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Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II

John W Verret, Harvard Law School

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Hedge Fund Regulation, Part II

Author: Jay Verret

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1J.D., Harvard Law School, class of 2006  
Master in Public Policy, Kennedy School of Government, class of 2006  
Clerk for the Delaware Court of Chancery, 2006-2007,  

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“Risks posed by private pools of capital are best addressed through market discipline, disclosure and transparency, not through new laws, regulations or registration.”

Robert K. Steel
Undersecretary for Financial Institutions, United States Treasury

"I believe the announcement today by Secretary Paulson on hedge funds is a first step in addressing questions presented by the significant growth of hedge funds...It is my hope that he will testify at a hearing on hedge funds the Financial Services Committee will hold this spring."

Representative Barney Frank
Chairman, U.S. House Committee on Financial Services

“The hedge fund industry is only two serious scandals away from vigorous legislation that goes far beyond the registration drive that the Securities Exchange Commission attempted two years ago.”

Professor Harvey Goldschmidt
Former Commissioner, Securities Exchange Commission

Executive Summary

Hedge funds are a fairly new asset class utilized by institutional investors and wealthy individuals. These funds can sometimes achieve remarkable returns. However, the market practice for fund managers is to charge performance fees that greatly exceed any other investment type in the financial services sector, leading some hedge fund managers to engage in illicit behavior, including fraud, that violates their duty to their investors and tempts institutional investors to violate their fiduciary duty to their principals.

This exploration examines a registration requirement, previously instituted by the Securities Exchange Commission (SEC) to combat instances of hedge fund fraud, which was struck down during the summer of 2006. It also examines the tools used by other regulators to oversee institutional investors. This study relies on a survey of general literature on financial regulation, specific commentary on the hedge fund regulatory reforms instituted, models of self-regulation, and analogous examples in other area of financial regulation that have been successful. The result is a critique of the previous regulatory regime and proposals that will make it more effective.

The rapid expansion of hedge fund investments is transforming the price discovery function of the securities markets, resulting in more efficient valuation and robust flows of capital. However, these innovative strategies morph so rapidly, and operationally they are so much leaner, that the simple regulatory strategies of the Securities Acts of 1933, 1934, and 1940 do not lend themselves to cookie cutter
application. Further, the decision-makers are sharply divided. The Administration has taken a firm stance in not supporting hedge fund regulation. Congress, under democratic control, has signaled that it is clearly interested in advancing regulation. The SEC under its previous chairman was 3-2 in favor of added regulation, though the DC Circuit Court subsequently overturned the form as it was adopted. The current Chairman does not support hedge fund registration.

The future consequences of this market shift are far from certain. The challenge is crafting a lasting and expensive governmental administrative structure with justification that must rest, in part, on faith in a particular regulatory philosophy or market efficiency theory. The present incarnation of the market dynamic is entirely novel. Maybe we will institute a regime that will constrain the benefits hedge funds offer. Maybe we will continue to fly blind across a cliff that will make previous financial disasters look like child’s play. Risk is part of the financial regulatory game just as much as it is the essence of finance itself. The only reasonable response is to learn from what worked in the past and attempt to model the variables that will persist in the future. Therefore, I am proposing a mean between the thus far advanced regulatory philosophies, using principles we find by analogy in other areas of financial regulation.

A self-regulatory model that utilizes the inherent advantage of firms regulating each other is a major theme of the policy recommendations presented. Crafting regulatory safe harbors, permissive information access, and designing legal defenses that encourage the operation of a self-regulatory entity to monitor this industry can help to overcome the severe disadvantage that bureaucratic regulators face in this field. Further, more elaborate administrative guidance and an element of federal pre-emption, especially in oversight of the entities investing in hedge funds, is advisable.

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Part I: History of hedge funds and background

Dr. Alfred Winslow Jones is generally credited with forming the first actively managed general investment partnership, a hedge fund, to evade SEC regulation and achieve full portfolio versatility and flexibility in 1949.2 Dr. Jones’ unique hedge strategy combined long and short positions in equities to appreciate the value of the portfolio

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Dr. Jones and the Raiders of Lost Capital during any stage of the market cycle. This strategy allowed him to minimize volatility, or beta in modern jargon, while maintaining a high alpha return utilizing his management expertise. In order to further maximize returns, he used enhanced leverage as well. He charged a performance fee of around 20%. The 1960s saw a number of current star managers getting into the hedge fund business, including George Soros’ Quantum Fund and Warren Buffets’ Buffet Partners.

The term “hedge fund” is a misnomer for many funds in the industry today, as they do not necessarily engage in a traditional hedge strategy. They may seek to capitalize on statistically significant divergences between two stock or commodities prices, that differ from expected past correlation, using complicated models. They may trade commodities or currency swaps based on macroeconomic data, or trade on expected results of a merger or acquisition between two companies. In short, their strategies are diverse, but many of the characteristics of Jones’ creation still apply. High leverage, management expertise, performance fees, and absolute return strategies are the hallmark of the industry. They share a belief that markets are not strongly efficient, and that adroit managers can take advantage of superior information, analysis, and minimization of trading costs to achieve absolute returns under any market conditions.

These funds have always fallen under the radar of the SEC by catering to only high net-worth individuals and institutions. They typically charge performance fees of 20% and management fees of 2% of assets under management. After taking these fees into account, they returned on average 9.5% last year and averaged roughly 13% annually over the last ten years. In addition to traditionally higher than average

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6 Paredes provides a quick summary of the three exemptions hedge funds use. See Troy Paredes, ON THE DECISION TO REGULATE HEDGE FUNDS: THE SEC’S REGULATORY PHILOSOPHY, STYLE, AND MISSION, 2006 U. ILL. L. REV. 975, *1035 fn 52 (2006) (“For example, a hedge fund (1) is not subject to the Investment Company Act if the fund has a hundred or fewer investors or if all of its investors are so-called "qualified purchasers"; (2) does not have to register its securities offering under the 1933 Act if it only allows so-called "accredited investors" to invest; and (3) does not have to register under the 1934 Act if it has only engaged in private offerings and has fewer than five hundred investors in the fund. See id. § 78l(g)(1); id. § 80a-3(c); 17 C.F.R. § 230.506 (2004); 17 C.F.R. § 240.12g-1 (2004).”).
returns, hedge fund investors seek diversification from absolute return strategies.\(^8\) Their returns do not correlate with returns from the long S&P or other traditional benchmarks.\(^9\) This lack of correlation brings a significant diversification advantage.\(^10\) This explains why many large pension funds and institutions tend to invest 5-15% of their portfolios in hedge fund vehicles.

Hedge funds currently manage roughly $1.5 trillion, compared to $400 billion just four years ago as measured by the CSFB/Tremont advisers index.\(^11\) Mutual funds, by comparison, collectively manage $8 trillion. Though 8,000 hedge funds are believed to operate today, only 2,500 of them were in operation ten years ago. When Tremont Partners was founded in 1984 to track hedge funds, only 64 were in operation.\(^12\) Further, hedge funds account for 40-50% of trading activity on stock markets in the United States and abroad.\(^13\) The average hedge fund size ($87 million) and the median hedge fund size ($22 million) frame an informative but incomplete picture of the industry.\(^14\) 3% of funds manage more than $500 million, 15% of funds manage $100-500 million, and roughly 38% manage each categories of $5-25 million and $25-100 million. So, the industry is fairly top heavy, with a few managers allocating vast sums and a throng of managers charged with small sums.\(^15\) Former Fed Chairman Alan Greenspan believes that the saturation of the hedge fund market will lead to significant consolidation of the industry.\(^16\)

There are also two interesting Delaware dimensions to hedge funds. They typically form as LLCs and LLPs, sometimes offshore but also frequently in Delaware as well.\(^17\) Thus, the hedge fund adviser that serves as a general partner or control shareholder in the LLC or LLP will be subject to Delaware fiduciary duties to its investors.\(^18\) One would expect that we should see some overlap between fiduciary duty rulemaking at the federal level and fiduciary duty suits at the Delaware

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\(^8\) Paredes, supra, at 982.
\(^10\) See Stultz, supra, at 15. “Per unit of volatility, an investor who could have invested in the hedge fund index would have done about twice as well as an investor who invested in the S&P 500 [over the period 1994-2006].”
\(^11\) See WSJ, supra, at A7.
\(^12\) Lhabitant, supra, at 8
\(^13\) European Wholesale Banks: Hedge Funds and Investment Banks, Credit Suisse First Boston Equity Research at 5 (March 9, 2005).
\(^14\) Lhabitant, supra, at 13
\(^15\) Id.
\(^16\) See Journal, supra, at A7.
\(^17\) Paredes, supra, at 982.
level. However, a limited partner’s ability to prosecute such a suit is constrained by the secretive nature of these funds. Presumably, partnership law’s analogue to the books and records inspections of corporations, would be useful in garnering information for that purpose. However, the “some credible evidence standard” will limit the usefulness of that model. Additionally, hedge funds are themselves frequently litigants in Delaware. Some hedge funds make use of activist strategies to institute 220 records inspections against the companies in which they invest, or they may make use of shareholder rights like appraisals and injunctions against mergers to negotiate for share buybacks or seats on a corporate board. So the effects of federal hedge fund regulation will uniquely impact the salience of hedge funds growing presence in corporate law.

Part II Regulation of Hedge Funds

Though hedge funds were previously exempt from registration under the Investment Adviser’s Act, the SEC’s Hedge Fund Registration Rule required any adviser to a fund with fifteen or more “shareholders, limited partners, members, or beneficiaries” to register as an investment adviser. Hedge fund general partners have always met the definition of “investment adviser” in the Advisers Act, but before the Hedge Fund Registration Rule they were exempt under the
“private adviser exemption” from registration in § 203(b)(3) of the Act. That section exempts “any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the Investment Company Act].” The SEC had interpreted this provision to only count the limited partnerships themselves, and not the actual limited partners, as “clients”. Even the largest hedge fund managers usually ran fewer than fifteen hedge funds and were therefore exempt.

Section I The previous scheme for SEC regulation of Hedge Funds

The Securities Exchange Commission adopted Rule 203(b)(3)-2 and amendments to Rule 203(b)(3)-1 under the Investment Advisers Act of 1940 on October 26, 2004 to require many hedge fund managers to register as investment advisers. The rule applied to “private funds”, defined as:

1) a fund not required to register as an investment company under the Investment Company Act of 1940 because of an exception under Sections 3(c)(1) or 3(c)(7) and
2) a fund that allows investors to redeem their investment within two years33 and
3) a fund offered based on an adviser’s expertise34

The new rules required advisers to private funds to register if they advise 15 or more investors. The rules formerly allowed use of the fiction that each investment entity counted as a single client, but the new rules required “looking through” each entity to count the funds clients individually. Non-U.S. investment advisers will only count U.S. clients toward the 15-investor limit, but have no minimum amount of assets under management to limit the registration requirement. The Investment Advisers Act threshold of 25 million under management also applied and would thus technically limit the scope of the new registration requirement. As some estimate that a hedge fund needs at least 50 million under management to survive, this minimum will not have been excessively constraining. The new rules exempted the assets of advisory personnel from counting towards the minimum.

Registration as an investment adviser alters the investor minimum for charging of performance fees. The minimum investor

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31 Id.
33 An exception especially crafted to exempt private equity funds and venture capital funds, which typically lock-up investments for longer than two years.
34 This synopsis is largely excerpted from a legal update of the Dechert Financial Services Group
wealth standard is effectively raised to $750,000 invested with the advisor or a net worth of 1.5 million by this registration requirement. This is because clients of registered investment advisers must meet that standard in order for their advisers to be eligible to charge performance fees. Registration as an adviser would also mean that the adviser and their staff will be subject to compliance examinations by the SEC. The Commission estimates that 975 funds would have needed to register, and that their annual aggregate information collection burden would increase to 578 hours per year. Vague estimates of compliance costs are around 55,000 per year. In addition, advisers will be required to answer a revised Form ADV, which asks if the investment manager is involved in any other investment funds, and if so, the details of this other fund. The new requirement would also have caused some funds to hire a compliance officer, an attorney whose salary may range from 200,000 to 500,000 annually depending on the size of the fund. The burden of these costs will fall most heavily on smaller funds whose management fee will be proportionally smaller. The Commission’s intent was to deter fraud and gather information through these requirements.

