

# HEDGE FUND “REGULATION” FOR SYSTEMIC RISK: LARGELY IMPOSSIBLE

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## INTRODUCTION

Although individual hedge funds may present little or no threat to the global economy, as a collective they actively manage and invest a significant amount of money.<sup>1</sup> Their increased ability to use leverage, flexibility of investment strategy, and the interconnectedness of global markets all increase the ripple-effects of hedge fund trading activities.<sup>2</sup>

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1. BarclayHedge reports that in the second quarter of 2013 hedge funds globally managed \$1.9 trillion. *Hedge Fund Industry – Assets Under Management*, BARCLAYHEDGE, [http://www.barclayhedge.com/research/indices/ghs/mum/HF\\_Money\\_Under\\_Management.html](http://www.barclayhedge.com/research/indices/ghs/mum/HF_Money_Under_Management.html) (last visited Aug. 28, 2013).

2. See, e.g., *Synopsis of Hedge Fund Strategies*, MAGNUM FUNDS, <http://www.magnum.com/hedgefunds/strategies.asp> (last visited Aug. 28, 2013) (explaining how hedge fund risk and volatility changes depending on the firms’ investment strategies).

Additionally, because hedge funds do not necessarily take into account the trading activities of other investment-based institutions, the consequences of any “bad bet” may be passed along to entities that act as counterparts to hedge fund trades (which may or may not be major participants in the same markets).<sup>3</sup> It is precisely this complex and interdependent nature of the risk that makes it impossible to regulate the hedge fund industry from the top down.

Prior to the 2008 financial meltdown, hedge funds were largely unregulated and generally left to their own devices.<sup>4</sup> After the financial crisis, financial regulators across the globe decided that increased regulation of the hedge fund industry was necessary.<sup>5</sup> In response to this realization, the United States Congress included the Private Fund Investment Advisers Registration Act of 2010 (“PFIARA”) in section four of Dodd-Frank,<sup>6</sup> and the European Union (“EU”) issued the Alternative Investment Fund Advisers Directive (“AIFMD”).<sup>7</sup> Despite broad support among legislators, both of these regulations have been quite controversial within the hedge fund industry.<sup>8</sup> Underpinning this conflict is the fact that the financial success of the hedge fund industry is dependent on factors that have the potential to create sources of systemic risk.<sup>9</sup>

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3. See Miguel A. Segoviano & Manmohan Singh, *Counterparty Risk in the Over-The-Counter Derivatives Market* 5 (Int’l Monetary Fund, Working Paper No. WP/08/258, Nov. 2008), available at <http://www.imf.org/external/pubs/ft/wp/2008/wp08258.pdf>.

4. See, e.g., Steven Sloan, *SEC Registration Captures More Hedge Fund Advisers*, BLOOMBERG (Mar. 29, 2012), <http://www.bloomberg.com/news/2012-03-29/sec-registration-captures-more-hedge-fund-advisers.html>; see also Norm Champ, Deputy Director, Sec. & Exch. Comm’n, Speech for the New York City Bar: What SEC Registration Means for Hedge Fund Advisers (May 11, 2012), available at <http://www.sec.gov/news/speech/2012/spch051112nc.htm>.

5. See Paul Oranika, *Should Hedge Funds Be Regulated?*, HEDGE.CO.NET, <http://www.hedgeco.net/hedge-fund-regulations.htm> (last visited Nov. 3, 2012); see also Roberta S. Karmel, *Hedge Funds After Dodd-Frank*, 244 N.Y. L.J. 3 (2010), available at <http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202473626349&slreturn=2012102154201>.

6. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 401, 15 U.S.C. 80b-20 (2012).

7. See Press Release, European Commission, Directive on Alternative Investment Fund Managers (‘AIFMD’): Frequently Asked Questions (Nov. 11, 2010), [http://europa.eu/rapid/press-release\\_MEMO-10-572\\_en.htm](http://europa.eu/rapid/press-release_MEMO-10-572_en.htm) [hereinafter European Commission Press Release FAQ]; see generally Directive 2011/61 of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 O.J. (L 174) 1 [hereinafter AIFMD].

8. See, e.g., Oranika, *supra* note 5.

9. See René M. Stulz, *Hedge Funds: Past, Present, and Future*, 21 J. ECON. PERSPECTIVES 175, 176 (2007).

It is the flexibility of hedge funds, only possible because of a lack of regulation, which contributes to their financial prowess.<sup>10</sup> Hedge funds are attractive vehicles for investors because they can generate massive returns and protect against market risk, which gives them greater capability to generate profits in the event of a market downturn.<sup>11</sup> The hedge fund industry is further defined by its ability to move in and out of markets quickly and efficiently, without fear of investor withdrawal from the fund at any moment.<sup>12</sup> The use of leverage and the ability to freely diversify their portfolios allows hedge funds to succeed where other regulated investors, like mutual funds, cannot.<sup>13</sup> Proponents of minimal hedge fund regulation theorize that the new legal regimes in the United States and the EU will be ineffective, cumbersome, costly, and potentially anathema to the industry.<sup>14</sup> On the other side, regulators worry that large, over-leveraged hedge funds may threaten market stability depending on their liquidity and market positions.<sup>15</sup> Post-2008, most studies have concluded that hedge funds may create some sources of systemic risk, but that any such threats are minimal and not unique to the industry.<sup>16</sup> Therefore, some oversight may be a good thing, but it is unclear to what extent regulation will deter systemic risk that results from hedge fund investment strategies.<sup>17</sup>

This leads to the question of whether it is feasible to regulate the hedge fund industry. A hedge fund is typically composed of three different parties—the investors, the advisers and the fund itself.<sup>18</sup> The fund is nothing more than one or two accounts, with no employees or corporate personnel.<sup>19</sup>

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10. See *id.* “Hedge funds exist because mutual funds do not deliver complex investment strategies. Part of the reason mutual funds do not is that they are regulated.” *Id.*

11. See LLOYD DIXON, NOREEN CLANCY & KRISHNA B. KUMAR, *HEDGE FUNDS AND SYSTEMIC RISK* 21 (2012).

12. See *id.* at 25.

13. See Stulz, *supra* note 9, at 176.

14. See DIXON, CLANCY & KUMAR, *supra* note 11, at 100; see also Sara Sjølin, *Hedge Fund Disclosures for SEC Eyes Only*, MARKET WATCH: WALL ST. J. (July 1, 2011, 2:16 p.m.), [http://articles.marketwatch.com/2011-07-01/investing/30757926\\_1\\_bulldog-investors-hedge-fund-fund-managers](http://articles.marketwatch.com/2011-07-01/investing/30757926_1_bulldog-investors-hedge-fund-fund-managers) (discussing the SEC’s decision not to require public disclosure of proprietary information).

15. See, e.g., DIXON, CLANCY & KUMAR, *supra* note 11, at 92-96.

16. See Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 203-04 (2008) (stating that although hedge funds may cause more potential systemic risk than other businesses, this is not due to their unregulated nature).

17. See DIXON, CLANCY & KUMAR, *supra* note 11, at 92-100 (discussing the effectiveness of Dodd-Frank’s direct and indirect attempts to regulate the hedge fund industry).

18. Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 247 (2009).

19. See, e.g., *id.*; Dan Barufaldi, *Hedge Funds: Structures*, INVESTOPEDIA, <http://www.investopedia.com/university/hedge-fund/structures.asp#axzz2DAhb5td5> (last visited Nov. 24, 2012); *Hedge Fund Structure – Hedge Fund Organizational Chart*, HEDGE

Often, the fund is divided into two accounts: a bank account, which operates as a holding account for investor funds, and a brokerage account.<sup>20</sup> Because the hedge fund is just a bank account, hedge fund businesses tend to be structured as limited partnerships.<sup>21</sup> The investment adviser, the entity most people envision when they hear the term “hedge fund,” acts as the general partner and manages the hedge fund.<sup>22</sup> The adviser employs a staff and dictates investment strategies and policies.<sup>23</sup> The investors are the limited partners, with no liability or responsibility for the activities of the hedge fund advisers.<sup>24</sup> For legal purposes, the fund is considered the “client” of the investment advisers, not the investors.<sup>25</sup> Because the investment adviser has the power over investor assets, both the United States and the EU attempt to regulate the investment advisers, and not the fund entity.<sup>26</sup>

As no governing authority has a clear understanding of how hedge fund organizational structure or trading tactics create systemic risk, this paper argues that it is currently impossible to “regulate” hedge funds for systemic risk. In support of this position, this paper compares the regulatory approach of the United States Securities and Exchange Commission (“SEC”) to the EU’s AIFMD. The SEC has, so far, largely taken this paper’s position, as its “regulation” of the hedge fund industry is more of an exercise in information gathering and less of an attempt to eliminate systemic risk in the hedge fund context. However, that is not to say the SEC will continue to merely monitor the industry in a passive fashion.<sup>27</sup> On the

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FUND LAW BLOG (Nov. 24, 2008), <http://www.hedgefundlawblog.com/wp-content/uploads/2008/12/organizational-chart-with-wire-fees.doc> [hereinafter *Hedge Fund Structure – Hedge Fund Organizational Chart*].

20. See *Hedge Fund Structure – Hedge Fund Organizational Chart*, *supra* note 19.

21. DIXON, CLANCY & KUMAR, *supra* note 11, at 10.

22. See *Hedge Fund Structure – Hedge Fund Organizational Chart*, *supra* note 19.

23. For example, Bridgewater Associates LP manages several funds, some of the more well-known including the Pure Alpha fund and the All Weather beta fund. See Renée Schultes, *Bridgewater Seeks Competitive Advantage Through Lateral Thinking*, FIN. NEWS (Sep. 11, 2006) <http://www.efinancialnews.com/story/2006-09-11/bridgewater-seeks-competitive-advantage-through-lateral-thinking>.

24. See Shadab, *supra* note 18, at 248.

25. See Anita K. Krug, *Institutionalization, Investment Adviser Regulation, and the Hedge Fund Problem*, 63 HASTINGS L.J. 1, 1-3 (2011); see also Dodd–Frank Wall Street Reform and Consumer Protection Act § 406, 15 U.S.C. § 80b-11 (2012) (stating that for certain purposes, the SEC may not define the word “client” to include investors in the hedge fund).

26. See generally AIFMD, *supra* note 7. See also Investment Advisers Act of 1940 § 80b-2(a)(11), 15 U.S.C. § 80b-1 (2010) (providing the definition of an investment adviser).

27. Recently the SEC has stepped up its enforcement efforts against hedge funds, bringing several high-profile cases against major investment advisers. See Chad Bray, *Falcone Settlement Seen as Model*, WALL ST. J., Aug. 20, 2013, <http://online.wsj.com/article/SB10001424127887323423804579025311717333426.html?KEYWORDS=sec>. However, some of the agency’s activity appears to have tapered off, perhaps in part due to the SEC’s assessment of substantive innocence or guilt rather than a lack of

other hand, the AIFMD's rigid approach to hedge fund regulation is really an attempt to dismantle the hedge fund industry, not an effort to regulate what currently exists, and may actually result in increased creation of systemic risk. In juxtaposition to the AIFMD, the SEC filing requirements provide benefits to all investors through increased information gathering and disclosure. This information will give the SEC the opportunity to defragment the various trading markets and to see the effect third party actions may have on overall market liquidity, providing a much needed component of investor protection in today's electronic securities markets.<sup>28</sup> Although a discussion of the cost-benefit analysis of hedge fund regulation is beyond the purview of this article, it is necessary to define the term "regulation" as it will be used throughout this discussion. Here, "regulation" will refer to the negative prohibitions and positive requirements that the law imposes on the hedge fund industry, such as capital requirements, leverage limits, compensation structure, and compliance requirements. Filing requirements and monitoring efforts will be treated as distinct concepts that are not equivalent to hard regulations like those mentioned above. This paper does not come to an ultimate conclusion on the cost-benefit analysis of regulating the hedge fund industry, but it does posit that certain government oversight efforts are more useful than others.<sup>29</sup>

Part II of this paper discusses the new rules promulgated by Dodd-Frank and how they impact the hedge fund industry. Part III discusses the EU's version of hedge fund regulation in the AIFMD and the impact it will have on alternative investment funds ("AIFs") located in Europe and abroad. Part IV explains the concept of systemic risk and how hedge funds create or contribute to sources of systemic risk. Part V provides a brief background on investor protection and how it promotes market stability. Part VI follows up on this notion and explains how and why the AIFMD will be ineffective in regulating the hedge fund industry for systemic risk.

