

“INVESTOR PROTECTION” IN EUROPE AND THE UNITED STATES: IMPACTING THE FUTURE OF HEDGE FUNDS

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I. INTRODUCTION

As the hedge fund market has grown into an influential force in financial trading markets, the call for sweeping hedge fund industry regulation has intensified. For years, hedge funds have operated largely without restraint, and the substantial growth of the industry has raised concerns about the need to introduce regulation. But regulators appear to be unsure what controls are necessary and have been hesitant to create sweeping hedge fund regulation. Hedge funds are complex financial products, and because this market has developed without substantial governmental oversight, regulators have little understanding of how the hedge fund market functions and thus the potential impact of regulation. This has led to much debate about whether regulation is necessary, what type would be effective, and what the true consequences of regulation would be. Despite the existing freedom, regulatory changes are beginning to emerge, including the Securities and Exchange Commission’s (SEC) unsuccessful attempt to impose registration requirements in the United States and increased monitoring from the Financial Services Authority (FSA) in the United Kingdom.¹

This Article looks at regulatory questions unique to hedge funds by discussing the changes in regulatory standards—particularly in the United States, United Kingdom, and the European Union—the responses to these changes and proposed regulations, and how the proposed or potential regulations may address the risks associated with hedge funds. The Article first discusses the history of hedge funds² and their defining characteristics and structures. It then reviews the historical regulatory

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¹ Pauline Skypala, *Industry Taking Regulation in Stride*, FIN. TIMES (U.K.), Jan. 9, 2006, at 6, available at 2006 WLNR 460614. See *Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006).

² Throughout this Article the terms “funds” and “hedge funds” are used interchangeably.

structures in the United States and parts of Europe. This background will help clarify the regulatory issues that follow. After setting forth these issues, the Article looks at changes to United States regulations that were recently incorporated and subsequently vacated. It also looks at European Union (EU) regulation and the unique consolidation issues the EU faces in managing the different regulatory requirements of its members. Further, the Article discusses recent developments in the UK hedge fund market. Most hedge funds are managed in the United States and the United Kingdom, and thus an understanding of these policies covers most regulatory issues. In its analysis, the Article compares the possible regulatory approaches and reviews how they influence one another, and, finally, attempts to predict the direction of hedge fund regulation in the United States and throughout Europe.

II. BACKGROUND: HEDGE FUNDS ARE COMPLEX FINANCIAL INSTRUMENTS THAT HAVE DEVELOPED UNDER A HISTORICAL LACK OF REGULATION

Identifying hedge funds is essential to understanding regulation because of the funds' complexity as a financial investment and business model. "Hedge fund" loosely refers to a certain type of investment strategy with a high investment risk and reward.³ The hedge fund is not a legal term but rather an industry term. It has come to signify a business organization with limited regulation and high net-worth members utilizing complex investment strategies.⁴ Traditionally hedge funds are identified by three components: their business organization, investment strategy, and investor pool.⁵

The funds are set up largely in the Cayman Islands for entity purposes.⁶ When a fund is said to be "in" the United States or the United Kingdom, this typically refers to where the fund is managed. Currently,

³ See *Hedge Fund is Now a Meaningless Term*, FIN. TIMES (U.K.), Aug. 18, 2005, at 20, available at 2005 WLNR 12960107.

⁴ Erik J. Greupner, *Hedge Funds Are Headed Down-market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1560-61 (2003).

⁵ Neil A. Chriss, Introduction to Hedge Funds, lecture to NYU Math Faculty (Dec. 1998), <http://www.math.nyu.edu/faculty/chriss/neil/lecture12/hedgelfunds.htm> (last visited May 30, 2007).

⁶ *Cayman Islands Mark 8,000th Hedge Fund*, PR NEWSWIRE, Sept. 13, 2006 [hereinafter *Cayman Islands*].

over eight thousand hedge funds are based in the Cayman Islands,⁷ which provide tax-free jurisdiction.⁸ Because hedge entities often exist outside their territorial jurisdiction, the United States and the United Kingdom are left with shifting the regulatory focus to the funds' other components, namely, fund managers and investors.

Hedge fund strategies largely involve the extensive use of options,⁹ derivatives,¹⁰ and high leverage.¹¹ Generally, hedge fund investment strategies are considered risky because of the potential for large gains and losses inherent in derivatives markets, which are enhanced by leveraged positions. Because there are many different investment techniques that are pursued by hedge funds, direct regulation is difficult.¹² These strategies result in hedge funds having two other identifying characteristics: high rates of return and (proportionately) higher management fees.¹³ Unlike other fund types, hedge fund management fees are not restricted, but investors are willing to pay higher fees because of the high rates of return managers deliver to them.¹⁴

Hedge funds' investor pools are the focus of regulation in both the United States and the United Kingdom.¹⁵ Hedge fund investor pools are mostly made up of high net-worth investors, which are increasingly institutional investors because of the risks associated with the investment strategies.¹⁶ In the United States, hedge funds are largely identified through investor pools.¹⁷ The Investment Company Act of 1940, as amended through the National Securities Markets Improvement Act of

⁷ *Id.* at 5; Neil Lomax, *Offshore: Fundamentals of Change*, LEGAL WEEK, Mar. 16, 2006.

⁸ *Cayman Islands*, *supra* note 6.

⁹ An option is "[t]he right to buy or sell a fixed quantity of a commodity, currency, security, etc., at a particular date at a particular price (the exercise price). Unlike futures, the purchaser of an option is not obliged to buy or sell at the exercise price and will only do so if it is profitable." DICTIONARY OF FINANCE 206 (Brian Butler & Alan Isaacs eds., 1993).

¹⁰ A derivative is "[a] financial instrument that is valued according to the expected price movements of an underlying asset, which may be a commodity, a currency, or a security." *Id.* at 82.

¹¹ Leverage is when a company uses "its limited assets to guarantee substantial loans to finance its business." *Id.* at 162. *See also* Chriss, *supra* note 5, at "Hedge Funds".

¹² Chriss, *supra* note 5. *See also* Hedge Fund Research, Inc., *HRFI Indices*, available at www.hedgefundresearch.com (follow "HFRI Monthly Indices" hyperlink under "HFR Indices" hyperlink; then follow "Strategies" hyperlink) (last visited Mar. 17, 2007) (hedge fund research currently has thirty-seven hedge fund indices, all based on distinct fund strategies).

¹³ Chriss, *supra* note 5, at "Pension Funds".

¹⁴ *Id.* at "Liquidity".

¹⁵ Helen Parry, *Hedge Funds, Hot Markets and the High Net Worth Investor: A Case for Greater Protection?*, 21 NW. J. INT'L L. & BUS. 703, 704-05 (2001).

¹⁶ *Id.* at 704.

¹⁷ *Id.*

1996, does not require hedge funds to register as long as they (1) sell to a limited number of qualified investors, and (2) do not make a public offering of the fund.¹⁸ Theoretically, any private fund can rely on the regulatory exemption, but the technique has been made popular largely by hedge funds. Hedge funds have commonly used the exception to avoid registering as an investment company or a securities offering, thus freeing themselves of the related substantial reporting and compliance requirements.¹⁹ Restrictions have a similar focus in the United Kingdom. UK hedge funds are categorized as “unregulated collective schemes” and have substantial restrictions on who may invest but looser regulations for fund management and reporting.²⁰

For regulatory purposes, a definition of hedge fund is nonexistent. This is partly because the large number of investment strategies and business structures creates difficulty for any regulatory definition to capture all types of hedge funds. The SEC has yet to define the term even in recent amendments specifically directed at hedge fund regulation.²¹ Despite the difficulty, a working definition of hedge funds and an understanding of how they function are fundamental to understanding regulatory policy because, as U.S. and UK regulations demonstrate, how hedge funds are defined may lead to divergent regulatory policies.

The SEC and FSA have relied on the three salient markers discussed above (business organization, investment strategy, and investor pools) to identify hedge funds and bring focus to their regulatory policies. The next section looks at the different approaches taken the United States, the United Kingdom, and the European Union.

