Regulation of US Hedge funds before and after the Dodd- Frank Act

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Abstract

The purpose of this thesis is to made a comprehensive study of hedge funds regulation before and after the Dodd-Frank Act and to primarily focus on the issue of, whether the increase in hedge funds regulation was a necessary fact and whether the DFA would be a right way, if the increase would be needed.

The thesis starts with a general overview of the hedge fund industry to provide the reader with necessary information for the further Chapters. It then summarizes the pre-DFA regulatory framework and it continues by elaborating on the role of hedge funds in the 2008 Credit crunch and the subsequent debate over the increase in their regulation. It concludes with a Chapter dedicated to the changes in hedge fund regulation after the DFA and their prospective impact on the hedge fund industry.

The thesis argues that even if we would agree that some adjustments in the hedge funds regulatory framework were necessary, the DFA pushed it over the edge hitting the wrong targets and leaving the most problematic parts of the hedge funds industry untouched.

Table of Contents

List of Abbreviations

US	United States of America
USD	United States Dollar
LTCM	Long Term Capital Management
M	million
LLC	Limited Liability Company
LP	Limited Partnership
SA	Securities Act
SEA	Securities Exchange Act
ICA	Investment Company Act
IAA	Investment Advisers Act
ERISA	Employee Retirement Income Security Act
SEC	US Securities and Exchange Commission
CFTC	Commodity Futures Trading Commission
AUM	Assets under management
CPO	Commodity Pool Provider
PWG	Presidential Working Group
MFA	Managed Funds Association
UK	United Kingdom of Great Britain and Northern Ireland
CDO	Collateralized Debt Obligation
SPE	Special Purpose Entity
PPM	Private Placement Memorandum
NASD	National Association of Securities Dealers
DFA	Dodd Frank Act
TBTF	Too big to fail

Introduction

People always feared new things. Not because they were new, but because most of them were beyond their understanding. The history of mankind is a systematic battle between those who innovate and those who fear innovation, as something they are not able to understand, and are prepared to use any possible excuse to strike down the foolish innovators.

The same pattern is visible in the evolution of the world of finance including hedge funds. When Alfred Winslow Jones in 1949 created the first hedge fund and as the industry grew in time, more and more people started to be afraid of it. Not because they thought there is something bad about it, they presume such evil just because they were not able to understand. When the AUM of hedge fund industry reached 2.25 trillion USD in 2007 the fear escalated to gigantic dimensions. Moreover, between 2007 and 2008 a huge economic crisis struck the world's economy and there was an imminent search for the sinners. Unfortunately for hedge funds, they made the perfect profile for the public enemy number one.

Even when later on, studies showed that hedge funds did not cause the crisis but they helped the economy to recover, it was already too late. The process created by the widespread of fear disseminated in society was already in motion and two years later, it created the Dodd-Frank Act, which would be known as the most comprehensive reform in the US world of finance since the Great Depression.

But why is DFA such a problem? To answer this question we have to go little bit in the history of hedge funds to see what was the key element which make them so successful and popular. This element was the way how they were structured in order to escape most of the federal securities law regulations. This freedom then gave them the opportunity to operate in waters others could not and use techniques others were not allowed to. The Dodd-Frank

Act is now closing most of the doors for hedge funds, putting more and more of them under the supervision of SEC or CFTC. While some argue that this is a problem since hedge funds will be turned into regular mutual funds and the market would be deprived of the unique function only hedge funds provided, others welcome this scenario with open arms saying that it will bring more safety to the investors and better financial stability. And as usual, the truth would be probably somewhere in the middle.

As my topic is situated in the field of capital markets, when the wind is changing direction very often, I based my research on the scholarly articles, which are much more common for this ever evolving field, where books are usually out of date immediately after their release. Also since the Dodd-Frank Act is quite new kid on the block, I also relied on the news articles, especially in the second part of the Chapter 4, the purpose of which is to foster a debate about the impact of Dodd-Frank Act on the day to day business in the hedge fund industry. Finally, I also used relevant federal legislation to reflect the regulation of hedge funds before and after the Dodd-Frank Act.

As research questions, I have selected two. Firstly, I would like to elaborate on the issue, whether the pre Dodd-Frank regulation was sufficient and whether there was objectively an actual need for the change in the regulation of hedge funds. The second question I will answer in this thesis is whether the way how the Dodd-Frank Act has changed the hedge funds regulation would be the right way, if the change in the regulation would be necessary. Basically those two research questions are interconnected and the thesis may in the end come out with one of the four possible scenarios.

Chapter 1: Hedge funds in general

Before I start addressing the main topic of this work, the regulation of US hedge funds before and after the Dodd Frank Act, I need to deal with the issue, that the general public knowledge about Hedge funds and their activities is not very developed. Therefore I feel obliged to include this chapter in my thesis, so the prospective readers will become familiar with the whole concept of hedge fund before I start addressing more specific issues regarding their regulation.

For a person new in the field of hedge funds industry, several very natural questions will arise: What is a hedge fund? Where did they come from? What do they look like? Who manage them and how do they operate? The purpose of this chapter is simply to make the reader familiar with hedge funds and to answer the abovementioned questions. To achieve this, I will start with a general definition of the hedge fund and the common types of hedge funds **(Section 1.1)**, then I will continue with a brief history of the hedge funds so we may better understand where they came from **(Section 1.2)**, afterwards I would like to deal a little bit with the structure of the fund **(Section 1.3)** and the whole chapter will be concluded by the enumeration of the most common strategies used by hedge funds on the markets **(Section 1.4)**.

1.1 What is a hedge fund?

Many authors argue that hedge funds have a similar function to mutual funds, to pool the investor's assets and invest them in order to gain a positive return. The difference is, however, how they do that. Hedge funds, compared to the mutual funds apply more flexible strategies such as short selling, use of leverage and other speculative strategies not commonly used with mutual funds[1]. The use of these strategies, known to be highly speculative and risky, is allowed to the hedge funds because they are very lightly regulated by authorities. I intentionally use the word lightly, while as we will see in the following Chapters[2], contrary to the common perception hedge funds were regulated even before the 2008 Credit crunch and continue to be regulated even today. However, truth be told, compared to the other investment vehicles, the level of regulation is much less strict.

Within the scholarly debate, there is probably no model definition of what the hedge fund is, since they are very diverse in their functions, structures and strategies, but just for the sake of better understanding what we are talking about, I would like to mention two definitions, I found most accurate. According to those definitions, hedge funds are:

> "…private investment vehicles where the manager has a significant personal stake in the fund and enjoys high level of flexibility to employ a broad spectrum of strategies involving use of derivatives, short selling and leverage in order to enhance returns and better manage risk"[3]

> "…an investment program whereby the managers or partners seek absolute returns by exploiting investment opportunities while protecting principal from potential financial loss"[4].

What can we extract from those two definitions are the major aspects of the hedge funds which are the generating of absolute positive return and the management of risk.

As for the generating of absolute positive return, this aspect makes another huge distinction between hedge funds and mutual funds. Since mutual funds aim to the relative

1 SEC Office of Investor Education and Advocacy, Investor Bulletin: Hedge funds, available at http://www.sec.gov/answers/hedge.htm
JOHN C. COFFEE, JR & HILLARY A. SALE, SECURITIES REGULATION 43 (Found. Press 2009).

2 See Cahpter 2 and Chapter 4.

3 VIKAS AGARWAL & NARAYAN Y. NAIK, INTRODUCTION TO HEDGE FUNDS 1. for Centre for Hedge Fund Research and Education, London Bus. School.

4 PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 50 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).

returns measured against pre-selected benchmarks, hedge funds aim to absolute returns which are not measured against any pre-selected benchmarks[5].

As for the management of risk, the idea of hedge funds was to make returns not dependent on the fact whether the market will rise or fall. The strategy used to achieve that I will explain later on, but what is most important that as we can see, the hedge funds were used to hedge their investors from market volatility, that may prospectively damage their investments. Therefore, this is the reason why they started to be called hedge funds. Today, however, not all the hedge funds really hedge and the term hedge fund is used as a generic term to indicate those investment vehicles[6].

1.2 History of the hedge funds

Most common public thoughts about hedge funds are that they are some kind of a new animal on the market. This is caused by the fact that hedge funds only came into the limelight recently due to the, in my point of view, not absolutely justified criticism about being one of the major causes of the 2008 Credit crunch. However, hedge funds really are not some kind of a new kind on the block. The first hedge fund, in all but name, was established by Alfred Winslow Jones in 1949. It is, however, true that the term hedge fund was firstly used in connection with Joneses fund in 1966 in an article in Fortune magazine[7]. Jones used the long-short strategy to hedge risk of potential market volatility and implied the leverage to multiply the profits. This strategy was so successful that Jones was outperforming all the competing mutual funds over the previous ten years by 87%, even after all fees were deducted from the

[5] A. V. Rajwade, *Hedge Funds*, 42 ECON. AND POLIT. WEEKLY 1147, 1147 (2007) (describing the introduction into hedge funds operations).
[6] Joshua Kennon, *What Is a Hedge Fund? A Simple Explanation of What a Hedge Fund Is and How It Operates*, ABOUT.COM GUIDE, available at http://beginnersinvest.about.com/od/hedgefunds/a/what-is-a-hedge-fund.htm.
[7] VIKAS AGARWAL & NARAYAN Y. NAIK, INTRODUCTION TO HEDGE FUNDS 1. for Centre for Hedge Fund Research and Education, London Bus. School.

profit[8]. Jones also kept his money in the fund, while he was of an opinion that without this step, it would be very hard to attract new investors.[9] By this technique he established something, which is also a widely used practice in today´s hedge funds and this is the significant personal stake of the manager in the fund.

Unfortunately for the hedge fund industry development, many hedge funds suffered severe loses during the bear markets from 1969 to 1974 and stayed out of major interest until 1986 when the market started to reestablish[10]. Research shows that the assets under management of hedge funds rose from 42 billion USD in 1988 to 487 billion USD in 2000. What is also important is that those figures represent only the capital account balances of the hedge funds and not the entire amount of money injected into the market[11]. Since some hedge funds strategies are heavily leveraged, the estimate total amount of USD invested by the hedge funds is approximately 1.43 trillion[12].

Hedge funds nowadays are mainly connected with events such as George Soros's speculations against the British Pound in 1992, the collapse of LTCM in 1998 or most recently the 2008 Credit crunch. While some of the authors and critics of hedge funds and their relative freedom argue that hedge funds are predominantly bad, as we will see in the following chapters[13], this is a vast generalization and most hedge funds, in the light of serious arguments, do not fit into this negative and farfetched cliché.

[8] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 49 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[9] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 50 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[10] VIKAS AGARWAL & NARAYAN Y. NAIK, INTRODUCTION TO HEDGE FUNDS 2. for Centre for Hedge Fund Research and Education, London Bus. School.
[11] VIKAS AGARWAL & NARAYAN Y. NAIK, INTRODUCTION TO HEDGE FUNDS 2. for Centre for Hedge Fund Research and Education, London Bus. School.
[12] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 50 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[13] See Chapter 3.

1.3 Structure of the hedge fund

Hedge funds, the same as other investment vehicles maintain certain structures, which significantly varies from fund to fund and are dependent on many separate factors. There are many different aspects of hedge funds structure and a whole master’s thesis could be probably written on this topic, however, since this is not the main aim of my thesis I will focus only on the most important ones. Being a potential investor, due diligence counsel or financial adviser, you need to ask yourself a single set of questions when you encounter the hedge fund, to be able to clearly establish what shall be your expectation about the whole fund. Those questions predominantly are: Who are the main figures? (**Sub-section 1.3.1**) What is the legal form of the hedge fund? (**Sub-section 1.3.2**) Is the fund open ended or close ended? (**Sub-section 1.3.3**) How are the fund´s assets valuated? (**Sub-section 1.3.4**).

1.3.1 Main players in the Hedge funds

One of the most important things which we have to focus on is who are the key players in the structure of hedge fund. Since hedge funds, compared to other investment vehicles, are only lightly regulated, the reputation and the past investment results of those players are taken into serious consideration by the prospective investors. There are generally three main figures in a hedge fund: the fund manager, the prime broker and the fund administrator. I will now address these three figures in this order and explain their roles and importance within the hedge fund structure.

The most important figure is naturally the manager of the fund. The manager or the general partner (depends on the legal form of the hedge fund) is responsible for executing the investment strategies, picking the right investments and being the brains of all the operations. The manager is generally a group of individuals, sometimes even forming a limited liability partnership. This group must possess a certain level of experience in the world of finance (mostly these people are former bankers or mutual fund managers) and they also need to have certain reputation to attract prospective investors[14].

Managers are typically paid two types of fees. This compensation formula is widely known as a 2 and 20 and is used by the majority of hedge funds today. According to this 2 and 20 formula, the hedge fund manager is entitled to "2% of assets and 20% of profits each year"[15]. To make things clear, I will make an example to illustrate how this works.

Example 1: Imagine that I am a manager of ABC hedge fund with total amount of AUM amounting to 100,000,000 USD. Through the year I made several investments and because I was very successful, I was able to double the assets of ABC hedge funds. Therefore, the total amount of the AUM of ABC hedge fund is now 200,000,000 USD, while the annual profit amounts to 100,000,000 USD. To calculate the 2% (generally called the management fee) we have to count 2% out of the total amount of assets under my management, therefore 200 M. the total amount of my management fee will be therefore 4M USD. This management fee is regularly distributed to the managers in several installments through the year to effectively cover their management expenses[16]. To count the other 20% (generally known as a bonus) we have to take into consideration only the profit, therefore 100 M. My total bonus will therefore be 20 M USD. I will therefore make 24 M in this year.

Example 1 shows us several problems connected to the evaluation of the managers. Firstly, what happens when the manager does not invest the money and just deposits it in a bank? In that case in Example 1 he will receive 2 M USD every year as a management fee for nothing. This problem will in my point of view be solved swiftly by the market itself, since

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[14] A. V. Rajwade, *Hedge Funds*, 42 ECON. AND POLIT. WEEKLY 1147, 1147 (2007) (describing the introduction into hedge funds operations).

[15] Joshua Kennon, *What Is a Hedge Fund? A Simple Explanation of What a Hedge Fund Is and How It Operates*, ABOUT.COM GUIDE, available at http://beginnersinvest.about.com/od/hedgefunds/a/what-is-a-hedge-fund.htm.

[16] Burton S. Hochberg & Daniel R. Van Vleet, *Hedge Fund*, 25 FAMILY ADVOC. 29, 29 (2003) (describing the fees paid to hedge fund managers).

people investing in hedge funds are mostly very sophisticated investors and therefore any such problem would be solved by the immediate request for withdrawal and massive damage towards the manager's reputation. Therefore we do not have to worry about this problem much.