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desire to prosecute. *See* Jean Eaglesham, *SEC's Hunt for Crisis-Era Wrongdoing Loses Steam*, WALL ST. J., Aug. 6, 2013, <http://online.wsj.com/article/SB10001424127887323968704578652532030191970.html?KEYWORDS=sec>. *But see* Kaitlyn Kiernan, *SEC Charges Former Oppenheimer Manager with Misleading Investors*, WALL ST. J., Aug. 20, 2013, <http://online.wsj.com/article/SB10001424127887324108204579025122859239320.html?KEYWORDS=sec> (providing an overview of the SEC's decision to bring fraud charges against Brian Williamson who used to lead the private equity firm Oppenheimer Global Resource Private Equity Fund LP).

28. *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-410, CLEARER GOALS AND REPORTING REQUIREMENTS COULD ENHANCE EFFORTS BY CFTC AND SEC TO HARMONIZE THEIR REGULATORY APPROACHES (2010), *available at* <http://www.gao.gov/assets/310/303489.pdf> (calling for enhanced jurisdictional clarity between the two organizations to promote transparency, efficiency and uniformity in securities regulations).

29. For a good cost-benefit analysis of regulating for systemic risk, *see* Schwarcz, *supra* note 16, at 234-43.

This section also argues that the SEC's disclosure policy, although costly, will provide the SEC with an overview of systemic risk throughout all markets. Finally, this paper concludes in Part VII that to "regulate" the hedge fund industry for the prevention of systemic risk, government agencies must first understand how hedge funds create systemic risk, and that the SEC's disclosure requirements will give the SEC a unique picture of market-wide risk levels.

## DODD-FRANK

### FSOC and the Fed

As part of the congressional response to the financial crisis of 2008,<sup>30</sup> the purpose of the Dodd-Frank Act is to forestall widespread market collapse by preventing the failure of any systemically important institutions.<sup>31</sup> The portions of Dodd-Frank that regulate hedge funds are really a call for other federal government agencies, like the SEC, to draft further implementing measures.<sup>32</sup> There are several sections of Dodd-Frank that have implications for hedge funds, the centerpiece being Title IV,<sup>33</sup> the PFIARA.<sup>34</sup> Dodd-Frank also created the Financial Stability Oversight Council ("FSOC"), which is supposed to monitor the financial industry for systemic risk,<sup>35</sup> and delegated new powers to the Federal Reserve Board ("the Fed"), the SEC and the Commodity Futures Trading Commission ("CFTC").<sup>36</sup> Some of these new powers may affect hedge funds more than others.

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30. See Mark Koba, *CNBC Explains: Dodd-Frank Act*, CNBC, May 11, 2012, [http://www.cnbc.com/id/47075854/CNBC\\_Explains\\_Dodd\\_Frank\\_Act](http://www.cnbc.com/id/47075854/CNBC_Explains_Dodd_Frank_Act).

31. See, e.g., 156 CONG. REC. E1383-01 (daily ed. July 20, 2010) (statement of Rep. Betty McCollum). In the fall of 2008, our country's financial system stood on the brink of collapse. The failure of large financial institutions quickly led to sinking home prices, a collapse in retirement savings, and job losses on a scale not seen since the Great Depression. Despite overwhelming opposition from Republicans and relentless lobbying from special interests, Congress has responded with legislation that imposes the toughest regulation of Wall Street in a generation. *Id.* See also Koba, *supra* note 30. Dodd-Frank also increases consumer protection in certain industry areas, specifically in lending practices. See Koba, *supra* note 30.

32. See Gill North & Ross Buckley, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Unresolved Issues of Regulatory Culture and Mindset*, 35 MELB. U. L. REV. 479, 481 (2011).

33. Title IV is captioned "Regulation of Advisers to Hedge Funds and Others." See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (codified in scattered sections of 12 U.S.C.) (2010).

34. See Dodd-Frank § 401.

35. See Dodd-Frank § 111; see also North & Buckley, *supra* note 32.

36. See, e.g., Dodd-Frank §§ 608, 619, 404, 712.

Of potential concern to hedge funds is FSOC's ability to designate a non-bank entity, such as a hedge fund, of systemic importance (referred to as a systemically important non-bank financial company, "SINBFC" or a systemically important financial institution, "SIFI").<sup>37</sup> FSOC may designate a hedge fund as a SINBFC if the fund "poses a threat to the financial stability of the United States."<sup>38</sup> FSOC also has this power with regard to foreign non-bank institutions.<sup>39</sup> If FSOC designates a hedge fund as a SINBFC, the Fed then has the power to set capital requirements, leverage limits, liquidity requirements, risk-management plans, and reporting requirements in various areas.<sup>40</sup> However, the recent standards FSOC promulgated for determining whether an entity is systemically important are controversial.<sup>41</sup>

FSOC's standards imply that hedge funds collectively managing over \$50 billion in consolidated assets are subject to potential SIFI designation.<sup>42</sup> Any potential designee must also satisfy several other requirements, including a 15:1 leverage ratio, to be considered.<sup>43</sup> Even though the

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37. See DIXON, CLANCY & KUMAR, *supra* note 11, at 86. Before FSOC's inquiry may begin, Dodd-Frank requires that the entity in question be considered a non-bank company "predominantly engaged in financial activities," Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 102(4), 12 U.S.C. 5311 (2012), as that term is defined by section 4(k) of the Bank Holding Company Act. Bank Holding Company Act of 1956 § 4, 12 U.S.C. 1843 (2012). Section 4(k)(4)(A) does include investing on the behalf of others as a financial activity. *Id.*

38. Dodd-Frank § 113(a)(1).

39. See Dodd-Frank § 113 (b)(1).

40. See DIXON, CLANCY & KUMAR, *supra* note 11, at 88.

41. See James Hamilton, *House-Senate Legislation Would Deprive FSOC of the Authority to Designate Hedge Funds and Other Non-Bank Financial Institutions as Systemically Important*, JIM HAMILTON'S WORLD OF SECURITIES REGULATION (Aug. 3, 2012, 11:29 AM), <http://jimhamiltonblog.blogspot.com/2012/08/house-senate-legislation-would-deprive.html> (discussing the recent parallel bills introduced in the House and the Senate that would revoke FSOC's ability to designate hedge funds as SINBFCs). *But see S. 3497: Terminating the Expansion of Too-Big-To-Fail Act of 2012*, GOV.TRACK.US, <http://www.govtrack.us/congress/bills/112/s3497> (last visited Nov. 17, 2012) (stating that "[t]his bill was introduced . . . but was not enacted").

42. 12 C.F.R. pt. 1310, app. A (2012). See also Joseph P. Vitale & Marc E. Elovitz, *FSOC Issues Final Rule on Designating Nonbanks as "Systemically Important" – What Private Fund Managers Need to Know*, SCHULTE ROTH & ZABEL LLP (Apr. 12, 2012), [http://www.srz.com/FSOC\\_Issues\\_Final\\_Rule\\_on\\_Designating\\_Nonbanks\\_as\\_Systemically\\_Important/](http://www.srz.com/FSOC_Issues_Final_Rule_on_Designating_Nonbanks_as_Systemically_Important/) [hereinafter SCHULTE ROTH & ZABEL'S *FSOC Issues*].

43. See 12 C.F.R. pt. 1310, app. A. Funds that may be subject to SIFI designation must also have at least \$30 billion in gross national credit default swaps . . . [at least] \$3.5 billion of derivative liabilities . . . [at least] \$20 billion in total debt outstanding . . . [a] leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1 . . . [or a S]hort-term debt ratio. . . of total debt outstanding (as defined above) with a maturity of less than 12 months to total consolidated assets (excluding separate accounts) of 10 percent. See SCHULTE ROTH & ZABEL'S *FSOC Issues*, *supra* note 42.

thresholds are such that no single hedge fund today would qualify,<sup>44</sup> the rule does not clarify how it will treat separate funds managed by the same investment adviser, although it suggests that this may depend on the similarity of the funds under management.<sup>45</sup> The standards' vagueness prompted Senator David Vitter (R), and Representative Scott Garnett (R) to introduce companion bills in both the Senate and the House that would repeal FSOC's potential authority to designate hedge funds and other non-bank institutions as SINBFCs.<sup>46</sup> Even if FSOC retains the power to designate hedge funds as potential SIFIs, there are only a handful of hedge fund advisers that have ever managed more than \$50 billion assets collectively in any single year.<sup>47</sup> Despite the limited number of hedge fund advisers that will be identified by FSOC as SINBFCs, a designation could pose serious issues for a hedge fund's financial structure.<sup>48</sup>

Being designated as an SINBFC would result in significant consequences for a hedge fund.<sup>49</sup> Dodd-Frank requires the Fed to first come up with increased stringency standards for SINBFCs "based on the[ir] systemic footprint and risk characteristics."<sup>50</sup> In implementing these mandatory stringency standards, the Fed has proposed regulations concerning "risk-based capital, leverage, liquidity, single-counterparty credit exposure limits, supervisory and company-run stress testing, risk management and a risk committee, and early remediation requirements."<sup>51</sup> The risk-based capital and leverage requirements would subject a covered SINBFC to the Fed's capital plan rule, which requires the covered entity to come up with an individualized "annual capital plan[], conduct stress tests, and maintain adequate capital."<sup>52</sup> Part of maintaining adequate capital requires the company to conform to certain pro forma regulatory minimum capital ratios.<sup>53</sup> These include a tier one common equity-based capital ratio

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44. See SCHULTE ROTH & ZABEL's *FSOC Issues*, *supra* note 42.

45. See Heath Tarbert, Sylvia Mayer & Derrick Cephas, *Systemically Important in Three Easy Steps? FSOC Approves Final Rule for Nonbank SIFI Designations*, 129 *BANKING L.J.* 419, 429-30 (2012).

46. See Hamilton, *supra* note 41.

47. See *Top-Performing Large Hedge Funds*, *BLOOMBERG MARKETS* 2 (Feb. 2012), [http://www.cerberuscapital.com/images/pdf/Bloomberg\\_Markets\\_2012\\_ePrint.pdf](http://www.cerberuscapital.com/images/pdf/Bloomberg_Markets_2012_ePrint.pdf).

48. See DIXON, CLANCY & KUMAR, *supra* note 11, at 88.

49. See *id.*

50. FINANCIAL STABILITY OVERSIGHT COUNCIL, 2012 ANN. REP. 97 (2012) [hereinafter *FSOC 2012 ANN. REP.*]. See also Dodd-Frank Wall Street Reform and Consumer Protection Act § 165, 12 U.S.C. 5365 (2012).

51. *FSOC 2012 ANN. REP.*, *supra* note 50, at 97.

52. *Id.* at 98.