¹⁸ 15 U.S.C. § 80a-3(c)(1) (2000); Greupner, *supra* note 4, at 1562 (noting that the NSMIA increases the amount of limited investors originally allowed by the 1940 Act).

¹⁹ 15 U.S.C. § 80a-3(c)(1); Greupner, *supra* note 4, at 1561-62. See DIVISION OF INVESTMENT MANAGEMENT, SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, EXECUTIVE SUMMARY ix-x (Sept. 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

²⁰ Parry, *supra* note 15, at 705.

²¹ Norton Rose, *United States: Hedge Funds—New US Regulation Requirements*, J. INT’L. BANKING L. & REG. 20(7) n.62, n.63 (2005), available at J.I.B.L.R. 2005, 20(7), n.62-64 (Westlaw).

III. AN INTRODUCTION TO FINANCIAL MARKETS AND REGULATORY POLICY

Because of sparse U.S. regulations, hedge funds have been operating autonomously since their inception in the United States. Since the early 1990s, the funds have saturated the U.S. market and have spread throughout Europe and into the Southeast Asian financial markets. This growth has created the call for regulation and reporting requirements. Regulatory proponents argue that the funds are no longer boutique financial products that can be overlooked because of their small market; rather, hedge funds' impact on financial markets needs to be recognized and understood. Hedge fund proponents argue against increased transparency because they say current reporting standards that apply to other investment funds would be misleading to hedge fund investors.²² The complex and short-term nature of the investments, along with the extensive off-balance sheet techniques employed by hedge funds, make reporting virtually meaningless to most investors.²³

There are two key policy goals of hedge fund regulation: market stability and investor protection.²⁴ The complexity of hedge funds as financial instruments invariably leads to difficulty in understanding the best methods for achieving these policy goals. The fundamental argument for any investment regulation stems from the need for investor protection. As a basic regulatory purpose, investor protections are necessary to effectively facilitate the formation of capital or encourage market participation.²⁵ In addition, increased investor protection is viewed as more important as the complexity and risk of the investment increase, because investors may not fully grasp what the investment decision involves. Protection is typically accomplished through disclosure and reporting regulations that provide full information to potential investors.²⁶

²² See James M. Amend, *Despite Pressures, It's Business as Usual for Hedge Funds*, MONEY MGMT. EXECUTIVE, Jan. 9, 2006, available at 2006 WLNR 462070 [hereinafter Amend, *Despite Pressures*].

²³ *Id.*

²⁴ Market stability is essentially a derivative or alternative form of investor protection. The distinction in this context is that the phrase "investor protection" focuses on those who actually invest or are looking to invest in hedge funds, while the phrase "market stability" refers to protecting the investors and markets generally from systemic risk.

²⁵ Yet these fundamental arguments appear to not even be an issue for hedge funds, as they continue to grow exponentially. See Parry, *supra* note 15, at 704.

²⁶ See generally 15 U.S.C. § 80 (2000).

In the case of hedge funds, countries have taken a variety of approaches to providing investor protection. Historically, the United States has had an open regulatory policy towards hedge funds, relying on barriers to entry into hedge fund markets to protect investors.²⁷ These barriers place restrictions on potential hedge fund investors and hedge fund marketing. Another approach is illustrated by EU policy, which historically has restricted the investment strategies of financial products sold in member countries.²⁸ The EU has unique goals because its objective is to create products that may be sold in all EU countries.²⁹ Limiting investment strategies, however, has affected the growth and maturity of EU financial products.³⁰ In between the regulatory approaches of the United States and the EU is the United Kingdom. The UK has restrictions similar to the United States, but its Financial Services Authority (FSA) seems more focused on monitoring UK fund managers.³¹ Despite differences among the approaches, policies are beginning to converge. The United States has attempted to introduce reporting requirements, while the EU has eased restrictions on investment strategies, and the UK has stepped up its monitoring practices.³²

The U.S. regulatory policy's chosen reliance on barriers to entry in hedge fund markets can be called an "indirect regulation approach" to investor protection.³³ It is referred to as indirect regulation because the funds themselves are largely unregulated once they have been formed. This type of investor protection does not change the high risk of substantial losses but merely limits who is exposed to these risks.³⁴ Although the United States has faced hedge fund failures in the past, regulatory policy has favored focusing on disclosure requirements and investor restrictions over measures that would address threats to market

²⁷ See Parry, *supra* note 15, at 704.

²⁸ *Green Paper on the Enhancement of the EU Framework for Investment Funds*, COM (2005) 314 final, 2 (July 12, 2005), available at http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005_0314en01.pdf [hereinafter *EU Green Paper*]. "Under the UCITS Directive 1 UCITS investment policy and its manager are authorised in accordance with *specific requirements*." *Id.* (emphasis added).

²⁹ *Id.*

³⁰ *Id.*

³¹ Fin. Services Authority, *Financial Risk Outlook 2006*, at 51 [hereinafter *Financial Risk Outlook*], available at www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2006.pdf.

³² See Parry, *supra* note 15, at 705, 705 n.8 (U.K.).

³³ *Hedge Fund Operations: Hearing Before the H. Comm. on Banking & Fin. Servs.*, 105th Cong. 26 (1998) (statement of Alan Greenspan, Chairman, Fed. Reserve Bank).

³⁴ Greupner, *supra* note 4, at 1561-62.

stability.³⁵ Instead of directly addressing market risk by limiting hedge fund transactions, regulators have relied upon limiting entry into the hedge fund market. In other words, regulation of transactions has been replaced by restrictions on the types of parties that are allowed to invest.³⁶

Former Federal Reserve Chairman Alan Greenspan has supported the United States' indirect regulation approach based on the mobility of hedge funds. Regarding hedge fund regulation in the United States, Greenspan stated:

It is questionable whether hedge funds can be effectively directed in the United States alone. . . . Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. The best we can do, in my judgment, is what we do today: Regulate them indirectly. . . . We are thus able to monitor far better hedge funds' activity, especially as they influence U.S. markets. If funds move abroad, our oversight will diminish.³⁷

Greenspan's recognition of the difficulty of regulating this investment vehicle in a global market came before the significant growth of hedge funds seen in recent years.³⁸ Since Greenspan made this statement, both the number and total value of hedge funds have grown dramatically to total well over one trillion dollars in assets in 2006.³⁹

EU and UK regulatory policies have followed the indirect regulation approach to a certain extent. As European markets experience growth and regulatory concerns similar to those in U.S. markets, countries such as Germany look to the United States for leadership.⁴⁰ However, European markets are not only focusing on managing the growing market for hedge funds but also trying to allow the market to develop within their existing financial products and regulations.⁴¹

³⁵ *Id.* at 1558.

³⁶ *Id.* at 1561-62.

³⁷ *Hedge Fund Operations*, *supra* note 33.

³⁸ Richard Willsher, *Hedge Funds: Heads on a Plate*, FIN. DIR., Sept. 30, 2005, at 41.

³⁹ *Id.*

⁴⁰ *Rules and Regulations*, EUROMONEY INSTIT'L INVESTOR, Sept. 1, 2005, at 4.

⁴¹ *EU Green Paper*, *supra* note 28. Also consider the response to the growth of hedge funds in emerging markets of Southeast Asia. Investment in Asian markets now exceeds \$100 billion. Florian Gimbel, *Asian Hedge Funds Top \$100 Billion Mark*, FIN. TIMES (U.K.), Feb. 6, 2006, available at 2006 WLNR 2050806. Hong Kong has recently finalized regulation that includes similar restrictions to UK investors but substantially stronger management requirements and collateral restrictions. See Susan L. Barreto, *Hong Kong Regulators Finalize Hedge Fund Guidelines*, HEDGEWORLD DAILY NEWS, Sept. 26, 2005, available at 2005 WLNR 15182221.

