, and their counterparty credit risk and these records could be subject to examination at any moment.

Indeed the PFIARA imposes stricter reporting and disclosure requirements that will affect the entire industry, including advisers already registered with the SEC. The PFIARA provides that disclosing non-public sensitive information would not be required and that all other information would be kept confidential. However, if one reads between the lines, one quickly realizes that hedge funds could in fact be asked to reveal their trading practices and positions as well as any other information that would be deemed necessary by the SEC and the Fed in order to protect investors and assess systemic risk. These informations would be shared with the Fed and any other entity whose aim is to control systemic risk, in particular with the newly established Financial Stability Oversight Council.

This forced disclosure if made publicly available may be extremely problematic as I shall explain further in Part III, mainly because hedge funds distinguish themselves from one another by their setting their own strategies. They create value using their unique models and one can imagine that having to publicly disclose this type of information would harm both hedge funds and their clients. It will be very interesting to see how the Senate will approach the disclosure requirements and whether it will require public disclosure or keep the confidential reporting adopted by the House.

The Dodd Bill seems to follow the PFIARA's path and provides that "proprietary information" such as trading data or strategies should not be made publicly available. However both versions allow these informations to be shared with courts, agencies or federal departments which still raise questions in terms of confidentiality and protection of business strategies.

In this regard, this paper supports the recommendation made by the Committee on Capital Markets Regulation141[141] (CCMR) to create a confidential reporting requirement, provided that the information collected remain confidential and is not accessible by other hedge funds.
Rather, the data should only be used by the regulator to assess potential threats to the financial stability and take action if needed to prevent failures and chain reactions. This information should also be made anonymous in order to avoid information leakage. The CCMR Report suggests that information about the fund's liquidity needs, use of leverage, risk concentrations and connectedness should be disclosed among others. It further adds, and I completely share this analysis, that "the regulator would bear the burden of demonstrating its need for the required information as well as its ability to use that information effectively".

[141] Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform*, Recommendation n°17, at 13 May 2009

The PFIARA has been well received by the industry, as most of them have already registered voluntarily with the SEC. The Alternative Investment Management Association (“AIMA”) whose Chairman Todd Groome declared that the association supported the registration of managers and Richard Baker of the Managed Funds Association (“MFA”) acknowledged that the mandatory registration of investment advisers was “the right approach” although not a “panacea”142[142], in particular because of the costs registration will entail.

Indeed, in an article published in December 2004, shortly after the adoption of the Hedge Fund Rule by the SEC, Chris Kentouris wrote that “the SEC's initial estimate of $50,000 a year”, in compliance costs, “was quickly debunked. There is just too much to do and too few who know how to do it, with some citing a figure of at least double that amount[143].

This approach chosen by the SEC would resemble the U.K’s which also require that advisers be registered with the FSA. This aspect can be seen as a significant and encouraging step toward greater harmonization of the legal regimes of the two main platforms for hedge fund managers[144], the United States and the United Kingdom.

1.2 Assessing the PFIARA

To assess the utility and the potential effectiveness of this proposal, two questions come to mind. (i) Does the PFIARA provide a real improvement and is likely to generate substantial changes in the hedge funds’ course of business? (ii) Does it address effectively the issue of systemic risk?

Registration

First of all, was the PFIARA really necessary? The main provision is the mandatory registration of all investment advisers who manage more than $30million of assets[145]. Many within the industry have expressed doubts as to what registration would really accomplish for investors, for hedge fund managers and for the markets. I tend to believe that registration is a good thing because it provides the SEC with the opportunity to exercise is oversight on the activity of hedge funds themselves through the oversight on hedge fund advisers.

However, I wonder why Congress would want to make this registration mandatory.

Indeed, there is a natural incentive from a hedge fund manager’s point of view to register as it gives them a competitive edge. It is particularly true in this economy that when an investor is faced with a choice between a registered fund and an unregistered one, she will naturally favor the one which is regulated.

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[142] Richard Baker in *Perspectives on hedge fund registration: hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services*, U.S. House of Representatives, One Hundred Eleventh Congress, first session, May 7, 2009, at 11

[143] Chris Kentouris, *The cost to comply*, Securities Industry News, December 6, 2004.

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

[145] Advisers managing less than $25 million in assets under management are prohibited from registering with the SEC and are subject to state law.

Some even declared that registration for registration's sake seems like a waste of time, as a growing number of hedge funds, 70% according to the Managed Funds Association, with majority of assets has already voluntarily registered, provide a list of holdings on a quarterly basis. The MFA further argues that having hedge funds register was in no way a guarantee that no incident would ever occur[146].

After all, the current crisis was caused by investment banks which are regulated and one of the biggest fraud of the century was committed by Madoff, a SEC registered broker-dealer.
Raising this particular issue, Juraj questioned in quite a humoristic way the effectiveness of regulation when he quoted one sentence from George Soros "I am having a good crisis"[147] and then the word "Guilty"[148] pronounced by Bernard Madoff at his trial and then explained that the main difference between these two gentlemen was that Madoff was subject to the SEC's oversight whereas Soros was not[149].

Finally, Groome expressed concerns however, as to the implications of the bill for non-US managers who could face dual registration and he therefore called for a full exemption for non U.S. managers who are already registered in an OECD country or others where domestic regulator cooperates and shares information with the SEC[150].

This concern, although legitimate, is addressed in the PFIARA which would, if not modified by the Senate, include a foreign private advisers exemption. Provided that (1) the adviser does not have her place of business in the United States (2) has had 15 or fewer clients in the preceding year, (3) has less than $25 million of assets under management[151] and (4) doesn't hold herself out to the public or advises a registered investment company, she wouldn't need to register with the SEC. The exemption seems a bit artificial because of the $25 million threshold which is low. As a result this exemption will be limited to a few investment advisers only whose involvement with U.S investors is low.

Transparency

Another concern is transparency. A previously discussed, hedge funds are often criticized for their opacity. However, stricter disclosure requirements to investors may not be needed.
Managers, whether registered or not, have fiduciary duties, are subject to antifraud provisions and must fulfill the requirements of private offerings under Section 4(2) of the Securities Act.

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[146] Eric Jackson, *The Good, the Bad and Ugly in Hedge Funds : A manager's view,* Business Week, March 5, 2009

[147] *I'm having a very good crisis,' says Soros as hedge fund managers make billions off recession*, Daily Mail, March 25, 2009.

[148] Diana B. Henriques, Jack Healy, *Madoff Goes to Jail After Guilty Pleas*, N.Y. Times, March 12, 2009

[149] Alexander Juraj, *New Governance and Hedge Fund Regulation: Shorting Federalism or Bernie's Nightmare?* Juraj,1 2009. On a similar argument also see Scott Garrett in Perspectives on hedge fund registration: hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, U.S. House of Representatives, One Hundred Eleventh Congress, first session, May 7, 2009 at 3

[150] *AIMA Reiterates Support for Registration of Hedge Fund Managers in the U.S.* November 3, 2009, available at http://www.aima.org/en/media_centre/press-releases.cfm/id/40F01E5D-3F04-4184-9B4E087C8FF502CD

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

They must make true, accurate and comprehensive disclosure in their Private Placement Memoranda (PPMs), their Partnership Agreements, their Subscription Agreements which typically contain the kind of information that would be required in a registration statement[152].

