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## Is Hedge Fund Adviser Registration Necessary to Accomplish the Goals of the Dodd–Frank Act’s Title IV?

Luther R. Ashworth II

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# Is Hedge Fund Adviser Registration Necessary to Accomplish the Goals of the Dodd–Frank Act’s Title IV?†

Luther R. Ashworth II\*

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### *I. Introduction*

Hedge funds have avoided direct regulation under federal securities laws for most of their existence.<sup>1</sup> The hedge fund industry has gained a reputation for being secretive and opaque mainly because information available on hedge funds is scarce.<sup>2</sup> Since the collapse of a massive hedge fund in the late 1990s, however, hedge funds have been targeted for increased regulation.<sup>3</sup> Over the decades, the federal government has provided a variety of policy reasons in favor of regulating hedge funds. The ebb and flow of hedge fund scrutiny, and the policy

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1. See *infra* Part II.A (discussing how hedge funds have historically avoided traditional federal securities laws).

2. See Barbara C. George, Lynne V. Dymally & Maria K. Boss, *The Opaque and Under-Regulated Hedge Fund Industry: Victim or Culprit in the Subprime Mortgage Crisis?*, 5 N.Y.U. J.L. & BUS. 359, 366 (2009) (referring to the hedge fund industry as “under-regulated and opaque”); see also J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 814 (2007) (explaining that the hedge fund industry is highly secretive).

3. See *infra* Part II.B (discussing the implications that the collapse of the massive hedge fund Long-Term Capital Management (LTCM) had on hedge fund regulation).

rationales behind hedge fund regulation, have predictably correlated with major financial events.<sup>4</sup>

In 2007, two Bear Stearns hedge funds that had largely invested in mortgage-backed investments<sup>5</sup> collapsed.<sup>6</sup> This signaled a deteriorating U.S. mortgage market that would eventually lead to the financial meltdown known as the subprime mortgage crisis of 2008 (Financial Crisis).<sup>7</sup> Soon after, the Financial Crisis caused the United States to fall into a deep recession.<sup>8</sup> Hedge funds' involvement in the Financial Crisis, like the hedge fund industry itself, is not fully understood.<sup>9</sup> Nevertheless, the Financial Crisis finally tipped the scales back toward hedge fund regulation.

In 2010, Congress passed the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act)<sup>10</sup> to provide stability to the damaged U.S. financial system.<sup>11</sup> Although several areas of the Dodd–Frank Act affect hedge funds, this Note focuses on Title IV of the Act, entitled the

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4. See SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 3:1 (2011) (noting that “the laws and rules to which hedge funds and their managers must adhere are found in a variety of statutes and regulations, reflective, to a large extent, of the gradual emergence of the hedge fund”).

5. See *infra* notes 187–95 and accompanying text (explaining the basics of mortgage-backed investments and their involvement in the financial crisis of 2008).

6. See STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 4 (2012) (noting that in “July 2007, two Bear Stearns hedge funds that had invested heavily in CDOs failed”).

7. See Matthew Beville, Dino Falaschetti & Michael J. Orlando, *An Information Market Proposal for Regulating Systemic Risk*, 12 U. PA. J. BUS. L. 849, 891 (2010) (“Though it was unclear at the time, the collapse of Bear Stearns’s funds was the first sign that the mortgage market was collapsing and that a large number of financial firms were overexposed to asset-backed securities and related derivatives.”).

8. See BAINBRIDGE, *supra* note 6, at 5 (noting that the “economy sank into the deepest recession in decades” because of the Financial Crisis).

9. See George et al., *supra* note 2, at 359–60 (noting that some argue that “hedge funds were among the contributors to the fiscal crisis” of 2008, while others argue “that the hedge fund industry did not play a direct precipitating role in the events leading to the financial meltdown”).

10. See Dodd–Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S.C.) (establishing financial regulatory reform to provide stability to the U.S. financial system after the Financial Crisis).

11. *Id.*

Private Fund Investment Advisers Registration Act of 2010 (PFIARA).<sup>12</sup> The PFIARA directly regulates the hedge fund industry by requiring certain hedge fund advisers to register with the Securities and Exchange Commission (SEC) under the Advisers Act of 1940 (Advisers Act).<sup>13</sup> This Note evaluates whether hedge fund adviser registration is necessary in light of the Financial Crisis and the goals of the PFIARA (and the Dodd–Frank Act generally), and if so, what form that regulation should take.

Part II provides an introduction to hedge funds by focusing on their history, general structures, and legal frameworks. Part III discusses regulatory aspects of hedge funds prior to the Financial Crisis and the enactment of the Dodd–Frank Act. Specifically, Part III focuses on how hedge funds avoided regulation over the years and looks to specific events that spurred interest in hedge fund regulation. Part IV explains the basics of the Financial Crisis and hedge funds’ involvement in it. Part IV then details the implications of the PFIARA’s enactment. Part V analyzes whether hedge fund adviser registration under the Advisers Act is necessary in light of the PFIARA’s goals. Next, Part V provides recommendations for hedge fund regulation going forward. Finally, Part VI offers conclusions.

Ultimately, this Note proposes that hedge fund adviser registration under the Advisers Act is unnecessary to advance the PFIARA’s goals because (i) there is already an adequate hedge fund anti-fraud rule in place; (ii) hedge funds have increased transparency to investors over the years; and (iii) hedge funds have a sophisticated investor class that does not need the same protections provided to ordinary investors. Because hedge fund adviser registration is unnecessary to the PFIARA’s goals, it is a waste of the hedge fund industry’s and the SEC’s resources.

The collection of systemic-risk-related<sup>14</sup> data from hedge funds, however, is necessary in light of the Financial Crisis, but

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12. *See id.* § 403, 124 Stat. at 1570 (codified as amended at 15 U.S.C. § 80b-20 note) (“This title may be cited as the ‘Private Fund Investment Advisers Registration Act of 2010.’”).

13. *See id.* §§ 403–404, 124 Stat. at 1571–74 (codified as amended in scattered sections of 15 U.S.C.) (amending adviser registration and reporting requirements under the Advisers Act).

14. *See infra* notes 122–24 and accompanying text (explaining the concept

adviser registration is not needed to achieve this task. This Note asserts that once a threshold (based on hedge fund size) is determined for an aggregate group of hedge funds most pertinent to systemic risk assessment, the Financial Stability Oversight Council (FSOC) should collect data directly through Form PF. Collecting data from smaller hedge funds that do not meet the determined threshold will produce an over-inclusive regime. At the same time, this Note argues that once a proper threshold is established, no hedge funds with assets under management (AUM) exceeding the determined threshold should be exempt from providing information related to systemic risk. Because size is critical to assessing systemic risk concerns, exempting any hedge funds with AUM exceeding the determined threshold would produce an under-inclusive element to the regime as well. This Note explores detailed recommendations to alleviate these issues.

## *II. Hedge Funds in General*

Part II of this Note addresses historical and legal aspects regarding hedge funds before the Dodd–Frank Act. Part II.A gives a history of hedge funds, while also discussing the general structures and investment strategies of more popular hedge funds. Part II.B examines hedge funds’ general legal frameworks.

### *A. Defining Hedge Fund*

Hedge funds are hard to define because of their diverse, complex, and secretive trading strategies.<sup>15</sup> Typically, “hedge funds” refer to private funds that pool the assets of wealthy and institutional investors “to invest and trade in equity securities, fixed-income securities, derivatives, futures and other financial

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of systemic risk).

15. See DOUGLAS HAMMER ET AL., SHARTSIS FRIESE LLP, U.S. REGULATION OF HEDGE FUNDS 1–2 (2005) (providing multiple examples of various hedge fund investment strategies and noting that “investment philosophies of hedge funds are as diverse as their portfolio managers”); see also Verret, *supra* note 2, at 814 (explaining that the hedge fund industry is highly secretive because hedge funds want to protect their unique trading strategies).

instruments.”<sup>16</sup> Most hedge funds are professionally managed and carry high levels of debt to increase certain investment positions with the intention of amplifying gains.<sup>17</sup> Hedge funds are sometimes referred to as alternative investments because usually they are not publicly traded, not very liquid, and difficult to value.<sup>18</sup> Also, despite the fact that hedge funds vary broadly in investment strategy, they all strive to achieve absolute return, which means that their “strategies are designed to generate positive return regardless of overall market performance.”<sup>19</sup>

Most agree that Alfred Winslow Jones, a Columbia University sociologist, pioneered the modern day hedge fund in 1949.<sup>20</sup> Jones created a fund that would “hedge” against market risks by offsetting declining values of long-stock positions with appreciating values of short-stock positions and vice versa.<sup>21</sup> Also, Jones borrowed money for a portion of the fund’s investments to increase leverage (debt-to-equity) in the hopes of magnifying returns.<sup>22</sup> Because Jones’s fund outperformed the leading mutual

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16. HAMMER, *supra* note 15, at 1.

17. See Verret, *supra* note 2, at 803 (“High leverage, management expertise, performance fees, and absolute return strategies are the hallmarks of the industry.”).

18. See LEDERMAN, *supra* note 4, § 1:3 (noting that alternative investments differ from traditional investments because they are “generally not traded on a public market and therefore tend to be less liquid and more difficult to value”).

19. *Id.*

20. See Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSPECTIVES 189, 189–90 (1999) (explaining that Alfred Winslow Jones started the first hedge fund in 1949).

21. See LEDERMAN, *supra* note 4, § 1:1 (discussing that “Jones reasoned that complementing a long portfolio with short positions would provide a ‘hedge’ against the influence of market movements on his portfolio as market-generated declines in the value of the long portfolio would be offset by similarly generated gains in the short portfolio”). This is because a long position appreciates when the value of the held security rises, while a short position appreciates when the underlying security’s value decreases. *Id.* Note that a long position generally refers to a speculative position in an asset that is purchased and held with the hopes that the asset’s value will rise over time. *Id.* Jones typically obtained his short positions by short selling stocks; this is where Jones would sell a stock that he did not own (borrowed the sold stock) and then would replace the sold stock once the price fell to make a profit. *Id.* In sum, Jones was taking long positions in stocks that he thought were undervalued and short positions in stocks that he thought were overvalued to reduce “the prospect of losses by taking a counterbalancing transaction.” Edwards, *supra* note 20, at 190.

22. See LEDERMAN, *supra* note 4, § 1:1 (detailing how borrowing, or

funds of that era, the hedge fund concept became increasingly popular.<sup>23</sup>

In 1970, an estimated 150 funds were managing over \$1 billion in assets.<sup>24</sup> By 2007, many factors—including the creation of new financial markets and instruments, an influx of capital, and an increase in the number of hedge funds—led to an estimated \$1.93 trillion in total AUM for hedge funds.<sup>25</sup> Nevertheless, the Financial Crisis negatively impacted the hedge fund industry both in performance<sup>26</sup> and reputation.<sup>27</sup> Although the hedge fund industry has slowly recovered, total AUM “remain below their peak level in 2007.”<sup>28</sup> Still, hedge funds play a key role in the U.S. economy, and it is estimated that there are almost “ten thousand hedge funds currently operating and managing \$1.5 trillion in assets.”<sup>29</sup>

Hedge funds’ general structures are diverse, but the majority of funds share some common characteristics. Most hedge funds require a significant initial minimum investment from their investors<sup>30</sup> and restrict their investors from withdrawing capital

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leverage, “can magnify returns” by increasing the amount in a certain position, but it can also magnify losses if the leveraged position moves contrarily of where the investor intended).

23. *See id.* (explaining that as Jones’s fund outperformed the leading mutual funds of his day, the hedge fund concept “generated interest with the investment community”).

24. *Id.*

25. *See id.* (discussing how new financial markets and instruments in the 1980s, combined with an increase in capital in the 1990s, spurred hedge fund growth).

26. *See id.* (examining how the Financial Crisis, among other reasons, led to “negative performance as well as record withdrawals by investors which combined to result in a decline in total assets managed in the hedge fund industry . . . at the end of 2008”).

27. *See* Wulf A. Kaal, *Hedge Fund Regulation Via Basel III*, 44 VAND. J. TRANSNAT’L L. 389, 391 (2011) (discussing that in the aftermath of the Financial Crisis, “[h]edge funds have been blamed for their part in the crisis and have become a scapegoat for the problems affecting many aspects of the financial markets”).

28. LEDERMAN, *supra* note 4, § 1:1.

29. Scott V. Wagner, Comment, *Hedge Funds: The Final Frontier of Securities Regulation and a Last Hope for Economic Revival*, 6 J.L. ECON. & POL’Y 1, 3 (2009).

30. *See* Edwards, *supra* note 20, at 191 (noting that hedge funds usually have high minimum-investment requirements and giving an example of a large hedge fund in the late 1990s that required a \$5 million minimum investment).



during a fixed “lock-up” period.<sup>31</sup> The lock-up period is designed to encourage long-term investment, while ensuring the fund’s liquidity by limiting withdrawals.<sup>32</sup> Typically, hedge funds compensate their managers in ways that highly reward gains.<sup>33</sup> Hedge fund managers usually require a 1–2% fee for all AUM to cover operating costs, while also requiring a 15–25% performance fee of all profits made in a given year.<sup>34</sup> From a managerial standpoint, this is a very attractive feature because mutual funds and other institutional funds usually pay flat fees.<sup>35</sup> To combat excessive risk-taking, and to further align the interests of management and clients, most hedge funds force managers to invest a certain amount of personal capital into the fund as well.<sup>36</sup> There is no doubt, however, that the possibility of enormous profits has attracted great talent to the hedge fund industry and has driven the development of creative investment strategies typical of hedge funds.<sup>37</sup>

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31. *See id.* (explaining that most hedge funds limit the ability of their investors to withdraw funds so that the managers can invest in more illiquid instruments over longer periods of time). The term “lock-up” refers to the minimum holding period that the investors will have to wait until they can withdraw funds. LEDERMAN, *supra* note 4, § 2:3.3.

32. *See id.*

33. *See* Wagner, *supra* note 29, at 3 (“Hedge fund managers structure their funds to create internal incentives that maximize returns.”).