The rules exempted commodity trading advisers, but not commodity pool operators. This incensed the Chairman of the CFTC, who felt that the lack of exemption duplicated regulation and encroached on her territory. This change passed through the SEC on a rare 3-2 margin, with an extensive dissent included in the final report.

Section II. Legal Challenge and Subsequent Developments

Fund managers immediately challenged the Commission’s authority to promulgate these rules. One challenge to the constitutionality of this rule relied on the holding of Lowe v. SEC. Lowe held that the definition of investment adviser requires personal investment advice; but, it failed to fully define that distinction in favor of holding that mass produced annual investment guides were exempt

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35 Staff of the S.E.C., Implications of the Growth of Hedge Funds (Washington 2003) page xii
36 Barreto, Compilation of the Managed Funds Association, mfinfо.org
37 Ibid
40 MFA collection page 6
41 For a broad exploration of the psychological and political factors shaping the SEC’s response, See Paredes, supra.
42 Ibid, page 9
as being impersonal. As the partnership relation in hedge funds comes with a fiduciary obligation, and hedge funds retain custody and authority over client assets, the hedge fund relationship could conceivably fit within the courts definition of Investment Adviser in Lowe. The Commission answered legal objections that it lacked the authority to alter the definition of client under Section 203(b)(3) by arguing in the Final Rule Notice that the first hedge fund did not arise until long after the '33 Act was passed, and thus arguments over legislative intent are inherently misleading. Further, Chevron U.S.A. v. NRDC maintains the right of administrative agencies to interpret ambiguous statutory language as long as the interpretation is reasonably related to the ends that the legislation seeks to achieve. The Commission has further promulgated numerous instances of past "look-through" provisions throughout its interpretative history. Though the DC Circuit Court was ultimately unmoved by the plaintiff's reliance on Lowe, the Commission's reliance on Chevron also ultimately proved unsuccessful.

The Goldstein Decision: Back to the Drawing Board

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. That challenge was ultimately

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43 Commodity Trend Service, Inc. v. Commodity Futures Trading Com'n 233 F.3d 981, *988 (C.A.7 (Ill.), 2000) citing Lowe v. SEC, 472 U.S. 181, 105 S.Ct. 2557, 86 L.Ed.2d 130 (1985) (held that impersonal advisors are exempt from regulation under the Investment Advisers Act ("IAA"). The Court stated that two factors were "significant" in reaching its conclusion that the IAA applies only to those "who provide personalized advice attuned to a client's concerns." Id. at 207-08 & n. 54, 210 n. 57, 105 S.Ct. 2557. First, the Court noted that the IAA "repeatedly refers to 'clients,' not 'subscribers.' " Id. at 208 n. 54, 105 S.Ct. 2557; see also id. at 201 n. 45, 105 S.Ct. 2557. Second, the SEC did not establish that Lowe and the other petitioners had "authority over the funds of subscribers," "been delegated decisionmaking authority to handle subscribers' portfolios or accounts," or "individualized, investment-related interactions" with their subscribers. Id. at 210 n. 57, 105 S.Ct. 2557. Also, the Court concluded by stating that Lowe and his corporations were presumptively not within the IAA as long as "the communications between petitioners and their subscribers remain entirely impersonal and do not develop into the kind of fiduciary, person-to-person relationships ... that are characteristic of investment adviser-client relationships." Id. at 210, 105 S.Ct. 2557.)

44 Ibid


successful, keeping the debate alive between the now democrat-controlled Congress and the Administration (with the SEC in the middle). The Commission’s position was that, since the Advisers Act doesn’t define client, it should have discretion in determining that definition. The Court invalidated that position, and the SEC’s interpretation of the meaning of “client”. First, it held that an ambiguous word in a statute does not permit an agency to utilize any definition for that word. It held that the Commission’s position was inconsistent with the intent of the Adviser’s Act as a whole. Additionally, it held that such a position was inconsistent with other definitions of client in the securities regulations. Further, it held that since an adviser only owes fiduciary duty to a fund under the adviser’s act, and fiduciaries are presumed to owe duties to their clients, the funds would logically be the client in the hedge fund advisory relationship.

The effect of Goldstein is to invalidate a blanket look through provision for counting clients. However, this does not mean that a later registration requirement that more narrowly tailors look-throughs would be invalid, as the Goldstein Court was sure to note. So this decision does not close the door to a future registration requirement through agency rulemaking. In addition, Congressional amendment to the Investment Adviser’s Act would effectively supersede Goldstein and expand the range of options available to regulate in this area.

The President’s Working Group on Capital Markets Report

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49 See remarks by Barney Frank, Chairman of the house Financial Services Committee. Some Republican members of the House Financial Services committee and the Senate Banking Committee are also interested in exploring new regulation of Hedge Funds as well. Available at http://dealbook.blogs.nytimes.com/2007/02/21/frank-talk-on-hedge-funds/.


51 Goldstein v. S.E.C. 451 F.3d 873, *878 (C.A.D.C.,2006) (The “words of the statute should be read in context, the statute’s place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account” to determine whether Congress has foreclosed the agency’s interpretation.”) citing PDK Labs, Inc. v. DEA, 362 F.3d 786, 796 (D.C.Cir.2004)


53 Id.


55 “[T]he Commission has not justified treating all investors in hedge funds as clients for the purpose of the rule. If there are certain characteristics present in some investor-adviser relationships that mark a “client” relationship, then the Commission should have identified those characteristics and tailored its rule accordingly.” Goldstein v. S.E.C. 451 F.3d 873, *883 (C.A.D.C.,2006).
President Reagan issued an executive order creating the President’s Working Group on Financial Markets (“PWG”)56 in response to the stock market crash of 1987.57 It consists of the Secretary of the Treasury, Chairman of the Federal Reserve, Chairman of the Commodities Futures Trading Commission, and the Chairman of the Securities Exchange Commission. The PWG has since expanded its purpose to serve as a coordinating body for the evolution of financial transactions, institutions, and phenomena that stretch across their various jurisdictions. The PWG issues reports on major topics of interest and promulgates principles from which the various agencies can establish a coordinated administration policy.

The PWG’s first report on the implication of hedge funds came in response to the Long Term Capital Management debacle in 1999.58 It advocated guidelines to enhance disclosure of risk, and also partly resulted in an enhanced Regulation T.59 In February 2007, the PWG issued its Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital (“PWG Report”) concerning regulation of hedge funds (which it refers to as “private pools of capital”).60 The adopted principles are two fold: The PWG endorsed “Public Policies that support market discipline, participant awareness of risk, and prudent risk management” and advocates that “Supervisors should use their existing authorities with respect to…fiduciaries…to foster market discipline in private pools of capital. Investor protection concerns can addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.”61

56 Also affectionately known as the “Plunge Protection Team”.
57 It’s purpose was originally defined for the narrow mission of investigating the events surrounding the 1987 market crash:

“Recognizing the goals of enhancing the integrity, efficiency, orderliness, and competitiveness of our Nation’s financial markets and maintaining investor confidence, the Working Group shall identify and consider: (1) the major issues raised by the numerous studies on the events in the financial markets surrounding October 19, 1987, and any of those recommendations that have the potential to achieve the goals noted above; and (2) the actions, including governmental actions under existing laws and regulations (such as policy coordination and contingency planning), that are appropriate to carry out these recommendations.”

Presidential Executive Order No. 12631. 53 FR 9421


59 A Federal Reserve limitation on margin lending. However, the 1999 PWG report advocated that further SEC regulation was not required. See 1999 PWG Report.


This paper will proceed in the same general direction as the PWG Principles for Private Pools of Capital. The ability of markets to self-police will be explored and regulation of the fiduciaries who invest in hedge funds will be examined. My approach will deviate from the PWG approach in two distinct ways, however. I will argue that the best way to encourage markets to self-police is to use financial regulatory policy to encourage self-regulation. I would call this a market-plus regulatory strategy. This could take the form of a new self-regulatory organization for hedge funds, or it could encourage more action by self-regulatory mechanisms already in place such as the National Futures Association for those hedge funds that trade in commodities through the form of safe-harbors from adviser registration. I will also argue that, despite the existence of the PWG, more coordination among regulators, both domestic and international, is essential.

Former Chairman Donaldson was the driving force behind the Hedge Fund Registration Rule, which passed by a narrow 3-2 vote. Chairman Cox, by signing onto the PWG report and not appealing the Goldstein decision to the U.S. Supreme Court, is clearly signaling that the Commission will not push forward hedge fund regulation as onerous as the previous attempt any time soon.62 However, he has already taken steps to address the retailization concern that was expresses in the SEC’s original Report on the Implications of the Growth of Hedge Funds with a rule proposal to increase the minimum wealth level required of investors who invest in hedge funds. And no one knows how future Commissioners will shape this evolving area of the law, as it will depend in part on who wins the White House in 2008.

Minimum Wealth Requirement: Maybe the Rich Are Different

On December 27, 2006 the SEC issued for comment a rules proposal to create a new recognized type of investor, termed an accredited natural person, to take the place of the accredited investor classification it previously used to determine the eligibility of investors to participate in these unregulated investments. Currently, Regulation D allows unregistered sales of securities to investors, in some cases, where they meet the accredited investor standard of one million in net worth or $200,000 annual income. The proposed change would effectively alter that exception to require unregistered hedge funds only solicit investors who are accredited natural persons, defined as investors owning at least 2.5 million (adjusted every 5 years for inflation, a new concept in SEC minimum wealth tests). The use of wealth as a proxy for investor sophistication, and indeed the use of a paternalistic strategy of limiting access to certain investments, is certainly a debatable discussion meriting exploration in other venues. However, for the purposes of this paper, it will allow us to minimize time exploring the retailization concern expressed in the original SEC Report on Hedge Funds, and instead focus on prevention of fraud aspect.

Some of the comments that the SEC has received thus far have been quite scathing:

"You have to be rich to be smart?"

"I find the idea that the definition of an accredited investor is based solely on a net worth requirement to be repugnant to the principles of equality of all people... The approach that you appear to be taking is short-sighted, mean-spirited and represents the easy way out."

"The proposed rule changes are discriminatory and anti-Constitutional. We have long since done away with property qualifications for voting, and with other forms of discrimination throughout our society."

"If I gave you $2.5 Million would it make you any smarter?"


One analysis of the effect of regulation on hedge funds finds that, where governments increase the minimum wealth level required to invest in these funds, hedge fund returns remain constant but the average fees paid to hedge funds for the same returns significantly increase. See Douglas Cumming and Li Que, A Law and Finance Analysis of Hedge Funds, working paper, (2007). Available at http://ssrn.com/abstract=946298. So, maybe the only difference between wealthy investors and others is that the rich are willing to pay more for exactly the same return. In which case, using wealth as a proxy for financial sophistication is suspect indeed.


Section III: Arguments and principles of Financial Regulation in the Hedge Fund Context

The Ethical and Economic Dilemma Posed by Hedge Funds

The high fees charged by hedge funds are the source of much strife for regulators. Hedge fund managers get 20% of the amount by which they can make the investment grow, and with typical hedge funds running a minimum of 100-500 million dollars, and many running 1-5 billion, those fees can become enormous.70 With that much at stake, some less reputable fund managers are willing to share the fee with an institution that runs money on behalf of others, even if the investment is not right for the risk profile of the investor in question. Sharing that money can come in the form of a rebate of the 2% management fee or, even worse, in the form of a side payment to the fiduciary. The hedge fund can agree to do other business with a bank, buy securities from it, or take loans from it. In addition, this industry is highly secretive.71 The information that hedge funds use to trade on and what trades they engage in could ruin the profitability of an investment if it got out to competitors, thus hedge funds typically disclose very little to their investors about their trading activities. Serious fee conflicts combined with secretive investment practices can be a dangerous combination for a regulator.72

The other ethical dilemma faced in the hedge fund world is that individuals charged with managing money may have a vested financial interest contrary to that of the individuals whose money they are managing. One overarching questions is whether, as in many other area of financial regulation, proper disclosure is enough to cure an ethical conflict. If provided documents describe the kinds of fees relationships that are involved, is that enough even if a conflict is still present? Is caveat emptor supplemented by mandated disclosure the approach that regulators should take to the ethical conflict?73 Or must the financial actors further disclose particular arrangements with hedge funds? Alternatively, is it a better idea to ban access to hedge funds for certain investors altogether and prevent possible trouble? Or would audits by independent accounting firms, or perhaps regulators, be

70 See Stulz, supra.
73 The Investment Advisers Act was enacted by Congress to “substitute a philosophy of full disclosure for the philosophy of caveat emptor” in the investment advisory profession. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).
enough? Further, if you over-regulate and prohibit certain groups from investing in hedge funds at all, are you really just limiting access to a potentially highly lucrative investment? To add further complexity to the issue, a bank that acts as trustee may also run its own hedge fund, or a mutual fund may invest money on behalf of investors in both hedge funds and mutual funds, giving it an incentive to allocate profitable trades to the vehicle that offers the largest performance fee, thus conflicts arise between two competing fiduciary relationships.