Moreover, as previously mentioned, as investors become more and more comfortable with hedge funds and their practices, their disclosure expectations grow which leads managers to disclose more information on the risks they take, on their compensation arrangements or on
the type of strategies used.

It is however difficult, in practice to grasp the risks that are taken as most of the time, PPMs list of types of potential risks to shield the manager and the fund from liability without being too specific, therefore failing to give an accurate picture of the risks at stake.
As far as the investor protection rationale is concerned, some argue that because pension and mutual funds invest in hedge funds additional protections should be created. Such protections already exist however. Mutual funds are subject to diversification requirements under the Investment Company Act and both pension funds and mutual funds' interests in a hedge fund cannot exceed 30%.

The second concern is the disclosure to counterparties. I don't believe that regulations need to be passed in order for broker-dealers or banks to assess risks. These counterparties have the expertise and the tools to carry their own due diligence and remain free not to enter into agreement if they reckon that the level of disclosure is not satisfactory enough. Therefore the opacity between hedge funds and counterparties can be solved by contractual agreements between parties, and need not regulatory intervention.

Leverage

Regulation T[153] already indirectly limits the amount of leverage hedge fund can undertake.
Indeed, Reg T regulates the extension of credit provided by broker-dealers and imposes a control of margin requirements of 50% for securities bought on margin. This means that hedge funds may be required at any time to satisfy margin calls and to deposit additional money or stocks to meet these requirements. This indirectly limits hedge funds' use of leverage as margin calls may occur at any time, especially when markets depreciate.

Jonna[154] however points out that broker-dealers typically arrange financing through foreign affiliates which are not registered with the SEC.

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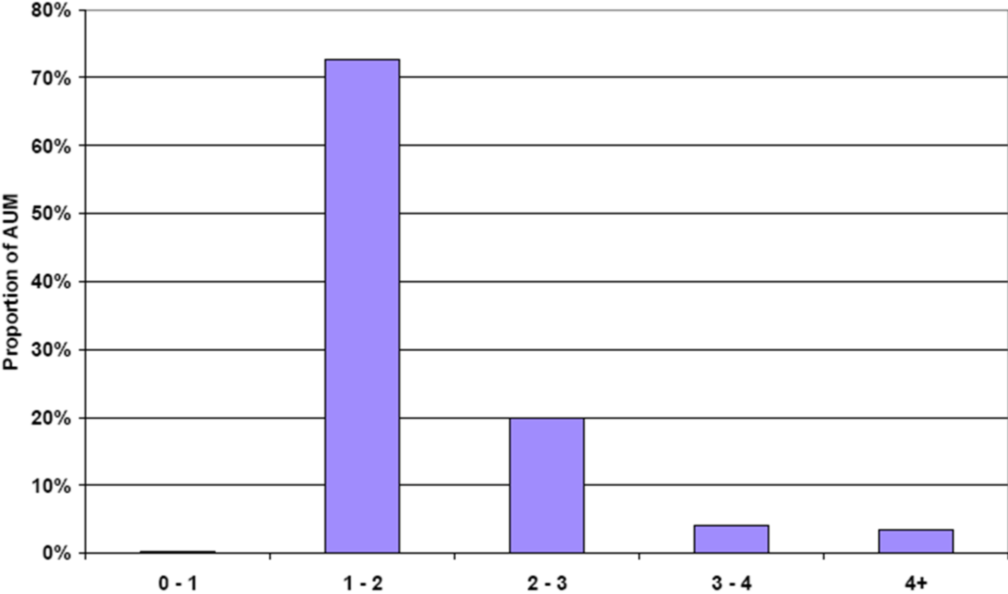
[152] Houman B. Shadad, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, Berkeley Business Law Journal, August 2009

[153] Federal Reserve Board Regulation 12 CFR §220, *available at* http://ecfr.gpoaccess.gov/cgi/t/text/textidx?c=ecfr&sid=635f26c4af3e2fe4327fd25ef4cb5638&tpl=/ecfrbrowse/Title12/12cfr220_main_02.tpl

[154] Paul Jonna, *In search of Market Discipline : the case for indirect hedge fund regulation*, 2008

Leverage can be a real issue in terms of systemic risk. However, it seems that the industry spontaneously limits its leverage use. The chairman of the FSA recently said that the average leverage of hedge funds was two or three to one and, which Congressman Edward Royce called a “staggeringly low amount of leverage if you consider that our most heavily regulated institutions like the government sponsored enterprises Fannie Mae and Freddie Mac, were leveraged here in the United States by 100 to 1”[155]. The exhibit below, provided by the Charles River Associates Report on the impact of the AIFM Directive illustrates this relatively low use of leverage on a global level. The report points out the fact that the amount of leverage depends on the strategies carried out by hedge funds and varies accordingly, arbitrage funds being for instance more leveraged than distressed securities-based investments[156].

Figure 11: Global assets under management by leverage



Source: Information provided to CRA by the Centre for Hedge Fund Research at Imperial College London. Analysis based on data available as of early September 2009.

The Fed also acknowledged that overall the industry showed a lack of leverage which explained why the losses hedge funds suffered didn’t threaten the stability of financial system.

Richard Baker, CEO of the Managed Funds Association reported that a recent study found that 26,9% of hedge funds used zero leverage[157].

The main reason explaining this relative lack of leverage is the fear to disappear. Leveraged funds run the risk of being wiped out.

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[155] Edward Royce in *Perspectives on hedge fund registration: hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services*, U.S. House of Representatives, One Hundred Eleventh Congress, first session, May 7, 2009, at 7

[156] Charles River Associates(CRA), *Impact of the proposed AIFM Directive across Europe*, October 2009 at 23

[157] Richard Baker in *Perspectives on hedge fund registration: hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services*, U.S. House of Representatives, One Hundred Eleventh Congress, first session, May 7, 2009, at 11

Indeed, hedge funds often invest in products that are already intrinsically leveraged and prone to illiquidity such as junk bonds. Moreover, because of redemption rights, investors may take their money away at any time, creating a potential danger for the fund, should it be too leveraged. Thus, there is a strong natural incentive for hedge fund managers to be spontaneously cautious about leverage. This incentive may be more effective at preventing irresponsible behaviors prone to pose a systemic risk problem than formal rules. The market acts as the best arbitrator between well and bad managed funds and operates a natural selection. Well managed, low leveraged funds are less likely to disappear, creating the best incentive for hedge fund managers to follow this "best practice".

Risk

Although one should not generalize too much, risks managers take may not be as dangerous as they appear, especially if one takes into account the fact that most hedge funds have socalled "high water mark" provisions which means that the manager only receives her performance fees when the assets' value is greater than its previous greatest value. Studies have shown that funds with high water marks perform better than those without, which according to Shadab demonstrates that managers react positively to this incentive[158].

Role of the SEC

One may question the relevance of the PFIARA. I believe one should be extremely careful when trying to constrain these vehicles not to be too aggressive but rather to favor flexibility.

This doesn't mean that hedge funds should be allowed to engage into any type of fraud or any other activity that would pose a real threat to the financial system. This means that the current legal framework needs not be changed. Preventing reckless behaviors and enforcing current rules may be achieved by reinforcing the powers of the SEC. In this regard, the recent trends and evolutions within the SEC must be applauded. Indeed, the SEC recently established five new units within its enforcement division, including one for hedge funds and private equity firms, regarded as one of the priority areas[159].