The second problem is a little bit complicated. Again I will start with an example to make things easier to understand.

Example 2: Imagine that in Example 1 I would not be so successful and instead of doubling the initial assets of ABC hedge fund, I will incur 50% loses. Then I will reduce the total assets of the ABC hedge fund to 50,000,000 USD. I will be then entitled to 1 M USD in management fee and 0 USD in bonus. Then next year I will learn from my mistakes and double the total assets of ABC hedge fund. Therefore, after 2 years, I will have the total amount of assets back on the initial 100,000,000 USD. This will entitle me to 2 M USD in management fee and theoretically 10 M in bonus.

But we may ask ourselves whether this is right? Am I really entitled to a 10 M USD bonus just for the fact that after two years, I am still at the level of the initial investment? The result will be same if I would deposit the money for two years in the bank with only distinction that instead of 13 M USD I would be entitled only to four M. To combat this problem, a technique called high-water -mark is employed. This technique ensures that the manager is not entitled to be paid any bonuses until any losses incurred by the manager are recovered[17].

Another technique used by investors is the so called hurdle rate. The hurdle rate is usually some percentage which is subtracted from the annual profit in favor of the investors

[17] Burton S. Hochberg & Daniel R. Van Vleet, *Hedge Fund*, 25 FAMILY ADVOC. 29, 29 (2003) (describing the fees paid to hedge fund managers).

before the rest is split between investors and the manager[18]. This hurdle functions again as some kind of incentive towards managers to generate more profit.

Moving from the manager, the second most important figure is the prime broker. The prime broker is in most cases a big investment bank which ensures securities lending in short sales, money lending as leverage, settlements and act as counterparty in derivatives transactions[19].

The third major player is the fund administrator. The fund administrator is usually some kind of medium who provides the flow of information in and out of the fund[20] and provides a back office service[21].

1.3.2 Legal form

The main goal of legal form selection is very obviously, to minimize taxation. There are two commonly used legal forms for hedge funds, Limited Partnership or Limited Liability Company[22]. The Limited Liability Companies are more favored within EU investors preferring to have all gains as capital gains. In the US, a Limited Partnership is more favored while it is considered to be tax transparent and it is subjected to less taxation. There is also the Master-Feeder structure, which incorporates the previous two legal forms. This structure allows for the formation of two Feeder funds, where one may be LP and the second LLC.

[18] Joshua Kennon, *What Is a Hedge Fund? A Simple Explanation of What a Hedge Fund Is and How It Operates*, ABOUT.COM GUIDE, available at http://beginnersinvest.about.com/od/hedgefunds/a/what-is-a-hedge-fund.htm.
[19] A. V. Rajwade, *Hedge Funds*, 42 ECON. AND POLIT. WEEKLY 1147, 1147-48 (2007) (describing the key figures in hedge fund structure).
[20] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 67 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[21] A. V. Rajwade, *Hedge Funds*, 42 ECON. AND POLIT. WEEKLY 1147, 1148 (2007) (describing the key figures in hedge fund structure).
[22] Joshua Kennon, *What Is a Hedge Fund? A Simple Explanation of What a Hedge Fund Is and How It Operates*, ABOUT.COM GUIDE, available at http://beginnersinvest.about.com/od/hedgefunds/a/what-is-a-hedge-fund.htm.

Those two funds will pool their assets in the Master fund who will function as a hedge fund of those two funds[23].

This kind of Master-Feeder structure is used also in the case of so called fund of funds. These vehicles invest in a wide range of different hedge funds providing their investors two advantages: lower investment threshold and more diversification for the one disadvantage in a form of additional layer of fees[24].

1.3.3 Open ended or Close ended?

The main difference between an open-ended and close-ended structure is that a close-ended structure does not allow investors to redeem their investments, but they have to sell their interest to someone else. Since as we will see further on, selling interest in a hedge fund may be problematic, most hedge funds are open-ended[25]. However, even if hedge funds are generally open-ended, the same as mutual funds, compared to the mutual funds, hedge funds often impose significant limitations on the withdrawal of investments, which provide them with opportunity to invest into more illiquid assets[26].

Hedge funds regularly limit the redemption on certain time periods (quarterly, annually) or impose the so called lock-up period (regularly 12 months) during which redemption is not possible. Also redemption fees may be charged or the redemption may be suspended due to the unfavorable market circumstances[27].

[23] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 54 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).

[24] A. V. Rajwade, *Hedge Funds*, 42 ECON. AND POLIT. WEEKLY 1147, 1147 (2007) (describing the introduction into hedge funds operations).

[25] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 59-60 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).

[26] VIKAS AGARWAL & NARAYAN Y. NAIK, INTRODUCTION TO HEDGE FUNDS 6. for Centre for Hedge Fund Research and Education, London Bus. School.

[27] SEC Office of Investor Education and Advocacy, Investor Bulletin: Hedge funds, available at http://www.sec.gov/answers/hedge.htm

1.3.4 Valuation of assets

The valuation of assets is a very important issue, since as you can see from Examples 1 and 2, the value of the assets significantly influences the fees played to the manager of the fund. In my point of view, the investors must be very careful about that, since managers would like to reduce the valuation of the initial assets of the fund and increase the value of the annual profits on the other hand. Since the management fee (which is calculated from overall managed assets) amounts only to 2% and the bonus (calculated out of the profit) is 20% such conclusions seems to me very logical.

There are three approaches towards the valuation, market approach, income approach and asset-based approach. Consequently, the asset based approach may be the most appropriate business valuation approach to use in the analysis[28].

1.4 Strategies of the hedge funds

Since the variety of strategies used by hedge funds is very wide and it is not the purpose of this work to focus on them, I found it sufficient to provide the reader only with this basic chart, created by Vikas Agarwal, concerning the most common strategies applied by the hedge funds: [29]

[28] Burton S. Hochberg & Daniel R. Van Vleet, *Hedge Fund*, 25 FAMILY ADVOC. 29, 29-30 (2003) (describing the fees paid to hedge fund managers).

[29] VIKAS AGARWAL & NARAYAN Y. NAIK, INTRODUCTION TO HEDGE FUNDS 5. for Centre for Hedge Fund Research and Education, London Bus. School.

Table 1 Classification of hedge funds

Non-Directional Strategies

Fixed Income Arbitrage	A strategy having long and short bond positions via cash or derivatives markets in government, corporate and/or asset-backed securities. The risk of these strategies varies depending on duration, credit exposure and the degree of leverage employed.
Event Driven	A strategy which hopes to benefit from mispricing arising in different events such as merger arbitrage, restructurings etc. Manager takes a position in an undervalued security that is anticipated to rise in value because of events such as mergers, reorganizations, or takeovers. The main risk in such strategies is non-realization of the event.
Equity Hedge	A strategy of investing in equity or equity-like instruments where the net exposure (gross long minus gross short) is generally low. The manager may invest globally, or have a more defined geographic, industry or capitalization focus. The risk primarily pertains to the specific risk of the long and short positions.
Distressed Securities	A strategy of buying and occasionally shorting securities of companies under Chapter 11 and/or ones which are undergoing some form of reorganization. The securities range from senior secured debt to common stock. The liquidation of financially distressed company is the main source of risk in these strategies.
Merger Arbitrage	A strategy of purchasing securities of a company being acquired, and shorting that of the acquiring company. The risk associated with such strategies is more of a "deal" risk rather than market risk.
Convertible Arbitrage	A strategy of buying and selling different securities of the same issuer (e.g. convertibles/common stock) seeking to obtain low volatility returns by arbitraging the relative mispricing of these securities.

Directional Strategies

Macro	A strategy that seeks to capitalize on country, regional and/or economic change affecting securities, commodities, interest rates and currency rates. Asset allocation can be aggressive, and leverage and derivatives may be utilized. The method and degree of hedging can vary significantly.
Emerging Markets	A strategy that employs a "growth" or "value" approach to investing in equities with no shorting or hedging to minimize inherent market risk. These funds mainly invest in the emerging markets where there may be restrictions on short sales.
Equity Non-Hedge	A strategy similar to equity hedge with significant net long exposure.
Short Selling	A strategy that focuses on selling short over-valued securities, with the hope of repurchasing them in the future at a lower price.

Chapter 2: Regulation of Hedge funds in the pre-Dodd Frank era

As I already indicated in the first Chapter, we simply cannot say that the hedge funds are absolutely unregulated, as wide public tends to believe. It is true, that hedge funds are very lightly regulated, but still they face a possibility of being directly and indirectly subjected to many regulations. The reason, why they are able to escape those regulations they face is not the fact, that there is a different legal environment for hedge funds and a different legal environment for other investment companies. Quite the contrary, all the investment companies are regulated the same way; however, the thing that makes the hedge funds escape most of the regulations is their structure that makes them use safe harbors in federal legislation.

In this Chapter I will focus on three major fields of hedge funds regulation. Firstly I will deal with the direct regulation imposed by federal and state laws (**Section 2.1**). Secondly I will elaborate on the attempts for indirect regulation of hedge funds through tightening regulation of investment banks and perspective investors (**Section 2.2**). Finally, I will shortly discuss a brand new regulatory style, which arose few years before Dodd Frank Act came into force, the so called Sound / Best Practice Standards (**Section 2.3**).

2.1 Direct regulation

As I wrote at the beginning of this Chapter, the magic of hedge funds light regulatory regime on the federal level is not some kind of shady exploitation of loopholes in federal legislation. The truth is that hedge funds had been so lightly regulated because of the structure of the federal securities laws. Most federal securities laws such as the 1933 Securities Act, 1934 Securities Exchange Act, 1940 Investment Company Act, 1940 Investment Advisers Act and the 1974 Employee Retirement Income Security Act contain a variety of exclusions[30] "the Congress has seen fit to build into the securities law regime"[31]. The hedge funds are then structured to fit those exclusions (also known as safe harbors) and to avoid the necessary regulation requirements[32]. In the first part of this Section, I will go through all the above mentioned Acts and elaborate on those exclusions to illustrate how Hedge funds commonly escaped the regulation under federal securities laws (**Sub-sections 2.1.1 – 2.1.5**).

Following this part I will then focus on the two attempts to tighten the hedge fund regulation in 1999, more precisely on Hedge funds Disclosure Act (**Sub-section 2.1.6**) and Derivatives Market Reform Act (**Sub-section 2.1.7**), which both died in 2000 with the end of the 106th Congress[33].

Afterwards, I will focus on regulatory attempts conducted by the Commodity Futures Trading Commission (**Sub-section 2.1.8**) and this section will then be concluded by a short review of a regulation of hedge funds in individual states by so called Blue Sky Laws (**Sub-section 2.1.9**).

2.1.1 1933 Securities Act

For our purposes, the most important part of the 1993 Securities Act is Section 5, which imposes a mandatory registration of securities subjected to public offering. However,

[30] Troy A. Pardles, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation* 4 (May 2007), Washington U. School of Law Working Paper No. 07-05-01, available at: http://ssrn.com/abstract=984450 or http://dx.doi.org/10.2139/ssrn.984450.

[31] Troy A. Pardles, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission* 2 (March 24, 2006), Washington U. School of Law Working Paper No. 06-03-02, available at: http://ssrn.com/abstract=893190 or http://dx.doi.org/10.2139/ssrn.893190.

[32] Troy A. Pardles, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation* 4 (May 2007), Washington U. School of Law Working Paper No. 07-05-01, available at: http://ssrn.com/abstract=984450 or http://dx.doi.org/10.2139/ssrn.984450.

[33] Paola Robotti, *Private governance and public withdrawals: the US regulatory regime on hedge funds* 19, Institut Barcelona d´Estudis Internationals, available at: http://idec.gr/iier/new/3rd%20Panhellenic%20Conference/ROBOTTI-PRIVATE%20GOVERNANCE%20AND%20PUBLIC%20WITHDRAWALS.pdf.

Section 4(2) and Regulation D of SA provide an exception from this mandatory registration for certain private placements of securities[34].

Section 4(2) of the SA states that: "The provisions of Section 5 shall not apply to transactions by an issuer not involving any public offering"[35]. The SA however, does not provide us with any definition what constitutes a public offering. Therefore the SEC adopted Rules 506 and 501 (a) of Regulation D to indicate transactions, which are not considered as a "public offering" and which therefore, comply with Section 4(2) SA. Simply speaking, if the transaction can be subsumed under any of the Rules 506 and 501 (a) examples, there is no need to register under the Section 5 of the SA[36].

According to Rule 506, the sale complies with Section 4(2) of SA if:

1. It is made to accredited investors
2. No general solicitation or advertising is involved
3. The security is bought for investment and not resale[37]

What is meant by the term accredited investor is explained in Rule 501 (a). An accredited investor is: "An individual whose net worth (or joint net worth with that person´s spouse) exceeds 1 million USD, or whose income was in excess of 200,000 USD in each of the preceding two years (or, together with that person´s spouse, in excess of 300,000 USD in each of the preceding two years" [38] or "Corporations, partnerships, trusts or foundations, not

[34] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 283 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[35] Securities Act of 1933, 15 U.S.C. §§ 77a et. Seq.
[36] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 283 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[37] *Id*. ad 283.
[38] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 283-284 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).

formed for the purpose of acquiring the securities offered, with total assets in excess of 5 million USD"[39].

As we can see, this is the reason, why we cannot generally find any advertisements on hedge funds in the financial press, when it is full of advertisements on mutual funds and pension funds. It is not because hedge funds would not like to advertise to attract more investors; it is because they simply cannot, if they want to stay out of the regulatory requirements of SA. Also the SA is the reason why hedge funds attract mostly the wealthy investors. The idea of Rule 501 (a) is very simple, to establish a threshold and draw a line between common investors, who need a protection of SEC and sophisticated and wealthy investors able to fend for themselves[40].

To sum up, as long as a hedge fund refrains from public advertisements and keeps an eye on the fact that it´s investors are accredited investors it is exempted from SA Section 5 mandatory registration.

2.1.2 1934 Securities Exchange Act

Another piece of federal legislation that may directly regulate the hedge funds is the 1934 Securities Exchange Act and primarily its Sections 10 and 12. Section 10 of the SEA forbids hedge fund managers to involve in any manipulative and deceptive behavior (also including insider trading)[41].

