June 16, 2009

New Governance and Hedge Fund Regulation: Shorting Federalism or Bernie’s Nightmare?

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Juraj Alexander, 1 2009

Abstract

Current proposals for reform of the financial markets regulation usually build on the same paradigm as the pre-crisis regulation. This paper, in the field of hedge funds and other alternative investment funds, proposes an alternative regulatory structure based on the new governance scholarship.

The proposal consists in allowing, within certain constraints, the coexistence and competition of multiple regulatory frameworks for hedge and other alternative investment funds. A framework could be private or public, domestic or foreign, institutionalized or not, and would be subject to authorization by the respective regulators. Terms of such authorization would be negotiated between the industry and regulators and renegotiation would be possible. Frameworks would not be limited by national borders, exact statutory qualifications or legislative petrification. Each fund (and its manager) would choose and could also change the framework to which it subscribes, subject to such framework's own rules.

The model should reduce regulatory capture and overload, harness the power of informal networks in the industry and eliminate the problems arising from regulatory forum shopping and related protectionist responses. It should also create an appropriate platform for search of proper regulatory responses and a system of checks and balances between the legislator, the regulator and the regulated industry.

1 LL.M. Fordham University School of Law, 2009. I would like to thank Professor Grainne De Burca and Justin I. Miller for their help in drafting this paper.
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“I’m having a very good crisis” said George Soros.  

“Guilty.” Mr. Madoff responded. 

The main difference between these two gentlemen, from a regulatory perspective, was that Mr. Madoff’s company was subject to the oversight of the Securities Exchange Commission’s (SEC), whereas that of Mr. Soros was not. Might that suggest something about the effectiveness of the respective regulation?

Although there seems to be agreement among academics that hedge funds cannot be blamed for the current financial crisis, calls for (more) regulation of hedge funds appeared soon after the crisis took a sharp cut into the global economy. Several legislative proposals soon appeared in the Senate, the House of Representatives and in Connecticut and the Treasury outlined its own ideas. A major proposal has been launched in the European Union. These proposals lack precise formulation of both the problems they address and of the goals they pursue and do not consider alternative regulatory

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2 ‘I’m having a very good crisis,’ says Soros as hedge fund managers make billions off recession, DAILY MAIL, Mar. 25, 2009.
4 The company BERNARD L. MADOFF INVESTMENT SECURITIES LLC is registered as an investment adviser with SEC file No. 801-67134, whereas SOROS FUND MANAGEMENT LLC is not, http://www.adviserinfo.sec.gov/ (last visited Apr. 11, 2009).
7 Hedge Fund Transparency Act of 2009, S. 344, 111th Cong. (2009) (subjecting hedge funds to certain requirements of the Investment Company Act 1940 and requiring disclosure of certain information by funds, including the identity of all their investors).
12 See e.g. James Crotty, Gerald Epstein, Proposal for Efficiently Regulating the U.S. Financial Markets to Avoid Yet
approaches. Therefore, some of the proposed rules could cause serious damage, while other proposals are trivial in not adding much to the existing industry framework. However, the political climate indicates that it is likely that hedge funds will be targeted by new regulation.

This paper reviews the existing entity level regulation (as opposed to transaction regulation) hedge funds and other private pools of capital and proposes its substantial overhaul based on the theoretical framework developed by the school of new governance. Acknowledging the diversity and flexibility of the industry and building on structural, rather than substantive, considerations, the proposal would enable multiple regulatory frameworks, public and private as well as domestic and foreign, to co-exist under the oversight of the federal regulators. As a coherent answer to the question how (as opposed to whom and what) to regulate not to end up in a crisis similar to this one (and to prevent the level of fraud preceding its culmination) does not seem to be readily available, I suggest that, instead of bureaucrats, the regulatory process itself and its participants should provide these answers. The proposal is similar to the model proposed by Professor Gower for the reform of the UK financial services regulation in 1980’s, which formed the basis of the Financial Services Act of 1986. That model, and in particular the way it was implemented in practice, however, differed from the model proposed herein in several crucial aspects, as will be illustrated below.

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10 Another Meltdown, available at http://www.peri.umass.edu (stating that “This 'shadow banking system' [hedge and private equity funds] played a key role in creating the conditions that led to the global crisis.” without reference).


16 The proposed EC directive mixes these two matters (regulating both entity-related issues, such as capital adequacy, and behavioral issues, such as acquisitions by HFs) which is a very good road to regulatory hell. See EC Directive Proposal, at 36, art. 26.