Historically, investment in hedge funds has been limited to high net-worth investors both in the United States and throughout Europe.⁴² However, even here there is divergent policy, as the United Kingdom requires stricter analysis of who qualifies as a sophisticated investor.

IV. INVESTOR PROTECTION AND MARKET STABILITY HAVE BECOME ISSUES AS HEDGE FUNDS BECOME AVAILABLE TO LESS SOPHISTICATED INVESTORS AND BEGIN TO INFLUENCE THE LARGER FINANCIAL MARKET

As markets change and more investors look to participate in the hedge fund market, the need for regulation changes as well. The theory behind using entry barriers as a limitation to investment is that wealthy investors either are sophisticated enough to understand the risk or can withstand significant losses.⁴³

Like any developing product, however, the increase in market demand has encouraged the development of different methods for hedge fund investment to reach less wealthy investors.⁴⁴ One method used to open hedge fund markets to mid-level investors is through funds of funds (FOFs). FOFs are essentially set up like mutual funds and thus are subject to the same regulations.⁴⁵ FOFs have grown to hold up to 45 percent of all hedge fund assets.⁴⁶ This seems like a safe alternative for mid-level investors because FOFs are subject to conventional regulatory restrictions.⁴⁷ Therefore, specific hedge fund regulation may still be unnecessary because the investors are either highly sophisticated individuals or FOFs subject to regulation.⁴⁸ However, there is no correlation between sophistication and fraud detection. Both sophisticated investors and regulated entities are interested in preventing

⁴² Greupner, *supra* note 4, at 1562. High net worth investors are generally defined as having in excess of \$1 million to invest. Parry, *supra* note 15, at 704.

⁴³ See Greupner, *supra* note 4, at 1588.

⁴⁴ *Id.* at 1575-76.

⁴⁵ Robert Pozen, *Reporting Standards For Hedge Funds Must Be Raised*, FIN. TIMES (U.K.), Jan. 12, 2006, at 19, available at 2006 WLNR 632057.

⁴⁶ *Id.*

⁴⁷ See generally 15 U.S.C. § 80 (2000).

⁴⁸ *Id.*; Greupner, *supra* note 4, at 1561-62.

fraud. Transparency is therefore an important tool for preventing fraud in any investment entity.

Investor protection may even be necessary for investors who do not have positions in hedge funds.⁴⁹ As funds grow and take different strategies to investing, they may take up large equity holdings in companies.⁵⁰ It is the general view that the goals of a hedge fund are dramatically different from the long-term goals of large corporations.⁵¹ One prime example of the potential effect of hedge funds on the financial markets occurred recently in the case of Deutsche Borse (DB), a German bank that had made a bid for the London Stock Exchange.⁵² The managers of funds that held a significant portion of stock in DB did not agree with the bank's strategic goals.⁵³ Using their collective ownership, they had board members replaced and stopped the bid for the London Stock Exchange.⁵⁴ This move was clearly within their rights as shareholders.⁵⁵ However, there is concern about how this may affect capital markets given that hedge funds target short-term gains rather than focusing on long-term growth and stability within a company or industry.⁵⁶ Critics argue that when a fund's strategy is for short-term profit, with no intention of holding a position for any length of time, the potential for harm to the company and traditional investors is apparent.⁵⁷

The success of the DB intervention may encourage other hedge fund managers who are looking to take a more active role in their holdings.⁵⁸ More recently, hedge fund managers used a borrowed shares strategy in order to block the takeover of Hong Kong's Henderson

⁴⁹ Fin. Services Authority, *Hedge Funds: A Discussion of Risk and Regulatory Engagement* 1-2 (2005).

⁵⁰ See, e.g., Willsher, *supra* note 38.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.* (stating that the three hedge funds were U.K.-based TCI and U.S.-based Atticus Capital and Jana Partners).

⁵⁴ See *id.* It is important to note that hedge funds typically do not maintain a long term stake in the equity of companies. Generally, hedge funds focus on short term arbitrage opportunities, so it is questionable if this issue was an isolated incident or whether hedge funds will continue to play an activist role in management.

⁵⁵ *Id.* at 2. See also Allianz CEO Says EU, US Need to Work Together to Regulate Hedge Funds, AFX INT'L FOCUS, July 21, 2005.

⁵⁶ See Willsher, *supra* note 38. One solution recently rejected in Germany was to restrict the voting rights of hedge funds invested in German companies. See Allianz CEO Says EU, *supra* note 55 (mentioning German government rejecting restriction of hedge funds' voting rights.).

⁵⁷ Willsher, *supra* note 38. See also Allianz CEO Says EU, *supra* note 55.

⁵⁸ Steven Schurr, *How to Stay Buoyant in Shark-infested Waters*, FIN. TIMES (U.K.), Jan. 9, 2006, at 12.

Investment.⁵⁹ The blocked takeover resulted in Henderson Investment stock dropping 19 percent.⁶⁰ This has led to further speculation that the hedge funds were profiting from market manipulation.⁶¹

As the U.S. market becomes saturated with hedge funds, these fund managers will increasingly look to Europe and Asia for investment opportunities. This is because as the hedge fund market begins to saturate, the funds' returns will start to decrease, and fund managers will look for ways to evolve and maintain a competitive edge within the industry.⁶² In fact, fund managers are already looking to Asian markets as the next big hedge fund opportunity.⁶³ Given the differences in business cultures between the United States and Europe, American funds may use the opportunity to actively promote alternative business strategies to improve fund performance.⁶⁴ Given that hedge funds are poised for even greater expansion, the question again arises: What regulatory strategies are being pursued to protect investors and minimize market risk?

The concern over market stability is founded in the belief that hedge funds, at their very least, do not add any value to financial markets and, at their most, are corroding the market.⁶⁵ It is true that hedge funds add liquidity to the markets, but does that always translate to value? Historically, people who invest in stocks rely on performance and growth to increase wealth. Further, the derivatives markets were established in response to the volatility in commodities markets, in order to protect the risk-adverse.⁶⁶ However, hedge funds profit from this very volatility, and at some point this cannot be in the best long-term interest of financial markets. When does the tail start wagging the dog? The liquidity created in financial markets by hedge funds is a clear example that hedge funds are already moving from a small percentage of investors predicting and capitalizing on market behavior to a significant percentage of

⁵⁹ Florian Gimbel & Francesco Guerrera, *Increase in Share Lending Sparks Concern*, FIN. TIMES (U.K.), Feb. 15, 2006, at 27, available at 2006 WLNR 2617553.

⁶⁰ Francesco Guerrera, *Pension Funds Chase Risky Buck*, FIN. TIMES (U.K.), Feb. 18, 2006, at 12.

⁶¹ Gimbel & Guerrera, *supra* note 59.

⁶² See Phil Davis & Pauline Skypala, *Hedge Funds Start to Catch Merger Bug*, FIN. TIMES (U.K.), Feb. 13, 2006, at 3 (noting that saturation and slowing performance has also led to another industry development: consolidation, as M&A activity has picked up among larger funds of funds throughout Europe).

⁶³ Gimbel, *supra* note 41.

⁶⁴ See *id.*

⁶⁵ Brooksley Born, *International Regulatory Responses to Derivative Crises: The Role of the U.S. Commodity Futures Trading Commission*, 21 NW. J. INT'L L. & BUS. 607, 607 (2001).

⁶⁶ *Id.* at 608-09.

investors influencing or manipulating market behavior.⁶⁷ This may be the evolution of financial markets, or it may be a threat to them.

Hedge funds may have the power to destabilize financial markets.⁶⁸ If a fund is large enough and becomes insolvent, the inability to pay obligations could disrupt markets.⁶⁹ By their very nature, hedge funds are heavily involved in derivatives markets.⁷⁰ There is some regulation of derivative transactions through the Commodity Futures Trading Commission in the United States, but over-the-counter markets⁷¹ are not regulated.⁷² This means that the majority of the transactions involving hedge funds have little or no monitoring.⁷³ Therefore it is difficult to see when a hedge fund may be at risk of default due to a market position.