Section 12 then deals with the perspective registration of hedge fund managers under the SEA. Section 12 (g)(1) of the SEA requires a manager of hedge fund which falls within

[39] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 283-284 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[40] Troy A. Pardles, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission* 4 (March 24, 2006), Washington U. School of Law Working Paper No. 06-03-02, available at: http://ssrn.com/abstract=893190 or http://dx.doi.org/10.2139/ssrn.893190.
[41] *Overview of the Securities Exchange Act of 1934*, (October 14, 2008), Hedge Fund Law Blog, available at: http://www.hedgefundlawblog.com/overview-of-the-securities-exchange-act-of-1934.html.

the exception in Section 3 (c)(7) of the Investment Company Act of 1940[42] to register under the SEA if the hedge fund have more than 10 million USD in assets and 500 or more investors[43].

In this case, it is worth mentioning, that any presence of "non-accredited investors" in hedge fund portfolio will immediately trigger registration with SEC under SA, therefore, if the hedge fund want to stay out of both SA and SEA registration regimes, it has to have no non-accredited investors and less the 500 qualified purchasers[44]. Moreover, the hedge fund must have less than 10 million USD in assets.

2.1.3 1940 Investment Company Act

In order to escape regulation under the Investment Company Act, hedge funds need to qualify for one of two major exceptions provided under Section 3 of ICA. If the hedge fund classifies under one of those exceptions, it will not be classified as an investment company for the purpose of ICA and again do not have to register with SEC. The above mentioned exceptions are Section 3(c)(1) and 3(c)(7) of ICA. Section 3(c)(1) of ICA excluded from the definition of investment company 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"[45].

Section 3(c)(7) of ICA then excludes any issuer: "…the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a

[42] Section 3(c)(7) of ICA then excludes any issuer…the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers", and which is not making and does not at that time propose to make a public offering of such securities.
[43] Securities Exchange Act of 1933, 15 U.S.C. §§ 78a et. Seq.
[44] The Investment Company Act of 1940 defines qualified purchaser as an individual "*who each own not less than 5 million USD in investments*".
[45] Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 – 80a-64.

public offering of such securities”[46]. The term qualified purchaser is then defined as individual “who each own not less than 5 million USD in investments”[47].

It is worth mentioning what is very obvious when we compare ICA with SA. Both Acts operate with some kind of privileged investor group, which in my opinion function as a safeguard for regular investors. The system, in my point of view, works the same way: if the hedge funds want to stay out of regulation; they have to deal only with this privileged group. What is however interesting, is the fact that there are different thresholds under both Acts. While the SA definition of accredited investor focuses on individual’s net worth, the ICA definition of qualified purchaser focuses on the amount of investments.

In my personal opinion the ICA requirement makes more sense and is more in a line with the general aim of investment company regulation. The sole fact that an individual has a certain net worth does not make him an individual, who is skillful in investment business and who does not need protection of SEC. He may very well gather the net worth by other activities. Therefore the amount of investments is a much better requirement to identify the real capital market veterans, who do not need the SEC protection and are skillful enough to deal with unregistered investment companies as hedge funds are.

Another interesting point is Section’s 3(c)(1) securities owners threshold established to be not more than 100. This is much less compared to SEA threshold of 500 qualified purchasers. Therefore if a hedge fund wants to stay out of SA, SEA and ICA the maximum amount of investors holding the hedge fund stock shall not exceed 100 accredited investors or 499 qualified purchasers, who will cumulatively fit also the definition of accredited investors under SA. In the latter case, the amount of assets of the hedge fund also shall not exceed 10 million USD.

[46] Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 – 80a-64.
[47] JOHN C. COFFEE, JR & HILLARY A. SALE, SECURITIES REGULATION 43 (Found. Press 2009).

2.1.4 1940 Investment Advisers Act

The regulation under the Investment Advisers Act does not focus directly on the hedge funds activity, but rather targets the hedge fund managers, requiring them to register with the SEC under the Section 203 of the IAA[48]. However, there is again a safe harbor in the form of Section 203(b)(3) stating that an investment adviser does not have to register if:

1. It advises to less the 15 clients
2. It does not hold himself as a n investment adviser to the public
3. It does not advise registered investment company[49]

This safe harbor was, however, supposed to end in 2004 after SEC campaign against light regulation of hedge funds. As a result of several major hedge funds scandals (which I will address in more detail in the following Chapter) SEC issued a new Rule 203(b)(3)-2. Under this new Rule, the hedge fund managers were supposed to look through their clients[50]. To explain what it meant, I will use the following example.

Example 3: Imagine that I am a hedge fund adviser, advising five individual hedge funds (A with 40 investors, B with 35 investors, C with 20 investors, D with 50 investors and E with 15 investors). Under the traditional system, I do not have to register, while I give advice to five clients. However, under the new system, I have to look through my clients and identify the clients of my clients. Therefore, I would have to register, as I would have 160 clients (cumulative number of hedge fund A, B, C, D and E clients).

[48] Troy A. Pardles, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation* 5 (May 2007), Washington U. School of Law Working Paper No. 07-05-01, available at: http://ssrn.com/abstract=984450 or http://dx.doi.org/10.2139/ssrn.984450.

[49] Troy A. Pardles, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission* 15 (March 24, 2006), Washington U. School of Law Working Paper No. 06-03-02, available at: http://ssrn.com/abstract=893190 or http://dx.doi.org/10.2139/ssrn.893190.

[50] *Id*. ad 15-16.

This new Rule introduced by SEC covered most of the hedge funds advisers and impose extensive obligations on them. Firstly, the advisers were imposed with extensive disclosure of information with SEC. Secondly; the adviser would be exposed to SEC oversight and examination of books. Thirdly, the advisers would be required to appoint and train a compliance officer and enforce a written code of ethics and a proxy voting procedure.[51]

This new Rule immediately brought a high level of criticism from the Hedge fund industry, but what is more interesting; two out of five SEC commissioners openly opposed this Rule and voted against its introduction (Glassman and Atkins)[52]. The rule was finally struck down in 2006 by the US Court of Appeals for District of Columbia in Goldstein v. SEC[53]. In this case, the court stated that this Rule seems arbitrary, because it resulted in different definition of client for purpose of advisers registration compared to any other contexts and therefore violating "the same words used in different parts of a statute have the same meaning"[54].

It is also important to point out, that Section 203A (a)(1)(A) of IAA provides that only investment advisers, not eligible for any exception, with assets under management equal or more than 25 million USD are required to register with SEC. investment advisers with less than 25 million USD of AUM, which is not eligible for any exception, is required to register with authorities of his State of residence[55].

[51] Dale A. Oesterle, *Regulating Hedge Funds* 7, (June 2006), Ohio State Public Law Working Paper No. 71, Center for Interdisciplinary Law and Policy Studies Working Paper No. 47, available at: http://ssrn.com/abstract=913045 or http://dx.doi.org/10.2139/ssrn.913045.

[52] Paola Robotti, *Private governance and public withdrawals: the US regulatory regime on hedge funds* 24, Institut Barcelona d´Estudis Internationals, available at: http://idec.gr/iier/new/3rd%20Panhellenic%20Conference/ROBOTTI-PRIVATE%20GOVERNANCE%20AND%20PUBLIC%20WITHDRAWALS.pdf.

[53] Zachary A. Goldfarb & David Cho, *Hedge Funds Making Way For Government Regulation* (March 14, 2009), WASHINGTON POST, available at: http://articles.washingtonpost.com/2009-03-14/business/36839878_1_fund-fraud-investment-pools-fund-managers.

[54] Goldstein, et al. v. SEC, No. 04-1434, 2006 (US Court of App. DC).

[55] Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 – 21.

2.1.5 1974 Employee Retirement Income Security Act

The Employee Retirement Income Security Act reacted on the recent increase of popularity of Pension plans investments in hedge funds. Pension plans were generally attracted by high returns promised by hedge funds and sometimes forgot about the risk posed by hedge fund investments[56]. Since the main purpose of ERISA is to protect the social benefits of pensions, it imposes the so called "25% Limit"[57]. In order to avoid regulation under this "25% Limit", a hedge fund must avoid a situation in which any employee benefit plan own more than 25 % of the hedge fund´s interest[58]. The main idea behind this rule is very simple; to protect the pension plans beneficiaries to lose their pensions over loses from hedge fund risky operations[59].

2.1.6 1999 Hedge funds Disclosure Act

In 1999, one year after the colossal crash of LTCM and its subsequent bailout, the public outcry over new set of rules regulating hedge funds arose. One of the immediate responses was a hedge funds Disclosure Act proposal, championed by Congressman Richard Baker[60]. The bill was supposed to: "…Require unregulated hedge funds to submit regular reports to Board of Governors of the Federal Reserve System, to make such reports available

[56] GAO Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House of Representatives, *Hedge funds Overview of Regulatory Oversight, Counterparty Risks, and Investment Changes* 10 (May 7, 2009), available at: http://www.gao.gov/new.items/d09677t.pdf.
[57] Sherman & Sterling LLP, *Hedge Fund compliance with 25% ERISA Limit* 1 (September 2004), Client publication, available at: http://www.shearman.com/files/Publication/0527637a-386d-4edd-b83b-b4babc648872/Presentation/PublicationAttachment/a8795ffd-7839-4515-8787-d058684f9ae2/eceb_092004.pdf.
[58] Dale A. Oesterle, *Regulating Hedge Funds* 3 (June 2006), Ohio State Public Law Working Paper No. 71, Center for Interdisciplinary Law and Policy Studies Working Paper No. 47, available at: http://ssrn.com/abstract=913045 or http://dx.doi.org/10.2139/ssrn.913045.
[59] GAO Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House of Representatives, *Hedge funds Overview of Regulatory Oversight, Counterparty Risks, and Investment Changes* 10 (May 7, 2009), available at: http://www.gao.gov/new.items/d09677t.pdf.
[60] Paola Robotti, *Private governance and public withdrawals: the US regulatory regime on hedge funds* 15, Institut Barcelona d´Estudis Internationals, available at: http://idec.gr/iier/new/3rd%20Panhellenic%20Conference/ROBOTTI-PRIVATE%20GOVERNANCE%20AND%20PUBLIC%20WITHDRAWALS.pdf.

to the public to the extent required by regulations prescribed by the Board, and for other purposes”[61].

The bill was widely opposed by the hedge fund industry, arguing that US authorities can only enforce public disclosure in order to protect investors. Since hedge funds do not pose any investors protection concerns, which may be corroborated by the fact that they classify for the 1940 Investment Company Act exception, there is no authority to enforce such bill. As a result of this opposition, the bill died in 2000 with the end of 106th Congress[62].

2.1.7 1999 Derivatives Market Reform Act

This Act, again in a form of a bill, came two months after the introduction of hedge funds Disclosure Act proposal and was championed by Congressman Edward Markey. It again involved a series of public disclosure requirements focused on unregulated hedge funds, but this time it went a bit far than hedge funds Disclosure Act. It also contained a proposal of amendment of the 1940 Investment Company Act as a reaction of a hedge funds Disclosure Act failure. This amendment would have required unregistered hedge funds to “file reports with the Commission no later than 15 days after the end of each calendar or fiscal quarter”. However, even the Markley bill had the same result as the hedge funds Disclosure Act and died in 2000 with the end of 106th Congress[63].

2.1.8 Commodity Futures Trading Commission Regulation

Hedge funds regularly engage in transactions regarding futures contracts, options and commodities. Due to these practices they may fall within the definition of “commodity pool”

[61] Paola Robotti, *Private governance and public withdrawals: the US regulatory regime on hedge funds* 15, Institut Barcelona d´Estudis Internationals, available at: http://idec.gr/iier/new/3rd%20Panhellenic%20Conference/ROBOTTI-PRIVATE%20GOVERNANCE%20AND%20PUBLIC%20WITHDRAWALS.pdf.
[62] *Id*. ad 15-17.
[63] *Id*. ad 18-19.

and a subsequent regulation of Commodity Futures Trading Commission[64]. The new CFTC Rules exempt from their reach only "commodity pools" selling to certain privileged investors[65].

The CFTC rules provide two exceptions from a general duty to register as a commodity pool operator. Under the Rule 4.13(a)(4) the CPO is exempted from registration if he sells only to "accredited investors" under Regulation D under SA[66]. The second exception can be found under Rule 4.7(a)(2) exempting the CPO from registration if he sells to "qualified purchasers" under the Investment Company Act (see Sub-section 2.1.3)[67].

2.1.9 Blue Sky Laws

Every US state has its own set of rules regulating the offering of securities within this state. Such rules are called Blue Sky Laws and are generally concerned with registration of the securities with a specific state agency. As in the federal legislation, exceptions from these registrations widely appear in the Blue Sky Laws[68]. Those exceptions are mostly inspired by Regulation D of SA. Therefore, to be on a safe side, it is highly recommended for hedge funds to inquire about any possible Blue Sky Laws that may apply to them, before offering stock in the US[69]. It is also worth mentioning that many states also have their broker-dealer registration requirements, which may again affect the hedge fund offering in their jurisdiction[70].

[64] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 289 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[65] Dale A. Oesterle, *Regulating Hedge Funds* 4 (June 2006), Ohio State Public Law Working Paper No. 71, Center for Interdisciplinary Law and Policy Studies Working Paper No. 47, available at: http://ssrn.com/abstract=913045 or http://dx.doi.org/10.2139/ssrn.913045.
[66] See Sub-section 2.1.1.
[67] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 290 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[68] JOHN C. COFFEE, JR & HILLARY A. SALE, SECURITIES REGULATION 43 (Found. Press 2009).
[69] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 290-291 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[70] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 291 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).

2.2 Indirect regulation

As we can see in the previous Section (Section 2.1), there are considerable problems with direct regulation of hedge funds. They regularly oppose the changes and what is more important, until the Dodd Frank Act, they were quite successful in this activity. Also there is a general fear that the possible over-regulation may suffocate the hedge fund industry[71] and some authors even argue that the pre-Dodd Frank growth of the hedge fund industry was caused by over-regulation of other investment companies, which made them unable to compete with hedge funds[72].

As a response to that, some attempts have been made to regulate hedge funds indirectly, instead of directly. These attempts pursue the same aim as the direct regulation, to protect investors from negative side effects of hedge funds risky operations[73], just instead of targeting hedge funds, they target banks or their investors.

As an example of such an attempt are the Counterparties Risk Management Group guidelines for banks dealings with hedge funds. These regulations arose from the idea that Hedge funds became so sophisticated and complicated, that public regulators are willing to delegate the regulation on private organizations with better insight[74]. Other examples of such an approach can be seen by limitations on lending to hedge funds, imposed on banks by

[71] Troy A. Pardles, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission* 1 (March 24, 2006), Washington U. School of Law Working Paper No. 06-03-02, available at: http://ssrn.com/abstract=893190 or http://dx.doi.org/10.2139/ssrn.893190.

