Vanderbilt Journal of Transnational Law

Volume 44
Issue 2 *March 2011*

Article 4

2011

Hedge Fund Regulation via Basel III

Wulf A. Kaal

Hedge Fund Regulation via Basel III

Wulf A. Kaal[*]

ABSTRACT

This Article is a rejoinder to a recent comment by Professor Romano on an earlier paper I coauthored with Christian Kirchner. Professor Romano suggests regulatory arbitrage, rather than the targeted regulation of bank lending to hedge funds under Basel III, as a hedge against systemic failure. I contend that it was not harmonization through Basel II but rather the profitability of certain assets and business strategies that caused banks to hold similar assets and engage in similar strategies. In particular, I find that the increasing role of hedge funds in the credit derivatives market, in combination with the market's recent failure, suggests that an increased emphasis on banks' lending exposure to hedge funds could be justified. Using the methodological approach of New Institutional Economics, I evaluate recent regulatory changes, including the U.S. Dodd–Frank Act, the AIFM Directive, and other pertinent regulation. I provide an impact analysis of regulatory changes, de lege lata and de lege ferenda, with a special emphasis on, and historical analysis of, hedge fund registration rules and asymmetric regulation in Dodd–Frank and the AIFM Directive.

---

* Assistant Professor, Mississippi College School of Law. Ph.D., Humboldt Universität zu Berlin; LL.M., J.D., University of Illinois College of Law; M.B.A., Finance, Durham University. The author would like to thank Christian Kirchner, John C. Coffee Jr., Geoffrey P. Miller, and the participants at the Third International Conference in Law & Economics of Global Financial Institutions at the University of St. Gallen, Switzerland. I would also like to thank Joan MacLeod Heminway and Lyman P. Q. Johnson for comments and David L. Mengle for helpful tips on data sources. Special thanks go to Roberta Romano for her response and comment on the paper coauthored with Christian Kirchner, "Economics of Financial Market Regulation: Banking Regulation, Corporate Governance, Financial Reporting Standards and Hedge Funds," presented on June 4, 2010 at the Third International Conference on Law and Economics at the University of St. Gallen (on file with author). This rejoinder hopes to address some of the issues. The author would also like to thank Ms. Caroline Kunz Ivanov for her outstanding research assistance. The Article was supported by a research grant from Mississippi College School of Law.

TABLE OF CONTENTS

I. INTRODUCTION

The collapse in the market for exotic financial instruments, the liquidity crisis in major financial institutions, and the government bailouts of 2008–2009 have undermined confidence in the financial markets and illustrated shortcomings in corporate governance and banking regulation.[1] Hedge funds have been blamed for their part in the crisis[2] and have become a scapegoat for the problems affecting many aspects of financial markets.[3] Regulators worldwide increasingly scrutinize hedge funds and have introduced, among other measures, registration requirements, limits on leverage, and more disclosure.[4]

Much of the new regulation in the Dodd–Frank Act has been criticized for being reactive and shortsighted.[5] Similar criticisms of

---

1. For a general analysis of causal factors of the international financial markets crisis, see Christian Kirchner, *Wege aus der Internationalen Finanzkrise*, 89 WIRTSCHAFTSDIENST 459–65 (2009).

2. *See, e.g.*, James Kanter, *Tighter Rules for Foreign Hedge Funds Advance in Europe*, N.Y. TIMES, May 17, 2010, http://www.nytimes.com/2010/05/18/business/global/18hedge.html?r=1 ("Regulators and lawmakers worldwide are tightening their scrutiny of hedge funds and private equity firms on the grounds that they have been partly to blame for the worst financial crisis in a generation.").

3. *See* Kate Burgess, *Suspect Strategies: Activism in the Hedge Fund Sector*, FIN. TIMES, June 22, 2010, http://www.ft.com/cms/s/2/40826fee-7dda-11df-b357-00144feabdc0.html#axzz1BtNc8avl (describing the German–European Union debate after the TCI's attempt to take over Deutsche Börse); *see also* Markus Lahrkamp, *Germany: Day of the Locusts?*, HEDGE FUND J., Mar. 2007, http://www.thehedgefundjournal.com/magazine/200703/commentary/germany-day-of-the-locusts.php (describing the "Locusts" debate); *America's Stockmarket Plunge: A Few Minutes of Mayhem*, ECONOMIST, May 13, 2010, http://www.economist.com/node/16113270 ("Another factor [in the debate] was the sudden retreat by the 'high frequency' firms whose algorithmic trading has come to dominate equity markets.").

4. For example, the Private Fund Investment Advisers Registration Act (PFIARA), incorporated in Title IV of the Dodd–Frank Act. Dodd Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act tit. IV, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (to be codified as amended in scattered sections of 15 U.S.C.); *see also, e.g.*, *Commission Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/.../EC*, at 3, COM (2009) 207 final (Apr. 30, 2009) [hereinafter *Commission AIF Proposal*] (stating that hedge funds have contributed to asset price inflation and the rapid growth of structured credit markets); *European Parliament Legislative Resolution of 11 November 2010 on the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives*, at 20, COM (2009) 0207 (Nov. 11, 2010) [hereinafter *November 11 Directive*].

5. Stephen M. Bainbridge, *Dodd–Frank: Quack Federal Corporate Governance Round II*, at 10 (UCLA Sch. of Law, Law–Econ. Research Paper No. 10–12, 2010), *available at* http://ssrn.com/abstract=1673575.

the Alternative Investment Fund Managers Directive (AIFM Directive) are likely. Scholars have proposed a wide range of possible solutions to address the concerns in the debate on hedge funds and hedge fund regulation.[6] In response to an earlier paper coauthored with Christian Kirchner, Professor Romano suggests regulatory arbitrage, rather than the targeted regulation of bank lending to

---

6. *See, e.g.*, Ronald J. Colombo, *Trust and the Reform of Securities Regulation*, 35 DEL. J. CORP. L. 829, 871–72 (2010) (proposing a trust-based approach, and explaining that those hedge funds that have not "gain[ed] traction in the development of affective and generalized trust . . ." could register, and "avail themselves of the next best thing: cognitive and specific trust via voluntary subjection to SEC regulation"); Evan M. Gilbert, *Unnecessary Reform: The Fallacies with and Alternatives to SEC Regulation of Hedge Funds*, 2 J. BUS. ENTREPRENEURSHIP & L. 319, 343–48 (2009) (offering alternatives to mandatory registration of hedge funds, including voluntary registration, regulating hedge fund creditors, regulating intermediary investment vehicles more stringently, relaxing regulations on mutual funds to create more competition for hedge funds, and giving hedge funds proprietary rights over their investment strategies); Paul M. Jonna, *In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation*, 45 SAN DIEGO L. REV. 989, 1022 (2008) (suggesting that pension funds may only invest in hedge funds that have registered with the SEC); Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28 ANN. REV. BANKING & FIN. L. 581, 635 (2009) (proposing the institution of general investor suitability requirements); David Schneider, *If at First You Don't Succeed: Why the SEC Should Try and Try Again to Regulate Hedge Fund Advisers*, 9 J. BUS. & SEC. L. 261, 307–10 (2009) (suggesting leverage limits and requiring the hedge fund industry to adhere to the principles in either PWG's Best Practices or the Managed Funds Association's Sound Practices guide for greater transparency); Dale B. Thompson, *Why We Need a Superfund for Hedge Funds*, 79 MISS. L.J. 995, 996 (2010) (suggesting that we borrow the concept of superfunds from environmental law, i.e., collect taxes from hedge funds relative to the amount of liquidity risk and use the revenue to purchase distressed assets, thus incentivizing the reduction of liquidity); J.W. Verret, *Dr. Jones and the Raiders of Lost Capital, Hedge Fund Regulation Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 817–24 (2007); Carl J. Nelson, Note, *Hedge Fund Regulation: A Proposal to Maintain Hedge Funds' Effectiveness Without SEC Regulation*, 2 BROOK. J. CORP. FIN. & COM. L. 221, 221 (2007) (proposing that investment requirements for hedge funds should be updated and that counterparties should be subject to greater disclosure); Christian Kirchner & Wulf A. Kaal, Economics of Financial Market Regulation: Banking Regulation, Corporate Governance, Financial Reporting Standards and Hedge Funds 2 (June 4, 2010) (presented at the Third International Conference on Law and Economics at the University of St. Gallen) (on file with author); Roberta Romano, *Against Financial Regulation Harmonization: A Comment* 2–3 (Yale Law & Econ., Working Paper No. 414, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1697348.

> [R]egulatory arbitrage is not a source of grave concern, in the absence of data to the contrary regarding specific products, entities or markets. Moreover, the solution to regulatory arbitrage, regulatory harmonization, can itself generate systemic risk to the financial system, which has only recently begun to be appreciated in the ongoing assessment of the factors contributing to the global financial crisis of 2007–08.

Romano, *supra*, at 2–3.

hedge funds under Basel III, as a hedge against systemic failure.[7] Others contend that the pre-Dodd–Frank approach of allowing advisers to voluntarily register was more effective, and they propose a trust-based approach that would allow funds that earned general trust from the public to operate on the basis of that trust, without the interference of regulation.[8] The debate over the most appropriate form of hedge fund regulation is far-ranging, and important proposals include changing the criteria for investing in hedge funds,[9] setting up a self-regulatory organization,[10] subjecting counterparties to greater disclosure,[11] increasing leverage limits[12] and transparency,[13] using the concept of superfunds and collecting taxes from hedge funds,[14] regulating hedge fund creditors,[15] relaxing the regulation of mutual

---

7. Romano, *supra* note 6, at 1 (arguing that regulatory arbitrage is a byproduct of regulatory diversity and "provides a valuable, and little appreciated, hedge against systemic failure").

8. Colombo, *supra* note 6, at 871–72 (explaining that those hedge funds that have not "gain[ed] traction in the development of affective and generalized trust" could take advantage of the option to register, and "avail themselves of the next best thing: cognitive and specific trust via voluntary subjection to SEC regulation"); *see also* Gilbert, *supra* note 6, at 344 (advocating a voluntary registration system for hedge funds).

9. Kaal, *supra* note 6, at 627–28; Nelson, *supra* note 6, at 231; Schneider, *supra* note 6, at 308.

10. Verret notes that because government regulators have difficulty regulating rapidly changing markets, "[o]ne answer to this problem is to let the private market regulate itself through encouragement and support from the government oversight body." Verret, *supra* note 6, at 817–18, 836–37. The SEC would oversee self-regulation in four ways: encouraging the formation of a self-regulatory organization, establishing rules, approving the rulemaking body to ensure the representatives encompass "a representative sample of the hedge fund industry," and establishing that there is a separate body within the organization that has independent authority to enforce violations of the self-regulating authority's rules. *Id.*

11. Nelson contends that those who provided excessive leverage to hedge funds should be more strictly monitored and because they are already regulated this would be an easy transition. Nelson, *supra* note 6, at 238–39. He further points to reports by the SEC and FTC that "indicated the most effective way to contain excess leverage was not by regulating hedge funds, but through the discipline of hedge fund counterparties, such as the banks who lend hedge funds capital with which to invest." *Id.*

12. Schneider states that one approach is to place leverage ratio limits on hedge funds. Schneider, *supra* note 6, at 307–08. "Leverage limits can insulate systemic risk for two reasons. First, hedge funds will be less likely to fail or default on their loans . . . . Second, should a hedge fund fail, creditors will feel less pain which will stem the possible ripple effect." *Id.*

13. *Id.* at 309–10.

14. Thompson suggests borrowing the concept of superfunds from environmental law to address the need for hedge fund regulation. Thompson, *supra* note 6, at 996–97. This proposed method would involve collecting a tax from hedge funds. *Id.* The tax payable by hedge funds would be relative to the amount of liquidity risk of the portfolio. *Id.* The revenue from the taxes would be used to purchase distressed assets when problems arise due to liquidity and valuation. *Id.*

15. Gilbert contends that hedge fund creditors should be regulated instead of hedge fund managers because by limiting the amount of credit the banks can extend to hedge funds, a hedge fund's collapse would have less impact. Gilbert, *supra* note 6, at

funds to increase competition for hedge funds,[16] introducing proprietary rights for hedge fund trading strategies,[17] and regulating hedge funds through their investors.[18]

Using New Institutional Economics as a methodological approach, the analysis in this Article is based on the assumption that regulation of hedge funds could minimize some of the social externalities that may be generated by the hedge fund industry. Given the global scale of hedge fund activities and the dynamic nature of their trading strategies, however, it is unclear if and to what extent hedge funds generate social externalities. The role of hedge funds in the financial crisis is also unclear.[19] After the collapse of Long-Term Capital Management (LTCM) in 1998, most dealer-banks required full collateralization of hedge fund transactions.[20] Accordingly, hedge funds were less levered than banks.[21] Later, the collapse of large hedge funds, like Amaranth in 2006,[22] and large redemptions by investors during and after the crisis[23] did not cause

---

345–46. Intermediary investment vehicles would be subjected to more stringent regulations because these regulations would also be more easily implemented. *Id.*

16. *Id.* at 346–47 (suggesting that relaxing regulations of mutual funds would create more competition for hedge fund business and would, in turn, incentivize more voluntary registration of hedge funds).

17. *Id.* at 347–48 (arguing that proprietary rights in hedge fund trading strategies and other private hedge fund information would eliminate the concern that hedge funds will not voluntarily register because they are concerned about making such strategies public).

18. *See* Jonna, *supra* note 6, at 1016–17 (suggesting a requirement that pension funds only invest in hedge funds that have registered with the SEC, or limiting the amount of plan assets that can be invested in unregistered hedge funds).

19. *See* Romano, *supra* note 6, at 3 ("[T]here is an absence of evidence pointing to hedge funds as a contributing factor in the recent financial panic.").

20. *Too Big to Swallow*, ECONOMIST, May 16, 2009, http://www.economist.com/node/13604641 (noting that after the failure of LTCM there was flight to traditional banking).

21. *Professionally Gloomy*, ECONOMIST, May 17, 2008, http://www.economist.com/node/11325440 ("After the collapse of Long-Term Capital Management in 1998, banks started scanning the counterparty horizon more carefully for risks from hedge funds. From now on they will look much more closely at each other.").

22. *Buttonwood: Paint It Black*, ECONOMIST, Oct. 20, 2007, http://www.economist.com/node/9993586 ("[T]raders repeatedly get caught out by 'unprecedented' market movements. The collapse of two hedge funds, Long-Term Capital Management in 1998 and Amaranth Advisors in 2006, were cases in point."); *see also The Galleon Affair: All at Sea*, ECONOMIST, Oct. 24, 2009, http://www.economist.com/node/14710676 (noting that the case against Raj Rajaratnam, cofounder of Galleon, for insider trading could decrease the credibility of hedge funds).

23. *See* Gregory Zuckerman & Ann Davis, *Hedge Fund's Heavy Metal; Red Kite Bet on Copper, then Good Times End*, WALL ST. J., Feb. 8, 2007, at C2 ("If rival traders believe a firm will have to sell positions to meet investor redemptions, they can sell those investments ahead of time, increasing the pressure. Some traders made those moves last fall when it emerged that hedge fund Amaranth Advisors LLC was having problems.").

systemic problems. Moreover, hedge funds have fewer assets and less leverage than banks. This may decrease the likelihood that hedge funds cause the next crisis. Without the threat of systemic risk and without a clear delineation of social externalities caused by hedge funds, the purpose of direct hedge fund regulation is unclear.

Nevertheless, recent regulatory initiatives in Europe and the United States attempt to address many perceived shortcomings of the current regulations and harmonize international banking regulation more effectively than before the crisis.[24] Regulatory initiatives such as registration requirements,[25] a passport regime,[26] limitations on leverage,[27] and general disclosure requirements[28] limit hedge funds' ability to provide above average returns to their investors. The Dodd–Frank Act restricts a banking entity from having an ownership interest in or being a sponsor of a private equity or hedge fund if such investments amount to more than 3 percent of the bank's Tier 1 capital or the bank's interest is more than 3 percent of the total ownership of the fund.[29] Moreover, private equity and hedge funds with assets under management of $150 million or more will have to register with the SEC, although venture capital funds will be exempt from full registration.[30] In the European Union, the EU Commission

---

24. *See, e.g.*, Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (to be codified as amended in scattered sections of 15 U.S.C.); *November 11 Directive*, *supra* note 4.

25. *See* Dodd–Frank Act § 410, 124 Stat. at 1576–77 (providing for federal registration of investment advisers, and registration and recording of venture capital funds).

26. *Draft Report on the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives*, at 18, COM (2009) 2014 (Nov. 23, 2009) [hereinafter *Draft Report*], *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&mode=XML&language=EN&reference=PE430.709.

27. *See id.* at 14 ("It is considered necessary . . . to impose limits on the level of leverage that AIFM could use . . . .").

28. *See id.* at 21 (describing the "disclosure obligations of AIFM").

29. *See* Dodd–Frank Act § 619, 124 Stat. at 1618–31.

> Notwithstanding any other provision of law, investments by a banking entity in a hedge fund or private equity fund shall . . . be immaterial to the banking entity, as defined, by rule, pursuant to subsection (b)(2), but in no case may the aggregate of all of the interests of the banking entity in all such funds exceed 3 percent of the Tier 1 capital of the banking entity.

Id.

30. *See id.* §§ 407–408, 124 Stat. at 1574–75.

> The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000. . . . No investment adviser that acts as an investment adviser solely to 1 or more venture capital funds shall be subject to the registration

introduced the AIFM Directive.[31] The AIFM Directive provides the possibility of harmonized requirements for entities engaged in the management and administration of alternative investment funds, i.e., European-wide regulation of hedge funds.[32] The AIFM Directive seeks to regulate more than just the hedge fund and private equity industries; it is an attempt to gain regulatory oversight over a large share of the "shadow banking system" that is presently unsupervised.[33]

At the same time, measures that are primarily intended to ensure the well-functioning of financial markets impact hedge funds as primary market participants. For instance, proposed EU legislation allows EU member state authorities, subject to coordination by the European Securities and Markets Authority (ESMA), to restrict or ban credit default swaps.[34] Similarly, the U.S. Dodd–Frank Act grants federal agencies broad regulatory authority over the trading of derivative securities and other financial

---

> requirements of this title with respect to the provision of investment advice relating to a venture capital fund.

Id.

31. *November 11 Directive*, *supra* note 4, at 30.

32. *Id.* at 10.

33. *See* 10 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 1:160 (2010) (noting that the AIFM Directive would subject depositories, which must be banks, to requirements that would result in greater transparency).

34. *See* Press Release, Europa, Public Consultation on Short Selling and Credit Default Swaps—Frequently Asked Questions (June 14, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/255&format=HTML&aged=0&language=EN&guiLanguage=en.

> The intention is that the measures envisaged on short selling should: [a.] ensure Member States have the power to act to reduce systemic risks and risks to financial stability and market integrity arising from short selling and Credit Default Swaps, [b.] *facilitate co-ordination* between Member States and the European Securities Markets Authority (ESMA) in emergency situations; [c.] *increase transparency* on the short positions held by investors; and [d.] *reduce settlement risks* linked with uncovered or naked short selling.
>
> . . . The options envisaged can be grouped into three types: [a.] Powers for competent authorities to temporarily restrict or ban short selling and Credit Default Swaps in emergency situations (subject to coordination by ESMA); [b.] Measures to increase transparency to regulators and the market about short selling positions, including those obtained through the use of derivatives; and [c.] Measures to reduce settlement risks of uncovered or naked short selling. The options under consideration also foresee powers for competent authorities to enforce the rules and the possibility of some limited exemptions (for market makers and shares whose principal market is outside the EU).

Id.

instruments that were blamed for the financial crisis.[35] As discussed below, the hedge fund industry is a major user of credit default swaps, and rules curtailing derivatives could disproportionally affect hedge funds. Because of hedge funds' role in the credit derivatives market, in combination with the market's recent failure, this Article suggests that an increased emphasis on hedge fund lending exposure could be justified.

The interdependence of corporate governance deficits, financial regulation, and hedge fund regulation has so far not been studied systematically. The Dodd–Frank Act and AIFM Directive appear to be mostly patchworks of politically motivated rules without an attempt to address the combined effects of deficits in different fields of regulation. Dodd–Frank and the AIFM Directive approach the regulation of banks and hedge funds separately, resulting in asymmetric regulation of financial institutions (hedge fund regulation versus bank regulation).[36]

This Article shows that financial market regulation in the European Union and the United States is suboptimal, and the asymmetric hedge fund regulation in Dodd–Frank and the AIFM Directive is counterproductive. The AIFM Directive could create incentives for regulatory arbitrage and potentially cause retaliatory action by non-EU countries. The Article explains how the Directive could undermine the competitiveness of the European Union's alternative investment community and the financial markets in Europe. The approach suggested here would minimize asymmetric hedge fund regulation by introducing hedge fund regulation via Basel III. Many of the regulatory complications in the AIFM Directive and Dodd–Frank Act could be avoided if the Basel Committee were to introduce a charge for banks' lending exposure to hedge funds. Building on the suggested increase in capital requirements for counterparty risk in Basel III,[37] Basel III could also include a charge for banks' assets based on their lending exposure to hedge funds. To

---

35. *See* Dodd–Frank Act §§ 610, 619, 124 Stat. at 1611, 1620 ("Lending limits applicable to credit exposure on derivative transactions, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions . . . . Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds.").

36. *See* Grant Kirkpatrick, *The Corporate Governance Lessons from the Financial Crisis*, 1 OECD J.: FIN. MARKET TRENDS 1–30 (2009) (showing the lack of regulation of corporate remuneration systems before the crisis to have been one of its biggest causes); Peter O. Mülbert, *Corporate Governance of Banks After the Financial Crisis—Theory, Evidence, Reforms* 8 (European Corporate Governance Inst., Working Paper No. 130/2009, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1448118 (discussing the lack of attention paid to banks' corporate governance before the crisis as a major cause of the crisis).

37. BANK FOR INT'L SETTLEMENTS [BIS], BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR 2, 5 (2010).

minimize systemic risk in the lending practice of banks to hedge funds, the New Basel III Accord could add a provision establishing capital requirements for banks that includes a charge for the particular bank's lending exposure to certain financial products, such as derivatives, that have recently experienced higher than normal volatility in world markets and are frequently used by hedge funds.[38] The Basel III measure for hedge fund lending exposure could be combined with an emphasis on banks' exposure to complex financial products. Consequently, this could help address the link between market failure in financial instruments and the increasing role of hedge funds in the market for financial instruments.

II. METHODOLOGY

A well-defined set of methodological assumptions can improve the analysis of the combined effects of deficits in different fields of regulation that impact the hedge fund industry and international financial markets. Legal research in *de lege ferenda* problems should first identify problems of *de lege lata* regulation and should then compare solutions for *de lege ferenda* proposals. Identifying existing problems requires impact and comparative impact analysis of existing regulation. Analyzing problems and suggesting solutions is possible through the falsification of testable hypotheses. New Institutional Economics (NIE), as a methodological instrument, supports impact analysis and comparative impact analysis of present regulatory structures and *de lege ferenda* solutions.[39] NIE is a relatively young offspring of economic theory focusing on the functioning and development of institutions (positive analysis) and proposals for improving existing institutions (normative analysis). Institutions are defined as general rules or sets of general rules, together with their

---

38. *European Banks Poised to Win Reprieve in Basel on Capital Rules*, BUS. WEEK, July 12, 2010, http://www.businessweek.com/news/2010-07-12/european-banks-poised-to-win-reprieve-in-basel-on-capital-rules.html.