53. The *FSOC 2012 ANNUAL REPORT* states a covered company must conform to the Fed's capital plan rule. See *id.* at 97.



of four percent,<sup>54</sup> a tier one leverage ratio of three or four percent,<sup>55</sup> a tier one risk-based capital ratio of four percent,<sup>56</sup> a total risk-based capital ratio of eight percent,<sup>57</sup> and a tier one common risk-based capital ratio of five percent “under both expected and stressed conditions.”<sup>58</sup> It is important to note that these ratios were developed with banking institutions in mind.<sup>59</sup> In step two, the Fed would exact a “risk-based capital surcharge”<sup>60</sup> based on Basel III.<sup>61</sup> For liquidity requirements, the Fed has also formulated a two-step process, the first involving internal assessments of liquidity needs, followed by a “quantitative liquidity requirement[] based on Basel III.”<sup>62</sup> The single counterparty rule would limit a SINBFC’s ability to borrow from a single counterparty to a certain percentage of the SINBFC’s “regulatory capital.”<sup>63</sup> These regulations are potentially onerous, but it remains to be seen whether any hedge funds will be designated as SINBFCs.

In addition to the potential for SINBFC designation, Dodd-Frank revamped the swap market in a way that could affect any hedge fund acting as a major swap participant or as a swap dealer by requiring them to register with the CFTC and to maintain certain capital and margin requirements (among other things).<sup>64</sup> Although the definitions of the two categories are potentially broad enough to include hedge funds within their scope, it is

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54. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., CAPITAL PLAN REVIEW 2013: SUMMARY INSTRUCTIONS AND GUIDANCE (2012), [hereinafter THE FED’S CAPITAL PLAN REVIEW 2013]. For a definition of tier one common ratio, see *Tier 1 Common Capital Ratio*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/tier-1-common-capital-ratio.asp#axzz2DIHjWJH0> (last visited Nov. 25, 2012).

55. See THE FED’S CAPITAL PLAN REVIEW 2013, *supra* note 54.

56. See *id.*

57. See *id.*

58. FSOC 2012 ANN. REP., *supra* note 50, at 98.

59. See generally THE FED’S CAPITAL PLAN REVIEW 2013, *supra* note 54.

60. *Id.*

61. See *id.*

62. *Id.*

63. *Id.*

64. See DIXON, CLANCY & KUMAR, *supra* note 11, at 71. Certain swaps must now be cleared with a central clearing agency, and then “submit[ted] . . . to a derivatives clearing organization.” *Id.* at 75. OTC swap trades are not subject to these clearing requirements. See Dodd-Frank Wall Street Reform and Consumer Protection Act §725, 7 U.S.C. 7a-1 (2012); see also SEC Proposes Rules for Security-Swap Based Swap Dealers and Major Security-Based Swap Participants, SEC. & EXCH. COMM’N (Oct. 17, 2012), <http://www.sec.gov/news/press/2012/2012-210.htm>; see also Regulatory Reform Task Force: Legal Alert, SUTHERLAND ASBILL & BRENNAN LLP 1 (May 10, 2012), <http://www.regulatoryreformtaskforce.com/files/upload/TheCFTCsFinalEntityRulesandTheirImplicationsforHedgeFundsandOtherPrivateFunds.pdf> [hereinafter SUTHERLAND’S Regulatory Reform Task Force: Legal Alert].

unlikely hedge funds will have to register.<sup>65</sup> A swap dealer, as defined by the CFTC, must act as a market maker and hold itself out as such.<sup>66</sup> Major swap participants have to hold a substantial position in swaps, which excludes hedging positions, and those positions must “create substantial counterparty exposure” that could pose very serious threats to the financial stability of the markets.<sup>67</sup> The CFTC has adopted a high threshold amount to qualify for a “substantial position” or a “substantial counterparty exposure” and has implemented a *de minimis* exception for both categories.<sup>68</sup> These implementing definitions make it doubtful that hedge funds will have to register as either major swap participants or swap dealers.

#### Investment Adviser Act and Investment Company Act

Title IV of Dodd-Frank effects the most sweeping and immediate changes to the hedge fund industry. It amends some of the predominant securities legislation,<sup>69</sup> including the Investment Advisers Act of 1940 (“IAA”)<sup>70</sup> and the Investment Company Act of 1940 (“ICA”).<sup>71</sup> The IAA and the ICA require certain investment advisers and investment companies to register with the SEC.<sup>72</sup> Prior to their enactment, many hedge fund advisers were exempt from registration.<sup>73</sup> Dodd-Frank created a new categorical requirement that all private fund investment advisers register with the SEC (subject to a narrow range of exceptions).<sup>74</sup> The definition of a

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65. See SUTHERLAND’S *Regulatory Reform Task Force: Legal Alert*, *supra* note 64, at 1 (using the data provided on the SEC’s website to determine whether hedge funds are likely to have to register with the CFTC).

66. See *id.* at 2.

67. Major swap participants are defined as any organization that is: (i) “not a swap dealer, and maintains a substantial position in swaps . . . excluding positions held for hedging or mitigating commercial risk” and certain employee benefit plans that are also supposed to mitigate risk; (ii) “whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability” on the economy of the United States; or (iii) “is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements,” and has a “substantial position in outstanding swaps.” Dodd-Frank Wall Street Reform and Consumer Protection Act § 721(a)(16), 7 U.S.C. § 1a (2012).

68. See SUTHERLAND’S *Regulatory Reform Task Force: Legal Alert*, *supra* note 64, at 2-4.

69. See, e.g., Dodd-Frank § 402.

70. See Investment Advisers Act of 1940 § 80b-3, 15 U.S.C. § 80b-1 (2010).

71. See Investment Company Act of 1940 § 80a-3, 15 U.S.C. § 80-1 (2010).

72. Investment Advisers Act § 80b-3(a). The ICA’s registration requirements are in section 8. See Investment Company Act § 80a-8(a).

73. See Timothy Spangler, *Deadline for Hedge Fund, Private Equity Fund Managers to Register with SEC Rapidly Approaching*, FORBES (Feb. 8, 2012), <http://www.forbes.com/sites/timothyspangler/2012/02/08/deadline-for-hedge-fund-private-equity-fund-managers-to-register-with-sec-rapidly-approaching/>.

74. See Dodd-Frank § 403.

private fund was cobbled together from provisions of the ICA that exempted certain investment companies from having to register with the SEC.<sup>75</sup>

Although hedge funds fall within the statutory definition of an investment company, they avoid registration as such because the consequences of registering as an investment company would eliminate their distinctive characteristics.<sup>76</sup> A registered investment company must have a board of directors, at least forty percent of whom must be independent.<sup>77</sup> In the United States, less than fifteen percent of hedge funds even have a board of directors.<sup>78</sup> Additionally, the ICA's effective ban on leverage would end nearly all hedge fund trading operations.<sup>79</sup> The ICA basically prevents registered companies from using any conventional leverage, as any amount must have asset coverage of 300%.<sup>80</sup> The SEC has recently stated that it will allow registered investment companies to continue using derivatives without technically meeting the 300% asset coverage requirement demanded by the ICA.<sup>81</sup> These provisions disallowing the use of leverage make it crucial for hedge funds to opt out of ICA regulation. Hedge funds usually do so through two statutory provisions in section 3(c) of the ICA.<sup>82</sup> Section 3(c)(1) exempts any issuer that has fewer than 100 beneficial investors and is not a publicly traded company.<sup>83</sup> Section 3(c)(7) exempts funds that are invested in exclusively by qualified purchasers.<sup>84</sup>

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75. See Dodd-Frank § 402(a).

76. See, e.g., Investment Company Act § 80a-10(a), 80a-18.

77. See Investment Company Act § 80a-10(a).

78. See Ratan Engineer & Arthur F. Tully, *Coming of Age: Global Hedge Fund Survey 2011*, ERNST & YOUNG 13 (June 22, 2012), [https://webforms.ey.com/Publication/vwLUAssets/Coming\\_of\\_age\\_Global\\_hedge\\_fund\\_survey\\_2011/\\$FILE/Coming%20of%20age\\_%20Global%20hedge%20fund%20survey%202011.pdf](https://webforms.ey.com/Publication/vwLUAssets/Coming_of_age_Global_hedge_fund_survey_2011/$FILE/Coming%20of%20age_%20Global%20hedge%20fund%20survey%202011.pdf).

79. See Investment Company Act § 80a-18.

80. See *id.*

81. See *Registered Investment Company Use of Senior Securities - Select Bibliography*, SEC. & EXCH. COMM'N, <http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm> (last updated Feb. 12, 2013).

82. See Hedge Fund Lawyer, *Overview of the Investment Company Act of 1940*, HEDGE FUND L. BLOG (Oct. 24, 2008), <http://www.hedgefundlawblog.com/overview-of-the-investment-company-act-of-1940.html>. See also Investment Company Act of 1940, 15 U.S.C. § 80a-3(c) (2012).

83. See Investment Company Act § 80a-3(c)(1). "Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." *Id.*

84. See Investment Company Act § 80a-3(c)(7). Qualified purchasers is defined by the ICA as either a natural person with not less than \$5 million in investments, or any person acting either for its own benefit or for the benefit of other qualified purchasers who "owns and invests on a discretionary basis, not less than [\$25 million] in investments." Investment Company Act § 80a-2(a)(51).

Conversely, hedge funds are not so lucky with respect to the IAA after Dodd-Frank. Dodd-Frank requires all “private fund” investment advisers to register, a term defined as any “issuer that would be an investment company, as defined in the Investment Company Act of 1940 [§80a-3], but for section 3(c)(1) or 3(c)(7) of that Act.”<sup>85</sup> Dodd-Frank also explicitly repealed the private adviser exemption that had existed previously in section 203(b)(3) of the IAA.<sup>86</sup> Dodd-Frank did maintain some exceptions for private advisers, which includes a *de minimis* exception of assets under management (“AUM”) of less than \$150 million.<sup>87</sup>

### SEC and CFTC Registration

Determining whether a hedge fund investment adviser must register with the SEC takes more than a review of Dodd-Frank; a hedge fund adviser must also read the SEC’s filing Form ADV. A hedge fund’s response to Part 1 of Form ADV is made publicly available on the SEC’s website, but Part 2 is not disclosed by the SEC.<sup>88</sup> Part 1 requires general information about the identity of the investment adviser and any associated persons as well as business practices.<sup>89</sup> This covers information about employees, clients, compensation policies, the value of AUM, industry affiliations, business interactions with clients, and custody of AUM as well as ownership and control.<sup>90</sup> Part 2 is divided into two sections, A and B, both of which are intended for distribution to the investors.<sup>91</sup> Part 2A is called the brochure and must contain information regarding the investment adviser’s business and funds managed, conflicts of interest, and risk in the investment strategies.<sup>92</sup> Part 2B is the brochure supplement, and focuses on the advisory personnel employed by the fund advisers.<sup>93</sup> Once Form ADV is filed and the investment adviser is successfully registered, the adviser must adopt a detailed compliance network with procedures that are “reasonably designed

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85. Dodd-Frank Wall Street Reform and Consumer Protection Act § 402(a), 15 U.S.C. 80b-20 (2012).

86. See Dodd-Frank § 403.

87. See Dodd-Frank § 408.

88. See *Guide To SEC Investment Adviser Registration For Hedge Fund And Private Equity Fund Managers*, BINGHAM MCCUTCHEN LLP 9 (July 2012), <http://www.bingham.com/Alerts/2011/02/~media/E87B98C6BC794D3FB2E1DD629DC5DE11.ashx> [hereinafter BINGHAM MCCUTCHEN LLP’s *Guide To SEC Investment Adviser Registration*]; see also *Form ADV*, SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/formadv.htm> (last modified Mar. 11, 2011).