[72] Dale A. Oesterle, *Regulating Hedge Funds* 2 (June 2006), Ohio State Public Law Working Paper No. 71, Center for Interdisciplinary Law and Policy Studies Working Paper No. 47, available at: http://ssrn.com/abstract=913045 or http://dx.doi.org/10.2139/ssrn.913045.

[73] Troy A. Pardles, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation* 8 (May 2007), Washington U. School of Law Working Paper No. 07-05-01, available at: http://ssrn.com/abstract=984450 or http://dx.doi.org/10.2139/ssrn.984450.

[74] Paola Robotti, *Private governance and public withdrawals: the US regulatory regime on hedge funds* 20, Institut Barcelona d´Estudis Internationals, available at: http://idec.gr/iier/new/3rd%20Panhellenic%20Conference/ROBOTTI-PRIVATE%20GOVERNANCE%20AND%20PUBLIC%20WITHDRAWALS.pdf.

Federal Treasury Regulations and limitation of broker-dealers through Regulation T of the Federal Reserve Board[75].

Another example of indirect regulation, this time targeting the investors, is the 2006 SEC proposal of "accredited natural person" definition[76]. This proposal was supposed to "increase hedge fund net worth requirements for participants"[77]. This proposal would then indirectly influence the registration requirements under the ICA, forbidding the hedge fund managers to charge performance fee to individuals below this threshold[78]. Estimation argues that this would in the end lead to an 88% reduction of current household participation in hedge funds[79].

2.3 Sound / Best Practice Standards

Finally, the conduct of hedge funds has started to be regulated through so called Sound / Best Practice Standards since 2003[80]. We may personally question how much these Standards really regulate hedge funds conduct, while they are non-mandatory[81], however, before delivering any quick judgment; let´s take a look at them.

In the US, there are currently two types of those Standards, the Asset Managers´ Guide under the PWG from 2008 and MFA Guide in its latest version from 2009[82]. If we take a closer look, we will see that many of those Standards involve the same or similar rules as IAA

[75] Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 30 REGULATION 36, 37 (2007) (describes regulation of hedge funds and current challenges for future regulation efforts).
[76] Troy A. Pardles, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation* 7 (May 2007), Washington U. School of Law Working Paper No. 07-05-01, available at: http://ssrn.com/abstract=984450 or http://dx.doi.org/10.2139/ssrn.984450.
[77] Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 30 REGULATION 36, 39 (2007) (describes regulation of hedge funds and current challenges for future regulation efforts).
[78] Troy A. Pardles, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation* 7 (May 2007), Washington U. School of Law Working Paper No. 07-05-01, available at: http://ssrn.com/abstract=984450 or http://dx.doi.org/10.2139/ssrn.984450.
[79] Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 30 REGULATION 36, 39 (2007) (describes regulation of hedge funds and current challenges for future regulation efforts).
[80] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 34 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).
[81] *Id*. ad 40.
[82] *Id*. ad 24.

and related rules imposed by SEC[83]. Therefore, we may assume that since those Standards are publicly accessible, the natural market demand will put a pressure on the hedge funds to comply with them, especially given the consideration of the "little child rule", which states that rules are more likely to be obeyed, it the subject thinks he is obeying them by his free will, not by order. Also we may assume that hedge funds would prefer to opt for those kinds of rules, they may easily escape if they will complicate their operations too much. Finally, it is my personal opinion that hedge funds opting for these Standards will become more trustworthy in the eyes of prospective investors and will attract more capital investment. If for no other reasons, then at least for the fact that those practices impose certain disclosure and corporate governance requirements, which may be positively valued by the prospective investors. The hedge funds which will opt for them will send a clear signal to the investors: we have nothing to hide and we are prepared to explain and show you, what will be done with your money. This signal shall be greatly welcomed by the investors thinking about hedge funds but being afraid about their secrecy.

[83] PETER ASTEFORD & DICK FRASE, HEDGE FUNDS AND THE LAW 40 (Peter Asteford & Dick Frase ed., London: Thomson Reuters 2010).

Chapter 3: Hedge funds in 2008 Credit crunch and the call for regulation

In the years 2007 and 2008, due to unexpected market developments, the US market was hit by a massive crisis[84]. It all started with the policy of expansion created by the Bush administration. Even when the US was in a war in Afghanistan and Iraq, people were pumped with confidence in the power of the US market and were excessively borrowing. The environment of endless optimism and trust that the prices of real estate will rise created the increase in lending to sub-prime borrowers[85].

Those sub-prime mortgages were strictly speaking mortgages made to individuals who have a bad credit risk, which in general means, that the probability of default was very high[86] . Those people were made loans in much higher values than the values of the collateral, their houses. The idea was simple, the borrowers expected that the price of the houses will rise sharply as in the previous years and if the sub-prime borrowers will default, they will be able to sell the houses for a sufficient price[87]. However, in 2006 the rate of sub-prime loans delinquencies increased substantially, a massive wave of foreclosures followed immediately and all this together triggered the decrees in the prices of housing prices[88].

This shockwave of defaults on subprime home mortgages, which eventually left the borrowers with houses nobody could afford the so called for the necessary price. Therefore the borrowers were not able to sell the collateral for amounts equal to the loans[89]. What follows is already known, this critical development on mortgage market devaluated mortgage

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84 ALASTAIR HUDSON, THE LAW OF FINANCE 830 (London: Thomson Reuters 2009).
85 *Id.* ad *833.*
86 HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 597 (Robert C. Clark ed, Found. Press 2009).
87 ALASTAIR HUDSON, THE LAW OF FINANCE 834 (London: Thomson Reuters 2009).
88 HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 597 (Robert C. Clark ed, Found. Press 2009).
89 ALASTAIR HUDSON, THE LAW OF FINANCE 834 (London: Thomson Reuters 2009).

backed securities and collateralized debt obligations which had been widely disseminated over the market in previous years[90]. This dissemination was even increased by favorable rating, provided by rating agencies to those types of securities and derivatives. The devaluation caused immediate panic and attempt to get rid of those securities as soon as possible. This deadly chase devaluated those securities even more and also caused problems of liquidity on the market. More easily said, there were too many people trying to get rid of them and too few willing to buy them.

This crisis did not remain in the US and due to the interconnection of world markets, in a few weeks it also spread to the European and Asian markets leaving them with massive loses. What I am speaking about is what most of the wide public knows under the nick name 2008 Credit crunch[91]. We all were somehow affected by this crisis and we may very well say that it was one of the biggest disasters on the capital markets since their founding.

As usual, when a huge catastrophe occurs, people immediately start to look for the one who caused it, point a finger at him and relieve their anger. For many reasons that I will elaborate on during this chapter many fingers pointed at hedge funds. In this chapter, I will firstly focus on the role of hedge funds in 2008 Credit crunch (**Section 3.1**), secondly I will elaborate on the major incentives used by the supporters of hedge fund regulation and I will discover, whether those incentives are justified (**Section 3.2**).

3.1 Role of hedge funds in 2008 Credit crunch

As I previously stated, the public perception of hedge funds is that they are shady operators and excessive risk takers. The truth is, however, that hedge funds are erroneously blamed for the crisis, which developed mainly from the actions of commercial and investment

[90] HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 598 (Robert C. Clark ed, Found. Press 2009).
[91] ALASTAIR HUDSON, THE LAW OF FINANCE 830 (London: Thomson Reuters 2009).

banks. It is true that hedge funds were greatly impacted upon the 2008 Credit crunch, but major economist scholars argue, that hedge funds did not initiate the crisis and that the crisis would have happened even without the existence of any hedge funds[92]. It is therefore clear that people tend to blame something they do not understand much as a major source of their problems.

This verdict was independently supported by the 2008 House Committee hearing on Oversight and Government Reform in US, the 2008 Turner Review in UK and the 2009 High-Level Group on Financial Supervision in EU[93]. Also according to the Rand Corporation report, it was the banks and credit rating firms which bore the major responsibility for the 2008 Credit crunch and state that "…hedge funds are vilified as terrible actors, and our report is not coming to that conclusion"[94]

What is more, some scholars argue that not only that the hedge funds were not the main source of the crisis, but that they also prevented the distressed markets from greater loses by absorbing certain amount of loses and providing liquidity to the market[95].

The main reasons for the wide public tendency to blame hedge funds for the 2008 Credit crunch was their involvement in the Collateralized debt securities market (**Sub-section 3.1.1**), the general perception that hedge funds cause market instability (**Sub-section 3.1.2**) and the hedge funds involvement in short selling practices (**Sub-section 3.1.3**). In this Section, I will elaborate on those reasons and will show, whether they were justified.

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[92] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 7 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.

[93] Photis Lysandrou, *The role of Hedge funds in the Crisis* (April 1, 2012), FINANCIAL TIMES, available at: http://www.ft.com/intl/cms/s/0/e83f9c52-6910-11e1-9931-00144feabdc0.html#axzz2N67Wab6s

[94] Juliet Chung, *Don´t Blame Hedge funds for the financial Crisis, Study Says* (September 19, 20012), WALL STREET JOURNAL, available at: http://blogs.wsj.com/marketbeat/2012/09/19/dont-blame-hedge-funds-for-financial-crisis-study-says/.

[95] Houman B. Shadab, *Hedge Funds and the Financial Crisis* 3 (January 2009), Mercatus on Policy No. 24, Jan. 2009; NYLS Legal Studies Research Paper No. 09/10 #31, available at: http://ssrn.com/abstract=1564847.

3.1.1 CDOs

As I mentioned before, CDOs were considered to be one of the prime sources of the 2008 Credit crunch. Therefore, before we start any inquiry to the role of hedge funds on the CDOs market, I find it necessary to introduce what CDO is. CDO is a "financial claim to the cash flows generated by a portfolio of debt securities or by basket of referenced obligations"[96] I will illustrate in the following examples how it works.

Example 4: Imagine that we have 1000 home owners, who have a mortgage on their households and are debtors of bank ABC. This bank will then create a special purpose vehicle, generally called special purpose entity (SPE)[97] and transfer all the newly bought mortgages to this entity. This SPE then issues bonds to the investors. Those bonds then provide their owners with certain amount of interest payment, let's say 5%. This 5% is generally called a yield. Therefore if everything will go well and the homeowners will pay their monthly payments on the mortgages, the investors of SPE will be paid a 5% yield.

What I have just described in Example 4 is called a mortgage backed security. The problem of mortgage backed securities was that for some market players those were too risky and for others too unprofitable. Therefore, what happened was that they were transformed into CDOs[98]. In the next example I will show how it was done.

Example 5: Imagine that we take our SPE from Example 4. This SPE however, creates more complex pool of MBS putting prime and sub-prime mortgages together[99]. Than we will divide this SPE into a number of different parts[100], usually three tranches (Senior, Mezzanine

[96] HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 577 (Robert C. Clark ed, Found. Press 2009).
[97] ALASTAIR HUDSON, THE LAW OF FINANCE 834 (London: Thomson Reuters 2009).
[98] HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 577-578 (Robert C. Clark ed, Found. Press 2009).
[99] ALASTAIR HUDSON, THE LAW OF FINANCE 834 (London: Thomson Reuters 2009).
[100] *Id.* ad 834.

and Equity)[101]. Then we will say that the senior tranche will be paid first, before all other tranches but only 2% yield. Mezzanine tranche will be paid after Senior but before equity 6 % yield and finally, the equity tranche will be paid last, if there will be some money left, but it will be paid 20% yield.

This, what I have explained in Example 5, is called CDO and was used to diversify the risk among different market participants[102]. The main problem with CDOs is now clearly visible: when people started defaulting on the mortgages in 2006 and 2007, the equity and mezzanine tranches were severely damaged, because there was no money to pay their yield.

Many argue, that it was hedge funds who were deeply involved in the CDOs market, however, such allegations have proved incorrect. Hedge funds were never considered to be major players on the CDOs markets. Studies show that as of July 2007, the total size of the US CDOs market was approximately 900 billion USD. Out of those, the total size of hedge funds involved in CDOs market was around 7 billion USD. A Fitch Rating study shows that hedge funds engaged in CDOs markets were leveraged approximately 10 to 1, which makes this final investment of hedge funds in CDOs market at maximum 70 billion USD out of total 900, which makes approximately 7.7%[103]. The 7.7% amounts to just a fraction compared to the rest of the market, which was mainly sponsored by commercial banks such as Wachovia and large investment banks such as Lehman Brothers[104].

Moreover, more than half of those hedge funds invested in the equity class of CDOs, which generally stands only for 5% value of all CDOs at maximum[105]. It is also worth

101 HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 577-578 (Robert C. Clark ed, Found. Press 2009).
102 HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 577-578 (Robert C. Clark ed, Found. Press 2009).
103 Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 8-9 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.
104 *Id.* ad 8.
105 *Id.* ad 9.

mentioning that equity class of CDOs was never considered a source of the 2008 Credit crunch, while it was considered very risky from the beginning, compared to middle and senior class, which was rated by the rating agencies as much safer[106].

Another argument widely used by hedge funds to defend against allegations is that they: "…did not provide nonconforming mortgages, repacked these mortgages into securities, bundle these securities together with other securities as collateral for yet other securities, gave a rating to the structured credit securities or distribute these securities"[107]. We may therefore conclude, that the role of the hedge funds in the CDOs market was a minor one and that the allegations about hedge funds being the main players on the CDOs market has proved incorrect.

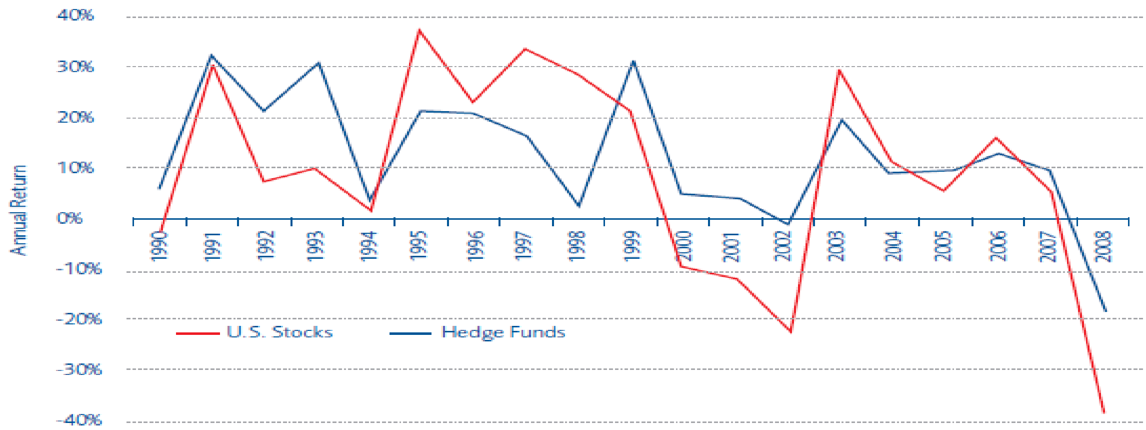
3.1.2 Market destabilization

Another general perception is, that hedge funds caused the 2008 Credit crunch, due to the fact that their excessive risk taking destabilized the market. Quite contrary to these allegations, many scholars argue that: "…hedge funds did nothing to exacerbate it. If anything, hedge funds have helped the economy to recover more quickly"[108].