Derivative investing is in and of itself a volatile market. Proponents of regulation point to the Long-Term Capital Management (LTCM) collapse in the late 1990s.⁷⁴ The Federal Reserve Bank of New York had to take action to bail out LTCM and prevent a potential market disaster.⁷⁵ Alan Greenspan identified risks, including distorted market prices and large losses to creditors, as reasons to support a bailout.⁷⁶ But the issues relating to market stability have been widely ignored in the United States.⁷⁷ After the LTCM bailout in the late 1990s, the SEC looked heavily into hedge funds' influence on market stability,⁷⁸ particularly on how the failure of a hedge fund could disrupt market liquidity. It is apparent that without government intervention, LTCM would have affected market stability, although to what extent is only speculative.⁷⁹ No additional regulation resulted from the LTCM bailout,

⁶⁷ Willsher, *supra* note 38.

⁶⁸ See Born, *supra* note 65, at 634 (discussing the impact of the LTCM collapse).

⁶⁹ *Id.*

⁷⁰ See generally 15 U.S.C. § 80 (2000).

⁷¹ An over-the-counter market is one "in which shares are bought and sold outside the jurisdiction of a recognized stock exchange." *DICTIONARY OF FINANCE*, *supra* note 9, at 210.

⁷² Born, *supra* note 65, at 608, 635.

⁷³ *Id.* at 608.

⁷⁴ *Id.* at 633-37 (including a detailed discussion of the collapse of LTCM and the subsequent government bailout).

⁷⁵ *Id.* at 634.

⁷⁶ *Id.*

⁷⁷ See David Wighton, *No Fretting on Wall Street Over Hedge Fund Threat*, *FIN. TIMES* (U.K.), Sept. 23, 2005, at 1.

⁷⁸ Greupner, *supra* note 4, at 1557.

⁷⁹ See Born, *supra* note 65, at 634.

and it appears that market stability is not a major concern to U.S. investors.⁸⁰ But does this mean stabilization should not be a worry?

The LTCM collapse and resulting investigations have led to more lenient bankruptcy laws for hedge funds rather than increased regulation.⁸¹ Recognizing the risks to market stability, the Report of the President's Work Group on Financial Markets recommended expanding safe harbors to a broader array of financial transactions, specifically transactions largely engaged in by hedge funds.⁸² This recommendation ultimately led to provisions in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 that effectively expanded the types of entities that qualify for safe harbors.⁸³ The purpose of these protections is to "limit the potential impact of insolvencies upon other major market participants."⁸⁴ Thus, the U.S. approach has been to allow hedge funds to avoid bankruptcy through expanded creditors' remedies rather than limiting the actions that lead to the need for these protections.⁸⁵ At what point does the risk assumed by wealthy investors (who have been deemed in need of less protection) through a loosely regulated product become a risk to all investors?

V. HEDGE FUND FREEDOM IN THE UNITED STATES: THE END OF AN ERA?

As explained above, U.S. hedge fund regulation has been largely nonexistent. Until 2004 the SEC had been content to let funds operate autonomously without significant reporting requirements.⁸⁶ The historic strategy had been to allow hedge funds to operate largely unregulated given that the risk was limited to wealthy investors. The United States had consistently been reluctant to regulate hedge funds any further.⁸⁷

Despite strong resistance from hedge fund managers, regulation appears to have finally moved to the forefront for the SEC, which attempted to enact rules requiring more hedge fund advisors to register

⁸⁰ Wighton, *supra* note 77.

⁸¹ Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697, 700-01 (2005).

⁸² *Id.* at 700.

⁸³ *Id.* at 701.

⁸⁴ *Id.*

⁸⁵ *Id.* at 712.

⁸⁶ Rose, *supra* note 21, n.62.

⁸⁷ *See id.*

with the SEC.⁸⁸ The primary goals of the new registration requirements were to gather basic information about hedge funds, deter fraud, and require funds to develop internal controls.⁸⁹ Another goal of this regulation was not only to monitor the actions of the funds but also to track who is investing in the funds, as well as to ensure that the investment is limited to qualified individuals.⁹⁰ “These new rules [were] designed to expand the protections of the Act, which requires investment advisers to register with the SEC, maintain business records, establish compliance programmes and appoint a chief compliance officer, as well as restrict advertising and performance fee arrangements with respect to registered advisors, to cover investors in hedge funds.”⁹¹ The new rules were announced in December of 2004 and went into effect in February 2005.⁹² The amended Advisors Act changed definitions of private funds and private advisors and would have increased the number of advisors required to register with the SEC by an estimated 8 to 15 percent.⁹³

Previously the private advisors exemption allowed asset managers to avoid registration.⁹⁴ The new regulation under section 203(b)(3)-2(b) created a “look-through” feature that changed the way users of the private advisors exemption calculate their fourteen client maximum.⁹⁵ These changes reduced the investor pool loophole that has been the hallmark of U.S. hedge funds.⁹⁶ With this change, all

⁸⁸ Greupner, *supra* note 4, at 1582-83; Rose, *supra* note 21, n.62.

⁸⁹ Carol E. Curtis, *Hedge Fund Dilemma: Will the Registration Rule Hold Up, and What Will It Accomplish, Anyway?*, SEC. INDUSTRY NEWS, Dec. 19, 2005.

⁹⁰ James M. Amend, *SEC Could Target Hedge Funds in 2006*, MONEY MGMT. EXECUTIVE, Jan. 9, 2006, at 7, 15.

⁹¹ Rose, *supra* note 21, n.62.

⁹² Registration Under the Advisors Act of Certain Hedge Fund Advisors, 69 Fed. Reg. 72054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pt. 275, 279, available at <http://www.sec.gov/rules/final/ia-2333.htm>).

⁹³ Rose, *supra* note 21, n.63 (The amended act does not specifically address hedge funds, still conspicuously not defined by the SEC. However, the act redefines “private funds,” which have characteristics inherent to most hedge funds; this text is clearly directed at hedge funds.).

⁹⁴ 15 U.S.C. § 80b-3(b)(3) (2000).

⁹⁵ The new regulation provides in part:

Methods for counting clients in certain private funds. (a) For purposes of section 203(b)(3) of the Act (15 U.S.C. § 80b-3(b)(3)), you must count as clients the shareholders, limited partners, members, or beneficiaries . . . of a private fund . . . (b) If you provide investment advisory services to a private fund in which an investment company registered under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 to 80a-64) is, directly or indirectly, an owner, you must count the owners of that investment company as clients for purposes of section 203(b)(3).

Methods for Counting Clients in Certain Private Funds, 17 C.F.R. § 275.203(b)(3)-2 (2004).

⁹⁶ See Rose, *supra* note 21, n.63.

shareholders in an institutional investor would have to be counted as shareholders.⁹⁷ This could severely restrict hedge fund growth as institutional investors have been continuously expanding into the hedge fund market. Further, under the amended rules the definition of “private fund” had been expanded to include funds that allow investors to redeem their interest within two years of purchase.⁹⁸ Hedge funds typically allow investors to access their investment in less than two years.⁹⁹ This change was designed to set a bright line rule as to what constituted a private fund and thus require registration.¹⁰⁰ Section 3 addressed foreign funds and was designed to exclude foreign retail funds, like the Undertakings for Collective Investment in Transferable Securities, but not foreign hedge funds, which were still considered private funds.¹⁰¹ The new registration requirements obligated hedge funds to, among other duties, report on the nature of their clients, provide audited financial statements, and disclose their trading strategy.¹⁰²

The new rules took effect in February 2005 and have already been challenged and overturned in federal court.¹⁰³ Phillip Goldstein, a hedge fund investment advisor, brought suit against the SEC in 2005.¹⁰⁴

⁹⁷ See *id.*

⁹⁸ American Bar Association, SEC No-Action Letter, [2005-2006 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,132, at 77,185-213 (Dec. 8, 2005) [hereinafter ABA No-Action Letter]. The new regulation provides in part:

Definition of “client” of an investment advisor. (d) *Private fund*. (1) A private fund is a company: (i) That would be an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. § 80a-3(a)) but for the exception provided from that definition by either section 3(c)(1) or section 3(c)(7) of such Act (15 U.S.C. § 80a-3(c)(1) or (7)); (ii) That permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and (iii) Interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser (3) Notwithstanding paragraph (d)(1) of this section, a company is not a private fund if it has its principal office and place of business outside the United States, makes a public offering of its securities in a country other than the United States, and is regulated as a public investment company under the laws of the country other than the United States.”