The newly appointed SEC's N.Y Chief George Canellos also confirmed that hedge funds were a big area of emphasis and that the SEC had conducted a number of significant sweeps of investment advisers in the last year or two. He further explained that they had moved towards cause and risk-based exams rather than more routine checks[160].
Finally, there seems to be a trend consisting in including more industry participants within the SEC's staff which is an interesting and encouraging evolution that could lead to a better understanding and therefore a better control of hedge fund activities.

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[158] Houman B. Shadad, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection,* Berkeley Business Law Journal, August 2009

[159] *New SEC Unit To Cover Hedge Fund, P.E. Probes*, FinAlternatives, January 14, 2010, *available at* http://www.finalternatives.com/node/10232

[160] Fin Alternatives, *SEC's New N.Y. Chief Turns Spotlight On Hedge Funds* January 4, 2010, available at http://www.finalternatives.com/node/10105

Based on the above-mentioned, I am doubtful of what the additional regulation could bring that market discipline and better-tailored SEC oversight couldn't achieve on its own.
Although registration is a good thing as it allows the regulator to have some control over hedge funds' activities, since there is a natural trend for hedge fund advisers to register voluntarily.

If the sole purpose of the PFIARA was to make registration mandatory, the impact will be very marginal compared to the time and costs this reform will have generated. It seems to methat the PFIARA fails to provide a sufficient benefit in terms of systemic risk reduction compared to the costs it entails.

The Obama/Volcker's proposal

The PFIARA is not the only proposal that would have an impact on the hedge fund world.
More problematic and potential harmful is the so-called Obama Proposal[161] introduced on January 21, 2010 which would bar bank holding companies from owning or investing in hedge funds and private equity funds. The rationale behind this proposal is to reduce systemic risk by limiting the interconnectedness of financial institutions. Yet, it is not clear that the rule would really have the effect it predicts. As Professor Hal Scott, Director of the Committee on Capital Markets Regulation expressed in his testimony before the U.S Senate Committee on Banking, Housing and Urban Affairs last February, "the Volcker Rules are *over-inclusive* because not all banks, and not even all large banks, pose chain-reaction risks to the financial system" and in the meantime, they "are also potentially *under-inclusive*, because many interconnected financial institutions which do pose systemic risks are not deposit-taking banks"[162].

Besides potentially failing to address the systemic risk issue, it would harm the hedge fund industry. Andrew Baker, CEO of the Alternative Investment Management Association expressed concerns about the "possibility of liquidity in markets being reduced and the prime broker relationship being adversely affected"163[163]. This situation is all the more preoccupying since the U.K has explicitly ruled out such a proposal and since the European Union is not likely to adopt such provisions. One can easily imagine what the lack of coordination might do to the U.S. hedge fund industry, should this proposal be adopted.

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161 This proposal was first introduced by former Federal Reserve Chairman Paul Volcker before Senate on February 2, 2010.

162 Hal Scott, *Prepared written testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, February 4, 2010, at 5, available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c372f56f-819f-4d93-bb5a-6c1802aeb18a

163 *Obama Proposal Would Block Banks From Hedge Funds, Private Equity*, FinAlternatives, January 21, 2010, *available a*t http://www.finalternatives.com/node/11031

2. The Alternative Investment Fund Managers Directive

2.1 Provisions of the Directive

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

First, fund managers who have less that € 500 million of assets under management, whose portfolios are unleveraged whose funds offer no redemption rights during 5 years may be out of the scope of this Directive. So would be an alternative fund manager who wouldn't manage a EU domiciled hedge fund and who wouldn't market in the European Union.

The AIFM Directive would require all alternative investment fund managers to be authorized in the member state in which its registered office is located and subject to harmonized regulatory standards on an ongoing basis. By alternative investment fund (AIF) the Commission means "any collective investment undertaking, including investment compartments thereof whose object is the collective investment in assets and which does not require authorization under the UCITS Directive"[164]. This definition, extremely broad and general includes hedge funds. Once authorized, fund managers would be allowed to market anywhere in the European Union, thus benefiting from the European passport[165], which would significantly reduce their costs.

Articles 19 to 21 impose transparency requirements such as the need to provide an audited annual report and to disclose information to investors and to regulators about the fund's investment strategy, the identity of depositary, the valuation procedure, and how liquidity risk is managed. According to CRA's impact report, the rationale behind this requirement is that, "disclosure to investors is expected to reduce asymmetric information and increase investor confidence about investing in the fund" and "disclosure to competent authorities is expected to bring about improved regulatory oversight of AIF including with respect to systemic
risk"[166].

Third countries funds could also be granted access to the European market provided that they meet EU regulatory and supervisory requirements and this, after a transitional period of three to five years. In other words, third countries funds would be allowed to be marketed in the EU if their legislations are equivalent to the provisions of the Directive, if there were reciprocal market access, and if they complied with the OECD Model Tax Convention standards.

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164 Article 3(a) of the Directive

165 Article 32 of the Directive

166 Charles River Associates(CRA), *Impact of the proposed AIFM Directive across Europe*, October 2009 at

Needless to mention that this particular provision, Article 35, has raised many critics that will be discussed below, all the more since only 5,8% of global hedge funds are domiciled in the EU, mainly in Ireland and in Luxembourg[167].

Finally, the AIFM Directive would impose minimum capital requirements[168], as well as conflicts, risk and liquidity management requirements[169], independent valuation of assets[170], threshold disclosure[171] and would limit the fund's use of leverage.

Assessing the AIFM Directive

On February 1st, the Spanish government, which currently holds the rotating presidency of the Union, published a new draft of the AIFM, the third one[172] which is heavily criticized, in particularly in the UK by the Bank of England, the Financial Services Authority and the House of Lords which warned that the rules could have disastrous consequences for the European economy and sap its competitiveness. On March 16, Spain announced that the vote of the Union's finance ministers on the AIFM Directive would be postponed to the beginning of the summer[173] which provoked strong reactions among members of the European Union Parliament and from some member states such as Germany.

Several provisions of the AIFM draft are problematic. The best illustration of the controversial nature of the European Commission language are the number of amendment suggestions[174] that have been made : more than 1000 so far, 80 were made by the AIMA[175] and the arguments it raised among member states and even within European institutions.

Leverage

The same reasoning as the one developed in the above PFIARA's assessment applies to the leverage requirements that the Directive would develop and impose on hedge funds. It seems like there is a natural incentive to limit leverage in order to avoid potential failures. Moreover, as the CRA impact study demonstrate, "it unclear that the AIFMD will be effective in preventing the transmission of systemic risk associated with leverage and leverage limits could add to pro-cyclicality at a time of crisis by forcing hedge funds to sell to stay within the prescribed regulatory limit. In addition, investors would no longer have access to particular strategies with high leverage, further reducing choice and returns"[176].

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[167] Charles River Associates(CRA), *Impact of the proposed AIFM Directive across Europe*, October 2009, at 18 and 58

[168] Article 14 of the Directive

[169] Articles 10 to 12 of the Directive

[170] Article 16 of the Directive

[171] Hedge funds would be required to disclose their positions when they reach 30% of voting rights

[172] The previous was introduced by the Swedish Presidency of the EU and was abandoned because of the critics coming mainly from the UK.

