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Proposed Regulatory Framework For Hedge Funds

Die schwerste Rezession seit der Weltwirtschaftskrise hat für Hedge Funds das bisher schlechteste Jahr seit der Gründung des ersten Hedge Funds durch A.W. Jones im Jahre 1949 bewirkt. Zusätzlich dazu wurden Investoren durch das enorme Schneeballsystem von Bernard Madoff traumatisiert. Politiker und Regulierungsbehörden haben dutzende Berichte zur Wirtschaftskrise publiziert. Dabei visieren sie v.a. Hedge Funds an. Bald werden von überall her prüfende Blicke auf die Schweiz geworfen, weil hier Regeln für den Hedge Fund-Handel fehlen. Im Gegensatz zum Bankgeheimnis muss die Schweiz hier aktiv werden. Die von den Autoren vorgeschlagenen rechtlichen Rahmenbedingungen berücksichtigen die neulichen Entwicklungen, bieten den Marktteilnehmern aber trotzdem genügend Flexibilität. Es ist eine grossartige Gelegenheit, die Wettbewerbsfähigkeit des Finanzplatzes Schweiz zu beflügeln. (ts)

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«Investing withouth research is like playing stud poker and never looking at the cards.»

Peter Lynch

I. Introduction

[Rz 1] The Hedge Fund («HF») industry has grown at an extreme rate since the creation of the first HF by Mr. A.W. Jones in 1949.[1] According to certain estimations more than 9,000 HF manage $2 trillion in assets globally and $1.5 trillion in the United States of America («USA»).[2] Thanks to this growth, HF have become subject to enhanced scrutiny by the authorities and the public. The collapse of Long Term Capital Management («LTCM») in 1998[3] and a series of frauds[4] committed by HF managers have strongly contributed to this phenomenon. These elements combined with the severity of the current economic crisis have put the financial authorities on every continent under immense pressure. Today almost every regulatory organization or association agrees upon the need for a new regulatory framework applying to HF or HF managers.[5] We already know that the United States of America as well as the European Union want to regulate HF. Soon they will exercise tremendous pressure on Switzerland to regulate HF.[6] It is an opportunity for our country to be proactive and foster the competitiveness of our marketplace by carving out a modern

1 Scott J. Lederman, *Nuts and Bolts of Financial Products 2009, Hedge Funds,* CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 259, 264, PLI Order No. 18678, (2009).

2 Jeffrey M. Sneeringer, *The Lesson of Goldstein v. SEC: If at first you do not succeed, regulate again?*, 36 CAP. U.L. REV. 1173, 1173 (2008); *Regulation of Hedge Funds before the U.S. Senate Committee on Banking, Housing and Urban Affairs*, 109th Cong. (July 25, 2006) (statement of SEC Chairman Christopher Cox), *available at* www.sec.gov/news/testimony/2006/ts072506cc.htm; Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style and Mission*, 2006 U. ILL. L. REV. 975, 982 (2006); United States Government Accountability Office («GAO»), *Hedge Funds, Regulators and Market Participants are taking Steps to strengthen Market Discipline, but continued Attention is needed*, at 1 (January 2008).

3 Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSP. 189 (1999); Report of the President's Working Group on Financial Markets, *Hedge Funds, Leverage and The Lessons of Long-Term Capital Management*, April 1999.

4 Press Release, *SEC Obtains Emergency Relief Against Palm Beach, Florida, Hedge Funds for Million Fraudulent Offerings* (March 3. 2005); Unaccounted for: *0 Million*, Wall St. J., August 29, 2005, at A1; Unaccounted for: *The Madoff Scandal*, The Economist, January 3, 2009, at 55.

5 Group of Thirty, *Financial Reform, A Framework for Financial Stability*, January 15, 2009, at 60; Testimony of Professor John Coffee, Jr. before the United States Senate Committee on Banking, Housing and Urban Affairs, *Enhancing Investor Protection and The Regulation of Securities Markets*, March 10, 2009, at 48; Technical Committee of the International Organization of Securities Commissions, *Hedge Funds Oversight*, Consultation Report, March 2009, at 33; United States Government Accountability Office («GAO»), *Hedge Funds, Regulators and Market Participants are taking Steps to strengthen Market Discipline, but continued Attention is needed*, at 34 (January 2008); United States Government Accountability Office («GAO»), *Financial Regulation, A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, January 2009, at 30; Tim Geithner, *Treasury Secretary Tim Geithner Written Testimony House Financial Services Committee Hearing*, March 26, 2009, at 4; International Monetary Fund, *Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management,* February 4, 2009, at 11; G-20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency*, March 25, 2009, at iv; High-Level Expert Group on Financial Supervision in The EU, *The de Larosière Group,* Spring 2009, at 25 (recommendation 7); Council of the European Union, *Presidency Conclusions*, March 20, 2009, at 3 (agrees with de Larosière Report); European Parliament, *Draft Report with recommendations to the Commission on Hedge Funds and private equity (2008/2238(INI))*, April 18, 2008; Financial Services Authority («FSA»), *The Turner Review, A Regulatory Response to the Global Banking Crisis*, March 2009, at 72.

6 The EU regulation proposal sets forth that HF domiciled in and/or managed offshore will be barred from distribution in the EU if the country of domicile of the HF manager does not provide a certain level of regulation.

regulatory framework applicable to HF. Our approach should avoid the flaws of the American and European proposals.

[Rz 2] The flaws of the American and European proposals are due in part to the immense pressure under which the regulators are to produce new regulation. But everybody knows that legislation produced in a hurry is bad law. Switzerland has the chance to act more rationally and to separate different issues concerning HF.

[Rz 3] The first challenge relates to investor protection. The regulator should keep in mind that investors with Bernard Madoff were «sophisticated» investors. If someone plays stud poker and never looks at his card the regulator cannot help much. Furthermore regulation can give the illusion that a third person will tell you that you have good cards, but it is unfortunately not the case. Market discipline should not be neglected because investors have been cheated.

[Rz 4] The second challenge relates to the systemic risk that Hedge Funds could pose. This risk is real. It should be defined in a first step and then addressed.

[Rz 5] This paper is aimed at proposing a new set of rules which are intended to address the risks raised by the various reports cited above while minimizing the negative impacts on the capital formation and allocation. Our innovative approach could contribute to attract HF deceived by the new American and European regulation while providing them with a certain level of supervision required to conduct business in Europe and in the United States of America.

[Rz 6] Our proposed regulatory framework is based on a thorough review of this economic crisis including the role of HF, of the current regulatory framework in the USA and EU and of the proposals submitted by various groups or organizations. First, we will attempt to define what a HF is, to explain how HF provide benefits to financial markets and to assess the extent to which HF have contributed to the economic crisis. However, we will not review in detail what led us to the worst economic crisis since the Great Depression. Our second chapter will describe what the regulator should bear in mind when he creates new regulations. We will outline the nine most important principles that will guide us throughout this work. In the third part, we will explain the extent to which HF are and are not regulated in the USA and in the EU. Our fourth chapter will focus on the rules that the European and American authorities have announced so far. In the last chapter, we will outline our regulatory framework for HF based on three pillars.

II. Preliminary remarks on HF and the economic crisis

A. What is a HF?

[Rz 7] It is notoriously difficult to give a comprehensive definition of HF. Nevertheless, the approach used by the International Organization of Securities Commissions («IOSCO») is sufficiently broad to give a good picture of the industry since it is based on what the institutions themselves consider to be HF.[7] According to IOSCO HF are investment schemes that combine some of the following characteristics:

- Leverage. It is important to highlight that average leverage across the industry amounted to only 1.7 in 2007 and fell to 1.4 in 2008[8] while the gross leverage of Bear Stearn was 34 to 1.[9] Furthermore, figures relating to leverage may be misleading since no unified calculation of the leverage exists;[10]
- Significant performance fees combined with high water mark provision;
- Periodical redemptions;
- Money invested by HF manager;
- Use of derivatives and complex financial products.[11]

[Rz 8] It is also very important to highlight that HF are not bank-like in their activities today.[12] They do not have short-term liabilities like bank deposits from retail investors to finance long-term assets. Finally, one characteristic that is missing in this definition of HF is that HF are NOT distributed to the public. This point is critical when we assess the need for enhanced investor protection by creating new prudential rules.

7 Technical Committee of the International Organization of Securities Commissions, *Hedge Funds Oversight*, Consultation Report, March 2009, at 6.

8 *Id.* at 17; Alexander Ineichen responsible for Industry Research at Alternative and Quantitative Investments at UBS found an average gross leverage of 2.5 times equity in 2007, Data in new UBS report supports Bernanke's view that HF leverage not a top concern, AllAboutAlpha.com, 24th February 2009; Financial Services Authority («FSA»), *The Turner Review, A Regulatory Response to the Global Banking Crisis*, March 2009, at 72.

9 Testimony of Professor John Coffee, Jr. before the United States Senate Committee on Banking, Housing and Urban Affairs, *Enhancing Investor Protection and The Regulation of Securities Markets*, March 10, 2009, at 17.