Definition of “Client” of an Investment Advisor, 17 C.F.R. § 275.203(b)(3)-1.

⁹⁹ ABA No-Action Letter, *supra* note 98.

¹⁰⁰ *Id.*

¹⁰¹ See Karen L. Anderberg & Michael J. McDonough, *U.S. Securities and Exchange Commission Publishes Final Rule Requiring Hedge Fund and Certain Other Private Fund Advisors to Register*, 20 J. INT’L. BUS. L. REG. 216, 220 (2005).

¹⁰² 17 C.F.R. pts. 275, 279.

¹⁰³ *Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006). See *Looking for Trouble*, THE ECONOMIST, July 2, 2005, at 63.

¹⁰⁴ Jeff Benjamin, *Suit Over Hedge Fund Registration On, But Industry Isn’t Holding Its Breath*, INVESTMENT NEWS, Oct. 17, 2005, available at 2005 WLNR 17090997.

“The lawsuit focuse[d] on the SEC’s authority to count the investors in a particular hedge fund as individual clients of the hedge fund manager.”¹⁰⁵ Although most felt the lawsuit had little chance of succeeding, the U.S. Court of Appeals for the District of Columbia ruled in favor of Goldstein and struck down the regulations.¹⁰⁶ The court referred to the SEC’s “Hedge Fund Rule” as arbitrary, finding no change in the client-advisor relationship that would justify the new rules.¹⁰⁷ The court noted that the SEC’s justification for the rules change—the growth and impact of the industry—is not rationally related to the number of clients because funds’ volume and market positions, and not number of clients, are what impact national markets.¹⁰⁸ The ruling seems to focus more on market stability than on individual investor protections.¹⁰⁹ This raises the question: what is the best way to focus on investor protection?

It is debatable whether reporting requirements would have changed hedge fund regulation all that dramatically given that 60 percent of hedge funds are already registered.¹¹⁰ Yet, opponents of registration argue that the added regulation would significantly increase overhead costs, thereby reducing profitability.¹¹¹ This is supported by the fact that employment predictions in the hedge fund industry are strong for 2006, not because of growth in the funds, but largely because of the need for funds to comply with the new registration requirements.¹¹² Also, U.S. hedge fund managers were already using alternatives to registering with the SEC, particularly by locking up¹¹³ investors, which effectively delayed the registration requirement.¹¹⁴ However, these lockups could potentially discourage investors who want access to funds.¹¹⁵ On the

¹⁰⁵ *Id.*

¹⁰⁶ *Goldstein*, 451 F.3d at 883.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ See Warren Boroson, *Rules on Hedge Funds Opposed*, Daily Record, Oct. 1, 2006, at D1, D2 (explaining that Goldstein believes that registration won’t prevent fraud, and will merely increase legal costs). In addition, Goldstein may proceed with another lawsuit against the SEC centered on hedge fund regulation under 13F. See Joshua Hamerman, *Gadfly Bulldog May Challenge SEC Hedge Fund Rules Again*, MERGERS & ACQUISITIONS REP., Sept. 25, 2006, at 4. Amend, *Despite Pressures*, *supra* note 22.

¹¹¹ *See id.*

¹¹² Amend, *supra* note 90.

¹¹³ A lock-up is “an investment in an asset that is not readily realizable or one that is specifically intended to be held for a long period (e.g. over ten years).” DICTIONARY OF FINANCE, *supra* note 9, at 168.

¹¹⁴ See Jeff Benjamin, *Hedge Funds Exploit a Loophole: Some Funds Extend Lockup to Avoid Regulatory Oversight*, INVESTMENT NEWS, Sept. 26, 2005, available at 2005 WLNR 15448825.

¹¹⁵ *Id.*

other side, cynics point to avoiding registration as a sign that fund managers are doing something illegal or unethical.¹¹⁶

Since the judicial ruling against the SEC in July 2006, hedge funds now have the option to ignore the vacated regulations.¹¹⁷ It is unclear to what extent hedge funds will take advantage of this ruling and attempt to de-register, or how clients would react to de-registration.¹¹⁸ Foreign hedge funds that had been forced to register with the SEC were already looking for a way out of the new requirements.¹¹⁹ Current estimates suggest that 20 percent of the funds that registered in February intend to de-register.¹²⁰

Despite the controversy, the vacated regulations would not have affected domestic hedge funds' flexibility or investment strategies, nor would they have required any disclosure regarding fund performance. However, they may foreshadow action to come.¹²¹ If so, there is a significant international issue with the SEC's regulatory approach: SEC regulations applied to any fund that had more than fifteen U.S. investors, not just U.S. funds.¹²² This would have infringed on foreign hedge funds where U.S. investors are involved with foreign-managed funds.¹²³ The SEC chose to subject "offshore advisors" to the same requirements as U.S. advisors but did soften the regulations' global impact by allowing exemptions for foreign funds publicly traded in a foreign jurisdiction.¹²⁴

The new U.S. regulations were criticized in the United States and the United Kingdom. Alan Greenspan viewed the new regulations as providing minimal investor protection, and former FSA Chairman Sir Howard Davies even stated that he didn't think "they [understood] what they [were] setting out to achieve."¹²⁵ Despite the lack of support for the regulations prior to their invalidation, the SEC feels the *Goldstein* decision left a "gaping hole" in the regulations¹²⁶ pointing to the large

¹¹⁶ See Greupner, *supra* note 4, at 1582-83.

¹¹⁷ *Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006).

¹¹⁸ *Id.*; Emma Trincal, *Regulators and Funds Looking Beyond the Goldstein Decision*, HEDGEWORLD DAILY NEWS, Sept. 18, 2006.

¹¹⁹ Liz Chong, *Hedge Funds Balk at SEC Rules*, THE TIMES (U.K.), Feb. 16, 2006, at 57.

¹²⁰ See Trincal, *supra* note 118.

¹²¹ See Pozen, *supra* note 45.

¹²² Charles Beazley, *FT Fund Management: New Year Special*, FIN. TIMES (U.K.), Jan. 9, 2006, available at 2006 WLNR 460619.

¹²³ *Id.*

¹²⁴ See 69 Fed. Reg. 72054, 72071 (Dec. 10, 2004).

¹²⁵ Chong, *supra* note 119, at 57.

¹²⁶ James J. Eccleston, *SEC Seeks to Protect Hedge Fund Investors*, CHICAGO LAWYER, Sept. 2006, at 30.

number of actions brought against hedge funds as justification that a change is needed to protect investors.¹²⁷

In response to the *Goldstein* decision, it appears that U.S. regulatory policy is back to where it was before the vacated regulations were introduced.¹²⁸ The SEC has since held that a U.S. manager that handles foreign funds with no U.S. investors is prohibited from registering as an investment advisor.¹²⁹ Further, the SEC has addressed the implications for advisors that remain registered.¹³⁰ In particular, offshore investment advisors to offshore funds are still not required to register unless they have U.S. clients.¹³¹ Moreover, funds have until February 1, 2007, to de-register and conform to the old rule regarding fourteen or fewer clients.¹³²

VI. EU FINANCIAL PRODUCTS ARE OPEN TO HEDGE FUND-STYLE INVESTMENT STRATEGIES

The European Union has the unique role of trying to manage a wide European market for investment funds. Its goal is to create an integrated financial market across Europe.¹³³ The most common investment funds in Europe are Undertakings for Collective Investment in Transferable Securities (UCITS), which account for 70 percent of managed assets in Europe.¹³⁴ These funds are similar to mutual funds in the United States in terms of investment strategy, but market inefficiencies currently keep UCITS to about one-fifth the size¹³⁵ of similar funds in the United States.