On the other side, hedge funds are a vital part of the U.S. economy. They provide liquidity to U.S. markets because they take short positions in equities that other large institutions cannot engage in. (Mutual Funds are prohibited from taking nearly any short positions in stocks).74 They are also more highly active investors than mutual funds and other players in the market, thus helping the price discovery objective of the national securities exchanges.75 They are becoming more engaged in corporate governance, taking large positions in firms and then advocating for organizational changes to enhance efficiency and returns for investors. Any regulation that affects hedge funds should be narrowly tailored to abusive practices so that the benefits that flow from the hedge fund industry to the national economy are not eliminated.

Assuming that preventability76 is the reason for the initiatives considered or undertaken in hedge fund and banking regulation, one question becomes readily apparent. What studies have been done to compare costs (which I measure as 1) compliance costs of hedge funds 2) opportunity cost of trades not undertaken due to an artificial dampening of risk appetite77 3) legal costs of private and governmental compliance and 4) enforcement costs) to benefits (measured as investment appreciation due to fraud prevention, less any appreciation realized as a result of fraud that is never ultimately discovered by the market), for each provision in a reform agenda?78 Any legislation or administrative rulemaking should be conducted with these questions in mind in order to ensure that the costs of the reform do not outweigh the benefit.

74 See Stultz, supra, at 11.
75 Also observed by Paredes, supra, at 986.
76 See Paredes, supra, at 1004.
77 For one of the first studies to provide a robust analysis of the effect of hedge fund regulation on hedge fund returns, completed in February 2007, See Cumming & Que, supra, at 4. “At a broad level, the data indicate regulatory requirements in the form of minimum capitalization, restrictions on the location of key services providers and restrictions on marketing channels via private placements tend to be associated with lower fund alphas, lower manipulation proof performance measures, lower average returns, higher fixed fees and lower performance fees.” They also admit, however, that there is a possible omitted variable bias in their regressions, as certain types of funds may forum select based on the regulations in that region.
Observations about financial regulation

The relationship between an investor and the investment adviser who manages that investor’s money is essentially the same principal/agent relationship that underlines most all of corporate and financial law. The investor, as principal, contracts with the investment adviser, as agent, to manage the assets of the investor diligently and for a specified fee or a specified percentage of the amount by which the adviser can make the investment grow. Jensen’s model of agency conflict informs a discussion of investment advisory relationships. Jensen described that relationship as one in which principals engage agents to perform a service which entails delegation of authority. If both parties to the relationship are utility-maximizers, many situations may arise in which the agents’ interest will diverge from that of the principal. Principals expend to create incentives for agents to limit aberrant activities, and agents frequently expend bonding costs to ensure principal interest and maintain a profitable relationship. If agents can take advantage of information asymmetries to engage in profitable aberration at the principals’ expense and without the principals’ knowledge, it may be rational for him to do so.

Government regulation is one answer to remedy the ineffectiveness of agency models in which the cost/benefit combination of bonding, performance incentives, and asymmetries leads to aberrant agent behavior and high social losses. In the case of hedge fund managers, arguments for or against regulation will ultimately rest on the operation of that market’s agency model absent regulation compared to the operation of the model within a given regulatory regime. The agency relationship inherent in the investment management situation is analogous to that of corporate managers utilizing investor wealth. For instance, the lack of disclosure of hedge

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81 See Fama and Jensen, supra.
82 See ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) AT 6
funds to their investors can be viewed as an information asymmetry that minimizes monitoring by principals. The social cost from aberrant behavior by investment managers might be market instability or investor losses due to fraud.

Merton and Bodie explore the role of institutional change versus functional change in explaining the financial system. Their conclusion is that the form of financial activity follows function rather than institution. Entrepreneurs are not as limited by traditional forms as regulators, whose authority is traditionally defined in terms of the institutions they govern, i.e. banks or broker-dealers. This process hinders the effectiveness of institution-centric government regulators. The regulator is always a little slow to adapt to new financial products, thus market participants can frequently engage in regulatory arbitrage by adapting the function of their activities to evade the purposes of regulation. The innovation problem is particularly cogent in the hedge fund industry. Some predict that regulatory solutions will become outdated “almost instantly” due to the diverse activities and investment strategies utilized by this industry.

Self Regulation

Governments may impose a penalty for fraud. This would entail social cost as social resources are used to conduct compliance audits. But, as we’ve seen, government regulators are severely constrained in their ability to regulate rapidly innovating markets. Government regulators would not be as effective because of regulatory limitations stemming from institutional focus and the slower pace of bureaucratic change. One answer to this problem is to let the private market regulate itself through encouragement and support from the government oversight body. Harnessing the advantages of self-regulation is one solution to the difficulties of rapid functional change. Organizations composed of financial institutions have some interest in ensuring the viability of a market for a profitable activity, such as hedge fund investing, that is harmed by those members who violate best practices. Thus, as a group, a self-regulatory organization may have

86 Axilrod, Stephen “Comments on Public Policy Issues raised by rescue of a large Hedge Fund, Long Term Capital Management”
88 Other professional organizations self-police, including law and medicine. For a study of the effects of self-regulation in the medical field, See Morrison, J and Wickesham, P., Physicians Disciplined by a State Medical Board, Journal of the American Medical Association (1998).
89 Id.
many interests that coincide with market regulators. The advantage is that the self-regulator can escape the bureaucratic morass of the administrative process and congressional review that constrains rapid adaptation to innovation. In addition, private market solutions can also solve this problem. If investors get value from a central information broker, then it may become profitable for a private firm to serve a similar role to the self regulator. Accordingly, one underlying theme of this discussion will be to examine self-regulatory and private market solutions to regulatory concerns in this area.

A classic example of the SEC’s embrace of self-regulation is the SEC’s settlement with the NASD in response to allegations that the NASD was engaged in price rigging. The settlement, among other things, created an independent regulatory capability within the NASD that would be governed by a separate group of securities professionals and attorneys independent of the various rulemaking proposals and disputes before the body. This settlement took advantage of precisely the benefits self-regulation have to offer. The Commission had neither the time nor the ability to adequately innovate its regulatory response to the complexities of securities pricing, so it decided to harness the capabilities of self-regulation by establishing a semi-independent division of an existing SRO to create a valid enforcement mechanism.

In the post-Sarbanes era, criticism of the Self-regulatory model is in vogue. Failures at the NYSE to oversee a reasonable compensation package for Dick Grasso signal the end of self-regulation to some. But some version of self-regulation will remain in the financial community

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90 For more on this, and how government oversight is particularly effective in the SRO sphere, See Peter Demarzo, Michael Fishman, and Kathleen Hagerty, Contracting and Enforcement with a Self-Regulatory Organization, (2000) available at ssrn.
91 Jackson, Howell and Edward Symons, Regulation of Financial Institutions, page 770.
92 In re National Association of Securities Dealers, Inc., Exchange Act Release No. 37,538 (Aug. 8, 1996); See Jackson, Howell and Edward Symons, Regulation of Financial Institutions, page 770. The settlement included the following six strategies to create an effective SRO by providing for:
1. an independent regulatory body within the NASD that would have primary day to day responsibility for the regulation, examination, and disciplining of NASD member firms,
2. fifty percent of all boards of the organization that exercise self regulatory function would be composed of independent members,
3. that the NASD would include participation of independent attorneys to preside over disciplinary proceedings,
4. that the NASD would provide for independence and autonomy for the NASD regulatory staff,
5. that the NASD staff would include an independent audit staff to review the activities of the NASD and report only to an audit committee composed of a majority of independent and non-industry governors, and
6. that the NASD would promulgate uniform standards for regulatory and access issues.
for some time, no one is considering abandoning the NASD. Indeed, just this year the NASD’s regulatory arm merged with its regulatory cousin at the NYSE to consolidate and enhance the effectiveness of its self-regulatory capability. The benefits of self-regulation are frequently paired with an element of supplemental government oversight. This helps to eliminate cases of market failure and establishes a forum for firms to compete with each other in policing themselves. Harnessing the private market to create a self-regulating entity would result in a more efficient and effective solution. The SEC would be instrumental in establishing and maintaining an SRO, as its effectiveness in creating a regulatory regime that could effectively signal fiduciary duty violations to investors would require government authority. The SEC would set up a game similar to that described below by mandating the creation of an SRO, after which the entities involved would then begin voting on compliance requirements that would follow the results of Model 2. The government’s role would be to make membership in the SRO mandatory, because only in that event will the equilibrium forces come into effect.

In theory, a self-regulatory strategy would utilize many of the advantages of a consolidated market structure while sidestepping many of its disadvantages. In effect, a part of the governance of the financial firm is outsourced to a self-regulating central organization (SRO), while the firms output for financial services is still determined based on free market outcomes. This central organization is an effective solution to the free rider problem of industry reputability and could help foster a healthy Nash Equilibrium to deter fraud in the hedge fund management industry.

Model 1: No information asymmetry

First assume that there is no information asymmetry to manager fiduciary violations. Fiduciary duty violations (FDV) is defined in this model as investment managers profiting at the expense of investors absent contractual agreement (i.e. not fees). There may not necessarily

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94 SRO’s, in some circumstances, can become subject to regulatory capture if the market power within the industry becomes sufficiently consolidated. For an interesting exploration of how SRO’s are most effective when they operate under the threat of more onerous government enforcement if they fail to adequately police fraud, See generally Peter Demarzo, Michael Fishman, & Kathleen Hagerty 79 REVIEW OF ECONOMIC STUDIES 687 (July 2005).
95 “Self regulation has played a key role in protecting investors for a very long time. Most observers agree that the SRO system has functioned effectively, and has served the government, the securities industry, and investors well.” Public Statement of Chairman Cox on announcement of the regulatory merger of the NYSE and the NASD. Available at http://www.sec.gov/news/speech/2006/spch112806cc.htm.
be a direct correlation between firms that engage in fraudulent activity and reputation costs. A single firm may find it profitable to engage in fraudulent behavior, where the profit \( P(1) \) exceeds its allocation of industry reputation cost \( C(1) \).

Assume two options for the SRO, allow FDV or stop FDV. If the SRO decided to allow FDV, the firms making up an SRO will experience profit of \( \Sigma P \) and reputation costs of \( \Sigma C \). The organization would allow fraud where \( \Sigma P > \Sigma C \). But, where fraud allows managers to profit at the expense of investors, reputation costs have to at least equal profits from fraud. In such an instance, it would not be profitable for an SRO to allow fraud.

This model would require no regulation, but is not realistic in the financial services world. Information asymmetries do exist, firms have access to data that consumers will never see. Thus, the next model will inform our understanding of this issue more clearly.

Model 2: Information Asymmetry

It is possible that \( \Sigma P \) from FDV does not correlate with \( \Sigma C \). This could be due to an information asymmetry between managers and investors. Hedge funds are highly secretive and utilize hazy valuation measures. Thus investors may not be aware of fraud if it occurs, resulting in a case where \( \Sigma P > \Sigma C \) and the SRO would seem to want to allow FDV.

Even if the reputation costs do not correlate with profits from fraud, an SRO could help lead to an optimal outcome. The SRO could be viewed as an effective forum for establishing a Nash Equilibrium where firms would not violate individually where they might all profit from allowing fraud together.