[173] *British Block European Hedge Fund Rules*, FinAlternatives, March 16, 2010 available at : http://www.finalternatives.com/node/11781

[174] *Avalanche of amendments inundate EU hedge fund rules,* FinAlternatives, January 28, 2010

[175] *Aima releases its list of amendments to Directive*, HFM week, January 13, 2010, *available at* http://www.hfmweek.com/news/427003/aima-releases-its-list-of-amendments-to-directive.thtml

[176] Charles River Associates(CRA), *Impact of the proposed AIFM Directive across Europe*, October 2009, at 4. This study was carried out for the FSA.

Finally, it should be mentioned that specific rules on leverage would be adopted through implementing measures after the Directive comes into force which creates uncertainty and make leverage limitations provisions difficult to assess at that stage of the legislative process.

Third country

The main critic targets the provision applicable to foreign funds. Under the current draft, foreign funds would not be allowed to market in the EU unless they meet EU standards that are stricter than most of their home jurisdictions', and only if co-operation arrangements are in place between the regulator of the manager's jurisdiction and that of the EU member state in which investors are located. This proposal would bar funds whose home jurisdictions' rules aren't as strict which represent 40% of the world's hedge funds according to Dan Waters, head of the FSA's asset management division[177].

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

Under such circumstances, the U.K's House of Lords has urged the British government to veto the proposed rules unless it is made "compatible with equivalent legislation with regulatory regimes in third countries and in particular in the United States"[178]. The HFSB also issued a statement expressing its concerns. "The draft directive has not been discussed with the key interested parties nor is it consistent with the analysis and recommendations of the Commission's own experts as outlined in the well received De Larosière Report. The Directive also ignores the efforts already underway to develop global proposals such as those taking place under the G20 process. We are particularly concerned that the draft Directive opts for prescriptive norms, in contrast with the principles-based approach under which the industry developed in the UK. It would empower the Commission to issue detailed regulations, in effect sidelining national regulators. It would also force non-EU countries to approve equivalent regulation if they want to maintain access to the European market"[179].

Jacques de Larosière himself acknowledged in a conference in June 2009 that the directive went "much further" than his report recommended[180].

Finally, the United States Secretary of Treasury has expressed his worries in a letter addressed on March 1, 2010 to EU Commissioner for Internal Market and Services Michel Barnier.

[177] *Avalanche of amendments inundate EU hedge fund rules,* FinAlternatives, January 28, 2010

[178] *British Lords Join In Savaging Proposed European Hedge Fund Rules*, FinAlternatives, February 10, 2010

[179] HFSB Statement on Alternative Investment Fund Managers Directive, April 29, 2009

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

Geithner asserts that "U.S-EU relationship is absolutely vital for achieving effective regulation of financial markets and that both markets should fulfill the G20 commitment to avoid discrimination and maintain a level playing field". He further explained that the United States is worried about "various proposals that would discriminate against U.S firms and deny them the access to the EU market"[181].

It is not clear at the moment whether the United States would fail the equivalence test since the criteria are not defined yet although the differences in tax regimes for instance could very well become an issue. Indeed the concerns expressed by third countries such as the United States come mainly from the lack of certainty regarding the criteria that would be used to determine whether a country's regulatory framework is equivalent and from the fact that these criteria are believed to be used as a way to bar non EU hedge funds from the European market.

The draft has also raised many critics within the hedge fund industry, particularly afraid that the Directive would put the hedge funds out of business in the EU. Hedge fund lawyers also expressed concerns about the potential outcome of such draconian measures and warned that should the Directive come into force, one would witness a hedge fund exodus and that soon no hedge fund would operate from within the European Union, since hedge funds are much more mobile than banks and would have no trouble relocating in more friendly jurisdictions[182].

Potential impact on investors

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

Article 3(d) of the Directive defines marketing as "any general offering or placement of units or shares in an AIF to or with investors domiciled in the Community[183], regardless of at whose initiative the offer or placement takes place".
Marketing would be prohibited for funds that do not comply with the Directive's provisions.

This is a different approach to that taken in the UCITS Directive, which allows investors to purchase securities that are not marketed in the EU. Since many funds will not be able to comply with the Directive requirements and will not be allowed to market in the European

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[181] T.Geithner, *Letter to Michel Barnier,* March 1, 2010 available at http://www.ft.com/cms/b102c1be-2d31-11df-9c5b-00144feabdc0.pdf
[182] *All Hedge Funds Will Leave European Union, Lawyer Warns,* FinAlternatives, December 14, 2009, *available at* http://www.finalternatives.com/node/9962
[183] Note that checking each investor's domiciliation could be challenging from a practical point of view as well as costly.

Union, investors will loose investment opportunities evaluated as a reduction in the annual returns to EU investors of around !1.4 billion[184]. This will also have a significant impact of such funds, as Andrew Baker from the AIMA explains. “Any restrictions imposed on European investors would also hit asset managers in financial centers such as the United States, Canada, Switzerland, Hong Kong, Singapore, Japan, Australia and South Africa”[185].

This paper supports the position taken by the UK and by the industry itself. The project of Directive doesn’t bring any benefit to European member states’ legal environments and may harm the industry. Its vagueness on disclosure issues and capital requirements for instance would make it either dangerous or ineffective. Moreover, the third country provision would be a disaster for hedge funds and for investors. Although some argue that the EU doesn’t want to discriminate against EU managers and that “it is a matter of level playing field”[186], one could answer to these people that the markets should not be regarded at the European level only but rather that one should seek to avoid discrimination on a larger scale, that is globally.

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

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

The debate of whether or not to regulate one player of the financial system is a crucial one that takes us back to a law and economics analysis of financial regulation.

Therefore, I would like to offer some general remarks on financial regulation and to apply those comments to the hedge fund situation (1). Following a cost/benefit approach, I conclude that current regulatory trends may be mis-oriented and fail to propose a better alternative to present legal regimes. Finally, Part III advocates for the creation of a global database of financial information that will allow regulators to monitor systemic risk without impairing hedge funds’ activities and performances and discusses the challenge of developing global standards (2).

1. General remarks on hedge fund regulation : What needs to be taken into account before considering more regulation

1.1 Questions to be asked and remarks to be made before considering modifying legal frameworks applicable to hedge funds Know what you want to regulate

When trying to regulate hedge funds one faces a major challenge that has to do with the subject of regulation itself.

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[184] Charles River Associates(CRA), *Impact of the proposed AIFM Directive across Europe*, October 2009, at 62

[185] *Spain re-introduces “protectionist” measure to European AIFM directive*, AltAssets, February 18, 2010, *available at* http://www.altassets.com/private-equity-news/article/nz17956.html

[186] Becher cited in *Foreign Funds Take Center Stage In EU Hedge Fund Debate*, FinAlternatives, February 6, 2010

Indeed, regulating hedge funds as a homogeneous entity may turn out to be a "fruitless exercise" because hedge funds are heterogeneous to the point of "being the entire investment world less the small subset of traditional investment strategies" from arbitrage to event driven or macro strategies. "With so broad a classification, seeking a uniform approach would be like developing a single set of traffic rules to apply for all modes of transportation, from pedestrians to commercial jets"[187]. Juraj makes a similar point when he writes that there is no single regulatory framework which can be imposed on all hedge funds because the variety of fund structure, strategies and their social positions require a varied approach[188].