39. EIRIK G. FURUBOTN & RUDOLF RICHTER, INSTITUTIONS AND ECONOMIC THEORY: THE CONTRIBUTION OF THE NEW INSTITUTIONAL ECONOMICS 35–37 (2d ed. 2005) [hereinafter FURUBOTN & RICHTER, INSTITUTIONS]; DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 3 (1990); RUDOLF RICHTER & EIRIK G. FURUBOTN, NEUE INSTITUTIONENÖKONOMIK (3d ed. 2003); STEFAN VOIGT, INSTITUTIONENÖKONOMIK (2d ed. 2009); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 15–16 (1985); Ronald Coase, *The New Institutional Economics*, 88 AM. ECON. REV. 72, 72–74 (1984); Christian Kirchner, *Public Choice and New Institutional Economics: A Comparative Analysis in Search of Co-operation Potentials*, *in* PUBLIC ECONOMICS AND PUBLIC CHOICE 19, 32 (Pio Baake & Rainald Borck eds., 2007); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 233 (1979).

enforcement mechanisms.[40] Both legal rules and standards are regarded as institutions if they are enforced, regardless of whether they are created by a legislator or by a private standard setter.[41] Institutional economics emphasizes the importance of informal institutions, such as social norms, rather than formal institutions.[42] Limiting the analysis to a subset of formal institutions, such as legal institutions, would ignore important problems. Including formal and informal institutions in the analysis is particularly helpful in analyzing corporate governance issues, in which social norms and formal institutions are often involved simultaneously.

Institutional economics distinguishes between the game and the rules of the game.[43] While traditional economics deals with the game itself, institutional economics focuses on the impact of the rules of the game, i.e., institutions.[44] Institutional changes lead to reactions by the addressees of those institutions. In order to predict such reactions, institutional economics works with a set of assumptions. Some of the core assumptions, including scarcity of resources, methodological individualism, and self-interested rational behavior, are shared with neoclassical economics.[45] Other assumptions in institutional economics are modified: bounded rationality is replacing the assumption of full rationality[46] and is being complemented by the assumption of opportunistic behavior.[47] Behavioral economics has criticized the rationality assumption and offered new insights into how actors behave in different situations and settings.[48] Institutional economics stresses that information is systematically incomplete.[49]

Many of these modified assumptions have found their way into modern economic analysis of financial markets[50] and the modern

---

40. FURUBOTN & RICHTER, INSTITUTIONS, *supra* note 39, at 7; VOIGT, *supra* note 39.

41. VOIGT, *supra* note 39.

42. *Id.*

43. For instance, corporate governance would here be the game itself or a set of rules for the game. Financial reporting would be distinguished from rules and standards on financial reporting.

44. FURUBOTN & RICHTER, INSTITUTIONS, *supra* note 39, at 7.

45. *Id.*

46. VOIGT, *supra* note 39, at 22–23.

47. *Id.* at 88–89; FURUBOTN & RICHTER, INSTITUTIONS, *supra* note 39, at 5.

48. Christine Jolls et al., *A Behavioral Approach to Law and Economics*, *in* BEHAVIORAL LAW & ECONOMICS 13, 20 (Cass R. Sunstein ed., 2000); Daniel Kahneman, *New Challenges to the Rationality Assumption*, 150 J. OF INSTITUTIONAL AND THEORETICAL ECON. 18, 36 (1994); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 263 (1979).

49. VOIGT, *supra* note 39, at 237–38.

50. HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 1 (2000); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 10 (2000).

theory of financial reporting.[51] Decisionmakers in financial markets are confronted with asymmetric information, opportunistic behavior, and a number of rationality anomalies. Recognition of the above-mentioned assumptions may improve the analysis of the combined effects of deficits in different fields of regulation impacting the hedge fund industry, as well as the predicted reactions of market participants to changes in the institutional framework of hedge funds.

III. HEDGE FUND REGULATION IN THE AFTERMATH OF THE FINANCIAL CRISIS

Regulators can use regulatory authority over entities that interact with hedge funds to regulate hedge funds indirectly. Alternatively, they can use a number of regulatory tools—including registration, capital, leverage, margin, and reporting requirements—to regulate hedge funds directly. Rules in the AIFM Directive and the Dodd–Frank Act combine direct and indirect measures. The AIFM Directive introduces the possibility of European-wide regulation of hedge funds[52] and regulatory oversight of a "shadow banking system" that is presently unsupervised.[53] As part of the Dodd–Frank Act, under Title IV, Congress enacted the Private Fund Investment Advisers Registration Act of 2010 (PFIARA).[54] Expanding the reporting requirements of private advisers to provide greater protection to investors,[55] PFIARA establishes rules and regulations for the registration of private funds with the SEC.[56] Additionally, PFIARA requires that hedge funds with more than $150 million in assets under management (AUM) register with the SEC as investment advisers and disclose to the agency information about their trades and portfolios.[57]

---

51. JENS WÜSTEMANN, INSTITUTIONENÖKONOMIK UND INTERNATIONALE RECHNUNGSLEGUNGSORDNUNGEN (2002).

52. *Commission AIF Proposal*, *supra* note 4, at 2.

53. BLOOMENTHAL & WOLFF, *supra* note 33, § 1:160.

54. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act tit. IV, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (to be codified as amended in scattered sections of 15 U.S.C.).

55. 156 CONG. REC. H4977 (daily ed. June 29, 2010) (Joint Explanatory Statement of Title IV).

56. Dodd–Frank Act §§ 402, 408, 124 Stat. at 1570, 1575.

57. *See id.* § 408, 124 Stat. at 1575.

> Section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3) is amended by adding at the end the following:
>
> "(m) EXEMPTION OF AND REPORTING BY CERTAIN PRIVATE FUND

1. *The AIFM Directive*

The AIFM Directive is the European Union's response to the financial crisis of 2008–2009.[58] In 2008, the EU Commission observed that the ensuing credit crisis underscored the accumulation of risk in the hedge fund sector and insufficient monitoring by regulators.[59] Although the drafters of the Directive did not contend that hedge funds and other alternative investment funds were the cause of the financial crisis, they pointed to the risks associated with hedge funds as a factor that may have contributed to turbulence in the market.[60] In February 2009, a EU Commission hearing on hedge funds reviewed the role of hedge funds in the financial crisis and suggested that legislative initiatives be consistent on a global level, because these industries have an international character.[61] The AIFM Directive harmonizes the regulation of alternative investment funds across Europe.[62]

a) A Controversial Drafting Process

The proposed EU rules in the AIFM Directive have been substantially redrafted, and numerous parties lobbied the EU Commission and Parliament to accept their changes.[63] As a result,

---

ADVISERS.—

> "(1) IN GENERAL.—The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000.

Id.

58. *Commission AIF Proposal*, *supra* note 4, at 2.

59. *Working Document of the Commission Services (DG Internal Market): Consultation Paper on Hedge Funds*, at 7 (2008), *available at* http://ec.europa.eu/internal_market/consultations/docs/hedgefunds/consultation_ paper_en.pdf.

60. *Commission AIF Proposal*, *supra* note 4, at 3; *see also Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives*, COM (2009) 0207, at 1.1 (Apr. 29, 2009) [hereinafter *Proposal on Alternative Investment*], *available at* http://www.europarl.europa.eu/oeil/FindByDocnum.do?lang=en&docnum=COM/2009/207.

61. *EU Commission Open Hearing on Hedge Funds and Private Equity*, at 1, 18 (Feb. 26–27, 2009) [hereinafter *EU Commission Hearing*], *available at* http://ec.europa.eu/internal_market/investment/docs/conference/summary_en.pdf. The Commission also suggested that strict reporting be required on capital, leverage, investment strategy, investment portfolio, links with systemic financial institutions, source of funds, and risk management metrics.

62. *Id.* at 9.

63. *See* James Watts, *United Kingdom: AIFM Directive Update*, MONDAQ BUS. BRIEFING, Mar. 24, 2010, http://www.mondaq.com/article.asp?articleid=96668 (noting

competing drafts of the AIFM Directive circulated in the European Parliament and among member states.[64] Many provisions in the drafts were highly contentious in some countries. Other countries, such as the United Kingdom, had already implemented requirements similar to those in the AIFM Directive. For instance, the United Kingdom already regulates the managers of alternative funds aimed at institutional investors.[65]

Despite frequent redrafting, the various drafts of the AIFM Directive consistently required hedge funds to register with government agencies.[66] All of the competing drafts also required disclosures to regulators and investors, and they included capital adequacy requirements for hedge funds.[67] Moreover, all of the versions required regulatory oversight for previously unregulated funds.[68] Hedge funds were also required to apply for authorization by the respective EU member state and, upon authorization, required to provide certain levels of disclosure to regulators and investors.[69] Furthermore, all versions of the AIFM Directive provided for

---

that the versions proposed by the EU Parliament and the EU Council were lobbied on behalf of industry participants).

64. *Commission AIF Proposal*, *supra* note 4; *Draft Report*, *supra* note 26; *Report on the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives* (March 10, 2010) [hereinafter *Report on EU Parliament Proposal*], *available at* http://register.consilium.europa.eu/pdf/en/10/st06/st06795-re03.en10.pdf.

65. *See* Matthew Lewis, Comment, *A Transatlantic Dilemma: A Comparative Review of American and British Hedge Fund Regulation*, 22 EMORY INT'L L. REV. 347, 355 (2008) (noting that U.K. hedge funds must be authorized under the Financial Services Act, which lacks exemptions that were provided in U.S. legislation).

66. *See Commission AIF Proposal*, *supra* note 4, at 22; *Draft Report*, *supra* note 26, at 7; *Report on EU Parliament Proposal*, *supra* note 64, at 25.

67. *See* Linda E. Rappaport, *Global Financial Regulatory Reform Proposals*, *in* PRAC. L. INST., TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES: TAX LAW AND PRACTICE: HOT ISSUES IN EXECUTIVE COMPENSATION 83, 85 (2010) (noting that though there are separate, revised drafts, the main proposals include: "Compulsory authorisation of fund managers located in the EU in order to manage funds; . . . ongoing reporting obligations to regulatory authorities; . . . [and] additional disclosure obligations for managers engaging in high levels of leverage and limits on leverage (mainly affecting hedge funds).").

68. *See Commission AIF Proposal*, *supra* note 4, at 20; *Draft Report*, *supra* note 26, at 6; *Report on EU Parliament Proposal*, *supra* note 64, at 3.

69. *See Commission AIF Proposal*, *supra* note 4, at 8, 9.

> To operate in the European Union, all AIFM will be required to obtain authorization from the competent authority of their home Member State. . . . [T]he AIFM will also be required to report to the competent authority on a regular basis on the principal markets and instruments in which it trades, its principal exposures, performance data and concentrations of risk.

Id.; Press Release, Europa, Financial Services: Commission Proposes EU Framework for Managers of Alternative Investment Funds 1 (Apr. 29, 2009), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/669.

minimum capital requirements for hedge funds, and, depending on the fund type, a limit on hedge fund leverage and standardization of hedge fund manager conduct (some Directive drafts also curtail hedge fund remuneration policies).[70] Under the valuation and depository requirements of the AIFM Directive drafts, assets were required to be independently valued and maintained by a depository bank.[71] Some drafts provided that in case of financial problems, the depository bank could be held liable.[72] Finally, AIFMs were mandated to disclose and report performance data, exposures, and risk on a regular basis.[73]

The latest version of the AIFM Directive, reviewed by the European Parliament in August 2010,[74] provided exemptions for social security, pension, and employee savings programs.[75] It also provided exemptions from the registration requirement for "non-systemically relevant" AIFMs.[76] Funds using leverage were exempt if they had less than €100 million AUM.[77] If funds did not use leverage, they were exempt if their total AUM did not exceed €500 million.[78]

---

70. *See Commission AIF Proposal*, *supra* note 4, at 14 ("It is necessary to provide for the application of minimum capital requirements to ensure the continuity and the regularity of the management services provided by the AIFM."). Articles 22 and 23 of the *Commission AIF Proposal* provide requirements related to assessment and disclosure of AIFs employing high levels of leverage. *Id.* at 34. "The proposed Directive contains the principles necessary to ensure that AIFM are subject to consistently high standards of transparency and regulatory oversight in the European Union . . . ." *Id.* at 8; *see also Report on EU Parliament Proposal*, *supra* note 64, ¶ 12(c) ("In order to promote supervisory convergences in the assessment of remuneration policies and practices, the Committee of European Securities Regulators should ensure the existence of guidelines on sound remuneration policies in the AIFM sector.").

71. There is significant discourse and disagreement between member states over the depository rule. *See* Martin Arnold et al., *Alternative Visions*, FIN. TIMES, May 14, 2010, http://www.ft.com/cms/s/0/3bee761c-5eef-11df-af86-00144feab49a.html#axzz1CfzbNK8s ("[M]ember states remain deeply split over the depository rule. France, where investors were badly stung by the Bernard Madoff fraud, is pushing hard for more investor protection, while UK funds and investors view the proposed rules as prohibitively expensive.").

72. *Id.*

73. *EU Commission Hearing*, *supra* note 61, at 1.

74. *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC*, at 3 (Aug. 27, 2010) [hereinafter *2010 Proposal*].

75. *Id.*

76. *Id.*

77. *See id.* at 4.

> AIFM which either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding, manage portfolios of AIF whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of €100 million . . . .

Id.

78. *See id.*

Perhaps one of the most contested provisions of the AIFM Directive was related to AIFMs in non-EU countries.[79] Non-EU AIFMs doing business in the European Union received different treatment in various proposals and drafts of the AIFM Directive.[80] Some drafts granted access only to EU-based funds but allowed individual member states to determine whether sophisticated investors could invest in funds managed outside the European Union.[81] To do business, non-EU funds were required to apply to each member state individually.[82] A version promulgated by the European Parliament allowed AIFMs in non-EU countries to obtain a "passport" to do business in any EU member state, provided they obtained authorization.[83] The European Parliament's draft focused on whether a fund's home country provided basic rules on transparency, taxation, and money laundering.[84] If certain

---

> AIFM which either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding, manage portfolios of AIF whose assets under management, in total do not exceed a threshold of €500 million when the portfolio of AIF consists of AIF that are not leveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF.

Id.

79. Press Release, Council of the European Union, 3015th Council Meeting: Economic and Financial Affairs (May 18, 2010) [hereinafter Council Meeting], *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=PRES/10/123&format=HTML&aged=0&lg=en&guiLanguage=en.

80. *Commission AIF Proposal*, *supra* note 4, at 19; *see also Report on EU Parliament Proposal*, *supra* note 64, ¶ 19 ("In order to ensure investor protection, the right for an AIFM to market AIF to professional investors in the Community on the basis of a single authorisation (the European passport for AIFM) should only be granted where the AIF is established in a Member State.").

81. *See Report on EU Parliament Proposal*, *supra* note 64, ¶ 19 ("[T]he right for an AIFM to market AIF to professional investors in the Union on the basis of a single authorisation (the European passport for AIFM) should only be granted where the AIF is established in a Member State."); Niki Tait, *EU Tries to Break Logjam on Hedge Funds*, FIN. TIMES, Apr. 13, 2010, http://cachef.ft.com/cms/s/0/f7c20c38-4742-11df-b253-00144feab49a.html#axzz1BuKfrxHk (noting that Jean-Paul Gauzes, the French Member of the European Parliament, proposed that non-EU managers who sought to market in the European Union could apply for a "passport" if they agreed to the European Union's new rules regarding registration and leverage, and if the managers' home countries agreed to regulate and oversee the managers' compliance).

82. Tait, *supra* note 81.

83. *Draft Report*, *supra* note 26, at 81.

84. *See* Tait, *supra* note 81 ("Mr Gauzes' revisions would also allow funds based outside the EU to gain passport rights if the jurisdiction in which they were housed met four conditions: concerning fiscal standards, rules on information exchange between supervisors, reciprocity and anti-money laundering rules."); JENNIFER WOOD, THE POTENTIAL IMPACT OF THE PROPOSED ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE ON INVESTMENT MANAGERS IN THE E.U. AND U.S. 4 (2009), http://www.dechert.com/library/The%20Potential%20Impact%20of%20the%20Proposed

requirements were fulfilled, the draft allowed non-EU funds to subscribe to EU principles via the "passport regime" and sell their funds in the European Union.[85] Commentators expected that the parliamentary draft would be favored by the hedge fund industry.[86] Even that draft, however, was expected to burden the industry because funds would incur costs in satisfying the EU standards, and regulators from their home jurisdictions were expected to ensure that these non-EU funds comply with EU rules.[87]

The latest proposal of the AIFM Directive also provided "Specific Rules in Relation to Third Countries."[88] Under these rules, non-EU AIFMs were able to market funds in the European Union if they provided both investors and regulators with sufficient information to oversee systemic risk.[89] Regulators in the state where the AIFM was incorporated were required to cooperate with regulators in the member states where the funds were marketed.[90] Under this draft, the ESMA was required to decide if the depositories in the AIFM's country of incorporation were sufficiently regulated and met minimum capital requirements.[91] The rules specified stringent conditions for managing, marketing, and registering non-EU

%20Alternative%20Investment%20Fund%20Managers%20Directive%20on%20Investment%20Managers%20in%20EU%20and%20US.pdf (listing the strict pre-conditions member states must meet "to authorize a non-EU AIFM to market units under the Directive to professional investors in that Member State").

85. *See* BLOOMENTHAL & WOLFF, *supra* note 33, at 2 ("[The Directive] will provide an 'EU passport' for the marketing of those third country funds which comply with stringent requirements on regulation, supervision and cooperation, including on tax matters."); Martin Sjoberg, *The Cutting Hedge*, FT ADVISER, June 17, 2010, http://www.ftadviser.com/FinancialAdviser/Investments/AssetClass/AlternativeInvestments/HedgeFunds/Features/article/20100617/d9cb3280-67dc-11df-90cb-00144f2af8e8/The-cutting-hedge.jsp ("[T]he new directive provides alternative investment funds with a passport allowing them to market their funds throughout all 27 EU member states once they are authorized in their home member state."); *see also supra* note 81.

86. *See* Jim Baird, *United Kingdom: Continued Controversy Over the EU Alternative Investment Fund Managers Directive*, FIN. SERVS. Q. REP. (Dechert LLP, London, U.K.), July 15, 2010, at 7 ("At first glance, the Parliamentary Draft looks more positive in that it expressly extends the marketing 'passport' to non-EU AIFM and AIF. However, the conditions that would apply are so extensive that it is doubtful whether these could be met, even by many developed jurisdictions.").

87. *See id.* at 8.

> A further difficulty under the Parliamentary Draft would be that the "passport" for non-EU AIFM and AIF would not provide for a single point of entry into the EU, as it does for EU AIFM. Instead, cooperation agreements would be required to be entered into between the relevant third country and each relevant Member State before a meaningful marketing network would be available.

Id.

88. *2010 Proposal*, *supra* note 74, at 72.

89. *Id.* ch. 7.

90. *Id.*

91. *Id.*

AIFMs.[92] Regardless of compliance with these strict standards, some countries generally opposed non-EU funds trading within the European Union.[93]

b) The Final Version

The final version of the AIFM Directive was promulgated on November 11, 2010.[94] It sets out core provisions on Alternative Investment Fund Managers (AIFMs) and Alternative Investment Funds (AIFs). It defines AIFMs and AIFs, and it addresses thresholds and exemptions from the AIFM Directive, a passport regime, rules on third country funds, depositaries, depositary liability, remuneration of AIFMs, governance of AIFs, restrictions on delegation of AIFM functions, transparency requirements, asset stripping by private equity funds, leverage, short selling, authorization of AIFMs, and capital requirements.[95] AIFs are collective investment undertakings outside of the scope of Undertakings for Collective Investment in Transferable Securities (UCITS) that (i) raise capital from a number of investors, and (ii) invest capital in accordance with predefined investment policies.[96] Generally, any AIF will fall within the scope of the AIFM Directive if it has an AIFM purveying marketing or management services.[97] There are certain exemptions for (i) AIFMs that manage AIFs with less than €100 million;[98] or (ii) AIFMs managing AIFs with total assets of less than €500 million, provided the AIFs are not leveraged and have no redemption rights for five years after the date of initial investment in each AIF.[99] The AIFM Directive also provides exemptions from the registration requirement for "non-systemically relevant" AIFMs.[100]

---

92. *Id.*

93. *See* Jonathan Williams, *France's Proposed Changes Jeopardizing AIFM Directive, Says Hewitt*, INVESTMENT & PENSIONS EUR., Sept. 29, 2010.

> French finance minister Christine Lagarde was expected to recommend changes to the directive that would see minimum national standards introduced that each country could apply independently. The revisions would do away with the proposed 'passport' model, which would allow a fund, once cleared, to trade and be based in any country in the European Union.

Id.

94. *November 11 Directive*, *supra* note 4.

95. *Id.*

96. *Id.* ch. I, art. 3(1)(b).

97. *See id.* ch. I, art. 3(1)(a) (defining "activities related to the assets of AIF").

98. *Id.* ch. I, art. 2a(2)(a).

99. *Id.* ch. I, art. 2a(2)(b).

100. *Id.*

Under the new rules, in order to market the shares of AIFs or provide management services to AIFs, an AIFM is required to be authorized by its home state regulator. Authorization in one member state allows the AIFM to operate in all member states.[101] Like most of the drafts, the final version of the AIFM Directive provides for the creation of a EU-wide passport allowing authorized AIFMs to advertise their funds throughout the European Union.[102] Authorized managers can market third-country (non-EU) funds in the European Union, provided the third-country AIFs and AIFMs comply with the requirements of the Directive.[103] However, private placement regimes imposing certain conditions will remain in place provisionally.[104]

As for the politically contentious depositary requirement, according to the final version of the AIFM Directive, AIFs are required to have a depositary.[105] Real estate funds and private equity funds are allowed to use professional advisers as depositaries.[106] All other AIFs will use investment firms and credit institutions.[107] As for the controversial element of depositary liability, the final version of the AIFM Directive seems to involve an intentional failure test.[108] However, some elements of strict liability remain.[109] Under the AIFM Directive, AIFMs' pay will be subject to the Capital Requirements Directive.[110] As such, AIFMs' remuneration structure, including limitations on overall compensation and bonuses, may be substantially aligned with that of bankers.

The governance structure under the AIFM Directive introduces the concept of fiduciary duties, or an equivalent thereof. AIFMs acting on behalf of AIFs and managing AIFs must act in the best interest of the AIFs.[111] Further specifying this duty, the Directive includes provisions on the independent valuation of AIFs' assets, risk management, due diligence, conflicts of interest, separation of valuation operations from risk and portfolio management, and the

---

101. *Id.* ch. VII, art. 35a. However, the AIFM is still subject to notification procedure via its home state. *Id.* ch. I, art. 2a(3)(a)–(b).
102. *Id.* ch. VII, art. 35a.
103. *Id.*
104. *Id.* pmbl. ¶ 28a.
105. *Id.* pmbl. ¶ 15b.
106. *Id.* pmbl. ¶ 15c.
107. *Id.*
108. *Id.* ch. III, sec. 4a, art. 18a(11).
109. *Id.* pmbl. ¶¶ 11–12.
110. *Id.* annex II.
111. *Id.* ch. III, sec. 1, art. 9(1).

integrity of the markets.[112] The AIFM Directive also requires enhanced disclosure to authorities and investors.[113]

Finally, externally appointed AIFMs are required under the AIFM Directive to comply with an initial capital requirement of €125,000.[114] AIFMs are also required to comply with limits on the amount of leverage they can use.[115] Moreover, member states of the European Union can impose limits on leverage in emergency situations.[116]

c) Impact Assessment

The AIFM Directive seems to curtail the ability of European institutions and individuals to invest with managers or funds domiciled outside the European Union.[117] Hedge funds domiciled in traditional alternative investment fund industry centers, such as the Cayman Islands, British Virgin Islands, Jersey, Guernsey, the United States, Canada, Switzerland, Hong Kong, Singapore, Japan, Australia, and South Africa, may be affected by the AIFM Directive.[118] Experience with the AIFM Directive will show if it causes a reduction in investor choice, increased costs, and lower returns.[119] If AIFM Directive provisions impair investors' choice and

---

112. *Id.*

113. *Id.*

114. *See id.* ch. II, art. 6a(1)–(2) (noting that the capital base for an internally managed AIF is €300,000 and that "[w]here an AIFM is appointed as external manager of one or more AIF, the AIFM shall have an initial capital of at least EUR 125 000, taking into account the following paragraphs").