89. See BINGHAM MCCUTCHEN LLP’s *Guide To SEC Investment Adviser Registration*, *supra* note 88, at 9.

90. See *id.*

91. See *id.*

92. See *id.*

93. See *id.*

to prevent violations of the [IAA].”<sup>94</sup> The investment adviser must employ a competent chief compliance officer to oversee all compliance activities.<sup>95</sup> Although the SEC has not promulgated detailed rules about the compliance structure, it has set out some particular areas that must be addressed.<sup>96</sup> In addition to compliance plans and training, the investment adviser has to formulate a code of ethics,<sup>97</sup> procedures to prevent insider trading,<sup>98</sup> client privacy policies, and substantive proxy voting standards.<sup>99</sup>

Form ADV existed prior to the enactment of Dodd-Frank, but the act also called for the SEC and CFTC to jointly develop a new procedure to collect information from advisers regarding systemic risk.<sup>100</sup> In response, the SEC and CFTC came up with Form PF. Form PF has resulted in the single largest addition to the hedge fund regulatory scheme.<sup>101</sup> It is confidential because it requires hedge fund advisers to disclose proprietary trading information.<sup>102</sup> Because of this, Dodd-Frank was amended to ensure the contents of Form PF were exempt from the Freedom of Information Act.<sup>103</sup> Despite this, the SEC and CFTC may use the information obtained from Form PF during investigations, enforcement proceedings, and for investor protection purposes.<sup>104</sup>

Form PF attempts to gauge hedge fund-created systemic risk by extracting varying amounts of information depending on the size and structure of the hedge fund.<sup>105</sup> Form PF requires hedge fund advisers to

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94. *See id.* at 12.

95. *See id.* at 14.

96. *See id.* at 12. These concerns include portfolio management procedures, trading practices, procedures to prevent misuse of proprietary information, means to ensure accurate disclosure, policies to prevent misuse of client funds, appropriate creation and maintenance of records, marketing practices, valuation processes and business contingency plans. *See id.* at 12-13.

97. *See id.* at 15

98. *See id.*

99. *See id.* at 16.

100. *See Form PF Readiness Assessment for Hedge Funds and Private Equity Funds: Are You Ready?*, DELOITTE 3 (2012), [http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/US\\_FSI\\_Form%20PF\\_012712.pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/US_FSI_Form%20PF_012712.pdf) [hereinafter DELOITTE’s *Form PF Readiness Assessment*].

101. *See* Champ, *supra* note 4<sup>101</sup>.

102. *See* Anthony Murray, *United States: Form PF: Essential Guide To Form PF*, MONDAQ (May 9, 2013), <http://www.mondaq.com/unitedstates/x/192396/Fund+Management+REITs/FORM+PF+Essential+Guide+To+Form+PF+August+2012>.

103. *See id.*

104. *See* BINGHAM MCCUTCHEN LLP’s *Guide To SEC Investment Adviser Registration*, *supra* note 88, at 18.

105. *See id.* *See also* *Form PF: Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors*, SEC. & EXCH. COMM’N, <http://www.sec.gov/rules/final/2011/ia-3308-formpf.pdf> (last visited Oct. 13, 2012) [hereinafter *Form PF*].

compile massive amounts of data collected over a period of time.<sup>106</sup> Hedge funds must report their investment strategies and the corresponding percentage of assets invested.<sup>107</sup> Funds must also report the exposure of counterparties, detailed information on over-the-counter (“OTC”) markets and centrally cleared trades, and the amount of assets invested in derivatives.<sup>108</sup> The advisers must also accumulate data on its long and short positions, including direction and length of time held, as well as the relative liquidity.<sup>109</sup> The form also requires general risk-related information, such as how the firm calculates value at risk and NAV.<sup>110</sup>

Form PF must be filed by investment advisers that are required to register with the SEC by the IAA, manage at least one private fund and have, either independently or in conjunction with a related person, at least \$150 million AUM.<sup>111</sup> Important to note here is the definition of assets under management since the SEC has changed the definition to regulatory assets under management (“RAUM”), which refers to gross assets without any deduction for leverage.<sup>112</sup> Certain sections of Form PF are only required above a certain amount of RAUM.<sup>113</sup> This change in the definition of AUM to RAUM may have the effect of requiring smaller hedge funds that are highly leveraged to file when they otherwise might have been exempt.<sup>114</sup> For a fund that manages less than \$1.5 billion assets, Form PF need only be filed annually.<sup>115</sup> Otherwise, for larger investment advisers, generally those with assets under management of over \$1.5 billion, Form PF must be filed quarterly.<sup>116</sup>

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106. See DELOITTE’S *Form PF Readiness Assessment*, *supra* note 100, at 6.

107. See *id.*

108. See *id.*

109. See *id.*

110. See *id.* NAV stands for net asset value, which is calculated by subtracting the value of a company’s liabilities from the value of its assets on a daily, weekly or monthly basis. See *Net Asset Value - NAV*, INVESTOPEDIA, <http://www.investopedia.com/terms/n/nav.asp#axzz2NGEqBREK> (last visited Mar. 11, 2013).

111. See *Form PF*, *supra* note 105, at 1. A related person is broadly defined in Form ADV as “[a]ny advisory affiliate and any person that is under common control with your firm.” *Form ADV: Glossary of Terms*, SEC. & EXCH. COMM’N 7, <http://www.sec.gov/about/forms/formadv-instructions.pdf> (last visited Oct. 13, 2012). The definitions in Form ADV are incorporated in Form PF. See DELOITTE’S *Form PF Readiness Assessment*, *supra* note 100, at 10.

112. See *Risky Reporting: Form PF in a Nutshell*, ERNST & YOUNG 1 (Jan. 2012), [http://www.ey.com/Publication/vwLUAssets/Risky\\_reporting\\_Form\\_PF\\_in\\_a\\_nutshell/\\$FILE/Risky%20reporting\\_Form%20PF%20in%20a%20nutshell.pdf](http://www.ey.com/Publication/vwLUAssets/Risky_reporting_Form_PF_in_a_nutshell/$FILE/Risky%20reporting_Form%20PF%20in%20a%20nutshell.pdf) [hereinafter ERNST & YOUNG’S *Risky Reporting*].

113. See *id.* at 1.

114. See *id.*

115. See Murray, *supra* note 102.

116. See *id.*

## ALTERNATIVE INVESTMENT FUND ADVISORS DIRECTIVE

In response to the 2008 financial crisis, the EU created the Alternative Investment Fund Advisers Directive (“AIFMD”).<sup>117</sup> The AIFMD indirectly seeks to impose substantial financial requirements on investment funds through regulation of investment advisers.<sup>118</sup> Specifically, the AIFMD is an attempt to fill the regulatory gap at the EU level for funds that do not fall within the scope of an undertaking for collective investment in transferable securities (“UCITS”).<sup>119</sup> The EU defines UCITS as investment entities that collectively invest in “transferable securities or in other liquid financial assets,”<sup>120</sup> using publicly raised capital while primarily engaging in risk-spreading techniques and whose investors may redeem their investment upon request.<sup>121</sup> UCITS are allowed to raise capital investments from the public at large if they are authorized pursuant to the UCITS directive.<sup>122</sup> An alternative investment fund (“AIF”) is much more narrowly defined as an entity that “raises capital from a number of investors,”<sup>123</sup> with the intention of following a defined investment plan that is “for the benefit of those investors.”<sup>124</sup> An AIF need not permit redemption upon request, but only formulate a plan consistent with its investment strategy, liquidity profile, and the frequency with which redemption is allowed.<sup>125</sup>

Much like Form PF’s exemptions for investment advisers with assets under management of less than \$150 million, the AIFMD also has a *de minimis* exception.<sup>126</sup> A leveraged AIF need not register if it manages assets under €100 million (U.S. \$130,320,000).<sup>127</sup> If the AIF is unleveraged, then the managing corporation need not register if assets managed do not exceed €500 million (U.S. \$651,600,000) and the fund does not provide redemption rights for five years after the initial investment.<sup>128</sup> One of the most controversial aspects of the AIFMD is that it does not differentiate between

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117. See European Commission Press Release FAQ, *supra* note 7; see generally AIFMD, *supra* note 7.

118. See AIFMD, *supra* note 7, art. 10, 2011 O.J. (L 174) 1, at 2; see also European Commission Press Release FAQ, *supra* note 7.

119. See AIFMD, *supra* note 7, art. 3, 2011 O.J. (L 174) 1, at 1.

120. See Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities, Council Directive 2009/65/EC, art. 1.2(a), 2009 O.J. (L302) 32, 43.

121. See *id.*

122. See *id.*

123. See AIFMD, *supra* note 7, art. 4(1), 2011 O.J. (L 174) 1, at 16.

124. See *id.* 2011 O.J. (L 174) 1.

125. See *id.* art. 16(2), 2011 O.J. (L 174) 1, at 25.

126. See *id.* art. 3, 2011 O.J. (L 174) 1, at 15.

127. See *id.* art. 3(2), 2011 O.J. (L 174) 1, at 15.

128. See *id.* art. 3(2), 2011 O.J. (L 174) 1, at 15.123.

EU and non-EU AIFs.<sup>129</sup> Non-EU AIFs that manage assets located outside of the EU are only exempted from the complex AIFMD requirements if they do not market themselves to EU investors.<sup>130</sup> If they wish to raise funds in the EU, hedge funds domiciled outside the EU will have to comply with all AIFMD provisions.<sup>131</sup> The AIFMD imposes a variety of structural and financial requirements, including capital requirements, a mandatory depositary for asset funds, business operation and governance regulations, a required valuation of assets by an external source, limited delegation abilities, compensation limits, prohibitions on asset stripping, and a 5% skin-in-the-game requirement for securitization investments.<sup>132</sup>

### Structural Requirements

Many of the corporate governance requirements attempt to minimize conflicts of interest.<sup>133</sup> The AIFMD anticipates conflicts of interest between the advisers and the fund and between the AIF's investors and other AIFs, as well as conflicts between one managed fund and another, or an AIF and a UCIT.<sup>134</sup> In order to limit these conflicts of interest, the AIFMD requires the AIF to make operational adjustments to separate potentially conflicting activities and, where that is not possible, to make sufficient disclosure of those conflicts to investors.<sup>135</sup>

Corporate governance regulations also require that the AIF "functionally and hierarchically separate the functions of risk management from the operating units, including from the functions of portfolio management."<sup>136</sup> This means the AIF must provide a separate risk adviser for each particular fund. The concern is that portfolio advisers are more risk-prone because they want to maximize returns, which conflicts with the AIFMD's desire to limit all risk.<sup>137</sup> Additionally, AIFs are under a tight rein when it comes to delegating these responsibilities – the directive requires that any delegation structure be objectively justified.<sup>138</sup> Any delegation of

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129. See, e.g., Wulf A. Kaal, *Hedge Fund Regulation via Basel III*, 44 VAND. J. TRANSNAT'L L. 389, 404 (2011).

130. See Carmen Reynolds, *EU Alternative Investment Fund Managers Directive: An Outline for Private Fund Managers*, WHITE & CASE 1 (Mar. 2011), [http://www.whitecase.com/files/Publication/Odcba43e-9556-46ef-a805-43b0f4f2435f/Presentation/PublicationAttachment/9e7d0ddf-66b1-442f-b5b3-53d61a82b598/alert\\_EU\\_Regulation\\_of\\_Investment\\_Funds.pdf](http://www.whitecase.com/files/Publication/Odcba43e-9556-46ef-a805-43b0f4f2435f/Presentation/PublicationAttachment/9e7d0ddf-66b1-442f-b5b3-53d61a82b598/alert_EU_Regulation_of_Investment_Funds.pdf).

131. See *id.*

132. See *id.* at 2.

133. See AIFMD, *supra* note 7, 2011 O.J. (L 174) 1, at 18, 20, 23-25.

134. See *id.*, art. 14, 2011 O.J. (L 174) 1, at 24.

135. See *id.*, art. 14(1), 2011 O.J. (L 174) 1, at 24.

136. *Id.*, art. 15(1), 2011 O.J. (L 174) 1, at 24.