Although I agree with the above, I would like to make a distinction between regulation as it is often regarded that is a between a rules-based approach and a principles-based approach of regulation. Trying to regulate such a heterogeneous group with stringent rules may be challenging, impossible and even dangerous. A principles-based regulation like the British Financial Services Authority's or the Dubai Financial Services Authority's (DFSA)[189] provides a general framework that the industry must follow and adapt to its own business. This approach is more flexible, thus making regulation better suited to the industry's needs and more likely to be properly enforced by hedge funds. This statement is illustrated by the forewords of the DFSA in its Hedge Fund Code of Practice: "Instead of rules, we have adopted a principles-based approach for developing best practice standards. We believe that those best practice standards will promote certainty while allowing industry participants a degree of flexibility to adapt these standards to suit their particular businesses in light of changing market conditions and emerging issues"[190].

The heterogeneity argument can also be applied to the size of these investment vehicles. It is quite intuitive to say that smaller funds are less likely to pose a systemic risk problem and thus need less supervision[191].

In the United States for instance 213 hedge funds are in the so-called "billion dollar club" and hold more than $1 billion of assets under management and 34 only manage more than $10billion[192]. This is a modest number compared to the 9 400 hedge funds that exist worldwide. This also means that most majority are probably too small to raise concerns of systemic risk.

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[187] Richard Bookstaber, *A Demon Of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation* John Wiley & Sons, Inc., 2007, at 248

[188] Alexander Juraj, *New Governance and Hedge Fund Regulation: Shorting Federalism or Bernie's Nightmare?* Juraj,1 2009

[189] In Dubai, hedge funds are required to comply with the Collective Investment Law (DIFC LAW No. 1 of 2006 which was enacted and came into force on 18 April 2006 and was amended in 2006 and 2007). These rules are broad and do not apply to hedge funds directly. Therefore, the DFSA has chosen to follow a U.K-like approach. In 2007, a non-biding Hedge Fund Code of Practice was launched. It aims at addressing issues and risks that are specific to hedge funds.

[190] Dubai Financial Services Authority, Hedge Fund Code of Practice, 2007 (came into force in 2008), at 2

[191] This point was made by Congressman Brad Sherman last May who said that small entities should not have to bear excessive regulation, in order to preserve what he referred to as "cowboy capitalism", in Perspectives on hedge fund registration: hearing before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, U.S. House of Representatives, One Hundred Eleventh Congress, first session, May 7, 2009, at 8

[192] Hedge fund intelligence, *Global Review 2010 Report,* 2010 *available at :* http://www.hedgefundintelligence.com/Article/2455359/Issue/74948/Global-hedge-fund-assetsrebound-to-just-over-18-trillion.html?Task=Report. The top 10 hedge funds manage between $20 billion to $50,4 billion as of January 2010.

It should be noted and appreciated that both the PFIARA and the AIFM address this concern by exempting small funds from registration and therefore by providing them a way out of complying and supporting the costs that registration and on-going disclosure would entail. Under the PFIARA, funds with less than $30 million of assets under management would be exempted from registration. The AIFM Directive also sets a threshold of € 100 million of managed portfolio below which hedge funds registration will not be required. Should the Directive be adopted, 90% of assets of EU domiciled hedge funds would fall under the scope of the Directive and would have to register[193]. The draft also sets a higher exemption threshold of !500 million for funds which do not use leverage and have a five years lock-in period for they are then deemed not to present a systemic risk.

Introducing more regulation can have several drawbacks that must be careful looked at prior to considering imposing new rules on one part of the financial industry. This analysis can be done by asking a set of questions as described below.
Are the potential benefits really worth the costs?

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

Because the term “regulation” encompasses the regulation of structure, of reporting, of activities, one must be extremely careful not to draw a conclusion that would be too general.
Indeed, although some types of regulation seem needed and relevant, some are not necessary.

Regulation consisting in the collection of data for instance allows to anticipate risks in order to mitigate them and avoid potential chain reactions. Allowing regulators to exercise a deeper oversight over the sector and to have access, under certain conditions already mentioned to hedge fund data bring a certain benefit to the financial system. Yet is this benefit really worth the costs and the energy governments are devoting to it at the moment?

One should never forget that introducing more regulation is costly, for governments, for regulators and for the industry itself. It is for instance estimated that the AIFM Directive would cost !3,2 billion[194] to the hedge fund/private equity industry due to rules on delegation and changes to legal structures which may require the reorganization of the business models, and around € 27 million in ongoing compliance costs[195]. Studies have also shown that the SEC’s estimates are understated[196].

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[193] *Financial services: Commission proposes EU framework for managers of alternative investment funds*, Press release Europa.eu, Brussels, April 29, 2009, *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/669
[194] *La proposition de directive AIFM pourrait coûter 3,2 milliards d'euros,* L'Agefi, October 16, 2009.
[195] For a detailed analysis of the impact of the Directive on costs, see Table 2 in Charles River Associates(CRA), *Impact of the proposed AIFM Directive across Europe*, October 2009, at 3
[196] Chris Kentouris, *The cost to comply*, Securities Industry News, December 6, 2004.

The term "costs" goes beyond the simple issue of compliance. Here costs refer to a broad category. It encompasses the time that will be devoted to discuss, evaluate, vote for, enforce on the part of the Legislator, to process the new registration, audit, investigate on the part of the regulator, to fill out forms, answer the regulator's demands, set out new compliance procedure, and provide extensive disclosure on the part of the investment managers. It also refers to the above-mentioned compliance costs for hedge funds and to a lesser extent to regulators as well as to reduced investment opportunities[197] for investors.

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

One needs to be extremely careful not to impose an excessive financial burden of hedge funds which could potentially harm them. This last remark is particularly addressed to the "third country" provision of the AIFM Directive which would probably have, should it come into force a disastrous financial impact on those funds and deter them and their managers from doing business from and with the European Union. The argument is less relevant however in the PFIARA case, which does not impose excessive requirements prone to financially destabilize hedge funds.

Finally, introducing new regulations can ultimately carry negative costs for the home country as it may impair its competitiveness. London, the EU's main hub for investment management could for instance lose a huge part of its business, should the Directive be enacted as it is drafted today. More generally one should think twice before passing regulations that could put a 1,7 trillion industry employing 150 000 people worldwide out of business[198].

What effect could direct regulation have on hedge funds, and on financial markets?
Introducing more regulation may also impair performances of hedge funds and harm the financial markets. Indeed, empirical studies[199] have shown that there is causal link between the amount of regulation and hedge fund performances and that the current legal regime in the United States is a source of Alpha[200]. According to Cumming "the data indicate that regulatory requirements in the form of restrictions on the location of key service providers and marketing channels that permit wrappers tend to be associated with lower MPPMs[201], lower alphas, lower average returns, higher fixed fees and lower performance fees.

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[197] According to CRA, investment opportunities in hedge funds would be reduced by 40% if the Directive were adopted.

[198] International Financial Services London (IFSL) Research, *Hedge Funds 2009,* April 2009, available at www.ifsl.org.uk

[199] For an empirical study on the impact of hedge fund regulation on performance, see Douglas Cumming*, A law and finance analysis of hedge funds*, April 5, 2008. The paper is based on an empirical analysis of a cross country dataset of 2137 hedge funds from 24 countries from January 2003 to December 2005.