115. *Id.* ch. III, sec. 1 art. 25(7).

116. *Id.* ch. III, sec. 1 art. 25(3).

117. *See Commission Staff Working Document Accompanying the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/.../EC: Impact Assessment*, at 53, COM (2009) 207 (Apr. 30, 2009) [hereinafter *Commission Staff Working Document*] ("AIFM domiciled in a third country will not be covered by the measure and will therefore not be able to market their AIF or to provide AIFM services in the EU under this Directive unless established/authorised in the EU in accordance with the proposed Directive.").

118. *See* Sjoberg, *supra* note 85 ("[The so-called third country issue] has generated much publicity and has caused the most discussion with many commentators predicting an exodus of hedge funds and investment talent from London to offshore centres such as the Cayman Islands and Switzerland.").

119. *See* DARINA BARRETT & BRIAN CLAVIN, KPMG FIN. SERVS., FEELING THE HEAT? ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE—ASSET MANAGERS GLOBAL SURVEY 11–12 (2010), http://www.kpmg.com/IE/en/IssuesAnd Insights/Articles Publications/Documents/FS-InvestmentMgt/AIFMD-Survey.pdf (noting that when asked about investment opportunities, 44 percent of investment managers surveyed felt that it has not yet been proven that the AIFM Directive will impact returns because of a reduction in investment opportunities, and 43 percent of investment managers do believe the AIFM Directive will impact returns by reducing investment

curtail their ability to select investments from the best available products globally, there is a risk that this will impact returns. More specifically, reduction of choice for EU investors could drive down returns for pension funds because pension fund managers may not have the ability to acquire their top picks for investors. The restrictions and compliance costs that the AIFM Directive imposes on international investors could precipitate a reduction in returns and higher costs. As a result, the AIFM Directive could undermine Europe's competitiveness.[120]

The obstacles for non-EU funds and managers to access the EU market seem protectionist in effect, if not in intent.[121] Curtailing entry into the European Union could signal a change in Europe's place as a global center for financial services and as a destination for international investment.[122] Discrimination against non-EU jurisdictions could provoke retaliatory action. As a consequence, retaliatory actions and a lack of intra-European cooperation could damage the European financial services industry and the whole European economy.[123] Further, the AIFM Directive could impact

---

opportunity; when asked about costs, 54 percent of investment managers surveyed believe the AIFM Directive will increase costs, thus lowering returns; and only 10 percent believe the proposals will have minimal impact).

120. *See id.* ("[A] not insignificant [26] percent believe that non-EU jurisdictions which might offer comparatively fewer investment restrictions, could be more attractive for this talent."); EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL ASS'N, THE EFFECT OF THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE ON INVESTING IN VENTURE CAPITAL 3 (2010) (reporting that when asked "[i]f you could not invest in venture beyond Europe to what degree would you change your investment in the European venture capital asset class," one-third of managers responded they would "reduce by over 1/3," and one-third responded that they would "leave the venture capital asset class").

121. *See* Wood, *supra* note 84, at 3, 5.

> [A]n authorized AIFM is required to ensure that a depositary (i.e., custodian) is appointed to fulfill various safekeeping responsibilities in relation to the AIFs the AIFM manages. The AIFM is also required to ensure that the depositary is an authorized credit institution having its registered office in the EU. . . . This would be unworkable for an international investment fund investing in non-EU markets.

Id.

122. *See id.* at 6 ("The requirement that the depositary's liability towards investors is not affected by reason of the delegation to a third country depositary of all or part of its tasks is unlikely to encourage depositaries to agree to provide services to AIFs that invest in these markets.").

123. *See Commission Staff Working Document*, *supra* note 117, at 57, 85.

> Gaps and inconsistencies in approaches to the registration and authorisation of AIFM in the EU may impede the effective oversight of the sector and varying standards may provoke regulatory arbitrage between jurisdictions. . . .
>
> . . . .
>
> A majority of respondents are not convinced that a "purely" European response is likely to be successful. They feel that it may even have adverse

small firms across Europe and make it more difficult for new businesses to be created.[124] The AIFM Directive could also result in negative social externalities across Europe if foreign investments are adversely influenced. Moreover, a possible consequence could be that European citizens have to pay higher pension contributions and insurance premiums.[125]

The AIFM Directive provisions on the role of depositaries and custodians may have been influenced by the losses suffered by French investors in the Bernard Madoff scandal.[126] Providing for strict liability for depositaries[127] in certain circumstances may be overreaching. Depositaries now need to weigh the risks and benefits of providing services to alternative investment funds within the European Union. If this risk assessment turns out negative, the business of depositories and, implicitly, hedge funds could be affected.[128]

2. *Dodd–Frank Hedge Fund Rules*

The Dodd–Frank Act, the largest overhaul of U.S. financial regulations since the 1930s, includes several important provisions on hedge funds. As part of this reform package, the Private Fund Investment Advisers Registration Act of 2010 (PFIARA) was enacted

---

effects on the European asset management industry, exposing it to regulatory arbitrage.

Id.

124. *See* Henry Smith, *AIFM Directive Scares Off EU Hedge Funds*, FT MANDATE, June 2010, http://www.ftmandate.com/news/fullstory.php/aid/2387/AIFM_directive_scares_off_EU_hedge_funds.html (asserting that the cost of the new regulations would be prohibitive for smaller firms).

125. *See The AIFM Directive: Another European Mess: Plans to Regulate Private Equity and Hedge Funds Takes Two Steps Forward*, ECONOMIST, May 18, 2010, http://www.economist.com/node/16156357 ("[L]egislators want to increase custodians' liability for the assets they look after. Pension funds and other investors fear they will be charged a higher premium by custodians as a result.").

126. *See supra* note 71.

127. *See* discussion on depositary liability *supra* Part III.1.b.

128. *See* EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL ASS'N, *supra* note 120, at 6.

> The AIFMD calls for the use of third-party depository to increase transparency of individual investments by management companies. Share certificates will need to be held by the depositary for safe keeping. Draw-downs from investors will need to be held by the depositary as will proceeds arising on the sale of a portfolio company. The cost implications are significant and of major concern to venture capital firms.

Id.

on July 21, 2010.[129] The legislation is intended to close regulatory gaps and end the speculative trading practices that contributed to the 2008–2009 financial crisis.[130] The Dodd–Frank Act restricts a banking entity from sponsoring or having an ownership interest in a private equity or hedge fund if such investments amount to more than 3 percent of the bank's Tier 1 capital or if the bank's interest is more than 3 percent of the total ownership of the fund.[131] This restriction allows banks to continue engaging in proprietary trading under safer, more client-friendly terms,[132] a practice that is otherwise curtailed by the Volcker Rule,[133] which would constrain banks from engaging in proprietary trading and owning or investing in hedge funds and private equity funds. Banks have several years to conform to the restrictions imposed by the statute.[134] Most significantly, PFIARA requires hedge funds with more than $150 million AUM to register with the SEC as investment advisers and disclose to the agency information about their trades and portfolios.[135] The registration requirement is intended to enable the SEC to gather

---

129. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act tit. IV, Pub. L. No. 111–203, 124 Stat. 1570, 1570–80 (to be codified as amended in scattered sections of 15 U.S.C.).

130. Ben Bernanke stated, "The financial reform legislation approved by the Congress today represents a welcome and far-reaching step toward preventing a replay of the recent financial crisis." Tom Braithwaite, *U.S. Senate Passes Financial Reform*, FIN. TIMES, July 15, 2010, http://www.ft.com/cms/s/0/6b9d4542-9026-11df-ad26-00144feab49a.html#axzz1CZnb1rTI.

131. *See* Dodd–Frank Act § 619, 124 Stat. at 1627 ("[I]n no case may the aggregate of all of the interests of the banking entity in all such funds exceed 3 percent of the Tier 1 capital of the banking entity.").

132. 156 CONG. REC. S5897 (daily ed. July 15, 2010) (statement of Sen. Jeff Merkley). The restriction allows banks to continue to engage in some limited traditional asset management businesses, including sponsoring and offering hedge and private equity funds.

133. *See* 156 CONG. REC. S5886 (daily ed. July 15, 2010) (statement of Sen. Ted Kaufman).

> [T]he scaled-back Volcker Rule contains a large loophole that allows megabanks to continue to own, control and manage hedge funds and private equity funds under certain conditions. Most notably, it includes a de minimis exception that permits banks to invest up to three percent of Tier 1 capital in hedge funds and private equity funds so long as their investments don't constitute more than three percent ownership in the individual funds.

Id.

134. *See* 156 CONG. REC. S5889 (daily ed. July 15, 2010) (statement of Sen. Kay Hagan) (noting that § 619(c)(2) provides a two-year period from the effective date of the Act before the restrictions will apply).

135. *See* Dodd–Frank Act § 408, 124 Stat. at 1575 ("The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000.").

appropriate information to prevent fraud, limit systemic risk, and provide information to investors.[136]

a) History of Hedge Fund Registration in the United States

PFIARA could be the last chapter in a debate that began with the inception of the hedge fund industry in the 1960s. Before the SEC adopted the investment adviser registration safe harbor in Rule 203(b)(3)[137] (now redundant under PFIARA) in 1985, it issued a long line of no-action letters requiring investment advisers to look through an entity and count each individual advisee or member as a separate client.[138] The SEC did not give much other guidance to the investing

---

136. 156 CONG. REC. S5902–01, S5928 (daily ed. July 15, 2010) (statement of Sen. Dick Durbin).

137. Investment Advisers Act of 1940 § 203(b)(3), 15 U.S.C. 80b–11(a) (2000). Under Section 203(b)(3) of the Advisers Act, an adviser was exempt if it had less than fifteen clients in the past twelve months, if it did not "hold itself out" to the public, i.e., did not offer investment advisory services to the general public, nor act as investment adviser to a registered investment company or business development company. In calculating the number of clients under § 203(b)(3), U.S. and non-U.S. clients had to be taken into account. Non-U.S. fund managers only had to count their U.S. clients. Andrew J. Donahue, Dir. Div. of Inv. Mgmt., Sec. & Exch. Comm'n, Speech by SEC Staff: Regulating Hedge Funds and other Private Investment Pools (Feb. 19, 2010), *available at* http://www.sec.gov/news/speech/2010/spch021910ajd.htm. Under § 203(b)(3)–1 of the Advisers Act, a limited partnership itself could be counted as a single client of the general partner or any other person acting as the investment adviser, provided that investment advice to the partnership was based on the partnership's objectives rather than on the needs and objectives of the limited partners. This rule also applied to an offshore fund in the corporate form, which may in general be treated as one client by an adviser. *Id.*

138. *See* Ruth Levine, SEC No-Action Letter, 1976 SEC No-Act. LEXIS 2719 at *2 (Dec. 15, 1976).

> Generally, we recognize limited partnerships as legal entities. However, if the partnership was organized by an adviser, or an affiliate of the adviser, the members of such partnership would probably each be counted in determining how many clients the adviser was serving, and the assets of those members might be treated separately for purposes of determining whether a variable fee could be charged.

Id. at *2; David Shilling, SEC No-Action Letter, 1976 SEC No-Act. LEXIS 865 at *3 (Apr. 3, 1976) ("In the context of investment clubs we would generally consider the individual members, rather than the club, as the advisees."); *see also* B.J. Smith, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 2642 at *1–2 (Dec. 25, 1975) ("As stated in our earlier reply we would regard your advice as being given to the individuals in the club. Accordingly, that exemption would not appear to apply to you if you were engaged to advise an investment club with fifteen or more members."); Wofsey, Rosen, Kweskin & Kuriansky, SEC No-Action Letter, 1974 SEC No-Act. LEXIS 2154 at *3 (Apr. 25, 1974) ("For the purposes of the 15 client test (assuming no public offering is made) we would regard each member of the club as an advisee, rather than the club as one entity."); S.S. Programs, Ltd., SEC No-Action Letter, 1974 SEC No-Act. LEXIS 599 at *6 (Oct. 17, 1974).

community, and its reliance on no-action letters alone led to significant legal uncertainty.[139] A lack of guidance may create legal uncertainty,[140] and legal uncertainty generates transaction costs.[141] The Second Circuit's inclination to change its position further exacerbated legal uncertainty: from 1976 to 1977, it characterized individual limited partners as "clients" of a general partner. But in *Abrahamson v. Fleschner*, the Second Circuit held that general partners of limited partnerships investing in securities were investment advisers.[142] This decision left unanswered the question whether the partnership, or each of the partners, should be counted as clients.[143] The U.S. Supreme Court later overruled that decision on other grounds in *TransAmerica Mortgage Advisors, Inc. v. Lewis*.[144]

The SEC did not require registration under the Investment Advisers Act of 1940 (Advisers Act) before or after the safe harbor

---

> In addition, since the general partner would be acting as the exclusive agency for the partnership and would receive special compensation in the amount of 1 1/2% per annum on the asset value of the partnership, investment adviser registration may be required for the general partner even if the partnership is not an investment company unless the exemption of Section 203(b)(3) of the Advisers Act is available. In this connection, we would view each partner as a separate client for purposes of determining the number of clients the general partner would have.

S.S. Programs, Ltd., 1974 SEC No-Act. LEXIS 599 at *6; *see also* Hawkeye Bancorporation, SEC No-Action Letter, 1971 SEC No-Act. LEXIS 883 at *2 (June 11, 1971) ("It is our view that Investment Management would be rendering investment advice to all members of the pools. If the addition of six new clients would give Investment Management more than fourteen clients, its registration as an investment adviser would be required.").

139. *See* Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 966–67 (1998) (contending that while the investing public's reliance on SEC no-action letters can be warranted, that reliance creates problems for courts).

140. *See generally* Helmut Wagner, *Legal Uncertainty—Is Harmonization of Law the Right Answer? A Short Overview* (Fern Universität in Hagen, Discussion Paper No. 444, 2009), http://www.fernunihagen.de/FBWIWI/forschung/beitraege/pdf/db444.pdf (discussing and defining legal uncertainty generally).

141. *See id.* at 4 ("Legal uncertainty generates the following transaction costs: (a) costs of collecting information, (b) costs of legal disputes, (c) costs of setting incentives for pushing through legal claims, and (d) other transaction costs.").

142. *See* Abrahamson v. Fleschner, 568 F.2d 862, 869–71 (2d Cir. 1977) (holding that general partners of an investment partnership were "investment advisers" within the meaning of the Advisers Act).

143. *See* Robert C. Hacker & Ronald D. Rotunda, *SEC Registration of Private Investment Partnerships After* Abrahamson v. Fleschner, 78 COLUM. L. REV. 1471, 1484 (1978) (noting that the court did not have to decide whether each limited partner is a separate client for purposes of § 203(b)(3)).

144. TransAm. Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 24–25 (1979) (holding that the Investment Advisers Act of 1940 (Advisers Act) confers a limited private remedy to void an investment contract but does not confer any other private causes of action, legal or equitable, thus overruling *Abrahamson v. Fleschner*).

was enacted in 1985.[145] The safe harbor permitted advisers to manage large amounts of securities indirectly through several hedge funds that collectively had hundreds of investors.[146] Section 12 of the Exchange Act,[147] in combination with Rule 12g–1,[148] required registration of any issuer with 500 holders of record of a class of equity securities and assets in excess of $10 million. Practically speaking, this meant that a single hedge fund could have up to 499 investors. Under Rule 203(b)(3)–1(a), an investment adviser could count a legal organization as a single client so long as the investment advice was based on the objectives of the legal organization rather than the individual investment objectives of any owners of the legal organization.[149] Considerable uncertainty existed about whether advisers to unregistered investment pools were required to look through the pools to count each investor as a client or could count each pool as a single client.[150] Without a rule on the issue, Rule 203(b)(3)–1 was interpreted to generally allow advisers to count each hedge fund as one client.[151] Combining this interpretation of Rule 203(b)(3)–1 with the limits of § 12 of the Exchange Act and Rule 12g–1 allowed hedge fund advisers to have fourteen funds with 499 investors in each, totaling 6,986 investors.[152]

Using its rulemaking authority under the Advisers Act,[153] in December 2004, the SEC issued a final rule to require hedge fund

---

145. Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 879 n.5 (D.C. Cir. 2006).

146. *See* Definition of "Client" of an Investment Adviser, 17 C.F.R. § 275.203(b)(3)–1 (2006) (defining "client" of an investment adviser for purposes of the Investment Advisers Act).

147. *See* Securities Exchange Act of 1934 § 12, 15 U.S.C. § 78 (2006) (providing registration requirements for securities).

148. 17 C.F.R. § 240.12g–1 (2011).

149. See 17 C.F.R. § 275.203(b)(3)–1(a)(2)(i) (2011) (defining a single client for purposes of § 203(b)(3) as a limited partnership to which investment advice is provided based on the objectives of the limited partnership rather than the individual objectives of the limited partners).

150. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 n.10 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279).

151. *See* Goldstein v. Sec. & Exch. Comm'n, 451 F.3d. 873, 876 (D.C. Cir. 2006) ("[T]he Commission had interpreted this provision to refer to the partnership or entity itself as the adviser's 'client.'").

152. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,065 n.134.

153. Investment Advisers Act of 1940 § 211(a), 15 U.S.C. § 80b–11(a) (2006). Section 211(a) asserts that the Commission may adopt rules "necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this subchapter" and "may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters." *Id.*; *see also id.* § 80b–2(a)(17) ("The Commission may by rules and regulations classify, for the purposes of any portion or portions of this subchapter, persons, including employees controlled by an investment adviser.").

advisers to register under the Advisers Act.[154] The rule was eventually issued by a three-to-two vote[155] and then overturned by the D.C. Circuit in 2006.[156] In an attempt to justify its rulemaking, the SEC cited the necessity to prevent losses caused by hedge fund advisers' fraud.[157] The SEC also pointed to the retailization of the hedge fund sector,[158] the growth of the hedge fund industry, "the broadening exposure of investors to hedge fund risk, and the growing number of instances of malfeasance by hedge fund advisers."[159] Furthermore, the SEC considered the increased risks to small investors caused by the decrease in minimum investment requirements[160] and the additional dangers associated with this phenomenon.[161] The SEC emphasized that it was "sensitive" to the costs and benefits of a registration requirement for hedge funds.[162] To further justify its rulemaking, the SEC cited benefits to mutual fund investors, other investors and markets, regulatory policy, and hedge fund advisers.[163] The benefits to hedge fund investors included the deterrence of fraud and curtailment of losses, the provision of basic information about hedge fund advisers, and improved compliance controls.[164] Commissioners Cynthia A. Glassman and Paul S. Atkins opposed releasing the final rule.[165]

---

154. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,054 (adopting a new rule and rule amendments that require advisers of certain private investment pools to register with the SEC pursuant to the Advisers Act).

155. For the history of U.S. hedge fund regulation before *Goldstein*, see WULF A. KAAL, HEDGE FUND REGULATION BY BANKING SUPERVISION: A COMPARATIVE INSTITUTIONAL ANALYSIS 177–98 (2005).

156. *Goldstein*, 451 F.3d at 883–84.

157. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,078 ("Registration allows us to conduct examinations of hedge fund advisers, and our examinations provide a strong deterrent to advisers' fraud, identify practices that may harm investors, and lead to earlier discovery of fraud that does occur.").

158. Alas, the SEC never quantified or attempted to prove, or at least show evidence of, the phenomenon of retailization. For a discussion of the phenomenon of "retailization," see Kaal, *supra* note 6.

159. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,059 (justifying the need for SEC action requiring hedge funds to register pursuant to the Advisers Act).

160. *See* U.S. SEC. & EXCH. COMM'N [SEC], IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 81 (2003) ("We have observed that the minimum qualifications required to invest in some hedge funds has decreased as newer entrants into the alternative investments market compete for investors.").

161. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,057–58 (noting several reasons for broader exposure to hedge funds in the investing public, including by investors who were previously too risk averse).

162. *Id.* at 72,078.

163. *Id.* at 72,078–80.

164. *See id.* at 72,078 (listing benefits that include a strong deterrent to advisers' fraud, identification of practices that may harm investors, earlier discovery of

As noted above, in *Goldstein v. SEC*, the D.C. Circuit struck down the hedge fund rule as an instance of arbitrary rulemaking by the SEC.[166] The court underscored the substantive limits of agency rulemaking power and rejected the SEC's position that it had authority to determine the meaning of the term "client" where the term had not otherwise been defined in the Advisers Act.[167] Many advisers who had previously registered under the rule decided to deregister.[168] Reacting to *Goldstein*, the SEC dramatically expanded fraud protection for investors[169] and proposed to increase the "accredited investor" standards under Regulation D.[170]

b) Dodd–Frank Hedge Fund Rules

Hedge funds have been accused of taking excessive risks that contributed to the financial collapse of 2008.[171] Under the Advisers Act, private advisers were exempt from registration if they had fewer than fifteen clients and did not hold themselves out to the public as

---

existing fraud, the ability to screen individuals seeking to advise hedge funds, and to deny entry to those with a history of disciplinary problems).

165. *Id.* at 72,089. Despite an emphasis by the majority on the risks of retailization, the dissenting commissioners pointed to the *2003 Staff Report*, which found that retailization was not an issue and argued that the inflow of funds is already so rapid that hedge fund advisers had more to invest than they could handle and were in no need to solicit retail investors. *See* SEC, *supra* note 160, at 80 ("[T]he staff has not uncovered evidence of significant numbers of retail investors investing directly into hedge funds.").

166. *See* Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 884 (D.C. Cir. 2006).

> [T]he *Hedge Fund Rule* only exacerbates whatever problems one might perceive in Congress's method for determining who to regulate. The Commission's rule creates a situation in which funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the Advisers Act. This is an arbitrary rule.

Id.

167. *Id.* at 880–83.

168. *See* Alison S. Fraser, Note, *The SEC's Ineffective Move Toward Greater Regulation of Offshore Hedge Funds: The Failure of the Hedge Fund Registration Requirement*, 92 CORNELL L. REV. 795, 798–99 (2007) (noting that once *Goldstein* overruled the Hedge Fund Rule, over one hundred hedge funds deregistered with the SEC).

169. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400 (proposed Dec. 27, 2006) (proposing a new rule to allow the SEC to bring enforcement actions against investment advisers who defraud investors or prospective investors of hedge funds).

170. *Id.* at 405.