The growth of the markets for UCITS and hedge funds, along with continuously evolving UCITS legislation, has led to a change in whether UCITS can invest in hedge funds.¹³⁶ In particular, UCITS III

¹²⁷ *Id.*

¹²⁸ *Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006).

¹²⁹ Credit Agricole Asset Management Alternative Investments, Inc., SEC No-Action Letter, [2005-2006 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,263, at 77,792 (Aug. 7, 2006).

¹³⁰ See generally ABA No-Action Letter, *supra* note 98, at 77,733.

¹³¹ *Id.* at 77,739-40.

¹³² *Id.* at 77,741.

¹³³ See *Paper Outlines EU Financial Services Policy for the Next Five Years*, EU FOCUS, May 19, 2005, at 2.

¹³⁴ *EU Green Paper*, *supra* note 28, at 2.

¹³⁵ *Id.* at 3.

¹³⁶ *Id.* at 4, 9.

legislation has opened the door to create UCITS that invest heavily in derivatives, which are primarily a hedge fund strategy.¹³⁷ Previously, UCITS were mainly restricted to using derivatives as a risk management tool for their portfolio, but the UCITS III regulation allows the use of derivatives solely as an investment strategy.¹³⁸ There is concern that the current UCITS legislation does not contain strict enough risk management requirements to effectively regulate any UCITS operating in derivatives markets.¹³⁹ However, UCITS III will still be regulated and monitored far more heavily than any other hedge fund-based product in the United States or the United Kingdom.¹⁴⁰

This new opportunity is leading to an expanded market for UCITS III products.¹⁴¹ Goldman Sachs Asset Management has announced plans to more than double their UCITS offerings and intends to take advantage of the removed restriction on investment techniques.¹⁴² Goldman's expansion is evidence of the significant restriction formerly placed on EU markets and the investment industry's desire to take advantage of the market potential.¹⁴³

Along with the expanded investment techniques for UCITS III come increased investor protection safeguards.¹⁴⁴ This is consistent with the EU's goal of being the primary investment method for retail investors throughout the EU.¹⁴⁵ Retail investors are largely kept out of U.S. and UK hedge fund markets, and the EU has heightened regulation in order to capture this market.¹⁴⁶ The EU is focusing on ensuring that the

¹³⁷ Charlotte Hill, *The FSA Launches the Debate on the Impact of Hedge Funds in the UK*, MONDAQ BUS. BRIEFING, July 25, 2005, at 2, available at http://www.mondaq.com/i_article.asp_Q_articleid_E_33815.

¹³⁸ *Financial Risk Outlook*, *supra* note 31, at 51.

¹³⁹ *See id.*

¹⁴⁰ *See* FIN. SERVICES AUTHORITY, THE COLLECTIVE INVESTMENT SCHEME INFORMATION GUIDE 4-7 (2006) (discussing the requirements for UK companies to sell products under UCITS; these would be the only investment strategy regulations currently imposed on U.S. or UK funds), available at <http://www.fsa.gov.uk/pubs/foi/collguide.pdf> (last visited May 5, 2007).

¹⁴¹ Philip Coggan, *Goldman Launches UCITS III Range*, FIN. TIMES (U.K.), Jan. 9, 2006.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *See EU Green Paper*, *supra* note 28, at 6-7.

¹⁴⁵ *See id.*

¹⁴⁶ *See* 15 U.S.C. § 80b-3(b)(3) (retail investors are generally kept out due to the private advisors exemption in the United States); Dan Waters, Asset Mgmt. Sector Leader, FSA Hedge Funds Blueprint Europe Conf. Speech (Feb. 8, 2005) at 1, available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/0208_dw.shtml (sophisticated investors requirements in the UK effectively restrict retail investors); *EU Green Paper*, *supra* note 28, at 6 (UCITS is striving to be the "investment vehicle of choice for the retail investor.").

European funds can effectively cross borders, which will allow for growth.¹⁴⁷ However, the EU also wants to ensure that investors have adequate information to assess the risks of investment funds given the addition of more sophisticated investment strategies such as hedge funds.¹⁴⁸ The EU does not have a clear picture of what, if any, systemic risks are associated with hedge funds, and is likely to rely on regulators in the United States and the United Kingdom to assess this risk.¹⁴⁹ The EU is focused on preventing regulatory fragmentation to improve cross-border marketability, but there doesn't appear to be enough information yet to justify a common EU approach to hedge funds.¹⁵⁰ Also, some argue that it is not the EU's responsibility to regulate hedge funds, believing instead that member regulators are in a better position to determine whether regulation is needed.¹⁵¹

While the EU is focused on market efficiency and investor protection, its members seem to view market stability as a more immediate concern.¹⁵² The UK appears intent on fully understanding market risks through reporting and data collection while Germany seems to have already decided that hedge funds, in their current unregulated state, are dangerous to market stability.¹⁵³

VII. SMALLER EUROPEAN MARKETS ARE TAKING DIVERGENT APPROACHES TO HEDGE FUND REGULATION

Germany appears to be in favor of substantial hedge fund regulation while at the same time recognizing the importance of a global policy.¹⁵⁴ If Germany chooses to act alone, the hedge fund market could potentially bypass its financial markets. While Germany seems intent on strict regulation, it is currently offering hedge funds to the public through

¹⁴⁷ *EU Green Paper*, *supra* note 28, at 2-3.

¹⁴⁸ *Id.*

¹⁴⁹ *Buck, Tobias, McCreedy Rejects Hedge Fund Call Proposed Regulations*, FIN. TIMES (U.K.), July 15, 2005.

¹⁵⁰ *See id.* at 9.

¹⁵¹ *McCreedy Tells EU Members to Lead Hedge Fund Regulation*, EUROMONEY INSTIT'L INVESTOR, COMPLIANCE REPORTER, Sept. 19, 2005, at 8.

¹⁵² *Buck, Tobias, McCreedy Rejects Hedge Fund Call Proposed Regulations*, *supra* note 149.

¹⁵³ *Id.*

¹⁵⁴ *Rules and Regulations*, *supra* note 40.

Deutsche Bank for approximately \$125 per share.¹⁵⁵ Germany's recent approach is the opposite of current policy in the United States. Germany is restricting how the funds are managed but opening the funds to all investors.¹⁵⁶ While the approach seems to be successful, it is important to keep in mind that Germany has a small percentage of the hedge fund market and that regulators are not trying to reign in an established market.

While Germany remains cautious, countries such as Gibraltar are attempting to expand their role in the hedge funds market.¹⁵⁷ Gibraltar has structured its financial markets and regulations similar to that of the UK, which makes it an attractive alternative location for hedge funds.¹⁵⁸ Also, membership in the EU allows Gibraltar to participate in the UCITS market.¹⁵⁹ Gibraltar's approach demonstrates that once workable regulatory models have been established, some countries will be eager to participate in this sector of financial growth.¹⁶⁰ Gibraltar has fairly clear regulatory models to rely on from the EU and the UK and hopes to build off its flexibility and cost advantages to capture a piece of the hedge fund market.¹⁶¹

While Germany is the largest economy in the EU, Gibraltar is one of the smallest. The low risk of disruption to the country as a whole may be why Gibraltar is willing to take a chance on capturing hedge funds. At the very least, the example of these two nations shows the contrast in approaches currently going on throughout Europe.

VIII. UK HEDGE FUND REGULATION: MONITORING FUNDS TO UNDERSTAND RISKS

UK hedge fund regulation is active and constantly evolving. No country appears to be more focused on understanding the hedge fund industry than the UK and its Financial Services Authority (FSA). The FSA has been continuously evaluating risks and issuing opinions on the

¹⁵⁵ Pozen, *supra* note 45, at 19 (hedge fund units were selling for 125 Euros as of January 2006).