[200] Houman B. Shadad, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, Berkeley Business Law Journal, August 2009

[201] Manipulation-Proof Performance Measure

The standard deviation of returns is lower among jurisdictions, with restrictions on the location of key service providers and higher minimum capitalization requirements”[202].
The current regime also has advantages on the market itself since hedge fund must constantly innovate to maintain their competitive edge, which the current legal framework allows thanks to its absence of constraints. Although some may argue that innovation tends to develop more complex products that carry more risks, innovation is first and foremost a key component of financial dynamism. Stifling financial innovation may result in stifling growth.

Alan Greenspan expressed further worries that over-regulating hedge funds may reduce liquidity which would have a large negative effect on the markets[203].
Is the proposed regulation flexible enough to meet hedge funds' characteristics?
Hedge funds are flexible investment vehicles tailored to meet the requirements of various exemption regimes. One need to keep in mind when dealing with this investment management funds that imposing strict regulations on them and/or on their advisers might not only drive them away but may also be counterproductive and encourage them to find loopholes.

By developing new techniques and products that would escape the regulatory scope they could potentially be even more dangerous for the market stability. Lo's comment on what regulation should be is, in this respect interesting when he writes that “new regulations should be adaptive and focused on financial functions rather than institutions, making them more
flexible and dynamic”[204].

Christian de Boissieu, comparing the tension between financial innovation and regulation to a « hide and seek game », concluded that a direct control of hedge funds would fail because the controlled instrument would reappear elsewhere under a new name and a new form.
According to him, it would better to rely on an indirect regulation of those funds, consisting in reinforcing controls on counterparties[205]. This is also the opinion of CESR Chairman Eddy Wymeersch who suggested that systemic risk-related information be gathered from prime brokers[206] and of Hellgardt who reckons that “since it is not warranted to destroy the hedge fund industry through heavy regulatory measures but rather to cultivate its beneficial impact on the financial markets, while monitoring the dangers for systemic stability, it is preferable to employ indirect regulatory techniques instead of reforming direct hedge fund regulation”[207] and to employ banks as gatekeepers for minimal interference with hedge funds operations.

[202] Douglas Cumming, *A law and finance analysis of hedge funds*, April 5, 2008 at 4.

[203] See John Horsfield-Bradbury, *Hedge Fund Self-Regulation in the US and the UK*, 2008

[204] Andrew W. Lo, *Hedge funds, systemic Risk, and the financial crisis of 2007-2008* : Hearing on hedge funds, written testimony prepared for the U.S. House of Representatives Committee on oversight and government reform November 13, 2008.

[205] Christian de Boissieu, L'articulation entre régulation et crise dans le secteur bancaire et financier, in Marie Anne Frison-Roche (sous la direction de), Les risques de la régulation *Volume 3*, Presses de Sciences Po et Dalloz, 2005, at 25

[206] EU Commission open hearing on hedge funds and private equity, February 26 and 27, 2009

[207] Alexander Hellgardt, *Hedge funds, the financial crisis, and regulatory competition : how to maintain U.S. supremacy in hedge fund incorporations,* Harvard Law School, 2010

These recommendations underline the need to regulate enough to prevent hedge funds from becoming a threat to financial stability, but not too much in order to avoid the counterproductive effects mentioned above.

The challenge lies in finding the right balance and appropriate measures that will provide benefits without creating a burden on hedge funds' competitiveness and operations. This comes down to asking the question of whether regulation is always the best alternative to reach the objectives sought and if similar goals could be reached otherwise.

The hedge fund industry gives a lot of importance to self-regulation, also known as market discipline which is organized by so-called SROs (self regulated organizations). The Hedge Fund Working Group in the UK, the Alternative Investment Management Association (AIMA), the Managed Funds Association (MFA), the Asset Managers' Committee to the President's Working Group on Financial Markets in the US are the main organizations providing guidelines to the industry and working hand in hand with regulators.

These SROs are well established authorities. In Europe for instance, the Hedge Fund Standards Board (HFSB) was set in 2008 and its board aim at codifying best practices.
Managers representing 60% of the European hedge fund industry and $350 billion in as assets follow the voluntary code of conduct of the Hedge Fund Standards Board[208].

Ben Bernanke in 2006 argued that "direct regulation may be justified when market discipline is ineffective at constraining excessive leverage and risk taking but, in the case of hedge funds, the reasonable presumption is that market discipline can work". He further underlined the costs in terms of moral hazard and the loss of private market discipline that direct regulation would imply and well as the possible limits on funds' ability to provide market liquidity[209]. SROs tend to establish rules that are better tailored to the realities and needs of the market and of the relevant activity. One of the main critic that was addressed to the SEC was that its staff was mainly composed of lawyers who may be disconnected from the realities of the industry they aim at regulating. Self regulation, through code of best practices enjoys a higher degree of acceptance by the rules addressees which as Fischer noted, leads to a greater degree of compliance by leveraging the industry's expertise by shifting at least part of the regulatory burden from the public authority to the industry[210].

Critics of self regulation include the suspicion of conflicts of interests, as the industry creates rules that will apply to themselves, and concerns as to how these codes of conduct could be enforced[211].

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[208] *BlueCrest, Winton Sign Up For Voluntary Hedge Fund Code*, FinAlternatives, February 11, 2010

[209] Chairman Ben S. Bernanke At the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, Sea Island, Georgia May 16, 2006

[210] Philipp Fischer, *Self-regulation in the financial sector; status quo and future outlook*, Harvard Law School, 2009 at 7

[211] Gaine (MFA), Lombard (AIMA) and Waters (FSA) in EU Commission open hearing on hedge funds and private equity, February 26 and 27, 2009. All three speakers view industry codes as a useful complement to regulation but point out the main problem with the self regulatory approach to be its enforcement.

The HFSB for instance specified in its response to a IOSCO consultation that "it is important to highlight that, while HFSB monitors the Standards, it does not serve as a regulator and does not enforce them"[212].

Therefore I do not believe in a control solely exercised by the industry but rather in a coordinated approach and in a stronger cooperation between regulators and SROs to create rules that are flexible enough to adapt to this fast-paced changing financial environment. By associating SROs to the rule-making process one may also achieve greater compliance and limit by-pass behaviors. One way of combining appropriately SROs and regulators would be to require mandatory membership in industry associations as Jiri Krol, Minister of Finance of the Czech Republic advocates for[213].

Juraj goes farther by suggesting that legislators should set basic goals and require regulators to ensure that each categories of funds adequately pursue these goals and that the assessment of adequacy should be a matter of negotiation and in case of controversy, of judicial determination[214]. This could however raise a lot of issues in terms of legal certainty and even more critical in terms of how the SEC would treat funds that carry several strategies and do not fall into one specific category.

Also interesting is the initiative of the Asset Managers' Committee to the President's Working Group on Financial Markets, which released its "Best practices" report together with a separate "Investors' Report", in order to increase accountability for hedge fund managers[215].
The PWG reckons that a large part of the responsibility of investment assessment should be on investors themselves[216]. This regulation by the market that would sanction managers that do not comply with best practices principles while educating investors at the same time can also help making sure that rules are effectively enforced without additional costs on regulators and on managers.

At that point a general recommendation can be made. When contemplating more regulation, legislator should keep in mind that the more they will make their interests and the industry's interests coincide, the more effective and the better enforced their rules will be. Regulation is often seen as a punishment on such or such activities or market players. This can and should be remedied by at least trying to reach an alignment of all parties' interests.