Profits from investment advising are denoted \( P \). \( P1 = \) profits including FDV when there is no mechanism in place to signal FDV to investors, \( P2 = \) profit with FDV when there is a signal to investors, \( P3 = \) profit without FDV when there is a signal to investors and the other half is also not engaging in FDV, and \( P4 = \) profit without FDV when the other half of the industry is engaged in FDV and there is a signal. Assume that \( P4 > P1 > P3 > P2 \). \( P4 \) is greatest because it results in market share taken from the firms exposed as engaging in FDV by firms not engaged in FDV. The following delineates outcomes in a simplified game in which the funds making up the SRO are divided into two

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halves and allowed to make independent decisions of whether or not to vote to allow FDV in the hedge fund market. Assume for simplicity that half of firms voting for no FDV will result in creation of a self-regulatory regime in which investors will be able to determine whether or not a firm is conforming to established best practices and thus whether or not the fund is engaging in FDV.

<table>
<thead>
<tr>
<th>Voting Outcomes, each group = .5 of industry, one vote for No FDV installs monitoring</th>
<th>B Group of Funds</th>
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<td>Vote for FDV</td>
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<td>A Group of Funds</td>
<td>Vote for FDV</td>
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<td>Vote for No FDV</td>
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The initial position is firms deciding whether or not to engage in FDV. This will decide how a firm will vote, since it would be irrational for a firm to vote to create the signal if it would lose in so doing. If either group of firms decides not to engage in FDV and votes accordingly, it will benefit because it will expose the other firms and thus profit from the additional investments it can now secure from investors. Further, if one group of firms votes not to allow FDV, then the other must not engage in FDV and vote to create the signal as well. Thus, the dominant strategy for both firms will be not to engage in FDV and voting not to allow FDV. In terms of the model above, firms might begin at the decision in the upper left quadrant. But, each firm would anticipate that the other firm would vote to create the signal, because it could profit by taking market share. The Nash Equilibrium model is really all about damage control. This results in both firms voting not to allow FDV. So the SRO functions to create a Nash equilibria because it gives firms an opportunity to create a signaling mechanism to overcome the information asymmetry. The two concepts are linked. The Nash


99 Ie, the the lower left quadrant would be preferable to the A group of funds and the upper right quadrant would be preferable to the B group. But, when each of them vote according to their individual best interest, they end up with an outcome in the lower right quadrant, creation of a regime that allows no one to engage in FDV but also gives no one a market advantage for being honest.

100 The standard response to Equilibria models is: why wouldn’t each firm, knowing how the other would respond, vote to collude. Thus, we’re back to the upper left quadrant above. But, that is why Nash equilibria are so effectively taught with the
outcome is a vote to create a signal that gets rid of a profitable information asymmetry. Collusion is not a concern because both halves would have an incentive to cheat no matter what agreement they came to before voting. Expanding the number of voters should fit with the model, it would simply make it more difficult for firms to collude because they would be less able to agree to vote to allow FDV.

This model makes an assumption that the market for investors is static, which is of course not the case in the real world. Perception of the hedge fund industry will affect the willingness of investors to put money in hedge funds as opposed to, say, private equity or index funds. However, thankfully, removing that assumption only helps the case for self-regulation. A hedge fund SRO would have an interest in creating signals to the general market of investors that the operational risk of fraud in hedge funds is minimal, as it would give them a competitive edge in acquiring investment capital flows over the other asset classes with which it competes. In effect, not only will individual fund managers want a signal about their low operational risk vis a vis their internal competition for capital, they will have an added incentive to create such a signal to aid in their external competition for capital with other asset classes.

Doubtless, every model of complex economic activity will have its flaws, especially when it is as simplistic as this one. However, with the presence of mild SEC oversight\footnote{One of the fundamental precepts that has characterized the SRO model since its inception in 1930s: the notion that regulation of the markets works best when the frontline regulator is close to the markets. The SEC and other government regulators would continue to benefit by being able to leverage their resources through an oversight role, and the securities markets would continue to be supervised by organizations familiar with the nuances of their operations.” Cox Statement supra.}, as we have seen with the NASD and the NYSE\footnote{Two organizations whose regulatory arms have recently merged, with the SEC’s blessing, in order to join forces and enhance the effectiveness of the self-regulatory advantage. See Howell Jackson & Stavros Gkantinis, Markets as Regulators, A Survey, Harvard Law and Economics Discussion Paper No. 579 (2007) available at http://ssrn.com/abstract=960168.}, we can steer the SRO in the right direction in the event that it becomes subject to regulatory capture.\footnote{For more on the effectiveness of SROs when backed up by government oversight, See Howell Jackson & Stavros Gkantinis, Markets as Regulators, A Survey, Harvard Law and Economics Discussion Paper No. 579 (2007) available at http://ssrn.com/abstract=960168.}

Regulatory Competition

example of the Prisoner’s Dilemma. (Two suspects in different rooms, the first one to talk gets five years and the other gets 10, but if they both stay silent they both walk free. Yet, acting in their individual self interest, they both talk and get a result that is detrimental to their collective self interest. Take out scratch paper and play it with a friend, you’ll see.) So, the response to that question is that, as soon as you agree to collude with your other partner, it’s still in each’s self interest to cheat on the collusion agreement, and we’re back to the Nash equilibrium. My apologies for the amateur economics, but the basic theory holds. Supplement that with Government agency review of the SRO’s decisions, and you have an effective governance alternative to full oversight.
A frequently highlighted debate in corporate governance is the usefulness of regulatory competition in state oversight of corporations. Many scholars point out such competition develops into a “race to the bottom” in which states compete to form the most liberal regime to attract chartering. A classic view is that states compete to develop superior competency through efficient and effective regulatory regimes, the so-called “race to the top”. Jackson points out that a similar line of thinking has emerged in the field of financial regulation. His analysis focuses on competition in the global financial marketplace. Proponents of regulatory competition argue that investors are able to take into account the value added by investing in companies that are listed in well-regulated regimes.

This third concept fits nicely into the previous two. Where governments act to solve the agency problem of investment management, they are frequently at their best where they compete (but also coordinate) with other agencies of the government insomuch as such competition encourages them to innovate to attract chartering. The rapidly changing function of financial activity, described by Merton, would be met by multiple regulators able to specialize in different types of institutions within that same industry. In the same way that banks charter under different regulators to meet their idiosyncratic needs, investment managers could do the same in a regulatory competition environment.

Section IV: Do we need to regulate Hedge Funds?

Some market regulators, such as former Fed Chairman Alan Greenspan, are concerned that regulation of hedge funds could harm

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106 See Ibid at 13

107 For a good primer on this idea, See Robert B. Ahdieh, Dialectical Regulation, 38 CONN. L REV. 863 (2006).

market liquidity. Many hedge funds add liquidity by engaging in short selling as part of their hedging operations, thus making them an effective counter party to long traders. The dearth of long trades in the market comes in part from the fact that some institutions, such as mutual funds, are prohibited from short selling. Thus anything that hinders hedge funds ability to operate could hinder market liquidity. This liquidity makes the flow of funds more efficient, reducing cost to all participants.

A registration requirement is constructive in that it would give regulators more information about an active market participant that is especially secretive. Absolute return requirements can put more pressure on managers when returns are low, as their watermark requirements will severely limit management compensation. Regulators are concerned that this will encourage engagement in excessive operational risk or fraudulent activity, as in the market timing and late trading scandals. Regulators hope to anticipate such activities using information gathered through a registration compliance process and analyzed by entities such as the SEC’s new Office of Risk Assessment. The anti-fraud provisions of the Securities Act already apply to hedge fund operators, but regulators complain that their secretive nature makes unfortunate post-event prosecution their only current tool to combat fraud. Critics question whether the SEC can

110 See Cumming & Que, supra, at 3.
112 (“Under existing laws, financial regulators are somewhat handicapped in their ability to identify the potential risks posed by hedge funds”). Willa E. Gibson, Is Hedge Fund Regulation Necessary? 73 TEMP. L. REV. 681, *709 (Summer 2000)
114 “By keeping a census of advisers, the Commission can better respond to, initiate, and take remedial action on complaints against fraudulent advisers” Goldstein v. S.E.C. 451 F.3d 873, *876 (C.A.D.C.,2006)
anticipate hedge fund malfeasance if it could not anticipate such problems through its oversight of mutual funds.117

Hedge funds often use extraordinary degrees of leverage in comparison to other vehicles. Excessive leverage brings in issues of systematic risk, as evidenced by the LTCM debacle.118 The system runs the risk that the insolvency of a large enough market participant could unwind and significantly affect the perception of market participants, rippling out into the economy at vast cost. Regulation T (a Federal Reserve borrowing limitation) already limits the leverage that a broker dealer can provide, but the lack of transparency in firms’ positions makes accurate measurement of the firms leverage ratio difficult for the primary brokers to measure. The leverage concern is not as prescient if one believes that the firms generally properly value their hedged positions to minimize risk. Nevertheless, an institution that adds systemic risk to the market and is by its very nature secretive in its movements and strategies is a difficult combination for a regulator. The information gathered through registration could be used to aid the Federal Reserve in its mission to ensure the stability of the payment system.119 Systemic risk was not a goal mentioned in the SEC’s report on the implications of hedge fund growth and will therefore be largely set aside for the remainder of this examination.

Excessive regulation may also make it worthwhile for hedge funds to move to offshore jurisdictions.120 This would mean that funds still pose the same risk to U.S. markets, but escape any government oversight. Offshore flight would be especially easy for funds already

117 Burns, Judith, Hedge Fund Primer, Dow Jones Newswires, page 131. See also John C. Coffee, Jr., A Course of Inaction: Where Was the SEC When the Mutual Fund Scandal Happened, 2004 Legal Aff. 46
118 Gibson provides a summary of the LTCM debacle: “The most widely publicized being the difficulties encountered by Long Term Capital Management, L.P., operating Long Term Capital Portfolio, L.P. (“LTCM”). The LTCM fund employed various trading strategies, with the majority of its trading positions in government bonds of the G-7 countries. In summer 1998, conditions caused by financial problems in Russia and other emerging markets caused LTCM to incur substantial losses. The enormous size of the LTCM hedge fund placed its trading counterparties and creditors in a position to lose substantial amounts because they had extended excessive credit to LTCM, either through trading counterparty or lending relationships. Since LTCM’s creditors and counterparties had allowed LTCM to build up dangerous levels of leverage, they faced the real possibility that LTCM would default on the credit obligations it owed them. To protect themselves from an LTCM default, some of the fund's creditors and counterparties created a consortium, which injected $3.6 billion in equity into LTCM in return for receiving ninety-percent equity stake in the fund. Banking regulators assisted LTCM creditors and counterparties in creating the consortium because they feared that LTCM's losses could cause financial shock to the markets if LTCM's seventy-five counterparties sought to liquidate their positions simultaneously in response to an LTCM default.” See Gibson, supra, at 682.
119 For a summary of how systemic risk is usually left off the SEC agenda, See Paredes, supra, at 984.
120 See Cumming & Que, supra, at 21.
running mirror offshore entities to achieve. But will all funds seek to move in response to heightened regulation? The bonding hypothesis for exchange listing holds that foreign companies list in the United States to signal to investors that they are well-governed companies with nothing to fear from regulation. Perhaps hedge funds will also wish to use domestic registration under heightened regulation to signal the same to institutional investors. Many of the larger funds already registered voluntarily before the current regulations to do just that.

**Section V: The SEC’s stated motives for requiring registration**

The Commission is concerned about fraud in the industry. The SEC has initiated roughly 40 enforcement actions involving fraud in the last five years involving hedge funds. Though these numbers are not proportionally significant, the losses involved in each case were far higher than most because the SEC was unable to act until long after the fraud occurred, due to the lack of information about the industry. The Commission justified the registration requirement on the grounds that information gained through registration and compliance will increase the probability that it can detect fraud in the future in this rapidly growing industry.