[106] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 10 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.
[107] Photis Lysandrou, *The role of Hedge funds in the Crisis* (April 1, 2012), FINANCIAL TIMES, available at: http://www.ft.com/intl/cms/s/0/e83f9c52-6910-11e1-9931-00144feabdc0.html#axzz2N67Wab6s.
[108] Veronique de Rugy, *The Truth about the Hedge funds and the financial Crisis* (March 18, 2011), REASON.COM, available at: http://reason.com/archives/2011/03/18/the-truth-about-hedge-funds-an.

According to McKinsey Global institute, most hedge funds generated higher and what is more important, less volatile returns than public equities and bonds, even in time of the crisis[109]. The same conclusion was made by Shadab in the following chart, which shows that hedge funds steadily over performed the US stock market[110]:

FIGURE 1: HEDGE FUNDS VERSUS U.S. STOCK MARKET FROM 1990 TO 2008



Moreover, due to the compensation structure of hedge fund managers[111], and the regular application of high water marks, the hedge fund managers are much more prudent in risk taking compared to other financial companies[112]. This may be corroborated even further by reference to evaluation of managers of great commercial and investment banks such as Bear Stearns and Lehman Brothers, where managers earn massive bonuses regardless of the company performance and even when the managers performance is unsustainable, he is regularly still awarded by a golden parachute. Something like this is unthinkable in the world of hedge funds[113].

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[109] Veronique de Rugy, *The Truth about the Hedge funds and the financial Crisis* (March 18, 2011), REASON.COM, available at: http://reason.com/archives/2011/03/18/the-truth-about-hedge-funds-an.

[110] Houman B. Shadab, *Hedge Funds and the Financial Crisis* 2 (January 2009), Mercatus on Policy No. 24, Jan. 2009; NYLS Legal Studies Research Paper No. 09/10 #31, available at: http://ssrn.com/abstract=1564847.

[111] See Chapter 1.

[112] Veronique de Rugy, *The Truth about the Hedge funds and the financial Crisis* (March 18, 2011), REASON.COM, available at: http://reason.com/archives/2011/03/18/the-truth-about-hedge-funds-an.

[113] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 5 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.

More importantly, not only did hedge funds not destabilize the market, but scholars argue that quite the opposite, they helped to stabilize it after the crisis[114]. Firstly, studies have shown that hedge funds increased market liquidity by purchasing poorly performing stock in total value of approximately 108 billion USD by the third quarter of 2008 and helped to create a market for those who wanted to get rid of those securities. This step not only helped to create liquidity, but also prevented the stock prices falling lower[115]. This opinion is also shared by professionals from the International Monetary Fund, stating: "…hedge funds' involvement in credit markets made the markets more stable and efficient"[116].

Therefore we must again conclude, that not only that hedge funds did not destabilize the market, but they helped to restore stability instead.

3.1.3 Problem of short selling

The final major reason why hedge funds were blamed for causing the 2008 Credit crunch was their involvement in so called shorting, which is generally considered as transactions damaging the market. Firstly, I would like to explain what shorting is and secondly, I will elaborate on whether such a technique is damaging to the market and was a cause of the 2008 Credit crunch.

Shorting is a technique in which a market participant borrows shares from a broker or other provider, sells them and then in a specific time buys them back and returns them to cover the position. This technique is widely used if the market participant is of an opinion that

[114] Houman B. Shadab, *Hedge Funds and the Financial Crisis* 3 (January 2009), Mercatus on Policy No. 24, Jan. 2009; NYLS Legal Studies Research Paper No. 09/10 #31, available at: http://ssrn.com/abstract=1564847.

[115] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 11 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.

[116] Houman B. Shadab, *Hedge Funds and the Financial Crisis* 3 (January 2009), Mercatus on Policy No. 24, Jan. 2009; NYLS Legal Studies Research Paper No. 09/10 #31, available at: http://ssrn.com/abstract=1564847.

the stock he is shorting will fall. I will provide a short example to better explain this technique.

Example 6: Imagine that hedge fund ABC thinks that shares of company DEA, currently traded at 7 USD per stock are overvalued and that their price will fall. The fund then borrows 1000 shares of company DEA and sells them 7 USD / share for total of 7 000 USD. In two weeks, the price of DEA stock fall to 5 USD per stock, due to the announcement of poor performance in the recent quarter. The hedge fund then buys the stock 5 USD per stock to cover the position in total of 5000 USD and earn 2000 USD on this transaction.

From this example, it is possible to see the reason why this technique is so widely criticized. It makes the short sellers profit, when the market falls. However, was the short selling really one of the sources of the 2008 Credit crunch? According to scholars, the answer is no.

They argue that short selling is beneficial for the market, since it makes market prices more efficient and also functions as a watch dog of possible problems in public companies. This was visible in March 2008 when attention to poor balance sheet performance of Lehman Brothers was brought by short selling by the hedge fund manager David Einhorn[117].

In my point of view, if we truly understand the process of short selling, we may also say, that it reduces market volatility. How? Very easily, the absolutely optimal short seller sells stock when it is at the highest value and buys when it is at lowest. This technique therefore reduces the spread between the best and worst market price of the stock and reduces the volatility of the prices. This also makes the short sellers very market objective in my perspective, while this technique is best used side by side with independent market research.

[117] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 13 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.

Therefore short sellers are not so easily tricked by inaccurate ratings and reports and provide market objective valuation of stocks.

To be objective on the other hand, it is true that short selling may increase destabilization in distressed markets and this was the reason, why on September 19th 2008 SEC declared a one month ban on short selling. What is, however, interesting is the fact that the stock of many companies dropped in this period and then slightly increased after the short selling was allowed again[118].

Therefore, taking into consideration the above mentioned opinions of scholars and also my own conclusions, we have to argue that even the allegations that hedge fund´s short selling was not the source of the 2008 Credit crunch, nor did it make it worse anyhow. Unfortunately, SEC was of a different opinion and since August 2009 it obliged all institutional investors owning more than 100 million in stock to disclose their short positions to SEC on weekly basis[119].

3.2 Pre-Dodd Frank status quo or more regulation?

The emergence of the 2008 Credit crunch not only triggered a series of accusations against hedge funds, but it once again raised the voice for tither regulation of those investment vehicles. The supporters of the increase in hedge fund regulation argued that the regulation is necessary, while the hedge funds are opaque (**Sub-section 3.2.1**), they excessively use leverage to increase their profits (**Sub-section 3.2.2**) and that they pose systematic risk to the market (**Sub-section 3.2.3**). Some also argued that since more and more people were getting over the threshold of accredited investor and qualified purchaser definition, it is necessary to protect those investors (**Sub-section 3.2.4**).

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[118] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 13 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.
[119] *Id.* ad 13.

In the following sub-sections, I will explore those arguments and elaborate on the fact, whether the concerns they raise are justified or not.

3.2.1 Hedge funds secrecy

As we already discussed in previous Chapters[120] hedge funds, due to their structure escape most of the federal securities laws regulation and registration requirements. This on one hand helps them to engage in more innovative investment strategies, on the other hand, it raises a series of criticisms based on the hedge fund secrecy and possible misuse of such secrecy.

The problem, as I stated, is that hedge funds are often engaged in highly innovative investment strategies, and their unique value is almost purely based on those strategies. Those strategies are, however, hardly patentable and therefore, the only possibility for hedge funds to protect their intellectual property is through trade secrets[121]. It is therefore understandable, that if we overregulate hedge funds and force them to extensively disclose their positions, we may very well kill the innovation in the financial industry, and hedge funds will lose their incentive to innovate[122].

But are hedge funds really so opaque? It is true that they are not required to register and disclose under federal securities laws, but evidence indicate that most of the hedge funds carry on extensive disclosure towards their investors through a private placement memorandums. The PPMs are standard forms including extensive information about hedge fund strategies, positions, fees and risk assessment reports[123]. Also, with the increase of the

[120] See Chapter 2.
[121] Andrew W. Lo, *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Written Testimony for the House Oversight Committee Hearing on Hedge Funds* 7-8 (November 13, 2008), available at: http://ssrn.com/abstract=1301217 or http://dx.doi.org/10.2139/ssrn.1301217.
[122] René M. Stulz, *Hedge Funds: Past, Present and Future*, 21 THE JOURNAL OF ECONOMIC PERSPECTIVES 175, 193 (2007) (describes a regulatory history and prospective future regulation of hedge funds).
[123] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 7 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.

number of hedge funds and therefore the prospective competition, it is now easier for investors to go and invest in some other hedge fund, if they do not like the information they got[124].

It is also worth mentioning, that even when hedge funds are not generally required to register with SEC or CFTC, more and more managers do that in order to attract clients. Studies show that in 2005, 86 % of hedge fund managers were registered with SEC, CFTC or NASD[125]. In 2007 the number grew to 87 %[126]. Those studies clearly contradict the allegations about hedge fund secrecy and shows that the increase in competition has forced hedge funds to disclose necessary portion of information as a stamp of trustworthiness.

3.2.2 Problem of leverage

Leverage functions as a multiplied in the financial world. There are two types of leverage, borrowing or derivatives[127]. The principle is simple, by the use of derivatives or by borrowing additional funds, a hedge fund may increase the amount of money used in investment strategy and therefore magnify the profits. But this works the other way round, if the strategy fails, the leverage magnifies the losses the equal way. The use of leverage was one of the major causes of LTCM gigantic loses in 1998 and the subsequent bail out of this fund. Since then, the discussion about the limitation of the use of leverage by hedge funds emerged[128]. This discussion was renewed at the dawn of 2008 Credit crunch again.

[124] Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 THE JOURNAL OF ECONOMIC PERSPECTIVES 189, 207 (1999) (describes the reasons and the outcomes from collapse of LTCM).

[125] Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 30 REGULATION 36, 41 (2007) (describes regulation of hedge funds and current challenges for future regulation efforts).

[126] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 7 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.

[127] Dale A. Oesterle, *Regulating Hedge Funds* 7 (June 2006), Ohio State Public Law Working Paper No. 71, Center for Interdisciplinary Law and Policy Studies Working Paper No. 24, available at: http://ssrn.com/abstract=913045 or http://dx.doi.org/10.2139/ssrn.913045.

[128] Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 THE JOURNAL OF ECONOMIC PERSPECTIVES 189, 208 (1999) (describes the reasons and the outcomes from collapse of LTCM).

However, many things have changed since 1999 and it is an opinion among scholars, that LTCM was a unique case which cannot be used to generalize hedge fund exposure to leverage[129]. A study of Organization for Economic Co-operation and Development from 2007 shows that on average hedge funds uses leverage of 3.9 to 1[130] (compared to 25 to 1 used by LTCM[131]). This is actually much less than the study shows commercial banks use (from 12 – 17 to 1[132]) or even investment banks use (from 20 – 30 to 1[133]). If then the investment bans leverage of 30 to 1 does not raise any public outcry for increase in regulation, one may ask why would the hedge fund´s leverage of 3.9 to 1 does that.

It is also worth mentioning that in 2006 a study showed that hedge funds using derivatives as leverage appeared to be safer than hedge funds that did not. It also states that most hedge funds use derivatives as a leverage instead of borrowing[134], this finding also undermines the arguments that use of leverage by hedge funds may be dangerous.

To stay objective, one must admit that the use of leverage may pose certain dangers; the collapse of LTCM was deplorable. On the other hand, as some authors argue: "…leverage is sometimes necessary for hedge funds to create value, because some investment ideas require amplifications to be successfully implemented. Just as some scientific discoveries

[129] Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 30 REGULATION 36, 40 (2007) (describes regulation of hedge funds and current challenges for future regulation efforts).
[130] Houman B. Shadab, *Hedge Funds and the Financial Crisis* 2 (January 2009), Mercatus on Policy No. 24, Jan. 2009; NYLS Legal Studies Research Paper No. 09/10 #31, available at: http://ssrn.com/abstract=1564847.
[131] Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks*, 5 JOURNAL OF FINANCIAL STABILITY 283, 288 (March 10, 2009) (describes the possibilities of direct and indirect regulation of hedge funds).
[132] Houman B. Shadab, *Hedge Funds and the Financial Crisis* 2 (January 2009), Mercatus on Policy No. 24, Jan. 2009; NYLS Legal Studies Research Paper No. 09/10 #31, available at: http://ssrn.com/abstract=1564847.
[133] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 3 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.
[134] *Id.* ad 3.

require the use of a microscope to be utilized, some hedge funds strategies likewise require the magnifying effect of leverage to be economically meaningful"[135].

Therefore, we may feel that there is some need to set certain rules on the use of leverage; the question is how it shall be done. Most authors argue that direct regulation would be inefficient, since measures of leverage may be deceiving[136], the limitation may easily overreach and put significant limits on ability of hedge funds to provide liquidity[137] and such regulation may pose also the so called moral hazard, through relaxing the vigilance of lenders and counterparties relying on the regulation instead of their diligence[138].

On the other hand, some authors welcome propositions of indirect regulation of use of leverage through lenders and counterparties[139]. One of the proposals of the indirect regulation is to tighten the risk management practices of the banks, which will adjust the credit terms according to the amount of information the fund will be willing to provide. This will make the credit for more secret and naturally more risky funds more expensive and will therefore reduce the amount of possible leverage for such fund. This would shield the bank from possible disruptions caused by the sudden failure of such a fund[140].

[135] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 4 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.
[136] Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks*, 5 JOURNAL OF FINANCIAL STABILITY 283, 288 (March 10, 2009) (describes the possibilities of direct and indirect regulation of hedge funds).
[137] Dale A. Oesterle, *Regulating Hedge Funds* 7 (June 2006), Ohio State Public Law Working Paper No. 71, Center for Interdisciplinary Law and Policy Studies Working Paper No. 26, available at: http://ssrn.com/abstract=913045 or http://dx.doi.org/10.2139/ssrn.913045.
[138] *Id.* ad 26.
[139] Dale A. Oesterle, *Regulating Hedge Funds* 7 (June 2006), Ohio State Public Law Working Paper No. 71, Center for Interdisciplinary Law and Policy Studies Working Paper No. 26, available at: http://ssrn.com/abstract=913045 or http://dx.doi.org/10.2139/ssrn.913045.
[140] *Id.* ad 26-27.