20 See JULIA BLACK, RULES AND REGULATORS (1997) [hereinafter Black Regulators] (describing the UK regulatory
Despite wide-spread conception that hedge funds are not regulated, their business is in fact subject to substantial regulatory constraints, some of which are unreasonable, but some of which fall far short of what might be considered optimal. Empirical argumentation and proper analysis being beyond the scope of this paper (and in my view properly impossible), I proceed building on the belief that some regulation is necessary given the importance that the funds came to play in the society. However, those who argue for curtailing financial innovation and imposing rigid structures on financial industry\textsuperscript{21} seem to forget that the crisis was preceded by an incredibly long period of growth, which is despite the market crash far from being obliterated,\textsuperscript{22} and the worn out regulatory structure of the New Deal would not prevent the occurrence of the crisis even if it was kept intact.\textsuperscript{23} The question is therefore how to structure new regulation “with an eye toward unleashing opportunities”.\textsuperscript{24}

This paper first introduces the hedge and other alternative investment funds (Part I), then inquires into the risks of the industry and goals or regulation (Part II) and screens the current regulatory framework for anomalies (Part III), reviews the industry landscape and discusses why methods of new governance are appropriate to address potential shortcomings (Part IV) and finally, introduces the model and subjects it to scrutiny from the point of view of both traditional and new-governance regulatory considerations, in particular answering those complaints raised against the UK system existing under the 1986 Act (Part V).

I. **WHAT IS A HEDGE FUND**

While there is no precise definition of a hedge fund (HF),\textsuperscript{25} a description as “lightly regulated

\begin{itemize}
\item \textsuperscript{23}See e.g. Jean Charles Rochet, *The Future of Banking Regulation: Basel II after the Crisis* (Columbia Univ. conference, Preventing the Next Financial Crisis, October 2008), available at http://www4.gsb.columbia.edu (stating that Northern Rock would fail whether it complied with Basel I or II).
\item \textsuperscript{25}See e.g. John P. Hung, *Hedge Fund Regulation: The President's Working Group Committees' Best Practices Reports –
investment vehicles that try to maximize risk-adjusted returns for investors” seems to be appropriate.26 They are set up as corporations, LLCs or, most usually, as limited partnerships (the fund), where the investors are shareholders or limited partners and (in partnerships) usually the manager the general partner (sometimes also major investors).27 The fund has no employees and the manager acts on behalf of, and directs the investments by, the fund. Besides hedge funds, private equity (PE) funds, venture capital (VC) funds and some other undertakings use similar structures (all referred to as alternative investment funds (AIFs)), but differ in their investment strategies. In further text, I refer to hedge funds, but, unless specifically pointed out to the contrary, the analysis should apply equally to PE, VC and other private collective investment undertakings.28

While the reported numbers widely differ, there are between 6,000 and 13,000 operating HFs world-wide29 with total assets under management30 between $1 and $3 trillions, representing up to 2% of world financial assets.31 These funds are managed by a total of some 1,600 management companies.32 The average size of a hedge fund is about $200 million, but the mean (i.e. the most usual) size is only about $10 million, as the industry is highly concentrated.33 The attrition rate in the hedge fund industry is quite high and in normal times, the average life span of a hedge fund is some 40 months. Since the beginning of the crisis many hedge funds closed down.34

28 While there might be important differences in detail, at the level of analysis provided in this paper the HF, VC and PE funds can be considered comparable, see e.g. Paredes, supra note 6, at 49 (noting that there was no principled reason for SEC to treat HFs differently from VC and PE funds in its 2006 effort to regulate HFs).
30 ‘Assets Under Management (AUM)’ refers to the amount of investor's money that the fund manages. The actual assets held by the fund can therefore, thanks to debt, be up to several times larger, see Hearing on Hedge Funds Before the Comm. on Oversight and Gov. Reform, 111th Cong. 1 (2008) (Testimony of George Soros), available at http://oversight.house.gov/story.asp?ID=2271.
31 See Michael R. King, Philipp Maier, Hedge Funds and Financial Stability: Regulating Prime Brokers will Mitigate Systemic Risk, 5 J. of Fin. Stability (forthcoming 2009) at 4; this is not a small amount compared to mutual funds within the U.S., which manage $12 trillion of assets, see Investment Company Institute, 2008 Investment Company Fact Book, http://www.icifactbook.org/lb_sec2.html#us.
32 See Miller, supra note 29, at 19.
33 See King, Maier, supra note 31, at 5, 8 (noting also that the largest 100 hedge funds account for 75% of total assets).
HFs use various investment strategies to reach high profit, including arbitrage (finding a mismatch between various correlated prices on the market), event driven strategy (focusing on price movements during mergers or bankruptcies)\textsuperscript{35} or directional investing (following short-term trends). This means that HFs generally actively trade in securities markets. Private equity funds tend to buy established firms, which are available for sale for less than their potential value, and often carry out thorough restructurings.\textsuperscript{36} PE funds use large amounts of debt to leverage their acquisitions, which are therefore called leveraged buy-outs (LBOs). PE funds investment horizon is longer than that of HFs, usually several years. Venture capital funds also invest relatively long-term, but focus on start-up companies and do not use significant amounts of debt.\textsuperscript{37} The boundaries are obviously unclear, as any of these funds can engage in any strategy, as long as its founding documents allow that.