¹⁵⁶ *Id.* (the funds are available to individual retail investors).

¹⁵⁷ James G. Lasry, *Gibraltar: An Alternative Fund Jurisdiction in the European Union*, J. INT'L BANKING L. & REG. (21)(2), 108, 108 (2006).

¹⁵⁸ *Id.* at 109 n.2.

¹⁵⁹ *Id.* 109 n.4.

¹⁶⁰ *Id.* at 109.

¹⁶¹ *Id.* at 111.

state of the hedge fund industry. As it progressively moves through the risks associated with hedge funds and establishes regulatory positions, the FSA has not been hesitant to expand to new issues.¹⁶² In the past two years, the FSA has focused on regulations and risks associated with market stability, investor protection barriers, and, most recently, valuation standards.¹⁶³

UK hedge fund regulation is vital to the balance of the hedge fund market. Currently, it is estimated that UK-based fund managers control up to 20 percent of the global hedge fund market.¹⁶⁴ Almost 90 percent of hedge funds are managed out of the United States and United Kingdom.¹⁶⁵ Though both countries are introducing or discussing new regulation, they have different existing policies and therefore different approaches to introducing regulation.¹⁶⁶ SEC regulation requirements are based on the number and type of U.S. clients and total assets; while FSA requirements are also based on the sophistication of clients, the activity of the fund and the location of the fund manager are relevant as well.¹⁶⁷

In 2005 the FSA published two Discussion Papers (DPs) related to the risks and concerns over hedge funds.¹⁶⁸ Discussion Paper 05/3 focused on a wide range of investment products and consumer protection.¹⁶⁹ Discussion Paper 05/4 focused on risks related to hedge funds and the position the FSA should take in regulating them.¹⁷⁰ DP 05/4 goes forward and identifies key potential risks, including but not limited to: serious market disruption and erosion of confidence, liquidity disruption leading to disorderly markets, risk management, market abuse, and conflicts of interest.¹⁷¹ These risks appear to be centered on market stability.

Some of the changes the FSA is considering include creating a center of hedge fund expertise in order to improve supervision of hedge fund managers and distinguishing hedge fund managers from ordinary investment managers in order to improve oversight.¹⁷² It is interesting to

¹⁶² See generally *Financial Risk Outlook*, *supra* note 31.

¹⁶³ *Id.*

¹⁶⁴ Waters, *supra* note 146.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* at 5.

¹⁶⁷ *Id.*

¹⁶⁸ Hill, *supra* note 137, at 1.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 3.

¹⁷¹ *Id.* at 3-4.

¹⁷² *Id.* at 4-5.

note that despite identifying market stability as a potential risk created by the hedge fund industry, the majority of the plans for increased regulation created by the FSA appear to focus on indirect regulation. The FSA has taken up the philosophy of Alan Greenspan and is hesitant to regulate too heavily for fear that the hedge funds will just move to a more lightly regulated jurisdiction.¹⁷³ One reason for this approach may be that the FSA doesn't have enough information to determine how much or what type of regulation is needed.¹⁷⁴ This poses a paradox, however, as regulation is the best way for the FSA or any regulatory agency to gather information.

Despite the unwillingness to move forward with regulatory action expressed by the FSA in the DPs, by early January 2006 the FSA had implemented a plan to monitor what it felt were the twenty-five most influential hedge funds in the UK.¹⁷⁵ This new level of direct oversight, referred to by the FSA as being "relationship managed," suggests that the United Kingdom has heightened its concern over market stability.¹⁷⁶ This indirect regulation has not led to any formal regulatory changes, but it is likely to foreshadow things to come in the UK. The FSA's primary targets for "relationship management" are funds that are highly leveraged or involved in heavy trading into and out of markets.¹⁷⁷ This could be a market stability focus, but the FSA says the focus is on funds that are "testing the boundaries of acceptable practice with respect to insider trading and market manipulation."¹⁷⁸

In its 2006 outlook, the FSA recently discussed event risks that could impact the global economy, identifying market complexity and liquidity as factors that could magnify risk.¹⁷⁹ While these factors were meant to apply to the entire financial market, it seems clear that they are a substantial part of hedge fund strategies. The FSA is encouraging "stress testing" as an effective way for firms to evaluate risk scenarios.¹⁸⁰ Stress testing includes running scenarios involving market liquidity and capital adequacy and trying to determine the limits of a firm's position.¹⁸¹

¹⁷³ *FSA: Regulation Should Not Push Hedge Funds Overseas*, EUROMONEY INSTIT'L INVESTOR, COMPLIANCE REPORTER, Sept. 26, 2005, at 10.

¹⁷⁴ *Over the Hedge*, COMPLIANCE MONITOR, Oct. 2005.

¹⁷⁵ Barney Jopson, *FSA Puts Hedge Funds Under Scrutiny*, FIN. TIMES (U.K.), Nov. 9, 2005.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *Financial Risk Outlook*, *supra* note 31, at 24.

¹⁸⁰ *Id.* at 25.

¹⁸¹ *Id.* at 25-26.

While stress testing is growing, particularly in the insurance industry, the FSA recognized its technological limitations and significant cost, particularly for the firms with large and complex strategies.¹⁸²

Specifically addressing hedge funds in its 2006 outlook, the FSA once again reiterated the market stability risk but also noted that the risk continues to be fairly low.¹⁸³ The FSA pointed to improvements in counterparty risk management and low leverage as offsets to the increased risks of industry growth.¹⁸⁴ In particular, the FSA identified the hedge fund industry's ability to cope with market disruptions from the automotive industry as an indication of the industry's ability to manage market stability.¹⁸⁵

Despite this confidence, the FSA recognized new risks associated with increased investment in illiquid assets¹⁸⁶ and operational control issues.¹⁸⁷ The FSA stated that some firms have increased their redemption periods in response to the liquidity changes.¹⁸⁸ However, it seems equally possible that this change was correlated to the SEC regulatory safe harbors discussed earlier.¹⁸⁹ The FSA also concluded that operational risks are a by-product of the increased growth of the funds, particularly that technology and staffing needs may not be growing as fast as the funds.¹⁹⁰ This also correlates to the growth in employment projections throughout the industry.¹⁹¹

The regulatory focus of the FSA for this emerging investor protection issue involves fund valuation.¹⁹² The FSA wants improved standards on valuation procedures.¹⁹³ The current practice in the UK is to get a third party to value a fund.¹⁹⁴ However, independent valuation will

¹⁸² *Id.*

¹⁸³ *Id.* at 55.

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ Illiquid assets are those which are "not readily convertible into cash, such as a stock, bond, or commodity that is not traded actively and would be difficult to sell at once without taking a large loss." *DICTIONARY OF FINANCE & INVESTMENT TERMS* 174 (John Downes & Jordan E. Goodman eds., 1985).

¹⁸⁷ *Financial Risk Outlook*, *supra* note 31, at 56.

¹⁸⁸ *Id.*

¹⁸⁹ *See* Campbell, *supra* note 81, at 700.

¹⁹⁰ *Financial Risk Outlook*, *supra* note 31, at 56.

¹⁹¹ Amend, *Despite Pressures*, *supra* note 22.

¹⁹² *Financial Risk Outlook*, *supra* note 31, at 51.

¹⁹³ *Id.* at 57.