1.2 Proposal for the creation of a global database of systemic risk
The dangers of mandatory public disclosure

Legislators and regulators need to understand hedge funds and the impact such regulation would have in order to achieve a reasonable legal framework that will not jeopardize their activities and their very existence. In that respect, initiatives such as

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[212] Hedge Fund Standards Board (HFSB) response to the IOSCO Consultation Report on Hedge Fund Oversight, 2009, *available at* http://www.hfsb.org/sites/10109/files/hfsb_response_iosco_hf_oversight_30_04_2009.pdf
[213] EU Commission open hearing on hedge funds and private equity, February 26 and 27, 2009
[214] Alexander Juraj, *New Governance and Hedge Fund Regulation: Shorting Federalism or Bernie's Nightmare?* Juraj,1 2009
[215] Best practices for the Hedge Fund Industry – Report of the Asset Managers' Committee to the President's Working Group on Financial Markets, April 2008
[216] John Horsfield-Bradbury, *Hedge Fund Self-Regulation in the US and the UK*, 2008, at 36

the studies of the AIFM Directive that were made, must be encouraged and developed[217].

To illustrate how regulators' goals can directly conflict with hedge funds activities, one can mention the provisions of both the PFIARA and the AIFM Directive requiring disclosure of positions and strategies. One can understand that there is a legitimate rationale in trying to assess the risks posed by each hedge funds to limit systemic risk. However it is not clear that these information will remain confidential or if they will be made public. If the purpose of these provisions is to disclose these information to the public, they could have dreadful consequences on the industry and be counterproductive in many respects.

First of all, it raises an intellectual property issue. Hedge funds distinguish themselves from other funds by their investment strategies. As Lo expresses it, hedge funds are "among the most secretive of financial institutions because their franchise value is almost entirely based on the performance of their investment strategies, and this type of intellectual property is perhaps the most difficult to patent"[218]. If forced to disclose such strategies, they may not be able to maintain their competitive edge, thus affecting their competitiveness and diminishing their contributions to markets liquidity. Lo warns about the disastrous effects forced disclosure would entail.

According to him the most intellectually innovative funds would cease to exist or move to less intrusive regulatory jurisdictions generating a major loss to the American capital markets. This argument is easily transposable to the EU. This provision could have a procyclic effect and increase systemic risk. Indeed if rules have a negative impact on hedge funds and lead them to fail, this will certainly not be an improvement for systemic risk prevention.

Second, full disclosure could entail moral hazard issues as the Issing Committee preparing the London G20 meeting highlighted in its report. According to the Committee, full disclosure could lead hedge fund advisers to feel "wrongfully safe"[219] and therefore less cautious.

Third, making positions and strategies available to other funds could lead to herding behaviors which, as we have previously discussed is source of systemic risk.
Finally, there is a practical concern which relates to the ongoing collection of hedge fund information. The Issing Committee called it "unrealistic, because of the fast changes in fund exposures and the enormous data collection and analytical requirements involved"[220].

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[217] The PFIARA also includes a provision on cost study to be carried out by the Comptroller General assessing the costs borne by investors and advisers due to new requirements within two years of the enactment of PFIARA. The Dodd version includes impact studies on the feasibility of a self-regulatory organization to oversee private funds, on the accredited investor standard and on short selling practices. Although this is a good initiative, carrying such a study prior the enactment would be preferable in order to anticipate rather than to adapt ex post.

[218] ! 218 Andrew W. Lo, *Hedge funds, systemic Risk, and the financial crisis of 2007-2008* : Hearing on hedge funds, written testimony prepared for the U.S. House of Representatives Committee on oversight and government reform November 13, 2008.

[219] New Financial Order Recommendations by the Issing Committee Preparing G-20 – London, April 2, 2009 Version: February 2, 2009

[220] New Financial Order Recommendations by the Issing Committee Preparing G-20 – London, April 2, 2009 Version: February 2, 2009

The day to day monitoring of hedge funds was also rejected by Ben Bernanke, who stated that "a system in which hedge funds and other highly leveraged market participants submit position information to an authority that aggregates that information and reveals it to the market would probably not be able to address the concern about liquidity risk. Protection of proprietary information would require so much aggregation that the value of the information to market participants would be substantially reduced"[221].

Preliminary remarks

Therefore, as previously mentioned, this paper advocates for a cautious approach to data collection. It supports the idea that all the information gathered be kept anonymous and confidential, accessible for the sole purpose of assessing risks and for the use of regulators only. To do so will guarantee that hedge funds will be able to carry their strategies while allowing regulators to properly exercise their control. This paper also supports the idea that burden of proving that the information are necessary to assess systemic risk should be placed upon regulators[222] in order to avoid excessive requests. It also argues that the day to day collection of data is irrelevant, excessive and costly and that information should be collected on a monthly basis, or at a smaller interval when the markets are too volatile and only if regulators prove it to be necessary.

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

For a global database of financial information

Taking into account all the arguments developed above, this paper recommends the creation of a global database of financial information[223].

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[221] Chairman Ben S. Bernanke At the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, Sea Island, Georgia May 16, 2006

[222] This recommendation was made by the Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform*, May 2009

[223] This recommendation was developed in the report prepared by the think-tank Club Praxis *in* Club Praxis *Rapport Flash sur la Régulation Financière Systémique,* New York, December 9, 2009, *available at* http://www.clubpraxis.com/spip.php?page=dossiers&id_rubrique=6. The report recommends that this database be a G20 initiative placed under the supervision of the Forum of Financial Stability

By financial information, I mean all useful and relevant information necessary to carry out a proper assessment of systemic risk, such as information on leverage, value-at risk (VaR)[224], collateral, liquidity needs, use of financial instruments, especially of complex financial instruments such as over-the-counter derivatives, and of course information about the interconnectedness to other large financial institutions.

Hedge funds would disclose such data but any other financial entity that is potentially systemically significant would be required to as well[225]. To do so will allow regulators to understand the structures and dynamics of interconnections between financial institutions and to develop an *ex-ante* approach to regulation of systemic risk which is probably the most effective way to deal with such complex financial networks. The information gathered on hedge funds would remain confidential and anonymous in order to avoid the intellectual property issues we already discussed.

On February 25, 2010, the International Organization of Securities Commissions (IOSCO), whose members amount 95% of the world's securities markets released a template for the global collection of hedge fund information to be disclosed every six months that "will assist in assessing possible systemic risks arising from the sector"[226]. Although, the organization has no formal authority to impose those disclosure requirements on hedge funds, its members are committed to follow its guidelines. This initiative is certainly a first step toward international cooperation but several reservations may be mentioned. This template diverges from the above proposal in several respects.

First of all, this provision is insufficient as it targets hedge funds only and fails to make this global database a true systemic risk monitoring tool that would encompass other financial institutions and would allow a complete assessment that would take into account mutual exposures.

Secondly, it is not clear that these informations will be confidential and will not be disclosed to the public which I regard as problematic. The third concern that may be expressed has to do with enforcement, as the IOSCO doesn't have any direct authority on hedge funds.

2. The challenge of developing a global approach to hedge fund regulation

2.1 The difficulties of developing global standards

Another quite intuitive remark must be made. In today's world, markets are interconnectedand finance ignores borders when the law is confined within a defined territory, creating a disjunction between territorial regulation and global activities.