10 John E. Baumgartner, Jr., *Hedge Fund Standards: Final Report*, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES, PLI Order No. 13992, April 24, 2008, at 437. We will use gross leverage «classic» calculation insofar these data exist (gross assets divided by equity). The UBS Report in Footnote 7 seems to refer to this classic calculation including off balance sheet vehicles since the total assets equal the capital contributions of the investors. The use of leverage is significantly different among the HF and depends on the strategy. For more information *see* Report of International Monetary Fund, *Global Financial Stability Report*, October 2008.

11 *See supra* note 7, at 6-7.

12 Financial Services Authority («FSA»), *The Turner Review, A Regulatory Response to the Global Banking Crisis*, March 2009, at 72.

B. Do HF provide benefits to the Financial Markets?

[Rz 9] HF are considered useful for the financial system by enhancing liquidity and promoting market efficiency and price discovery.[13] The market becomes more efficient when HF target price inefficiencies, including wide bid/ask spreads (arbitrage). Especially in times of great volatility like the period experienced during the ongoing economic crisis HF provide benefits to financial markets by willing to assume risks that more regulated institutions cannot or are unwilling to assume.[14] In this context it is worth mentioning that part of the Financial Stability Plan unveiled by Treasury Secretary Geithner relies on the willingness of alternative investment funds to acquire «toxic» assets that other market participants do not want to purchase.[15] Furthermore, HF are known for their innovation skills. The innovation in turn enables to allocate risks more properly[16] and mitigates wide concentrations of risk by transferring and distributing risk through the HF's willingness to be counterparties in derivatives trades.[17]

C. Have HF contributed to the economic crisis?

[Rz 10] The current economic crisis is due to a combination of macro economic factors and regulatory failures. There is a broad consensus among the experts that the massive inflow of capital in the USA combined with cheap credit drove the investment yields to the bottom. The search for yields combined with securitization, which fostered the origination of bad loans since the originator did not, or was not supposed to[18], support the risk of default, a lack of supervision over the loan originators, an extreme leverage at investment banks, the failure of Basel II and the failure of risk modeling together created a real estate bubble in the USA.[19] The failure of the credit rating agencies to rate these new securities properly has contributed to amplify the bubble by creating the false impression that investors could obtain higher yields with lower risks.[20] Furthermore, the real estate bubble in the USA was spread to the entire financial system through the globalization of the financial institutions.[21]Moreover, the mark-to-market accounting rule helped fueled the bubble by its cyclical effect[22] and amplified the downturn by huge write-offs.[23] Finally the lack of regulation over certain systemic important institutions such as AIG did also amplify the bursting of the bubble by adding some panic in the middle of the burst.

[Rz 11] It is however interesting to note that no single report on the current economic crisis points to the specific role played by HF during the crisis although every single report concludes that HF shall be regulated. No report contends that HF contributed significantly to the bubble or to its systematical bursting. The de Larosière Report is the most striking with respect thereto. It reckons that «the Group considers they [Hedge Funds] did not play a major role in the emergence of the crisis»[24] but reaches the conclusion that every HF manager should be regulated due to their role of transmission which is not further detailed. The IOSCO Report acknowledges that the argument according to which HF amplify economic crisis because of their leverage and a possible cyclical behavior is questionable.[25] First HF leverage tends to be much less than bank's leverage.[26] Second the strategy long/short is intended to eliminate the systematic risk (overall market risk) in order to pick up stocks that will increase or drop because their idiosyncratic risk (i.e. the risk of price change due to the unique circumstances of a specific security) is mispriced. Such a strategy, which accounts for more than one third of the assets under HF management[27], is not likely to facilitate the creation of a bubble. One author nevertheless implies that HF have played a wide role in the formation of this economic crisis in mixing them with investment banks but he does not explain how they caused damages to the market except by pointing out to their ability to create financial innovation.[28] In our opinion the mere possibility to create financial innovation should not be viewed as negative. The contrary seems to be true: financial innovation is useful to spread risks insofar the market participants know how to use and price the tools. To summarize, it is fair to say that one might think that HF did not trigger or significantly amplify this crisis since, otherwise,

[13] United States Government Accountability Office («GAO»), *Hedge Funds, Regulators and Market Participants are taking Steps to strengthen Market Discipline, but continued Attention is needed*, at 2 (January 2008).

[14] Id.

[15] Outline of the Financial Stability Plan available at: www.financialstability.gov/roadtostability/index.html.

[16] Id.

[17] *See supra* note 7, at 10.

[18] The special purpose vehicles created off balance sheets by the banks were not supposed to represent a liability for the banks. It turned out that either a form of liquidity guarantee was provided or for reputation purposes the banks were forced to assume the liabilities of these entities by providing the necessary short term funding.

[19] *See supra* note 5.

[20] Aaron Unterman, Innovative Destruction-Structured Finance and credit market Reform in the Bubble Era, 5 HSTBLJ 53, 2009, at 96.

[21] Id.

[22] The compensation system itself is not the real problem. The issue is that the compensation system, which has to rely on the accounting system, was based on an arguably flawed accounting system. This factor contributed to create an excess risk taking.

[23] Nouriel Roubini, Ten Fundamental Issues in Reforming Financial Regulation and Supervision in a World of Financial Innovation and Globalization, RGEMONITOR, March 31, 2008, at 6.

[24] High-Level Expert Group on Financial Supervision in The EU, *The de Larosière Group,* Spring 2009, at 23.

[25] *See supra* note 7, at 16.

[26] *See supra* note 8.

[27] Id.

[28] *See supra* note 20, at 91.

at least one report would have blamed them for putting the world in such an economic turmoil.

D. Do HF pose systemic risks?

[Rz 12] If HF did not contribute significantly to the severity of this crisis it does mean that HF could not pose systemic risks at all in the future. As the LTCM collapse reminds us, HF might create systemic risks.[29] In this context it is nevertheless useful to note that even Mr. Parkinson, Deputy Director of Research & Statistics at the Federal Reserve Board stated during a conference call that in his opinion there may not be any HF that would be systematically important.[30] Although the systemical importance of HF is debatable the Report of the Investor's Committee («Investor Report») and the Report of the Asset Manager's Committee («Asset Manager's Report») to the President's Working Group on Financial Markets («PWG Report») apparently believe that HF do pose systemic risks.[31] In addition to the fact that the industry considers itself as systematically important the Turner Review makes the following argument: HF's size could change in the future and thus pose systemic risks.[32] In light of these arguments we will not further discuss the potential systemic risks that HF can cause in case of failure but we will keep in mind that HF, contrary to the majority of the banks, do not automatically raise systemic questions.[33] Finally, the argument consisting of saying that HF have been hit by the crisis because of the redemptions of investors and credit restrictions causing HF to deleverage and to sell assets; this consequently pushing the price of assets further down, highlights a consequence of the crisis and not a cause.[34,35] Moreover, it is difficult to see how this could have been avoided by any regulation (would any regulator want to prevent HF from selling assets during a market downturn?). This will influence how we evaluate the need for further prudential regulation for all HF.

III. General risks related to HF Regulation

A. Aim of the Regulator

[Rz 13] First, the supervision and regulation of financial institutions is necessary for the financial stability as we have experienced it during the ongoing crisis.[36] Second, the efficient functioning of the economy depends on a proper allocation of savings and investments.[37] This efficiency is created by transparency rules enabling a fair competition among the market players (e.g. disclosure obligations in order to fill the information gap between the participants; adverse selection problematic) and other prudential rules that enhance the confidence of the public in the financial system (e.g. fraud; best execution; limit on certain activities).[38] It is important to stress that prudential regulation is usually warranted because the depositors may not assess the riskiness of their counterparties because of a lack of expertise and information (this is

[29] It could be argued that the collapse of LTCM did not create systemic risks since the counterparties were able to absorb the losses without no further disruption for the markets; *see* also Consultation Paper of the European Commission on Hedge Funds.

[30] Conference Call of the White House / Treasury Department on March 27, 2009 accessible to members of the Managed Funds Association.

[31] Investor's Committee and Asset Manager's Committee to the President's Working Group on Financial Markets, *Best Practices For The Hedge Fund Industry*, January 15, 2009, at 1; John P. Hunt, White Paper, *Hedge Fund Regulation: The President's Working Group Committees' Best Practices Reports – Raising the Bar but Missing Risks*, Berkeley Law, June 2008 available at bclbe@law.berkeley.edu.

[32] *See supra* note 12.

[33] See also in Investor's Committee to the President's Working Group on Financial Markets, *Best Practices For The Hedge Fund Industry*, January 15, 2009, at 1: «Some hedge funds have demonstrated correlations to other asset classes during this crisis that have been higher than anticipated, even in the context of capital markets characterized by extreme risk aversion which temporarily drives all asset classes to much higher correlations»; and see in Roger T. Cole, Greg Feldberg, and David Lynch, *Hedge Funds, credit Risk Transfer and Financial Stability*, FINANCIAL STABILITY REVIEW, April 2007, at 13: «in a crisis, interlocking credit exposures would be the key mechanism by which risks would be transmitted from one institution to another, potentially transforming a run-of-the-mill disturbance into a systematic situation», and further at 15: «in illiquid markets, hedge funds may be forced to sell positions to meet margin requirements, driving down market prices». This is certainly true but the only remedy is to require more collateral from the beginning and this is not a case for more regulation of HF except when the HF has a size that poses systemic risk.