34. *See* Edwards, *supra* note 20, at 191 (noting that hedge fund administrative fees usually range from 1–1.5% of assets under management, while large incentive fees range from 15–20%). Many funds also impose a “hurdle rate,” which requires fund managers to exceed a minimum rate of return before the manager’s performance fee will actually kick in. LEDERMAN, *supra* note 4, § 2:3.3. Furthermore, some hedge funds subject their managers to “high water marks,” which require fund managers to cover prior years’ losses before earning a performance fee. *Id.*

35. *See* Edwards, *supra* note 20, at 191 (noting that mutual funds and other institutional investors are usually prohibited from using incentive performance fees, so they often have to employ a flat fee rate).

36. *See* LEDERMAN, *supra* note 4, § 2:2.4 (pointing out that a major distinction between hedge funds and mutual funds is the fact that most “[h]edge fund managers usually invest a significant portion of their own liquid net worth in their hedge funds alongside of the fund’s other investors”).

37. *See* Verret, *supra* note 2, at 828–29 (stating that mutual funds have had a hard time competing with hedge funds for professional talent because of hedge fund fee structures).

As noted, hedge funds are extremely diverse because of their flexible nature.<sup>38</sup> Exploring the basics of three of the more popular hedge fund strategies, however, will shed light on this alternative investment. One type of hedge fund uses a hedge-equity strategy similar to Alfred Jones's long- and short-position model, but in the modern world, its focus is more specified—such as a country-specific equity market focus or an industry equity market focus.<sup>39</sup> Another type of hedge fund, called a global-opportunistic hedge fund, looks to exploit macroeconomic factors in different countries or regions.<sup>40</sup> These hedge funds are more event-driven—fund managers may look at political or currency trends—and use their managers' discretion or advanced computer systems to find developing trends.<sup>41</sup> A third type of hedge fund, known as an arbitrage (or relative-value) hedge fund, looks to “exploit pricing inefficiencies between or among related instruments.”<sup>42</sup> This very small sample of hedge fund strategies shows just how diverse and flexible the hedge fund industry is as a whole.

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38. See Sue A. Mota, *Hedge Funds: Their Advisers Do Not Have to Register with the SEC, but More Information and Other Alternatives Are Recommended*, 67 LA. L. REV. 55, 57–58 (2006) (“While many trade in securities, bonds, and currencies, some also trade in derivatives and other assets, such as movies and even the rights to soccer players.”).

39. See LEDERMAN, *supra* note 4, § 1:2.1 (noting the hedged equity strategy is similar to the Jones model, but has evolved over time to focus more on areas like country-specific and industry-specific equity markets). It is estimated that 30% of hedge funds use a strategy similar to the hedge equity strategy. *Id.*

40. See *id.* § 1:2.2 (explaining that the global-opportunistic strategy looks at macroeconomic data to speculate on factors such as political or currency trends).

41. See *id.* (“Global macro managers have historically been known for making high risk, significantly leveraged investments that are often directional in nature rather than being hedged.”); see also Verret, *supra* note 2, at 803 (“They may trade commodities or currency swaps based on macroeconomic data, or trade on expected results of a merger or acquisition between two companies.”).

42. LEDERMAN, *supra* note 4, § 1:2.3.

### B. Legal Framework

The vast majority of domestic hedge funds are set up as limited partnerships or limited liability companies.<sup>43</sup> These structures allow them flexibility in terms of the relationship between their managers and their investors.<sup>44</sup> These are the most popular legal structures for hedge funds because they offer flexibility in governance (and management), limited liability, and certain tax advantages.<sup>45</sup> Most hedge funds form in Delaware, “where they are subject to Delaware fiduciary duties.”<sup>46</sup> Delaware provides hedge funds with legal predictability because it has well-developed case law for both limited partnerships and limited liability companies.<sup>47</sup>

Most of the legal implications facing hedge funds before the Dodd–Frank Act hinged on the fact that sophisticated, wealthy investors have traditionally made up the majority of hedge fund investors.<sup>48</sup> Historically, the government has viewed this affluent class of investors as having the capabilities necessary to assess the risks associated with hedge funds.<sup>49</sup> For this reason, before the Dodd–Frank Act hedge funds were largely unregulated.<sup>50</sup>

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43. See Edwards, *supra* note 20, at 190 (“Although a hedge fund can be organized as a limited liability company, most are organized as limited partnerships . . .”).

44. See LEDERMAN, *supra* note 4, § 2:3.3 (discussing that organizing a hedge fund as a limited partnership or limited liability company provides flexibility between the managers and investors because “[s]ubject to the manager’s fiduciary and disclosure obligations, these terms can be tailored and adjusted for different groups of investors within the fund”).

45. See *id.* § 2:3 (determining that limited partnerships and limited liability gives hedge funds “flexibility and enables the fund to meet both objectives of limited liability and tax efficiency”). The tax ramifications of hedge funds are beyond the scope of this Note.

46. See Verret, *supra* note 2, at 804–05.

47. See LEDERMAN, *supra* note 4, § 2:3 (explaining that Delaware is the most popular jurisdiction for hedge fund formation because of its well-developed case law for limited partnerships and limited liability companies).

48. See Edwards, *supra* note 20, at 190 (“The clear intent of the legal framework surrounding hedge funds is to limit them to wealthy and sophisticated investors who are capable of assessing the risks associated with hedge fund investments.”).

49. *Id.*

50. See *id.* (stating that because the government has viewed the affluent class of typical hedge fund investors as capable of assessing the risks of hedge

Some argue that minimal regulation in the hedge fund industry has provided a true alternative investment for investors because fund managers can creatively adapt to changing financial markets without the fear of competitors immediately copying their investment strategies.<sup>51</sup> This freedom encourages the development of diverse financial products because hedge funds can produce unique investment strategies that may have little (or no) correlation with traditional financial benchmarks.<sup>52</sup> Furthermore, hedge funds encourage broad and efficient markets by increasing trade in both established and less-established markets.<sup>53</sup> Price discovery of nontraditional assets is possible because larger markets (or markets in general) are created for nontraditional assets that normally would be extremely difficult to value.<sup>54</sup> Thus, liquidity becomes possible for traditionally illiquid assets.<sup>55</sup> Opponents of hedge fund regulation argue that “[t]he lack of regulation has been paramount to the hedge fund’s success.”<sup>56</sup>

### *III. (Attempted) Regulation Before the Dodd–Frank Act*

Predictably, hedge fund regulation correlates with the growth and popularity of the hedge fund industry—the interest in regulating the hedge fund industry has grown with the development of the industry itself.<sup>57</sup> Because hedge funds have

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funds, hedge funds have gone mostly unregulated).

51. See Wagner, *supra* note 29, at 5 (noting that the limited regulation of hedge funds has allowed them to “adapt better to dynamic markets by encouraging research and development of new and creative financial models”).

52. See Verret, *supra* note 2, at 804 (pointing out that hedge funds typically have higher than average returns that “do not correlate with returns from the long Standard and Poor’s 500 . . . or other traditional benchmarks”).

53. See Wagner, *supra* note 29, at 6–7 (discussing that hedge funds provide large amounts of capital and help increase efficiency in both traditional and nontraditional markets).

54. See *id.* at 6 (“Funds provide a means for a large amount of cash to enter nontraditional investments and help force assets to their true valuations.”).

55. See *id.* at 7 (explaining that markets become “more efficient as assets move closer to true valuation”). Furthermore, “with more capital in the market, investors can more easily trade through the increased liquidity.” *Id.*

56. *Id.*

57. See *supra* note 4 and accompanying text (noting that laws and rules

evolved over a number of decades, hedge fund regulation is scattered throughout various statutes and regulations.<sup>58</sup> Part III.A analyzes how hedge funds have historically avoided traditional securities regulation. Next, Part III.B discusses past events that spurred interest in hedge fund regulation. Then, Part III.C explores past attempts to directly regulate hedge funds prior to the Dodd–Frank Act.

*A. Traditional Securities Regulation: Historical Exemptions for Hedge Funds*

Four pieces of legislation—the Securities Act of 1933,<sup>59</sup> the Securities Exchange Act of 1934,<sup>60</sup> the Investment Company Act of 1940,<sup>61</sup> and the Investment Advisers Act of 1940<sup>62</sup>—make up the core federal securities laws applicable to hedge fund regulation.<sup>63</sup> Nevertheless, prior to the Dodd–Frank Act, hedge funds generally were able to avoid regulation under these laws through various exemptions.<sup>64</sup>

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affecting hedge funds have correlated with the evolution of the hedge fund).

58. See LEDERMAN, *supra* note 4, § 3:1 (“As a result of the evolutionary development of the hedge fund, the regulation of these financial vehicles cannot be found in one concise codification.”).

59. See 15 U.S.C. §§ 77a–77aa (2010) (requiring that any offer or sale of securities be registered with the SEC pursuant to the Securities Act, unless an exemption from registration exists under the law).

60. See *id.* §§ 78a–78mm (creating various regulations on U.S. financial markets and establishing the Securities and Exchange Commission (SEC) as the federal agency primarily responsible for enforcement of U.S. federal securities law).

61. See *id.* §§ 80a-1 to 80a-64 (directing the SEC to regulate investment companies and securities exchanges).

62. See *id.* §§ 80b-1 to 80b-21 (establishing federal laws to regulate and monitor investment advisers based on shareholder complaints of fraud).

63. See Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 682 (2000) (explaining that without certain exclusions and exemptions, “hedge funds would be subject to regulation under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940”).

64. See Mota, *supra* note 38, at 58 (noting that hedge funds “often escape regulation because they fall within the exemption provisions” of the traditional U.S. federal securities laws).

The Securities Act of 1933 (Securities Act) regulates primary market transactions in which a business entity (issuer) offers and sells its securities publicly to raise money.<sup>65</sup> Importantly, the Securities Act requires issuers offering public securities to file a registration statement with the SEC.<sup>66</sup> The registration statement serves as a disclosure mechanism that allows potential investors to gather information regarding “the issuer’s business, properties, material legal proceedings, directors and officers, ownership, and financials.”<sup>67</sup> To raise money, hedge funds offer interests in their funds that usually fall within the Securities Act’s definition of “security.”<sup>68</sup>

Recall that hedge funds typically form as hybrid entities, such as limited partnerships or limited liability companies.<sup>69</sup> The Securities Act’s definition of security does not specifically mention any hybrid entity interests.<sup>70</sup> Nevertheless, hedge fund interests offered to investors usually qualify as securities because they are interpreted as “investment contracts.”<sup>71</sup> An investment contract, as defined by the Supreme Court, involves “investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial

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65. See STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 38 (3d. ed. 2012) (explaining that the Securities Act “focuses on primary market transactions” and “requires issuers making a public offering to file mandatory disclosure documents containing information deemed important to investors”).

66. See 15 U.S.C. § 77e(c) (2010) (“It shall be unlawful for any person . . . to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security . . .”).

67. See *id.* § 77g (detailing specific information required in the registration statement).

68. See *id.* § 77b(a)(1) (defining the term security under the Securities Act as any “note, stock, treasury stock, security future, bond, debenture . . . investment contract,” and many other financial instruments).

69. See *supra* notes 43–45 and accompanying text (noting that the vast majority of domestic hedge funds are set up as hybrid entities, such as limited partnerships or limited liability companies).

70. See *supra* note 68 and accompanying text (providing the definition of security under the Securities Act).

71. See HAMMER, *supra* note 15, at 111 (explaining that most hedge fund interests offered to investors are interpreted as investment contracts, which is the “catch-all” category of the Securities Act’s security definition).

efforts of others.”<sup>72</sup> Hedge funds offer their limited partnership and limited liability company interests to passive investors who receive nominal (or no) management authority—and because these investors expect profits from management (efforts of others), most hedge fund offerings qualify as investment contracts.

Still, the majority of hedge funds avoid registration under the Securities Act because they use the private securities offerings exemption (private offering exemption).<sup>73</sup> Under § 4(2) of the Securities Act, any “transactions by an issuer not involving a public offering” are exempt from having to comply with the Securities Act’s disclosure and registration requirements.<sup>74</sup> Furthermore, in 1983, the SEC promulgated Regulation D<sup>75</sup> under the Securities Act to clarify and provide more predictability for when funds trying to use the private offering exemption are exempt from registration.<sup>76</sup> Rule 506 of Regulation D is most applicable to hedge funds because it provides a safe harbor for the private offering exemption in certain situations.<sup>77</sup> For example, Rule 506 exempts from registration hedge fund offerings that meet certain conditions,<sup>78</sup> including only offering interests to

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72. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975). Note that the quoted investment contract test in *Forman* is derived from the original investment contract test in *SEC v. Howey*. *SEC v. Howey*, 328 U.S. 293 (1946). The original *Howey* investment contract test states, “The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” *Id.* at 301.

73. *See Mota*, *supra* note 38, at 59 (detailing how most hedge fund securities offerings may avoid registration under the Securities Act using the private offering exemption found in § 4(2) of the Securities Act).

74. *See* 15 U.S.C. § 77d(2) (2010) (establishing that the registration requirements provided in the Act do not apply to “transactions by an issuer not involving any public offering”).

75. *See* 17 C.F.R. §§ 230.501–.506 (2011) (establishing Regulation D to provide issuers with more clarity in private placements).

76. *See* CHOI & PRITCHARD, *supra* note 65, at 550 (explaining that the SEC promulgated Regulation D of the Securities Act to “provide issuers greater certainty in private placements”).

77. *See* 17 C.F.R. § 230.506 (establishing a safe harbor for the § 4(2) exemption in the Securities Act).

78. *See id.* § 230.506 (detailing conditions that must be met in order for an offer or sale of securities to be exempt from registration requirements under Regulation D of the Securities Act).

purchasers that qualify as “accredited investors.”<sup>79</sup> Most hedge funds comply with these limits and avoid registering their offerings under the Securities Act.<sup>80</sup> In fact, the SEC has proposed rules to implement the newly enacted Jumpstart Our Business Startups Act<sup>81</sup> that make Rule 506 even friendlier to hedge funds by eliminating the prohibition on general solicitation in private placements so long as the only purchasers are accredited investors.<sup>82</sup>

The Securities Exchange Act of 1934 (Exchange Act) created the SEC<sup>83</sup> and contains provisions that are relevant to hedge funds.<sup>84</sup> Specifically, the Exchange Act regulates secondary market transactions in which “one investor resells securities of the issuer to another investor.”<sup>85</sup> The Exchange Act requires periodic reporting to the SEC for certain companies that qualify under the statute (usually publicly-traded companies).<sup>86</sup> Some of

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79. See *id.* § 230.501(a) (providing the conditions that must be met in order to qualify as an “accredited investor” under the Securities Act). Generally, an individual with a net worth exceeding \$1 million (excluding the individual’s home residence after the Dodd–Frank Act) or an individual whose total yearly income is more than \$200 thousand will qualify as an accredited investor. *Id.* Also, a company or university with assets exceeding \$5 million, usually, will qualify as an accredited investor. *Id.* These are the basic requirements for an accredited investor; however, there are more focused situations covered under Regulation D of the Securities Act. Also, Rule 506 of Regulation D allows an issuer to satisfy exemption requirements if the issuer offers interests to no more than thirty-five non-accredited purchasers. *Id.* § 230.506.