Another significant concern is the retailization of hedge funds. The hedge fund exception to registration requirements was based on limiting investment in the fund to individuals meeting a wealth threshold. One of the justifications for a past lack of regulation has been the assumption that wealth is a proxy for sophistication and sophisticated investors are able to look after themselves. The advent of Funds of Hedge Funds (FOHF) and pension fund investment in hedge funds increases the exposure of “unsophisticated” investors. There are no limitations on an investor’s wealth in a FOHF. However, a previously mentioned, the increase in minimum wealth requirements should take care of most of that issue for now.

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121 See Stultz, supra, at 6.
122 For a summary of the over-regulation and under-regulation by the SEC driven by bias and political factors, see Paredes, supra, at 1025.
124 See Ali, supra, at 74.
125 An interesting phenomenon that will turn this entire question on its head, and indeed shows just how the structure of securities products follows function rather than form, is the advent of hedge fund IPOs, where the hedge fund adviser will subject itself to registration under the 33 and 34 act. See, e.g., the 2007 Fortress Investments IPO “Fortress, which priced 34.3 million shares at $18.50 to raise $634 million, is the first alternative investment firm to go public in the USA and the second-biggest IPO so far in 2007.” Available at http://www.usatoday.com/money/markets/us/2007-02-08-hedge-fund-ipo-usat_x.htm. Whether this remedies the issues discussed in this paper I leave to further examination.
Surprisingly, though, the Commission was also concerned about the lack of disclosure to sophisticated investors. Valuation methods for hedging operations are tricky, and investor sophistication may not be sufficient to protect their investments from fraud. The Commission was also concerned that disclosure about conflicts of interest with other investment management activities of the general partners were not being sufficiently disclosed. The traditional prophylaxis for avoiding conflict has been a market norm that hedge fund management invest nearly all of their personal wealth in the fund.\textsuperscript{126} The theory is that their motives will align with their investors and conflict will be avoided. Valuation issues nevertheless remain when investors cash in and where they cash out. An unethical manager could game the valuation of the funds holdings, which often lack comparables, to ensure that management receives more than their fair share of the pooled funds.

The Commission has also expressed concern over the role of advisers running mutual funds and hedge funds simultaneously. Mutual funds have recently suffered from an inability to compete for professional talent with hedge funds.\textsuperscript{127} The fees they offer are no match for fees in mutual funds.\textsuperscript{128} In addition, management at mutual fund advisory companies are themselves interested in a piece of the action. This has resulted in many mutual fund advisors starting their own hedge fund operations.\textsuperscript{129} A significant conflict of interest faces firms that operate both mutual funds and hedge funds. The fact that the investment manager would have a fiduciary duty to investors on both sides, through an investment adviser obligation to the mutual fund and fiduciary obligation to the partners in the hedge fund partnership, makes the issue especially complex. There are two instances in which the conflict is readily apparent. There is a danger that firms will allocate a trading opportunity to the hedge fund over the mutual fund in order to take advantage of the higher performance fee. There is also a possibility that the firm will use the long investing in the mutual fund to mirror and support the shorting activities in the hedge fund.\textsuperscript{130} Even if the mutual fund trades result in a loss, management’s take of the performance fee in the hedge fund more than compensates for the loss. Greupner argues that the proper arena for reform should be on the Investment Company Act side, to enhance the regulations so that mutual funds are prevented from such activity.\textsuperscript{131} The information asymmetry between the fund and investors would still remain. Without statutory requirements for the hedge fund to submit to a compliance

\textsuperscript{126} See Ali, supra, at 76.
\textsuperscript{127} Greupner, Eric J., Hedge Funds are headed down market, A Call for Increased Regulation, 40 SAN DIEGO L. REV. 1555, 1560 (2003).
\textsuperscript{128} See Stultz, supra, at 7.
\textsuperscript{129} See Greupner, supra.
\textsuperscript{131} Greupner.
audit, there would be no way for the Commission to ascertain whether a conflict of interest was being exploited by the mutual fund management through their activities in a hedge fund they also managed.

Section VI: Problems with the previous regulation

In order to exempt private equity funds from the registration, the SEC’s previous attempt exempted funds that didn’t permit their investors to withdraw their investments within the first 2 years, a requirement common in private equity investment contracts.\(^{132}\) However, in order to avoid registration, many hedge funds simply increased their lockup requirement. If Hedge funds move to 2-year lockup periods in order to exempt from a future registration requirement, it will become more difficult for FOHFs (Funds of Hedge Funds that pool investment in different hedge funds together for smaller investors)\(^{133}\) to move between funds. This result will mean that smaller investors in the FOHFs will lose some of the advantages of having a manager select hedge funds for them. Smaller investors gain access to the privileged world of hedge funds through FOHFs, but with added diversification and fund picking expertise. This buffer helps to protect the downstream investors that are brought in through retailization of this investment vehicle. It could be that the two-year lock up exception will have the ironic effect of harming downstream, smaller investors. With a two-year lock up, a FOHF will lose its ability to exit poorly performing funds and enter well-managed funds. It is still possible that some funds will not institute the lock-up provisions in order to attract FOHF money.\(^{134}\) Smaller hedge funds will be the harder hit by registration expenses, so they are more likely to make use of the lock up exception.\(^{135}\) So at the very least, we should expect that FOHFs will have access to fewer small hedge funds as a result of the SEC’s new rule.

Registration may also send the wrong signal to investors that a hedge fund is completely safe when registration only means that minimal compliance audits of some especially risky firms have been conducted.\(^{136}\) This implied seal of approval may further increase the exposure of retail investors to hedge funds as smaller investors demand access. One effective result of registration will be an enhanced review of conflicts for dual mutual fund/hedge fund operators. Previously, the Commission only had access to compliance audits of the mutual fund’s operations. They will now be able to compare the activities of both funds to police for violations of fiduciary duty.

\(^{132}\) For more on lockups, See Paredes, \textit{supra}, at 1017.
\(^{133}\) \textit{See} Stultz, \textit{supra}, at 10.
\(^{134}\) MFA page 15
\(^{135}\) MFA 16.
\(^{136}\) MFA page 23,
Section VII: Lack of Coordination between the SEC and the Commodities Self-Regulators\textsuperscript{137}

The global nature of the financial market system is a component of policymaking in this area that one cannot afford to forget. Financial intermediaries work across multiple borders; payments flow digitally over oceans instantaneously. Ideally, financial regulation should take into account global effects and would be composed with an eye for what other countries are doing so that global regulation of financial intermediation works in unified harmony. The U.K. Financial Services authority already has a regulatory regime for hedge funds that the U.S. should at least consider in crafting its own. FSA and SEC processes are typically very different, with the SEC having more expansive disclosure requirements and the FSA having a more onerous application process.\textsuperscript{138} This compounds the expense of regulatory compliance for cross-border funds. The risk that cross-border hedge funds will have inconsistent rules across jurisdictions is even worse. The globalization of finance is a net benefit to all concerned. Regulators need to be more careful to coordinate their rulemaking efforts so that they do not accidentally hinder inter-border investment. If accumulating market intelligence is truly one of the SEC’s goals in creating this rule, cooperation with the FSA is vital. Information sharing, combined with cooperatively designed regulatory regimes, would help both countries to maintain market stability and achieve investor protection. The Commission has mentioned in a footnote to the Final Rule Release that it will seek such information sharing, a marginal accommodation that seems to lack substance in light of its failure to coordinate the registration requirement.\textsuperscript{139}

Many allege that the Commission was also guilty of failing to cooperate fully with its fellow domestic regulators.\textsuperscript{140} The CFTC Chairman was particularly incensed about the registration rule. Many funds that would have been forced to register as Investment Advisers were already registered with the CFTC as commodities trading advisers or commodities pool operators.\textsuperscript{141} Even many funds exempt from CFTC registration voluntarily registered for supervision by the National Futures Association (NFA; A self regulatory body under the jurisdiction


\textsuperscript{138} MFA 18

\textsuperscript{139} “So that our oversight of offshore advisers can be conducted effectively and efficiently in light of potential overlap with foreign regimes, we have asked our Division of Investment Management, our Office of Compliance Inspections and Examinations, and our Office of International Affairs to explore ways to obtain and share information with foreign authorities with oversight of hedge advisers that may register with the SEC.”


\textsuperscript{141} MFA 11
of the CFTC). The NFA promulgated best practices guidelines and conducted periodic audits to the satisfaction of the CFTC Commissioner. Many were concerned that the registration requirement may have encouraged firms already voluntarily registered with the CFTC and the NFA to keep only their mandated SEC registration as a cost saving measure.

Self-regulatory strategies, as previously examined, are particularly effective in the area of finance. The FASB, NFA, NASD, and to some extent the Federal Reserve are all examples of self regulatory organization sponsored by Federal Regulators. The advantage of these institutions is their flexibility to accommodate rapid financial innovation. Though a self-regulator faces more conflicts of interest, it is also more capable of preventing regulatory arbitrage and fostering innovation. Further, conflicts of interest are constrained by the optimal voting models explored in part I of this essay. If NFA oversight of hedge fund activity is jeopardized, the SEC runs the risk of limiting the effectiveness of hedge fund oversight. Accordingly, Chairman Brown-Hruska sought an exemption from the SEC for those funds already registered with the CFTC.

The SEC specifically rejected the proposal to exempt CFTC registered entities, claiming that the Section 203(b)(6) exemption from registration for any firm registered under the Commodities Exchange Act whose business “does not consist primarily of acting as an investment adviser” should be sufficient. The SEC has failed to give much comment on its definition of investment adviser, thus the exemption is largely moot. The SEC also felt that firms would begin to take advantage of recent CFTC exemptions to withdraw from registration, but failed to address the significance of voluntary

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142 “Pursuant to our delegated authority to the NFA, elective registration with the CFTC results in an independent and expert review that includes periodic examinations, evaluation of internal controls, and review of required disclosure documents and financial statements. In our review of the NFA’s audit and compliance program, the NFA has demonstrated the necessary understanding of the complexities of the firms they examine, and a willingness to be tough when problems are uncovered. “Sharon Brown-Hruska, Acting Chairman Commodity Futures Trading Commission, in remarks to the Securities Industry Association Hedge Funds Conference November 30, 2004, at http://www.cftc.gov/opa/speeches04/opabrown-hruska-22.htm

143 For a summary of the CFTC regs affecting hedge funds that invest in commodities, See Gibson, supra, at 699-701.

144 “In my comment to the SEC, I requested that the SEC provide a registration exemption for CFTC-registered CPOs and CTAs that sponsor, operate or advise privately-offered commodity pools and that do not hold themselves out to the general public as investment advisers. It is my view that such a registration exemption would avoid duplicative regulation and would be consistent with good government, the principle of functional regulation, and current exclusions and exemptions in the Advisers Act for regulated financial institutions. This exemption for CFTC-registered CPOs and CTAs would be complemented by a formal information sharing agreement between the CFTC and SEC related to CFTC registrants.” Ibid.

145 Dorsey & whitney white paper, MFA 34
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compliance through the NFA. Indeed, even if firms are withdrawing from CFTC oversight, that says nothing about an exemption for those firms that remain.

If the SEC approved the exemption for funds registered with the CFTC, it would give funds a choice of regulators. This would be similar to the multi-regulator architecture in banking. Banks have the option to charter under either the Federal Reserve, Comptroller, or state regulators. As previously explored, many would assert that this competition between regulators has made them more innovative, encouraging them to both streamline the cost of regulation to attract registrants and maintain tight oversight so that other regulators don’t outshine them before Congressional oversight. It has also allowed the multiple regulators to specialize. Hedge fund oversight could benefit from such a multi-regulatory structure, but only if the overlap forged by the SEC’s previous rule is not renewed.

Section VIII: Policy Recommendations

I will now examine a variety of alternative regulatory strategies and structures through which the SEC can make a second, more narrowly tailored attempt at regulating hedge funds. The lack of overlap between the registration requirement imposed and the concerns addressed by the SEC in their report calls for some additional effort to address those concerns. The general line of analysis explored here, the least cost and highest efficiency alternative, is an extension of the self-regulatory thesis previously explored. There are three entities that the SEC can use, the NFA, MFA, and NASD, (all examples of SROs or quasi-SROs) to enhance the self-regulatory form of governance over this market. I examine these supplements to SEC central regulation as they might resolve some of the problems inherent in the previous regime.