[34] This argument is also put forward by the European Commission to regulate HF. In our view this argument is inconsistent with the purpose of protecting investors and rendering the markets more efficient. First we have some difficulties to understand how any regulation could avoid such a problem. Second «healthy» funds which have not put in place any restriction on redemptions have provided enhanced liquidity to investors in need of cash (is that bad?). Third prices on the markets are not driven by the quantity of buy and sell trades but much more by the information conveyed by the trades. This means that prices would not have dropped if investors believed that HF only sold assets to redeem the participation of their investors. Investors apparently rightly believed that HF did not trust these assets anymore. Such disbelief cannot be avoided by regulation. Liquidity in funds should be fostered by the regulator and not condemned since it first disciplines the management; second allows investors to get their cash when they want to re-allocate their portfolio; and third permits the capital markets to be efficient by providing more accurate prices (information conveyed by the trades). The EU Directive's proposal seems to forget that liquidity is fundamentally good even though prices can fall due to a bearish mood of investors. The prices of Asset Backed Securities or Collateralized Debt Obligation did not fall because investors were or are irrational but because they were overpriced compared to the risk involved.

[35] International Swaps and Derivatives Association, ISDA response to European Consultation Paper on Hedge Funds.

[36] Asian Development Bank, Financial Sector Legal and Regulatory Toolkit, Part Three II. (2009).

[37] Id.

[38] For a comprehensive general theory of regulation see: Carolyn V. Currie, *Towards a General Theory of Financial Regulation: predicting, measuring and preventing financial crisis*, SCHOOL OF FINANCE AND ECONOMICS, UNIVERSITY OF SYDNEY, Working Paper No. 142, May 2005.

not the case for HF where the investors are supposed to be sophisticated).[39]

[Rz 14] Basically the financial regulator should tackle these issues by adopting four different kinds of rules:

- Competition regulation (anti-competitive behavior);
- Market integrity regulation (market misconduct);
- Prudential regulation (information asymmetries and safety and soundness of individual institutions);
- Financial stability regulation (systemic instability).[40]

[Rz 15] Nevertheless, the regulator should be and is, indeed, aware of the fact that zero risk is neither possible to reach nor desirable since the vital economic functions of the financial system is to manage, allocate and price risk. Therefore not every activity or practice is subject to regulation. To assess which activity must be regulated the task of the authority is to decide which financial promises have characteristics that warrant much higher levels of safety than would otherwise be provided by markets (even when institution is subject to competition and market integrity regulation).[41] This assessment has to be done in weighing the costs associated with any regulation.

[Rz 16] It should be noted that HF are already subject to competition regulation and market integrity regulation. Therefore, we will deal only with the prudential rules and the systemic instability.

B. Specificities Related to HF

[Rz 17] As we explained above a characteristic of HF is to be designed and distributed exclusively to sophisticated investors. The regulator assumes that rich individuals or companies having a certain size are able to gather the information needed to assess investment opportunities. Put differently, these investors can address the problem of asymmetric information or opportunistic behavior themselves. Furthermore, the other market participants such as prime brokers or custodian banks are also deemed able to deal with HF in a professional fashion and do not warrant further protection. These institutions are already monitored and must deal with their counterparty's risks in line with maybe imperfect but existing regulation. However, the fraud committed by Bernard Madoff seems to demonstrate that even informed and sophisticated market participants were not able or at least did not feel a need to perform sound due diligence. Mr. Parkinson, during his conference call with the MFA, recognized that the regulation of HF was warranted after the fraud of Madoff.[42] This tends to confirm Professor Paredes's opinion according to which: «the risk of fraud and other hedge fund abuses weighed disproportionately on the agency [SEC], prompting it to act when it had not in the past. The particular concern is that such political and psychological influences result in overregulation.»[43] Furthermore, it is interesting to notice that Mr. Bernard Madoff was registered with the Securities Exchange Commission («SEC») since 2006 as Investment Advisor and before as Broker-Dealer.[44] One should bear in mind that the registration with the SEC creates a potential problem since a signal is sent to the investors that the HF manager is supervised and subject to strict rules. The investor could thus drop his guard.

[Rz 18] In our opinion, every regulatory framework concerning HF or HF managers should address the following nine main issues:

- When the HF manager is subject to oversight by an authority to protect the investor, basic rules of common sense must apply. For example the separation between the custodian and the HF manager as well as the requirement of an independent and qualified auditor must be mandatory.[45] The HF manager would be subject to a qualified audit whose scope extends to the offshore HF. It is indeed very imprudent to require HF to be registered and to apply lax rules since it decreases the market discipline without bringing any advantage. This is the case up to date although the SEC regulates an estimated two thousand HF which include approximately fifty of the largest HF having one-third of all HF's assets under management.[46]
- The rules must be crafted in taking into account the specificities of HF, especially their very different strategies. These differences have several impacts on the valuation of the investments and the disclosure requirements regarding leverage.[47]
- The regulatory framework must be proportional to the risks posed by HF.[48] This is important in order to put in place minimal barriers to entry and exit from markets and products. Small HF and their benefits to financial markets must be taken care of by avoiding huge compliance costs. Furthermore, the risk of having imperfect information can be priced by the sophisti-

[39] Lawrence J. White, The Role of Financial Regulation in a World of Deregulation and Market Forces, STERN SCHOOL OF BUSINESS (2009), at 4.

[40] *See supra* note 36.

[41] Phil Hanratty, The Wallis Report on the Australian Financial System: Summary and Critique, Research Paper 16 1996-1997.

[42] *See supra* note 30.

[43] Troy A. Paredes, *On the Decision to Regulation Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 UILLR 975 (2006), at 976.

[44] *See supra* note 9.

[45] Id.

[46] *See supra* note 13, at 5.

[47] *See supra* note 31, at Appendix E.

[48] *See supra* note 41, at 195.

cated investor.[49] HF managers are already subject to prohibitions against fraud and owe fiduciary duties to their clients whether they are established in the USA, EU or Switzerland.[50] This means that contractual and criminal enforcement mechanisms exist to protect even the sophisticated investors.

- The financial innovation created by HF should be fostered and not undermined by burdensome legislation or restrictions on trades in order to ensure efficient, liquid and stable financial markets.[51]
- While being strict on certain core principles the regulation must be more principle based[52] since we do not know how the HF industry will evolve.[53] In our opinion these kinds of rules fit the HF industry particularly well since it enables the regulator to catch up with the more recent developments.[54]
- HF counterparties such as prime brokers and counterparties to derivative instruments are heavily regulated. Therefore an additional prudential regulation of HF is not necessary insofar they do not pose systemic risks.[55]
- The regulator must bear in mind that HF deal with what are supposed to be sophisticated investors. If the definition of sophisticated investors is inaccurate, the corresponding rule has to be changed instead of the whole regulatory framework. Maybe the sophistication should not be assumed simply by looking at the net wealth but the definition should contain qualitative criteria. The regulator should avoid a paternalistic approach to sophisticated investors. Even though frauds like the one of Madoff are terrible for the investors it is nevertheless a good reminder for investors that there is unfortunately no free lunch. Furthermore, frauds are very difficult to detect and such a thing as zero risk does not exist.
- Every moral hazard associated with supervision of HF must be avoided to the extent possible. The regulatory framework should also avoid creating the false impression that the adverse selection's issue has been solved although this is not the case. This occurs when two categories of HF are established based upon their size. The investor is given the impression that the regulated ones are «good» HF although they are only regulated because of their size. The size and the resulting regulation, does not mean that the HF is better than the unregulated one.
- An eventual systemic regulator needs information about HF to perform its supervision's duty.

IV. Current Regulatory Framework

A. USA

[Rz 19] Despite some frauds and the collapse of LTCM, HF are basically not regulated in the USA. Nevertheless, more than 2,000 of HF have registered with the SEC since the latter eliminated the safe harbor provision of section 203(b) of the Advisers Act by redefining how to count clients of a private fund.[56] The rule which was overturned by Goldstein[57] subjected all HF that permitted redemptions within two years of purchase to supervision by the SEC.[58]

[Rz 20] The lack of mandatory registration is obviously due to the Goldstein's ruling combined with the following exemptions:

B. Securities Act of 1933 («Securities Act»)

[Rz 21] Every public offering of securities involving U.S. jurisdictional means must be registered with SEC unless an exemption is available.[59] One exemption is the private offering according to section 4(2) of the Securities Act. Private placements of participations in HF are generally made through the safe harbor Rule 506 of Regulation D.[60] This rule permits the sale of securities to an unlimited number for accredited investors. It qualifies as an accredited investor any individual whose net worth or joint net worth with that person's spouse

49 *See supra* note 43, at 994.

50 *Id.*, at 989.

51 *Id.*

52 Speech by Callum McCarthy, Chairman of FSA, *British American Business London Series and Financial Services Forum*, February 13, 2007. This speech gives a good overview of how the principle based regulation works.

