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J. W. Verret

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Review: Is Hedge Fund Registration Necessary?

J.W. Verret*

In *Is Hedge Fund Adviser Registration Necessary To Accomplish the Goals of the Dodd–Frank Act's Title IV?*,[1] Luke Ashworth sets out a formidable case that questions the grounds for the mandatory hedge fund registration requirement contained in the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act).[2] This review of his Note will offer a description of the piece's key strengths, suggest some challenges to the solutions it offers, and close with suggestions about areas that might build on Ashworth's work in future scholarship.

I. Review

A. The Argument

Ashworth lays out a well-researched background of the history of the hedge fund industry, prior attempts to regulate the industry, and the complex regulatory regime that previously exempted the industry from mandatory registration which was amended by the Dodd–Frank Act.

He explores the underlying justification for the mandatory registration rule by describing hedge fund crises at Long-Term Capital Management in 1999 and two Bear Stearns hedge funds during 2007. He notes how the drafters of the hedge fund registration rule were motivated by a desire to prevent investor fraud and to minimize and monitor systemic risk.

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* Assistant Professor of Law, George Mason University School of Law.

1. Luther R. Ashworth II, *Is Hedge Fund Adviser Registration Necessary to Accomplish the Goals of the Dodd–Frank Act's Title IV?*, 70 WASH. & LEE L. REV. 651 (2013).

2. Dodd–Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S.C.).

Ashworth's skepticism of the mandatory registration requirement as a response to the financial crisis is even stronger than he suggests. The Financial Crisis Inquiry Commission's (FCIC) *Final Report on the Causes of the Financial and Economic Crisis in the United States* mentions hedge funds quite infrequently, and even when it does so it does not describe their involvement in any way that would support the mandatory registration provision.[3] While hedge funds were active participants in markets for asset-backed securities that quickly lost value in the financial crisis,[4] it is unclear that they were more aggressive than other investors. Indeed, many hedge funds also took short positions in real estate-derived assets, and companies invested in them, that can be credited with popping the asset bubble before it grew even bigger.[5]

It is also unclear how registration would have affected those funds that played a role in the asset bubble. For example, the FCIC Report examines the role of "hedge funds" at Bear Stearns that had significant positions in mortgage-backed securities, which ultimately brought down the investment bank in 2007 and eventually led to the government-facilitated takeover of the bank by JP Morgan in 2008.[6] But Bear Stearns was not an unregulated entity—in fact it was much more heavily regulated under the Security and Exchange Commission's (SEC) Consolidated Supervised Entity (CSE) capital regulation program than the investment adviser registration regime that hedge funds will be subject to post-Dodd–Frank.[7]

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3. *See* FIN. CRISIS INQUIRY COMM'N, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, at xi (2011) [hereinafter FCIC REPORT], http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (reporting "to the President, the Congress, and the American people the results of [the Financial Crisis Inquiry Commission's] examinations and conclusions as to the causes of the crisis").

4. *See, e.g.*, *id.* at 136 (noting that hedge funds often invested in asset-backed securities, such as mortgage-backed securities and collateralized debt obligations).

5. *See, e.g.*, Lauren Schuker Blum, *John Paulson Double Down*, WALL ST. J., Oct. 19, 2012, at M3 ("Hedge-fund manager John Paulson famously made nearly $4 billion in 2007 correctly betting that the housing bubble, fueled by the subprime mortgage market, would pop.").

6. *See* FCIC REPORT, *supra* note 3, at xxi.

7. *See* OFFICE OF INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED

Ashworth accepts that large hedge funds had a prominent role in the financial crisis but argues that the registration requirement is overbroad from an alternative perspective. Ashworth effectively demonstrates that the redundancy created by Dodd–Frank, in which both the Office of Financial Research (OFR) under the Financial Stability Oversight Council (FSOC) and the SEC will serve as information coordinators, will not aid systemic risk oversight and may cause its own problems. The reader is left convinced that information-reporting requirements, for the same purpose but from different regulators, will compound compliance costs and may even create mutually inconsistent reporting requirements.