3.2.3 Systematic risk

The collapse of LTCM in 1998 drew attention to another problem potentially posed by hedge funds. They have become bigger players on the market. Studies show that in 2007 hedge funds were managing approximately something between 1.5 -2.25 trillion USD[141]. Policy makers therefore started to be concerned, that possible failure of several major hedge funds may spread loses to third parties such as banks and counterparties[142]. This concept of potential transmission of losses is called the systematic risk. But are the hedge funds really a possible cause of systematic risk for the future? Even when 2.22 trillion USD seems like a big amount of money for regular people, in the world of capital markets it is just a tiny fraction compared to other participants like mutual funds or pension funds[143]. According to the chart below, which was created by International Financial Services London in 2008, this amount still represents only 1.5% of the total funds and assets[144].

Table 1
Relative size of hedge funds (US Dollars in Trillions).

Year	Hedge funds[a]	Pension funds[a]	Mutual funds[a]	Insurance comps.[a]	Global assets of the largest 1000 banks	Hedge funds as % of total[b]
1998	0.22	13.57	9.40	10.40	33.2	0.3%
1999	0.32	17.26	11.40	11.50	35.5	0.4%
2000	0.41	16.07	11.87	10.10	36.7	0.5%
2001	0.56	15.52	11.65	11.50	37.9	0.7%
2002	0.59	14.63	11.32	10.40	39.6	0.8%
2003	0.80	18.34	14.05	13.90	43.9	0.9%
2004	1.00	20.77	16.16	15.00	52.4	0.9%
2005	1.40	22.80	17.77	16.70	60.5	1.2%
2006	1.75	25.97	21.82	17.39	63.8	1.3%
2007[c]	2.25	28.57	26.20	19.13	74.2	1.5%

141 Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks*, 5 JOURNAL OF FINANCIAL STABILITY 283, 285 (March 10, 2009) (describes the possibilities of direct and indirect regulation of hedge funds).
142 Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 30 REGULATION 36, 39 (2007) (describes regulation of hedge funds and current challenges for future regulation efforts).
143 Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 THE JOURNAL OF ECONOMIC PERSPECTIVES 189, 208 (1999) (describes the reasons and the outcomes from collapse of LTCM).
144 Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks*, 5 JOURNAL OF FINANCIAL STABILITY 283, 285 (March 10, 2009) (describes the possibilities of direct and indirect regulation of hedge funds).

In the light of the above mentioned chart, the argument about some hedge funds becoming too big to fail[145] seems a bit farfetched. It is true that fall of LTCM in 1998 initiated a subsequent bail out, which is a procedure typical for TBTF institutions, however, retrospectively, some author argue that the fall of LTCM "…did not actually pose a threat to the financial system"[146]. This argument may be corroborated even further by reference to 2006 fall of 6.6 billion hedge fund Amaranth[147] which had only a "trivial impact on the market"[148].

It is also worth mentioning that some authors, instead of using the TBTF argument, assert that the problem may not be with a fall of one big hedge fund, but of multiple smaller funds[149]. This so called "contagion"[150] argument is also supported by empirical studies showing that the bigger the funds are, the less they are prone to collapsing[151]. However, as Sadab argues, those concerns are more hypothetical than at a real level[152].

3.2.4 Protection of investors

As I indicated in Chapter 2, the light regulation is not unconditional. In order to avoid regulation, among other things hedge funds may have only accredited investors or qualified

[145] Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks*, 5 JOURNAL OF FINANCIAL STABILITY 283, 287 (March 10, 2009) (describes the possibilities of direct and indirect regulation of hedge funds).
[146] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 14 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.
[147] Houman B. Shadab, *Hedge Funds and the Financial Crisis* 3 (January 2009), Mercatus on Policy No. 24, Jan. 2009; NYLS Legal Studies Research Paper No. 09/10 #31, available at: http://ssrn.com/abstract=1564847.
[148] René M. Stulz, *Hedge Funds: Past, Present and Future*, 21 THE JOURNAL OF ECONOMIC PERSPECTIVES 175, 188 (2007) (describes a regulatory history and prospective future regulation of hedge funds).
[149] Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 30 REGULATION 36, 39 (2007) (describes regulation of hedge funds and current challenges for future regulation efforts).
[150] *Id*. ad 30.
[151] Houman B. Shadab, *Hedge Funds and the Financial Market: Written Testimony Submitted to the United States House Committee on Oversight and Government Reform* 15 (November 13, 2008), available at: http://ssrn.com/abstract=1302705 or http://dx.doi.org/10.2139/ssrn.1302705.
[152] Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, 30 REGULATION 36, 39 (2007) (describes regulation of hedge funds and current challenges for future regulation efforts).

purchasers of their stock[153]. The idea behind this is simple, as long as the hedge funds want to stay unregulated, they may not target the general public, which deserves the special protection of SEC[154].

I do not want to question such a principle, as I personally find it absolutely reasonable. What I want to do is to elaborate on two major problems of recent years. Firstly, more and more institutional investors start to invest in hedge funds and second the increase in salaries is putting more and more individuals over the threshold of qualified purchasers and accredited investors.

The promising returns of hedge funds make them recently very fashionable or even cool as some authors argue[155]. This inevitably has attracted even nontraditional hedge fund investors, such as pension funds[156] or mutual funds[157]. The problem with this phenomenon is that those investment institutions manage money of people which mostly do not qualify under the above mentioned definitions of investors. Therefore, even if those investors are formally protected by SEC, indirectly, through pension funds or mutual funds, they become investors of hedge funds where they do not enjoy the formal protection of SEC.

This line of thought, however, lacks one major piece of information. This information is the fact that between the public investors and hedge funds in this scenario stands the institutional investor. This institutional investor is certainly a professional not requiring special SEC help and owing a fiduciary duty to investor of its own. I therefore consider this

[153] Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 THE JOURNAL OF ECONOMIC PERSPECTIVES 189, 190 (1999) (describes the reasons and the outcomes from collapse of LTCM).
[154] *Id.* ad 191.
[155] Troy A. Pardles, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission* 25 (March 24, 2006), Washington U. School of Law Working Paper No. 06-03-02, available at: http://ssrn.com/abstract=893190 or http://dx.doi.org/10.2139/ssrn.893190.
[156] GAO Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House of Representatives, *Hedge funds Overview of Regulatory Oversight, Counterparty Risks, and Investment Changes* 10 (May 7, 2009), available at: http://www.gao.gov/new.items/d09677t.pdf.
[157] Troy A. Pardles, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission* 25 (March 24, 2006), Washington U. School of Law Working Paper No. 06-03-02, available at: http://ssrn.com/abstract=893190 or http://dx.doi.org/10.2139/ssrn.893190.

concern not so pressing as some argue it is. However, to be on the safe side, I am of the opinion that some form of indirect regulation of how much those institutional investor may invest in hedge funds, may calm the cry for increase of regulation. A good example may be found in the ERISA regarding the pension funds.

What concerns me more is the fact, that due to the increase in salaries in the US, more and more individuals are getting over the threshold of qualified purchasers and accredited investors[158]. What may have been a sufficient threshold in 1933 and 1940 to indicate wealthy and experienced investors is not enough nowadays. More and more people are allowed to invest in hedge funds, even when their experience is questionable[159]. Here I see a real need to increase regulation. But again the indirect one may serve the best. By increasing a threshold of qualified purchasers and accredited investors, we will on one hand target investors and not the funds, on the other hand we will be able to restore the old rule, that only wealthy and experience individuals invest in hedge funds.

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[158] Troy A. Pardles, *Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation* 7 (May 2007), Washington U. School of Law Working Paper No. 07-05-01, available at: http://ssrn.com/abstract=984450 or http://dx.doi.org/10.2139/ssrn.984450.

[159] *Id*. ad 7.

Chapter 4: Regulation of hedge funds after the Dodd Frank Act

As John Coffee Jr. states: "A good crisis should never go to waste" [160] and as he then follows "…experience has shown, that only after a catastrophic market collapse can legislators and regulators overcome the resistance of financial community"[161]. It is true that major regulatory changes always follow the major market failures and we do not have to go very far for corroborative examples. Just take a look at the 1933 SA and 1934 SEA. It is not a coincidence that both followed immediately after the Great Depression. And again the Sarbanes-Oxley Act was issued in 2002, one year after the collapse of Enron. The same circumstances occurred after the 2008 Credit crunch which immediately launched a series of regulatory attempts which escalated on July 21st, 2010 when President Obama signed the Dodd Frank Wall Street Reform and Consumer Protection Act[162].

As many authors argue, the Dodd Frank Act "…represents the most comprehensive financial regulatory reform measures taken since the Great Depression"[163]. The Dodd Frank Act is an 848 pages long document which, among other things, elaborates on regulation of nearly every subject of current financial industry including tightening of bank supervision and regulation, amendments of 1940 IAA, creating new oversight systems over the financial industry and establishing Financial Stability Oversight Council charged with monitoring of perspective systematic risk issues. The Dodd Frank Act also rapidly increased the SEC oversight and regulatory powers and entrusted it, side by side with CFTC, to regulate the over the counter business on derivatives markets. Finally it, among other things, increases the

[160] EILÍS FERRAN, NIAMH MOLONEY, JENNIFER G. HILL & JOHN C. COFFEE, JR, THE REGULATORY AFTERMATH OF GLOBAL FINANCIAL CRISIS 301 (Marco Becht ed., Cambridge Uni. Press 2012).
[161] *Id*. ad 301.
[162] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 4 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.
[163] Morrison & Forester, *The Dodd-Frank Act: a cheat sheet* 2, available at: http://www.mofo.com/files/Uploads/Images/SummaryDoddFrankAct.pdf.

disclosure requirements for registered investment companies and reduces the possibilities to stay unregulated[164].

The massive scale of the Dodd Frank Act can be demonstrated even further by the fact, that it will be necessary to issue almost 400 new Rules, before the Act will be fully implemented[165]. Just to provide the reader with an example, at the beginning of 2012, nearly two years after the signing of Dodd Frank Act, only 93 out of the 400 rules were implemented[166]

We cannot say that the Dodd Frank Act´s prime target was to regulate hedge funds. In the end, as I showed in the first part of the previous Chapter, hedge funds cannot be blamed for the 2008 Credit crunch. However, what is clear is the fact, that hedge funds will be subjected to much harder regulation after the Dodd Frank Act will be fully implemented. In the first part of this Chapter, I will therefore elaborate on the major regulatory changes affecting directly or indirectly the hedge funds after the Dodd Frank Act (**Section 4.1**). In the second part, I will deal with the issues of how these changes will influence the hedge funds in their development and day to day business (**Section 4.2**).

[164] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 5 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.
[165] Frank G. Zarb, *Dodd-Frank Bill a Year and a Half Later* 2 (March 2012), Thought Leadership Paper in conjunction with the Hofstra University, available at: http://www.hofstra.edu/pdf/academics/colleges/zarb/zarb_paper_doddfrank.pdf.
[166] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 4 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.

4.1 Major changes in the regulation of hedge funds after the Dodd Frank Act

As I stated above, due to the necessary implementation of approximately 400 new rules, the overall impact of the Dodd Frank Act may not be clear today[167]. As some authors argue, there is a tendency to tone down the regulatory effort after a crisis passes and the situation turn out to be better[168]. Therefore it is not clear, whether all the rules will be implemented in the end and it is thus still too early to speak about the overall impact of DFA on the hedge funds. What is however clear today, is that the major regulations will affect hedge funds greatly. One of the major changes for the hedge funds will certainly be the increase in investment advisers registration (**Sub-section 4.1.1**), increase in reporting requirements for registered funds and advisers (**Sub-section 4.1.2**), new regulations for prospective investors in hedge funds (**Sub-section 4.1.3**), increase of SEC and CFTC regulatory powers over derivatives markets (**Sub-section 4.1.4**) and finally, an increase of the regulation of banks through the Volcker Rule (**Sub-section 4.1.5**). In the following Sub-sections, I will address those new regulatory changes one after another.

4.1.1 Investment advisers registration

The major regulatory change in the field of hedge fund industry may be found in Title IV of the DFA called: Regulation of Advisers to Hedge Funds. This Title amends the IAA of 1940 in certain ways[169].

Firstly, it wiped out the private advisers exception under the Section 203(b)(3) of the IAA[170]. Therefore, all advisers to private funds who have 150 million USD assets under

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[167] Alvi Abuaf, Edward Hawthorne, Sandeep Vishnu, Emmanuel Chesnais & M. Edward Keprta, *Hedge funds and Dodd-Frank: Institutionalize, fly low or else!* 13 (2011), available at: http://marketsmedia.com/wp-content/uploads/2011/11/T1038_Hedge-Funds_final.pdf.

[168] EILÍS FERRAN, NIAMH MOLONEY, JENNIFER G. HILL & JOHN C. COFFEE, JR, THE REGULATORY AFTERMATH OF GLOBAL FINANCIAL CRISIS 305 (Marco Becht ed., Cambridge Uni. Press 2012).

[169] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 9 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.

management or more, must newly register with SEC and comply with IAA[171]. The registration deadline was firstly set on 21st of July 2011 but due to administrative obstacles[172], it was prolonged until 30th of March 2012[173].

Since DFA in many of its parts deals with the term private fund, it is necessary to explain it before going any further. The Act considers as a private fund any hedge fund, which was previously organized under Sections 3(c)(1) or 3(c)(7) exceptions[174] of ICA of 1940[175].

Secondly, the DFA on one hand wiped out the private advisers exception, but on the other hand added three more exceptions, venture capital funds exception, private fund adviser exception and foreign private adviser exception[176]. From the perspective of hedge funds, the last two are most important.

The DFA created a new exception under newly created Section 203(m) of IAA which is called the private fund adviser exception. This exception states that any adviser who:

1. Has his place of business in US,
2. Acts solely as an adviser to qualified private fund,
3. And manages private funds assets of less than 150 million USD.

[170] For more details see Chapter 2.

[171] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 5 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.

[172] Rob Curran, *Hedge fund regulation? What hedge fund regulation?* (June 14, 2011), CNN MONEY, available at: http://finance.fortune.cnn.com/2011/06/14/hedge-fund-regulation-what-hedge-fund-regulation/.

[173] Norm Champ, *Speech by SEC Staff: What SEC Registration Means for Hedge Fund Advisers* 1 (May 11, 2012), available at: http://www.sec.gov/news/speech/2012/spch051112nc.htm.

[174] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 9 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.

[175] For more details see Chapter 2.

[176] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 9 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.

is not subjected to registration under IAA[177]. The term qualified private fund is to be defined by SEC[178].