53 *See supra* note 12.

54 *See supra* note 52.

55 Michael King, Bank of International Settlements, Philipp Maier, Bank of Canada, Best way to regulate HF is to regulate prime brokers better, Hedge Fund Regulation, November 11, 2008.

56 Registration under the Advisers Act of Certain Hedge Fund Advisers, 66 Fed. Reg. 72054 (Dec. 10, 2004).

57 *Goldstein v. SEC*, 451 F.3d 873, 874 (D.C. Cir. 2006).

58 *See supra* note 43.

59 E. GREENE, E. ROSEN, L. SILVERMAN, D. BRAVERMAN, S. SPERBER, U.S. REGULATION OF THE INERNATIONAL SECURITIES AND DERIVATIVES MARKETS §1.02 (2006), at 1-6.

60 JAMES M. SCHELL, PRIVATE EQUITY FUNDS, BUSINESS STRUCTURE AND OPERATIONS §8.01[2] (2008), at 8.10; Please note that an amendment to Regulation D has been proposed by the SEC on August 3, 2007. The new Regulation is aimed at large accredited investors and would expand the possibilities of advertising by the HF. Furthermore, the regulation would strengthen Rule 506 in adding to the current annual income and net worth standards an alternative investments-owned standard of 0,000 for individuals and ,000,000 for entities. Furthermore, the adoption of proposed Rules 509 and 216 would create a new «natural accredited investor standard». Basically an additional ,500,000 in investments would be required to be accredited investor.

exceeds $1,000,000 at the time of the purchase or whose income exceeds $200,000 a year the two most recent years prior to the purchase. A corporation qualifies as accredited investor when it has more than $5,000,000 in assets. Furthermore, Rule 502(c) prohibits any offer or sale through general solicitation or general advertising.[61] A form D must be filed electronically in order to be covered by Regulation D.

1. Securities Exchange Act of 1934

[Rz 22] According to section 12(g) of the Securities Exchange Act domestic issuers of securities with total assets exceeding $10,000,000 and a class of securities held of record by 500 or more persons must register such class of securities unless there is an exemption available.[62] HF strive to avoid such a registration of the partnership's interests since then the HF is subject to periodic disclosure obligations.

2. ERISA

[Rz 23] HF[63] are generally subject to the Employee Retirement Income Security Act of 1974 («ERISA») if «benefit plan investors» hold, in the aggregate, more than 25% of interests in a HF.[64] Since the adoption of the Pension Protection Act of 2006 the participation of a fund of funds, which qualifies as «benefit plan investor» because it has more than 25% of its assets coming from pension plans, will cause the HF to qualify as «benefit plan investor» only insofar the percentage of ERISA investments by the fund of funds in an HF exceeds 25% of the HF's assets.[65] HF try to avoid such a qualification since it implies further fiduciary duties and compensation limitations which may not be compatible with the typical structure of HF.[66]

3. Investment Company Act of 1940

[Rz 24] The Investment Company Act requires investment companies to register unless there is an exemption. There are basically two exceptions available to HF: (i) they have less than 100 beneficial owners which qualify as «accredited investors» pursuant to the Securities Act or (ii) they can have an unlimited number of «qualified purchasers» defined by the Investment Company Act.[67]

[Rz 25] (i) In addition to qualify as accredited investors the HF may neither publicly offer its interest in accordance with the Securities Act nor have more than 100 beneficial owners. In order to count the 100 beneficial owners there is a look through rule (section 3(c)(1) of the Investment Company Act). If an investing entity owns less than ten percent of the interests of the HF it will be considered as one person. However if a company owns ten percent or more of the interests of the HF and the ten percent owner is an investment company in the sense of the Investment Company Act, the beneficial owners of the ten percent owner are deemed to be beneficial owners of the HF.[68] The different HF managed by a single HF manager may be integrated if they have the same strategy.[69] The goal of the integration is to prevent HF from circumventing the exemption.

[Rz 26] (ii) The other exemption is open to qualified individual purchasers who own more than $5,000,000 in investments or qualified companies which own more than $25,000,000 in investments. Knowledgeable employees and directors also qualify as qualified purchasers under the Investment Company Act.[70]

[Rz 27] HF do their best to fit in one exemption since the Investment Company Act imposes certain restrictions on investments, transactions with affiliates, compensation, use of leverage, and requires independent directors as well as periodic filings.[71]

4. Investment Advisers Act of 1940

[Rz 28] Investment advisers are required to register with the SEC under the Investment Adviser Act. A person who «for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to advisability of investing in, purchasing, or selling securities […]»[72] is an investment adviser. Performance fees may not be charged unless the client has more than $1,000,000 under management with the adviser. Nevertheless section 203(b) of the Investment Advisers Act provides that an investment adviser having less than fifteen clients is exempted from registration. Each HF counts as one client of the HF manager.[73]

[Rz 29] The proposal of the SEC to adopt a new Rule 203(b)(3)-2 of the Investment Advisers Act in 2006[74] would have eliminated the possibility to count only the HF and not the investors themselves as clients. This would have implied that the HF with a lock in period of less than two years would have had to register with the SEC. In fact, a lot of HF registered

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61 *See supra* note 1, at 266.

62 *Id.*, at 268. It is worth noting that under section 7704 of the Internal Revenue Code a partnership is treated as a corporation if interests are deemed to be traded on a secondary market. This can be avoided if the HF limits investor redemptions or the number of investors to 100.

63 Plan Asset Regulations of the Employee Retirement Income Security Act of 1974.

64 *Id.*, at 268.

65 *See supra* note 60, at 8-66.5.

66 *Id*, at 8-62.

67 *See supra* note 1, at 272.

68 *See supra* note 60, at 8-38.1.

69 *Id.*, at 8-38-2.

70 *See supra* note 1, at 273.

71 *Id.*, at 269.

72 15 U.S.C § 80b-2(a)(11) (2000); *See supra* note 2, at 1183.

73 17 C.F.R. § 275.203(b)(3)-1(b)(3) (2008).

74 Registration under the Advisers Act of Certain Hedge Fund Advisers, 66 Fed. Reg. 72054 (Dec. 10, 2004).

with the SEC in preparation of this new regulation and have never withdrawn their registration statement since this new rule was struck down in *Goldstein v. SEC*.

[Rz 30] The registration with the SEC as investment adviser «means, among other things, that a hedge fund manager must (1) file a Form ADV with the SEC, which requires disclosures regarding the fund's business practices and the manager's background, although the manager does not have to disclose details of the fund's investment strategies or trades; (2) deliver basic information to clients about the fund's business practices and the manager's background; (3) adopt a code of ethics; (5) develop a system of internal controls and compliance procedures to prevent violation of the Adviser's Act; (6) appoint a chief compliance officer […]»[75] and (7) maintain specified books and records available to the SEC. The fiduciary duties and prohibitions against fraud apply to the investment adviser even if he is not required to register.

[Rz 31] In our opinion the rules of the Investment Adviser Act create false incentives as they are lax. The auditor of the investment adviser could be a small accounting shop, the compliance officer the brother of one of the principals or the custodian an affiliate of the HF as the fraud of Mr. Madoff taught us. It is better not to regulate than to regulate in a poorly fashion that decreases market discipline. Furthermore, the compliance with very precise rules will always permit the market participants to find ways to get around them. We are of the opinion that Madoff's investors would have been better off with strict compliance principles than a rule stating precisely that the HF needs a compliance officer and omitting to require that this person had to be an independent person. The regulator should reckon that all future possible misbehaviors cannot be foreseen and thus rules cannot encompass them. These elements will be further discussed below.

5. Regulation as Market Participants

[Rz 32] There are five main regulations applicable to HF as market participants: (i) new issues commonly referred to as «Hot Issue Rule» restrict principals of HF to receive initial public offerings of most equity securities, but not convertible bonds, unless these securities are sold to an account in which the beneficial interests of restricted persons do not exceed 10%[76]; (ii) Soft Dollars arrangements which are the commissions paid by HF in excess of the amounts required to compensate brokers for simply executing trades in exchange of research for the HF manager and thus creating conflicts of interest between the HF manager receiving the research and the investors in the HF are restricted[77]; (iii) the Naked Short Selling Antifraud Rule when the HF does not have the ability to deliver the underlying stock because, for example, it cannot borrow, it constitutes a fraud under Rule 10b-21 of the Securities Exchange Act[78]; (iv) public reporting is required when the HF exceeds the threshold of 5% ownership in securities registered with the SEC[79]; (v) the HF must be registered with the Commodity and Futures Commission («CFTC») unless the investors are «sophisticated» in accordance with CFTC Regulation 4.13(a)(4).[80] The aforementioned regulations and exemptions are not intended to be exhaustive but to give a picture of the existing constraints applicable to HF.