¹⁹⁴ *Id.* at 56.

become increasingly difficult with the increase in illiquid assets.¹⁹⁵ This might lead to relying on the funds themselves for information—a reliance the FSA is pushing to avoid.¹⁹⁶ It is notable that the valuation practices in the United States rely entirely on fund managers, and independent verification is not required.¹⁹⁷ This move toward valuation indicates a slow and steady progression by the FSA to penetrate the lightly regulated hedge fund industry. Fund valuation is the basis of management fees.¹⁹⁸ The risk of valuation-challenges—or, worse, valuation-fraud—will directly impact investors because artificially high valuations will affect fees.¹⁹⁹

Prime brokerage relationships are also emerging as an area where the FSA has turned its focus.²⁰⁰ This is a direct result of prime brokers being the counterparties to hedge fund transactions and the risk management necessary to maintain the relationship with hedge funds.²⁰¹ While prime brokers (investment banks) are subject to regulation, the added risks of working with the hedge funds necessitate further risk management.²⁰² Specifically, when a hedge fund works through multiple prime brokers, it may be difficult for the brokers to understand the risk exposure that results from working with that hedge fund.²⁰³ While the FSA has not made any regulatory changes in this area, it is working to continue to collect information on the potential impact to prime brokers.²⁰⁴

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *FSA Rings the Alarm*, FIN. TIMES INVESTMENT ADVISER, Jan. 30, 2006, available at 2006 WLNR 1696189.

¹⁹⁹ *Id.*

²⁰⁰ *Financial Risk Outlook*, *supra* note 31, at 43.

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ *Id.* at 44.

²⁰⁴ *Id.*

**IX. THE UK IS FAR AHEAD OF THE UNITED STATES
REGARDING INVESTOR PROTECTION AND HAS
MOVED INTO MONITORING FOR AND SAFEGUARDING
AGAINST THE INFLUENCES OF SYSTEMIC RISK; THIS
MAY LEAD TO A SHIFT IN REGULATORY LEADERSHIP
SURROUNDING HEDGE FUNDS**

Investor protection, rightly or wrongly, has been the primary focus of regulators.²⁰⁵ As one fund manager pointed out, concern over market stability seems to be secondary.²⁰⁶ Accessibility to funds that employ absolute return strategies is expanding, as evidenced by the UCITS III directive discussed earlier.²⁰⁷ If regulators were so concerned with market stability based purely on the trading techniques employed by hedge funds, there would be more talk about trading restrictions and less about reporting requirements. Concern instead lies with transparency issues and fraud prevention.

The United Kingdom is clearly ahead of the United States when it comes to registration and reporting requirements. UK regulations appear to have much closer scrutiny over fund managers' activities.²⁰⁸ So, if the UK and EU markets are so much more regulated, how is it that hedge fund management is thriving in Europe and not flocking to the United States? It may simply be that Europeans are comfortable working within their regulatory schemes. This very same reason may also explain the backlash to the ultimately vacated regulations in the United States.²⁰⁹

The United States has moved forward with formal changes to regulation requirements, and there is a clear backlash throughout the hedge fund industry.²¹⁰ These outcries, however, need to be taken in context; never does anything free want to be reigned in. Hedge fund managers are not unlike spoiled children, and the regulatory agencies like parents trying to establish discipline. However, hedge fund managers seem to be saying that spoiled does not mean unruly, and

²⁰⁵ See generally Parry, *supra* note 15; *EU Green Paper*, *supra* note 28; *Financial Risk Outlook*, *supra* note 31.

²⁰⁶ *Over the Hedge*, *supra* note 174.

²⁰⁷ *Id.*

²⁰⁸ *Financial Risk Outlook*, *supra* note 31, at 65.

²⁰⁹ *Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006).

²¹⁰ Consider also the backlash to what is perceived as "regulatory overreach" in Sarbanes-Oxley regulation. See, e.g., *Darned SOX, Reaction to Sarbanes-Oxley*, *ECONOMIST*, Sept. 16, 2006, at 84.

regulation isn't necessary because the funds have arguably been functioning well within the markets without regulation. Questions remain as to whether reporting requirements will add any value to investors.

UK hedge fund managers are vying with U.S. hedge fund managers for this highly profitable industry. With the recent vacating of the SEC registration, U.S. fund managers are not subject to reporting requirements, but despite the *Goldstein* decision, the SEC still has anti-fraud remedies to protect investors.²¹¹ Meanwhile, UK fund managers are subject to reporting requirements and monitoring from authorities.²¹² Which approach is better? As one author points out, the SEC has brought over ninety-seven enforcement cases under anti-fraud provisions in the past seven years, while the FSA has only fined one.²¹³ Is this a sign of better controls, poorer controls, or a smaller UK market?

When new regulations manage to cross borders and influence funds managed in other countries, the global economy can be affected. The new U.S. policy, before being vacated, was criticized as too far-reaching. On the other hand, it may have been an indicator of what is truly needed—uniform regulation by an international body. Consider the recent comments issued by representatives of the SEC, Federal Reserve, and FSA, all of which advocate for “more agility and co-operation among supervisors.”²¹⁴ Cooperation and improved processes may be the best approach to protecting investors and monitoring the industry.

X. CONCLUSION

Registration and monitoring will continue to expand and will likely impact hedge fund profit margins, but ultimately they will not restrict the growth of hedge funds in emerging markets. Hedge funds have been largely free of regulation since their inception, but there are permanent changes on the horizon. The United States and United Kingdom are both pushing for increased regulation and monitoring by

²¹¹ *Goldstein*, 451 F.3d at 884. See, e.g., 17 C.F.R. § 240.10b-5.

²¹² See Fin. Services Authority, *supra* note 49, at 4 (the FSA has a “centre of hedge fund expertise” set up to increase monitoring of the hedge fund industry).

²¹³ *Capitals of Capital*, THE ECONOMIST, Sept. 2, 2006, at 62. See also *Jabre Drops Appeal Against 750,000 Trading Penalty*, EUROMONEY INSTIT'L INVESTOR, Aug. 4, 2006.

²¹⁴ Timothy Geithner et al., *A Safer Strategy for the Credit Products Explosion*, FIN. TIMES (U.K.), Sept. 27, 2006, at 19, available at 2006 WLNR 16833416.

focusing largely on reporting requirements.²¹⁵ The European Union, on the other hand, is allowing hedge fund strategies within existing regulated products.²¹⁶

The United Kingdom and the United States account for almost 85 percent of the hedge fund market.²¹⁷ With both sides continually squeezing in on the funds, it is likely that increased regulation is permanent. Neither country is proposing increasing restrictions on hedge fund transactions despite identifying risks associated with the transactions, which are important to the identity and growth of the market as a whole.²¹⁸ Hedge funds want to protect their ability to maintain returns. While indirect regulation (reporting) risks reduced profitability, it remains a pivotal part of the regulatory approach.²¹⁹ However, the funds are so profitable not because of the lack of reporting, but because of the freedom of restrictions on investments. Direct regulation of market positions by hedge funds could handcuff the industry from continuing to be profitable. Regulatory agencies recognize this but also see a duty to protect individual investors in their dealings with hedge funds and a duty to protect the stability of the broader markets so that other investment vehicles can continue to serve their purpose.

The added costs associated with additional reporting and compliance requirements are going to cut into investment returns.²²⁰ However, over-saturation of hedge funds is likely to be the more significant drain on investment returns, just another reason the funds want to prevent any additional changes. Both of these factors mean returns on hedge funds are bound to diminish. The worst-case scenario for the industry would be alternative restrictions on investment strategies, direct regulation that continues to be nonexistent in the United States and the United Kingdom. This approach appears to be dormant, and market instability is likely the only force that could bring the direct approach to life. Until then, like any developing market, reporting requirements and risk management monitoring will increase and the industry will adjust. “Some have moaned about the prospect of closer scrutiny. But only by

²¹⁵ *Id.*

²¹⁶ Hill, *supra* note 137.

²¹⁷ *Id.*

²¹⁸ See Lasry, *supra* note 157; Wighton, *supra* note 77.

²¹⁹ See Anderberg & McDonough, *supra* note 101, at 220.

²²⁰ *Id.*

knowing more about where risk exists can a wise regulator decide when to step in and when to leave well alone.”²²¹

²²¹ Barney Jopson, *City Warned of Growing Legal Dangers*, FIN. TIMES (U.K.), Jan. 26, 2006, at 4, available at 2006 WLNR 1413408.