137. See *id.*, art. 15, 2011 O.J. (L 174) 1, at 24-25.

138. See *id.*, art. 1, 2011 O.J. (L 174) 1, at 27.



portfolio or risk management may only be delegated to another authorized or registered asset adviser.<sup>139</sup> The AIF must maintain full control over the investment decisions, and it must be able to show that the delegated entity is capable of performing the tasks entrusted to it and that it was selected with due care.<sup>140</sup>

The AIF must also set specific leverage limits and liquidity requirements aligned with each managed AIF.<sup>141</sup> Leverage limits are to depend on a variety of considerations including, but not limited to, the type of investment strategy, identity of counterparties and their need to have limited exposure, the level of collateralized leverage, and the sources of leverage.<sup>142</sup> Although this seems relatively hands-off, the EU Commission has made it clear that it intends to adopt further specifying measures on “the risk management systems to be employed by AIFMs . . . .”<sup>143</sup> Liquidity for each fund must be in line with the investment strategy and the redemption frequency, but that is not entirely up to the AIF as the Commission is to provide further clarifying measures on “the alignment of the investment strategy, liquidity profile and redemption policy . . . .”<sup>144</sup> Additionally, the AIF must maintain a minimum amount of capital, which is either €300,000 if the AIF is self-managed or €25,000 if the fund is “externally managed.”<sup>145</sup> In order to ensure that there is sufficient capital to cover potential exposure, the investment advisers must either invest their own capital or purchase professional indemnity insurance.<sup>146</sup>

Assets must be valued at least once a year and must be kept in a physically separate location by an independent depository.<sup>147</sup> The assets kept by the depository must be valued by either an independent, outside evaluator or the AIF may value the assets if the evaluator is free from conflicts presented by the risk management and portfolio management functions.<sup>148</sup> The external evaluation may not be performed by the depository unless the AIF can ensure that the evaluator is free from any conflicts presented by its depository functions.<sup>149</sup>

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139. See AIFMD, *supra* note 7, 2011 O.J. (L 174) 1, at 2.

140. See *id.*, 2011 O.J. (L 174) 1.

141. See *id.*, art. 15(4), 16, 2011 O.J. (L 174) 1, at 25.

142. See *id.*, 2011 O.J. (L 174) 1.

143. *Id.*, art. 15(5), 2011 O.J. (L 174) 1, at 25.

144. *Id.*, art. 16(3), 2011 O.J. (L 174) 1, at 25.

145. *Alternative Investment Fund Managers Directive Survival Kit*, LINKLATERS 29 (Nov. 2011), [http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=5&ved=0CEEQFjAE&url=http%3A%2F%2Fwww.linklaters.com%2Fpdfs%2Fmkt%2Fluxembourg%2FAIFMD-Survival-kit.pdf&ei=C9u3UIHfM6m70QHvroCoCw&usg=AFQjCNFSCtDLhkrMes\\_DQ4pE-Aksci2e7w](http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=5&ved=0CEEQFjAE&url=http%3A%2F%2Fwww.linklaters.com%2Fpdfs%2Fmkt%2Fluxembourg%2FAIFMD-Survival-kit.pdf&ei=C9u3UIHfM6m70QHvroCoCw&usg=AFQjCNFSCtDLhkrMes_DQ4pE-Aksci2e7w).

146. See AIFMD, *supra* note 7, art. 23, 2011 O.J. (L 174) 1, at 4.

147. See *id.*, art. 19, 2011 O.J. (L 174) 1, at 26.

148. See *id.*, art. 19(4), 2011 O.J. (L 174) 1, at 26.

149. See *id.*

Subject to certain exceptions, the depositary must be a credit institution and subject to EU law.<sup>150</sup> For EU AIFs, the depositary must be located in the same country as the AIF.<sup>151</sup> This is of huge significance as many European hedge funds keep their assets outside of the EU.<sup>152</sup> For non-EU AIFs, they may locate a depositary outside of the EU only under certain conditions.<sup>153</sup> The depositary in question for a non-EU AIF must be of similar caliber as those in the EU, subject to oversight and government regulation that has “the same effect as Union law.”<sup>154</sup> A non-EU AIF appears to have more latitude in choosing a depositary that is not necessarily a credit institution<sup>155</sup> and a non-EU AIF may keep the funds in a depositary in the home Member State of the fund or the investment advisor.<sup>156</sup>

The directive requires a lot of responsibility be taken on by the depositary agency.<sup>157</sup> The depositary must monitor AIF cash flows, ensure payments made by the AIF are received, and must ensure that all AIF cash is deposited in accounts bearing the name of the AIF or investment advisor.<sup>158</sup> Its duty to the fund does not end there—the depositary must also ensure all recorded financial instruments that are capable of being held in custody are segregated by AIF, and for all other assets the depositary must verify ownership by the registered AIF.<sup>159</sup> The depositary must ensure that all the adviser’s trades are legal, must ensure that the annual valuation was performed in accordance with applicable national law, and must refuse to perform any AIF request that is not in conformity with applicable national law (whatever that may be).<sup>160</sup> Furthermore, the depositary must objectively justify and verify any delegation of AIF-related work to another third party.<sup>161</sup> Finally, the depositary is to be held liable for all losses of an adviser, the AIF, and the investors.<sup>162</sup> The AIFMD purports to distinguish between assets held in the depositary’s custody, in which case the depositary is liable under all circumstances, and those not in the depositary’s custody, in which case the depositary is only liable “in the case

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150. *See id.*, art. 34, 2011 O.J. (L 174) 1, at 5.

151. *See id.*, art. 35, 2011 O.J. (L 174) 1, at 5.

152. *See* Tim Frawley & Peter Huber, *Corporate Governance Best Practices for Cayman Islands Hedge Funds*, HEDGE FUND L. REPORT 1 (Jan. 19, 2012), [http://www.maplesfiduciaryservices.com/industry-ews/HFLR%201\\_19\\_12%20Directors.pdf](http://www.maplesfiduciaryservices.com/industry-ews/HFLR%201_19_12%20Directors.pdf).

153. *See* AIFMD, *supra* note 7, art. 35, 2011 O.J. (L 174) 1, at 5.

154. *Id.*, 2011 O.J. (L 174) 1.

155. *See id.*, art. 34, 2011 O.J. (L 174) 1, at 5.

156. *See id.*, art. 35, 2011 O.J. (L 174) 1, at 5.

157. *See id.*, art. 21, 2011 O.J. (L 174) 1, at 28.

158. *See id.*, art. 21(7), 2011 O.J. (L 174) 1, at 29.

159. *See id.*, art. 21(8), 2011 O.J. (L 174) 1, at 30.

160. *See id.*, art. 21(9), 2011 O.J. (L 174) 1, at 30.

161. *See id.*, art. 21(11), 2011 O.J. (L 174) 1, at 30.

162. *See id.*, art. 44, 2011 O.J. (L 174) 1, at 6.

of intent or negligence.”<sup>163</sup> However, the ultimate definition of custody adopted by the Commission suggests that it is open to the notion of constructive-custody.<sup>164</sup>

#### Transparency Requirements

The AIFMD also has a variety of transparency requirements. The AIF must prepare an annual report that is made available to the home state authorities and to investors upon request.<sup>165</sup> Hedge fund advisers must disclose balance sheet information, income and expenses, a general financial activities report, and upper level management compensation plans.<sup>166</sup> Unlike Form PF, the AIF must divulge to investors its investment strategies, the assets it invests in, and the trading techniques it relies on, as well as information regarding leverage sources, uses and limits.<sup>167</sup> Like Form ADV, the AIFMD also provides investors with useful information regarding their contractual rights, the AIF’s internal procedures, voting and redemption rights, the identity of third parties who have been delegated certain tasks, and a description of fees they may be charged.<sup>168</sup> The Member State, relevant agencies, and European Securities and Markets Authority (“ESMA”) are entitled to information regarding the percentage of AUM that are illiquid, new liquidity management techniques, the risk profile and risk-management strategies the AIF uses, general information on the primary asset-class the fund invests in, and stress-test results.<sup>169</sup> The Member States, agencies, and ESMA are often required to exchange this information and to act on any potential sources of systemic risk.<sup>170</sup> Finally, the directive takes power away from the Member State and gives it to ESMA by allowing ESMA the discretion to publicly expose a Member State’s refusal, and its reasons for doing so, to comply with ESMA’s proposed measures to combat systemic risk posed by an AIF.<sup>171</sup>

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163. *Id.*, 2011 O.J. (L 174) 1.

164. *See AIMA Note: Analysis of Divergences Between the EU Commission’s Draft Regulation Implementing the AIFMD and the ESMA Advice*, ALT. INV. MGMT. ASS’N 3 (Apr. 2012), [http://www.aima.org/objects\\_store/aifmd\\_divergences\\_from\\_esma\\_advice\\_-\\_aima\\_note\\_-\\_ec.pdf](http://www.aima.org/objects_store/aifmd_divergences_from_esma_advice_-_aima_note_-_ec.pdf) [hereinafter *AIMA Note*]. The Commission determined that even when assets are not in technical custody of the depositary, the asset should be treated as in the custody of a delegated party. *See id.*

165. *See AIFMD*, *supra* note 7, art. 22, 2011 O.J. (L 174) 1, at 32.

166. *See id.*, art. 22(2), 2011 O.J. (L 174) 1, at 32-33.

167. *See id.*, art. 23(1), 2011 O.J. (L 174) 1, at 33.

168. *See id.*, art. 23(1), 2011 O.J. (L 174) 1, at 33-34.

169. *See id.*, art. 24, 25, 2011 O.J. (L 174) 1, at 34-35.

170. *See id.*, art. 25, 2011 O.J. (L 174) 1, at 35.

171. *See id.*, art. 25(8), 2011 O.J. (L 174) 1, at 36.

## Transitional and Final Provisions

Several parts of the AIFMD call for further transitional and final provisions to be drafted by the European Commission.<sup>172</sup> These are often referred to as “level 2 implementing measures.”<sup>173</sup> One of ESMA’s tasks was to assist the European Commission in the development of these level 2 regulations.<sup>174</sup> ESMA provided the Commission with advice on how to formulate those provisions,<sup>175</sup> and the Commission recently issued a draft proposal.<sup>176</sup> The Alternative Investment Management Association (“AIMA”)<sup>177</sup> has reviewed the Commission’s draft in detail and issued a cautionary statement that the Commission failed to take ESMA’s advice in several key implementing measures.<sup>178</sup> Some of the more important changes include the calculation of AUM for purposes of the *de minimis* exception, professional indemnity insurance (“PII”), the calculation and use of leverage, and the ability to use non-EU brokers and counterparties for derivatives.<sup>179</sup>

ESMA suggested that the calculation of AUM not include foreign exchange and interest rate positions if the positions are not being held with the intent to create a return.<sup>180</sup> The Commission’s definition of AUM deleted ESMA’s advice, indicating that these positions would be included in the AUM calculation, which could result in the regulation of smaller firms that should not be covered by the directive.<sup>181</sup> With regards to leverage, ESMA provided three methods of calculating leverage: gross, commitment, and advanced.<sup>182</sup> The gross method does not allow for any netting of positions and requires the fund to use the absolute value of all positions held.<sup>183</sup> The commitment method provides a little more leeway, allowing the fund to

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172. See AIFMD, *supra* note 7, art. 56, 2011 O.J. (L 174) 1, at 61.

173. See *EU Asset Management Regulation: AIFMD*, ALT. INV. MGMT. ASS’N, <http://www.aima.org/en/regulation/asset-management-regulation/eu-asset-management-regulation/aifmd/index.cfm> (last visited Nov. 24, 2012).

174. See *Investment and Reporting: Investment Management*, ESMA, <http://www.esma.europa.eu/page/investment-management> (last visited Nov. 24, 2012).

175. See *id.*

176. See *EU Asset Management Regulation: AIFMD*, *supra* note 168. ESMA’s technical advice was transmitted to the Commission in November of 2011. See *id.*

177. AIMA is a global corporate organization representing the hedge fund industry at the international level. See *About AIMA*, ALT. INV. MGMT. ASS’N, <http://www.aima.org/en/about/index.cfm> (last visited Nov. 27, 2012).