The DFA also created another exception under newly created Section 202(a)(30) of IAA which deals with foreign private advisers[179]. Therefore also advisers who:

1. Have no office in US
2. Advice fewer than 15 clients
3. Manage less than 25 million USD in US investments
4. And do not hold themselves out as an investment advisers

are exempted from registration under the IAA[180].

It is also important to mention that qualifying under any of the above mentioned exception does not exclude the adviser from the scope of IAA in general. This regime only does not require them to register, but all the other provisions of IAA regarding prohibition of fraud and insider trading are normally applicable to them[181]. This however does not apply to family office exclusion under the SEC Rule 202(a)(11)(G)-1 under the IAA, which is defined as office which is:

1. Having only family clients,
2. Wholly owned by family clients,

[177] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 11 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.
[178] *Id.* ad 11.
[179] *Id.* ad 13.
[180] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 9 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.
[181] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 7 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.

3. Controlled solely by family members or entities,

4. Not holding itself as an investment adviser in public.

This exception then excludes the family office from the whole scope of IAA and allows it to escape much more from the regulatory scope of federal securities laws[182].

Thirdly, the DFA increases the AUM threshold for registration with SEC from previous 25 million USD to 100 million USD. Therefore any adviser with less than 100 million AUM will be subjected to State regulation and not the SEC[183]. However, advisers with less than 100 million USD AUM will still be entitled to register with SEC, it due to their business activities, they would be required to register in 15 or more states[184].

4.1.2 Reporting duties

On the ground of DFA, SEC adopted several changes and largely increased the amount of information needed to be disclosed under the ADV Form. The ADV Form is a form which each investment adviser registered with SEC is obliged to hand in[185]. The DFA requires the advisers to provide SEC with additional information in three main areas:

1. Information about the funds they manage.

2. More information about their advisory business, including conflicts of interest, information about their employees, strategies and types of clients they regularly advice.

[182] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 23 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.
[183] Alvi Abuaf, Edward Hawthorne, Sandeep Vishnu, Emmanuel Chesnais & M. Edward Keprta, *Hedge funds and Dodd-Frank: Institutionalize, fly low or else!* 13 (2011), available at: http://marketsmedia.com/wp-content/uploads/2011/11/T1038_Hedge-Funds_final.pdf.
[184] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 18 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.
[185] *Id.* ad 19.

3. Certain information about their non-advisory activities.

The main idea behind this is that with the increase of information flow to SEC, it will be better informed in its risk assessments and therefore will be able to regulate and oversight the market more efficiently[186].

It is important to mention, that advisers, which are in general exempted from the registration with SEC under the IAA due to two of the newly created exceptions[187] under the DFA, are considered to be exempt reporting advisers, who are subjected to limited obligation to file ADV Form. Those exempt reporting advisers are also required to update the ADV Form annually, especially in order to prove the eligibility for one of the above mentioned exceptions[188].

DFA also requires all registered advisers to private funds with at least 150 million USD of AUM to periodically file new PF Form to FSOC[189]. The FSOC was newly established by the SEC in order to gather information about possible systematic risk and to identify possible threats to financial stability[190]. The amount of information and the frequency of filing are dependent, whether the adviser advises to hedge fund or large hedge fund. The adviser of a large hedge fund is defined as an adviser with a minimum of 1.5 billion in hedge fund AUM[191].

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186 Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 19 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.

187 Venture capital fund advisers and advisers to private funds.

188 Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 16-17 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.

189 Henry Raschen, *The Dodd-Frank Act: its implications for hedge fund managers* (October 30, 2012), HSBC, available at: http://www.hsbcnet.com/gbm/global-insights/insights/2012/dodd-frank-act-implications-for-hedge-fund-managers.html.

190 Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 24 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.

191 Norm Champ, *Speech by SEC Staff: What SEC Registration Means for Hedge Fund Advisers* 2 (May 11, 2012), available at: http://www.sec.gov/news/speech/2012/spch051112nc.htm.

All advisers to hedge funds are required to file Section 1a of PF Form, which requires general information about the adviser. All advisers are also required to file Section 1b to identify asset valuation, investor concentration, borrowing, liquidity and performance for each individual fund under management. Finally, Section 1c requires all hedge fund advisers to disclose their investment strategies and information related to them[192].

Advisers to large hedge funds are then required to file much more detailed information under Sections 2a and 2b of the PF Form and also contrary to the advisers of small hedge funds, who are required to file annually in 120 days after the end of their fiscal year[193], they are obliged to file quarterly in 60 days after the end of their fiscal quarter[194].

It is understandable, that since all hedge fund advisers are newly required to disclose their investment strategies under Section 1c of PF Form, they were obviously afraid of possible leaks, which may be exploited by their rivals. Therefore SEC ensures that the data will be kept secret and confidential[195].

4.1.3 New regulation of prospective investors in hedge funds

The DFA also changes the requirements for investors being accredited investors under Rule 501 (a)[196]. After the DFA, in order to be qualified as an accredited investor under SA of 1933, the individual has to have a net worth (or joint net worth with that person´s spouse) exceeding 1 million USD, while the value of the investor´s primary residence is newly

[192] Norm Champ, *Speech by SEC Staff: What SEC Registration Means for Hedge Fund Advisers* 2 (May 11, 2012), available at: http://www.sec.gov/news/speech/2012/spch051112nc.htm.
[193] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 25-26 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.
[194] Norm Champ, *Speech by SEC Staff: What SEC Registration Means for Hedge Fund Advisers* 2 (May 11, 2012), available at: http://www.sec.gov/news/speech/2012/spch051112nc.htm.
[195] Nick Summers, *Dodd-Frank? Not Such a Drag After All* (October 15, 2012), BLOOMBERG BUSINESSWEEK, available at: http://www.businessweek.com/articles/2012-10-15/dodd-frank-not-such-a-drag-after-all.
[196] For more details see Chapter 2.

discounted from this calculation. The SEC would be also entitled to adjust the net worth with regard to current inflation[197].

4.1.4 Changes to the derivatives market

The same as the new regulation of prospective investors in hedge funds, the changes in derivatives market established by DFA represents one of the indirect ways of prospective regulation of hedge funds. You may ask what have the regulation of derivatives market in common with hedge funds. The answer is clear, as I indicated in my previous Chapters[198], hedge funds often use derivatives as a form of leverage instead of borrowing. Therefore any new increase of regulation of derivatives market will naturally increase the compliance burden on the hedge funds.

Firstly, Title VII[199] of the DFA largely increases the regulatory powers of SEC and CFTC over the derivatives markets[200]. According to this, derivatives will be newly divided into two groups, swaps and security-based swaps. While the CFTC will have jurisdiction over the swaps, SEC will have jurisdiction over security-based swaps[201]. This dual regulatory oversight will be supported by the joint jurisdiction of SEC and CFTC over the so called mixed swaps, which are swaps with characteristics of both swaps and security-based swaps[202].

Just for the readers better imagination, the definition of swap will include, among others "options and other derivative contracts for the purchase or sale of, or based on the value of, rates, currencies, commodities, indices, quantitative measures, or other financial or economic

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[197] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 9 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.
[198] Chapter 1 and Chapter 3
[199] Wall Street Transparency and Accountability Act of 2010
[200] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 10 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.
[201] Morrison & Forester, *The Dodd-Frank Act: a cheat sheet* 11, available at: http://www.mofo.com/files/Uploads/Images/SummaryDoddFrankAct.pdf.
[202] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 32 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.

interests“[203]. The security-based swaps will then, among others include: “agreements in which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein“[204].

Secondly, the DFA shifts most of the swaps trading from the over the counter to centralized clearing houses[205]. Therefore, assuming the absence of any exception, which shall be specified by SEC or CFTC[206], all the three above mentioned new groups of derivatives will have to be cleared through centralized clearing agencies. Those agencies will be tasked with gathering information about the derivatives market and providing them to SEC and CFTC[207].

One of the exceptions provided by the DFA, which may be very useful to hedge funds, and which excludes the derivatives transactions from the mandatory clearing requirements is the so called commercial end user exception. Under this exception, clearing is not mandatory if one of the counterparties of the swap or security-based swap:

1. Is not a financial entity,
2. is using swaps to hedge or mitigate commercial risk
3. and notices SEC or CFTC about how it regularly meets its financial obligations regarding entering into non-cleared swaps[208].

[203] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 11 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.
[204] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 11 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.
[205] Frank G. Zarb, *Dodd-Frank Bill a Year and a Half Later* 18 (March 2012), Thought Leadership Paper in conjunction with the Hofstra University, available at: http://www.hofstra.edu/pdf/academics/colleges/zarb/zarb_paper_doddfrank.pdf.
[206] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 32 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.
[207] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 11-12 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.
[208] Morrison & Forester, *The Dodd-Frank Act: a cheat sheet* 12, available at: http://www.mofo.com/files/Uploads/Images/SummaryDoddFrankAct.pdf.

Finally, DFA creates four new groups of participants on the derivatives market, swap dealers, security-based swap dealers, major swap participants and major security-based swap participants[209]. From the perspective of hedge funds, the definition of major security participant is mostly important, while it among other things states: "…a major swap participant is any person who is not a swap dealer and is a financial entity, that is highly leveraged relative to the amount of capital that it holds, is not subject to any Federal banking agency´s capital requirements, and maintains a substantial position in outstanding swaps in any major swap category"[210]. It is possible to imagine that some hedge funds using excessive leverage during their investment strategies may fall under this definition. This scenario would be very painful to a hedge fund, as it would immediately require it to register with SEC or CFTC and it would trigger extensive oversight and disclosure requirements[211].

4.1.5 Volcker Rule

As I showed in the previous Chapter, bank speculative trading in CDO´s was one of the major reasons of the 2008 Credit crunch. The Volcker rule is supposed to be a reaction on that. The provisions named after the Federal Reserve Chairman Paul Volcker were not initially supposed to be included in DFA, however, in January 2010, the Obama Administration endorsed them[212].

The Volcker rule basically forbids banks and non-banking entities regulated by Federal Reserve to engage in any kind of proprietary trading and invest, sponsor or retain

[209]Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 12 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.
[210] Morrison & Forester, *The Dodd-Frank Act: a cheat sheet* 12, available at: http://www.mofo.com/files/Uploads/Images/SummaryDoddFrankAct.pdf.
[211] Scot E. Draeger & Caleb C.B. DuBois, *The Dodd-Frank Act: Impact on investment Advisers* 32 (May 2, 2012), available at: http://www.bernsteinshur.com/wp-content/uploads/2012/05/Dodd-Frank-Act-White-Paper-May-2012.pdf.
[212] Morrison & Forester, *The Dodd-Frank Act: a cheat sheet* 18, available at: http://www.mofo.com/files/Uploads/Images/SummaryDoddFrankAct.pdf.

ownership in any hedge funds or private equity funds[213]. Volcker rule, however, allow proprietary trading, which will be limited to bank 3% of Tier I capital[214].

This seems to me like a quite interesting reaction, which may be seen as a very similar to previous Glass-Stegall Act, which separated commercial and investment banking, and which was repealed few years before the 2008 Credit crunch. What I am trying to say is that there is a probability, that Federal regulators received a pretty big wakeup call about the usefulness of bank proprietary trading. Unfortunately, taxpayers had to pay for this call quite a lot of money.

4.2 The impact of Dodd Frank Act on hedge funds in day to day business

In the previous chapter I solely focused on the changes in hedge funds regulation brought by DFA. This shopping list however, will not help us to understand, what would be the real impact on the day to day business in the hedge fund industry. The purpose of this part is to focus on what is hiding behind those fancy headings such as increase in investment advisers registration, increase of reporting duties or Volcker rule.

It is true that the hedge industry will be changed on a massive scale after the DFA and as I wrote in the previous part, only time will show, whether it will be beneficial to financial stability or not. It is also true that to write about all the consequences of the DFA for the hedge fund industry would be enough to make another thesis. To avoid that, and considering that the practical impact of the DFA is only one of many topics of my thesis, I will focus only on the major consequences, which are highly discussed in today's media. One of the major concerns of the hedge fund industry is the problem of increase in costs, which compliance with DFA would bring (**Sub-section 4.2.1**). Some authors are also concerned that the increase

[213] Alvi Abuaf, Edward Hawthorne, Sandeep Vishnu, Emmanuel Chesnais & M. Edward Keprta, *Hedge funds and Dodd-Frank: Institutionalize, fly low or else!* 13 (2011), available at: http://marketsmedia.com/wp-content/uploads/2011/11/T1038_Hedge-Funds_final.pdf.
[214] Lisa C. Briece, *Dodd-Frank Act Regulation of Hedge Funds and Derivatives* 10 (September 10, 2010), available at: http://ssrn.com/abstract=1679187 or http://dx.doi.org/10.2139/ssrn.1679187.

in regulation will make some hedge funds to become even less transparent and instead of making the industry more open, it will make it more secret (**Sub-section 4.2.2**). Also the introduction of the Volcker rule will bring several problems, including the need of recapitalization and possible creation of hedge fund monopoly position (**Sub-section 4.2.3**). DFA also leaves a very wide area of regulation at the sole discretion of SEC and CFTC, which is by some considered as a lack of certainty (**Sub-section 4.2.4**). Finally, some argue that the regulation, contrary to all the negative connotations it bears, will make the hedge funds more attractive to prospective clients (**Sub-section 4.2.5**).

4.2.1 Increase of costs and technological requirements

Truth be told, the amount of new regulatory compliance for hedge funds after the DFA is enormous. They have to change their bookkeeping, asset valuation and asset custody protocols to meet the uniform requirements of SEC and to be able to properly file the PF and ADV Forms[215]. They will need to hire chief compliance officer and set up compliance programs[216]. Finally, they have to invest piles of money in new technology and personnel to keep all the necessary data[217] and to be able to technologically catch up with central clearing agencies[218].

Speaking for myself as a graduate lawyer, I must admit that I understand why they are so scared about that. Not only that they have to invest between 50,000 and 200,000 USD just

215 Rob Curran, *Hedge fund regulation? What hedge fund regulation?* (June 14, 2011), CNN MONEY, available at: http://finance.fortune.cnn.com/2011/06/14/hedge-fund-regulation-what-hedge-fund-regulation/.
216 Azam Ahmed, *For Small Hedge Funds, Success Brings New Headaches* (January 20, 2011), THE NEW YORK TIMES DEALB%K, available at: http://dealbook.nytimes.com/2011/01/20/for-small-hedge-funds-success-brings-new-headaches/.
217 Donna Rogers, *The Dodd-Frank Act Requires Hedge Fund Investments In Compliance and Technology*, ABOUT.COM, available at: http://financialservices.about.com/od/EthicsCompliance/a/The-Dodd-Frank-Act-Requires-Hedge-Fund-Investments-In-Compliance-And-Technology.htm.
218 Alvi Abuaf, Edward Hawthorne, Sandeep Vishnu, Emmanuel Chesnais & M. Edward Keprta, *Hedge funds and Dodd-Frank: Institutionalize, fly low or else!* 9 (2011), available at: http://marketsmedia.com/wp-content/uploads/2011/11/T1038_Hedge-Funds_final.pdf.

to comply with all the new obligations[219], but they will also have to invest piles of money to hire experts, who will tell them how to do that. You may ask why, but the answer is very simple, the DFA is a one huge mess full of exceptions from exceptions from exceptions. It is extremely hard to orient yourself in these 848 pages of pure regulatory jungle and concerning that fact that the Act is still in the process of implementation, sometimes "no one seems to know what´s going on"[220].