6. Proposed Hedge Fund Registration Bill

[Rz 33] In reaction to *Goldstein v. SEC* and the current economic crisis Carl Levin and Charles Grassley introduced a bill requiring HF managers with assets under management exceeding $50,000,000 to register with the SEC.[81] We do not intend to treat this bill in details but it would require the HF to file an annual public disclosure form with the following information made available to the public: names of the companies and natural individuals who are the beneficial owners of the HF's manager, ownership structure, names of affiliates, minimum investment commitment, total number of investors, names of the accountant and broker and the current value of the fund's asset and assets under management.[82] As stated above under IV.A.5 regarding the proposal of the SEC of 2006, we are of the opinion that these kinds of regulation do not provide any benefit to the investors and to the markets in general.

C. EU

1. EU – Legislation

[Rz 34] At the EU level two pieces of legislation could be relevant to HF: the UCITS III Directive (85/611/EEC), which consists of Directive 2001/107/EC of the European Parliament and of the Council (the «Management Directive») and Directive 2001/108/EC of the European Parliament and of the Council (the «Product Directive») and a new UCITS IV[83] ap-

75 *See supra* note 43, at 988-989.

76 *See supra* note 1, at 281.

77 *Id.*, at 282.

78 *Id.*, at 283.

79 *Id.*, at 284

80 *Id.*, at 288.

81 Hedge Fund Transparency Act, S.344 to require hedge funds to register with the Securities Exchange Commission, and for other purposes, January 29, 2009.

82 The Monitor, *Senators Introduce Hedge Fund Registration Bill,* 28 No. 3 BNKFSPR 26;

83 Olivier Sciales, From UCITS III to UCITS IV, Law Blog on Lawyers.com. There are basically five innovations introduced by UCITS IV: (i) the cross border distribution (To cope with this problematic deficiency, it is proposed to replace the current regime with a simple, electronic, regulator-to-regulator notification procedure by which a UCITS seeking to market its units in another Member State informs its own regulator of its intention to do so and sends to it the necessary notification documents); (ii) Key investor information (The simplified prospectus is replaced by a ‹key investor information› document, which will provide key facts to investors

proved by the European Parliament on 13 January 2009, to be implemented in 2011, and the MiFID Directive (2004/39/EC).

[Rz 35] HF managers are subject to UCITS regulation when they elect to manage a UCITS collective investment scheme. Certain HF might elect to manage UCITS collective investment schemes in order to get the European passport facilitating the distribution of HF's interests. Since articles 12 to 22 of the Product Directive impose strict investment restrictions on HF the vast majority of HF managers did not elect to set up UCITS collective investment schemes. Therefore, UCITS collective investment schemes may be viewed as the equivalent of the mutual funds in the USA. As UCITS collective investment schemes do not fit in our definition of HF under II.A we will not expand on these rules further. As regards MiFID HF managers are not subject to this directive regarding their core activity of managing unregulated collective investment schemes.[84] HF would however be subject to MiFID rules if they were selling interests in the EU. In order to avoid being subject to MiFID the offshore HF manager undertakes the sale of interests.[85] The onshore HF manager is in fact an advisory to the offshore HF manager. In addition the onshore HF advisory may promote the HF without being subject to MiFID, but must comply with national regulation which in every European country forbids the promotion of HF to retail investors.[86]

[Rz 36] As we have seen HF can escape regulation at the EU level if they wish to. However, some countries in the EU regulate HF managers or advisors implemented in their country. This is the case in the United Kingdom (UK). We analyze the UK regulation since this set of rules will be relevant to our proposed regulatory framework and this is the most comprehensive set of rules regarding HF in the EU.

before the conclusion of a contract. It will have to be set out in a common format in all Member States, thereby allowing for effective comparison, and shall be presented in a brief manner and in non-technical language, likely to be understood by retail investors); (iii) Fund mergers (provides a framework for domestic and cross-border mergers of UCITS, introducing a basic principle that all UCITS are entitled to merge, regardless of the structure (e.g. corporate, unit trust or contractual); (iv) Master – Feeder Structure (The feeder UCITS and the master UCITS must enter into a legally binding agreement in which the feeder fund will be required, inter alia, to have at least 85% of its assets in a single master fund); (iv) Management Company Passport (The most controversial element introduced by the UCITS III regulation was the management company passport, originally designed to enable a manager that managed UCITS in a number of jurisdictions to centralise its activities within a single jurisdiction. UCITS IV intends to clarify these rules.

84 Article 3 of MiFID Directive; Stephane Janin, *MiFID Impact on Investment Managers*, JOURNAL OF FINANCIAL REGULATION AND COMPLIANCE, vol. 15, number 1, 2007, at 6.

85 Olivier Lodge, Andrew Lowin, UCIS – The new Requirements.

86 Graham P.N. Philips, *Operational risk: an alternative challenge, The regulation, taxation and distribution of hedge funds around the globe*, Investment Management and Real Estate, PriceWaterhouseCooper.

2. UK – Legislation

[Rz 37] Under article 51(1)(a) Financial Services and Markets Act 2000 («FSMA»)[87] HF managers are regulated by the Financial Services Authority («FSA») and subject to FSA Principles for Businesses. There are eleven principles that HF managers or advisors have to comply with[88]:

1 Integrity	A firm must conduct its business with integrity.
2 Skill, care and diligence	A firm must conduct its business with due skill, care and diligence.
3 Management and control	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4 Financial prudence	A firm must maintain adequate financial resources.
5 Market conduct	A firm must observe proper standards of market conduct.
6 Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly.
7 Communications with clients	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8 Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9 Customers: relationships of trust	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10 Clients' assets	A firm must arrange adequate protection for clients' assets when it is responsible for them.
11 Relations with regulators	A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

[Rz 38] In addition to these principles FSA developed the following implementing rules applicable to HF managers or advisors:

- **Senior Management Arrangements, Systems and Controls (SYSC)**[89]: This set of rules is intended to implement Principle 3 (SYSC 1.2.1) and prescribes

87 Order 2001 (SI 2001/544).

88 PRIN 2.1 The Principles available at http://fsahandbook.info/FSA/html/handbook/PRIN/2/1.

89 Available at http://fsahandbook.info/FSA/html/handbook/SYSC.

certain organizational measures that HF have to put in place. These measures concern general organizational requirements, skills of employees, risk control, out-sourcing, record-keeping, conflict of interests, group risk management;

- **Threshold Conditions (COND)**[90]: This document sets out the minimum requirements to remain registered with the FSA;
- **Statements of Principle and Code of Practice for Approved Persons (APER)**[91]: This document sets out the fundamental obligations that an approved person under article 59 of FSMA has to fulfill. There are seven principles;[92]
- **The Fit and Proper test for Approved Persons (FIT)**[93]: This document sets out the main criteria that an approved person has to fulfill to remain registered;
- **General Provisions (GEN)**[94]: This document serves the interpretation of the Handbook, sets out the fees, approval by the FSA, emergencies, status disclosure, the FSA logo and insurance against fines;
- **Asset Managers – Business Standards**[95]: This document is composed of the Conduct of Business Sourcebook (COBS)[96], which sets out how the HF advisory has to perform reporting duties to clients, promotion, best execution and suitability tests, the Client Assets (CASS)[97], which imposes custody requirements on the HF advisory, the Market Conduct (MAR)[98], and the Training and Competence (TC);[99]
- **Supervision (SUP)**[100]: This document regulates how the FSA may gather information from registered managers.

[Rz 39] With regard to the UK legislation applicable to HF managers it is interesting to note that HF managers do not have to comply with prudential rules (e.g. capital requirements; liquidity requirements or restrictions on activities and leverage) and that the information provided by the HF manager is kept confidential by the FSA.

V. Diverse proposals up to date

A. G20

[Rz 40] The G20 summit took place in London on April 2, 2009. In preparation of this summit the Working Group 1 set up to make proposals for enhancing sound regulation and strengthening transparency issued its final report on March 25, 2009 («G20 Report»).[101] The G20 Report contains twenty-five recommendations. We will focus on the recommendations which concern the HF industry. The first set of recommendations refers to institutions that pose systemic risks. The second set of recommendations refers specifically to private pools of capital such as HF.

[Rz 41] According to recommendation 2 every national financial regulator must implement appropriate tools to assess systemic risks and coordinate domestic responses to address such risks.[102] Recommendation 3 provides an idea of the macroprudential tools that the national regulator could use to address systemic risks: (a) Risk-based capital measures with simpler indicators to measure the build-up of leverage, with enhanced sensitivity to off-balance sheet exposures; (b) Capital requirements that adjust over the financial cycle; (c) Loan-loss provisioning standards that incorporate all credit information available; (d) The use of longer historical samples to assess risk and margin requirements; and (e) Greater focus on loan-to-value ratios for mortgages.[103] Under Recommendation 5 every financial institution that poses a systemic risk will be subject to oversight and appropriate prudential rules.[104] The national regulator has to put in place a system that permits to gather relevant information about all financial institutions. Given the importance of systemic risks and the impossibility to undertake this oversight's task without having appropriate information our proposed regulatory framework will address this issue. In accordance with Recommendation 6 the international organizations must develop criteria of systemically important institutions.[105] By now the main criteria are the size, the leverage, the interconnectedness and funding mismatches (short term liabilities versus long term assets). It is interesting to note that these criteria are not new and every financial regulator has had the task to monitor systemically important institutions. We are worried that if no common understanding on this issue is met in the near future, no definition will emerge, letting national regulators alone to answer this question.