178. See *AIMA Note*, *supra* note 164, at 2.

179. See *id.* at 6.

180. See *id.*

181. See *id.* at 7.

182. See *AIFMD – What Does Your Business Need to Know?*, DELOITTE & TOUCHE 19 (2012), [http://www.deloitte.com/assets/Dcom-Ireland/Local%20Assets/Documents/investment%20management/AIFMD\\_Link\\_n\\_Learn\\_10.05.2012.pdf](http://www.deloitte.com/assets/Dcom-Ireland/Local%20Assets/Documents/investment%20management/AIFMD_Link_n_Learn_10.05.2012.pdf).

183. See *id.*

take into account some hedging positions if they relate to the same asset class.<sup>184</sup> The advanced method would have allowed the AIF to use the value at risk calculation, which focuses on the exposure the position caused, but the Commission left this out entirely.<sup>185</sup> Additionally, ESMA concluded that it was impossible to “use a single figure to designate the use of leverage on a substantial basis.”<sup>186</sup> The Commission disagreed and decided that leverage is being used on a substantial basis when the AIFM’s “leverage ratio exceeds 2 x NAV.”<sup>187</sup> Additionally, the Commission seems to have determined that an AIF may not use a non-EU derivative counterparty or a non-EU prime broker.<sup>188</sup> The Commission has also decided to effectively bar an adviser from delegating any portfolio or risk management activities to non-EU entities.<sup>189</sup>

## SYSTEMIC RISK

### Overview

Despite how frequently systemic risk comes up in economic debate, there is no universal concept of systemic risk,<sup>190</sup> although the notion of cascading market failure is consistently present.<sup>191</sup> Competing definitions of systemic risk all refer to “a trigger event, such as an economic shock or institutional failure, [that] causes a chain of bad economic consequences . . . .”<sup>192</sup> These consequences range from significant losses to a single business coupled with serious market volatility all the way to total failure of multiple markets.<sup>193</sup> Systemic risk is often classified according to several different types of categories, some of which are casually-based while others are

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184. See *AIMA Note*, *supra* note 164, at 12.

185. See *id.* at 6-9. Value at risk measures financial risk in a fund by measuring three variables: “the amount of potential loss, the probability of that amount of loss and the time frame.” *Value At Risk –VaR*, INVESTOPEDIA, <http://www.investopedia.com/terms/v/var.asp#axzz2DZHAfcY7> (last visited Nov. 29, 2012).

186. *AIMA Note*, *supra* note 164, at 6.

187. *Id.*

188. See *id.*

189. See *id.* at 19.

190. See EDWARD V. MURPHY, CONG. RESEARCH SERV., R42545, WHAT IS SYSTEMIC RISK? DOES IT APPLY TO RECENT JP MORGAN LOSSES? 1 (2012).

191. See, e.g., Anne Riviere, *The Future of Hedge Fund Regulation: A Comparative Approach: United States, United Kingdom, France, Italy and Germany*, 10 RICH. J. GLOBAL L. & BUS. 263, 265 (2011) (defining systemic risk “as the risk of chain reactions of failures”); DIXON, CLANCY & KUMAR, *supra* note 11, at 3 (defining systemic risk as “a major and rapid disruption in one or more of the core functions of the financial system caused by the initial failure of one or more financial firms or a segment of the financial system”).

192. Schwarcz, *supra* note 16, at 198.

193. See *id.*

impact-based.<sup>194</sup> Essentially, systemic risk seems to be any large scale default that results in the reduced availability of capital or credit across an industry, a market, or all markets.<sup>195</sup> In terms of specific sources of systemic risk, this paper discusses the traditional credit and market-based channels.

On the credit side, systemic risk is inversely correlated with credit availability: as credit availability decreases, systemic risk increases.<sup>196</sup> When credit-lending institutions go under (either en masse or just the especially large ones), they cease to provide capital and liquidity to the markets.<sup>197</sup> This is the run on the bank situation.<sup>198</sup> As credit and capital become harder and harder to come by, the cost of borrowing increases, making loans difficult to afford.<sup>199</sup> In the modern world of securities exchanges, commodities trading exchanges, and OTC markets, businesses no longer have to raise capital through intermediary banking institutions.<sup>200</sup> Instead, they may elicit funding directly from the public.<sup>201</sup>

With regard to market sources, systemic risk refers to the possibility that a sudden and unexpected failure in one market will bleed over into other linked markets due to diverse and fragmented trading strategies and the interrelationships of large market-players.<sup>202</sup> Systemic risk arises because of the possibility that a failure in one market may actually cause failures in others.<sup>203</sup> In this case, the secondary markets become illiquid because there are too many sellers and not enough buyers.<sup>204</sup> As in the institutional setting, the end result is that the markets are left in an extremely illiquid state with a high cost of capital.<sup>205</sup>

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194. See *id.* Schwarcz categorizes systemic risk by impact on the financial sectors. See *id.* But see FINANCIAL SERVICES AUTHORITY, ASSESSING THE POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS 10 (Feb. 2012), available at <http://www.fsa.gov.uk/static/pubs/other/hedge-fund-report-feb2012.pdf> [hereinafter FINANCIAL SERVICES AUTHORITY February 2012]. Systemic risk is analyzed based on the two channels out of which the FSA believes it may arise. See generally *id.*

195. See John Kambhu, Til Scheuermann & Kevin Stiroh, *Hedge Funds, Financial Intermediation, and Systemic Risk* 8 (Staff Rep. Fed. Reserve Bank of N.Y., Working Paper No. 291).

196. See Schwarcz, *supra* note 16, at 198-99.

197. See *id.* at 198.

198. See *id.*

199. See *id.* "Increases in the cost of capital, or decreases in its availability, are the most serious direct consequences of a systemic failure." *Id.* at 198-99.

200. See *id.* at 200.

201. See *id.*

202. See *id.*

203. See *id.* at 200-01.

204. See, e.g., *id.* at 201.

205. See, e.g., *id.* at 202. See also THE JOINT FORUM, THE BASEL COMMITTEE ON BANKING SUPERVISION, REVIEW OF THE DIFFERENTIATED NATURE AND SCOPE OF FINANCIAL REGULATION: KEY ISSUES AND RECOMMENDATIONS 56 (2010). This report details the

## How Do Hedge Funds Contribute to Systemic Risk?

Although there is some debate about whether hedge funds actually create sources of systemic risk, there are strong arguments that hedge funds at least contribute to systemic risk.<sup>206</sup> Hedge funds are believed to pose systemic risk through the credit and market channel, by riding market bubbles, and by the inherent conflicts of interest created by the compensation structure and investor redemption plans.<sup>207</sup> Some of the leading work on hedge funds and systemic risk concludes that hedge funds do not contribute much systemic risk through the credit channel, but that they do present some threats through the market channel.<sup>208</sup> However, there is no single factor that is determinative—systemic risk in the hedge fund industry is a combination of a fund’s investment decisions, trading strategies, and trading counterparties. A behind-the-scenes force in each of these activities is the amount of leverage maintained.

Leverage is its own subject of debate, but it is important to discuss here as it is considered a key source of systemic risk.<sup>209</sup> Leverage is at the heart of systemic risk—it is one of the reasons cascading failures from institution to institution are even possible.<sup>210</sup> This is because absent leverage there are no corresponding debts to be repaid.<sup>211</sup> When an institution is highly leveraged and it experiences more losses than it has surplus capital to repay, it becomes insolvent, and passes its losses on to its lenders.<sup>212</sup> However, leverage is distinct from the concept of capital on hand.<sup>213</sup>

Although leverage may have a conceptual definition, there is no single, industry-wide approach to calculating leverage.<sup>214</sup> At the broadest level, leverage is explained as “the creation of exposure greater than the

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systemic risk posed by hedge funds, but instead refers to institutional risk as credit risk. *See id.*

206. *See* JOHN P. HUNTE, HEDGE FUND REGULATION: THE PRESIDENT’S WORKING GROUP COMMITTEES’ BEST PRACTICES REPORTS – RAISING THE BAR BUT MISSING RISKS 2 (2008).

207. *See e.g.*, Riviere, *supra* note 191, at 293-95.

208. *See* DIXON, CLANCY & KUMAR, *supra* note 11, at 45. *See also* Schwarcz, *supra* note 16, at 202.

209. *See, e.g.*, Schwarcz, *supra* note 16, at 223.

210. *See id.*; *see also* Robert E. Rubin, Alan Greenspan, Arthur Levitt & Brooksley Born, THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999) [hereinafter THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS].

211. *See* Schwarcz, *supra* note 16, at 223-24.

212. *See id.* at 224.

213. *See id.* at 223-25.

214. *See* David Asermely, *Portfolio Leverage Ratio*, PERSHING PRIME SERVICES, BNY MELLON ASSET SERVICING 1 (Dec. 2010) [http://www.bnymellon.com/foresight/pdf/portfolio\\_leverage.pdf](http://www.bnymellon.com/foresight/pdf/portfolio_leverage.pdf).

capital invested.”<sup>215</sup> Leverage is a debt-to-equity ratio, which, at hedge funds, is calculated by aggregating the market value of all long and short positions “divided by equity capital.”<sup>216</sup> The problem with calculating leverage is determining what sorts of leveraged positions should be included on the debt side of the ratio.<sup>217</sup> The inclusion of derivatives is subject to debate, as they do not represent borrowed cash but do “increase[] exposure to an underlying asset via synthetic leverage...”<sup>218</sup> Derivatives act as a form of leverage because the borrower need only put up the margin to use the full value of the derivatives contract.<sup>219</sup>

Because derivatives transactions mirror the effects of leverage, they present a potential source of systemic risk, which is amplified in the hedge fund industry due to high usage.<sup>220</sup> When hedge funds default on derivatives transactions, there is potential for heightened risk depending on the counterparty.<sup>221</sup> This so-called counterparty risk is another source of market risk because the impact of a failed derivatives transaction depends on the counterparty’s exposure to the financial markets.<sup>222</sup> Despite the debate over derivatives transactions, the median hedge fund leverage ratios for 2012 are between 2.7% (2.7 as a percent of NAV) based on cash borrowing method of calculation and 3.8% (3.8 as a percent of NAV) based on gross exposure, which includes synthetic leverage from derivatives.<sup>223</sup> Investment banks, in comparison, reported leverage ratios in the first quarter of 2011 of 13.3% at Goldman Sachs and 20% at JP Morgan.<sup>224</sup>

Other more general trading strategies used by hedge funds may increase the effects of leverage in a default. Hedge funds that are over-invested and the predominant players in an illiquid asset may create sources of systemic risk.<sup>225</sup> However, the hedge fund industry invests in a variety of asset classes, markets, and trading strategies, which diversifies their collective impact across markets. According to a recent study in 2010, 33%

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215. *See id.*

216. *See* DIXON, CLANCY & KUMAR, *supra* note 11, at 25.

217. *See id.*

218. FINANCIAL SERVICES AUTHORITY February 2012, *supra* note 194, at 10.

219. *See Primer: Derivatives*, FINANCIAL POLICY FORUM: DERIVATIVES STUDY CENTER, <http://www.financialpolicy.org/dscprimer.htm> (last updated 2002).

220. *See id.*

221. *See* Segoviano & Singh, *supra* note 3.

222. *See id.*

223. *See* FINANCIAL SERVICES AUTHORITY, ASSESSING THE POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS 13-14 (Aug. 2012), *available at* <http://www.fsa.gov.uk/static/pubs/other/hedge-fund-report-aug2012.pdf> [hereinafter FINANCIAL SERVICES AUTHORITY August 2012].

224. William Wright, *Investment Banks and the Death of Leverage*, FINANCIAL NEWS (Apr. 26, 2011), <http://www.efinancialnews.com/story/2011-04-26/investment-banks-and-the-death-of-leverage>.