[224] The Value at risk "measures how much the institution can be harmed by market moves: it is concerned with the marginal loss distribution of the institutions portfolio" see Rama Cont, Amal Moussa, Andreea Minca, *Too interconnected to fail: Contagion and Systemic Risk in Financial Networks,* Working Paper, Columbia Center for Financial Engineering, 2009. The VaR may be an interesting indicator but measuring systemic risk implies that one understands how much the financial system can be harmed by the failure of an institution. Therefore additional indicators may be needed. The paper mentions in this footnote proposes two new measures of systemic risk which I find compelling: the "default impact" which measures the connectivity with other market participants and the magnitude of exposures, and the "expected systemic loss" measure.

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

[226] International regulators publish systemic risk data requirements for hedge funds, IOSCO press release, February 25, 2010, available at http://www.iosco.org/news/pdf/IOSCONEWS179.pdf

This remark is a general one but applies to hedge funds and might be one of the greatest challenge financial law is faced with.
Indeed, with operations and investors in different jurisdictions come besides the potential conflicting regulations issues as well as high costs of compliance. It also carries the risk of forum shopping since the absence of coordinated approach at the international level allows hedge funds to run away to less stringent jurisdictions out of the reach of regulatory oversight which is hardly good news for the efforts to mitigate systemic risk.

This aspect was highlighted by the Florence Lombard, Executive Director of the Alternative Investment Management Association (AIMA) who called for a system of mutual recognition of international standards even from offshore jurisdictions[227]. It seems that a coordinated approach to regulation would be much more effective and less costly.
Achieving a global harmonized legal framework for hedge funds appears to be very utopian, at least for now. As Part I demonstrated there is no common regulatory approach in the United States and even within the European Union. As Part II then tried to convey, the current reform proposals didn't seize the opportunity to promote a coordinated approach.

There still is no consensus on what form regulation should take, on what should be regulated.
Even within the European Union, member states fight among themselves to impose their own visions of financial regulation and do not seem to be willing to compromise and move toward greater harmonization.
This paper doesn't support the idea that international financial regulation can never be achieved, it just acknowledges the fact that there are some structural and cultural elements that must be taken into account by anyone who is willing to overcome those difficulties and promote an international framework.

There are some deep philosophical and cultural differences that have shaped different conceptions of regulation itself and of regulation of investment vehicles in particular. There seems to be on one side the U.K and the U.S and to a lesser extent Italy which favor a flexible approach to hedge fund regulation, and France and Germany on the other side which keep pushing for more regulation. Understanding these divergences is the first step to overcome them and to develop an international legal framework.

These differences may, first of all, be rooted in the very conception of the role of the state, as France and Germany have a strong state intervention tradition while the US has a more liberal. This may also come from the role of the law itself in each country. France for instance has always been a highly regulated country and has a frantic legislative activity while the United States regulates more lightly and only if necessary.

[227] EU Commission open hearing on hedge funds and private equity, February 26 and 27, 2009

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

Finally, and despite the efforts of the G20, there seems to be a competition between the jurisdictions mentioned in this paper to impose their own vision of regulation in a very chauvinistic way which is prejudicial in my view[228].

In today's financial world, one can no longer afford this nationalism of another age. I particularly find regrettable certain statements made by regulators or politicians that jeopardize the efforts to built an effective international cooperation. For instance, the answer given by the President of the French AMF when asked what should be done at the European level to deal with hedge funds which consisted in the following answer: "setting the example and not be subject to a regulation that would be strictly American"[229] or EU Commissioner Michel Barnier who declared that he would not be "bullied by Paris, by London and certainly not by Washington", the FSA officials publicly saying that the UK would not make any compromise on the current draft of the AIFM Directive, or Angela Merkel who verbally attacked Gordon Brown over his refusal to move forward with the Directive[230].

Beyond philosophical and cultural differences, there is a competitiveness issue that makes the internationalization of financial regulation quite slow. Indeed, although achieving a levelplaying field seems compelling in many respects, many countries fight to keep their competitive edge in sometimes a very protectionist way. This is what Joseph Stiglitz develops in a recent article when he states that "each country looks at each proposal and assesses how it affects the competitiveness of its financial system. The objective too often is to find a regulatory regime that crimps competitors more than one's own companies. As the saying all politics is local, and, at least in the US and many other jurisdictions, finance is a big political player"[231].

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

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

[230] Tony Czuczka and Patrick Donahue, *Merkel Berates U.K. Over Hedge-Funds*, BusinessWeek, March 17, 2010

[231] Joseph Stiglitz, *Watchdogs need not bark together,* Financial Times, February 10, 2010

2.2 Overcoming divergences and differences to effectively mitigate systemic risk on a global scale

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

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

Failure to achieve global standards in current reform proposals doesn't mean that efforts in that sense do not exist. Examples of these efforts to develop global cooperation may for instance be illustrated by the existence of bilateral agreements between regulators such as the "memorandum of understanding on consultation, cooperation and information exchange related to the supervision of financial services firms and market oversight" between the FSA in the U.K and the SEC in the United States. The "strategic dialogue" between the two regulators was initiated in 2006 and met for the fifth time on February 2nd to discuss among other things the regulation of hedge funds and investment advisers[232].

Efforts are also made for instance within the G20, IOSCO, the CESR and various *fora* and committees to develop international standards, which should be encouraged.
Yet, if such initiatives exist, they are often more formal and rarely lead to legal harmonization, often confronted with legislators who are not willing to go down that path. The most advanced example of global cooperation to this date remains at the SROs' level.

They indeed easily generate consensus within the industry. The guidelines they provide the industry with are flexible and easily transposable on a global level. Andrew J. Donohue, Director of the Division on Investment Management at the SEC referred to such rules as "serving as an excellent model for the way in which industry can work together with regulators around the globe to develop smart and sensible solutions to hedge fund regulatory issues and to strengthen and enhance confidence in all of our markets"[233].

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[232] FSA Press release, *SEC and UK FSA Hold Fifth Meeting of the SEC-FSA Strategic Dialogue available at* http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/021.shtml and *SEC, FSA To Boost Cooperation On Hedge Funds*, FinAlternatives, February 2, 2010, *available at* http://www.finalternatives.com/node/11207

[233] Andrew J. Donohue, Keynote Address at the 9th Annual International Conference on Private Investment Funds March 10, 2008

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

The proposal presented in this paper takes this structural difficulty into account. It acknowledges the natural tendency jurisdictions have to handle regulation on a national-basis.

The creation of a global database of systemic risk doesn't negate national prerogatives to regulate as each country sees fit but promote a framework for global cooperation via an information sharing system superimposed on national regulations.

Conclusion

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

The paper deplores the lack of global coordination and convergence in current efforts to reform the hedge fund legal framework. It therefore recommends that hedge funds remain lightly regulated and that increased harmonization be reached through private initiatives that have demonstrated their success in developing international best practice standards, which are now widely accepted by the industry and implemented.
Nonetheless this paper acknowledges that hedge funds raise legitimate concerns about systemic risk, and that action should be taken in order to try to mitigate potential threats to financial stability.

Systemic risk is neither national nor limited to one player. It must be treated using a coordinated and global approach. As a report of the British Academy very well noted "risk calculations were most often confined to slices of financial activity, using some of the best mathematical minds in our country and abroad. But they frequently lost sight of the bigger picture"[234]*.* In order to reach this "bigger picture" this paper recommends the creation of an international database that would be in charge of collecting of all the financial positions and the counterparts of all the big financial institutions and to monitor systemic risk on a global scale through increased cooperation efforts.

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