171. 155 CONG. REC. H14441–42 (daily ed. Dec. 9, 2009) (statement of Rep. Sheila Jackson-Lee).

investment advisers.[172] The Dodd–Frank Act amends the Advisers Act by establishing rules and regulations for the registration of private funds with the SEC.[173] Title IV of Dodd–Frank is entitled the Private Fund Investment Advisers Registration Act of 2010 (PFIARA).[174] The purpose of the Title IV amendments is to provide greater protection to investors by expanding the reporting requirements of private advisers to the SEC.[175] Recognizing that there are those who operate in the "shadows of our markets," apparently a reference to hedge funds generally, the Act mandates hedge fund adviser registration to increase record keeping and disclosure.[176]

The extensive reforms promulgated under the Dodd–Frank Act represent Congress's attempt to secure markets and to protect consumers and investors.[177] Representatives supporting the new hedge fund rules maintained that years without regulation ushered in the financial crisis.[178] Legislators opposed to the new regulations argued that hedge funds played no role in the crisis, were irrelevant to the financial system as a whole, and did not create systemic risk.[179] They alleged that the SEC should have been able to sufficiently curtail hedge funds under the existing rules but failed to do so.[180] Furthermore, some legislators were concerned that the exemptions in Title IV would render the regulation of hedge funds ineffective.[181]

---

172. Investment Advisers Act of 1940 § 203, 15 U.S.C. § 80b–3 (2006).

173. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act §§ 402, 408, Pub. L. No. 111–203, 124 Stat. 1376, 1570, 1575 (2010) (to be codified as amended in scattered sections of 15 U.S.C.).

174. *Id.* § 401, 124 Stat. at 1570.

175. 156 CONG. REC. H5196 (daily ed. June 29, 2010) (Joint Explanatory Statement of Title IV, Regulation of Advisers to Hedge Funds and Others, by the House and Senate Conference Committee).

176. 155 CONG. REC. H14420 (daily ed. Dec. 9, 2009) (statement of Rep. Paul Kanjorski).

177. *Id.* at H14418 (statement of Rep. Henry Waxman).

178. *Id.* at H14413 (statement of Rep. Barney Frank); *id.* at H14418 (statement of Rep. Henry Waxman).

179. *See* 156 CONG. REC. S5876 (daily ed. July 15, 2010) (statement of Sen. Richard Shelby).

> [T]he bill gives the Securities Exchange Commission . . . a new systemic risk mandate to oversee advisers to hedge funds and private funds. Yet no one contends private funds were a cause of the recent crisis or that the demise of any private fund during the crisis resulted in a systemwide shock.

Id.

180. *Id.*

181. *See* 156 CONG. REC. H5235–39 (daily ed. June 30, 2010) (statement of Rep. Paul Kanjorski) (outlining concerns with several of the exemptions).

(1) Disclosure Requirements

Title IV requires registered advisers to maintain records and any other information that may be necessary and appropriate to avoid systemic risk.[182] Accordingly, investment advisers have to provide confidential reports related to systemic risk.[183] Risk-related information includes trading and investment positions; trading practices; the amount of assets under management; the use of leverage, including off-balance sheet leverage; counterparty credit risk exposures; valuation policies; and side letters.[184] Dodd–Frank also requires investment advisers to adopt a written code of ethics that complies with federal securities law.[185] Furthermore, each registered investment adviser must establish, maintain, and enforce written policies to prevent insider trading.[186] Additionally, registered investment advisers are required to maintain financial and other business-related books and records, which facilitates inspections by the SEC.[187] PFIARA provides a one-year transition period before the registration requirements take effect.[188]

(2) Hedge Fund Registration Exemptions

Recognizing that some entities operating in the markets pose fewer risks than others, the PFIARA exempts private fund advisers with less than $150 million AUM,[189] venture capital fund advisers,[190] and advisers with less than $100 million AUM who provide advice to clients on investments other than private funds.[191] It also provides

---

182. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act, Pub. L. No. 111–203, §§ 404, 405, 124 Stat. 1376, 1571–74 (2010) (to be codified as amended in scattered sections of 15 U.S.C.).

183. *Id.* § 404, 124 Stat. at 1571–74.

184. *Id.*

185. *Id.* § 725, 124 Stat. at 1687.

186. *See id.* § 404, 124 Stat. at 1571–73 (requiring covered investment advisers to make disclosures to the SEC to protect investors and the "integrity of the markets").

187. *Id.*

188. *See* id. § 419, 124 Stat. at 1580.

> Except as otherwise provided in this title, this title and the amendments made by this title shall become effective 1 year after the date of enactment of this Act, except that any investment adviser may, at the discretion of the investment adviser, register with the Commission under the Investment Advisers Act of 1940 during that 1-year period, subject to the rules of the Commission.

Id.

189. *Id.* § 408, 124 Stat. at 1575.

190. *Id.* § 407, 124 Stat. at 1574–75.

191. *Id.* § 410, 124 Stat. at 1576–77.

an exemption for foreign private advisers with fewer than fifteen clients and investors in the United States.[192] The exemption for foreign private advisers requires that the adviser has no place of business in the United States, has less than $25 million AUM attributed solely to U.S. clients and investors, and does not hold itself out to the U.S. public as an investment adviser.[193] Although the exempt entities are not per se required to register, PFIARA mandates those advisers with less than $150 million AUM to maintain records and provide the SEC with annual reports or any other reports that the SEC deems appropriate or necessary to protect investors.[194]

Although the registration requirement seems to silence some of the hedge fund industry's critics, some of the exemptions are already under scrutiny. The exemption for venture capital fund advisers could raise concerns.[195] Moreover, a number of international financial institutions conduct substantial operations in the United States[196] and have structured their operations to meet U.S. regulatory requirements in reliance on SEC no-action letters to *Uniao de Bancos de Brasileiros S.A. (Unibanco)*[197] and its progeny,[198] under which a U.S. subsidiary and a non-U.S. parent are separate entities for the purpose of the registration requirements under U.S. securities law. Prior to the enactment of Title IV, the policies expressed in *Unibanco* and its successors provided foreign financial institutions with substantial value in terms of cost and minimization of regulatory burdens.[199] The removal of the private adviser

---

192. *Id.* §§ 402–403, 124 Stat. at 1570–71.

193. *Id.* The PFIARA specifies that the SEC may exercise its rulemaking powers and raise this amount. *Id.* § 402(a), 124 Stat. at 1571.

194. *Id.* § 408, 124 Stat. at 1575.

195. *See* 156 CONG. REC. S5915 (daily ed. Jul. 15, 2010) (statement of Sen. Jack Reed) (expressing concern for the "carve-outs" in the Dodd–Frank bill for venture capital).

196. *See* Rule Comment from Katten Muchin Rosenman LLP on File No. DF Title IV Exemption, to SEC (Sept. 14, 2010) (asking the SEC to clarify the exemption for foreign private advisers, because Katten Muchin Roseman had a lot of clients in that category and has previously relied on the *Unibanco* standard).

197. Uniao de Banco de Brasileiros S.A., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 817 (July 28, 1992).

198. *See, e.g.*, Royal Bank of Canada et al., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 620 (June 3, 1998) (following the *Unibanco* approach of treating U.S. subsidiaries and non-U.S. parent financial institutions separately for purposes of registration under U.S. securities law); ABN AMRO Bank N.V. et al., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 754 (July 1, 1997) (same); Murray Johnstone Holdings Limited et al., SEC No-Action Letter, 1994 SEC No-Act. LEXIS 734 (Oct. 7, 1994) (same); Kleinwort Benson Investment Management Limited et al., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 1181 (Dec. 15, 1993) (same); Mercury Asset Management PLC, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 652 (Apr. 6, 1993) (same).

199. *See supra* notes 197–98 for a discussion of a softer regulatory burden on foreign financial institutions.

exemption[200] makes reliance on *Unibanco* and its progeny less certain for international financial institutions. More specifically, the foreign private adviser exemption in Title IV has only very limited application, [201] and it is unclear if international financial institutions can still rely on *Unibanco* and its progeny. This may create substantial uncertainty, curtailing the activities of international financial institutions in the United States. Timely clarification by the SEC as to the continuance of its policies expressed in *Unibanco* could minimize the impact on U.S. markets.

PFIARA authorizes the SEC to promulgate rules pertaining to exempt entities.[202] Given the SEC's concerns during the legislative process and its rulemaking authority in the context of hedge fund registration exemptions,[203] there is a chance that the limited exemptions under PFIARA could be further curtailed. PFIARA requires the SEC to examine factors such as the "size, governance, and investment strategy of an adviser" to determine the systemic risk a fund may create and impose registration and examination procedures accordingly.[204] Legislators feared that by including even limited exemptions in hedge fund regulation, the exemptions could effectively "swallow the rules."[205] Accordingly, the Dodd–Frank Act empowers the SEC to utilize its rulemaking authority to prevent this outcome.[206] The legislators supporting the Dodd–Frank Act wanted the SEC to be able to obtain the basic information necessary to prevent fraud, protect against systemic risk, and provide investors with useful information about the funds—even funds that are exempt

---

200. *See* Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act § 403, Pub. L. No. 111–203, 124 Stat. 1376, 1571 (2010) (to be codified as amended in scattered sections of 15 U.S.C.) (removing the private adviser exemption from the Advisers Act).

201. *See id.* §§ 402–403, 124 Stat. at 1570–71 (laying out the specifics of the foreign private adviser exemption).

202. *Id.* § 408, 124 Stat. at 1575.

203. *See* 156 CONG. REC. S5915 (daily ed. Jul. 15, 2010) (statement of Sen. Jack Reed) (noting the importance of bringing hedge funds within the "umbrella of financial regulation").

204. *See* Dodd–Frank Act § 408, 124 Stat. at 1575.

> In prescribing regulations to carry out the requirements of this section with respect to investment advisers acting as investment advisers to mid-sized private funds, the Commission shall take into account the size, governance, and investment strategy of such funds to determine whether they pose systemic risk, and shall provide for registration and examination procedures with respect to the investment advisers of such funds which reflect the level of systemic risk posed by such funds.

Id.

205. 156 CONG. REC. H5238 (daily ed. Jun. 30, 2010) (statement of Rep. Paul Kanjorski).

206. *Id.*

from registration.[207] Others question whether regulators would have the resources to promulgate and enforce rules that can protect against systemic risk.[208] If regulators lack the resources to protect against systemic risk, hedge fund regulation could be futile.

(3) *De Minimis* Hedge Fund Investment Exemption

Title VI allows banks to make or retain a *de minimis* investment in private equity or hedge funds.[209] Under this exception, banks can invest up to 3 percent of Tier 1 capital in hedge and private equity funds,[210] provided that such investments are less than 3 percent of the total ownership interests of the funds.[211] The exception was not included in the first drafts of the bill,[212] and the exact language was not incorporated until the May 20, 2010, draft.[213]

Banks have several years to structure their activities to comply with the *de minimis* rule.[214] This may make the *de minimis* revision of the Volcker Rule workable.[215] The revised rule may also protect against bailouts, and it prohibits banks from guaranteeing or insuring the performance of any sponsored private equity or hedge fund.[216] Although the *de minimis* exception restricts banking entities with regard to hedge funds, it may not affect traditional banking.[217] Both supporters and those opposed to the *de minimis* exception and

---

207. *See* 156 CONG. REC. S5912 (daily ed. Jul. 15, 2010) (statement of Sen. Patrick Leahy) (supporting the Dodd–Frank bill because, among other things, it requires hedge funds to register with the SEC).

208. *See id.* at S5875–78 (statement of Sen. Richard Shelby) (criticizing the Dodd–Frank bill's reliance on massive bureaucracy and questioning the effectiveness of such a scheme at reducing systemic risk).

209. Dodd–Frank Act § 619(d)(4), 124 Stat. at 1627.

210. *See* 156 CONG. REC. S5889 (daily ed. July 15, 2010) (statement of Sen. Kay Hagan) ("The section's limitations on financial organizations that own a depository institution from investing or sponsoring in hedge funds or investments in private equity to 3 percent of an organization's assets, in the aggregate, references 'tier 1 capital.'").

211. *Id.*

212. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

213. Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. § 617 (as amended in the Senate May 20, 2010).

214. *See* Dodd–Frank Act § 619(c), 124 Stat. at 1622–23 (providing that § 619 takes effect either a year after final rules are issued or two years after the law is enacted, whichever is earlier).

215. *See* 156 CONG. REC. S5889 (daily ed. July 15, 2010) (statement of Sen. Kay Hagan) (praising the fact that § 619 gives banking entities several years to conform with the new rule).

216. *Id.* (citing Dodd–Frank Act § 619(d)(1)(G)(v), 124 Stat. at 1625).

217. *See id.* ("I am pleased that as part of the conference report that the Volcker language was modified to permit a banking entity to engage in a certain level of traditional asset management business, including the ability to sponsor and offer hedge and private equity funds.").

other provisions of the Dodd–Frank Act agree that it will be crucial for the SEC to define the rules and implement the provisions in a way that protects the functioning of the market.[218] It is unclear if the SEC and other regulators are equipped to handle this task.[219]

(4) Revision of Accredited Investor Standards

Before the enactment of PFIARA, hedge fund regulation in the United States was largely based on exemptions for hedge fund advisers[220] and compliance with accredited investor standards.[221] As long as hedge funds did not advertise or otherwise hold themselves out to the public, limited the resale of their securities, and curtailed the sale of their securities to only a limited number of wealthy investors, they were exempt from U.S. securities law.[222] To ensure that they were exempt from registration and supervision, hedge funds generally complied with these requirements and limited the sale of their securities to sophisticated and wealthy investors.[223] Prior to the changes in PFIARA, Regulation D provided a safe harbor under § 4(2) of the Securities Act and defined an "accredited investor" as a person with a net worth of more than $1 million.[224] The SEC noted that inflation might have eroded the significance of a $1 million net worth as a proxy for investor sophistication, and it proposed to amend Regulation D.[225] Determining what level of wealth acts as an effective proxy of "sophistication" of investors remains difficult.

---

218. *See* 156 CONG. REC. S5906, 5913 (daily ed. July 15, 2010) (statements of Sen. Evan Bayh & Sen. Jack Reed) (noting the importance of regulating the financial industry in a way that does not impede market functions).

219. *See id.* at S5875–78 (statement of Sen. Richard Shelby) (noting that this is giving the SEC a new mandate to oversee, where it failed to carry out its existing mandates in the past). *But see id.* at S5899 (statement of Sen. Carl Levin) ("We believe the SEC has sufficient authority to define the contours of the rule in such a way as to remove the vast majority of conflicts of interest from these transactions, while also protecting the healthy functioning of our capital markets.").

220. *See* Investment Advisers Act of 1940 § 203(b), 15 U.S.C. § 80b-3(b) (2006) (providing broader registration requirement exemptions for hedge fund advisers than the Dodd–Frank Act).

221. *See* SEC Regulation D—Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.501 (2011) (providing rules for hedge funds).

222. Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. LEGIS. & PUB. POL'Y 251, 285–90 (2008).

223. *Id.* at 289–90. *But see id.* at 309–18 (arguing normatively for the establishment of a hedge fund market for retail investors).

224. R. 506, SEC Regulation D, 17 C.F.R. § 230.501(a)(5).

225. *See* SEC Proposed Rules, 72 Fed. Reg. 405–08 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pt. 230) (proposing a two-step approach to determine whether an individual is an accredited investor: (1) whether the individual meets the test in Rule 501(a) or Rule 215, and (2) whether the individual owns at least $2.5 million in investments).

Prior to the enactment of PFIARA, U.S. hedge fund regulation was based on the idea that investors who met the Regulation D criteria qualified to invest in hedge funds because they could "fend for themselves."[226] Regulation D defined the term "accredited investor" as a natural person whose individual net worth (or joint net worth with such person's spouse) exceeded $1 million at the time of the purchase,[227] or whose individual income exceeded $200,000 (or joint income with the person's spouse exceeded $300,000) in each of the two most recent years, and who had a reasonable expectation of reaching the same income level in the year of investment.[228] After its attempt to require hedge fund registration and its subsequent defeat in the D.C. Circuit's *Goldstein* decision,[229] the SEC, in December 2006, dramatically expanded fraud protection for investors.[230] At the same time, it proposed to increase the accredited investor standards under Regulation D[231] by adding a requirement of ownership of at least $2.5 million in investments[232] to the net worth or income test specified in Rule 501(a)[233] and Rule 215.[234] The SEC's reasoning that "natural persons may have indirect exposure to private pools"[235] and "many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments"[236] seems to suggest that the retailization of the hedge fund industry was a major concern.[237]

---

226. *See* Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (reasoning that based on the purpose of exemptions in the Securities Act, exempt transactions are for those who have no need for protection of the act because they are able to "fend for themselves").

227. 17 C.F.R. § 230.501(a)(5).

228. *Id.* § 230.501(a)(6).

229. *See* Goldstein v. Sec. & Exch. Comm'n, 451 F.3d. 873, 883–84 (D.C. Cir. 2006) (striking down SEC rule requiring that hedge fund investors be counted as clients of the fund's adviser for purposes of the fewer than fifteen clients exemption).

230. *See* SEC Proposed Rules, 72 Fed. Reg. 400 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pt. 275) (explaining provisions of the proposed rule allowing the SEC to bring enforcement actions against investment advisers who defraud investors or prospective investors).

231. *Id.* at 405.

232. *Id.* at 414 (clarifying that in addition to other Regulation D requirements, an accredited investor must own not less than $2.5 million in investments, after inflation adjustment).

233. *Id.* at 416.

234. *Id.* at 414.

235. *Id.* at 404.

236. *Id.*

237. *Id.* at 405.

> As proposed, the term accredited natural person would include any natural person who meets the requirements specified in the current definition of accredited person, as that term relates to natural persons, and would add a requirement that such person also must own (individually, or jointly with the

Preempting the SEC proposal, PFIARA revised the definition of "accredited investor" in Regulation D by excluding the value of a natural person's primary residence for purposes of determining whether the person meets the $1 million net worth standard.[238] PFIARA has a one-year transition rule.[239] However, the SEC staff indicated that this revision will take immediate effect.[240]

c) Impact Assessment of Hedge Fund Rules Under Dodd–Frank

Almost all hedge fund advisers complied with the private adviser exemption[241] in order to avoid registration as an investment adviser under federal rules.[242] Without exemptions, hedge fund advisers were subject to SEC inspections, books and record keeping

---

person's spouse) not less than $2.5 million (as adjusted every five years for inflation) in investments at the time of purchase of securities issued by private investment vehicles under Regulation D or section 4(6).

Id.

238. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act § 413, Pub. L. No. 111–203, 124 Stat. 1376, 1577 (2010) (to be codified as amended in scattered sections of 15 U.S.C.). To the contrary, the definition promulgated by the SEC to define "accredited investor" in the Securities Act of 1933 did not include the exclusion of the person's primary residence in determining that person's net worth. 17 C.F.R. § 230.215 (2011).

239. Dodd–Frank Act § 419, 124 Stat. at 1580.

240. SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 4:2, at 4–7 (2010) (stating that the change went into immediate effect).

241. *See* Investment Advisers Act of 1940 § 203(b), 15 U.S.C. § 80b–3(b) (2006) (providing more generous registration requirement exemptions for hedge fund advisers than the Dodd–Frank Act).

242. Kaal, *supra* note 6, at 32 n.172.

> It is unclear what role investment adviser registration with the SEC plays in the current environment. Some of the data made available to the author by Robert E. Place of the SEC's Investment Management Division highlights the importance of *Goldstein v. Sec. & Exch. Comm'n*, 451 F.3d 873 (D.C. Cir. 2006): 11,292 investment advisers are registered with the Commission with total AUM of $43 trillion. 1,845 or 16 percent of these advisers are identified by Form ADV as hedge fund advisers. 790 hedge fund advisers have registered since January 1, 2005 (and are still registered). 217 of these advisers have registered since the Goldstein decision (June 23, 2006). 169 hedge fund advisers are located outside the U.S. 11,710 private investment funds ("PIF") identified; (10,029 PIFs once duplicate names are removed). $3 trillion in private investment fund assets identified; ($2.6 trillion in PIF assets once duplicate names are removed). 753 or 30 percent of the HF advisers that were identified on June 23, 2006, either withdrew their registration or had their registration cancelled. 382 or 15 percent of the HF advisers that were identified on June 23, 2006, have been reclassified as non hedge fund advisers because of changes they made to their Form ADV.

Id. (internal quotation marks omitted).

requirements,[243] disclosure requirements,[244] and code of ethics requirements.[245] Additionally, advisers incurred significantly higher legal fees. PFIARA replaced the private adviser exemption with a general requirement that an investment adviser to any hedge fund or private equity fund must register with the SEC.[246] Investment advisers who previously relied on the private adviser exemption[247] and are required to register with the SEC must register by July 21, 2011.[248] PFIARA exempts private fund advisers with less than $150 million AUM,[249] venture capital fund advisers,[250] and advisers with less than $100 million AUM who provide advice to clients on investments other than private funds.[251] PFIARA also provides an exemption for foreign private advisers with fewer than fifteen clients and investors in the United States.[252] Some of the exemptions have already raised concerns.[253]

If exempted private fund advisers with less than $150 million AUM[254] have not previously registered under state law because they complied with federal law and were registered with the SEC, they may now be required to deregister with the SEC and become subject to a state registration requirement.[255] The administrative and compliance cost of deregistering under federal law and reregistering under state law may be significant and could harm the industry.

---

243. 17 C.F.R. § 275.204–2 (2011).

244. *Id.* § 275.204–3.

245. *Id.* § 275.204A–1 (requiring registered investment advisers to "establish, maintain and enforce a written code of ethics," subject to some minimum requirements included in the rule).

246. *See* Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act §§ 403, 408(m), Pub. L. No. 111–203, 124 Stat. 1376, 1575 (2010) (to be codified as amended in scattered sections of 15 U.S.C.) (eliminating the private adviser exemption and providing for more stringent registration requirements for hedge funds and other private investment advisers).

247. *See* Investment Advisers Act of 1940 § 203(b), 15 U.S.C. § 80b–3(b) (2006) (providing more generous registration requirement exemptions for hedge fund advisers than the Dodd–Frank Act).

248. *See* Dodd–Frank Act § 419, 124 Stat. at 1580 (providing that the registration requirements take effect one year after enactment). The Dodd–Frank Act was enacted on July 21, 2010. *Id.* pmbl., 124 Stat. at 1376.

249. *Id.* § 408, 124 Stat. at 1575.

250. *Id.* § 407, 124 Stat. at 1575.

251. *Id.* § 410, 124 Stat. at 1576.

252. *Id.* §§ 402–403, 124 Stat. at 1570–71.

253. *See* 156 CONG. REC. S5915 (daily ed. July 15, 2010) (statement of Sen. Jack Reed) ("While I successfully convinced the conferees to drop a carve-out for private equity advisers, the bill still contains problematic exemptions for venture capital firms and family offices.").

254. Dodd–Frank Act § 408, 124 Stat. at 1575.

255. Rules Implementing Amendments to the Investment Advisers Act of 1940, 75 Fed. Reg. 77,051, 77,054 (Dec. 10, 2010) (to be codified at 17 C.F.R. pt. 275) ("[A]n adviser no longer eligible for Commission registration would transition to State registration.").

Even advisers that do not have to comply with the federal registration under this PFIARA exemption will nonetheless be subject to certain disclosure and recordkeeping requirements to be defined by the SEC.[256]

(1) Increased Disclosure Obligations

PFIARA further requires registered advisers to maintain records and any other information that the SEC and the systemic risk regulators deem necessary and appropriate.[257] Advisers must provide confidential reports with respect to certain information related to systemic risk,[258] such as trading and investment positions; trading practices; the amount of AUM; the use of leverage, including off-balance sheet leverage; counterparty credit risk exposures; valuation policies; side letters; and other information deemed necessary.[259] Dodd–Frank also requires all hedge funds to be subject to SEC examinations.[260] PFIARA provides a one-year transition period before the registration requirements take effect.[261]

The SEC may or may not have the resources to evaluate data involving dynamic hedging strategies and trades. If the SEC were to attempt to evaluate such data, perhaps in an effort to ensure that systemic risks are curtailed, its ability to hire additional, well-qualified staff to evaluate such data is unclear. An understanding of dynamic hedging trades and strategies requires a significant level of financial sophistication and training, and the task of attracting staff with such knowledge could place the SEC in competition for talent with hedge funds and banks. Even if the SEC were to start hiring math and accountancy majors who otherwise would have good prospects to work as analysts in the financial services industry, the setup costs would be significant. Perhaps, if a position as an analyst with the SEC is perceived as a stepping stone to becoming an analyst with a major hedge fund or investment bank, qualified candidates could be incentivized to work for the SEC before starting a career in finance.