[Rz 42] The second set of recommendations requires all pri-

90 Available at http://fsahandbook.info/FSA/html/handbook/COND.

91 Available at http://fsahandbook.info/FSA/html/handbook/APER.

92 Available at http://fsahandbook.info/FSA/html/handbook/APER/2/1.

93 Available at http://fsahandbook.info/FSA/html/handbook/FIT.

94 Available at http://fsahandbook.info/FSA/html/handbook/GEN.

95 Available at http://fsahandbook.info/FSA/html/handbook/.

96 Available at http://fsahandbook.info/FSA/html/handbook/COBS.

97 Available at http://fsahandbook.info/FSA/html/handbook/CASS.

98 Available at http://fsahandbook.info/FSA/html/handbook/MAR.

99 Available at http://fsahandbook.info/FSA/html/handbook/TC.

100 Available at http://fsahandbook.info/FSA/html/handbook/SUP/2.

101 Report of the Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency*, March 25, 2009.

102 *Id.*, at 12.

103 Id.

104 *Id.*, at 13.

105 *Id.*, at 14.

vate pools of capital to be registered with an authority.[106] If this recommendation is only intended to provide the financial regulator with the information needed to perform its task of oversight over systemically important financial institutions we fully agree on its principle. However, registration means very often more than just providing information to the regulator. If this recommendation means that all HF have to be subject to specific rules of business conduct or worse to capital requirements we disagree in principle since we are of the opinion that such a system would be too intrusive as we will explain in our proposed regulatory framework. Furthermore, only HF that pose a systemic risk should be constrained in their management operations.

B. Treasury Secretary Geithner's Proposal

[Rz 43] On March 26, 2009 Treasury Secretary Geithner outlined a framework for regulatory reform.[107] The overall plan deals with four broad components: (i) Addressing Systemic Risk; (ii) Protecting Consumers and Investors; (iii) Eliminating Gaps in the Regulatory Structure; (iv) Fostering International Coordination. The outline of Treasury Secretary of March 26, 2009 was intended to address the (i) component of the plan (i.e. only systemic risk).

[Rz 44] The first part of the plan unveiled on March 26, 2009 («Plan») prescribes the creation of a single independent regulator with responsibility over systemically important firms. The Plan does not reveal which authority would be in charge of this task, but most probably the Federal Reserve System («FED») would act as systemical regulator. It is beyond the scope of this paper to address the suitability of the FED for this task but it could pose certain problems of conflict of interest.[108] The FED could lose its precious independence required for setting the monetary policy.[109] The FED would be drawn as systemic regulator into the politics of regulation, adversely affecting its credibility of its efforts to maintain price stability.[110] Like in the G20 Report the Plan does not give a comprehensive definition of the firms systemically important. It rightly adds one characteristic which is the firm's importance as a source of credit for households, businesses, and governments and as a source of liquidity for the financial system. This regulator would establish higher standards on capital and risk management for systemically important firms. HF above a certain threshold would be required to register with the SEC.

[Rz 45] The registration with the SEC is apparently needed to gather information about HF in order to assess whether they are systemically important. This conflicts with Mr. Parkinson's statement according to which registration is needed following Bernard Madoff's fraud and probably no HF has the size of a systemically important firm.[111] Notwithstanding certain incoherence towards the goal of the registration it is important to recall that Bernard Madoff was registered as Investment Adviser and Broker-Dealer with the SEC. The registration would imply «mandating investor and counterparty disclosure». We construe investor disclosure as meaning that the HF would have to provide certain information to its investors as it provides information to its counterparty. Our understanding is that the investors would remain anonymous as are the counterparties since there is absolutely no purpose of publicly identifying these persons or entities. In addition to this disclosure requirement to contractual parties of the HF regulatory reporting would be provided to the SEC on a confidential basis. This information, when relevant, would be shared by the SEC with the systemical regulator. Then the systemically regulator would be entitled to take preventive actions against a firm that is considered systemically important. The Plan, however, does not provide any detail on the information gathered by the SEC or the business conduct rules that would apply to HF. As we will see in detail below we are of the opinion that mandatory registration is too intrusive and that more proportionate actions could be taken to achieve the same results (i.e. gathering and monitoring systemically important firms).

[Rz 46] It is worth noting that there is no call in the Plan for automatic prudential regulation of HF. HF would be subject to such strains only when they are deemed to be systemically important.

C. EU

[Rz 47] The European Parliament adopted one report drawn up by Poul Nyrup Rasmussen and one drafted by Klaus-Heine Lehne on September 23, 2008.[112] The European Parliament calls for more regulation and especially for prudential regulation.[113] The prudential rules concern capital and liquidity requirements directly imposed on HF.[114] In addition to that counterparties of HF, such as prime brokers, would be required to hold more capital when dealing with HF. The capital adequacy directives (2006/48/EC and 2006/49/EC) would be amended in accordance therewith. Precise rules on leverage and valuation would be also implemented. On the business conduct side the HF would be required to address conflicts of interests arising from different operations. Finally,

[106] *Id.*, at 15.

[107] Report of Treasury Secretary Department, Geithner, *Treasury Outlines Framework For Regulatory Reform*, March 26, 2009.

[108] Peter J. Wallison, *Casting the FED as Systemic Risk Regulator*, FINANCIAL SERVICES OUTLOOK, AEI ONLINE, February 24, 2009, at 2.

[109] European Central Bank, The Role of Central Bank in Prudential Supervision, (2001), at 5.

[110] *See supra* note 108.

[111] *See supra* note 30.

[112] MEPs call for new legislation to ensure financial stability, European Parliament 23rd september 2008.

[113] European Parliament resolution of 23 September 2008 with recommendations to the Commission on hedge funds and private equity.

[114] *See* Recommendation 1 of the Rasmussen Report.

the compensation of the executives would be disclosed. It is however uncertain under Recommendation 2 (c) whether this compensation data would be disclosed to the public or on a confidential basis to the regulator or to the investor. It would be odd to oblige a privately held HF manager to disclose to the public the remuneration of its executives. Even if the information is disclosed only to the investor we do not understand the purpose of the rule since what should and indeed does interest the investor is how much fees he does pay and not how much the HF manager earns thanks to all fees. Furthermore, investors would have demanded such information until this day were they interested in it.

[Rz 48] In response to this vote of the European Parliament the European Commission issued a consultation paper on HF on December 18, 2008 («Consultation Paper»).[115] Comments could be submitted until January 31, 2009. First the Consultation Paper seems to agree upon the possibility that certain HF might be systemically important. On the other hand it reckons that the failure of Amaranth[116] and even LTCM did not create systemic risks since the losses were absorbed by their counterparties. Moreover, the Consultation Paper does seem to challenge the fact that indirect regulation through counterparties' capital requirements is a difficult task. As the current economic crisis has taught us counterparties were not able to manage their risk exposure appropriately. There is therefore a good case for monitoring HF more closely which could pose systemical risks. Second the Consultation Paper addresses the problem of short selling and recognizes that this issue does not concern only HF. An eventual response would thus concern the entire financial system. Third the Consultation Paper stresses the need for improvement in risk management while admitting that liquidity issues are not a major concern. Finally, the Consultation Paper comments on disclosures to investors and takes notice of improvement thanks to the adoption of standards (e.g. the Hedge Fund Standards adopted by the Hedge Fund Standards Board[117]).

[Rz 49] On February 26, 2009 the European Commission announced that it will propose legislation on HF.[118] We expected that the proposal of the European Commission would not go too far as Charles McCreevy, European Commissioner for Internal Market and Services, had already reminded the European Parliament that HF are not responsible for the current economic crisis and he had indicated in the past that he did not support burdensome legislation for HF.[119]

[Rz 50] However, on April 29, 2009, the European Commission proposed new rules that go beyond what we expected. Under these rules, Managers of alternative investment funds («AIFM»), which include hedge funds, private equity funds, real estate funds and commodity funds operating in the European Union and managing more than ¬100 million would be required to register with the financial authority of the country where they operate. A higher threshold of ¬500 million applies to AIFM not using leverage (and having a five years lock-in period for their investors i.e. mainly private equity funds) as they are not regarded as posing systemic risks.[120] The regime will apply irrespective of the legal domicile of the HF. AIFM would be set a minimum capital requirement of ¬125,000, plus 0.02% of the amount by which their portfolios exceed ¬250 million.[121] They would be placed under a legally binding «authorisation and supervisory regime», including requirements to implement solid risk management systems (e.g. AIFM shall implement an appropriate, documented and regularly updated due diligence process when investing on behalf of HF, according to the investment strategy, the objectives and risks profile of the hedge fund), and to take «all reasonable steps» to avoid conflicts of interest (e.g. AIFM shall segregate within its own operating environment, tasks and responsibilities which may be regarded as incompatible with each other. HF Managers shall assess whether its operating conditions may involve any other material conflict of interest and disclose them to HF investors).[122] The proposed Directive provides for a minimum level of service and information provision to its (professional) investors, on an initial and ongoing basis, to facilitate their due diligence and ensure an appropriate level of investor protection. The proposed Directive requires AIFM to provide to their investors a clear description of the investment policy, including descriptions of the type of assets and the use of leverage; redemption policy in normal and exceptional circumstances; valuation, custody, administration and risk management procedures; and fees, charges and expenses associated with the investment.[123] The AIFM will also be required to report to the competent authority of the home Member State on a regular basis on the principle markets and instruments in which it trades its principle exposures, performance data and concentrations of risk. The AIFM will also be required to notify the competent authorities of the home Member State of the identity of the AIF managed, the markets and assets in which HF will invest and the organizational and risk management arrangements established in relation to that HF.[124]

[115] Working Document of the Commission Services (DG Internal Market), Consultation Paper on Hedge Funds, December 18, 2009.