80. See Wagner, *supra* note 29, at 10 (“Hedge funds typically meet the requirements of Regulation D by limiting fund investors to individuals with high net worth or institutional investors that meet the minimum thresholds.”).

81. See JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of the U.S.C.) (aiming to increase job creation and economic growth by improving access to the public capital markets for emerging growth companies).

82. See generally Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9354 (Aug. 29, 2012).

83. See 15 U.S.C. § 78d (2010) (establishing the SEC as a regime for regulating secondary markets).

84. See Mota, *supra* note 38, at 59–60 (noting that some of the provisions of the Exchange Act may apply to hedge funds).

85. CHOI & PRITCHARD, *supra* note 65, at 1. Willa Gibson notes that the Exchange Act “covers all facets of the securities markets and all transactions involving securities, in contrast to the Securities Act which is directed primarily at the offering and distribution of securities.” Gibson, *supra* note 63, at 691.

86. See, e.g., 15 U.S.C. § 78m (stating specific periodical and other



the Exchange Act's provisions could affect hedge funds issuing equity.<sup>87</sup> For example, a hedge fund would have to make extensive disclosures, through periodic reporting, to the SEC if it qualified as a public company under § 12(g)<sup>88</sup> of the Exchange Act.<sup>89</sup> To trigger § 12(g) and its associated rules, a hedge fund would have to issue equity interests to over 2000 persons—or 500 persons who are not accredited investors—and the fund's assets would need to exceed \$10 million.<sup>90</sup> Regardless, this threshold has been easy for hedge funds to avoid.<sup>91</sup> Thus, the Exchange Act has not played a large part in the history of hedge fund regulation.

Another traditional U.S. securities law, the Investment Company Act of 1940 (Investment Company Act), has the potential to regulate hedge funds. Many financial funds, such as mutual funds, register as investment companies under the Investment Company Act.<sup>92</sup> Registered investment companies are limited in the types of transactions they can use.<sup>93</sup> For example, registered investment companies are restricted in their use of short sales and must obtain shareholder approval for investing in certain assets and borrowing substantial money.<sup>94</sup> As discussed above, “[t]hese transactions are core elements of most hedge

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reporting requirements certain issuers of securities must file with the SEC).

87. See Mota, *supra* note 38, at 59–60 (discussing that the Exchange Act's periodic reporting requirements could be relevant to hedge funds).

88. See 15 U.S.C. § 78l(g) (outlining when an issuer under the Exchange Act must register and providing certain exemptions).

89. See Mota, *supra* note 38, at 59–60.

90. See 15 U.S.C. § 78l(g) (2010) (outlining when an issuer under the Exchange Act must register and providing certain exemptions).

91. See Mota, *supra* note 38, at 60 (“Most hedge funds . . . avoid registration under the 1934 Act . . .”).

92. See *Goldstein v. SEC*, 451 F.3d 873, 875 (D.C. Cir. 2006) (noting that mutual funds must register with the SEC under the Investment Company Act).

93. See *id.* (“The Investment Company Act places significant restrictions on the types of transactions registered investment companies may undertake.”).

94. See 15 U.S.C. § 80a-12(a)(3) (2010) (stating that it is unlawful for a registered investment company “to effect a short sale of any security,” except in certain situations, contrary to the rules and regulations promulgated by the SEC under the Investment Company Act); see also *id.* § 80a-13(a)(2) (stating that in most situations a registered investment company, without majority shareholder approval, cannot “borrow money, issue senior securities, underwrite securities issued by other persons, purchase or sell real estate or commodities or make loans to other persons”).

funds' trading strategies."<sup>95</sup> The Investment Company Act requires investment companies—defined as almost any issuer which is “in the business of investing, reinvesting, or trading in securities”<sup>96</sup>—to register with the SEC and disclose investment activities, investment policies, and other information.<sup>97</sup> Although hedge funds fall within the definition of an investment company, the Investment Company Act has two exemptions available to most hedge funds.<sup>98</sup> First, any investment company that is not owned by more than 100 investors and does not plan to make a public offering of its securities is exempt.<sup>99</sup> Hedge funds generally do not make public offerings, so this exemption is favorable to hedge funds with less than 100 investors.<sup>100</sup> Second, the Investment Company Act exempts investment companies exclusively owned by “qualified purchasers.”<sup>101</sup> This allows hedge funds owned solely by “qualified purchasers” to circumvent

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95. *Goldstein*, 451 F.3d at 875.

96. *See* 15 U.S.C. § 80a-3(a)(1) (stating that an investment company under the Investment Company Act is a broad term that means, but is not limited to, “any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities”).

97. *See id.* § 80a-8(b) (stating that an investment company must disclose investment activities, investment policies, and other information when an investment company is required to register with the SEC under the Investment Company Act).

98. *See Goldstein v. SEC*, 451 F.3d 873, 876 (D.C. Cir. 2006) (noting that the definition of an investment company in the Investment Company Act “nominally describes hedge funds”).

99. *See* 15 U.S.C. § 80a-3(c)(1) (explaining that “[a]ny issuer whose outstanding securities . . . 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” is not recognized as an investment company under the Investment Company Act).

100. *See Goldstein*, 451 F.3d at 876 (explaining most hedge funds “are exempt . . . because they have one hundred or fewer beneficial owners and do not offer their securities to the public”).

101. *See* 15 U.S.C. § 80a-3(c)(7) (2010) (noting an exemption for registration under the Investment Company Act is allowed for “[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers”). Generally, a “qualified purchaser” is any person or family-owned company owning more than \$5 million in investments or any person who owns and invests on a discretionary basis \$25 million or more. *Id.* § 80a-2(a)(51)(A).

registration under the Investment Company Act, even if the fund has more than 100 investors.

The fourth traditional federal securities regulation relevant to hedge funds is the Investment Advisers Act of 1940 (Advisers Act). The Advisers Act requires all investment advisers, including hedge fund advisers, to register with the SEC and disclose information such as compensation, the adviser's balance sheet, the scope of the adviser's authority, and other data.<sup>102</sup> Prior to the Dodd–Frank Act, however, an exemption excused advisers managing less than fifteen clients from having to register with the SEC under the Advisers Act (private-adviser exemption).<sup>103</sup> To qualify for the private-adviser exemption, hedge fund advisers historically argued that each hedge fund they managed only counted as one client (rather than counting every investor in every hedge fund managed by the adviser).<sup>104</sup> So, hedge funds could manage up to fourteen different hedge funds, regardless of the number of investors in each fund, and still be exempt from registration under the Advisers Act.<sup>105</sup> Then, in 1984, to the delight of hedge fund advisers, the SEC passed a safe harbor rule that explicitly allowed private fund managers to count each fund managed as one client.<sup>106</sup>

Nevertheless, Title IV of the Dodd–Frank Act (PFIARA) has repealed and amended sections of the Advisers Act.<sup>107</sup> Most important to this Note (and as discussed below), the Dodd–Frank Act eliminated the private-adviser exemption from the Advisers Act.<sup>108</sup> Although hedge funds have eluded traditional federal

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102. See 15 U.S.C. § 80b-3(a)–(c) (detailing disclosure and registration requirements for investment advisers under the Advisers Act).

103. See Wagner, *supra* note 29, at 12 (stating that the exemption under the Advisers Act allowed an exemption for advisers with fewer than 15 clients).

104. See *id.* (“Traditionally, hedge fund advisers avoided registration under the Advisers Act by arguing that fund managers maintain only one client, the hedge fund itself.”).

105. See Kaal, *supra* note 27, at 414 (“Even the largest hedge fund managers usually ran fewer than fifteen hedge funds and were, therefore, exempt.”).

106. See Mota, *supra* note 38, at 62 (“In 1985, the SEC adopted a rule allowing investment advisers to count each pooled investment vehicle as a single client.”).

107. See *infra* Part IV and accompanying text (discussing the implications of the Dodd–Frank Act's amendments to the Advisers Act relating to the regulation of hedge funds).

108. See *infra* Part IV and accompanying text (same).

securities laws for decades, the Dodd–Frank Act’s amendments to the Advisers Act are the most direct regulation of hedge funds to date.

*B. 1990s: Major Hedge Fund’s Collapse Spurs Regulation Debate*

For decades, hedge funds avoided SEC registration and most regulation under the traditional federal securities laws without controversy. In the late 1990s, however, the collapse of the massive hedge fund Long-Term Capital Management (LTCM) sparked debate regarding the need for hedge fund regulation.<sup>109</sup>

A group of highly reputable traders formed LTCM in 1994.<sup>110</sup> The fund had starting equity of \$1.3 billion (\$100 million of which was contributed by the general partners) and required outside investors to invest at least \$10 million.<sup>111</sup> At LTCM’s peak, in 1997, the fund grew to larger than \$7 billion after the fund made returns of 19.9% in 1994, 42.8% in 1995, 40.8% in 1996, and 17.1% in 1997.<sup>112</sup> LTCM typically used an investment strategy that held “long positions in bonds that it considered undervalued and short positions in bonds that it considered overvalued.”<sup>113</sup> Based on the yield spread between its positions in high- and low-risk bonds, LTCM would essentially bet on the spread to widen or narrow using derivatives contracts.<sup>114</sup>

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109. See Edwards, *supra* note 20, at 200 (noting that the collapse, near bankruptcy, and bailout of LTCM in late 1990s sparked conversation about whether there was a need for additional hedge fund regulation).

110. See *id.* at 199 (noting that the general partners included a former head of bond trading at Salomon Brothers, a former vice chairman of the Federal Reserve Board, and two Nobel Prize recipients for work in the pricing of financial instruments).

111. See *id.* at 197 (explaining that LTCM was formed in February 1994 with equity of \$1.3 billion, of which \$100 million came from its general partners, and the fund “required a minimum investment of \$10 million, and no withdrawals for three years”).

112. *Id.*

113. *Id.* at 197–98.

114. See *id.* at 198 (explaining that LTCM would buy “high-yielding, less liquid bonds, such as Danish mortgage-backed securities” and then sell short “low-yielding, more liquid bonds, such as U.S. government bonds”). Then, if LTCM thought “the yield spread between the high and low risk bonds . . . was excessively wide,” the fund would bet on the spread to narrow using derivatives contracts. *Id.*

In early 1998, LTCM became convinced, for a number of reasons, the yield spread between its high- and low-risk bonds was too wide; thus, LTCM bet on the yield spread to narrow.<sup>115</sup> LTCM borrowed \$125 billion from banks (on top of the fund's then \$4.8 billion AUM) and increased its leverage ratio (debt-to-equity ratio) to more than 20-to-1.<sup>116</sup> This leverage ratio, which is extraordinarily large for any hedge fund, would magnify gains or losses depending on the widening or narrowing of LTCM's yield spread.<sup>117</sup> Later that year, a number of circumstances instilled fear in global bond investors and there was a "stampede to quality" bonds.<sup>118</sup> Thus, LTCM's yield spread widened (instead of narrowed) and the fund's failed bet was exposed.<sup>119</sup>

In September 1998, the Federal Reserve Bank of New York became worried about LTCM's creditors (including banks and securities firms) that would suffer losses as a result of LTCM's collapse.<sup>120</sup> A creditor consortium, including the government, decided that the collapse of LTCM posed "systemic risk" (due to the number of overexposed parties and the amount of money involved) and agreed to a bailout of over \$3.6 billion.<sup>121</sup> Systemic risk is defined as the risk that "an economic shock such as a

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115. *See id.* at 198 ("LTCM believed that in late 1997 and early 1998, partly as a consequence of the collapse of Asian countries in the summer of 1997, the yield spread between high and low risk bonds . . . was excessively wide.").

116. *Id.*

117. *See id.* (describing LTCM's leverage ratio in 1998 as "high by any standard"). Because the leverage ratio was so high, "[e]ven a small reduction in yield spreads would mean huge profits for LTCM." *Id.* On the reserve side, losses would be magnified as well. *Id.*

118. *See id.* at 199 ("As fear spread of what the market repercussions to . . . market breakdowns might be . . . there was a stampede to 'quality.'"). This stampede to quality meant bond investors began to dump their more risky bonds for safer (yet lower-yielding) bonds. *Id.* Among the leading reasons for global fear in the bond market was the result of Russia devaluing its currency and refusing to honor contracts sold to customers. *Id.*

119. *See id.* ("This sharp widening of yield spreads caused by a stampede to liquidity and quality was just the opposite of what LTCM was betting on.").

120. *See id.* at 200 (explaining that in September 1998, the Federal Reserve Bank of New York became aware of LTCM's potential collapse and held meetings to discuss the situation).

121. *See id.* (describing how a creditor consortium decided to bailout LTCM to the tune of \$3.6 billion after the group decided LTCM's collapse posed systemic risk based on the amount of money involved and the number of overexposed lenders involved).

market or institutional failure triggers (through panic or otherwise) either the failure of a chain of markets or institutions or a chain of significant losses to financial institutions, resulting in increases in the cost of capital or decreases in its availability.”<sup>122</sup> Systemic risk can be paralleled to a domino effect in which a trigger event (here LTCM’s collapse) “causes a chain of bad economic consequences” that have the potential to bring down other financial institutions and overall markets.<sup>123</sup> LTCM’s collapse was the first event that clearly demonstrated hedge funds could have systemic risk consequences. The magnitude of LTCM’s exposure to other market participants showed that a massive hedge fund’s failure could have devastating effects on the overall market.<sup>124</sup>

As a result of LTCM’s collapse, the government issued two reports detailing what went wrong with LTCM and how the hedge fund industry could be better regulated.<sup>125</sup> The first report by the President’s Working Group on Financial Markets,<sup>126</sup> recommended that more information on hedge funds should be disclosed publicly to prevent hedge funds from overleveraging their investments.<sup>127</sup> This report also urged lenders to establish better standards for evaluating hedge funds when extending credit.<sup>128</sup> The second report, conducted by the United States General Accounting Office (GAO), confirmed that LTCM’s massive size and leverage created systemic risk that posed a

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122. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008).