---

256. Dodd–Frank Act § 407, 124 Stat. at 1575 ("The Commission shall require investment advisers exempted by reason of this subsection to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors."). For a discussion of the impact of the SEC's rulemaking authority, see *infra* Part III.2.c.2.

257. Dodd–Frank Act § 404(b)(1)(A), 124 Stat. at 1571–72.

258. *Id.* § 404(b)(3), 124 Stat. at 1572.

259. *Id.* § 404(b)(3)(H), 124 Stat. at 1572.

260. *Id.* § 404(b)(6)(A), 124 Stat. at 1573.

261. *Id.* § 416, 124 Stat. at 1579.

By excluding proprietary information of private funds from public disclosure, Dodd–Frank increased the SEC's authority to exempt information from the Freedom of Information Act requirements.[262] Even though the SEC is exempt from disclosing information it obtains from hedge funds,[263] there is a risk that the information will not be kept private. Another major concern is leakage by the regulator, especially leakage of disclosed trading positions, trading strategies, and dynamic hedging strategies. The SEC and other regulators who obtain and review proprietary information could inadvertently pass this information on to third parties. The confidential nature of this information makes it highly valuable for third parties who engage in the same markets as the owner of the proprietary information, and this form of leakage could undermine trading strategies and the long-term viability of hedge funds. Leakage of proprietary information by the regulators may be more of a problem for hedge funds with an established track record. Start-up funds, however, could also be affected if star traders with established trading records and successful trading strategies decide to set up their own fund or funds. Leakage could also affect specific positions in the market. Front-running and other abusive practices may be unavoidable if regulators leak information pertaining to specific and potentially market-moving positions of large private equity and hedge funds. Even if regulators may have been successful in "maintaining secrecy regarding sensitive private information,"[264] information pertaining to trading strategies and positions held by hedge funds could have a different quality and heightened sensitivity than comparable information that was otherwise kept confidential by regulators.

(2) SEC's Rulemaking Authority

As discussed above,[265] PFIARA authorizes the SEC to promulgate rules pertaining to exempt entities.[266] Given concerns over the SEC's rulemaking authority during the legislative process,[267]

---

262. *Id.* § 929I, 124 Stat. at 1857–59.
263. *Id.*
264. Romano, *supra* note 6, at 13.
265. *See supra* Part II.b.2.
266. Dodd–Frank Act § 408, 124 Stat. at 1575.
267. *See* 156 CONG. REC. S5915 (daily ed. Jul. 15, 2010) (statement of Sen. Jack Reed).

> The Dodd–Frank bill also closes a significant gap in financial regulation by requiring advisers to hedge funds and private equity funds to register with the Securities and Exchange Commission. Based on legislation that I introduced, we will for the first time bring advisers to those funds within the umbrella of financial regulation. This will allow regulators to obtain the basic information

the limited exemptions under PFIARA could be further curtailed. PFIARA requires the SEC to examine the "size, governance, and investment strategy of an adviser" to determine the systemic risk that these funds create and impose registration and examination procedures accordingly.[268] Legislators, fearing that the exemptions would effectively "swallow the rules,"[269] empowered the SEC to utilize its rulemaking to prevent this outcome.[270] The legislators supporting the Dodd–Frank Act wanted the SEC to be able to obtain the basic information necessary to prevent fraud, protect against systemic risk, and provide investors with useful information about the funds, even funds that are exempt from registration.[271] Others questioned whether the regulators are capable of making this determination and whether they have the resources to promulgate and enforce rules that successfully protect against systemic risk.[272]

If the SEC uses its rulemaking authority to continue curtailing the hedge fund industry, the consequences could be significant for that industry and financial markets. In particular, the compliance costs to the hedge fund industry could be substantial. It may be indicative that all of the hedge funds that were forced to register with the SEC before *Goldstein*[273] deregistered upon the D.C. Circuit's holding that the SEC exceeded its authority by attempting to register

---

> they need to prevent fraud and mitigate systemic risk, while at the same time providing investors with more information and greater transparency.

Id.

268. Dodd–Frank Act § 408, 124 Stat. at 1575.

> In prescribing regulations to carry out the requirements of this section with respect to investment advisers acting as investment advisers to mid-sized private funds, the Commission shall take into account the size, governance, and investment strategy of such funds to determine whether they pose systemic risk, and shall provide for registration and examination procedures with respect to the investment advisers of such funds which reflect the level of systemic risk posed by such funds.

Id.

269. 156 CONG. REC. H5238 (daily ed. June 30, 2010) (statement of Rep. Barney Frank).

270. *See id.* ("[T]he success of this landmark reform effort will ultimately depend on the individuals who become the regulators.").

271. *See* 156 CONG. REC. S5902 (daily ed. July 15, 2010) (statement of Sen. John Kerry) (clarifying that the goal of the Financial Stability Oversight Council should be to target financial companies, regardless of size, that could pose a risk to the financial stability of the United States).

272. *See id.* at S5875 (statement of Sen. Richard Shelby) (criticizing the Dodd–Frank Act for creating an even larger bureaucracy and questioning its ability to make the correct decisions); *id.* at S5885 (statement of Sen. Ted Kaufman) (raising the concern that agencies may not have the resources to properly carry out all of their obligations under the Dodd–Frank Act).

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

hedge funds.[274] Perhaps the SEC would be well advised to interpret the authority it received from Congress rather than to increase the requirements on hedge funds to address concerns over potential systemic risk. There are some indicia that hedge funds may not pose a systemic risk.[275] Even assuming that systemic implications arise from hedge fund investing, systemic risk is such a multifaceted issue that it could require the involvement of more than one regulator in one jurisdiction.[276] As such, cooperation among regulators internationally could help to address systemic concerns. The SEC alone may not be able to accomplish the task, and its rulemaking under PFIARA should not impose additional requirements on hedge funds under the guise of minimizing systemic risk. To the contrary, the SEC's rulemaking authority has the potential to support the hedge fund industry. Clarification and guidance on hedge fund rules under PFIARA would be tremendously valuable to the investing community. Many open issues exist under PFIARA, and any guidance by the SEC would give market participants more confidence in the rules and their meaning and interpretation. Moreover, this guidance may minimize transaction and compliance costs, reduce uncertainty, and facilitate market participants' efficient operation.

(3) Blue Sky Laws

PFIARA provides that an investment adviser who gives investment advice to clients other than private funds (e.g., an adviser with separate accounts) is not subject to federal registration.[277] This exemption applies if the adviser has less than $100 million AUM and would be required to comply with state registration rules and register with the state in which it maintains its principal office and place of business.[278] If advisers who are not obligated to register with the SEC are required, under state law, to register with fifteen or more states, Dodd–Frank allows them to register with the SEC under federal law.[279] Under PFIARA, however, the SEC has authority to

---

274. Fraser, *supra* note 168, at 798–99.

275. *See infra* Part V.

276. Matthew Beville, Dino Falaschetti & Michael J. Orlando, *An Information Market Proposal for Measuring Systemic Risk*, 12 U. PA. L. REV. 849, 873–74 (averring that systemic risk is difficult to measure because the information required is "widely dispersed," the very definition of systemic risk is unclear, and political pressure may influence objectivity).

277. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act § 410(2)(A), Pub. L. No. 111–203, 124 Stat. 1376, 1576 (2010) (to be codified as amended in scattered sections of 15 U.S.C.).

278. *Id.*

279. *Id.* ("[I]f by effect of this paragraph an investment adviser would be required to register with 15 or more States, then the adviser may register under section 203.").

define certain disclosure and recordkeeping requirements that will apply to advisers who are exempt from federal registration.[280]

It may be presumed from the PFIARA exemption for advisers with less than $100 million AUM that state law *de minimis* exemptions do not apply.[281] Attorneys advising hedge fund start-ups, however, often use state law *de minimis* exemptions to minimize costs to their clients and help them raise funds without registering with the SEC.[282] In contrast, registering with the SEC and filing Form ADV involves substantial administrative attention for the fund adviser, and attorney's fees can be substantial.[283] The number of start-ups and smaller hedge fund operations has not been formally determined, but it cannot be underestimated. Hedge fund managers have incentives to bring investors into the hedge fund as soon as possible to facilitate a new hedge fund's timely and efficient operation. Keeping the number of investors below fifteen is vital in this process.[284] Even though a "client" under the Advisers Act can include legal entities,[285] hedge fund managers would probably want to make sure, especially in the start-up phase of a fund, that they maximize the counting of potential clients that would be excluded from the fifteen-client limit under federal law. Such clients could be retail investors who could qualify to invest under state-specific *de minimis* exemptions.

Under *de minimis* exemptions in state Blue Sky laws, there could be several scenarios allowing retail investors to invest in hedge funds and hedge fund-like vehicles.[286] Hedge fund managers may consider bringing retail investors into a hedge fund under such exemptions. If the hedge fund manager wants to bring U.S. investors into the fund and the respective investors are residents of certain states, the fund manager would have to register as an investment adviser under the respective state laws if the state does not have a *de minimis* exemption that exempts the manager from registration.[287]

---

280. *Id.* § 408, 124 Stat. at 1575 (giving the SEC authority to require even exempted advisers to keep records and make reports as it deems necessary).

281. Rules Implementing Amendments to the Investment Advisers Act of 1940, 75 Fed. Reg. 77,052, 77,054 (Dec. 10, 2010) (to be codified at 17 C.F.R. pt. 275).

282. Kaal, *supra* note 6, at 613 ("Under *de minimis* exemptions in state Blue Sky laws, there could be several scenarios in which retail investors would be able to invest in hedge funds and hedge-fund-like-vehicles.").

283. *Id.* at 613–14.

284. *Id.* at 613.

285. 17 C.F.R. § 275.203(b)(3)–1(a)(2) (2011).

286. *See* Kaal, *supra* note 6, at 611–17 (Chapter on CFTC rules and Blue Sky *de minimis* exemptions).

287. Most large states, however, do have *de minimis* exceptions. *See, e.g.*, CAL. CORP. CODE § 25202(a) (2005); CONN. GEN. STAT. § 36b–6e (2007); ILL. ADMIN. CODE tit. 14, § 130.805 (2006); MASS. GEN. LAWS ANN. ch. 110A, § 401(m)(1)(G) (2002); N.J. STAT.

Such registration under state law would require filing a Form ADV, used by the SEC to federally register certain investment advisers, with the appropriate state through the Investment Adviser Registration Depository.[288] Using Form ADV may result in significant transaction costs. Especially in the start-up phase of a hedge fund, the manager may want to avoid such costs. Managers also want to avoid concerns over the eligibility of investors. Additionally, managers want to use existing investors in the fund as a form of advertising to bring in additional investors, to establish a track record, and to facilitate efficient operations in a timely fashion. Accordingly, especially in the start-up phase of a hedge fund, managers may consider certain state *de minimis* investment adviser registration exemptions for investors an attractive alternative to complying with federal laws.[289]

(4) Cost of Compliance

Before PFIARA, without the private adviser exemption, investment advisers were subject to SEC inspections, books and record keeping requirements,[290] disclosure requirements,[291] code of ethics requirements,[292] and consequently, significantly higher legal fees. Scholars and industry representatives argued that these requirements increased the cost of doing business for the hedge fund industry.[293] PFIARA requires investor registration with the SEC,[294] and voided the private adviser exemption while creating other exemptions.[295] Nevertheless, investment advisers will have to comply with a litany of PFIARA requirements. For instance, investment advisers that are required to register under federal law must register with the SEC using Form ADV.[296] The cost of

---

ANN. § 49:3–56(g) (2001); N.Y. GEN. BUS. LAWS § 359–eee (2007); 7 TEX. ADMIN. CODE § 7:116.1(b)(2)(C) (2008).

288. *See generally Form ADV*, SEC, http://www.sec.gov/answers/formadv.htm (last visited Feb. 28, 2011).

289. *See* statutes cited *supra* note 287.

290. 17 C.F.R. § 275.204–2.

291. *Id.* § 275.204–3.

292. *Id.* § 275.204A–1 (requiring registered investment advisers to "establish, maintain and enforce a written code of ethics," subject to some minimum requirements included in the rule).

293. Jacob Preiserowicz, Note, *The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?*, 11 FORDHAM J. CORP. & FIN. L. 807, 842 (2006) (arguing that the repercussions of regulating hedge funds include increased administrative and legal costs).

294. *See* registration discussion *supra* Part III.2.a.

295. *Id.*

296. *Form ADV*, *supra* note 288.

complying with the requirements of Form ADV, including attorney's fees, can be substantial.[297]

In part as a reaction to the Madoff scandal, PFIARA requires registered investment advisers that have "custody"[298] of client accounts to keep all client assets with a qualified custodian.[299] Investment advisers also have to provide detailed statements of what assets are held by whom.[300] Additionally, advisers must obtain an annual surprise verification of client assets by independent accountants if their funds do not obtain audited financials complying with Generally Accepted Accounting Principles (GAAP) and distribute them promptly to investors.[301] Moreover, PFIARA requires investment advisers to adopt written policies and procedures to prevent and detect violations of federal securities law.[302] The cost of compliance with these requirements could be significant, and the efficiency of this provision may be called into question. The implementation of written policies and procedures to prevent and detect violations of federal securities law implies that potential violations of securities law are foreseeable. But because securities law has been substantially changed under the Dodd–Frank Act, the foreseeability of potential violations could be further curtailed.

Investment advisers must also appoint a Chief Compliance Officer.[303] To ensure compliance with ethical business standards, Dodd–Frank mandates the adoption of a written code of ethics that complies with federal securities law.[304] In particular, this code must

---

297. *See* Verret, *supra* note 6, at 807 (noting that filing a Form ADV generally requires hiring an attorney to serve as a compliance officer at a salary of $125,000 to $500,000 per year).

298. "Investment adviser" is defined broadly under the Advisers Act to cover virtually all private fund managers. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act § 411, Pub. L. No. 111–203, 124 Stat. 1376, 1577 (2010) (amending 15 U.S.C. 80b–1 et seq. by adding at the end the following, "An investment adviser registered under this title shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe."); *see also Materials Submitted by Nora M. Jordan, Davis Polk & Wardwell, in* PRAC. L. INST., GLOBAL CAPITAL MARKETS & THE U.S. SECURITIES LAWS 2010: STRATEGIES FOR THE CHANGING REGULATORY ENVIRONMENT 629, 640 (2010) (arguing that based on the SEC's failure to discover Madoff's Ponzi scheme, the investment adviser risk ratings should be based on information compiled by all SEC divisions).

299. Dodd–Frank Act § 411, 124 Stat. at 1577.

300. *Id.*

301. *Id.* § 404, 124 Stat. at 1571.

302. Id. § 409(b), 124 Stat. at 1575–76 (to be codified as amended at 15 U.S.C. § 80b–2).

303. *Id.* § 753, 124 Stat. at 1750. PFIARA, however, does not require that the Chief Compliance Officer be an employee of the firm. Advisers can outsource this function, but they must conduct and document an annual review to show the effectiveness of its compliance program. *Id.* § 725, 125 Stat. at 1685.

304. *Id.* § 725(b)(3)(A)(ii), 124 Stat. at 1687.

set forth standards governing personal securities trading by the adviser's personnel.[305] Reinforcing insider-trading monitoring, PFIARA requires each registered adviser to establish, maintain, and enforce written policies to prevent insider trading.[306] In part to facilitate SEC inspections, registered investment advisers are required to maintain a long list of financial and other business-related books and records.[307] It is unclear whether the SEC will actually be able to evaluate all of the data that PFIARA requires advisers to disclose upon inspection.[308] The SEC's ability to evaluate this data depends to some degree on its budget. However, as discussed above,[309] even with additional funding, the SEC may not have the resources to hire sufficiently qualified staff to evaluate such data.

(5) *De Minimis* Investment Exemption

The Dodd–Frank Act allows banks to make or retain a *de minimis* investment in hedge funds or private equity funds[310] if such investments constitute less than 3 percent of the total ownership interests of the funds.[311] Although the *de minimis* exemption will provide restrictions on the hedge fund exposure of banking entities, it may not affect traditional banking.[312] This limitation may support breaking the connection between a bank's balance sheet and its risk taking in the market.[313] At the same time, the *de minimis* amendment may have reduced the impact of the Volcker Rule, which attempts to limit the ability of U.S. banks to make investments for their own accounts rather than on behalf of their customers.[314] The revised version of the Volcker Rule could be workable, however, because it gives banks several years to bring their activities within compliance.[315] The 3 percent *de minimis* exception will require the SEC to closely monitor banks to prevent abuse.[316] Although there may be a risk that banks continue to own and manage large hedge

---

305. *Id.* The ethics code also has to require covered personnel to pre-clear purchases in IPOs and private placements and to report personal securities holdings and transactions periodically. *Id.*

306. *Id.* § 404, 124 Stat. at 1571.

307. *Id.*

308. In the context of enhanced disclosure requirements, see *supra* Part III.2.c.1.

309. *See supra* Part III.2.c.1

310. Dodd–Frank Act § 619, 124 Stat. at 1620.

311. *Id.*

312. 156 CONG. REC. S5870, S5889–90 (daily ed. July 15, 2010) (statement of Sen. Kay Hagan).

313. *Id.* at S5894–99 (statement of Sen. Jeff Merkley).

314. *Id.* at S5884–87 (statement of Sen. Ted Kaufman).

315. *Id.* at S5889–90 (statement of Sen. Kay Hagan).

316. *Id.*

funds,[317] the revised rule prohibits a bank from guaranteeing or insuring the performance of any sponsored hedge or private equity fund.[318] The failure of a bank-managed hedge fund could increase the financial risk to the bank substantially and could result in a bailout,[319] which Dodd–Frank prohibits.[320] It is unclear, however, if the prohibition against bailouts will be enforced if it has systemic dimensions.[321] Dodd–Frank also imposes restrictions on banks acting as investment advisers to hedge funds, and these restrictions could impact the use of *de minimis* investments in hedge funds.[322] Ultimately, the regulators will be tasked with defining the rules and implementing the provisions in a way that protects the functioning of the market.[323] It is unclear if the regulators are equipped to handle this task.[324]

d) Revision of Accredited Investor Standards

PFIARA revises the accredited investor standards set forth in the Securities Act of 1933.[325] Under PFIARA, an "accredited investor" is defined as an investor with an individual net worth of $1 million, exclusive of the value of the individual's primary residence,[326] and the SEC has rulemaking authority to review this definition and modify it to protect investors.[327] Current orthodoxy

317. *Id.*

318. *Id.* (citing Dodd–Frank Wall Street and Consumer Protection (Dodd–Frank) Act § 619(d)(1)(G)(v), Pub. L. No. 111–203, 124 Stat. 1376, 1620 (2010) (amending the Bank Holding Company Act of 1856, 12 U.S.C. § 1841 et seq. (2006), by adding a new section, 12 U.S.C. § 1851(d)(4)(G))).

319. *Id.* at S5884–87 (statement of Sen. Ted Kaufman).

320. Dodd–Frank Act § 619, 124 Stat. at 1624–25.

321. 156 CONG. REC. S5884–87 (daily ed. July 15, 2010) (statement of Sen. Ted Kaufman).

322. *Id.* at S5897 (statement of Sen. Jeff Merkley) (commenting specifically on the criteria required under § 619, including restrictions on firms bailing out the funds).

323. *Id.* at S5889 (statement of Sen. Carl Levin).

324. *Id.* at S5876 (statement of Sen. Richard Shelby) (noting that this is giving the SEC a new mandate to oversee, where it failed to carry out its existing mandates in the past); *id.* at S5899 (statement of Sen. Carl Levin) ("We believe that the SEC has sufficient authority to define the contours of the rule in such a way as to remove the vast majority of conflicts of interest from these transactions, while also protecting the healthy functioning of our capital markets.").

325. Dodd–Frank Act § 413, 124 Stat. at 1577.

326. *Id.* ("[A]ny net worth standard shall be $1,000,000, excluding the value of the primary residence of such natural person."); *see* 17 C.F.R. § 230.215 (2010) (providing the general rule promulgated by the SEC to define "accredited investor" in the Securities Act of 1933, which did not include the exclusion of the person's primary residence in determining that person's net worth).

327. Dodd–Frank Act § 413, 124 Stat. at 1577.

suggests that the SEC may use this authority to merely increase the numerical wealth requirement or to react to market movements that affect the great majority of Americans and impact their qualification as hedge fund investors. Alternatively, the SEC could implement investor suitability measures.[328]

As noted earlier,[329] the traditional system of hedge fund regulation used the wealth of investors as a proxy for their sophistication: if an investor qualified as "sophisticated" based on a wealth threshold, the investor was "qualified" to invest in hedge funds.[330] The numerical wealth requirements currently in place to define qualified investors do not, however, take into account that even investors who fulfill the numerical wealth requirements do not always have the adequate level of knowledge, understanding, and sophistication required to invest in highly complex financial instruments.[331] For instance, some retirement funds of large companies are member managed,[332] and it is possible that the members of a certain trade (firemen, policemen, etc.) will manage their own retirement fund. These members may not have significant investing experience or a background in finance. In fact, they may never have been involved in investing and were appointed by chance, upon retirement, or at some other point in their careers, to manage the fund. Nevertheless, under existing securities law, they would be deemed "sophisticated" and, therefore "qualified" to invest in hedge funds.[333] Although the SEC has previously proposed to toughen the numerical wealth requirements for hedge funds,[334] such attempts have failed to ascertain the appropriate level of sophistication and adequate understanding of highly complex financial instruments.

Congress's decision to exclude the value of an individual's primary residence in the definition of "accredited investor" under

---

> The Commission may undertake a review of the definition of the term 'accredited investor' . . . excluding the requirement relating to the net worth standard described in subsection (a), should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy.

Id.

329. *See generally* Kaal, *supra* note 6 (discussing the shortcomings of accredited investor standards and the benefits of investor suitability standards).

329. *See* supra Part III.2.b.4

330. *See* discussion *supra* Part III.2.b.4.

331. Kaal, *supra* note 6.

332. Debra A. Davis, *Do-It Yourself Retirement: Allowing Employees to Direct the Investment of their Retirement Savings*, 8 U. PA. J. LAB. & EMP. L. 353, 375–76 (2006) ("[M]any employers allow participants to direct the investment of their retirement plan accounts.").

333. 17 C.F.R. § 230.215 (2010).

334. *See* discussion in the context of Regulation D *supra* Part III.2.b.4

PFIARA[335] takes into account inflationary trends that enabled individuals to qualify for hedge fund investments even though they barely matched the numerical wealth requirement. Given the significant devaluation of home equity in the United States in 2009 and 2010,[336] however, Congress should have further increased the numerical wealth requirement for hedge fund investments. More importantly, the general policy of qualifying investors by using wealth as a proxy for sophistication seems questionable.[337] The policy fails to take into account investors who technically fulfill the numerical wealth requirements but lack an adequate level of financial sophistication. Using investor suitability measures could be a preferable approach.[338]

3. *Impact Assessment of Asymmetric Regulation in Dodd–Frank and the AIFM Directive*

Eighty-five percent of all hedge fund AUM are located in U.S. and U.K. jurisdictions.[339] The AIFM Directive applies to U.K.-registered hedge funds, and Dodd–Frank applies to U.S.-registered hedge funds. Although U.S. and EU hedge funds operate in the same markets and follow similar strategies in those markets, they are subjected to different regulatory schemes. Despite several exemptions, Dodd–Frank requires hedge fund advisers to register with the SEC if their AUM exceed $150 million.[340] Given this threshold, the U.S. registration requirement under Dodd–Frank does not correspond with the registration requirement under the AIFM

---

335. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act § 413, Pub. L. No. 111–203, 124 Stat. 1376, 1577 ("[A]ny net worth standard shall be $1,000,000, excluding the value of the primary residence of such natural person."); *see* 17 C.F.R. § 230.215 (2010) (providing the general rule promulgated by the SEC to define "accredited investor" in the Securities Act of 1933; the definition did not include the exclusion of the person's primary residence in determining that person's net worth); discussion *supra* Part II.2.b.4.