Government regulation has a historical tendency to grow outward beyond the intent of current thinking, I merely hope to provide some alternative lines of analysis through the remainder of this essay.

Recommendation #1 The Commission should take steps to encourage creation of a private market intermediary. One step might be to make information gathered through a compliance process available to a select few officially chartered private rating agencies. The idea is admittedly tricky, the confidentiality of firms’ proprietary data would have to be assured, but the possibility deserves exploration. The analysis explored above of agency problems created by asymmetries, and the use of SROs to overcome these, could be sidestepped with a

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method to eliminate the information asymmetry itself. A private information intermediary could at least minimize the agency conflict by providing more information to hedge fund investors. Dr. Harvey Westbrook, an economist for the SEC, recently published a paper exploring the capabilities of such an intermediary that are particularly insightful.147

Dr. Westbrook proposes harnessing the growing institutional investor interest in hedge funds to encourage a private certification process. He asserts that institutional market power can be used to negotiate for fund participation in a verification process to assure fund management operates within independently established operating procedures. Institutional investors are a future source of enormous funding for the industry. Many chase absolute return strategies to meet dramatic funding shortfalls.148 Their market power has been demonstrated in their ability to force funds into voluntary registration as investment advisers before the previous regulations were promulgated. Nevertheless, their bargaining capability is not unlimited, and so this recommendation is not intended to stand alone.

The efficacy of institutional investor market power has already been tested in the arena of corporate governance. Calpers has achieved some success, especially in the use of “moral suasion”. Nevertheless, many firms face a collective action problem. The profits from acting are exceeded by the individual cost of activism. It is cheaper to sell holdings and take the “Wall Street walk” (to simply sell the investment). This situation may be analogous to the hedge fund world. The positive externality that Dr. Westbrook aptly identifies, that institutional investors monitoring firms spills over into individual investor protection, is a case in point. The institutions have no way of internalizing that profit, and will act only where the cost/benefit analysis makes the decision to certify a rational one.

A private hedge fund certification entity may be possible if it can become a self sustaining and profitable venture, as in the case of ISS for corporate governance. Perhaps the entity will not be created by the institutions as much as it will be an intermediary earning a profit for its owners. If that entity can achieve economies of scale such that the cost of the service to each institutional investor customer is exceeded by their value attributed to monitoring, then intermediary certification can be achieved. If hedge funds are to cooperate with the certification body, assurances of the confidentiality of proprietary data will certainly be required. Though many hedge fund informational services exist, and some are able to obtain access to internal controls and trading data, the industry standard of strict confidentiality limits their effectiveness. I offer one possibility, affording access to SEC, NFA, or Hedge Fund SRO

148 See Ali, supra, at 74.
audit results to a limited number of certified intermediaries, as one idea by which the Commission would need to encourage the creation of a valid information intermediary.

Adding a new intermediary into the flow of financial funds can help to alleviate operational risk. Still, adding a new principal-agent relationship to the system of investment flow also creates more potential conflict of interest. Also analogous to ISS, and independent intermediary would run the risk of attending to its own interests at the expense of investors. It could sell consulting services to hedge funds. It could game the certification process and play both sides against the middle. The efficacy of the intermediary would depend on its market power, the ability of competitors to challenge it (whether certification is a natural monopoly), and the regulatory environment facing certification providers. Even if a certification intermediary is established, it is also unlikely that it will fully internalize the negative externality of systematic risk that hedge fund’s use of leverage may engender. The intermediary will still face the same difficulty as regulators in measuring leverage, and it will never have as high an incentive as a regulator to limit such risk.

**Recommendation #2** The SEC should request the Managed Funds Association (MFA) to put together a proposal for a disclosure statement requirement in accordance with an original suggestion of the SEC staff in its report on hedge funds. The MFA is a private lobbying and research organization that serves the hedge fund industry. At the very least, it could make use of the “moral suasion” frequently cited by academics as a vital element of financial regulatory policy. A regulatory body can encourage private sector action through the implicit threat of added regulation. **In addition, it should go a step further and consider a grant of authority to the MFA to license members. The Commission could then extend an exemption for registrants with the MFA to any future registration requirement.** If the arrangement could be properly designed, with independent regulatory authority and power vested within the private organization, the result could be a self regulatory capability similar to that used in

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149 This point is also a component of the recent statement of principles of the President’s Working Group on Financial Markets. See 2007 PWG Report, *supra*, at 5. “[Principle] 9- Managers of private pools of capital should have information, valuation, and risk management systems that meet sound industry practices and enable them to provide accurate information to creditors, counterparties, and investors with appropriate frequency, breadth, and detail.”

150 This follows in line with the PWG’s overarching guideline that “The vitality, stability and integrity of our capital markets are a shared responsibility between the private and public sectors….Investor protection concerns can be addressed most effectively through…market discipline.” *See* 2007 PWG Report, *supra*, at 1.
broker dealer regulation on the NASDAQ, facilitated by an opt-over provision from SEC registration.\footnote{Some have argued the case for rules for which one cap opt out in corporate law. See Lucian Arye Bebchuk & Assaf Hamdani, \textit{Optimal Defaults for Corporate Law Evolution}, 96 NW. U. L. REV. 489 (2002). This would be an opt-over provision.}

As an informative example, the SEC’s settlement with the NASD in response to allegations that the NASD was engaged in price rigging reviewed in the self regulatory section of this essay would be analogous to this recommendation.\footnote{Jackson, Howell and Edward Symons, Regulation of Financial Institutions, page 770} If the SEC could persuade the MFA to create a similar enforcement body within its ranks, and offer the extension of an exemption for firms registered with the MFA regulators, then it would allow a forum for a Nash regulatory equilibrium to ensue.

The NASD may also be able to aid in regulating primary brokers in the area of hedge funds to look for conflicts. Hedge funds typically use a primary broker who acts not only as their main securities broker but also provides accounting and custodial services to the fund.\footnote{1999 PWG Report, supra, at B-5} Those brokers are already regulated by SROs, including the NASD. For example, the SROs and the SEC already enforce their own liquidity requirements, promulgated by the FED or the SRO, for broker dealers to ensure minimization of counterparty risk.\footnote{1999 PWG Report, supra, at B-5} They could add enhanced oversight of conflicts through this established vehicle as well. Through the SEC’s leadership, these established self-regulatory forums could be used to create the kind of regulatory Nash equilibrium described in the previous section.

It is important to note that the self-regulatory model is insufficient to regulate systematic risk, or the risk that over leverage in the industry will lead to a domino effect of loan defaults and resulting in financial meltdown. This risk forms a negative externality that consumers and suppliers of financial services do not take into account in their economic decisions. Therefore, the Federal Reserve should maintain vigilance in this area. But since this is largely a response the non-liquidity concerns of hedge funds, and rather the fraud and self-dealing occurrences in the industry, I will leave exploration of that problem to more qualified experts.

**Recommendation #3** The SEC should enhance coordination with other regulators. The Commission should also exempt CFTC registrants from any future registration requirement. This would continue to encourage funds to register with the NFA, thus continuing the benefits of self-regulation in this exceptionally complex and rapidly changing environment.\footnote{See Saloner, G., “The Self-Regulating Commodity Futures Exchanges” The Industrial Organization of Futures Markets Lexington (1984).} This would also eliminate the high cost and
redundancy in dual-regulation from both Commissions and help to foster a competitive regulatory environment.

The CFTC Chairman’s request for an exemption was an olive branch from the CFTC to prevent turf wars over regulation of a 1.5 trillion dollar industry and could lead to enhanced information sharing between the two regulators. The Commission should also create a working group to coordinate information gathering with the U.K. FSA, and find ways to make registration easier for offshore registrants. International cooperation would help to minimize the impact of regulatory costs. As part of this initiative, the SEC should consider an exemption for entities registered in the U.K. The same arguments justifying a similar exemption under Rule 144A for Canadian issuers selling securities would apply. Regulatory competition is frequently cited as creating a “race to the top” in corporate and banking law, the same principle would apply in this forum.

**Recommendation #4** The Securities Exchange Commission should establish some statutory recognition to hedge fund best practices through safe harbor rule-making to encourage registration with a self-regulatory body. It could provide a defense to regulatory enforcement action to any hedge fund that follows guidelines promulgated by such a body, in much the same way it recognizes such for firms that follow GAAP accounting rules promulgated by the Financial Accounting Standards Board or broker-dealer best practices promulgated by the National Association of Securities Dealers.

Admittedly, there should already be some impetus to following these kinds of rules, as following best practices promulgated by an industry group should provide some common law defense for the reasonableness of a firms activities. But statutory protection would be more well defined and coordination preferable to a patchwork of legal decisions in this area.

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156 The International Organization of Securities Commissions makes some headway in this area, See Lawrence A. Cunningham, Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance, 84 CORNELL L. REV. 1133 (1999). However, formal, one-on-one coordination directly between the FSA and the SEC would be advisable, since those two jurisdictions contain the overwhelming majority of hedge fund operations.


158 See Ahdieh, supra, at 883.


160 Jackson at page 10.

161 Paredes argues that merely promulgation of best practices is enough, citing literature on the expressive function of corporate law. See Paredes, supra, at 1028, citing Russell Korobkin, Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms, 51 VAND. L. REV. 1583 (1998); Russell Korobkin, The
Recommendation #5 The Martin Act should be amended by the New York legislature to limit the powers of the New York Attorney General\textsuperscript{162} so that activities in compliance with SEC regulations are statutorily exempt from the definition of fraud. This will help ensure that the priorities and activities of the Attorney General’s Office and the SEC do not provide inconsistent guidance to the financial community generally and the hedge fund world in particular.\textsuperscript{163}

Recommendation #6 The SEC should adopt the other recommendations issued by the SEC staff. The SEC staff made a number of recommendation in its report on the “Implications of the Growth of Hedge Funds” requested by the Commission members in anticipation of rulemaking that were noticeably absent from the previous rule change. Among those were:

1. The Commission staff should consider addressing certain valuation, suitability, and fee disclosure issues relating to registered FOHFs
2. The Commission should consider permitting general solicitation in Fund offerings limited to qualified purchasers
3. The Staffs of the Commission and the NASD should monitor capital introduction services provided by broker dealers
4. The Commission should encourage the Hedge Fund Industry to embrace and further develop best practices\textsuperscript{164}

The Commission’s previous rule failed to address many of these recommendations. Encouraging best practices would be an especially useful tool that the SEC failed to address at all. Best practices are a weak form of SRO regulation that could effectively supplement the Commission’s efforts. Without any carrot or stick to encourage funds abiding by best practices, or dialogue with the MFA to maintain best practices guidelines, that avenue will remain unexplored.

Part III: Regulation of Institutions Investing in Hedge Funds

Section I. Regulatory Environment for Institutions Investing in Hedge Funds

In Dr. Jones’ time, only wealthy individuals and families invested in hedge funds. Yet now, there are two types of institutions that dominate the market of hedge fund investors, banks and pension funds. Banks typically act as fiduciaries for a number of account classes for which they act as a trustee. In 2002, trustees in the United States controlled over 1.1 trillion dollars in trust accounts, with 40% of that total run by chartered banks. As such, they have discretion over which asset classes these accounts will be invested in. Different institutions regulate banks depending on the source of its charter and its ownership structure. They may be chartered by the Comptroller of the Currency or by the Federal Reserve, or they may be state chartered and regulated by the FDIC. States typically allow non-banks to act as trustee for funds. In addition, if they are owned by a Financial Holding Company, the Federal Reserve will pre-empt other federal regulators.

Each state has a body of fiduciary duty and trust law that will apply to these activities. Whether the bank in question is a federally chartered bank or not, it will still be subject to such laws. This is because OCC regulations proscribe that national banks chartered by the Comptroller of the Currency will be permitted to invest common trust assets in mutual funds and other equity classes provided that such investment is permitted for State banks organized under the laws of the State in which the national bank maintains its headquarters.