123. *Id.* at 198.

124. *See id.* at 203 (“In LTCM, the potential for systemic risk existed not by reason of its intrinsic status as a hedge fund but by the sheer size of its exposure to other institutions and market participants.”).

125. *See* LEDERMAN, *supra* note 4, § 3:3 (“In the wake of LTCM, two significant governmental studies were issued in 1999.”).

126. PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999), <http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf>.

127. *See id.* at 31 (“Improving transparency through enhanced disclosure to the public should help market participants make better, more informed judgments about market integrity and the creditworthiness of borrowers and counterparties.”). This is because the report thought “[t]he central public policy issue raised by the LTCM episode is how to constrain excessive leverage more effectively.” *Id.*

128. *See id.* at 30 (explaining that there was a breakdown in market discipline of lending practices during the LTCM situation).

threat to the financial system.<sup>129</sup> Nevertheless, these reports focused on improving public information about hedge funds through disclosure rather than calling for the exemptions for hedge funds in traditional securities laws to be amended or repealed.<sup>130</sup>

In response to these reports and the crash of LTCM, Congress proposed two bills that suggested information-gathering strategies to prevent another major hedge fund collapse, rather than direct regulation.<sup>131</sup> The first bill, the Hedge Fund Disclosure Act (1999 Disclosure Bill),<sup>132</sup> required “unregulated hedge funds” to submit certain information to the Board of Governors of the Federal Reserve System (Federal Reserve Board).<sup>133</sup> The bill defined an unregulated hedge fund as any private fund with \$3 billion or more in capital that was not registered under the Investment Company Act; this also included any family or group of pooled hedge funds with AUM of \$20 billion or more.<sup>134</sup> These unregulated hedge funds would have to make public quarterly reports including the funds’ total assets, derivatives positions, leverage ratios, and other measures of market risk identified by the Federal Reserve Board (and other government actors such as the SEC).<sup>135</sup> Hedge funds could request that some proprietary information, such as investment

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129. See LEDERMAN, *supra* note 4, § 3:3 (“The second study, conducted by the United States General Accounting Office (GAO), also focused on LTCM’s extensive leverage and its potential adverse impact on the financial system as a whole.”).

130. See Mota, *supra* note 38, at 63 (explaining that of the reports and recommendations that were issued in the aftermath of LTCM, none of them recommended “changes to . . . the exemptions for hedge funds under” traditional federal securities laws).

131. See LEDERMAN, *supra* note 4, § 3:3 (explaining that two bills came in response to LTCM’s collapse and the ensuing government studies).

132. See H.R. 2924, 106th Cong. (1999) [hereinafter 1999 Disclosure Bill] (proposing federal legislation that requires certain hedge funds to disclose specified information to the Board of Governors of the Federal Reserve System).

133. See *id.* § 4 (describing that unregulated hedge funds have to submit quarterly reports to the Federal Reserve Board).

134. See *id.* § 3(3) (providing the definition for unregulated hedge fund under the proposed legislation).

135. See *id.* § 4(a) (detailing the information that an unregulated hedge fund would have to provide to the Federal Reserve Board on a quarterly basis).

strategies, be kept confidential from the public.<sup>136</sup> Congress recognized that hedge funds had the potential to affect systemic risk, but it did not think direct regulation was the best option.<sup>137</sup> Still, the proposed legislation called for “reliable information about hedge fund activities”<sup>138</sup> to ensure that the government could prevent (or, if necessary, control) the collapse of any major hedge funds that could cause a “severe burden on the United States financial system.”<sup>139</sup>

The second bill introduced was the Derivatives Market Reform Act of 1999 (1999 Reform Bill).<sup>140</sup> It aimed to reduce systemic risk in the financial markets through “enhance[d] oversight over certain derivatives dealers and hedge funds.”<sup>141</sup> Titles I and II of the 1999 Reform Bill dealt largely with derivatives markets.<sup>142</sup> Title III, however, shared many of the same reporting requirements for certain hedge funds as the proposed 1999 Disclosure Bill.<sup>143</sup> The 1999 Reform Bill required quarterly reporting to the SEC for “unregistered hedge funds,” defined as “any pooled investment vehicle, or group or family of pooled investment vehicles, that has total AUM of \$1 billion or more,” and is not registered under the Investment Company Act.<sup>144</sup> Thus, the threshold for reporting was \$2 billion lower than

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136. *See id.* § 4(c) (explaining that a hedge fund may request that “proprietary information concerning investment strategies and positions” in a quarterly report “be segregated in a confidential section of the report which shall not be available to the public”).

137. *See id.* § 2 (stating that the congressional findings noted that hedge funds can potentially “pose a threat to the safety and soundness of the United States and international financial systems,” but “market forces, rather than government regulations, are the best tools for constraining hedge funds”).

138. *Id.* § 2(8).

139. *Id.* § 2(7).

140. *See* H.R. 3483, 106th Cong. (1999) [hereinafter 1999 Reform Bill] (“[A]mend[ing] federal securities laws to enhance oversight over certain derivatives dealers and hedge funds, reduce the potential for such entities to increase systemic risk in the financial markets, enhance investor protections, and other purposes.”).

141. *Id.*

142. *See id.* §§ 101, 201 (providing reform for federal securities laws dealing with certain derivatives dealers and broker-dealer oversight).

143. *See* LEDERMAN, *supra* note 4, § 3:3 (noting the similarities in the quarterly reporting requirements, for certain hedge funds, of the 1999 Reform Bill compared to those of the 1999 Disclosure Bill).

144. H.R. 3483, 106th Cong. § 301(k)(5)(A) (1999).



the 1999 Disclosure Bill, and it had no “family or group” of pooled hedge funds distinction. The quarterly reports would include detailed financial information and “[a] description of the models and methodologies that the pooled investment vehicle use[d] to calculate, assess, and evaluate market risk.”<sup>145</sup> This information would be made public by the SEC and shared amongst various federal agencies.<sup>146</sup> The 1999 Reform Bill also allowed hedge funds to request that information, such as trading strategies, be kept confidential.<sup>147</sup>

Ultimately, Congress did not enact either of the two bills.<sup>148</sup> The collapse of LTCM was soon regarded as a one-off that was unlikely to occur again.<sup>149</sup> Many saw LTCM as an outlier to the hedge fund industry and believed banks (and other lenders) had tightened their lending practices enough to avoid another such build-up of excessive leverage.<sup>150</sup> The hedge fund industry vowed to become more transparent to its investors, providing additional comfort that increased hedge fund regulation was unnecessary.<sup>151</sup> Although no direct regulation of hedge funds resulted from the collapse of LTCM, the situation sparked more serious debate for hedge fund regulation.<sup>152</sup>

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145. *Id.* § 301(k)(1)(A)–(F).

146. *See id.* § 301(k)(3) (describing the availability of the quarterly reports upon the SEC’s receipt under the 1999 Reform Bill).

147. *See id.* § 301(k)(4) (stating the procedures for the confidentiality of proprietary information under the 1999 Reform Bill).

148. *See* LEDERMAN, *supra* note 4, § 3:3 (noting that neither the 1999 Disclosure Bill nor the 1999 Reform Bill were enacted).

149. *See id.* (“As the events of 1998 receded in time, there was a growing appreciation that the facts surrounding LTCM were not representative of hedge funds in general.”).

150. *See id.* (explaining that in 1998 the International Monetary Fund and The President’s Working Group noted that banks, and other lenders, had improved their management of hedge fund exposures through better credit practices after the collapse of LTCM).

151. *See id.* (discussing how the “hedge fund industry itself responded with initiatives to improve risk management and provide greater transparency to investors”).

152. *See* Wagner, *supra* note 29, at 17 (suggesting that 2004 hedge fund regulation proposals were, in part, a result of reports and meetings that occurred after the collapse of LTCM).

*C. 2004: Push for Direct Hedge Fund Regulation*

The debate regarding hedge fund regulation did not seriously resurface until 2003 when the SEC called for a Hedge Fund Roundtable.<sup>153</sup> At that time, the technology bubble had burst and investors were looking for alternative ways to invest their money.<sup>154</sup> As a result, the SEC noticed that hedge funds were enjoying an influx of capital and the industry was growing.<sup>155</sup> This led to the rise of so-called “funds of funds,” which invest in a variety of different hedge funds to maintain exposure to the hedge fund industry while diversifying portfolio allocations.<sup>156</sup> The SEC became concerned that funds of funds could directly expose less wealthy—and often less-sophisticated—individual investors to hedge funds through public offerings.<sup>157</sup> The SEC acknowledged, however, most of these offerings were limited to institutional investors (pension funds, public companies, etc.).<sup>158</sup> Meanwhile, institutional investors also were investing more in general hedge funds, so less-sophisticated individual investors, who had invested in various institutional investors, were now being indirectly exposed to hedge funds.<sup>159</sup> And, in the

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153. See Mota, *supra* note 38, at 63 (noting that the SEC held a Hedge Fund Roundtable in 2003 to discuss the possibility of a hedge fund study).

154. See LEDERMAN, *supra* note 4, § 3:4 (noting that when the bull market of the 1990s came to an end, with the burst of the technology bubble, more investors looked to alternative investments, such as hedge funds).

155. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) [hereinafter 2004 Hedge Fund Rule] (noting that in 2003 the hedge fund industry assets had grown 30% in the previous year and 260% in the previous five years).

156. See SEC. & EXCH. COMM’N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 67 (2003) [hereinafter 2003 SEC REPORT], <http://www.sec.gov/news/studies/hedgefunds0903.pdf> (defining a fund of hedge funds as a “hedge fund that utilizes a multi-manager, multi-strategy approach by investing all, or a significant portion of its assets in hedge funds”).

157. See 2004 Hedge Fund Rule, 69 Fed. Reg. at 72,057 (noting “the development of ‘funds of hedge funds’ ha[d] made hedge funds more broadly available to investors” by 2003).

158. See *id.* (explaining that only institutional investors participated in the offerings of most funds of hedge funds in 2003).

159. See *id.* at 72,058 (explaining that in the few years before 2003, “a growing number of public and private pension funds, as well as universities, endowments, foundations, and other charitable organizations, ha[d] begun to invest in hedge funds or ha[d] increased their allocations to hedge funds”).

background of all of this, the SEC had seen an increase in their enforcement actions against fraudulent hedge fund advisers.<sup>160</sup>

By September 2003, the SEC issued a report called *Implications of the Growth of Hedge Funds* (2003 Report)<sup>161</sup> that recommended direct regulation of hedge funds through the Advisers Act based on various public policy concerns.<sup>162</sup> The 2003 Report cited the growth of hedge funds, growth in hedge fund fraud, and broader exposure to hedge funds as reasons for direct regulation.<sup>163</sup> The 2003 Report noted that prior SEC staff reports had studied the systemic risks posed by hedge funds, but this report chose to focus on “the growth and investor protection implications of hedge funds.”<sup>164</sup>

Accordingly, in 2004, the SEC promulgated a rule under the Advisers Act entitled the Registration Under the Advisers Act of Certain Hedge Fund Advisers (2004 Hedge Fund Rule).<sup>165</sup> The SEC cited the 2003 Report’s policy reasons for the administrative action.<sup>166</sup> The 2004 Hedge Fund Rule made changes to how an adviser could qualify for registration exemption under the Advisers Act.<sup>167</sup> Recall that hedge fund advisers were traditionally exempt from SEC registration under the Advisers Act if they managed less than fifteen clients—and prior to the

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160. See *id.* at 72,056 (stating that by 2003 the SEC had seen a “growth in the number of [SEC] hedge fund fraud enforcement cases”).

161. 2003 SEC REPORT, *supra* note 156.

162. See *id.* at 88 (noting that the 2003 Report’s primary recommendation to the SEC was to “consider mandating federal registration of hedge fund investment advisers under the Advisers Act” based on a variety of concerns).

163. See *id.* at 76–88 (outlining the growth of hedge funds, the growth in hedge fund fraud, and the broader exposure to hedge funds as reasons for recommending regulation of hedge funds under the Advisers Act to the SEC).

164. *Id.* at 3.

165. See 2004 Hedge Fund Rule, 69 Fed. Reg. 72,054, 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (stating that the SEC adopted the 2004 Hedge Fund Rule to require certain hedge funds to register with the SEC under the Advisers Act).

166. See *id.* at 72,055–059 (citing growth of hedge funds, growth in hedge fund fraud, and broader investor exposure to hedge funds as the primary reasons for promulgating the 2004 Hedge Fund Rule).

167. See 17 C.F.R. § 275.203(b)(3)-2(a) (2004), *invalidated by* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (requiring hedge funds to count “shareholders, limited partners, members, or beneficiaries” as clients for purposes of § 203(b)(3) of the Advisers Act).

2004 Hedge Fund Rule, hedge fund advisers could count each fund they managed as one client rather than counting every individual investor in each managed fund.<sup>168</sup> This enabled hedge fund advisers to manage fourteen separate funds, each with multiple investors, and still qualify for the private-adviser exemption under the Advisers Act.<sup>169</sup> The 2004 Hedge Fund Rule, however, required hedge fund advisers to “look-through” each of their managed funds and actually count every individual client in each fund.<sup>170</sup> Consequently, the 2004 Hedge Fund Rule required most hedge funds to register with the SEC by February 1, 2006.<sup>171</sup>

The SEC passed the 2004 Hedge Fund Rule by a narrow 3–2 vote.<sup>172</sup> The two dissenting SEC commissioners did not think registration under the Advisers Act was the best alternative and argued that the SEC should have “collected and analyzed the existing information [on hedge funds] and determined what new information would be useful before imposing mandatory registration.”<sup>173</sup> The dissent also suggested this was a misuse of the SEC’s already limited resources.<sup>174</sup> Not surprisingly, most hedge fund advisers were unhappy about having to register with the SEC, and it did not take long before a prominent hedge fund

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168. See *supra* notes 103–07 and accompanying text (discussing historical exemptions for hedge fund advisers under the Advisers Act).