336. William C. Dudley, President, Fed. Reserve Bank of N.Y., Lecture, *in* 15 FORDHAM J. CORP. & FIN. L. 357, 369 (2010) (noting that, because of the length and severity of the recession, home equity has "dried up").

337. Kaal, *supra* note 6, at 612–13.

338. *Id.* at 635–36 (showing that existing FINRA investor suitability standards could be a model for reform).

339. HEDGE FUND WORKING GRP., HEDGE FUND STANDARDS: FINAL REPORT 3 (2008), http://www.efinancialnews.com/share/media/downloads/2008/01/2449616462.pdf.

340. *See supra* note 57.

Directive, which currently necessitates registration if a fund's AUM exceed €100 million.[341] Other dissimilarities between the provisions of Dodd–Frank and the AIFM Directive include the EU-wide passport regime,[342] limitations on compensation structure of European AIFMs,[343] fiduciary duties for AIFMs,[344] and limits on the amount of leverage AIFMs can use.[345]

---

341. *November 11 Directive*, *supra* note 4, ch. I, art. 2a(2)(a). Under the prior draft version of the AIFM Directive, the registration requirement was triggered if a hedge fund had AUM in excess of €250 million. *Commission AIF Proposal*, *supra* note 4, at 28.

342. *November 11 Directive*, *supra* note 4, ch. VII, art. 35a; *see* discussion on effects of passport regime *supra* Part III.1.b. Upon registration with the SEC, private fund advisers in the United States do not have to comply with burdensome and costly passport regime requirements to do business in other U.S. states.

343. *November 11 Directive*, *supra* note 4, Annex II. Under the AIFM Directive, AIFMs' remuneration structure, including limitations on overall compensation and bonuses, may be substantially aligned with that of bankers, as AIFMs' pay will be subject to the Capital Requirements Directive. The Dodd–Frank gives the SEC the authority to determine if rules are necessary to prohibit certain compensation schemes for investment advisers. Dodd–Frank Act § 913 (g)(l) (2).

344. *November 11 Directive*, *supra* note 4, at ch. III, sec. 1 art. 9(1). AIFMs acting on behalf of AIFs and managing AIFs must act in the best interest of the AIFs. In the United States, § 913(g) of the Dodd–Frank Act authorizes the SEC to establish a fiduciary duty for brokers and dealers:

> (g) AUTHORITY TO ESTABLISH A FIDUCIARY DUTY FOR BROKERS AND DEALERS.—
>
> (1) SECURITIES EXCHANGE ACT OF 1934.—Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) is amended by adding at the end the following:
>
> "(k) STANDARD OF CONDUCT.—
>
> "(1) IN GENERAL.—Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission may promulgate rules to provide that, with respect to a broker or dealer, when providing personalized investment advice about securities to a retail customer (and such other customers as the Commission may by rule provide), the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under section 211 of the Investment Advisers Act of 1940. The receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer. Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.

Dodd–Frank Act § 913(g), 124 Stat. at 1828; *see Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?: Hearing on S.3217 Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 111th Cong. 1 (2010) (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law Columbia Univ. Law Sch.) (supporting the imposition of a fiduciary duty on investment bankers and brokers but noting that the SEC could carve out safe harbors and exemptions to prevent the provisions from being overbroad). *But cf. id.* at 24

The asymmetry of hedge fund regulation could have larger implications. Asymmetric regulation of entities operating in the same markets creates legal uncertainty and significant transaction costs.[346] If hedge fund managers are subjected to stricter rules in one jurisdiction while competing for clients and profit margins with funds in jurisdictions that impose less restrictive rules, they could be at a comparative disadvantage. It remains to be seen what mechanisms European hedge fund managers develop to cope with the new regulations. Increased costs are likely to be passed on to clients.

The drafters of PFIARA, the AIFM Directive, and other recent direct and indirect regulatory measures aimed at hedge funds[347] assume that hedge funds played a role in the financial crisis. However, the role of hedge funds in the financial crisis has not been systematically studied or evaluated. After the collapse of Long-Term Capital Management (LTCM) in 1998, most dealer-banks required full collateralization of hedge fund transactions,[348] and consequently hedge funds have been less levered than banks for quite some time.[349] Furthermore, the collapse of large hedge funds like Amaranth in 2006[350] and large redemptions by investors during and after the crisis[351] did not cause systemic problems.[352] Because hedge funds

---

(statement of Larry E. Ribstein, Mildred Van Voorhis Jones Chair, Univ. of Ill. Coll. of Law) (stating that fiduciary duties are the "wrong tool" for dealing with investment banking because applying fiduciary duties to investment bankers would potentially punish conduct that is legitimate); Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 232 (2005) (discussing the problems of imposing fiduciary duties outside a conventional fiduciary relationship and suggesting that fiduciary duties are only appropriate in a "narrow class of cases").

345. *November 11 Directive*, *supra* note 4, ch. III, sec. 1 art. 25(7). Moreover, member states of the European Union can impose limits on leverage in emergency situations. *Id.* ch. III, sec. 1 art. 25(3). Under the Dodd–Frank Act, investment advisers must report their use of leverage, including the amount of off-balance sheet leverage. However, the Dodd–Frank Act does not specify that the SEC may promulgate rules limiting investment advisers' use of leverage. Dodd–Frank Act § 404, 124 Stat. at 1571–74.

346. Wagner, *supra* note 140, at 1.

347. *See* discussion *supra* Part III.A.1–2.

348. *Too Big to Swallow*, *supra* note 20 (noting that, after the failure of LTCM hedge funds, there was flight to traditional banking).

349. *See* Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: Not Again!*, AM. BANKR. INST. J., Sept. 2007, at 41 (noting that investors became averse to risky securities following the failure of LTCM); *Too Big to Swallow*, *supra* note 20.

350. *See Buttonwood: Paint it Black*, *supra* note 22 ("[T]raders repeatedly get caught out by 'unprecedented' market movements. The collapse of two hedge funds, Long-Term Capital Management in 1998 and Amaranth Advisors in 2006, were cases in point.").

351. Zuckerman & Davis, *supra* note 23, at C2 ("If rival traders believe a firm will have to sell positions to meet investor redemptions, they can sell those investments ahead of time, increasing the pressure. Some traders made those moves last fall when it emerged that hedge fund Amaranth Advisors LLC was having problems.").

have fewer assets and less leverage than banks, they are less likely to cause the next crisis. Without the threat of systemic risk, the purpose of direct hedge fund regulation is unclear.

IV. BASEL III

The Basel Accords' focus on regulation of bank capital is a relatively recent phenomenon. Basel III, the new capital proposal of the Basel Committee on Banking Supervision, was announced on September 12, 2010, and is widely anticipated to be adopted.[353] All twenty-seven member countries have signed on to the new principles.[354] In an attempt to prevent a recurrence of the recent financial crisis, Basel III introduces new worldwide liquidity and leverage standards.[355] Basel III, which will apply to all G-20 banks,[356] will regulate and alter credit standards of banks and impact hedge funds' level of leverage.[357] In its current version, Basel III

---

352. Annette L. Nazareth, SEC Comm'r, Remarks Before the PLI Hedge Fund Conference (June 6, 2007), *available at* http://edgar.sec.gov/news/speech/2007/spch060607aln.htm ("In September 2006, the hedge fund Amaranth lost over $6 billion. Despite the astounding size and speed of the losses to Amaranth and its unfortunate investors, there were no significant effects on the markets from a systemic risk point of view."). *Contra* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD–00–3, REPORT TO CONGRESSIONAL REQUESTERS, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK 10 (1999), http://www.gao.gov/new.items/gg00003.pdf ("The LTCM crisis demonstrated that lapses in market discipline can create potential systemic risk.").

353. The G–10 Governors and Heads of Supervision (GHOS) announced their agreement on a new capital proposal on September 12, 2010. *U.S. Supports G10 Basel Agreement*, NEWSROOM BULL., Sept. 12, 2010, http://newsroom-magazine.com/2010/international/us-supports-g10-basel-agreement.

> The U.S. federal banking agencies support the agreement reached at the September 12, 2010, meeting of the G-10 Governors and Heads of Supervision (GHOS). This action, in combination with the agreement reached at the July 26, 2010, meeting of GHOS, sets the stage for key regulatory changes to strengthen the capital and liquidity of internationally active banking organizations in the United States and around the world.

Id. The G–20 nations are likely to adopt Basel III. Huw Jones, *Basel Committee Says Agrees Bank Buffer Strategy*, REUTERS, July 16, 2010, http://www.reuters.com/article/idUSTRE66F11K20100716 (noting Basel III on track for approval in November 2010).

354. Brooke Masters, *Basel Breakthrough in Drive to Tighten Rules on Global Banking*, FIN. TIMES, July 27, 2010, at 1.

355. BIS, *supra* note 37, at 11.

356. *Id.* at 17 n.16 (noting that Basel III, like Basel II, will apply not only to all G–20 banks, but consolidated banking groups as well).

357. *Id.* at 5.

> The Committee is introducing a leverage ratio requirement as well as the following proposal: Going forward, banks must determine their capital requirement for counterparty credit risk using stressed inputs. This will address concerns about capital charges becoming too low during periods of

would not directly apply to hedge funds.[358] However, many entities, including hedge funds, engage in financial transactions that are the functional equivalent of banking activities. Basel III has been criticized for not applying to this "shadow banking system."[359] As such, Basel III or similar requirements may, in the not too distant future, be extended to non-bank entities, such as hedge funds, that engage in banking activities.[360]

1. *The Evolution of the Basel Accords*

Prior to the enactment of the first Basel Accord in 1988, banking regulation focused on interest rates, market structure, and asset allocation rules.[361] In an attempt to address a market environment that was changing because of financial and technological innovation,[362] the Basel Committee, in its 1988 Accord, introduced minimum capital requirements for banks.[363] The Accord required a

---

compressed market volatility and help address procyclicality. The approach, which is similar to what has been introduced for market risk, will also promote more integrated management of market and counterparty credit risk.

Id.

358. *See generally id.*

359. *See generally* Adrian Blundell-Wignall & Paul Atkinson, *Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity*, 2010 OECD J.: FIN. MARKET TRENDS 13–14 (2010), http://www.oecd.org/dataoecd/42/58/45314422.pdf (averring that an issue with Basel III is that it does not address "shadow banking" and that if regulation is increased, the "shadow banking" will shift or be reduced).

360. STANDARD & POOR'S GLOBAL CREDIT PORTAL: RATINGSDIRECT, BASEL III PROPOSAL TO INCREASE CAPITAL REQUIREMENTS FOR COUNTERPARTY CREDIT RISK MAY SIGNIFICANTLY AFFECT DERIVATIVES TRADING (2010), http://www.bis.org/publ/bcbs165/spccr.pdf ("We believe that banking groups with significant trading activities and a high proportion of financial intermediaries as counterparties (such as hedge funds) would likely be the most affected by the implementation of this proposal."). Some believe that a number of, if not all, G–20 countries will extend Basel III or similar requirements to other types of financial entities that engage in bank-like activities. In the United States, for example, such requirements could be extended to systemically important financial institutions and to insurance companies. *Id.*; *see generally* 156 CONG. REC. S5894 (daily ed. July 15, 2010) (statement of Sen. Jeff Merkley) (noting that Dodd–Frank creates a mechanism via the Financial Stability Oversight Council by which U.S. nonbank financial companies would be subject to heightened standards).

361. Robert F. Weber, *New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of Internal Models Approach to Capital Adequacy Regulation*, 62 ADMIN. L. REV. 783, 799 (2010) (noting that prior to the first Basel Accord banks were regulated by measuring the risk exposure of the bank's total assets).

362. Aldo Caliari, *Assessing Global Regulatory Impacts of the U.S. Subprime Mortgage Meltdown: International Banking Supervision and the Regulation of Credit Rating Agencies*, 19 TRANSNAT'L L. & CONTEMP. PROBS. 145, 193 (2010) (stating that the Basel Accord was intended to improve risk evaluation where conditions had undergone rapid changes and advances in financial techniques).

363. Pierre-Hughes Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT'L L. 113, 132 (2009) (averring that the 1988 Basel Accord's most

capital charge of 8 percent of a loan for ordinary credit risk,[364] 4 percent for credit risks on loans to other banks or mortgage loans,[365] and 0 percent for loans to sovereign debtors.[366] In 1993, in an attempt to regulate market risk, the Basel Committee introduced rigid capital ratios, its "standard approach."[367]

The capital ratios in the Basel Committee's standard approach were vehemently criticized as reactionary by the banking industry.[368] The banks claimed that, through the use of quantitative models with a substantial empirical foundation, they had already achieved a level of risk management that was more finely attuned to actual risk than the capital ratios of the standard approach.[369] The Basel Committee reacted to this criticism and introduced the 1996 Amendment to the Capital Accord to Incorporate Market Risks.[370] The Amendment allowed banks to sideline the standard approach and determine regulatory capital by using their own risk calibration models.[371] Finally, in 2000, Basel II allowed banks to use their own risk models to determine credit and market risks.[372] Thereafter, the Basel Committee modified the Basel II Accord to improve risk calibration of capital requirements.

---

significant achievement was setting regulatory capital requirements for banks that were active on an international level).

364. BIS, BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS ¶ 44 (1988), http://www.bis.org/publ/bcbs04a.pdf ("[T]he Committee confirms that the target standard ratio of capital to weighted risk assets should be set at 8% (of which the core capital element will be at least 4%).").

365. *Id.*

366. *Id.*

367. Nicholas Dorn, *The Governance of Securities*, 50 BRIT. J. CRIMINOLOGY 23, 32–33 (2010).

> [I]n 1993, the Basel Committee on Banking Supervision consulted on a standard approach to bank capital requirements, [and] the banking industry responded with intensive criticism, arguing that such regulation would represent a step back from the very sophisticated risk management procedures that they themselves had started to implement on the basis of quantitative models. The banks won and their 'model-based' approach was codified in 1996.

Id.

368. Walter I. Conroy, *Risk-Based Capital Adequacy Guidelines: A Sound Regulatory Policy or a Symptom of Regulatory Inadequacy?*, 63 FORDHAM L. REV. 2395, 2418 n.160 (1995) (noting that the capital ratios were arbitrary and "seat of the pants stuff" (quoting Peter Cooke, a Bank of England official who chaired the BIS Committee on Banking Supervision)).

369. Dorn, *supra* note 367, at 32–33.

370. *Id.* at 33.

371. BIS, BASEL COMM. ON BANKING SUPERVISION, BASEL II: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK ¶ 18 (2004), http://www.bis.org/publ/bcbs107.pdf; *see also* BIS, *supra* note 37, at 12.

372. BIS, *supra* note 37, at 12.

2. *The Basel Approach Revised*

The Bank of International Settlement and the Basel Committee face significant criticism over Basel III.[373] Some countries would have preferred a more comprehensive proposal.[374] Others sought a much more expedited implementation schedule.[375] Still others proposed requirements, such as Tier 1 leverage requirements, loss-absorbing capacity of systemically important banks, and liquidity ratios, that were not initially adopted as part of Basel III but will be studied and could be introduced later.[376] U.S. regulators are supportive of the Basel III effort,[377] but they prefer higher standards,[378] especially measures to deal with the "too big to fail" problem.[379] EU regulators are equally supportive of the Basel III rules, but they would prefer adjusting the definition of capital,[380] leverage limits,[381] and liquidity rules.[382]

---

373. Peter Miu et al., Can Basel III Work? Examining the New Capital Stability Rules by the Basel Committee—A Theoretical and Empirical Study of Capital Buffers (Feb. 20, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1556446 (expressing concern that Basel III has several shortcomings, which will result in numerous unintended consequences).

374. *Id.* (noting further that Basel III should focus more on developing better risk and capital management processes, and maintaining higher quality capital).

375. Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT'L L. 581, 628 (2010) (opining that Basel III implementation will be time consuming).

376. Danforth Townley, Davis Polk & Wardwell, L.L.P., *Summary of the Dodd–Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30,* 2010, *in* PRAC. L. INST., HEDGE FUNDS 2010: STRATEGIES AND STRUCTURES FOR AN EVOLVING MARKETPLACE 49, 105 (2010) (asserting that the current draft of Basel III excludes hybrid capital in Tier 1, though in the United States hybrid capital is sometimes permitted to be held in Tier 1 capital, subject to quantitative limits and restrictions).

377. Press Release, Bd. of Governors of the Fed. Reserve Sys., U.S. Banking Agencies Express Support for Basel Agreement (Sept. 12, 2010), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20100912a.htm (opining that the Basel III agreement is "a significant step forward in reducing the incidence and severity of future financial crises, providing for a more stable banking system that is less prone to excessive risk-taking, and better able to absorb losses while continuing to perform its essential function of providing credit to creditworthy households and businesses").

378. *Id.* (opining that the Dodd–Frank Act "requires the establishment of more stringent prudential standards including higher capital and liquidity requirements for large, interconnected financial institutions").

379. *Id.*

380. PHILIP HÄRLE ET AL., BASEL III: WHAT THE DRAFT PROPOSALS MIGHT MEAN FOR EUROPEAN BANKING 1 (2010), http://ec.europa.eu/internal_market/bank/docs/gebi/mckinsey_en.pdf (estimating that the effect of the current changes in capital ratios and leverage ratios in the proposals would result in significant capital shortfalls).

381. *Id.*

Most U.S. investment banks and European banks endorsed and implemented Basel II[383] and are, consequently, mostly highly leveraged.[384] U.S. banks that implemented Basel II or a hybrid of Basel I and II may not have performed as well as competitors who did not implement either of the Basel Accords.[385] Critics point out that the international harmonization of banking regulation through the Basel Accords could have led a majority of large banks to follow financial strategies similar to those that eventually led to the financial crisis of 2008–2009.[386] Prompted by the Basel Accords, similar financial strategies could have influenced the selection of assets and investments, and their securitization could have resulted in the use of similar risk models.[387] It is possible that the implicit

---

382. *Id.* (expressing concern that the new liquidity rules will severely affect funding and European banks would have to raise up to €5.5 trillion in additional capital).

383. David Zaring, *International Law and the Economic Crisis: International Institutional Performance in Crisis*, 10 CHI. J. INT'L L. 475, 483 (2010) (noting that big U.S. and European banks were capitalized under the standards of Basel II, and specifically pointing out that the Basel committee set the standard followed by Bear Stearns and Lehman Brothers, which clearly was inefficient in keeping these banks solvent).

384. Herald Benink & George Kaufman, *Turmoil Reveals the Inadequacy of Basel II*, FIN. TIMES, Feb. 27, 2008 (contending that the wide implementation of Basel II coincided with the massive losses reported by big banks and suggesting that Basel II "creates perverse incentives to underestimate credit risk"); *cf.* Pierre-Hughes Verdier, *Recent Books on International Law*, 104 AM. J. INT'L L. 338, 340 (reviewing DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION (2008)) (asserting however, that while most large U.S. banks implemented Basel II, the banks resisted safeguards proposed by the banking agencies to protect against significant capital declines, which led to prolonged struggles among banking regulators, Congress, and the banks); Franceso Cannata & Mario Quagliariello, *The Role of Basel II in the Subprime Financial Crisis: Guilty or Not Guilty* 15 (Centre for Applied Res. in Fin. Working Paper Group, Working Paper No. 3/09, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330417 (proposing, on the contrary, that while Basel II was a component of banks' supervision, it alone cannot be blamed for the excessive risk taking and high leveraging of banks during the financial crisis because other supervisory components also had weaknesses).

385. *Cf.* Zaring, *supra* note 383, at 483 (suggesting that Basel II played a role in the demise of America's "big five investment banks," thus calling into question the usefulness of the Basel Accord).

386. *Id.*

387. *Cf.* Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 EUR. J. INT'L L. 15, 21–22 (2006) (noting that Basel was intended to create international harmonization and was introduced specifically to reduce systemic risk from bank failures and to limit externalities that may lead to a lack of information sharing; and asserting that Basel has succeeded "in providing global public goods of information"); Stavros Gadinis, *The Politics of Competition in International Financial Regulation*, 49 HARV. INT'L L.J. 447, 506 (2008) (asserting further that implementation of the Basel Accords has required uniformity in risk investment techniques and information technology, making it difficult for smaller banks to comply); Salman Banaei, *Global Governance of Financial Systems: The International Regulation of Systemic Risk*, 35 DENV. J. INT'L L. & POL'Y 547, 552–53 (2007) (reviewing KERN ALEXANDER ET AL., GLOBAL GOVERNANCE OF FINANCIAL SYSTEMS: THE

harmonization of bank lending practices was, therefore, not restricted to one nation. Consequently, critics of Basel argue that harmonization of lending practices did not minimize systemic risk but, paradoxically, increased it.[388] The Basel Accords allegedly produce globally similar business and regulatory strategies.[389] As a result of harmonization, mistaken policies can result in global financial distress.[390] Therefore, greater harmonization of international banking regulation via Basel III is unlikely to lead to better outcomes and may well exacerbate future crises.[391]

3. *The Core Rules in Basel III*

Central to the new rules is an attempt to prevent banks from using off-balance sheet vehicles and risk-weighing methods to hide the true size of their balance sheet.[392] At the same time, the Basel Committee simplified certain core definitions. Basel III establishes the following three measures for capital: Tier 1 Capital (6 percent), Common Equity (4.5 percent), and Total Capital (8 percent).[393] The

---

INTERNATIONAL REGULATION OF SYSTEMIC RISK (2006)) (averring that the first and third pillars of Basel II promoted "dangerous homogeneity").

388. *Cf.* Banaei, *supra* note 387, at 550–51 (asserting that the substantive rules set forth by the Basel Accords do not limit systemic risk because they do not address the banking needs of less developed nations, and because Basel has an "imbalanced decision making structure").

> The debates surrounding the adoption of the Accord reveal that, even when faced with a collective action problem that requires cooperation to reduce systemic risk and improve global financial stability, national regulators take positions that reflect the interests of domestic constituencies. As a result, the adoption of common standards will require solving distributive problems where the interests of these constituencies diverge.

Verdier, *supra* note 363, at 142; *cf. also* Barr & Miller, *supra* note 387, at 21 (suggesting further that harmonization reduces flexibility, resulting in slower regulatory change and blocking regulatory competition).

389. *Cf.* Barr & Miller, *supra* note 387, at 20 (noting that the Basel Accords could be viewed as "regulatory imperialism," developing rules affecting nations that have no role in the development process).

390. Verdier, *supra* note 384, at 358 (suggesting that the current global financial crisis is due in large part to harmonized capital standards implemented through the Basel Accord).

391. *Contra We Need a Basel III for a New Order: Soros*, ECON. TIMES, Apr. 11, 2008, http://economictimes.indiatimes.com/news/economy/indicators/We-need-a-Basel-III-for-a-new-order-Soros/articleshow/2942920.cms (arguing that Basel II must be reworked to overcome the serious financial crisis).