This whole scenario is mainly burdensome for the smaller funds. What may be just a small amount for bigger hedge funds is actually an existential one for hedge fund with around 150 million USD of AUM. Like Grange Johnson, the manager of LaGrande Capital Partners says: "It´s not like there´s so much money lying around at a 150 million USD hedge fund that you´re not going to miss a quarter of a million bucks"[221]. He also adds that "The expense for registration could pay for two junior analysts"[222].

As we can see, there are reasons for smaller funds to be troubled. It may turn out to be inconsistent with future existence of mid-sized hedge funds which are too big not to be regulated, but too small to survive the additional costs connected to regulation. Then they will have to decide between two options, to consolidate with others and create bigger financial background or to became even smaller and escape regulation. This will in the end create an hourglass-shaped industry with few big players and plenty of small ones[223]. This hour-glass

[219] Nick Summers, *Dodd-Frank? Not Such a Drag After All* (October 15, 2012), BLOOMBERG BUSINESSWEEK, available at: http://www.businessweek.com/articles/2012-10-15/dodd-frank-not-such-a-drag-after-all.
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[221] Azam Ahmed, *For Small Hedge Funds, Success Brings New Headaches* (January 20, 2011), THE NEW YORK TIMES DEALB%K, available at: http://dealbook.nytimes.com/2011/01/20/for-small-hedge-funds-success-brings-new-headaches/.
[222] Azam Ahmed, *For Small Hedge Funds, Success Brings New Headaches* (January 20, 2011), THE NEW YORK TIMES DEALB%K, available at: http://dealbook.nytimes.com/2011/01/20/for-small-hedge-funds-success-brings-new-headaches/.
[223] Alvi Abuaf, Edward Hawthorne, Sandeep Vishnu, Emmanuel Chesnais & M. Edward Keprta, *Hedge funds and Dodd-Frank: Institutionalize, fly low or else!* 5 (2011), available at: http://marketsmedia.com/wp-content/uploads/2011/11/T1038_Hedge-Funds_final.pdf.

structure is typical for the social geography of oligarchy, so make your own assessment how this will probably work in the future.

Another concern of many smaller funds is that DFA created effective impediment for the new generation of start-up managers of hedge funds. If we look back into history, todays giants like David Einhorn or King Street Capital begun very humbly. Einhorn started with less than a million and King Street with just four[224]. It is clear that the new requirements of DFA will make it harder for the next generation of hedge fund managers. As John Carney says: "…several rugs on the leader they climbed to epochal wealth have been broken, even if the leader hasn´t yet been kicked down entirely. Someday you may have to marry a Soros, a Niederhoffer, or a Druckenmiller if you want to benefit from the investment prowess of the greatest minds in finance"[225].

Contrary to these fears, 2012 study of Professor Wulf Haal states the opposite. According to Hall´s survey, "…industry seems to be adjusting well and the impact of the registration and disclosure rules appears to be much less intense then the industry initially anticipated"[226]. However, to be objective, Hall´s survey has one substantial flaw, out of 1,264 asked hedge fund managers, only 94 replied[227]. Maybe, as Nick Summers suggested, the rest were just "too buried by paperwork to reach the phone"[228].

[224] Azam Ahmed, *For Small Hedge Funds, Success Brings New Headaches* (January 20, 2011), THE NEW YORK TIMES DEALB%K, available at: http://dealbook.nytimes.com/2011/01/20/for-small-hedge-funds-success-brings-new-headaches/.
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[228] Nick Summers, *Dodd-Frank? Not Such a Drag After All* (October 15, 2012), BLOOMBERG BUSINESSWEEK, available at: http://www.businessweek.com/articles/2012-10-15/dodd-frank-not-such-a-drag-after-all.

4.2.2 Some hedge funds will become less transparent

The main reason why through the DFA the hedge funds became more regulated was the problem of lack of clarity on what the hedge funds are doing[229], however, the result may be directly the opposite.

There are signals that some of the largest hedge funds are trying to avoid regulation through the home office exception, by the cutting of outside investors. First Druckenmiller did this by shutting down his 12 billion USD Duquesne Capital Management hedge fund and he continued to manage only assets belonging to him, which amounts approximately to 30 – 40 % of the fund. Carl Icahn did the same and stayed in management of "only" 1.76 billion USD. The same happened with George Soros, returning 1 billion of outside investments and keeping only his 20 billion under management[230].

As you can see, those guys are still sitting on a huge sum of money, which certainly deserves to be regulated more than 150 million USD fund, but by cutting off the outside investors, it will be even more difficult to track their investments now[231]. Just think about it for a minute, who do you think deserves to be regulated more, those who have not enough money to comply with all the requirements, or those who can cut 1 billion in outside investments and still be strong enough to win 1.2 billion in speculations against the Japanese yen at the beginning of 2013?

[229] Antti Petajisto, *Hedge Funds after Dodd-Frank* (July 19, 2010), NYU STERN, available at: http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/07/hedge-funds-after-doddfrank.html.
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4.2.3 Recapitalization and the threat of Monopoly

As I wrote before, the Volcker rule basically forbids banks and non-banking entities regulated by Federal Reserve to engage in any kind of proprietary trading and invest, sponsor or retain ownership in any hedge funds or private equity funds[232].

This will, in my opinion, influence hedge funds in two ways, in one good way and in one bad way. What is bad for hedge funds is that after the DFA, they can no longer rely on banks as a source of capital and need to find some other source, if they are willing to use leverage in form of borrowing. Therefore, some of them will eventually need to recapitalize, this idea is also shared by today's news[233].

On the other hand, banks will be forced to reduce or cancel their proprietary trading desks, which will reduce the competition for hedge funds and also hedge funds may welcome new inflow of experienced professionals, who formerly worked for bank proprietary desks. There is just one catch in this all, as some argue hedge funds may due to the Volcker rule become the "only source of sophisticated and relatively unconstrained capital, thus making them perhaps the main liquidity providers across a variety of markets"[234] and this smells like a clear monopoly.

4.2.4 No certain indication of SEC and CFTC powers

It is also worth mentioning that the DFA gives SEC and CFTC a wide power to define its own regulatory powers and to demand additional information it "deems necessary" from the hedge funds. As typical scenario regarding regulators is a trend to expand their regulatory

[232] Alvi Abuaf, Edward Hawthorne, Sandeep Vishnu, Emmanuel Chesnais & M. Edward Keprta, *Hedge funds and Dodd-Frank: Institutionalize, fly low or else!* 13 (2011), available at: http://marketsmedia.com/wp-content/uploads/2011/11/T1038_Hedge-Funds_final.pdf.

[233] Donna Rogers, *The Dodd-Frank Act Requires Hedge Fund Investments In Compliance and Technology*, ABOUT.COM, available at: http://financialservices.about.com/od/EthicsCompliance/a/The-Dodd-Frank-Act-Requires-Hedge-Fund-Investments-In-Compliance-And-Technology.htm.

[234] Antti Petajisto, *Hedge Funds after Dodd-Frank* (July 19, 2010), NYU STERN, available at: http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/07/hedge-funds-after-doddfrank.html.

powers, we may expect the same behavior from SEC and CFTC[235]. And this smells to me like a clear breach of principle of legal certainty. How can anyone be granted the role of decider over its own powers and demand information based on such a vague grounds as a necessity without posing significant thread to the legal certainty in the industry?

4.2.5 Becoming more attractive to conservatives

Not to be only negativistic over the impact of DFA on the hedge fund industry, it is true that recent studies show that more conservative investors, such as pension funds or endowments and foundations are allocating more money to the hedge funds after the DFA[236]. Therefore, my thoughts about such behavior is that the increase in registration of hedge funds advisers and the extensive disclosure may bring new investors to hedge funds, especially from the more conservative waters. But do the hedge funds really need that? As we can see, some of the major players are rather cutting off investors in order to stay unregulated; it therefore seems to me, that hedge funds prefer freedom from the company of more investors. But even if this was true and it would really benefit the hedge fund industry it is still dozens against one on the field of battle between disadvantages and advantages. Another battle over the question whether the DFA will be beneficial for the whole financial stability and worth of the complications it brings is much bigger, I would even say epic, but we have to wait for the result a few years, while right now, the generals are only assembling their troops.

235 Antti Petajisto, *Hedge Funds after Dodd-Frank* (July 19, 2010), NYU STERN, available at: http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/07/hedge-funds-after-doddfrank.html.

236 Alvi Abuaf, Edward Hawthorne, Sandeep Vishnu, Emmanuel Chesnais & M. Edward Keprta, *Hedge funds and Dodd-Frank: Institutionalize, fly low or else!* 7 (2011), available at: http://marketsmedia.com/wp-content/uploads/2011/11/T1038_Hedge-Funds_final.pdf.

Conclusion

When reading through this thesis, you must have realized that from the beginning of the history of the hedge fund industry, the public and even scholars were divided into two groups, those who want to regulate them more and those who want to regulate them less. Hedge funds were basically the same as every controversial person in the world; there were some who loved them, some who hated them and almost no one who did not care about them. Until the 2008 Credit crunch hedge fund industry was able to repeal attacks on its freedom, but after 2008 everything turned upside down and the regulators fuelled with public fear prevailed. These are, the facts and no thesis will make any difference to that. The purpose of this thesis was, however, not to change the course of the hedge fund regulation. The purpose of the thesis was to say, whether more regulation was needed and if the DFA is the right way on the journey to a brighter future.

The answer to the first question, whether the pre-DFA status quo was sufficient, would probably never be a clear cut case. But even if we do not agree with the increase in the hedge fund regulation, we must see that since 1949, many things have changed. The people are in general having higher salaries, it is not so hard to become a millionaire in the US any more, the financial systems have started to be more interconnected, creating the problem of possible systematic risk. I may continue in this enumeration for a long time, and I already did some of that in the previous Chapters, but what I am trying to say here, is that regulation of hedge funds must evolve side by side with the evolution of society.

We cannot keep the one million threshold for becoming accredited investor and say that it still represents the group of the highest social elite who can make informed investment decisions, as in 1933, when according to studies, there were 6.7 million of such individuals in

2008 in US[237]. We again cannot say that the use of leverage in connection with short selling is not, under any circumstances, a threat to US financial stability, especially not after what we can witness during the fall of LTCM. And finally, we may not close our eyes to the fact that the financial markets are more and more interconnected and that the failure of one piece may create a terrible domino effect.

All these arguments suggests that certain changes in regulation of hedge funds are necessary to be done. Even the biggest critics of hedge funds regulation, and truth to be told, I consider myself to be one of them, must admit that something had to be done. Therefore to sum up, answering the first of my research questions, I would say that the pre-DFA regulatory framework became insufficient, and it was necessary to make several adjustments to it to keep it up to date.

But when I said several adjustments, I certainly did not mean the typhoon called DFA. Not only that it extremely overregulates the hedge fund industry, but it also causes so much collateral damage to innocent participants while on the other hand sometimes missing the real targets. As I indicated in my answer to the first research question, one of the problems of hedge fund regulation was non-actual threshold for accredited investors, but all the DFA did was that it kept the one million and discounted the value of investor's primary residence. Not such a big deal right?

But then, instead of focusing its aim on the protection of investors through this proposal and creating an indirect regulation of industry, it hits hedge funds in full force with new registration and reporting duties causing a chaos in the industry. And even if we would say that this was a right step, let´s see whether this really helps the financial stability and protects investors more. As I indicated in Chapter 4, the biggest players like Druckenmiller,

[237] Wikipedia, available at: http://en.wikipedia.org/wiki/Millionaire.

Icahn and Soros are cutting off outside investors. Why? Because they may afford it, still stay strong and escape even the DFA new regulations. And this all happens next to people like Grange Johnson managing barely a 150 million USD fund and facing the enormous expenses of DFA new regulatory framework. Just ask yourself a question, who of these guys creates more threat for financial stability? For me, this reminds me of the scene when in the ancient battles, the shiny and dressed up generals are fleeing the field on their horses after suffering a first scratch, leaving their regular front line troops to bleed to death in the desperate attempt to escape the battlefield.

The same criticism may go to the glorious Volcker Rule. It is true that I was suggesting that banks should be regulated on the amount they may borrow to hedge funds and I supported the healthy influence of Glass Stegall Act. Volcker Rule, however, goes much further by prohibiting banks to finance hedge funds at all. The question, however, is where those 150 million USD funds shall get the money they need to finance their investment strategies? Certainly, again this is not the problem of the big players, who are willing to refuse one billion in outside investments just to stay out of the DFA regulation. And again we can see the fleeing troops scenario here as well.

Honestly, the most positive part of the DFA for me is the creation of central clearing of derivatives. It is true that the derivatives market was one of the major problems in the 2008 Credit Crunch and it make sense to keep an eye on it and be able to prevent any unexpected failures.

Therefore my answer on the second research question is: that the increase in hedge funds regulation in a DFA style was not a very successful step. However, it happened and only time will show whether my opinions were too critical or not. What is however true is, that the hedge fund industry is standing on the edge of a new era. Whether it will be successful or not mainly depends on the great ability of hedge funds to adjust to new environments. So in the end, we may only say: The king is dead, long live the king!

I personally think that the biggest contribution of this thesis is the fact that it is written about something very new, about something which may be properly measured only in the future and about something, not many comparative works were written so far. As I indicated at the beginning, I relied mostly on scholarly writings and news and I think that such a comparative study of regulatory environment of hedge industry before and after the DFA may serve as a got tool for further research.

As I may also judge from the feedback I have received from my friends during my process of writing, the thesis explains the general problems of the hedge fund regulation in easy and understandable way, so people who are not so many aware of economics may understand the problem. This was particularly achieved by the fact that I am not an economist and I spent hours and hours doing research on general economic topics, before I started the research on hedge funds. This contribution may therefore help people like I am, to get a general understanding of the hedge fund industry and its recent problems.

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