Trustee powers are first construed based on the documents controlling the contract relationship, with an eye toward upholding freedom of contract so long as a prudent investor rule is met. Though there is a common law rule against delegation of trustee responsibilities, that delegation does not include investment in investment companies. This is justified under the assumption that the trustee has control over whether to invest in the investment company and whether to liquidate such investment when appropriate. Though it was originally illegal for trustees to pay a management fee to investment companies out of trustee assets, state laws have since been amended to allow the practice.

Though supplemented by statute and narrowed by contractual limitations, fiduciary duty common laws are the overriding principle around which a fiduciary’s activities are judged. They require that investment of trust money be done in accordance with the prudent interest of the trust beneficiaries, with that prudent interest being

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165 See Ali, supra, at 74-75.
166 Broome, Lissa L. and Jerry Markham, Regulation of Bank Financial Service Activities, 2004, West Group, P 753.
167 Broome, supra, at 753.
168 OCC Trust Banking Circular No. 4 [Sept., 1976].
169 See Ali, supra, at 80.
171 Onbank, supra, at 4.
172 Broome, supra, at 769.
defined by statutory constructs and case law. The seminal state case in this area was Harvard College v. Amory:

“All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probably outcome, as well as the probably safety of the capital to be invested.”

Self-dealing, or investing trust assets in a way that benefits the trustee to the detriment of the trust beneficiary, is one recognized violation of the prudent investor rule. For instance: investing trust money in a publicly traded stock where the trustee also has a large holding in the stock, when there is some evidence that the stock is overpriced and the investment is large enough to have a detrimental effect on prudent diversification of the trust portfolio is a clear case of fiduciary duty violation. Though not binding precedent, the Third Restatement of Trusts is an informative source of law used by both state legislators and judges in interpreting trust duties. It was amended in 1994 to address the issue of fiduciaries investing in other entities, and its approach essentially embraces modern portfolio theory.

Pensions are another pooled investment entity that places money in hedge funds. They are similar to trusts in that they utilize a trusted manager who has broad discretion in placing pooled assets. Under the Employee Retirement Income Security Act of 1974 (ERISA),

173 Also noted in 2007 PWG Report, supra, at 3. “Concerns that less sophisticated investors are exposed indirectly to private pools through holdings of pension funds, fund-of-funds, or other similar pooled investment vehicles can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles. These fiduciaries have a duty under applicable law to act in the best interest of the beneficiaries. They have an ongoing responsibility to perform due diligence to ensure that their investment decisions are prudent and conform to sound practices for fiduciaries. Such pooled investment vehicles should address any special issues relating to investment in private pools of capital, including the availability of relevant, accurate, and timely historical and ongoing material information.”

174 Harvard College v. Amory, 26 Mass 446 (1830).
175 Central Bank of Mattoon v. U.S. Dept. of Treasury, 912 F 2d 897 (7th Cir. 1990).
176 “(1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term "portfolio" embraces all the trust's assets. UPIA § 2(b). (2) The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration. UPIA § 2(b). (3) All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. UPIA § 2(e). (4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3. (5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards.” UPIA § 9.Uniform Prudent Investor Act, National Conference of Commissioners on Uniform State Laws, 1994

177 See Ali, supra, at 89.
fiduciaries of employee retirement plans are regulated to protect pension holders from abuse. The fiduciary law of trusts was invoked by Congress within the ERISA framework to define the general scope of authority and responsibility for pension officers.\textsuperscript{178} ERISA guidelines supplement the general fiduciary duty law of trusts and further define the law of private pensions as including the duties of prudence and loyalty.\textsuperscript{179} As a general matter, there is nothing wrong with fiduciaries, pension or otherwise, investing in hedge fund if the investment comports with the prudent investor rule.\textsuperscript{180} To meet these duties, an ERISA plan fiduciary must, at the time of the transaction, utilize proper methods to investigate, evaluate, and structure the investment; act in a manner as would others familiar with such matters; and exercise independent judgment when making investment decisions.\textsuperscript{181} As with most trusts, when the governing contract restricts an ERISA plan officer’s investment discretion further than ERISA guidelines, such restriction will govern. To increase the web of complexity in this area, ERISA plan administrators will frequently place the assets of the plan with a bank to serve as a trustee for the ERISA plan beneficiaries. In those cases, fiduciary obligations will apply to the trustee through both common law and common law as adopted by federal statute.

The Comptroller of the Currency has discretion to issue a notice of intent to revoke a bank’s permission to provide trust services, and can do so upon providing a hearing before an OCC administrative Law judge, if it has evidence that bank has exercised its trust powers unlawfully or unsoundly.\textsuperscript{182} Currently, the OCC provides some guidance on fiduciary standards in the form of circulars issued under authority granted in 12 CFR §9.\textsuperscript{183} State regulators and private litigants further supplement the enforcement of fiduciary standards.\textsuperscript{184} The OCC has requested comment on whether it should adopt uniform fiduciary duty standards for trust officers.\textsuperscript{185}

The Federal Reserve has broad discretion as a regulator. It can define something as an unsafe banking practice harmful to deposit holders and require a bank to cease the activity. To provide guidance to banks in making decisions, the Federal Reserve issues advisory letters that help banks predict how the Federal Reserve will react to particular activities and provides guidance on the standard of review the Federal Reserve will use in evaluating those activities. The Federal Reserve has issued supervisory guidance letter SR 99-7 to help banks navigate the

\textsuperscript{178} Laborers National Pension Fund v. Northern Trust, 173 F. 3d 313, (5th Cir 1999).
\textsuperscript{179} 29 U.S.C. §1104
\textsuperscript{180} See Ali, supra, at 86.
\textsuperscript{181} Id.
\textsuperscript{182} 12 U.S.C. §92a(k)
\textsuperscript{183} Freedland, Marvin, National Banks as Service providers to Employee Benefit Plans, 113 Banking LJ 994 (1996) page 1.
\textsuperscript{184} OCC Trust Banking Circular No. 4 [Sept., 1976]
\textsuperscript{185} 65 Fed. Reg. 34, 792 (July 2,2001)
fiduciary conflicts that may arise in placing trust assets with mutual funds, but has issued no such letter regarding placement of trust assets within hedge funds.\textsuperscript{186} Though its prescriptions may be helpful by analogy, more guidance is needed due to the particular nature of hedge fund fees and their attendant conflict risks.\textsuperscript{187}

Hedge funds that met the high net worth test for their investors are still largely unregulated. The fact that their activities were highly secretive, combined with the presence of some large hedge funds at the center of late trading mutual fund scandals, was cause for much concern among federal regulators and anyone investing in these funds.\textsuperscript{188} The SEC tried to require registration, as explored above, that would have been of use to regulators in addressing issues facing regulators of those who invest in hedge funds. For instance, registration would have given the SEC some insight into the trading activities of these funds through compliance audits. Further, anyone who engage in securities trading is

\textsuperscript{186} Hearing on H.R. 106-9 Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Banking and Financial Services, 106th Cong. 106-21 (1999) (statement of Gov. Laurence H. Meyer) (explaining that supervisory opinion letters are intended to “enhance and support market discipline by strengthening the risk management processes of major creditors and counterparties”)

\textsuperscript{187} SR-97 requires the following: “Reasoned Legal Opinion - The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, trust instrument, or court order, as well as any applicable disclosure requirements or "reasonableness" standard for fees set forth in the law. Establishment of Policies and Procedures - The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations and sound fiduciary principles, including any disclosure requirements or "reasonableness" standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff. Analysis and Documentation of Investment Decisions - Where fees or other compensation are received in connection with fiduciary account investments over which the institution has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with the provisions of the Prudent Investor or Prudent Man Rules, as appropriate.” SR 99-7 SPE, Federal Reserve Division of Banking Supervision and Regulation, March 26, 1999.

\textsuperscript{188} See Ali, supra, at 88.
always subject to the general anti-fraud provisions of the Securities Act of 1934. Proper coordination between the SEC and other regulators will determine whether a future SEC regulatory regime for hedge funds helps to cure some of the problems faced by institutions that invest in hedge funds. In addition, many hedge funds advisers are still voluntarily registered as advisers, so the Goldstein decision will not affect the SEC’s intelligence capability in that regard.

Section II: Problems facing institutions investing in hedge funds

The ethical dilemma faced by banks engaged in trust activities is that they may have a vested financial interest contrary to the interest of their trust beneficiary. A fund may provide a trustee with a fee rebate in return for investing in the fund. Hedge funds typically borrows most of what they invest (if investing 10 million, a hedge fund may well borrow an additional 50 or 60 million to invest). So what if, in exchange for placing trust assets in the hedge fund, the hedge fund takes out loans from the same bank that is placing its trust assets with the hedge fund? The risk is that the trustee will not make decisions on where to place trust assets based on the proper risk/return provided by the asset, but rather by the hope for interest fees from the hedge fund as a quid-pro-quo.

If the trust documents describe the kinds of fees that a trustee will accept from a hedge fund, is that enough to cure the dilemma? Or must the trustees further disclose particular arrangements with hedge funds? Alternatively, is it a better idea to ban the practice altogether and prevent possible trouble? Should you go as far as requiring that the trust divisions submit to random compliance audits from a regulator to look for trouble? Or would audits by independent accounting firms be enough?

The bank that acts as trustee may also run its own hedge fund. In that case, it will have a clear vested interest in placing trust assets with its fund (remember the 20% performance fee). A common device used to cure institutional conflicts is by building operation walls around potential conflicts; i.e. requiring that trust officers and hedge fund managers be supervised and compensated by different parts of the institution. Is this enough to cure the conflict? Could an employee still have a vested interest in the general economic well being of the institutional employer despite the operational wall?

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189 See generally Id.
190 See Ali, supra, at 86.
191 This is overly simplistic, as the “bank” will of course be made up of numerous holding companies, such as fiduciary operations at Goldman Sachs Asset Management and hedge fund trading at Goldman Sachs Capital Partners, but with ultimately one umbrella organization in control, so you get the point.
Section III: Political Challenges

The U.S. banking system is subject to both horizontal and vertical regulatory competition. Banking regulators will have a vested interest in the outcome of this regulation. If the Comptroller and the FDIC take positions different from the Federal Reserve, or state regulators take fundamentally different positions, it may mean banks that wish to engage in hedge fund investing will prefer the lighter regulator.

Other institutions that regulate hedge funds themselves may also conflict with the Federal Reserve. The Commodities Future Trading Commission (CFTC) and the Securities Exchange Commission (SEC) issues rules that define the activities that hedge funds can engage in. If the Federal Reserve issues rules in its capacity as a regulator of fiduciaries that incentivize hedge funds in some way that is adverse to the goals of the SEC and the CFTC, then the potential for more political turf wars, and Congressional involvement, is present.

Public pension funds present a unique political and administrative challenge in this area as well. Public pensions are governed by public bodies consisting of elected officials and individuals appointed by elected officials. This makes them uniquely accountable to the electorate, but many times it invokes severe conflicts of interest. Investment groups will frequently give to the campaigns of elected officials, or pay lobbying fees to former members of pension oversight bodies, in order to garner investments and reap the management and carry fees from them. These conflicts are furthered by the fact that public pensions are not regulated by the federal government in the way that private pensions are under ERISA. As this area will require a state political solution, rather than a federal policy oriented solution, I will leave the question open to future exploration.

In addition, the banking and financial services lobbies will be uniquely interested in the outcome of these rules, and may seek to overturn Federal Reserve pronouncements with Congressional lawmaking. If they can convince Congress to pass a statute granting a safe harbor for certain activities, for instance, then they might pre-empt the Federal Reserve’s regulation. Other groups with a vested interest will be mutual funds, which compete with hedge funds for fiduciary money, and trust beneficiaries themselves.

Another political challenge that regulators in this area face is that state attorney generals may want to override federal regulation to catch some of the glamour that comes along with prosecuting a large financial institution on behalf of voters. This may reap political capital, but it wreaks havoc with private markets and federal regulators. Attorney Generals are frequently unwilling to coordinate with other regulatory bodies, thus leaving banks without any ability to plan their activities to

\[192 \text{ See 2007 PWG Report, supra, at 2.}\]
maintain compliance. These state Attorney Generals also frequently lack the financial sophistication to properly regulate financial markets, relying instead on broad fraud statutes and showy trials before unsophisticated juries.