169. See Verret, *supra* note 2, at 806 (noting that before the 2004 Hedge Fund Rule, “[e]ven the largest hedge fund managers usually ran fewer than fifteen hedge funds and were, therefore, exempt”).

170. See 2004 Hedge Fund Rule, 69 Fed. Reg. at 72,066 (requiring hedge fund advisers “to ‘look-through’ the funds to count the number of investors as ‘clients’ for purposes of the private-adviser exemption” under the Advisers Act).

171. See *Goldstein v. SEC*, 451 F.3d 873, 877 (D.C. Cir. 2006) (“The [2004 Hedge Fund Rule] had the effect of requiring most hedge fund advisers to register by February 1, 2006.”).

172. See Kaal, *supra* note 27, at 415 (“The [2004 Hedge Fund Rule] was eventually issued by a [3–2] vote . . .”). This was not a party-line vote as Chairman William H. Donaldson (Republican) joined Harvey J. Goldschmid (Democrat) and Roel C. Campos (Democrat) in favor of the 2004 Hedge Fund Rule. Cynthia A. Glassman (Republican) and Paul S. Atkins (Republican) dissented.

173. 2004 Hedge Fund Rule, 69 Fed. Reg. 72,054, 72,089 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

174. See *id.* at 72,090 (arguing that the 2004 Hedge Fund Rule would result in a misuse of the SEC’s limited resources).

manager challenged the regulation in court.<sup>175</sup> In *Goldstein v. SEC*,<sup>176</sup> on June 23, 2006, the Court of Appeals for the District of Columbia invalidated the look-through provision of the 2004 Hedge Fund Rule.<sup>177</sup> With the 2004 Hedge Fund Rule vacated, hedge fund managers reverted back to counting each fund they managed as one client to qualify for the private-adviser exemption under the Advisers Act.

After *Goldstein* vacated the 2004 Hedge Fund Rule, the SEC did not pursue an appeal. The SEC, however, remained focused on protecting hedge fund investors from fraudulent hedge fund advisers.<sup>178</sup> In 2007, instead of attempting another round of direct regulation, the SEC proposed<sup>179</sup> and adopted Rule 206(4)-8 (Hedge Fund Anti-Fraud Rule) under § 206 of the Advisers Act.<sup>180</sup> Specifically, the Hedge Fund Anti-Fraud Rule prevents hedge fund advisers from “making false or misleading statements to investors” or “otherwise defrauding” them.<sup>181</sup> The SEC noted that it “would not need to demonstrate that an adviser violating [the Hedge Fund Anti-Fraud Rule] acted with scienter [(knowledge or

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175. See Verret, *supra* note 2, at 809 (“In June of 2006, Philip Goldstein and his hedge fund Opportunity Partners L.P. challenged the SEC’s equation of ‘client’ with ‘investor’ in the new regulation.”).

176. See *Goldstein*, 451 F.3d 873, 884 (D.C. Cir. 2006) (holding the 2004 Hedge Fund Rule, requiring that investors in a hedge fund be counted as clients of the fund’s adviser for purposes of the private-adviser exemption from registration under the Advisers Act, was invalid).

177. See *id.* (vacating the 2004 Hedge Fund Rule).

178. See *Testimony Concerning the Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 109th Cong. 9 (2006) (statement of Christopher Cox, Chairman, SEC) (recommending that the SEC promulgate an anti-fraud rule under the Investment Advisers Act after the decision in *Goldstein*).

179. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 400 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230, 275) (proposing an anti-fraud rule that would affect all hedge fund advisers).

180. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,756 (Aug. 9, 2007) (to be codified at 17 C.F.R. pt. 275) [hereinafter Hedge Fund Anti-Fraud Rule] (adopting an anti-fraud rule that “prohibits advisers to [hedge funds] from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those [hedge funds]”).

181. *Id.* For the full codification of the SEC’s Hedge Fund Anti-Fraud Rule, see 17 C.F.R. § 275.206(4)-8 (2011).

intent to deceive, manipulate, or defraud)].<sup>182</sup> The SEC decided that using a negligence standard for determining the liability of fraudster hedge fund advisers is appropriate under the Hedge Fund Anti-Fraud Rule.<sup>183</sup> Furthermore, the Rule extends to all hedge fund advisers, including those exempt from SEC registration.<sup>184</sup> The Hedge Fund Anti-Fraud Rule, therefore, has a lower standard than the “catch-all” anti-fraud securities rule under the Exchange Act, Rule 10b-5, which requires scienter for liability.<sup>185</sup> Although the SEC did not ultimately prevail with direct adviser registration through the 2004 Hedge Fund Rule, the Hedge Fund Anti-Fraud Rule is a serious disincentive for fraudulent activity by hedge fund advisers.

#### *IV. Direct Hedge Fund Regulation under Title IV (PFIARA) of the Dodd–Frank Act*

Part IV.A looks at the basics of the Financial Crisis and the role hedge funds played in it. Part IV.B details the implications of the enactment of Title IV of the Dodd–Frank Act (PFIARA).

##### *A. Two Failed Hedge Funds Kick-Off Financial Crisis*

Although the causes of the Financial Crisis are myriad and complex (and largely beyond the scope of this Note), the general background of the crisis will help shed light on hedge fund regulation under the Dodd–Frank Act. By 2006, there was a flood of capital into the U.S. real estate market because of low interest rates and investor optimism surrounding “seemingly ever-rising housing prices.”<sup>186</sup> Through securitization, which “involves

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182. Hedge Fund Anti-Fraud Rule, 72 Fed. Reg. at 44,759.

183. *See id.* at 44,759 (“[The SEC] believe[s] use of a negligence standard also is appropriate as a method reasonably designed to prevent fraud.”).

184. *See id.* at 44,758 (“[The Hedge Fund Anti-Fraud Rule] applies to both registered and unregistered investment advisers.”).

185. *Tellabs, Inc. v. Makor Issues & Rights, Inc.*, 551 U.S. 308, 318 (2007) (“To establish liability under § 10(b) [of the Exchange Act] and Rule 10b-5, a private plaintiff must prove that the defendant acted with scienter, a mental state embracing intent to deceive, manipulate, or defraud.”) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193–94 (1976)).

186. BAINBRIDGE, *supra* note 6, at 4.

pooling income-generating assets and then selling interests in the pool that derive their value from those underlying assets,”<sup>187</sup> a broad range of investors became exposed to mortgage-backed securities (MBSs).<sup>188</sup> In MBSs, mortgages (the underlying, income-generating asset) are pooled together and then investors can buy securities representing claims to the underlying income stream.<sup>189</sup>

Banks used credit enhancements for MBSs, such as guarantees covering defaulting mortgages in the pool, to encourage investor confidence.<sup>190</sup> Banks also hired credit-rating agencies to rate the securities for marketing purposes.<sup>191</sup> The credit-rating agencies rated the MBSs using models that assumed the U.S. housing market would continually rise and mortgage default rates would remain low.<sup>192</sup> This led to more investors exposing themselves to what they thought was a low-risk, always appreciating U.S. housing market. As demand for MBS-type investments increased, “more complex pools-of-pools (collateralized debt obligations, or CDOs)—and even pools-of-pools-of-pools (so called CDO squared)—emerged.”<sup>193</sup> And, as money rolled into the housing market, banks “started to lend heavily to subprime mortgage borrowers with weak credit ratings” to sustain the process.<sup>194</sup>

By 2007, mortgage defaults increased, for a variety of reasons, and these MBSs (and CDOs) began to rapidly lose

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187. Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 313 (2011).

188. *See id.* at 314 (“Between 1996 and 2007 the stock of outstanding securitized credit in the United States would expand almost five-fold . . .”).

189. *See* CHOI & PRITCHARD, *supra* note 65, at 164 (describing a general asset-backed security).

190. *See* Bruner, *supra* note 187, at 313 (explaining that mortgage-backed securities (MBSs) were “often bolstered by credit enhancements, including guarantees obligating the sponsoring bank to cover defaulting mortgages in the pool”).

191. *See* ROBERT C. POZEN, *TOO BIG TO SAVE?* 49 (2010) (noting that banks hired credit-rating agencies to analyze and rate MBSs in order to be competitive with other securities).

192. *See* Bruner, *supra* note 187, at 314 (discussing how credit ratings for MBSs “were built on quantitative models assuming low default rates and rising home values”).

193. *Id.* at 313.

194. BAINBRIDGE, *supra* note 6, at 4.

value.<sup>195</sup> Consequently, credit-rating agencies downgraded many of their ratings for MBSs because their underlying assumptions proved misguided.<sup>196</sup> Because many hedge funds and banks had taken large positions in MBSs and CDOs, this created systemic risk.<sup>197</sup> At the same time, many investors had participated in credit default swaps.<sup>198</sup> A credit default swap—in which one party agrees to pay the principal amount if a home mortgage defaults in exchange for a stream of payments from the counterparty—is supposed to serve a risk-hedging function for MBSs in case of default (almost like insurance).<sup>199</sup> Nevertheless, many hedge funds (and other investors) used credit default swaps for speculative purposes to profit from the defaulting MBSs and declining housing market.<sup>200</sup> When the housing market crashed, however, many of these credit default swaps became worthless because counterparties could not pay the large volume of credit default swaps coming due at one time.<sup>201</sup> Thus, without a hedge for the toxic mortgage-backed investments that so many financial institutions held, a domino effect of financial crisis spread across the United States.<sup>202</sup>

Notably, the systemic risk implications of the housing market, and the involvement of hedge funds in the crisis, came to

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195. See *id.* (explaining that in 2006 and 2007 “mortgage defaults increased significantly” and “[t]he resulting deterioration in mortgage performance adversely affected mortgage-backed securities and their more complicated variants”).

196. See POZEN, *supra* note 191, at 60 (explaining that as subprime mortgages began to default, the credit-rating agencies downgraded the ratings of many MBSs).

197. See CHOI & PRITCHARD, *supra* note 65, at 166 (“The correlated positions of banks and hedge funds in CDOs and MBSs created systemic risk.”).

198. See Bruner, *supra* note 187, at 314 (noting that “outstanding credit default swaps—derivative contracts equally suitable for hedging risks on mortgage-related securities and speculating against them—literally skyrocketed” between 2001 and 2007).

199. See CHOI & PRITCHARD, *supra* note 65, at 166 (describing a general credit default swap and its typical uses).

200. See *supra* note 198 and accompanying text (explaining that credit default swaps can be used for speculative as well as hedging purposes).

201. See CHOI & PRITCHARD, *supra* note 65, at 166–67 (explaining that when the housing market declined, “the web of credit default swaps started to unravel” and many credit default swaps became essentially worthless).

202. See *id.* at 167 (discussing that when many banks and other institutions could no longer hedge against the deteriorating MBSs, the crisis spread).



the forefront in July 2007.<sup>203</sup> At that point, two Bear Stearns hedge funds “that had invested heavily in CDOs failed.”<sup>204</sup> In March 2008, Bear Stearns was bailed out when the government orchestrated a buyout by J.P. Morgan.<sup>205</sup> Bear Stearns’s failure, sparked by the collapse of two of its hedge funds, was the beginning of an economic contagion that infected the United States.<sup>206</sup>

Soon more serious systemic risk consequences came to light as a result of the massive amount of leverage in the financial system, “particularly among investment banks and hedge funds.”<sup>207</sup> When financial institutions began suffering huge losses because of deteriorating MBSs, many institutions had to sell liquid assets to maintain required leverage ratios.<sup>208</sup> Because banks and other institutions needed cash on their balance sheets, they began “calling outstanding loans of hedge funds and other institutional investors.”<sup>209</sup> Many of these hedge funds were highly leveraged, so they also had to sell liquid assets to pay the banks.<sup>210</sup> Furthermore, “credit became scarce and interest rates soared on short-term debt” because banks were hesitant to lend in the midst of so much financial uncertainty.<sup>211</sup>

This created a ripple effect in which financial entities began selling liquid assets for cash, especially publicly-traded stocks.<sup>212</sup>

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203. See BAINBRIDGE, *supra* note 6, at 4 (noting that in “July 2007, two Bear Stearns hedge funds that had invested heavily in CDOs failed”); see also Beville et. al., *supra* note 7, at 855–56 (noting that “systemic implications became apparent as large subprime lenders warned of significant losses” and when “Merrill Lynch seized \$400 million in assets of a Bear Stearns fund that incurred heavy losses in mortgage-backed investments”).

204. BAINBRIDGE, *supra* note 6, at 4.

205. See *id.* (“An ad hoc government rescue was hurriedly put in place, culminating in JP Morgan’s acquisition of Bear Stearns.”).

206. See *supra* note 7 and accompanying text (noting that the collapse of the Bear Stearns hedge funds signaled the beginning of the Financial Crisis).

207. POZEN, *supra* note 191, at 122.

208. See *id.* at 123 (explaining that losses in MBSs forced financial institutions to sell assets to maintain required leverage ratios).

209. *Id.* at 122.

210. See *id.* (noting that because hedge funds were highly leveraged, they also were forced to sell assets in order to pay the banks calling outstanding loans).

211. *Id.* at 123.

212. See *id.* at 122 (“Since the markets for corporate bonds and asset-backed

This process, known as “deleveraging,” creates a cycle in which firms “sell assets, [and] prices decline in response to the increased supply, creating further losses and potentially requiring additional selling.”<sup>213</sup> Ultimately, the crisis in the housing market spread to the capital markets, and the U.S. stock market plummeted by over 38% in 2008.<sup>214</sup> With systemic risk consequences in full effect, the Financial Crisis developed into one of the worst recessions in the United States’ history.<sup>215</sup>

### *B. Dodd–Frank Title IV (PFIARA)*

In response to the Financial Crisis, Congress passed the Dodd–Frank Act to promote financial stability in the United States.<sup>216</sup> One of the primary ways the Dodd–Frank Act seeks to provide this stability is by monitoring financial markets for systemic risks.<sup>217</sup> Importantly, Congress established the FSOC<sup>218</sup> to identify systemic risks and “respond to emerging threats” to the U.S. financial system.<sup>219</sup> In light of these goals, and to fill what many saw as a regulatory gap, Title IV of the Dodd–Frank Act (PFIARA) was enacted to regulate hedge funds directly.<sup>220</sup>

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securities were frozen, the sellers turned to their most liquid holdings—publicly traded stocks.”).