392. *See* BIS, *supra* note 37, at 65–66 (providing a table with a summary of the proposed new rules).

393. Press Release, Bank for Int'l Settlements, Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards (Sept. 12, 2010), http://www.bis.org/press/p100912.pdf [hereinafter BIS Press Release].

total capital ratio will remain at the current required level of 8 percent.[394] The new principles would require banks to limit Tier 1 Capital,[395] the only capital that can be counted on to absorb losses, to 3 percent of unweighted assets.[396] At the same time, the Basel Committee softened its prohibition on counting the equity held by minority shareholders in overseas subsidiaries toward Tier 1 Capital.[397] The minimum capital requirement is less onerous than feared by the banking industry. Furthermore, banks will not have to publish their ratios until 2015 and will not have to comply with the 3 percent minimum until the end of 2017.[398] To avoid a repeat of the Lehman Brothers collapse, regulators want banks to have enough liquid assets to survive a thirty-day crisis.[399] For the liquidity

---

> Under the agreements reached today, the minimum requirement for common equity, the highest form of loss absorbing capital, will be raised from the current 2% level, before the application of regulatory adjustments, to 4.5% after the application of stricter adjustments. This will be phased in by 1 January 2015. The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, will increase from 4% to 6% over the same period.

Id.

394. *Id.* Annex 1.

395. BIS, *supra* note 37, at 4.

> The Committee therefore is announcing for consultation a series of measures to raise the quality, consistency, and transparency of the regulatory capital base. In particular, it is strengthening that component of the Tier 1 capital base which is fully available to absorb losses on a going concern basis, thus contributing to a reduction of systemic risk emanating from the banking sector.

Id.

396. BIS, BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: PROPOSED ENHANCEMENTS TO THE BASEL II FRAMEWORK ¶ 80 (2009), http://www.bis.org/publ/bcbs150.pdf; *see also* Miu et al., *supra* note 373, at 7 ("[T]he Basel Committee has proposed that a buffer range should be established above the minimum capital requirements such that, if Tier 1 capital should fall into the buffer range, [financial institutions] would be constrained in the total amount of discretionary earnings distributions.").

397. BIS, *supra* note 396, at 10.

> Pillar 1 capital requirements represent *minimum* requirements. An appropriate level of capital under Pillar 2 should exceed the minimum Pillar 1 requirement so that all risks of a bank—both on- and off-balance sheet—are adequately covered, particularly those related to complex capital market activities. . . . While all banks must comply with the minimum capital requirements during and after such stress events, it is imperative that systemically important banks have the shock absorption capability to adequately protect against severe stress events.

Id.

398. BIS Press Release, *supra* note 393, at 1–2.

399. *See, e.g.*, Nout Wellink, President of De Nederlandsche Bank, Remarks at the Inst. of Int'l Fin. 2010 Spring Meeting (June 11, 2010), http://www.bis.org/speeches/sp100611.pdf ("Banks must hold a stock of high-quality

coverage ratio, however, the Basel Committee eased up its definition of how severe the outflows in a crisis would be and allowed banks to count corporate bonds of a high quality, in addition to cash and government bonds, toward their stockpile.[400] However, the Committee still wants banks to hold more long-term assets to match long-term liabilities, but it acknowledges that the proposal needs work and will not be implemented before 2018.[401]

In addition to the three capital ratios, the Committee requires that banks hold capital above the regulatory minimum by introducing capital conservation buffers.[402] Conservation buffers are intended as financial reserves that banks can draw on in times of economic stress,[403] and need to be large enough that they remain above the minimum in periods of significant sector-wide downturns.[404] The buffers would rise and fall in a countercyclical manner.[405] Capital conservation buffers consist of about 2.5 percent of common equity and will be phased in under Basel III at the beginning of 2016.[406] Full implementation is expected in 2019, and banks are required to hold common equity plus a conservation buffer of 7 percent, amounting to a total capital plus conservation buffer of 10.5 percent.[407] Basel III incentivizes preserving the buffer by constraining earning distributions if a bank is approaching the minimum capital ratio requirements.[408]

Most importantly for the purposes of this Article, in an attempt to reduce risk to counterparties,[409] the Basel Committee is increasing

---

liquid assets that is sufficient to allow them to survive a 30-day period of acute stress.").

400. BIS, BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS, AND MONITORING 2 (2009), http://www.bis.org/publbcbs150.pdf (including in the definition of liquid assets that satisfy various conditions).

401. BIS Press Release, *supra* note 393, at 4 ("Existing public sector capital injections will be grandfathered until 1 January 2018.").

402. Blundell-Wignall & Atkinson, *supra* note 359, at 10 ("[T]he Committee is proposing that banks hold buffers of capital above the regulatory minimum—large enough that they remain above the minimum in periods of significant sector-wide downturns.").

403. BIS Press Release, *supra* note 393, at 2 ("The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress.").

404. *Id.*

405. Blundell-Wignall & Atkinson, *supra* note 359, at 10.

406. BIS Press Release, *supra* note 393, Annex 2 (showing the incremental increases in capital conservation buffers from 2016 to 2019).

407. *Id.*

408. *Id.* at 2.

409. Manmohan Singh & James Aitken, *Counterparty Risk, Impact on Collateral Flows, and Role for Central Counterparties* 3 (Int'l Monetary Fund, Working Paper No. WP/09/173, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1457596.

capital requirements on counterparty risk.[410] This has major implications for market participants and markets.[411] For instance, "increasing capital requirements on counterparty risk provides a strong incentive for banks to push more over-the-counter (OTC) derivatives transactions through qualified clearing houses."[412] In this context, Dodd–Frank, in Title VII, also puts in place clearing requirements for all swaps over which either the SEC[413] or the Commodity Futures Trading Commission (CFTC) has authority.[414] Each registered swap dealer or major participant will be subject to minimum capital requirements,[415] which are to be set by regulators who must consider the risks of the types of swaps and the risks of other activities in which the dealer is engaged.[416] Dodd–Frank also gives authority to the CFTC to set margin levels on futures exchanges.[417] These requirements will subject swap dealers and major participants to even higher margin and capital requirements than required by the clearinghouses.[418] In setting the requirements, regulators could infringe on laws in international jurisdictions, and

---

410. BIS, *supra* note 37, at 1.

411. STANDARD & POOR'S GLOBAL CREDIT PORTAL: RATINGSDIRECT, *supra* note 360, at 6.

> [I]ncreasing capital requirements on counterparty risk provides a strong incentive for banks to push more OTC derivatives transactions through qualified clearing houses (against which zero capital charges are expected to apply under the proposal). Because most nonfinancial intermediary market participants are not likely to become general clearing members in clearing houses, we believe that banks will still offer trades and collect fees from such participants, but more hedges are likely to be transferred to exchanges and clearing houses. Although we expect that this could reduce counterparty risk overall, it might also introduce systemic risks posed by the clearing houses themselves. . . . Because clearing houses typically impose initial and variation margins to general clearing members, we expect that banks likely will seek to re-price increasing costs to end users, possibly increasing the overall cost of hedging interest-rate and currency risks for these participants.

Id.

412. *Id.*

413. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act § 410(2)(A), Pub. L. No. 111–203, 124 Stat. 1376, 1762 (2010) (to be codified as amended in scattered sections of 15 U.S.C.).

414. *Id.* § 723, 124 Stat. at 1675.

415. *Id.* § 731, 124 Stat. at 1704–05 (amending the Commodity Exchange Act, 7 U.S.C. § 1 et seq. (2006), by inserting 7 U.S.C. § 6s(e)).

416. *Id.*

417. *Id.* § 736.

418. MARK JICKLING & KATHLEEN ANN RUANE, CONG. RESEARCH SERV., R41398, THE DODD–FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: TITLE VII, DERIVATIVES (2010), http://www.llsdc.org/attachments/files/239/CRS-R41398.pdf ("Swap dealers and major swap participants—firms with substantial derivative positions—will be subject to margin and capital requirements above and beyond what the clearinghouses mandate.").

such infringement could lead to inconsistencies and inefficiencies.[419] Moreover, it is unclear how the legislation will be applied to international transactions.[420] An increase in capital is also likely to result in dividend restrictions, bonus restrictions, and constraints on equity investments.[421] Bonus restrictions and, to a limited extent, dividend restrictions could make it harder for banks to retain top talent.[422] The new rules will, however, be in a test phase until the end of 2017.[423]

V. AN ALTERNATIVE APPROACH TO HEDGE FUND REGULATION

Hedge fund regulators face an interesting dichotomy. On the one hand, their mandate is to protect investors and ensure well-functioning markets. On the other hand, they do not want to over-regulate the hedge fund industry, and they need to tailor regulation to entities that actually engage in activities that give rise to systemic concerns. The imposition of additional limitations on hedge funds may impose unwarranted burdens on other types of private investment pools, such as venture capital funds and structured financings that do not raise the same issues as hedge funds.

Regulators can use regulatory authority over entities that interact with hedge funds to regulate hedge funds indirectly. Alternatively, regulators can use a number of regulatory tools, including registration, capital, leverage, margin, and reporting requirements, to regulate hedge funds directly. The complex trading, investing, and corporate structures of active international hedge funds are major constraining factors on effective supervision. Because of the complex structure of both hedge funds and financial intermediaries, most regulatory authorities base their judgment of hedge fund-generated market risks on somewhat inadequate information.[424] However, hedge fund trading strategies are mostly

---

419. Letter from David Geen, Gen. Counsel, Int'l Swaps and Derivatives Ass'n, Inc., to Theo Lubke, OTC Derivatives Supervisors Grp. (Sept. 17, 2010), http://www.sec.gov/comments/df-title-vii/swap/swap-16.pdf.

420. CADWALADER, WICKERSHAM & TAFT LLP, THE NEW SCHEMES FOR THE REGULATION OF SWAPS (2010), http://www.cadwalader.com/assets/clientfriend/072010_DF7.pdf.

421. LINKLATERS, PRO-CYCLICALITY: COUNTERPARTY CREDIT RISK AND LEVERAGE RATIO 2 (2010), http://www.linklaters.com/pdfs/publications/FRDevs/A11703839_1A.pdf.

422. *Id.*

423. BIS, BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING INSTITUTIONS 28 (2010), http://www.bis.org/publ/bcbs189.pdf.

424. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,059 (codified at 17 C.F.R. pts. 275 & 279 (2008)) (recognizing that

based on the interpretation of certain market environments and require a certain level of confidentiality. For instance, engaging in a securities-based swap agreement to bet against the value of a publicly listed stock works substantially better if the buyer does not disclose his or her strategy to other market participants who may otherwise emulate it and lower the potential profit margin. Hedge funds' profitability may be directly correlated with their level of confidentiality. If other market participants trade along or are enabled to anticipate certain transactions by a hedge fund because of required disclosures, the disclosing hedge fund may not be able to fulfill its mandate to maximize shareholders' value, because its absolute returns may be negatively affected.

Before the financial crisis of 2008–2009, most jurisdictions did not claim direct regulatory authority over hedge funds. A significant number of hedge funds operate through offshore centers and are thus outside the jurisdiction of many legislators. The problem of regulatory arbitrage (upon the imposition of direct regulatory measures by a particular jurisdiction, hedge funds have an exit option, i.e., relocating to offshore jurisdictions) could have played a role in deterring regulators from imposing stricter standards before the financial crisis. Legislators also had disincentives to impose harsher requirements on the hedge fund industry, because harsher regulation could have resulted in a loss of franchise taxes and other business to offshore centers. Before the enactment of the Dodd–Frank Act,[425] the SEC repeatedly attempted but failed to regulate the hedge fund industry.[426] Under the new regime, certain investment advisers who manage private funds with less than $150 million AUM are exempt from federal registration in the United States.[427] Advisers with less than $150 million AUM who had previously not registered under state law because they complied with federal law and were registered with the SEC may now be required to deregister with the SEC and become subject to a state registration requirement.[428]

Banks play a prominent role in financial markets and facilitate hedge fund investments as market makers, creators of complex financial products, or lenders, among others. As such, they "are well suited to reduce adverse selection and moral hazard problems in

---

the regulators lack basic information about hedge funds, often relying on third-party data that may be unreliable).

425. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (to be codified as amended in scattered sections of 15 U.S.C.).

426. *See* KAAL, *supra* note 155, at 178–80.

427. Dodd–Frank Act § 408, 124 Stat. at 1575.

428. Rules Implementing Amendments to the Investment Advisers Act of 1940, 75 Fed. Reg. 77,054 (Dec. 10, 2010) (to be codified at 17 C.F.R. pt. 275).

financial markets,"[429] and "banks have particular advantages over other financial intermediaries in solving asymmetric information problems."[430] More specifically, banks' lending practices and counterparty credit risk management (CCRM) may allow them to curtail excessive risk taking, because they are in a position to use the threat of cutting off future lending to improve a hedge fund's behavior.[431] Banks also have advantages in reducing moral hazard, because they can monitor counterparty credit risk at lower costs than individuals.[432] Contracting with hedge funds in their lending practice allows banks to negotiate collateral requirements, specifying interest rates and other contractual terms.[433] As a result, this helps to sort borrowers into risk pools that may reduce adverse selection and moral hazard incentives for borrowers to engage in excessively risky activities.[434] Establishing risk pools also helps to minimize information asymmetries in their lending practice.[435] Furthermore, banks, as market makers, creators of hedge fund products, and lenders, are in a position to establish long-term relationships that allow for targeted information collection. This can help to further minimize information asymmetries, facilitate efficient long-term monitoring, and manage hedge fund counterparty credit risk.[436] Banks' unique position as hedge fund and financial market intermediaries qualifies them as the primary institution to address asymmetric information, moral hazard problems, and other primary

---

429. Frederic S. Mishkin, *Prudential Supervision: Why Is It Important and What Are the Issues?*, *in* PRUDENTIAL SUPERVISION: WHAT WORKS AND WHAT DOES NOT 4 n.1 (Frederic S. Mishkin ed., 2001). ("The traditional financial intermediation role of banking has been in decline in both the United States and other industrialized countries because of improved information technology that makes issuing securities easier. Nonetheless, banks continue to be important in the financial system.").

430. *Id.* at 4.

431. *See* Joseph E. Stiglitz & Andrew Weiss, *Incentive Effects of Terminations: Applications to Credit and Labor Markets*, 73 AM. ECON. REV. 912, 912 (1983) ("[T]he threat of termination encourages behavior that the [bank]. . . finds desirable").

432. *See* Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. OF ECON. STUD. 393, 393 (1984) (noting that it is cost-effective for a bank to monitor loan contracts because "the alternative is either duplication of effort if each lender monitors directly, or a free-rider problem, in which case no lender monitors").

433. *See* Kaal, *supra* note 6, at 620–21.

434. JOHN KAMBHU ET AL., HEDGE FUNDS, FINANCIAL INTERMEDIATION, AND SYSTEMIC RISK 1–2 (2007) (noting that banks are in a unique position to limit their counterparty credit exposure).

435. *Id.* at 10 (suggesting that the connection between hedge funds and the economy involves the banks' role in resolving information problems).

436. *See* Allen N. Berger & Gregory F. Udell, *Did Risk-Based Capital Requirements Allocate Bank Credit and Cause a "Credit Crunch" in the United States?*, 26 J. MONEY, CREDIT & BANKING 585, 588 (1994); Leonard I. Nakamura, *Commercial Bank Information: Implications for the Structure of Banking*, *in* STRUCTURAL CHANGE FOR BANKING 131–60 (M. Klausner & L.J. White eds., 1993).

concerns in the context of hedge funds activities. This Article does not attempt to determine how to calculate a potential Basel III charge on banks' capital assets for their systemic risk exposure to hedge funds.

1. *Moral Hazard and Its Impact on Indirect Regulation of Hedge Funds via Counterparty Credit Risk Management (CCRM)*

The global financial crisis has precipitated a deeply rooted presumption that taxpayer funds can be used by governments to bail out banks. This creates a moral hazard by providing strong incentives for banks to take excessive risks. Hedge funds are not counterparties in government bailouts, but if banks get bailed out, they may have less incentive to monitor their hedge fund lending activities or other hedge fund-related business. Given the opaqueness of the activities of hedge funds, the absence of a common measure with which to calculate leverage and exposure, and the dynamic nature of hedge funds' trading strategies, the CCRM process is also faced with significant information asymmetries.[437] Information asymmetries, in turn, obstruct the efficient supervision of agents by their principals.

2. *Systemic Risk and Externalities*

To the extent that hedge funds disrupt banks from providing financial markets with credit, they could create systemic risk.[438] If, and to what extent, this could have happened in the period leading up to the financial crisis of 2008–2009 is unclear, but the inability of a hedge fund to repay bank loans impairs banks' ability to provide credit to other market participants or liquidity to the financial system.[439] After the collapse of LTCM, however, many dealer-banks required full collateralization of hedge fund transactions.[440] This may have lowered the leverage ratio of hedge funds below that of most banks. The common exposure to market risk factors of banks'

---

437. KAMBHU ET AL., *supra* note 434, at 1 (averring that hedge funds' use of leverage and opacity make effective CCRM more challenging).

438. *Id.* at 11.

439. *Id.* at 19.

> Credit exposure to hedge funds may create externalities in the banking system or broader financial markets in several ways. If the potential exposure amounts to a significant share of bank capital, for example, then a large shock to hedge funds could weaken banks and impair their ability to provide liquidity to the financial system or credit to borrowers.

Id.

440. *Id.* at 21, 24 (noting that after the collapse of LTCM, CCRM has improved and many banks' exposures to hedge funds are collateralized).

proprietary trading desks and hedge funds could detrimentally impact their respective trading positions and, thus, the banking system or broader financial markets on a larger scale.[441]

An institution or country creates externalities if it manages its own hedge fund-generated systemic risk without considering the impact of its actions or inactions on the risk in the system as a whole.[442] Systemic risk and financial market stability generate public good and free-rider problems: banks are not incentivized to adequately monitor or limit hedge fund risk exposure because of their reliance on hedge fund credit risk management by other banks.[443] Thus, regulation has a role in reducing this inefficient systemic risk.

3. *Market Failure in Financial Instruments*

The theory of market failure has been a subject of scholarly debate for many years.[444] Keynesian economist Paul A. Samuelson, among others, defined the phenomenon of market failure and formalized it.[445] Other scholars later opined that Samuelson's

---

441. *Id.* at 11.

442. *Id.* at 10.

> [M]arket failures include agency problems, externalities, free-rider problems, moral hazard, and coordination failures. We emphasize that these concerns apply more generally to many types of credit provision, but are likely more acute where information problems are most severe, where banks are eager to capture a share of a growing market, and where potential profits are encouraging stiff competition. Hedge fund exposures fit this description quite well . . . .

Id.

443. *Id.*

444. For a thorough discussion of the theory of market failure and most of the arguments pro and contra, see, for example, DOUGLASS C. NORTH & ROBERT P. THOMAS, THE RISE OF THE WESTERN WORLD: A NEW ECONOMIC HISTORY (1973); PAUL A. SAMUELSON, ECONOMICS: AN INTRODUCTORY ANALYSIS (6th ed. 1964); DAVID L. WEIMER & AIDAN R. VINING, POLICY ANALYSIS: CONCEPTS AND PRACTICE, (2d ed. 1992); Steven N. S. Cheung, *The Fable of the Bees: An Economic Investigation*, 16 J. L. & ECON. 11 (1973); Ronald H. Coase, *The Lighthouse in Economics*, 17 J. L. & ECON. 357 (1974); Louis De Alessi, *Error and Bias in Benefit–Cost Analysis: HUD's Case for the Wind Rule*, 16 CATO J. 129 (1996); Joseph Farrell, *Information and the Coase Theorem*, 1 J. ECON. PERSP. 113 (1987); J.E. Meade, *External Economies and Diseconomies in a Competitive Situation*, 62 ECON. J. 54 (1952); Richard Nelson, *Roles of Government in a Mixed Economy*, 6 J. POL'Y ANALYSIS AND MGMT. 541 (1987); Charles Wolf, *A Theory of Nonmarket Failure: Framework for Implementation Analysis*, 22 J. L. & ECON. 107 (1979).

445. Samuelson uses an example of a lighthouse to show a

> divergence between *private* advantage and money cost [as seen by a man odd enough to try to make his fortune running a lighthouse business] and true *social* advantage and cost [as measured by lives and cargoes saved in

arguments were, in many respects, fallacious.[446] In some cases, markets would be inefficient because agreements within the market were not enforced.[447] Market inefficiencies today may not be the direct result of any inherent failures, but they could be the result of the neglect to set up an institutional framework.

In 2007, before the credit crisis, the market experienced record downgrades in mortgage-backed securities.[448] Collateralized debt obligations (CDOs), and other complex debt securities, fueled unprecedented bank write-downs. "Some AAA rated debt lost all its value."[449] January 2008 was the worst month for CDOs in more than ten years, with issuance of CDOs grinding to a near halt worldwide.[450] The value of the CDO market had previously been estimated at more than $2 trillion. As the value of CDOs fell, the market for them disappeared.[451] Similar events took place in the credit default swap (CDS) market.[452] These events in markets for CDOs and CDSs raised concerns over market failure in financial

---

comparison to (1) total costs of the lighthouse and (2) extra costs that result from letting one more ship look at the warning light].

SAMUELSON, *supra* note 444, at 45 n.1.

446. *See, e.g.*, THE THEORY OF MARKET FAILURE—A CRITICAL EXAMINATION (Tyler Cowen ed., 1988) (compiling a collection of primary critiques of market-failure theory with suggestions on further research).

447. *See, e.g.*, NORTH & THOMAS, *supra* note 444, at 8 ("Governments take over the protection and enforcement of property rights because they can do so at lower cost than private volunteer groups . . . .").

448. Timothy A. Canova, *Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model*, 3 HARV. L. & POL'Y REV. 369, 382 n.59 (2009) (noting that Moody's alone downgraded over 5,000 securities in 2007).

449. John Shenn, *CDO Market Is Almost Frozen, JPMorgan, Merrill Say*, BLOOMBERG, Feb. 5, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aN6qn2s5bAuA ("The slowdown of the more than $2 trillion CDO market follows record downgrades in mortgage-linked securities last year. Some AAA rated debt lost all its value.").

450. Paul J. Davies, *Trading in CDOs Slows to a Trickle*, FIN. TIMES, Feb. 11, 2008, http://www.ft.com/cms/s/0/39f3e128-d808-11dc-98f7-0000779fd2ac.html?nclick_check=1.

451. IBISWORLD, U.S. INDUSTRY REPORT: PRIVATE EQUITY, HEDGE FUNDS & INVESTMENT VEHICLES 31 (2008); Jennifer E. Bethel et al., *Legal and Economic Issues in Litigation Arising from the 2007–2008 Credit Crisis* 10 (Harvard Law Sch. Program on Risk Regulation, Research Paper No. 08–5, 2008), *available at* http://ssrn.com/abstract=1096582 (discussing the significant slowdown in growth of CDOs when their performance declined in 2007 after housing prices fell and foreclosures increased).