**Section IV: Is increased regulation the answer?**

It seems that there is a marked difference between willingness, on the part of regulators, to allow investors to undertake some risks, such as systematic risk and interest rate risk, while at the same time expending significant government resources and requiring expenditure of investment company resources to minimize operational risk (risk of fraud). What is the reason for the difference? For some unique ideas for why that is, See Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003).

If interest rate risk was something that political actors legitimately felt they could shield investors from, then would we set up an organization run by the state to aid them in assessing and minimizing exposure to interest rate risk? Is it that operational risk is easier to quantify, measure, or prevent? If interest rate risk was something that political actors legitimately felt they could shield investors from, then would we set up an organization run by the state to aid them in assessing and minimizing exposure to interest rate risk? And if that is the case, would bolstering enforcement of these existing avenues of regulatory oversight be a less costly way to achieve the same result?

Investing in hedge funds is a relatively new phenomenon for banks. In accordance with the self-regulatory theme of other sections, this proposal focuses on initiatives likely to increase information available to other actors that would allow enhanced information gathering and bolster regulatory powers already available to other entities. To the extent that fiduciary duty violations are unique when these entities invest in hedge funds rather than other investment vehicles, banking regulators should provide guidance on point in the form of administrative opinions. As bank compliance officers face unique challenges in response to trust office inquiries, they will seek guidance from the banking regulators. But it should come at the inquiry of industry to address issues they face individually, not the other way around. The self-regulatory scheme described in the hedge fund world is already functionally in place in banking. Though a governmentally empowered entity, the regional boards of directors of banks.

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194 For another take on this, that regulators merely regulate whether its necessary or not, See Milton Friedman, *Why Government is the Problem*, in *Essays on Public Policy* (1993).
the Federal Reserve are voted on by member banks. Thus, the Regional Bank Presidents are an actor standing between two worlds, self-regulation and governmental oversight, making many of the themes explored in the self-regulation section applicable. Banks should be interested in enhancing information flow requirements to enhance public perception of the trust industry.

Many of the ethical conflicts facing actors in the hedge fund industry can already be addressed using the tools presently available in the regulatory environment. For instance, if a future, less onerous registration requirement goes into effect, it would be advisable that the Commission, or whatever SRO is instituted, establish a formal information sharing capacity with banking regulators. If registering entity were to use its compliance powers with registered hedge funds to collect information on trust officers that invested with those funds, banking regulators could cross reference that information in their own compliance audits to look for abuse of fiduciary status. In addition, if that information were made available to private litigants and other enforcement agencies upon issuance of a subpoena, then other enforcement mechanisms already in place would be enhanced. Due to the high costs of creating new enforcement initiatives, it would be advisable to utilize current avenues more effectively if that can achieve the same desired result.

Furthermore, global banking institutions will face unique challenges if the Federal Reserve’s rules on this are fundamentally different from financial regulators in other countries. If the Financial Services Authority (FSA, UK) or the Bank of Japan (BOJ) take dramatically different positions, then the complexity facing a global institution like Citigroup may be prohibitive. For instance, what should it do with money it is holding as a fiduciary for a sophisticated and wealthy investor who is a citizen of the EU, who invests with a London branch of Citigroup, which is a US chartered bank, where the best available investments are hedge funds in the US and abroad that invest around the world? In short, a lack of global harmony in banking fiduciary regulations could potentially run counter to investor protection objectives. If the approach used by the Fed and the OCC incorporates self-regulatory organizations and enhances existing regulatory regimes, then Federal rules will not engage in cross border conflicts and SROs will already be attuned to cross border challenges as they are made up of many banks that are global themselves.

Section V: Policy Recommendations

Recommendation #1 In the event that some new form of registration enters the agenda, the information gathered during compliance audits could be material to the oversight of institutions that invest in hedge funds by private actors and government agencies. Thus, information gleaned during these audits should be made
available to those authorities and individuals to enhance their ability to prevent mismanagement and fraud. In addition, if the proposal for creation of a Self-Regulatory Agency overseeing hedge funds themselves goes through, it should have access to the same information.

Accordingly, the financial regulators should establish a Financial Regulatory Coordination Board, with a full staff and a board comprised of representatives from banking regulators, securities regulators, and private SROs. They could establish guidelines for releasing the results of compliance audits to each other and to private investors. These guidelines would set a standard that information is sent to private actors when a case or controversy is established in some forum of dispute or the agencies have a reasonable belief that the interests of investors is in material danger. The standard would be lower for information sent to coordinating agencies and self-regulating organizations. Further, guidelines would be issued to ensure that the proprietary character of trading operations is protected and firms do not lose money from their trading operation being revealed to the exchange markets.

Recommendation #2 The Federal Reserve and the Comptroller of the Currency should issue Supervisory Releases and Circulars that encourage regulated fiduciaries that invest in hedge funds to disclose to all fiduciaries the precise nature and amount of fee relationships that the bank has with the fund. The release would not mandate disclosure, but merely describe it as a safe harbor that would permit the fiduciary to rely on disclosure as one practice that will presumptively protect it from liability for breach of fiduciary duty. For the disclosure to provide protection, it should require that the bank reveal any other relationships that the bank, or any affiliate thereof, and the fiduciary, or any affiliate thereof, has with the hedge fund or any of its affiliates. The Federal Reserve and the Comptroller of the Currency should include in the same administrative releases an encouragement that the banks get proxy approval from fiduciaries for the fees charged, with withdrawal of funds as a permitted alternative to approval.

195 Also observed in 2007 PWG Report, supra, at 6. “Supervisors should take full advantage of both formal and informal channels of coordination and cooperation across financial industry sectors and international borders when carrying out their responsibilities related to internationally active financial institutions’ management of exposures to private pools and leveraged counterparties.” Though the President’s Working Group on Financial Markets is a good start, it is not enough.

196 This recommendation also follows in line with the recent PWG principles. See 2007 PWG Report, supra, at 5. “Supervisors should clearly communicate their expectations regarding prudent management of counterparty credit exposures, including those to private pools of capital and other leveraged counterparties, who are increasingly utilizing complex instruments, including certain over-the-counter derivatives and structured securities, such as collateralized debt obligations…. Supervisors’ expectations with respect to prudent risk management practices should take into account developments in financial markets and advances in best practices for
Recommendation #3 The Banking regulators should encourage existing banking associations to promulgate best practices in trust creation relating to fee compensation, with model trust documents that best protect the trust beneficiary from fee exploitation. Compliance with such a document would be another factor that the Fed and the OCC would include as being among the presumptive best practices that afford safe harbor protection in their administrative release.197

Recommendation #4 The Federal Reserve and the OCC should encourage Congress to establish a federal pre-emption in regulation of fiduciaries.198 Any action taken in compliance with Fed or OCC guidelines for fiduciaries should be considered presumptively fulfilling state fiduciary duty requirements. This will prevent the states and the federal authorities from pursuing inconsistent goals.199 Though regulatory competition can be particularly useful, as explored in the first counterparty credit risk management. Supervisors should actively monitor such developments and revise their policies and associated guidance as appropriate in a timely manner. In turn, supervisors should actively monitor and assess whether policies and procedures measure up to regulatory guidance and industry efforts to identify best practices.”197

197 Ali, supra, at 87-88, provides a fiduciary investor’s best practices guide that might serve as a useful start: “(a) Understand the legal structure of the hedge fund; (b) Understand the hedge fund’s investment strategy, including the risks inherent in that strategy, whether there are any limits on the ability of the hedge fund manager to take concentrated, the degree to which leverage is used by the hedge fund manager to implement that strategy, and the scalability of the hedge fund’s investment strategy; (c) Understand the market or ‘systematic’ risk of the bond, share and derivatives markets in which the hedge fund invests; (d) Understand the composition of the hedge fund’s portfolio, the ‘unsystematic’ or unique risks, in particular the credit risk or risk of default and insolvency, associated with the individual instruments in which the hedge fund has invested, and the price volatility (that is, the extent to which the price of an instrument fluctuates) and the liquidity (that is, the ability to buy or sell instruments expeditiously at a reasonable price) of those instruments; (e) Understand the liquidity of the hedge fund upon the hedge fund’s lock-up and redemption policies, the liquidity of the instruments invested in by the hedge fund and whether there is a secondary market for interests in the hedge fund (hedge funds are not usually listed on an official exchange such as the London Stock Exchange); (f) Monitor the returns generated by the hedge fund,64 in particular declines (or ‘draw downs’, as they are euphemistically referred to) in the net asset value of the hedge fund and the extent to which the fiduciary’s own portfolio is exposed to the hedge fund; (g) Monitor changes to the composition of the hedge fund’s portfolio. (h) Monitor redemptions of hedge fund interests. And (i) Where possible, demand more detailed and regular disclosure about the matters listed in items (f) to (h).”

198 Indeed, how can financial regulators achieve the international coordination recommended in the PWG Statement of Principles if they must contend with 50 additional sets of patchwork fiduciary duty principles. See 2007 PWG Report, supra, at 6.

199 For example, the same was accomplished with federal pre-emption of state blue sky laws. See The National Securities Markets Improvement Act of 1996.
section of this paper, it is unlikely that state banking regulators can achieve the kind of sophistication and expertise to necessary to police the industry in the current environment.\textsuperscript{200} Therefore, though horizontal-regulatory competition between the OCC and the Federal Reserve may be useful for the reasons explored in previous sections, it is inadvisable on the vertical level.

**Part IV Conclusion**

There is a marked discrepancy between the SEC’s stated goals in their initial report on the implications of the Growth of Hedge Funds and their previous registration rule. They set up a basic reporting regimen, but did little to establish controls on things like retailization, manager conflict between mutual and hedge funds, the disclosure problem, or establish incentives for the fostering of best practices. It is likely that regulatory activities will expand to address these issues. When it does, this paper suggests that the regulatory stratagem incorporate significant elements of self-regulation and regulatory competition.

Any future attempts at hedge fund regulation can be enhanced by the effectiveness of the self-regulatory model. Information collected during a compliance process, for instance, will be available to the agency. For any hedge fund to misrepresent itself to a party in connection with the sale of securities would be securities fraud, so the incentive to hedge fund operators to lie to a central information advisory agency would be reduced. Further, information collected during the compliance process can be shared. Though hedge fund operators complain that any audit of their activities risks the proprietary secrecy of their trades, surely data on who is investing with them and the fee relationships between the fund and the client, and any other relationships between the two, will not pose the same risk. With that information available, the wide array of ethical conflicts posed here can be minimized.

One danger is that, caught up in the regulatory zeal, the SEC and banking regulators will burden the nimble traders of the hedge fund world with regulation akin to the mutual fund industry and seek to limit access for institutional investors like trusts and pension funds to this useful asset class. This is where the self-regulatory argument is most cogent, and should be utilized to frame any future rulemaking in this area. Additionally, the growing presence of hedge funds in political lobbying calls for a measured and final rule on this issue before Congress becomes subject to regulatory capture.\textsuperscript{201}


\textsuperscript{201} The MFA intends to double the size of its political action committee in 2007. *See* [http://www.washingtonpost.com/wp-dyn/content/article/2007/02/08/AR2007020801829_2.html](http://www.washingtonpost.com/wp-dyn/content/article/2007/02/08/AR2007020801829_2.html).
Oversight of trust officers and fiduciaries in the banking sector has occupied banking regulators since before the founding of this country. Though Hedge Funds are a relatively new phenomenon, the Federal Reserve and other banking regulators should be able to tool the fiduciary regulatory regime to account for the unique challenges of hedge fund investing if it properly accounts for the economic, international, and political implications facing rulemaking in this sphere. Proper integration with state international banking regulators, and securities regulators is essential, and should be tempered with a balance between the interests of the various constituencies involved.

If Dr. Jones legacy, this source of liquidity that has risen up to dominate our financial system in the last ten years, is to survive intact then the Securities Exchange Commission must maintain a coordinated and creative regulatory response that harnesses the capabilities of other regulators; including Federal, International, and SRO organizations. Otherwise, it risks constraining the growth of funds through unnecessary expense and limiting the effectiveness of its regulatory action. As its regulatory capability in this area grows and develops, the Commission should consider adding an element of self-regulation into the arena as a supplement to its own efforts.