213. *Id.* at 123.

214. *Id.*

215. *See* BAINBRIDGE, *supra* note 6, at 5 (noting that the “economy sank into the deepest recession in decades” because of the Financial Crisis).

216. *See* Dodd–Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010) (codified as amended in scattered sections of the U.S.C.) (stating the Dodd–Frank Act was enacted to “promote the financial stability of the United States”).

217. *See, e.g., id.* § 403, 124 Stat. at 1571–72 (codified as amended at 15 U.S.C. § 80b-4) (establishing a system in which the SEC can require certain private fund advisers to report information for the assessment of systemic risk by the Financial Stability Oversight Council (FSOC)).

218. *See id.* § 111, 124 Stat. at 1392–93 (codified as amended at 15 U.S.C. § 5321) (establishing the FSOC).

219. *Id.* § 112(a), 124 Stat. at 1394–95 (codified as amended at 15 U.S.C. § 5322).

220. *See id.* § 403, 124 Stat. at 1571 (codified as amended at 15 U.S.C. § 80b-3) (eliminating the private-adviser exemption under the Advisers Act that most hedge funds relied on to avoid SEC registration).

### 1. *What Is the Point of the PFIARA?*

The PFIARA has two goals: (i) to provide better protection to private fund investors from private fund advisers; and (ii) to assess systemic risk posed by private funds.<sup>221</sup> The PFIARA primarily aims to further the first goal by amending adviser registration and reporting requirements under the Advisers Act.<sup>222</sup> The second goal is to be accomplished by requiring registered advisers to file certain information with the SEC that the FSOC can then use to assess systemic risk.<sup>223</sup> The PFIARA defines a private fund as an investment fund that falls under the Investment Company Act (but for any exemptions under the Investment Company Act).<sup>224</sup> The SEC makes clear that this definition includes hedge funds.<sup>225</sup>

### 2. *Who Has to Register Under the Advisers Act Because of the PFIARA?*

The PFIARA requires all hedge fund advisers to register under the Advisers Act unless exempted.<sup>226</sup> Notably, the PFIARA eliminates the private-adviser exemption under the Advisers Act

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221. See H.R. REP. NO. 111-57, at 866 (2010), <http://www.gpo.gov/fdsys/pkg/CRPT-111hrpt517/pdf/CRPT-111hrpt517.pdf> (stating Title IV of the Dodd–Frank Act “expands the advisers’ reporting requirements to the SEC as necessary or appropriate in the public interest and for the protection of investors or for the assessment of risk by the FSOC”).

222. See Dodd–Frank Act, Pub. L. No. 111-203, §§ 403–404, 124 Stat. 1376, 1571–74 (2010) (codified as amended in scattered sections of 15 U.S.C.) (amending adviser registration and reporting requirements under the Advisers Act).

223. See *id.* § 404, 124 Stat. at 1571–74 (codified as amended at 15 U.S.C. § 80b-3) (requiring private fund advisers registered under the Advisers Act to submit certain information to the SEC that the FSOC can use to assess systemic risk).

224. See *id.* § 402(a)(29), 124 Stat. at 1570 (codified as amended at 15 U.S.C. § 80b-2) (defining private fund under the PFIARA).

225. See Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA 3222, at 3 (June 22, 2011) [hereinafter SEC Exemptions Release] (“Private funds include hedge funds . . .”).

226. See Dodd–Frank Act § 403, 124 Stat. at 1571–74 (codified as amended at 15 U.S.C. § 80b-3) (providing the exemptions for hedge fund adviser registration under the Advisers Act).

that hedge fund advisers traditionally relied on to avoid SEC registration.<sup>227</sup> Instead, the PFIARA sets out a narrow list of exemptions, so that more private fund advisers have to register with the SEC.<sup>228</sup> The first exemption for adviser registration includes any private fund adviser who manages solely private funds and has AUM less than \$150 million.<sup>229</sup> Thus, if a hedge fund adviser manages more than \$150 million in assets, regardless of the number of clients in the fund(s), she must register with the SEC under the Advisers Act. States will have responsibility for hedge fund advisers with AUM between \$25 million and \$100 million.<sup>230</sup> The determination of AUM is to be made annually.<sup>231</sup>

The second exemption is for “family office” funds as defined by the SEC.<sup>232</sup> A family office fund cannot have clients other than “family clients.” Family clients include current and former family members, certain key employees of the family office, charities funded exclusively by family clients, and other entities as deemed appropriate by the SEC.<sup>233</sup> These funds must be exclusively controlled by one or more family members and wholly owned by family clients.<sup>234</sup> The SEC notes that the premise behind the

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227. See *id.* (eliminating the private-adviser exemption under the Advisers Act).

228. See SEC Exemptions Release, *supra* note 225, at 3 (“The primary purpose of Congress repealing § 203(b)(3) [of the Advisers Act] was to require advisers of ‘private funds’ to register under the Advisers Act.”).

229. See Dodd–Frank Act, Pub. L. No. 111-203, § 408, 124 Stat. 1376, 1571–74 (2010) (codified as amended at 15 U.S.C. § 80b-3) (explaining an exemption from registration for private fund advisers managing solely private funds and with AUM less than \$150 million).

230. See *id.* § 410, 124 Stat. at 1576–77 (codified as amended at 15 U.S.C. § 80b-3a) (providing the assets threshold for federal registration of investment advisers).

231. See SEC Exemptions Release, *supra* note 225, at 90 (stating that an adviser must “annually calculate the amount of private fund assets it manages”).

232. See Dodd–Frank Act § 409, 124 Stat. at 1575–76 (codified as amended at 15 U.S.C. § 80b-2) (providing the adviser registration exemption for family office funds).

233. See Family Offices, Release No. IA 3220, at 6 (June 22, 2011) (defining the term family client under the family office fund adviser registration exemption).

234. See *id.* at 30 (outlining the family ownership and control requirements for a private fund to qualify for the family office exemption under the Advisers

family office fund exemption is “to allow families to manage their own wealth.”<sup>235</sup> Interestingly, the SEC takes the approach that key employees can participate in family funds, without registering under the Advisers Act, because their position and experience enable them to protect themselves as investors.<sup>236</sup> Furthermore, exempting key employees allows family office funds to attract talented investment professionals.<sup>237</sup> The family office fund exemption, therefore, allows families (and key employees) to manage hedge funds, regardless of AUM, without having to register with the SEC.

The third exemption is for qualifying venture capital funds’ advisers.<sup>238</sup> The venture capital fund must fit into a narrow set of criteria to avail its adviser(s) of this exemption.<sup>239</sup> To be exempt as a venture capital fund adviser, the private fund must generally limit leverage, represent itself as pursuing a venture capital strategy to its investors, and not offer redemption rights to investors (among other criteria).<sup>240</sup> Because of its narrow language, virtually no hedge funds will qualify for the venture capital fund exemption. The final exemption, for certain foreign private advisers, is extremely narrow and beyond the scope of this Note.<sup>241</sup>

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Act).

235. *Id.* at 28.

236. *See id.* at 23–30 (discussing the SEC’s rationale for allowing key employees to be included in family office funds).

237. *See id.* at 28 (explaining that permitting key employees in family office funds “allows family offices to attract talented investment professionals”).

238. *See* Dodd–Frank Act, Pub. L. No. 111-203, § 407, 124 Stat. 1376, 1574–75 (2010) (codified as amended at 15 U.S.C. § 80b-3) (outlining the adviser exemption for certain venture capital fund advisers).

239. *See id.* (stating the venture capital fund adviser exemption criteria will be promulgated by the SEC).

240. *See* SEC Exemptions Release, *supra* note 225, at 9–72 (providing a full summary of the criteria required for the venture capital fund adviser exemption).

241. *See* Dodd–Frank Act § 403, 124 Stat. at 1571–74 (codified as amended at 15 U.S.C. § 80b-3) (providing an adviser exemption for certain foreign private advisers). To qualify for the foreign private-adviser exemption, a hedge fund adviser must have AUM less than \$25 million (among other criteria). *Id.* Because this threshold is so narrow, this exemption is unlikely to have any significant effect on systemic risk.

### 3. PFIARA Goal 1: How Will Investor Protection Be Furthered?

As mentioned, the PFIARA's first goal aims to provide greater investor protection by amending adviser registration and reporting requirements under the Advisers Act.<sup>242</sup> Because hedge fund advisers managing over \$150 million now have to register under the Advisers Act, they have to file Form ADV with the SEC. Form ADV is the form used by investment advisers to register with the SEC.<sup>243</sup> The SEC states that the data collected from Form ADV is used "to protect investors" and "to create risk profiles of investment advisers."<sup>244</sup>

Form ADV, divided into Part One and Part Two, is updated by the registered investment adviser at the end of each year (some information requires more frequent updating).<sup>245</sup> Part One requires information about the investment adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its employees (in addition to other information).<sup>246</sup> Part Two requires registered advisers to provide new and prospective clients with a brochure and brochure supplements containing most of the information required in Form ADV's Part One.<sup>247</sup> All of the information disclosed under Form ADV is fully available to the public.<sup>248</sup>

Interestingly, the SEC now requires all exempt private funds to file Part One of Form ADV as well.<sup>249</sup> And, even though the

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242. See *supra* notes 221–22 and accompanying text (discussing investor protection as a goal of the PFIARA).

243. See *Form ADV*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/formadv.htm> (last visited Feb. 3, 2013) ("Form ADV is the uniform form used by investment advisers to register with both the SEC and state securities authorities.") (on file with the Washington and Lee Law Review).

244. Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA 3221, at 54 (June 22, 2011) [hereinafter SEC Implementing Release].

245. See *id.* at 16 (describing when a registered adviser must update Form ADV).

246. See *Form ADV*, *supra* note 243 (explaining the general requirements of Form ADV's Part One).

247. See *id.* (explaining the general requirements of Form ADV's Part Two).

248. See SEC Implementing Release, *supra* note 244, at 49 (stating that all information contained in Form ADV and filed with the SEC is to be made available to the public).

249. See *id.* at 40 (explaining exempt reporting advisers still have to report

adviser is exempt from registration, the disclosed information is available to the public.<sup>250</sup> The SEC explains that “Congress gave [it] broad authority under §§ 203(l) and 203(m) of the Advisers Act to require exempt reporting advisers to file reports as necessary or appropriate in the public interest or for the protection of investors.”<sup>251</sup> The SEC thinks public reporting requirements will “provide a level of transparency that will help [it] to identify practices that may harm investors, will aid investors in conducting their own due diligence, and will deter advisers’ fraud and facilitate earlier discovery of potential misconduct.”<sup>252</sup>

The SEC plans to monitor the data collected from Form ADV and then conduct “examinations” on advisers that raise red flags.<sup>253</sup> In an examination, the SEC checks the adviser’s books and records for conflicts of interest and other misconduct. Although exempt and registered advisers are subject to examinations, former SEC Chairman Mary Schapiro stated that the SEC does “not intend to conduct routine examinations” of exempt reporting advisers because “[a]s many observers know, the [SEC] has scarce resources and it is important therefore that [it] target those resources toward the advisers actually registered.”<sup>254</sup>

#### 4. PFIARA Goal 2: How Will the Systemic Risks of Private Funds Be Assessed?

The second goal of the PFIARA, the assessment of systemic risk posed by hedge funds, is to be accomplished through a

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information on Part One of Form ADV).

250. See *supra* note 248 and accompanying text (discussing the public availability of information reported with Form ADV).

251. SEC Implementing Release, *supra* note 244, at 110.

252. *Id.* at 49–50.

253. See *id.* at 117 (noting that the information from Form ADV will allow the SEC “to conduct targeted examinations of private fund advisers”).

254. Mary Schapiro, Chairman, Sec. & Exch. Comm’n, Opening Statement at SEC Open Meeting: Dodd–Frank Act Amendments to the Investment Advisers Act (June 22, 2011), available at <http://www.sec.gov/news/speech/2011/spch062211mls-items-1-2.htm>.

collection of data for the FSOC to assess.<sup>255</sup> The SEC will collect this data using the newly created Form PF.<sup>256</sup> The SEC requires all registered hedge fund advisers under the Advisers Act to file Form PF.<sup>257</sup> The SEC, however, has differentiated reporting requirements based on whether the hedge fund adviser is a “Small Private Fund Adviser” or a “Large Private Fund Adviser.”<sup>258</sup> A Small Private Fund Adviser of a hedge fund has AUM between \$150 million and \$1.5 billion.<sup>259</sup> A Large Private Fund Adviser of a hedge fund has AUM over \$1.5 billion.<sup>260</sup> Form PF is divided into four sections, but only Section 1 and Section 2 apply to hedge funds.<sup>261</sup>

All registered hedge fund advisers (Large and Small Private Fund Advisers) must fill out Section 1 of Form PF.<sup>262</sup> Section 1a requires registered hedge fund advisers to provide basic information about any hedge funds they manage.<sup>263</sup> Section 2b asks for more detailed information about each fund, such as each fund’s gross and net assets, the aggregate value of its derivatives positions, and its use of leverage.<sup>264</sup> This section also asks for the “percentage of the fund’s equity held by the five largest equity holders.”<sup>265</sup> The SEC says Section 1b “is designed to allow the

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255. See *supra* notes 221–23 and accompanying text (discussing the goals of the PFIARA).

256. See Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF, Release No. IA 3308, at 7 (October 31, 2011) [hereinafter Form PF Release] (stating that registered advisers must submit Form PF to the SEC to satisfy systemic risk reporting requirements under the PFIARA).

257. See *id.* at 18 (describing which investment advisers must file Form PF).

258. See *id.* at 20–21 (differentiating adviser reporting requirements for Form PF based on the size of the hedge fund).

259. See *id.* at 21 (explaining the Small Private Fund Adviser threshold under Form PF).

260. See *id.* (explaining the Large Private Fund Adviser threshold under Form PF).

261. See *id.* at 20–21 (noting which sections of Form PF are applicable to hedge funds).

262. See *id.* at 63 (stating that all registered hedge funds are required to fill out Section 1 of Form PF).

263. See *id.* at 63–65 (outlining information required by Section 1a of Form PF).

264. See *id.* (outlining information required by Section 1b of Form PF).

265. *Id.* at 65–66.