225. *See* DIXON, CLANCY & KUMAR, *supra* note 11, at 53.



of all assets managed in the hedge fund industry were invested in equities, 25% were invested in fixed-income assets, and only 3% were invested in commodities.<sup>226</sup> Interestingly, 38% of total assets were invested in multi-asset funds.<sup>227</sup> The method of investment in these assets depends on the fund. Funds often trade in the underlying security, but, as mentioned above, will also trade in derivatives.<sup>228</sup>

One of the more controversial trading practices hedge funds often engage in is short selling.<sup>229</sup> Short selling is believed to pose systemic risk through the market channel and was criticized as contributing to the 2008 financial meltdown.<sup>230</sup> Although short selling has been blamed for creating sources of systemic risk and false impressions of equity issuers,<sup>231</sup> it is highly unlikely that an individual hedge fund could destabilize a healthy business from short selling stocks.<sup>232</sup> However, it is possible that a group of hedge funds acting in concert and trading at high volumes could depress the share prices of an otherwise profitable company.<sup>233</sup> On the other hand, the borrowing and lending of securities provides a lot of short term capital to the institutional investors that often act as counterparties to hedge fund trading transactions.<sup>234</sup> Additionally, when a hedge fund correctly believes that a business' stock is overvalued, a short sale is an effective means of price discovery that countermines inflated valuations.<sup>235</sup> A short sale requires the hedge fund to borrow the underlying security,<sup>236</sup> thus acting as a form of leverage, but hedge funds may achieve the same effect in either an exchange-traded futures contract or through an OTC derivatives transaction.<sup>237</sup>

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226. *See id.* at 23.

227. *See id.*

228. *See id.* at 2-3.

229. *See id.* at 55.

230. *See id.*

231. *See id.* at 55-59.

232. *See id.* at 56.

233. *See id.*

234. *See, e.g.,* FSOC 2012 ANN. REP., *supra* note 50. Securities lenders tend to be institutional investors. *See id.* Those investors lend securities to a borrower in exchange for cash collateral from the borrower. *See id.* The lender pays interest on the cash collateral, which the lender invests to earn a return. *See id.*

235. *See* DIXON, CLANCY & KUMAR, *supra* note 11, at 55.

236. *See Short Sales*, SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/shortsale.htm> (last modified Sep. 6, 2011).

237. *See* THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 210, at 23.

## Investor Protection

Investor protection generally refers to the notion that securities regulations should afford investors certain legal assurances regarding their capital contributions.<sup>238</sup> The SEC, for example, focuses on this mandate in the form of public disclosure of information so that investors may investigate the businesses they are choosing to support.<sup>239</sup> The SEC's rule of thumb is that all investors deserve equal access to information.<sup>240</sup> This is because an investment gives the investor a claim to some part of the company.<sup>241</sup> However, all public companies and many close companies are characterized by the separation of ownership from management,<sup>242</sup> and there is often no guarantee that management will adequately protect or properly control corporate property for the benefit of owners.<sup>243</sup> As a result, the law of investor protection evolved to fill that void so that investors, particularly outside investors, may freely invest their capital in securities without fear that management will improperly expropriate their investments.<sup>244</sup> Investor protection law ensures the stability of our economy.<sup>245</sup> Without adequate protections, investors are more likely not to invest and economies tend to stagnate without the benefits of added capital.<sup>246</sup>

Although Dodd-Frank is primarily focused on systemic risk prevention, it gave the SEC specific authority to compel information from hedge funds on behalf of investors as well as for systemic risk assessment.<sup>247</sup> Dodd-Frank also directed the SEC to "monitor the markets for the protection of investors and the integrity of the markets."<sup>248</sup> This

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238. See, e.g., *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC. & EXCH. COMM'N, <http://www.sec.gov/about/whatwedo.shtml> (last updated June 10, 2013) [hereinafter *The Investor's Advocate: How the SEC Protects Investors*].

239. See, e.g., *id.*

240. See *SEC's Enforcement Program Continues to Show Strong Results in Safeguarding Investors and Markets*, SEC. & EXCH. COMM'N (Nov. 14, 2012), <http://www.sec.gov/news/press/2012/2012-227.htm>.

241. See Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 5 (2000).

242. See, e.g., Kenneth Lipartito & Yumiko Morii, *Rethinking the Separation of Ownership from Management in American History*, 33 SEATTLE U. L. REV. 1025, 1027 (2010).

243. See *id.* at 1027-28.

244. See La Porta et al., *supra* note 241, at 6-7.

245. See *The Investor's Advocate: How the SEC Protects Investors*, *supra* note 238.

246. See La Porta et al., *supra* note 241, at 4.

247. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 404, 15 U.S.C. 80b-4 (2012) (amending § 204 of the IAA).

248. See *id.*

suggests a much broader notion of investor protection than the client-focused approach previously championed by the SEC.<sup>249</sup>

#### SUCCESSFUL GOVERNMENT PREVENTION OF SYSTEMIC RISK IN THE HEDGE FUND INDUSTRY

##### The AIFMD Will Prove Ineffective

The AIFMD will prove ineffective at regulating hedge funds because it is not currently possible to effectively regulate the hedge fund financial structure to prevent systemic risk. The ways in which hedge funds present sources of systemic risk cannot be effectively regulated at the industry level nor will they be responsive to fixed approaches. Hedge funds present sources of systemic risk through a confluence of factors that are particularized to each hedge fund. Use of leverage fluctuates depending on the performance of the fund—in good times advisers may step up their use of leverage, whereas if a fund suffers a loss, leverage is decreased.<sup>250</sup> The capital reserves of a hedge fund fluctuate depending on the fund's redemption policies and ultimately on the fund's performance.<sup>251</sup> Furthermore, both of the above will depend on the investment adviser's liquidity and risk profiles for a given fund, which may depend on the assets invested in,<sup>252</sup> positions taken, and whether the fund uses relative value arbitrage or some other investment strategy. It is impossible to control these variables at the industry level using an inflexible methodology.

The AIFMD's rigid approach to lowered leverage limits, increased capital requirements, delegation restrictions and depositary requirements are an attempt to eradicate the hedge fund industry as it operates today. As such, the AIFMD regulations will not effectively regulate hedge funds for the prevention of systemic risk, but will only force them to behave more like mutual funds.<sup>253</sup> The success of the hedge fund industry depends on a delicate balancing act that requires financial agility.<sup>254</sup> The AIFMD will eliminate that agility, especially in light of the European Commission's level 2 implementing measures. Many of the Commission's implementing measures are rigid and inflexible, deliberately ignoring ESMA's thoughtful

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249. See Anita K. Krug, *Moving Beyond the Clamor for "Hedge Fund Regulation": A Reconsideration of "Client" under the Investment Advisers Act of 1940*, 55 VILL. L. REV. 661, 664 (2010).

250. See Yingcong Lan, Neng Wang & Jinqiang Yang, *The Economics of Hedge Funds 2* (Nat'l Bureau of Econ. Research, Working Paper No. 16842, 2012).

251. See *id.* at 7.

252. The particular asset invested in might require higher or lower margins than others. See *id.* at 8.

253. See Stulz, *supra* note 9.

254. See DIXON, CLANCY & KUMAR, *supra* note 11, at 25.

comments.<sup>255</sup> ESMA's recommendations for the level 2 implementing measures demonstrate that it was cognizant of the need to regulate with a flexible approach that was not one-size-fits-all.

The recent EU transaction tax lends further support to the argument that the AIFMD's goal is really to regulate the hedge fund industry out of existence.<sup>256</sup> The transaction tax, formally proposed on February 7, 2013, has not been agreed upon yet, but has sparked a violent reaction from the United States.<sup>257</sup> The goal of the tax is to reduce risky and high frequency trades while raising revenue for European citizens.<sup>258</sup> Although the tax would only apply to trades made in participating countries and to trades of stock that were issued there, it will most likely have a chilling effect on the European stock market.<sup>259</sup>

#### The AIFMD Is Counterproductive in its Efforts to Combat Systemic Risk

The depositary requirements, independent asset valuation rules, and restrictions on delegation seem ambiguous for investor protection purposes at best<sup>260</sup> and will certainly have serious ramifications for hedge fund performance, as they directly conflict with the limited partnership organizational structure of many hedge funds and with "funds employing prime broking strategies."<sup>261</sup> The objective justification requirement for a certain delegation structure interferes with a hedge fund's ability to freely determine its organizational structure.<sup>262</sup> Hedge funds commonly delegate authority to prime brokers who act in a variety of ways.<sup>263</sup> Prime brokers often serve as counterparties to derivative contracts, lend money and securities for short selling, execution, clearing and settlement purposes.<sup>264</sup> Prime brokers tend to be part of larger investment banks and many hedge

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255. See *AIMA Note*, *supra* note 164, at 6.

256. See Gabriele Steinhauser & Jenny Strasburg, *U.S. Slams EU's Tax-on-Trade Plan*, WALL ST. J. (Feb. 13, 2013), <http://online.wsj.com/article/SB10001424127887324432004578302242512322674.html>.

257. See *id.*

258. See *id.*

259. See *id.* Costs for retailers purchasing shares through an intermediary could go up from \$10 for 1,000 shares to \$70. See *id.*

260. See *AIMA Note*, *supra* note 164, at 3.

261. *Our Guide to the AIFMD*, NORTON ROSE FULBRIGHT (Dec. 2010), <http://www.nortonrose.com/knowledge/publications/27542/our-guide-to-the-aifm-directive>.

262. See *id.* "The rules restricting delegation still prejudice many multi-manager strategies . . ." *Id.*

263. See AIFMD, *supra* note 7, art. 43, 2011 O.J. (L 174) 1, at 6.

264. See *The Counterparty's Over: Brokers May Now be a Bigger Risk*, ECONOMIST (June 12, 2008), available at <http://www.economist.com/node/11554264>.

funds deposit their assets with a prime broker.<sup>265</sup> It seems doubtful that a prime broker, who is not also part of a credit institution subject to laws that have the same effect as EU law, may continue to function as a depositary.<sup>266</sup> In fact, the AIFMD specifically says that prime brokers should not double as depositories unless they have managed to “functionally and hierarchically separate[]” the two responsibilities.<sup>267</sup>

The various attempts to constrain hedge fund operations within EU borders will be quite problematic for a large number of hedge funds.<sup>268</sup> A majority of the global hedge fund industry keeps its funds in the Cayman Islands, but that may no longer be possible under the new AIFMD rules.<sup>269</sup> The valuation requirements also present problems for U.S. hedge funds. In the United States, the investment adviser is often the party valuing the assets.<sup>270</sup> However, the AIFMD prohibits any AIF from valuing its own assets unless it has separated the risk management function from the portfolio adviser’s tasks.<sup>271</sup>

Finally, the AIFMD will actually contribute to the creation of systemic risk in the hedge fund industry, especially through the credit channel.<sup>272</sup> The AIFMD requires a depositary to be a credit institution, or something comparable, in most cases.<sup>273</sup> It also requires that a depositary be liable for any losses of an AIF.<sup>274</sup> The way it has defined those losses is likely to include assets out of the technical control of the depositary.<sup>275</sup> The effect of this will be to exacerbate the exposure of those credit institutions serving as depositories for hedge funds, potentially causing a run on the bank-type situation if a hedge fund’s losses are too large and the credit institution is of systemic importance.<sup>276</sup> Finally, the AIFMD has made such an attempt to restrict the depositary to certain EU-only institutions that it will end up concentrating liability for hedge fund default when it would have ordinarily

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265. See Suzanne Craig & Azam Ahmed, *Wall St. Banks Help Hedge Funds Recruit*, N.Y. TIMES, Oct. 10, 2011, <http://dealbook.nytimes.com/2011/10/10/wall-st-banks-help-hedge-funds-recruit/>.