If systemic risk is the issue, it is unclear whether and to what extent creating multiple information-collection entities, in both the SEC and the OFR at the Treasury Department, will provide additional value. Where the OFR will be able to coordinate with the FSOC, charged with systemic risk determinations, the SEC will be a step removed from the central decision-making and will have to coordinate through multiple layers to obtain useful information. Redundancies in this area will not be costless, but will add multiple layers of compliance requirements and multiply the risk that proprietary trading information will be revealed to market competitors.

Ashworth's argument would have been edified by considering the SEC's failure to respond appropriately to tips it received and preliminary inquiries it initiated in the Madoff and Stanford cases, both generally recognized as exceptional failures by the agency to catch multi-billion dollar Ponzi schemes despite the hedge funds being voluntarily registered with the SEC, and despite the Madoff broker-dealer subsidiary having received successful compliance audits from the SEC prior to the frauds

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SUPERVISED ENTITY PROGRAM, at v (2008), http://www.sec-oig.gov/Reports/AuditsInspections/ 2008/446-a.pdf ("The [CSE] program is a voluntary program that was created in 2004 by the [SEC] . . . . This program allows the [SEC] to supervise [certain] broker-dealer holding companies on a consolidated basis."). Thus, the CSE program allowed the SEC to supervise Bear Stearns prior to the financial crisis in a manner that "extend[ed] beyond the registered broker-dealer to the unregulated affiliates of the broker-dealer to the holding company itself." *Id.* After the collapse of Bear Stearns, the SEC stated that even with increased oversight, "[I]t is undisputable that the CSE program failed to carry out its mission in its oversight of Bear Stearns . . . ." *Id.* at viii.

being revealed.[8] Even worse, after examining the Stanford funds, the SEC compliance staff suggested to the SEC enforcement staff that it was probably a Ponzi scheme, whereupon the SEC enforcement staff nevertheless decided against taking action.[9] Though the legislative history of Dodd–Frank references both objectives of fraud prevention and systemic risk oversight,[10] it remains unclear whether the mandatory registration requirement was more predominantly an investor protection measure or a systemic risk measure. If the latter, a critique of the SEC's response to the Madoff and Stanford cases remains relevant.

B. Review of Ashworth's Recommendations

While the Note offers skepticism of the ability of the SEC to monitor systemic risk, it accepts the general notion that large financial players implicate systemic concerns. It is important to note that during the financial crisis, many hedge funds made bets against the real estate bubble, in effect correcting a wayward market.[11] Hedge funds have enjoyed a level of investment flexibility and freedom from regulatory rigidity that has historically led them to take a commanding role in short selling, which helps to foster a vibrant price discovery function and

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8. *See* Lori A. Richards, Dir., Office of Compliance Inspections & Examinations, Sec. & Exch. Comm'n, Testimony Concerning Examinations by the Securities and Exchange Commission and Issues Raised by the Bernard L. Madoff Investment Securities Matter (Jan. 27, 2009), *available at* http://www.sec.gov/news/testimony/2009/ts112709lar.htm ("Examinations of the Madoff broker-dealer firm did not find the alleged fraud committed by Mr. Madoff, and the [SEC's] staff did not examine his advisory opinions, which first became registered with the [SEC] in late 2006.").

9. *See* SEC. & EXCH. COMM'N, INVESTIGATION OF THE SEC'S RESPONSE TO CONCERNS REGARDING ROBERT ALLEN STANFORD'S ALLEGED PONZI SCHEME 16 (2010), http://www.sec.gov/news/studies/2010/oig-526.pdf (providing an executive summary of the SEC's role in the Stanford Ponzi scheme).

10. *See* H.R. REP. NO. 111-57, at 866 (2010), http://www.gpo.gov/fdsys/pkg/CRPT-111hrpt517/pdf/CRPT-111hrpt517.pdf (stating that 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").

11. *See supra* note 5 and accompanying text.

provides liquidity to the market.[12] Therefore, Ashworth's suggestion for a compromise approach focusing on systemic risk oversight of larger firms must nevertheless take into account the possibility that his compromise approach may also inhibit those functions served by the hedge fund industry.