FSOC to monitor certain systemic risks for the broader private fund industry.”<sup>266</sup> The final part of Section 1, Section 1c, gathers data on each separate hedge fund managed by the adviser, such as “each fund’s investment strategies and the percentage of the fund’s assets managed using high-frequency trading strategies.”<sup>267</sup> In addition, advisers have to identify each hedge fund’s top trading counterparties and information on trading and clearing practices.<sup>268</sup> The SEC states Section 1c is “designed to enable FSOC to monitor systemic risk that could be transmitted through counterparty exposure, track how different trading strategies are affected by and correlated with market stresses, and follow the extent of private fund activities conducted away from regulated exchanges and clearing systems.”<sup>269</sup>

Section 2 of Form PF requires information solely from Large Private Fund Advisers of hedge funds (AUM greater than \$1.5 billion).<sup>270</sup> The SEC tailored Section 2 to acquire additional data focused on “relevant areas of financial activity that have the potential to raise systemic concerns.”<sup>271</sup> Section 2a requires Large Private Fund Advisers of hedge funds to give very detailed reports on the value of “assets invested (on a short and long basis) in different types of securities and commodities (e.g., different types of equities, fixed income securities, derivatives, and structured products).”<sup>272</sup> The SEC believes this will help the FSOC monitor different asset classes typically held by hedge funds and show trends in hedge funds’ exposures.<sup>273</sup> Section 2b requires further disclosure on each separate hedge fund managed with a net asset value over \$500 million at the end of any month in the prior fiscal quarter.<sup>274</sup> Advisers must disclose information such as portfolio liquidity, large institutional positions, posting of

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266. *Id.* at 73.

267. *Id.* at 74–75.

268. *See id.* (describing information required by Section 1c of Form PF).

269. *Id.* at 76.

270. *See id.* at 21 (explaining large hedge fund advisers must complete Section 2 of Form PF).

271. *Id.* at 77.

272. *Id.* at 78.

273. *See id.* at 82 (explaining the rationale behind Section 2a of Form PF).

274. *See id.* at 83 (describing the requirements of Section 2b of Form PF).

collateral by counterparties, leverage, and internal risk assessments.<sup>275</sup>

Large Private Fund Advisers have a quarterly reporting requirement, and Small Private Fund Advisers only have to make annual reports.<sup>276</sup> The SEC designed the Large Private Fund Adviser threshold for hedge funds to gather more systemic risk information on a substantial portion of assets in the hedge fund industry.<sup>277</sup> The SEC estimates that the \$1.5 billion threshold will capture “over 80% of the U.S. hedge fund industry.”<sup>278</sup> Comparatively, Small Private Fund Advisers of hedge funds have to report less information, less frequently, than Large Private Fund Advisers. This is because, from a systemic risk monitoring perspective, the SEC does not think additional information or more frequent reporting is justified for hedge funds smaller than \$1.5 billion.<sup>279</sup>

All of the information gathered in Form PF is to remain confidential because of its proprietary and sensitive nature.<sup>280</sup> The information, however, may be shared with other federal departments, agencies, or self-regulatory organizations within the scope of their jurisdiction, subject to confidentiality agreements.<sup>281</sup> The SEC said it will also coordinate with foreign financial regulators using the Form PF data.<sup>282</sup> The SEC promises to adopt controls and systems to protect the confidentiality of the collected information.<sup>283</sup>

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275. *See id.* at 83–97 (providing a full summary of Section 2b reporting requirements under Form PF).

276. *See id.* at 50 (stating the frequency of reporting for Form PF based on hedge fund size).

277. *See id.* at 31 (explaining the rationale behind the Large Private Fund Adviser threshold for hedge funds on Form PF).

278. *Id.* at 31. This is 2011 data that comes from a hedge fund industry survey that the SEC has access to called HedgeFund Intelligence. *Id.*

279. *See id.* at 54 (explaining the rationale behind the smaller hedge fund adviser reporting requirement on Form PF).

280. *See id.* at 112 (explaining the rationale behind keeping information gathered from Form PF confidential).

281. *See id.* (discussing entities that the Dodd–Frank Act allows Form PF data to be shared with).

282. *See id.* at 11 (noting that the Dodd–Frank Act “states that FSOC shall coordinate with foreign financial regulators in assessing systemic risk”).

283. *See id.* at 115 (explaining potential controls and systems that the SEC may use to protect the confidentiality of Form PF data).

Ultimately, the SEC gives the acquired data to the FSOC.<sup>284</sup> The FSOC uses the data to monitor hedge fund activities and trends in the hedge fund industry that relate to systemic risk.<sup>285</sup> The FSOC interprets the data and decides whether hedge funds' activities or trends "could create or increase the risk of significant liquidity, credit, or other problems spreading" across U.S. financial markets.<sup>286</sup> Then, the FSOC can make recommendations to applicable regulatory agencies to "apply new or heightened standards and safeguards for a financial activity or practice" that is causing systemic risk.<sup>287</sup> Also, if the FSOC finds that a particular hedge fund—based on "the nature, scope, size, scale, concentration, interconnectedness, or mix of activities" of the hedge fund—poses a systemic threat to the financial stability of the United States, it can require the Federal Reserve Board to supervise the hedge fund.<sup>288</sup>

### V. *Analysis and Recommendations*

Part V of this Note provides a final analysis of hedge fund regulation after the enactment of the PFIARA. Part V.A analyzes whether hedge fund adviser registration under the Advisers Act is necessary in light of the PFIARA's goals. Part V.B provides recommendations for hedge fund regulation going forward.

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284. See Dodd–Frank Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376, 1571–74 (2010) (codified as amended at 15 U.S.C. § 80b-4) (stating that the SEC must collect information related to the assessment of systemic risk from certain private investment funds and provide that information to the FSOC).

285. See *id.* § 112(a), 124 Stat. at 1394–96 (codified as amended at 12 U.S.C. § 5322) (detailing the purposes and duties of the FSOC).

286. *Id.* § 120(a), 124 Stat. at 1408–09 (codified as amended at 12 U.S.C. § 5330).

287. *Id.*

288. *Id.* § 113(a)(1), 124 Stat. at 1398 (codified as amended at 12 U.S.C. § 5323).

*A. Is Hedge Fund Adviser Registration Necessary in Light of the PFIARA?*

This section analyzes whether hedge fund adviser registration under the Advisers Act is necessary in light of the PFIARA's two goals: hedge fund investor protection and hedge fund systemic risk assessment.<sup>289</sup> This Note argues that hedge fund adviser registration is unnecessary because the PFIARA's goals can be met without it. Thus, resources are being wasted from the perspective of the hedge fund industry and the SEC.

*1. Hedge Fund Adviser Registration Is Unnecessary for Investor Protection*

At first blush, the PFIARA's hedge fund adviser registration requirements do not seem particularly onerous. Much of the proprietary information that hedge fund advisers have to disclose will not be reported on Form ADV.<sup>290</sup> Instead, items like trading strategies and asset positions will be reported on Form PF and kept confidential.<sup>291</sup> Passed after a moment of crisis, the PFIARA integrated hedge fund adviser registration into the Dodd–Frank Act—an Act largely concerned with controlling systemic risks to avoid a national financial meltdown.<sup>292</sup> Thus, the issue becomes whether adviser registration, from an investor protection standpoint, squares with the core goals of the Dodd–Frank Act and whether adviser registration is even necessary in the hedge fund industry.

The Advisers Act “is mainly a registration and anti-fraud statute.”<sup>293</sup> There is nothing to suggest, however, that hedge funds' involvement in the Financial Crisis stemmed from fraudster hedge fund advisers. Although the SEC states hedge

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289. See *supra* note 221 and accompanying text (stating the two goals of the PFIARA).

290. See *supra* Part IV.B.3 (discussing reporting information required by Form ADV).

291. See *supra* Part IV.B.4 (same).

292. See *supra* notes 216–20 and accompanying text (discussing the goals of the Dodd–Frank Act and the circumstances surrounding its enactment).

293. *Goldstein v. SEC*, 451 F.3d 873, 876 (D.C. Cir. 2006).

fund investor protection is a goal of the PFIARA, it does not offer any evidence that hedge fund adviser fraud played a key role in the Financial Crisis.<sup>294</sup> As discussed, many academics are reluctant to state (with certainty) the exact part hedge funds had in the Financial Crisis.<sup>295</sup> But many academics agree that hedge funds contributed to the systemic risk consequences that resulted in (and from) the Financial Crisis.<sup>296</sup> For example, many suggest that some hedge funds speculated against deteriorating MBSs by using credit default swaps, other hedge funds invested heavily in toxic CDOs (Bear Stearns), and many hedge funds played a large role in the deleveraging process of the financial system that further intensified the crisis.<sup>297</sup> Nonetheless, it has not been proposed that hedge fund adviser fraud played a key role in the Financial Crisis.

Recall, in 2007, the SEC passed the Hedge Fund Anti-Fraud Rule, which provides a route for the SEC to bring actions against fraudster hedge fund advisers using a negligence standard.<sup>298</sup> The Hedge Fund Anti-Fraud Rule, therefore, has a lower standard for liability than Rule 10b-5 under the Exchange Act.<sup>299</sup> Furthermore, after the crash of LTCM, hedge funds vowed to provide their investors with more transparency.<sup>300</sup> Since then, investors and counterparties to hedge funds “demand, and usually receive, disclosure to the extent it helps them assess the merits of their investments.”<sup>301</sup> In addition, the SEC now requires

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294. The SEC does not offer any evidence that hedge fund adviser fraud related to the Financial Crisis in its Implementing Release, the SEC Exemptions Release, or the SEC Study on Enhancing Investment Adviser Examinations following the Financial Crisis and the enactment of the Dodd-Frank Act.

295. *See supra* note 2 and accompanying text (acknowledging that hedge funds’ involvement in the Financial Crisis is not fully understood).

296. *See supra* Part IV.A (analyzing the roles, of which many academics agree, hedge funds played in the Financial Crisis).

297. *See supra* Part IV.A (analyzing the roles, of which many academics agree, hedge funds played in the Financial Crisis).

298. *See supra* notes 178–83 and accompanying text (discussing the SEC’s promulgation of the Hedge Fund Anti-Fraud Rule).

299. *See supra* note 185 and accompanying text (discussing Rule 10b-5’s liability standard).

300. *See supra* note 151 and accompanying text (explaining how the hedge fund industry vowed greater transparency to investors after the crash of LTCM).

301. Schwartz, *supra* note 122, at 218.

exempt hedge fund advisers under the Advisers Act to file certain information about each fund they manage on Form ADV.<sup>302</sup> This information is publicly available, and the SEC suggests that it will provide investors with more transparency and deter adviser fraud.<sup>303</sup>

The hedge fund industry also, from an investor protection standpoint, has many safeguards. Hedge funds require high initial investments that restrict the industry to sophisticated investors.<sup>304</sup> Hedge funds also limit interests in their funds to accredited investors<sup>305</sup> to avoid reporting requirements under the Securities Act.<sup>306</sup> The Dodd–Frank Act actually heightened standards for what qualifies as an accredited investor under the Securities Act in private offerings.<sup>307</sup> This will further ensure that hedge funds offer their interests to more sophisticated parties. In sum, hedge fund adviser registration is unnecessary because (i) there is already an adequate anti-fraud rule in place; (ii) hedge funds have increased transparency to their investors; and (iii) hedge funds have a sophisticated investor class that does not need the same protections provided to ordinary investors.

In addition, there are a few other thoughts worth noting. First, there are financial and resource concerns from the perspective of smaller hedge fund advisers, and, more importantly, the SEC. Not all funds can afford to hire new compliance officers to gather the information required by adviser registration under the Advisers Act.<sup>308</sup> Although \$150 million in

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302. See *supra* notes 249–52 and accompanying text (discussing how the SEC requires exempt private hedge fund advisers under the Advisers Act to report information on Form ADV's Part One).

303. See *supra* note 252 and accompanying text (explaining the reasoning behind why the SEC is requiring exempt private hedge fund advisers under the Advisers Act to report certain information that will be publicly available).

304. See *supra* note 30 and accompanying text (discussing how hedge funds require significant minimum investments).

305. See *supra* note 79 and accompanying text (explaining the term accredited investor under the Securities Act).

306. See *supra* note 79 and accompanying text (explaining the term accredited investor under the Securities Act).

307. See Dodd–Frank Act, Pub. L. No. 111-203, § 413, 124 Stat. 1376, 1577 (2010) (codified as amended at 15 U.S.C. § 77b note) (adjusting the accredited investor standard under the Securities Act so that the net worth of an accredited investor must be over \$1 million excluding the value of the investor's primary residence).

308. See Azam Ahmed, *For Small Hedge Funds, Success Brings New*

AUM seems large on the surface, some smaller hedge fund advisers note that this is just a blip in an almost \$1.6 trillion industry.<sup>309</sup> This threshold appears over-inclusive in a sector that the SEC estimates is dominated by funds managing over \$1.5 billion in assets (over 80% of all hedge fund AUM).<sup>310</sup> Also, the SEC admits that it has limited resources to carry out hedge fund adviser examinations in light of the PFIARA. In a study required by the Dodd–Frank Act, *Study on Enhancing Investment Adviser Examinations*, the SEC stated “[it] will not likely have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency” after the PFIARA’s enactment.<sup>311</sup> The increased strain on smaller funds and the SEC are additional reasons why hedge fund adviser registration under the Advisers Act is unnecessary.

Also lurking in the background of whether or not hedge fund adviser registration is necessary under the Dodd–Frank Act, is another question: Even if hedge fund adviser fraud was a legitimate reason for passing the PFIARA, is hedge fund adviser registration the best option to combat this supposed problem? Although this raises a host of issues that are likely the topic of another discussion, history suggests adviser registration has its weaknesses. The recent uncovering of the shocking, and financially devastating, Ponzi scheme of Bernie Madoff<sup>312</sup>—who had voluntarily registered his hedge funds with the SEC and

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*Headaches*, N.Y. TIMES DEALBOOK (Jan. 20, 2011, 8:00 PM), <http://dealbook.nytimes.com/2011/01/20/for-small-hedge-funds-success-brings-new-headaches/> (last visited Feb. 3, 2013) (detailing the financial burdens many smaller hedge funds will face as a result of the Dodd–Frank Act) (on file with the Washington and Lee Law Review).