[116] Amaranth Advisors LLC was an American multistrategy hedge fund managing US billion in assets. In September 2006, it collapsed after losing roughly US billion in a single week on natural gas futures.

[117] *See supra* note 10, at 301.

[118] European Commission to Propose Regulation of Hedge Funds and Private Equity Funds, WilmerHale 10th March 2009.

[119] Comment available at www.altassets.com/casefor/hedgefunds/2008/nz14284.php.

[120] 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.

[121] *Id.*

[122] Id.

[123] Id.

[124] Id.

[Rz 51] Moreover, the proposal foresees the creation of an internal market for HF, in which registration in one member state would entitle them to market their fund to professional investors throughout the EU. As a corollary of the common regulatory standard achieved by the draft Directive, Member States of the EU will not be permitted to impose additional requirements on HF managers domiciled in another Member State insofar as marketing to professional investors is concerned. The cross-border marketing of HF to professional investors would be subject only to a notification procedure, under which relevant information is provided to the host Member State.[125] The legislative process will certainly start in October 2009 since a new Commission as well as a new European Parliament will be in charge in June.

[Rz 52] We do not support these new rules for the same reason we object Treasury Secretary Geithner's proposal. Under Part VI of this work, we will explain in details our objections and proposals. Nevertheless, the two main arguments can be summarized as follows. First, we are of the opinion that setting out a threshold above which HF managers have to register creates false incentives. On the one hand it increases the moral hazard of HF managers by giving the wrong signal that relatively big institutions are closely monitored, and thus decreases the market discipline. Furthermore, institutions subject to strict prudential rules tend to be bailed out down the road since governments feel responsible for the failure of supervision. This moral hazard cannot be overstated. On the other hand it creates unfair competition since HF managers labeled as «supervised» could benefit from a competitive advantage over smaller institutions which are not regulated. In other words this establishes two unrepresentative classes of HF: the «good» and the «bad» although «good» ones can be unregulated and «bad» ones regulated. This is in our opinion the wrong answer to the adverse selection's issue. In our proposed regulatory framework different classes would be created based upon qualitative criteria opened to all HF and not mandatory quantitative criteria. Second, the legislation sets out requirements that could be unnecessarily burdensome for certain HF managers. We do not understand why HF managing more than ¬100 millions should be imposed prudential rules when they do not pose systemic risks. Such rules could impact the efficiency of the HF, and thus adversely strike the efficiency of the European capital markets.

D. Consequences of the EU Directive for HF Managers based in Switzerland

[Rz 53] To the extent the marketing activities of the HF Manager in or from Switzerland of shares or interests in an unregistered foreign collective investment scheme do not constitute a «public offering» within the meaning of the Swiss Collective Investment Schemes Act of June 23 2006 («SCISA»), the conduct of asset management, investment advisory or research for a non-Swiss collective investment scheme is not regulated in Switzerland. Nevertheless compliance with the Swiss Money-Laundering Act and its implementing ordinances is mandatory.

[Rz 54] The draft EU Directive provides for specific rules in relation to third countries. In particular, the European Commission will allow, after a transition period of three years, AIFM established in a third country (including Switzerland) to market their funds in a Member State of the EU provided in particular that (i) the regulator framework and supervisory arrangements in that third country are equivalent to those of the proposed Directive, (ii) EU operators enjoy comparable access to that third party legislation, (iii) a cooperation agreement between the competent authorities of the relevant Member State and the supervisor of the AIFM exists which ensures an efficient exchange of all information that are relevant for monitoring the potential implications of the activities of the AIFM for the stability of systematically relevant financial institutions and the orderly functioning of markets in which the AIMF is active, and (iv) the third country has signed an agreement with the Member State in which it applies for authorisation which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters.[126] So far the Swiss regulator has launched the idea of an amendment of Article 13 Section 4 of the SCISA which would permit HF managers based in Switzerland but managing offshore funds to be subject to regulation on a voluntary basis.[127] If the EU Directive entered into force it would mean that all HF managers based in Switzerland would probably use this right to become regulated under this new Article 13 Section 4 of the SCISA in order to keep their European investors. We assume here that such an amendment could be deemed equivalent by the EU. In practice all HF managers based in Switzerland would be regulated.

VI. Proposed Regulatory Framework

A. Introduction

[Rz 55] Under III.B we set out nine concerns related to the regulation of HF that the regulator should take into account when it attempts to design the new system. Unfortunately, the regulator's judgment is often obscured by cognitive biases.[128] «Whatever value judgments motivate regulators and, as a result, whatever normative weights regulator place on various outcomes, unconscious biases that affect regulator's

[125] Id.

[126] Id.

[127] Swiss Federal Banking Commission, Hedge-Fonds, Markentwicklung, Risiken und Regulierung, Positionspapier der Eidg. Bankenkommission, at 54, September 2007.

[128] *See supra* note 43, at 1023.

judgment and decision can frustrate regulatory efforts, even when regulators are acting in what they honestly believe is the best interest of the public.»[129] After the frauds recently uncovered in the world of asset management it is very likely that regulator's judgment will be biased when faced with crafting new rules. This is what should be avoided right now.

[Rz 56] As Professor Paredes further noticed in his article an additional problem is that «policymakers often see themselves as having two choices: adopt particular mandates or do nothing».[130] But there is a middle path consisting in default rules that market participants can bargain around.[131] We explain how this system works out and why it could benefit Switzerland to adopt it in light of the latest developments in the EU and to create a regulatory framework as regards HF managers which will place Switzerland at a «regulatory» advantage relative to the EU or the USA. This new Swiss regulatory framework would only regulate the conduct of asset management, investment advisory or research for non-Swiss collective investment schemes which are not regulated in Switzerland. In our opinion, such a system of notification and opting-out could be deemed equivalent under the EU Directive without mandatory subjecting all HF managers to the somewhat burdensome rules of the SCISA.[132] This lets us thinking that our regulatory framework is likely superior to a more straightforward amendment of Article 13 Section 4 SCISA which would result in practice of regulating almost all HF managers in Switzerland.[133] We agree with the reports cited under II.C that HF should be regulated at the place of domicile of the HF advisor or manager since there is in fact no other good alternative. We do not get involved in the debate as to which authority is in better place to perform the supervision.

B. Detailed Rules

1. Notice to FINMA in connection with an Opt-out

[Rz 57] Every advisor or manager of HF would have to give notice to the FINMA regarding their activity.[134] The FINMA would be granted extensive power to collect information about the activity. This permits the FINMA to share this information with a systemic regulator, if new created, in case the size of the HF does raise systemic concerns. When the HF is considered systemically important the systemic regulator whether the FINMA or another newly created institution can impose on it prudential rules described under VI.B.3. It is important to stress that the applicability of the prudential rules in the event the HF is systematically important cannot be opted out.

[Rz 58] In addition to giving notice the HF manager or advisor has to opt out if he wants to avoid being subject to regulation except that the HF cannot opt out of the prudential regulation imposed on systemically important institutions. This relates to the second pillar of the regulation. The opt-out rule is appealing since it gives much more information to the market participants than an opt-in.[135] The HF manager or advisor would have to explain in relative details why he cannot or does not want to comply with the stringent rules established by the authority. We have to bear in mind that the more stringent the rules are the more likely they do not fit all forms of business and we are of the opinion that if there is regulation it should be stringent in order to overcome the moral hazard and adverse selection problems. For example if the authority mandates a certain valuation technique for assets it is possible that a HF having an activity close to a private equity fund would have some great difficulties to value the assets in accordance with such a rule.

[Rz 59] Moreover, the opt-out should not be too burdensome for small HF managers while allowing them to be regulated if they wish to have the competitive advantage connected with the label «regulated». We assume that HF managers of all kinds of HF (small, mid-size, big) would decide to opt-out (managers of small HF probably to keep compliance costs low, what an investor would understand, and all HF managers for other reasons, e.g. innovation, inappropriate rules). Thanks to various practices across the industry the investor would keep his guard and the market discipline would thus be preserved. Put differently not only HF managers of one sort or size of HF will be registered or would have opted out and this variety increases the vigilance of the investors. This is superior to a system where HF managers have to register when the HF reaches a certain size because such a rule would send the following signal to the investors: every middle size HF is regulated (decreasing the market discipline), so it is safe, but small HF are not, so keep your guard. We cannot overstate how market discipline is important and how the illusion of solving the problem of adverse selection can be harmful. The day HF are perceived as mutual funds the investors could be in trouble since they would stop conducting thorough due diligence. In our opinion, the amendment of Article 13 Section 14 of SCISA proposed so far by the Swiss Federal Banking Commission does not sufficiently take into account these elements since this amendment together with the EU Directive would result in the regulation of almost all HF managers.