266. See AIFMD, *supra* note 7, 2011 O.J. (L 174) 1, at 5-6.

267. See *id.*, art. 43, 2011 O.J. (L 174) 1, at 6.

268. See Frawley & Huber, *supra* note 152.

269. See *id.*

270. See *Hedge Fund Information for Investors*, FED. BUREAU OF INVESTIGATION, [http://www.fbi.gov/about-us/investigate/white\\_collar/hedge-fund-fraud](http://www.fbi.gov/about-us/investigate/white_collar/hedge-fund-fraud) (last visited Dec. 2, 2012).

271. See AIFMD, *supra* note 7, 2011 O.J. (L 174) 1, at 26.

272. See *AIMA Note*, *supra* note 164, at 2 (stating that the Commission level 2 implementing measures could even thwart the investor protection and market stability goals of the directive).

273. See AIFMD, *supra* note 7, art. 35, 2011 O.J. (L 174) 1 at 5.

274. See *id.*, art. 44, 2011 O.J. (L 174) 1, at 6.

275. See *AIMA Note*, *supra* note 164, at 3.

276. See *id.*

been spread among a more diverse group of financial institutions in various countries.<sup>277</sup> The Fed has done the exact opposite by requiring SINBFCs to diversify risk over a variety of counterparties.<sup>278</sup> This suggests that concentrating lending or exposure risks in a narrowly defined group of parties is a bad idea for systemic risk purposes.

#### Dodd-Frank Will Not Force the Hedge Fund Industry to Change

Even though Dodd-Frank creates the potential that hedge funds could be designated as systemically important entities, which would subject them to “hard regulation” by the Fed, that result is unlikely to occur.<sup>279</sup> Very few, if any, hedge funds have ever managed \$50 billion assets at any single time and AUM fluctuates constantly in the hedge fund industry, which would make it difficult to determine when a hedge fund passed the AUM threshold. Another factor weighing against designation is the ill-suited nature of the Fed’s regulations for hedge funds. For instance, the Fed’s regulations would not make any sense if they were imposed on hedge funds.<sup>280</sup> In addition to the fact that the pro forma capital plans were created with banking institutions in mind,<sup>281</sup> the capital ratios are calculated based on common equity that is freely available to absorb any losses the bank might incur.<sup>282</sup> Investor funds in a hedge fund are not invested with that purpose in mind; in fact, quite the opposite. It seems perverse to require hedge funds to be subject to a capital ratio based on a principal at odds with the purpose of a hedge fund.

The biggest impact Dodd-Frank has on hedge funds is the SEC registration and resulting disclosure requirements. Most hedge funds are now required to register.<sup>283</sup> Registration requires hedge funds to disclose confidential information to the SEC and investors and to implement compliance programs.<sup>284</sup> Through Form ADV, the information hedge fund advisers must disclose gives investors the ability to verify the advisers’ competency and identity.<sup>285</sup> In contrast with Form ADV, the information

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277. See AIFMD, *supra* note 7, 2011 O.J. (L 174) 1, at 4-6.

278. See THE FED’S CAPITAL PLAN REVIEW 2013, *supra* note 54, at 1-2.

279. See SCHULTE ROTH & ZABEL’S *FSOC Issues*, *supra* note 42.

280. See generally THE FED’S CAPITAL PLAN REVIEW 2013, *supra* note 54, at 7-8, 12.

281. See *id.* at 1-2.

282. See Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52792, 52801 (proposed Aug. 30, 2012) (to be codified at 12 C.F.R. pts. 3, 5, 6, 167).

283. See Champ, *supra* note 4.

284. See BINGHAM MCCUTCHEN LLP’S *Guide To SEC Investment Adviser Registration*, *supra* note 88, at 9, 15, 16.

285. See *id.* at 9.

gathered from Form PF is not distributed to investors or the public.<sup>286</sup> Form PF is designed to enable the SEC to understand how hedge funds may pose systemic risk to the markets.<sup>287</sup> It requires disclosure of many of the same things that the AIFMD and the Commission chose to actively regulate instead.<sup>288</sup> Some of the more salient areas being monitored by the SEC include “detail[s] about hedge fund investments, leverage and investor composition,”<sup>289</sup> as well as information from counterparties and other third parties.<sup>290</sup> Although the SEC is not “regulating” these aspects of the hedge fund industry, it is imposing other costs.

Some of the costs of registration may force hedge fund advisers to alter some of their business practices, but this is mostly achieved indirectly by giving investors more bargaining power to demand better corporate governance and transparency. The actual financial costs of providing the SEC with all this information will be staggering.<sup>291</sup> Bank of America has estimated that a hedge fund adviser managing \$5 billion in assets should expect to pay around \$500,000 for new technology and staff.<sup>292</sup> Advisers that manage \$1.5 billion can expect a bill closer to \$125,000, and even smaller firms may have to spend between \$25,000 and \$125,000.<sup>293</sup> The time commitment is not small either; smaller firms will need to spend a month or two filling out Form PF, while larger firms are looking at half a year.<sup>294</sup> However, the actual substantive changes to corporate governance structures will be brought about through increased investor activism at larger firms.<sup>295</sup> The SEC disclosure and compliance requirements are already giving investors more leverage to bargain with hedge fund advisers.<sup>296</sup> Hedge fund advisers are slowly, but surely, becoming more responsive to the governance concerns of their investors.<sup>297</sup>

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286. See Murray, *supra* note 102.

287. See Champ, *supra* note 4.

288. See DELOITTE’S *Form PF Readiness Assessment*, *supra* note 100, at 6; see also AIFMD, *supra* note 7, 2011 O.J. (L 174) 1, at 5-6; see also AIMA Note, *supra* note 164, at 3.

289. See *BofA Tallies Costs of Form PF Filing*, HEDGE FUND ALERT (Mar. 28, 2012), <http://corp.bankofamerica.com/documents/10157/84201/BofATallies.pdf>.

290. See *id.*

291. See *id.*

292. See *id.*

293. See *id.*

294. See *id.*

295. See generally Emma Cusworth, *Operational Due Diligence Has Grown in Importance to Institutional Investments in Hedge Funds*, HEDGE FUNDS REVIEW, July 26, 2012, <http://www.hedgefundsreview.com/hedge-funds-review/feature/2193351/operational-due-diligence-has-grown-in-importance-to-institutional-investment-in-hedge-funds>.

296. See *id.*

297. See *id.*

### The SEC Is Protecting Market Investors From Hedge Fund-Created Systemic Risk

The SEC is monitoring the hedge fund industry for systemic risk for the benefit of all market investors, not regulating hedge funds with the goal of eliminating sources of systemic risk. As Dodd-Frank explicitly made clear, the SEC may use information on Forms PF and ADV for its general investor protection efforts.<sup>298</sup> This paper argues that, in the hedge fund industry, market sources of systemic risk should be treated as aspects of investor protection, which is essentially the approach the SEC has adopted. Compelling disclosure of information designed to provide investors with this sort of information is traditionally viewed as a way of providing investors with protection.<sup>299</sup> This article argues that the SEC treats systemic risk as an aspect of investor protection by requiring information from hedge funds about their assets, positions, directionality and information regarding counterparty exposure.<sup>300</sup> All these pieces of information define the markets in terms of third party interactions and the effect their relationships will have on overall market liquidity. In the absence of focusing on the individual investor and his or her relationship with the hedge fund, the SEC will actually be able to provide more substantive protection for investors generally.

#### CONCLUSION

Systemic risk in the hedge fund context should be treated as if it were an aspect of investor protection because disclosure of information is the best way to assess potential for systemic risk and because the SEC should be concerned about the impact a hedge fund's activities have on investors of *other* companies. Hedge funds not only affect the investments of their own investors, but of investors everywhere.<sup>301</sup> However, when hedge funds engage in transactions that have the potential to affect the price of another company's stock, the hedge fund has no direct relationship or obligation to those shareholders or the issuer.<sup>302</sup> It is the un-governed relationship of the hedge fund to those other market participants that defines how hedge funds

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298. See BINGHAM MCCUTCHEN LLP's *Guide To SEC Investment Adviser Registration*, *supra* note 88, at 18.

299. See *e.g.*, *The Investor's Advocate: How the SEC Protects Investors*, *supra* note 238.

300. See DELOITTE'S *Form PF Readiness Assessment*, *supra* note 100, at 6.

301. See DIXON, CLANCY & KUMAR, *supra* note 11, at 55.

302. For example, by purchasing CDOs in large numbers, hedge funds contributed to the housing market bubble, but had no obligations to the underlying asset-owners. See *id.* at 46.



create systemic risk through the market channel.<sup>303</sup> The source of systemic risk is the hedge fund's ability to influence market prices in dramatic and sudden ways.<sup>304</sup> These particularized market sources of systemic risk are not as responsive to leverage restrictions like those used by the Fed and the AIFMD, or capital requirements. Most hedge funds already have very low leverage ratios, very close to or already within the Fed's requirements for SINBFCs.<sup>305</sup> Additionally, leverage ratios using NAV do not take into account the hedging or netting strategies hedge funds usually use, meaning that any leverage ratio imposed would not affect any positive change in terms of market risk.<sup>306</sup> Capital requirements would primarily assist through the credit channel, but would not necessarily work against certain market sources.<sup>307</sup> Short of eliminating the hedge fund industry as we understand it today, there is no way to regulate the hedge fund industry for systemic risk, at least not in the way the AIFMD attempts to.

The ability of the SEC to prevent systemic risk posed by hedge funds will depend on its flexibility to pursue a more expansive notion of investor protection. Monitoring systemic risk information provided by hedge funds is the key to regulating the markets for investor protection and stability in a more efficient manner. The information the hedge funds will provide to the SEC will allow it to construct a more unified picture of the markets, not fragmented by underlying asset type or exchanges, because the entire hedge fund industry will be providing so much information about all their assets, trading strategies and positions, that the SEC will be able to see differences in an asset's prices over exchange traded stocks, as well as the prices of its derivative contracts centrally cleared and OTC.<sup>308</sup>

The difficulty in achieving this utopian vision of SEC monitoring is the technological backwardness of the SEC.<sup>309</sup> It has been clearly established that the SEC lacks the technology to compete with the private sector.<sup>310</sup> Receiving this information from hedge funds at the hedge funds' expense is certainly a windfall for the SEC. However, depending on the type of analysis necessary to piece all this information together, the SEC

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303. *See id.* at 45. *See also* Schwarcz, *supra* note 16, at 202.

304. Short selling is a good example of this. *See* DIXON, CLANCY & KUMAR, *supra* note 11, at 55-59.

305. *See* FINANCIAL SERVICES AUTHORITY August 2012, *supra* note 233, at 13-15.

306. *See id.* at 13.

307. Capital requirements would cover the hedge funds ability to pay back their own investors and lenders, which may limit the creation of systemic risk through counterparty exposure, but it would not affect short selling.

308. *See* DELOITTE'S *Form PF Readiness Assessment*, *supra* note 100, at 6.

309. *See* Melanie Waddell, *SEC Creates Deputy CIO Position to Spur Modernization*, ADVISOR ONE (Oct. 11, 2012), <http://www.advisorone.com/2012/10/11/sec-creates-deputy-cio-position-to-spur-modernizat>.

310. *See id.*

may not be up to the task. FSOC does receive a lot of the information that the SEC gets from Form PF.<sup>311</sup> So, alternatively, FSOC may be better able to process the information hedge funds provide. However, it is important to ensure that the ramifications of this information do not become excuses to impose “hard regulations” above and beyond minimal compliance programs. This paper concludes that the best response to findings of systemic risk from a hedge fund should be determined on a case by case basis, or at least on an asset class or trading strategy-basis. The one-size-fits-all approach of the AIFMD is why it will be ineffective, while the SEC’s monitoring strategy will be more successful for detecting and understanding systemic risk caused by hedge funds.

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311. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 112(a)(2), 12 U.S.C. 5322 (2012).