309. See *id.* (explaining that one hedge fund adviser thinks \$150 million funds are the “guppies” of the industry and do not pose great risks to the U.S. financial system).

310. See *supra* note 278 and accompanying text (detailing hedge fund data used by the SEC).

311. SEC. & EXCH. COMM’N, STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS 3–4 (2011), <http://www.sec.gov/news/studies/2011/914studyfinal.pdf>.

312. The author thanks George Mason University School of Law Professor J.W. Verret for pointing out this interesting dynamic as it related to this Note. Also, the author thanks Professor Verret for noting potential reasons for the hedge fund industry’s apathy towards the Dodd–Frank Act’s adviser registration amendments. See *infra* notes 314–16 and accompanying text.

whose fraudulent activity went undetected for years<sup>313</sup>—suggests that adviser registration may not be the government’s solution to the kind of fraudulent activity that it fears, regardless of whether or not this registration is necessary under the Dodd–Frank Act.

Lastly, although some suggest that many hedge funds remain unconcerned about adviser registration,<sup>314</sup> this may be more telling of another story. In an industry dominated by larger funds,<sup>315</sup> perhaps existing funds do not mind adviser registration because smaller funds are more likely to bear the brunt of the costs.<sup>316</sup> Further, SEC registration expenditures will certainly raise entry costs for start-up hedge funds, which may deter future competition. The hedge fund industry’s apathy towards this new legislation, therefore, could be the combination of a couple things: (i) large, existing hedge funds may view adviser registration as a vehicle that will help them maintain their top status by stifling smaller competition; and (ii) the hedge fund industry may not think that adviser registration presents much of an obstacle at all, which calls into question whether such registration serves as a deterrent for issues like adviser fraud.

## *2. Hedge Fund Adviser Registration Is Unnecessary for Systemic Risk Assessment*

The collection of systemic risk information related to hedge funds is a logical solution for hedge fund regulation. Hedge funds have evolved into a large part of the U.S. financial markets.

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313. See SEC. & EXCH. COMM’N, INVESTIGATION OF THE FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF’S PONZI SCHEME 20–21 (2009), <http://www.sec.gov/news/studies/2009/oig-509.pdf> (“[T]he SEC received more than ample information . . . over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff . . . for operating a Ponzi scheme, and . . . despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed.”).

314. See generally Bloomberg BNA, *Hedge Funds Not Concerned About SEC Registration, Study Finds*, SEC. L. DAILY (Apr. 16, 2012) [http://news.bna.com/sdln/SDLNWB/split\\_display.adp?fedfid=25818205&vname=sldbullallissues&jd=a0d1k6f9q5&split=0](http://news.bna.com/sdln/SDLNWB/split_display.adp?fedfid=25818205&vname=sldbullallissues&jd=a0d1k6f9q5&split=0) (last visited Feb. 3, 2013) (on file with the Washington and Lee Review).

315. See *supra* note 278 and accompanying text.

316. See *supra* note 308 and accompanying text.



Current hedge fund data is scattered throughout a variety of industry surveys and a lot of information about hedge funds remains opaque.<sup>317</sup> The confidentiality of Form PF protects the secretive nature of the hedge fund industry and preserves the dynamic trading strategies that make hedge funds a viable alternative investment.<sup>318</sup> Also, the FSOC's wait-and-see approach (monitoring the information, studying it, and making recommendations) allows it to obtain a full grasp on the evolving issues of the hedge fund industry (such as systemic risk concerns) before acting rashly.<sup>319</sup>

Nevertheless, hedge fund adviser registration under the Advisers Act is unnecessary to gather information related to systemic risk. If the government wants to collect systemic-risk-related data from hedge funds, then why not simply collect the information? Congress and the SEC could require hedge funds (deemed to impact systemic risk) to report the exact information in Form PF to the FSOC without hedge fund adviser regulation. This would save the SEC's (admittedly) limited resources and would reduce adviser registration compliance costs for smaller hedge funds—most importantly, it would accomplish the PFIARA's goal of assessing the systemic risks that stem from hedge funds. This practical alternative would reduce costs and provide a smooth transition because the FSOC regime is already in place.

### *B. Recommendations*

This Note asserts that hedge fund adviser registration requirements should be eliminated under the PFIARA. As explained, hedge fund adviser registration is unnecessary from the investor protection standpoint and the systemic risk assessment standpoint alike. But continuing to gather systemic-risk data from hedge funds through Form PF is a logical solution

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317. See *supra* note 2 and accompanying text (describing the hedge fund industry as opaque).

318. See *supra* note 280 and accompanying text (stating the confidentiality of Form PF).

319. See *supra* notes 284–88 and accompanying text (explaining how the FSOC will utilize Form PF data).

because it fills an information gap for an opaque, but important, industry. The information required by Form PF provides the FSOC with detailed information that will help with the monitoring of systemic risk.

Currently, the SEC thinks hedge funds with AUM exceeding \$1.5 billion should provide the most information connected with systemic risk because these funds make up an estimated 80% of the hedge fund industry.<sup>320</sup> Arguments favoring this threshold make sense because it includes a majority of the hedge fund industry. Also, this amount is similar to the thresholds proposed in the 1999 Disclosure Bill (over \$3 billion AUM) and the 1999 Reform Bill (over \$1 billion AUM), which both dealt with controlling hedge-fund-related systemic risks after LTCM's collapse.<sup>321</sup> Determining a threshold for what aggregate group of hedge funds would provide the most pertinent information related to systemic risk, however, is beyond the scope of this Note.

Nonetheless, once the threshold is determined, this Note asserts that only data from the group of hedge funds deemed most important to systemic risk assessment should be collected. So, if the government determines hedge funds with more than \$1.5 billion AUM are most pertinent to systemic risk assessment, requiring hedge funds with less than \$1.5 billion AUM to report data would be over-inclusive and a waste of resources. At the same time, any exemptions (relating to systemic risk data collection) for hedge funds exceeding the determined threshold would render the policy under-inclusive. This Note, therefore, suggests that once the line is drawn, no hedge funds with AUM exceeding the determined threshold should be exempt from providing information on Form PF. This is because "size matters" when determining systemic risk concerns.<sup>322</sup>

For example, family office hedge funds with AUM that would exceed the determined threshold should not be exempt from

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320. See *supra* note 278 and accompanying text (detailing hedge fund data used by the SEC).

321. See *supra* notes 131–47 and accompanying text (describing the hedge fund reporting thresholds for the two proposed 1999 bills following the crash of LTCM).

322. See Schwarcz, *supra* note 122, at 203 (explaining that size matters when considering the potential for systemic risk in a hedge fund).

reporting information related to systemic risk. The theory behind exempting family office hedge funds is that these extremely private funds and families (along with key investment employees of the family office fund) should be able to manage their wealth without interference.<sup>323</sup> But what makes a tight-knit family fund managing billions of dollars less likely to affect systemic risk than a similarly situated hedge fund whose investors are not blood relatives? Famous hedge fund manager George Soros recently kicked outside investors of his Soros Fund Management hedge fund to the curb.<sup>324</sup> Soros does not want to disclose any information in light of the PFIARA's enactment, so he decided the family office fund exemption was in his best interest.<sup>325</sup> The Soros Fund Management hedge fund has AUM of approximately \$25 billion.<sup>326</sup> What is to say this fund's failure or risky investment decisions could not affect systemic risk? After all, George Soros is the same hedge fund adviser who almost single-handedly crushed the British pound sterling in currency markets by betting on its devaluation in 1992 (and subsequently made around \$1 billion off the bet).<sup>327</sup> Thus, to thoroughly evaluate systemic risks posed by hedge funds, all hedge funds that are deemed important to systemic risk assessment (whether alone or in the aggregate) should provide information to the FSOC without exception.

There are problems, however, with this approach. First, compliance costs will still be high for hedge funds. But, given the serious consequences of the Financial Crisis, it is hard to make an argument that more information is not needed on systemic

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323. See *supra* note 235 and accompanying text (discussing the rationale behind the family office fund adviser registration exemption).

324. See Ben Rooney, *Soros Hedge Fund is Now a \$25 Billion Family Matter*, CNN MONEY (July 26, 2011, 1:01 PM), [http://money.cnn.com/2011/07/26/news/companies/soros\\_fund/index.htm](http://money.cnn.com/2011/07/26/news/companies/soros_fund/index.htm) (last visited Feb. 3, 2013) (stating that George Soros's hedge fund, Soros Fund Management, "has officially closed the doors to outside investors") (on file with the Washington and Lee Law Review).

325. See *id.* ("The fund's Quantum Group will complete its transition to a 'family office' ahead of regulatory changes . . .").

326. *Id.*

327. See Ronald F. Lipp, *The Crisis in International Trade: Remarks at the 20th Annual McGeorge International Law Symposium*, 15 TRANSNAT'L LAW. 31, 35 (2002) (noting that in 1992 George Soros almost single-handedly broke the British pound currency markets by betting on the devaluation of the British pound sterling).

risk—especially information on a largely opaque hedge fund industry. Second, it is questionable whether the SEC and the FSOC have the resources and expertise to adequately assess the systemic risk information given by hedge funds. This is a legitimate concern, but the only practical alternative is to establish a Self-Regulatory Organization (SRO). Common “[s]ecurities SROs include national securities exchanges and securities associations registered with the SEC, such as the New York Stock Exchange.”<sup>328</sup> Practitioners and academics proposed this idea prior to the Financial Crisis and the Dodd–Frank Act.<sup>329</sup> The premise is that the hedge fund industry could regulate itself through a private SRO that would coordinate with government regulatory agencies.<sup>330</sup> The SRO would be able to respond more quickly to evolving hedge fund trends and would have more expertise in dealing with hedge funds.<sup>331</sup> There is a strong argument for self-regulation through an SRO, but Congress has largely ignored it.

The Dodd–Frank Act required the GAO to conduct a feasibility study for a hedge fund adviser SRO, but, for a variety of reasons, the report was largely dismissive of the idea.<sup>332</sup> The report stated that while an SRO for hedge fund advisers is feasible, it would require legislative action and present challenges.<sup>333</sup> Among other concerns, the report suggested that a hedge fund adviser SRO would present conflict-of-interest issues and funding the SRO would be expensive.<sup>334</sup> The GAO report

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328. U.S. GOV'T ACCOUNTABILITY OFFICE, PRIVATE FUND ADVISERS: ALTHOUGH A SELF-REGULATORY ORGANIZATION COULD SUPPLEMENT OVERSIGHT, IT WOULD PRESENT CHALLENGES AND TRADE-OFFS 9 (2011) [hereinafter 2011 GAO REPORT], <http://www.gao.gov/new.items/d11623.pdf>.

329. See generally Verret, *supra* note 2 (providing a self-regulation proposal for hedge funds in 2007 prior to the Dodd–Frank Act).

330. See 2011 GAO REPORT, *supra* note 328, at 9 (providing the potential benefits of an SRO).

331. *Id.*

332. See Dodd–Frank Act, Pub. L. No. 111-203, § 416, 124 Stat. 1376, 1579 (2010) (stating that the GAO must conduct a study on a self-regulatory organization for private funds).

333. See GAO REPORT, *supra* note 328, at 11 (explaining that “the general consensus was that forming a private fund adviser SRO . . . could be done but not without challenges”).

334. See *id.* at 20 (noting potential problems with a hedge fund adviser SRO).

suggested that the SRO might actually “increase the overall cost of regulation by adding another layer of oversight.”<sup>335</sup> The report was also concerned that transparency would be limited because the “SRO would be accountable primarily to its members rather than to Congress or the public.”<sup>336</sup> Although there is a strong argument for a private SRO, the practical implications of the GAO report suggest that it is an unlikely option.

Finally, there are confidentiality concerns in providing information related to systemic risk to the SEC and the FSOC with Form PF. The hedge fund industry has a competitive advantage in creating unique investment strategies.<sup>337</sup> These unique strategies prevail because competitors have not been able to use reverse engineering techniques to copy others’ strategies.<sup>338</sup> This is possible because hedge funds have been able to keep proprietary information confidential. Some will argue that allowing the government to share the collected information with other agencies and foreign governments (subject to confidentiality agreements) poses a huge threat to hedge funds. The SEC has stated, however, that it will not require systemic information reporting through Form PF until it has controls and systems in place.<sup>339</sup> Thus, the only way to advance this counterargument is to suggest a hypothetical circumstance in which the government does not follow through on its confidentiality promise. Because that argument is largely speculative, it does not hold much weight.

## VI. Conclusion

For years, proponents of hedge fund regulation called for Congress to fill what they perceived as a regulatory gap. Although hedge funds avoided most regulation for decades, the Financial Crisis tipped the scales toward direct federal

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335. *Id.*

336. *Id.*

337. *See supra* notes 51–52 and accompanying text (discussing competitive advantages of hedge funds).

338. *See supra* notes 51–52 and accompanying text (same).

339. *See supra* note 283 and accompanying text (explaining that the SEC plans to maintain confidentiality of Form PF data).

regulation. The enactment of the Dodd–Frank Act, and more specifically the PFIARA, forces many hedge funds to register with the SEC under the amended Advisers Act. This Note asserts, for several reasons, that hedge fund adviser registration under the Advisers Act is unnecessary to advance the PFIARA’s goals: hedge fund investor protection and hedge fund systemic risk assessment. Consequently, hedge fund adviser registration is a waste of the hedge fund industry and the SEC’s resources.

This Note, however, suggests that the collection of hedge fund data, related to systemic risk, is necessary in light of the Financial Crisis, but adviser registration is unnecessary to achieve this goal. This Note provides more practical and tailored alternatives to accomplish this task. Mainly, this Note asserts that once a threshold (based on hedge fund size) is determined for an aggregate group of hedge funds most pertinent to systemic risk assessment, the FSOC should collect data directly through Form PF. Collecting data from smaller hedge funds that do not meet the determined threshold is unnecessary because this will produce an over-inclusive regime. On the other hand, this Note also argues that once a proper threshold is established, no hedge funds with AUM exceeding the determined threshold should be exempt from providing information related to systemic risk. This will avoid an under-inclusive element to the regime as well and accomplish the PFIARA’s most important goal—hedge fund systemic risk assessment.