[Rz 60] Finally, the opt-out permits HF managers to innovate by allowing them to contract out the rules that do not fit their strategies. The innovation creates more efficient and liquid markets which in turn decrease the cost of capital permitting

[129] *Id.*, at 1023.

[130] *Id.*, at 979.

[131] Id.

[132] Our system requires a notification and an opting out which would be much less burdensome than a registration connected with a supervision.

[133] If the HF manager did not subject itself to the SCISA it would be prevented from having European investors.

[134] *See supra* note 2, at 1191.

[135] *See supra* note 43, at 1026.

companies to invest in more projects with net positive present value.

2. Regulation Applicable to Registered Hedge Funds

[Rz 61] HF managers or advisors which do not opt-out would be regulated by the FINMA. The regulation should follow the Principles and Best Practices developed by the President's Working Group[136] and the Hedge Fund Standards drafted by the Hedge Fund Standards Board (both reports together hereinafter referred to as the «Standards»). Naturally, instead of «should» the rules would be drafted in «shall» to become mandatory. Finally, the regulation of HF by the FSA is a good starting point. FSA can gather relevant information and monitors closely the activity of HF with a specific team dedicated to HF.[137] The FSA has probably the best understanding and data on HF. It will also be interesting to see the reaction of the FSA to the regulation proposed by the European Commission.

[Rz 62] We propose some principles on five topics. These recommendations are drawn upon the work of John P. Hunt[138] and the Standards and do not intend to be exhaustive. We stress the fact that in our proposed regulatory framework HF can opt-out.

a) Disclosure

- The reporting system shall take «core principles» of the public company reporting regime and adapt them to hedge funds. The disclosure is intended to be towards the investors and not the public.
- HF managers shall communicate to investors the risk profile and the investment policy of the HF. The risk profile disclosure shall include at least the following information: realized volatility, value at risk measures, leverage (and explain which type of leverage is used and why this type is used), percentage of hard-to-value assets, investment instruments used during the reporting period and every unusual concentration of the portfolio in one class of assets.
- The private placement memorandum, periodic performance information and other investor communications shall be clear and disclose all material information in an unequivocal fashion, including side letters. The calculation of the performance shall be agreed upon in advance between the fund administrator and the HF manager and be disclosed in the offering documents.
- Every change in investment policy shall be approved by an advisory board composed of some investors. This is relevant since this crisis has shown that at least some HF invested much more in illiquid assets than stated at the outset of the relationship with the investor.
- All HF managers shall provide annual audited GAAP compliant financial statements to investors.
- HF managers and counterparties shall agree at initiation of the relationship on the information HF make available, adding that such information should be subject to appropriate protection of confidentiality. It is very difficult to state in general terms which information is needed by the counterparties due to the variety of financing methods. Nevertheless HF shall commit to the highest transparency while counterparties commit to the highest confidentiality.
- HF managers shall comply with information requests emanating from the regulator. Disclosure of position on a confidential basis may be requested by the regulator. All information filed by HF is kept confidential by the regulator in order to constraint the attraction of the public for HF. HF may not be distributed to retail investors. Consistent with that premise no information should be disclosed to the public.
- HF shall disclose their controlling investors (e.g. investors having controlling rights) in order to ensure that these persons conduct irreproachable activity.

b) Valuation

- The valuation of assets shall be segregated from the portfolio management. A third party shall be primarily responsible to perform this task in collaboration with an in-house responsible. The in-house responsible shall not be compensated based on the performance of the HF.
- HF managers shall report what percentage of fund assets are at each level of the FAS 157 hierarchy of valuation difficulty.[139]
- HF managers shall place hard-to-value assets which are intended to be held over a long period into side-pocket funds. The redeeming investor shall get a proportionate participation to this side-pocket fund.[140] The problem of the fees levied on such side pocket funds shall be addressed in the offering documents and performance fees shall not be perceived on these

[136] *See supra* note 33 and 11.

[137] For more details *see* FSA, *Hedge Funds:* A discussion of risk and regulatory engagement, Feedback on DP 05/4, March 2006.

[138] John P. Hunt, White Paper, *Hedge Fund Regulation: The President's Working Group Committees' Best Practices Reports – Raising the Bar but Missing Risks*, Appendix: Summary of Key Committee Recommendations, Berkeley Law, June 2008, available at bclbe@law.berkeley.edu.

[139] There are three levels: The first for observable market prices; the second for less observable market prices but not quoted; and the third for hard to value assets. If the assets are supposed to be held for a long term the historical price should be accounted for since the mark-to-market accounting makes sense only for trading assets.

[140] *See supra* note 10, at 43 for a good overview of the problematic.

funds until the investment is realized. This is consistent with historical cost accounting.

c) Risk Management

- HF managers shall determine an overall risk profile for the fund and adopt a comprehensive framework to measure, monitor, and manage risk.
- As stated under the disclosure section HF managers shall disclose separately any material risk related information to investors and to the regulator.
- The risks shall be broken down into different categories: Portfolio Risk, Operational Risk and Outsourcing Risk. Portfolio risks are basically composed of market risks, counterparty risk, liquidity risk and leverage risk. The operational risks shall be addressed by internal controls, corporate governance, Chinese walls, sound IT systems, legal advises and processes regarding the trading activity. To address the outsourcing risk the HF managers shall put in place assessment methods regarding their business partners. The HF shall appoint a reputable and independent auditor.

d) Conflicts of Interest

- Conflicts of interest shall be addressed in the documents establishing the structure. An advisory board composed of investors shall be created to resolve potential conflicts of interest arising from the relationship. All conflicts of interest shall be disclosed to investors. The regulator shall acknowledge that the current structure of HF where HF principals invest along with other investors decrease the potential conflicts of interest. Furthermore, too much focus on corporate governance could institutionalize HF with bad consequences on incentive compensation by creating a gap between ownership and management.[141]
- HF managers shall segregate the valuation of assets and calculation of fees from the portfolio activities. An independent fund administrator shall perform these tasks in collaboration with an in-house responsible.
- The custodian (often prime broker) shall be independent from the HF managers.

e) Market Abuse

- HF managers are already subject to the market abuse and anti-fraud provisions of the Swiss Criminal Code and related stock exchange regulations. HF managers shall implement procedures ensuring compliance with these rules.

[141] Gretchen Morgenson of New York Times reporting on John C. Bogle, He does not let Money Managers off the Hook.

3. Systemic Supervision by an Authority to be Defined

[Rz 63] As we have described above under II.D HF might pose systemic risks due to their large aggregate size and trading volume as well as channels through which distress in the HF sector could spread to the wider economy.[142] In any case, as Mr. Turner points it out in the Turner Review HF could evolve and the regulator has to keep pace with these developments.[143] Therefore we propose through the opt-out system that all HF have to report to an authority whether monitored by the regulator or not. This information is intended to serve the systemic regulator.

[Rz 64] If the systemic regulator decides that a HF, regulated or not, has reached a «critical size» (still to be defined by the lawmakers; probably the size, the leverage, the interconnectedness and funding mismatches) it could subject it to prudential rules. We propose that this information would be kept confidential between the systemic regulator, the HF regulator and the HF in order to avoid great moral hazard on the counterparties. The prudential rules could consist in capital requirements and restriction of certain activities. The HF could also be forced to close capital contributions to avoid a «too big to fail» situation.

[Rz 65] We acknowledge that work has still to be done to propose a decent definition of systemic institutions and such a task is beyond this work. But a definition has to be proposed since it is not foreseeable to give very extensive powers to the systemic regulator without constraining its ability to declare an institution systemically important.

VII. Conclusion

[Rz 66] As Professor Paredes prophesized in 2006 securities regulators will get it «wrong» when they regulate under uncertainty.[144] It is difficult to imagine a more uncertain period than the actual one. Therefore, Swiss regulators and lawmakers should be careful when crafting a new regime that will have a great impact on the financial markets, and thus on the life of every citizen, and last for an indefinite period. It is precisely now that the regulator should recognize its vulnerabilities and use its power in a measured way.

[Rz 67] Given the last developments in the EU which will have consequences for Switzerland and the fact that we are not blindly confident in self-regulation we have proposed a middle path consisting of stringent rules applicable to HF willing to be regulated and leaving the others the possibility to explain why they do not want or cannot respect the rules. The

[142] John Kambhu, Til Scheuerman and Kevin Stiroh, *Hedge Funds, Financial Intermediation, and Systemic Risk*, FEDERAL RESERVE BANK OF N.Y. ECON. POL. REV (2008), at 6.

[143] *See supra* note 12.

[144] *See supra* note 43.

explanation statement would unveil important information to market participants while letting innovative and creative people do their business as they think it should be done. We are confident that such a regulatory framework would provide the flexibility needed by the markets while protecting the interests of the investors and the economic system in general.

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