452. Adrian Blundell-Wignall et al., *The Current Financial Crisis: Causes and Policy Issues*, FIN. MARKET TRENDS 8 (2008), www.oecd.org/dataoecd/47/26/41942872.pdf (asserting that the early disasters in the crisis involved investment banks that had massive CDS losses and "[t]he push to keep fee income from securitisation of (low-capital-charge) mortgages as a key source of earnings growth necessitated moving further and further into low quality mortgages").

instruments.[453] Market failure in complex financial instruments could have been a contributing factor in the recent credit crisis.[454]

Hedge funds themselves may not have caused the credit crisis.[455] Nevertheless, legislators in Europe and the United States have used the impact of hedge funds on market stability to legitimize attempts to impose stricter rules on hedge funds.[456] Professor Romano points out correctly that: "[Hedge Funds] manage only a small proportion of the investment universe, particularly as compared to banks' assets and are far less leveraged than banks."[457] However, it appears that hedge funds do manage a proportionally large part of complex financial instruments, such as CDOs and other derivatives.[458] This trend seems to be continuing.[459]

---

453. Adrian Blundell-Wignall et al., *The Elephant in the Room: The Need to Deal with What Banks Do*, 2009 OECD J.: FIN. MARKET TRENDS 2 (2009), www.oecd.org/data oecd/13/8/44357464.pdf.

> While some large diversified banks that focused mainly on commercial banking survived very well, financial conglomerates built on investment banking, the structuring of complex derivatives and proprietary trading as the main drivers of growth, as well as other smaller and less diversified banks, particularly those focused on mortgages, suffered crippling losses.

Id.

454. *Id.*; John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 121 (2009) (describing the credit rating agencies' failures to assess the risk of CDOs and other complex instruments as a "common thread" in narratives about what caused the credit crisis).

455. Romano, *supra* note 6; *see also* Stephen Brown et al., *Hedge Funds After Dodd–Frank*, N.Y.U. STERN (July 19, 2010, 3:41 PM), http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/07/hedge-funds-after-doddfrank.html ("Rather than causing or contributing to the recent crisis, hedge funds helped mitigate the crisis by taking some illiquid assets off the balance sheets of other institutions and by providing liquidity in general.").

456. *See, e.g.*, 156 CONG. REC. H5233–01 (daily ed. June 30, 2010) (statement of Rep. Paul Kanjorski) (supporting hedge fund regulation in PFIARA; Rep. Paul Kanjorski stated: "While hedge funds may not have directly caused this latest financial crisis, we do know that these investment vehicles have previously contributed to significant market instability . . . ."); *Proposal on Alternative Investment*, *supra* note 60, at 1.1 ("The risks associated with [AIFM] activities have manifested themselves throughout the AIFM industry over recent months and may in some cases have contributed to market turbulence. For example, hedge funds have contributed to asset price inflation and the rapid growth of structured credit markets.").

457. Romano, *supra* note 6, at 4.

458. BRIT. BANKERS' ASS'N [BBA], CREDIT DERIVATIVES REPORT 2006, at 5 (2006).

459. *Id.*

TABLE 1: MARKET PARTICIPANTS IN CREDIT DERIVATIVES, 2000–2006[460]

	2000	2002	2004	2006
Banks	72	64	60.5	51.5
Hedge Funds	4	8.5	15.5	30
Insurers	15	19.5	13.5	11.5
Pension Funds	2	1.5	3.5	3
Mutual Funds	1.5	2.5	3.5	2.5
Corporate	4.5	3	2.5	1.5
Others	1	1	1	1

The British Bankers' Association discontinued publishing this data in 2007, perhaps in a timely fashion given the unraveling of the market in credit derivatives.[461] Table 1 shows that since 2000, hedge funds have steadily increased their share in the credit derivatives market while banks' role in the market for credit derivatives has progressively declined. Hedge funds' market share for credit derivatives can be expected to continue to rise. Additionally, hedge funds' (dynamic) trading strategies require the increasing availability of (credit) derivatives. Taking into account the dominant position of a select group of banks in the derivatives market and their primary role as market makers in credit derivatives,[462] perhaps the role of banks in credit derivatives could be further discounted, making hedge funds the primary customers and primary users in the market for credit derivatives.

The role of hedge funds in the credit derivatives market and the failure of this market could suggest that an increased emphasis

460. *Id.* Upon evaluating the raw data, the author provided averages of buyers protection and sellers protection for each year. The data was discontinued by the British Bankers' Association (BBA) in 2007.

461. Currently, there do not seem to be other adequate sources on market participants in credit derivatives available. When contacted, Jacques Gauthe and the wholesale team of the BBA reported that the 2006 data is the most recent data on market participants in credit derivatives produced by the BBA. E-Mail from Jacques Gauthe, Brit. Bankers' Ass'n, to Caroline Kunz Ivanov, Miss. Coll. Sch. of Law (Jan. 12, 2011) (on file with author). The BBA referred the author to the International Swaps and Derivatives Association. *Id.* Dr. David Mengle, Head of Research at the ISDA indicated that the ISDA did not have specific counterparty information. E-mail from David L. Mengle, Head of Research, Int'l Swaps & Derivatives Ass'n, to Wulf A. Kaal, Assoc. Professor & Co-Dir. of Bus. & Tax Law Ctr., Miss. Coll. Sch. of Law (Dec. 6, 2010) (on file with author).

462. Louise Story, *A Secretive Banking Elite Rules Derivatives Trading*, N.Y. TIMES, Dec. 11, 2010, at A1.

on hedge fund lending exposure is justified. The proposal in this Article to focus on a charge in Basel III that would apply to the particular bank's lending exposure to hedge funds could be combined with Basel III's emphasis on banks' exposure to certain financial products,[463] such as CDOs, CDSs, and other derivatives that are frequently used by hedge funds. This would address the crucial link between market failure in financial instruments and the increasing role of hedge funds in the market for financial instruments.

Complex financial products had an important role in the recent credit crisis.[464] Banks could be expounding, if not doubling, their exposure to high-risk financial derivatives by having lending exposure to hedge funds and, at the same time, exposure to financial derivatives that are most frequently used by hedge funds. A combination of measures in Basel III for banks' exposure to financial products and hedge funds could be tailored to account for this added exposure.

4. *Hedge Fund Regulation via Basel III*

Banks are ideally positioned to deal with asymmetric information, moral hazard, and systemic issues pertaining to hedge funds. The suggested increase in capital requirements for

---

463. Basel III will require default risk capital for counterparty credit risk as well as increased capital charges on OTC derivatives. BIS, *supra* note 37, at 31.

> [A] bank must add a capital charge to cover the risk of mark-to-market losses on the expected counterparty risk (such losses being known as credit value adjustments, CVA) to OTC derivatives. The CVA capital charge will be calculated . . . depending on the bank's approved method of calculating capital charges for counterparty credit risk and specific interest rate risk.

Id.; BIS, BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: CAPITALISATION OF BANK EXPOSURES TO CENTRAL COUNTERPARTIES 2 (2010), http://www.bis.org/publ/bcbs190.pdf. ("As part of the Basel III reforms, the Committee has materially changed the CCR regime. These changes significantly increase the capital charges associated with bank OTC derivatives and SFTs . . . .").

> The Basel III proposal attempts to fix the shortcomings of an earlier revision, known as Basel II, which was initiated by lenders in the late 1990s and lowered capital requirements by as much as 29 percent for some banks. The new rules would tighten control of what goes into the banks' calculation of risk, redefine what counts as capital and impose higher charges against holdings such as derivatives.

European Banks Poised to Win Reprieve in Basel on Capital Rules, BUSINESSWEEK, July 12, 2010, http://www.businessweek.com/news/2010-07-12/european-banks-poised-to-win-reprieve-in-basel-on-capital-rules.html.

464. *See* Hunt, *supra* note 454, at 21 ("[T]he ratings agencies did a poor job assessing the default risk of CDOs and other instruments based on subprime RMBS . . . [and] high ratings on such securities had an inordinate effect on markets . . . .").

counterparty risk in Basel III[465] could be a starting point to establish a charge for banks' assets based on their lending exposure to hedge funds and the respective systemic risk contribution. This charge could apply to the particular bank's lending exposure to certain financial products, such as CDOs, CDSs, and other derivatives,[466] that are frequently used by hedge funds.

However, after the 1998 collapse of LTCM, most dealer-banks required full collateralization of hedge fund transactions.[467] Accordingly, hedge funds were less leveraged than banks,[468] dealers have already reduced risks of lending to funds, and, arguably, no obvious problem exists for Basel III to address.[469] The collapse of large hedge funds like Amaranth in 2006[470] and large redemptions by investors during and after the crisis did not cause systemic problems,[471] and hedge funds have fewer assets and less leverage than banks, creating less likelihood that hedge funds could cause the next crisis. Without the threat of systemic risk, it is unclear why bank lending to hedge funds should be treated differently from bank lending to other market participants.[472]

International harmonization of banking regulation through the Basel Accords may have led a majority of large banks to follow the same financial strategies, which may have contributed to the financial crisis.[473] This trend has large implications for the reforms proposed in this Article. Greater harmonization of international banking regulation via Basel III is unlikely to lead to better outcomes and may well exacerbate future crises.[474] The Basel Accords allegedly produce globally similar business and regulatory

---

465. BIS, *supra* note 37, at 18 (stating that "minimum capital requirements calculated under Pillar 1 are often insufficient").

466. *See* sources cited *supra* note 463.

467. *Too Big to Swallow*, *supra* note 20 (noting that after the failure of LTCM there was flight to traditional banking).

468. *Professionally Gloomy*, *supra* note 21 ("After the collapse of Long-Term Capital Management in 1998, banks started scanning the counterparty horizon more carefully for risks from hedge funds. From now on they will look much more closely at each other.").

469. *Contra* Jones, *supra* note 353 (reporting that the Basel Committee feels a Basel III is necessary to create stringent reforms ensuring banks have sufficient capital so as to prevent another taxpayer bailout).

470. *Buttonwood: Paint It Black*, *supra* note 22 ("[T]raders repeatedly get caught out by 'unprecedented' market movements. The collapse of two hedge funds, Long-Term Capital Management in 1998 and Amaranth Advisors in 2006, were cases in point."); *The Galleon Affair: All at Sea*, *supra* note 22 (noting that the case against Raj Rajaratnam, cofounder of Galleon, for insider trading could decrease the credibility of hedge funds).

471. *Buttonwood: Paint it Black*, *supra* note 22.

472. Romano, *supra* note 6, at 3.

473. *See supra* discussion Part IV.2.

474. *Contra We Need a Basel III for a New Order: Soros*, *supra* note 391.

strategies.[475] As a result of harmonization, mistaken policies may result in global financial distress.[476] For instance, in 2008, many financial institutions sold assets to improve their long-term prospects and free themselves from toxic papers.[477] Consequently, prices plunged and the same institutions were forced to sell even more assets.[478] Similar effects must be anticipated for greater centralization.

Changing the regulatory approach in response to crisis is a common U.S. practice,[479] with often-disastrous consequences.[480] It is cheap, visible, and easily explainable to the general public. However, it has not been successful. For instance, the Sarbanes–Oxley Act of 2002 has been heavily criticized.[481] Congress's belief in the effectiveness of the new systemic regulator, to be created under Dodd–Frank, could be misplaced.[482] Current forecasting models were not capable of anticipating the last crisis, let alone its depth.[483]

---

475. *Cf.* Barr & Miller, *supra* note 387, at 21 (relating that the Basel process was designed to achieve harmonization and coordination of international bank supervision among the major industrialized countries). *Contra* Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127, 133 (2009) (suggesting that because Basel II only began a phased-in implementation in the United States in January 2009, it is too early to evaluate its effects).

476. Verdier, *supra* note 384, at 338 (suggesting that the current global financial crisis is due in large part to harmonized capital standards implemented through the Basel Accord). *Contra* Cannata & Quagliariello, *supra* note 384, at 15 (arguing that Basel II did not play a major role in the financial crisis, and if revised, it should include greater harmonization of enforcement, as opposed to radical changes).

477. Bethel et al., *supra* note 451, at 28 ("In the severely stressed market of 2008, however, numerous financial institutions were selling assets, resulting in a market glut and plummeting prices.").

478. *Id.* ("These lower prices set off rounds of write-downs and a further need to raise cash and delever.").

479. Roberta Romano, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005) (stating that Sarbanes–Oxley was "emergency legislation, enacted under conditions of limited legislative debate, during a media frenzy involving several high-profile corporate fraud and insolvency cases," all during an economic downturn); *see also* Larry E. Ribstein, *International Implications of Sarbanes–Oxley: Raising the Rent on U.S. Law* 3 (Ill. Law & Econ. Working Paper Series, Paper No. LE03–005, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=401660 (stating that the securities laws often go through periods of punctuated evolution in the wake of stock market crashes).

480. *See, e.g.*, Ribstein, *supra* note 479, at 3–4 (summarizing the "perverse effects" of Sarbanes–Oxley on international securities markets).

481. *Id.*

482. *See* Viral V. Acharya, *Failures of the Dodd–Frank Act*, FIN. TIMES, Jul. 15, 2010, http://www.ft.com/cms/s/0/ccbb38ea-9010-11df-91b6-00144feab49a.html#axzz1BtNc8avl (asserting that the Dodd–Frank Act both fails to discourage individual firms from "putting the system at risk" and to regulate by function, as opposed to form).

483. Erik F. Gerding, *Code, Crash, and Open Sources: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127, 136 (2009) (observing that the financial crisis made it clear that industry risk models failed to anticipate or price financial risk).

Another major argument against indirect regulation is that if two banks give loans to hedge funds, neither has an overall view of what the hedge fund does and what the hedge fund's risk exposure might be. CCRM will not work effectively unless the bank has an exclusive relationship with the hedge fund that allows it to control the relationship.

The role of the Basel Committee is to mitigate transnational externalities by coordinating supervision over multinational firms.[484] This coordination, not harmonization, should prevent destabilizing actions by a country's regulators.[485] Moreover, it is not harmonization through Basel II that made banks hold similar assets: banks held similar assets because of the profitability of these assets.[486] Harmonization is only a framework and is not synonymous with conforming rules and regulations.[487] Basel II calls for self-regulation, allowing banks to be substantially involved in their own oversight, and is characteristically open-ended and enables efficient exchange between banks.[488] The Basel Accords were introduced specifically to reduce systemic risk from bank failures and to limit externalities that may lead to a lack of information sharing.[489] The Accords have succeeded in providing "global public goods of information"[490] and can help to ensure that banks have sufficient capital so as to prevent another taxpayer bailout. Moreover, even though the collapse of large hedge funds like Amaranth and large redemptions by investors during and after the crisis may not have caused systemic problems, they are likely to have increased market pressure on positions held by market participants when rival traders sold investments ahead of time, anticipating investor redemptions.[491] In isolation, this market pressure on positions will not give rise to systemic concerns.[492] However, if the market is generally distressed,

---

484. Zaring, *supra* note 383, at 480 ("The members declared, via a press release, that the primary purpose of the Committee would be to provide its members with a regular forum for airing cooperative approaches to the supervision of multinational banks.")

485. Barr & Miller, *supra* note 387, at 21.

486. Anastasia Nesvetailova, *The Crisis of Invented Money: Liquidity Illusion and the Global Credit Meltdown*, 11 THEORETICAL INQUIRIES IN LAW 125, 140–42 (2010) (proposing that the banking industry responded to Basel by "driving risky assets off the balance sheets," instead of strengthening balance sheets by weighing the riskiness of their assets as was intended by the Basel Accords, and further asserting that banks were acting out of an "aggressive search for profits").

487. *See* Krawiec, *supra* note 475, at 173.

488. *Id.*

489. Barr & Miller, *supra* note 387, at 21.

490. *Id.* at 22.

491. *See supra* note 23.

492. *See generally* Romano, *supra* note 6, at 3 & n.3 (pointing to the lack of evidence that hedge funds contribute to systemic risk in general).

a potential exists that this market pressure could contribute to the general distress.

Even if international harmonization of banking regulation through the Basel Accords led banks to follow the same financial strategies and risk models, potentially creating systemic risk, the federal regulations that incorporated the Basel market risk amendments have also led many institutions to "significantly improve their risk modeling techniques, and, in particular their modeling of specific risk."[493] The implementation of Basel II alone is also unlikely to have caused U.S. and EU banks to be highly leveraged; U.S. banks are so highly leveraged because of the potential for great reward when resources are leveraged and risks are taken.[494] Some hedge fund managers do call for a new order through Basel III.[495] The Basel II Accord gives banks a significant amount of flexibility in selecting the measurement of operational risk and the resulting capital requirement,[496] and it may not have played a major role in the financial crisis.[497] If revised, it should include greater harmonization of enforcement, as opposed to radical change.[498]

Most hedge funds do have more than one banking relationship.[499] There may be a risk that CCRM would not work effectively if the bank does not have an exclusive relationship with the hedge fund that allows it to control the relationship.[500] The exclusivity of a banking relationship is perhaps not the only effective way to exercise control and manage risk. The intensity, endurance, and quality of the relationship also influence the level of control a bank may exercise over a hedge fund.[501] If a bank exercises control

---

493. Andre Scheerer, *Credit Derivatives: An Overview of Regulatory Initiatives in the U.S. and Europe*, 5 FORDHAM J. CORP. & FIN. L. 149, 179 n.112 (2000).

494. Cannata & Quagliariello, *supra* note 384, at 1–2.

495. *We Need a Basel III for a New Order: Soros*, *supra* note 391.

496. Krawiec, *supra* note 475, at 129.

497. Cannata & Quagliariello, *supra* note 384, at 15.

498. *Id.* at 12.

499. Henry Smith, *Prime Brokerage: Changing Relationships*, FT MANDATE, Nov. 1, 2008, at 1.

> Amid heightened concern about counterparty risk, the search for a secure haven for their assets has become hedge funds' top priority. Consequently, there has been both a move away from those investment banks regarded as risky and a drive to diversify exposure by setting up accounts with a number of different prime brokers. Hedge funds, with the exception of the smallest ones, are moving to using multiple prime brokers.

Id. (internal quotation marks omitted).

500. *See* Eddy Wymeersch, *The Regulation of Private Equity, Hedge Funds and State Funds* 10 (Fin. Law Inst., Working Paper No. 2010–06, 2010) (emphasizing the importance of indirect regulation of hedge funds by their banks or "prime brokers").

501. *See* Casper G. de Vries & Philip A. Stork, *Hedge Funds and Financial Stability* 33 (Pol'y Dep't Econ. & Sci. Pol'y, Study/Briefing Note IP/A/ECON/IC/2007–

over a hedge fund to the detriment of its performance, the hedge fund may decide to terminate the banking relationship.[502] On the other hand, in today's environment of increased scrutiny of lending and lending relationships, hedge funds could have disincentives to terminate a lending relationship.[503] Some of hedge funds' dynamic trading strategies may depend on the immediate availability of capital.[504] Without sufficient lines of credit to supply required additional capital, these trading strategies may not work. Perhaps banks will have enough influence over hedge funds even if hedge funds have multiple lending relationships.

Professor Romano raises the question of whether the proposal of this Article could create incentive problems similar to those of credit rating agencies.[505] Perhaps it is worth pointing out that banks' role in monitoring hedge funds is not easily comparable to the principal–agent problem between buyers of securities and credit rating agencies. Banks have perhaps more influence over hedge funds than buyers of securities over credit rating agencies and their ratings.

Basel III capital charges based on a bank's lending exposure to hedge funds could help to address the threat of regulatory arbitrage. Implementing a charge for the particular bank's lending exposure to hedge funds or systemic risk contribution deriving from hedge fund lending exposure under Basel III would not require any implementation. Once the bank has signed on to join the framework, it would merely be the responsibility of the participating banks to comply with the framework. Hence, transaction costs for national regulators would be avoided. Regulating hedge funds through rules in Basel III would also avoid the cost of compliance, as well as registration and reporting, otherwise required by the AIFM Directive[506] and the Dodd–Frank Act.[507] The AIFM Directive

---

23, 2007), *available at* http://ssrn.com/abstract=1120595 ("Hedge funds need banks for their credit to be able to leverage their positions. Banks profit from hedge funds as prime brokers and from financing the hedge funds. The banking sector and hedge fund industry are also strongly intertwined during times of stress.").

502. KAMBHU ET AL., *supra* note 434, at 22 (noting that competition for new hedge fund business could erode CCRM by weakening credit risk management practices).

503. Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risk*, 5 J. FIN. STABILITY 283, 295 (2009) ("[G]iven the increasing volume of complex transactions, policymakers are concerned whether counterparty exposures are being monitored appropriately.").

504. KAMBHU ET AL., *supra* note 434, at 3 ("An important part of [the counterparty and hedge fund] relationships is the extension of credit to the hedge fund.").

505. Romano, *supra* note 6, at 11–12 ("Credit agencies were specially recognized by government regulation with a role of monitoring the creditworthiness of the investments that they rated, a policing role similar to what [the author] propose[s] for banks with respect to hedge funds.").

506. *November 11 Directive*, *supra* note 4, ch. IV, art. 19–21 (providing for annual reports, reporting obligations, and disclosures to investors).

introduces the possibility of harmonized requirements for entities engaged in the management and administration of alternative investment funds, resulting in Europe-wide regulation of hedge funds.[508]

Regulation through Basel III would also address issues of systemic risk because Basel III will not only regulate and alter credit standards of banks, but also counterparty credit risk and, thus, hedge funds' level of leverage.[509] Moral hazard would be addressed because disclosure of additional information could be necessary to introduce a charge for the particular bank's lending exposure to hedge funds or to measure the systemic risk contribution deriving from hedge fund lending exposure. That disclosure of additional information might further reduce the capital-leverage ratio of hedge funds. The moral hazard problems after the bailout of LTCM and the bank bailout in the aftermath of the financial crisis of 2008–2009 (banks had disincentives to monitor their counterparty credit risk exposure with hedge funds if they could rely on taxpayer-funded bailouts)[510] would be less likely to occur.

Many of the issues pertaining to hedge fund rules under Dodd–Frank would perhaps be addressed if the Basel Committee were to decide to account for banks' lending exposure to hedge funds. The *de minimis* investment rule under Dodd–Frank already curtails banks' exposure to hedge funds.[511] In Basel III, the Basel Committee could set up rules that account for any remaining exposure. Exclusive reliance on rules in Basel III alone, however, could be misplaced. Even the combination of hedge fund regulation via rules in Basel III and *de minimis* investment rules in Dodd–Frank could leave open some issues. The calibration of such a regulatory combination requires time and experience.

---

507. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (to be codified as amended in scattered sections of 15 U.S.C.).

508. *November 11 Directive*, *supra* note 4, ch. I, art. 1. The Directive provides "rules for the authorisation, ongoing operation and transparency of the managers of alternative investment funds (AIFM), which manage and/or market such funds in the union." *Id.*

509. *See supra* note 357.

510. *See* discussion *supra* Part V.4.

511. *See* discussion *supra* Part III.2.b.3, c.5 (discussing the *de minimis* Investment Rule under Dodd–Frank).

VII. CONCLUSION

Recent attempts at regulating hedge funds by registering them with regulators and requiring disclosure of pertinent information could help to minimize moral hazard, social externalities, and systemic risk generated by the hedge fund industry. The extent of hedge funds' involvement in the credit crisis of 2008–2009 remains unclear. Asymmetric hedge fund regulation in Dodd–Frank and the AIFM Directive is counterproductive. The AIFM Directive could create incentives for regulatory arbitrage and could potentially cause retaliatory action by non-EU countries. In the long run, it could undermine the competitiveness of the European Union's alternative investment community and financial markets in Europe. In Dodd–Frank, Congress authorized the SEC to implement rules to interpret the exemptions for hedge funds. The SEC should use its discretion to provide much-needed guidance. Many of the regulatory complications in the AIFM Directive and the Dodd–Frank Act could be avoided if the Basel Committee were to introduce a charge for banks' lending exposure to hedge funds. Basel III capital requirements for banks could introduce a charge for a bank's assets based on its systemic risk contribution. The Basel III measure for hedge fund lending exposure could be combined with an emphasis on banks' exposure to complex financial products. This could help to address the link between market failure in financial instruments and the increasing role of hedge funds in the market for financial instruments.

***