Ashworth accepts the popular argument that size is the key dimension of systemic risk, relying on work seeking to give preliminary definition to systemic risk by Schwarcz.[13] But it should also be noted that another important vein of scholarship discounts the role of size in systemic risk.[14]

As Ashworth notes, the SEC has left jurisdiction over hedge fund registration for firms with assets under management between $25 million and $100 million to states. The compromise he suggests would be complicated by the SEC's current allocation of authority between the states and the federal government. Small firms would be registered with states, medium-sized firms would be unregistered, and larger firms would be regulated by the FSOC. This donut hole of unregulated companies may create some potentially costly unintended consequences.

The existence of even light-touch regulation pursuant to the Investment Advisers Act of 1940[15] or the FSOC may serve merely as a prelude to subsequent enhanced regulation. A few high profile problems in the hedge fund sector could mean the SEC or the FSOC, or the Federal Reserve as regulator of designated systemically significant financial institutions, will feel pressure to enhance its regulatory authority in this area from the existing investment adviser oversight to a new regime mirroring the investment company or publicly-traded company model, in which disclosure methodologies become mandatory, the ability of investment managers to communicate with investors and

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12. *See* 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, 815 (2007) (explaining vital roles hedge funds play in the U.S. economy).

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

14. *See* Chen Zhou, *Are Banks Too Big to Fail? Measuring Systemic Importance of Financial Institutions*, 6 INT'L J. CENT. BANKING 205, 205 (2010) ("Both the theoretical model and empirical analysis reveal that, when analyzing the systemic risk posed by one financial institution to the system, size should not be considered as a proxy of systemic importance.").

15. 15 U.S.C. §§ 80b-1 to 80b-21 (2010).

potential investors will be limited to regulatory approved forms, and the investment strategies will be directly or indirectly regulated by the SEC. If that occurs, it would seriously damage the liquidity and price discovery functions the hedge fund industry serves.

II. Groundwork for Future Inquiry

There are two readily apparent avenues for further research that might build on Ashworth's successful Note in future work. The newly passed Jumpstart Our Business Startups Act (JOBS Act)[16] includes a lift on the general solicitation ban found in Regulation D, one which hedge funds frequently use in soliciting investments.[17] Further, the fact that the hedge fund industry itself embraced the mandatory registration regime, or at least did not fight against it, presents a puzzle for which public choice theory may provide an answer.

Henry Manne's work in the public choice dynamics of securities regulation suggests that one motivating force behind the development of the securities laws is that large incumbent firms seek to stifle competition from newer, upstart entrants to markets by supporting regulations that increase the costs of entry into markets.[18] If any participants in the hedge fund industry supported the mandatory registration rule, this could explain why.

Another suggestion for further inquiry would be to consider how changes found in the JOBS Act will change Luke's argument. Among the provisions of the JOBS Act is a requirement that the SEC lift the ban against general solicitations under Regulation D.[19] This is an exemption frequently used by hedge funds. What does lifting the general

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16. Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of the U.S.C.)

17. *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).

18. *See generally* HENRY G. MANNE ET AL., WALL STREET IN TRANSITION: THE EMERGING SYSTEM AND ITS IMPACT ON THE ECONOMY (1974).

19. *See supra* note 17 and accompanying text.

solicitation ban do to his investor sophistication argument? Will the fact that hedge funds will be able to communicate with potential investors more broadly significantly alter the cost–benefit calculus behind the mandatory registration rule? Or will the fact that hedge funds will still be limited to investments by accredited investors minimize the impact of the JOBS Act on this discussion?

III. Conclusion

Ashworth's work is provocative and insightful, and offers a unique willingness to question the conventional wisdom behind a popular item in the Dodd–Frank Act. It opens the door for future inquiry into this new avenue of securities regulation and suggests exciting opportunities for thinking about the SEC's hedge fund regulatory regime with veins of thought in the securities regulatory, finance, and public choice scholarship.