Hedge funds and other AIFs developed on the basis of exceptions from the securities legislation enacted in the US in 1940s to regulate collective investment undertakings. The purpose of the exceptions was to exclude “private investment companies” and personal and family holding companies from the scope of legislation, but the SEC “knowingly permitted any group of up to 100 people to create a private investment pool.”\textsuperscript{38} The first HF (A.W.Jones &Co.) and VC funds appeared soon, but it took almost two decades until they were named.\textsuperscript{39} Private equity funds occurred in 1970s on the basis of the same statutory safe harbor.

HFs and other AIFs use particular corporate structure, which reportedly deals very effectively with the agency problems inherent in the corporate form, whether on the level of the fund or on the level of the underlying investments.\textsuperscript{40} The structure of fees, the threat of redemption and the oft-en-present material investment by the manager generally align the interests of the manager with those of


\textsuperscript{36} These restructurings and related lay-offs are the reason for the attempt to regulate acquisitions by AIFs by the proposed EU directive. However, as well described in GEORGE P. BAKER, GEORGE D. SMITH, THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE (1996), such restructurings often create substantial value or only accelerate events (corporate failure), which would occur anyways.


\textsuperscript{38} Miller, supra note 29, at 31.

\textsuperscript{39} Miller, supra note 29, at 35 (the name “hedge funds” and the public discovery of the industry occurred in a 1966 Fortune article by Carol J. Loomis).

\textsuperscript{40} See Shadab, supra note 3, at 4, and Gilson, supra note 29, at 1076 (describing how the portfolio-company level contracts and fund-level agreements with investors each individually and all together align incentives to bring all the participants to jointly create value).
the investors much better than the structure of a classical corporation.\textsuperscript{41}

AIFs are generally perceived positively as benefiting the financial markets by creating liquidity, leading price discovery (i.e. looking for mispriced assets), advocating shareholder rights\textsuperscript{42} and enabling reduction of risk.\textsuperscript{43} Hedge funds are often able to endure in a declining market and to create investment portfolios un-correlated with the general market, unlike classical mutual funds.\textsuperscript{44} In the current crisis, hedge funds lost in aggregate some 20\%, compared to 42\% loss by the global equities.\textsuperscript{45} Hedge funds are also responsible for most of the investment in distressed assets, contrary to many traditional institutions, which often refuse to even hold such assets.\textsuperscript{46}

\section*{II. WHAT'S WRONG WITH THEM?}

Some commentators suggest, and public might easily agree, that a lack of restraints on hedge funds was among the main causes of the financial crisis.\textsuperscript{47} As mentioned above, this does not seem to be the case and any proposal for hedge fund regulation requires a much more fine-tuned inquiry into existing problems with the industry.\textsuperscript{48} Some basic and very broad categories of risk\textsuperscript{49} are identified below.\textsuperscript{50}

\begin{footnotesize}
\begin{enumerate}
\item See Shadab, \textit{supra} note 3, at 21 (noting that hedge funds use substitute governance mechanisms for those found in public corporations).
\item See Davidoff, \textit{supra} note 15, at 351 n. 62.
\item See \textit{e.g.} Oesterle, \textit{supra} note 35, at 5 (quoting Timothy F. Geithner, Keynote Address at the National Conference of the Securities Industry: Hedge Funds and their Implications for the Financial System (Nov. 17, 2004)).
\item See Shadab, \textit{supra} note 3, at 2.
\item \textit{Id.}, at 2.
\item As an example, the Citadel hedge fund invested, in a very complex and innovatively structured transaction, $2.5 billion in E*trade Financial, a discount broker and savings bank with 4.5 million customers, to save it from almost certain bankruptcy, see \textit{e.g.} E*TRADE Financial Announces $2.5 Billion Investment Led by Citadel, available at https://investor.etrade.com/releasedetail.cfm?ReleaseID=279066 (last visited Apr. 7, 2009), \textit{Why Citadel Pounced On Wounded E*Trade}, WSJ, Nov. 30, 2007.
\item Paul M. Jonna, \textit{In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation}, 45 SAN DIEGO L. REV 989, 994 (2008) (“it is evident … that the restraints of the free market failed to impose adequate market discipline on hedge fund market participants”).
\item In Europe, the discussion focuses also on HFs’ negative impact on the companies, in which they invest, but as this is in my view a completely inappropriate rationale for entity-level regulation of HFs, I disregard it, \textit{see} Gerald Spindler, Sebastian Bednarz, \textit{Die Regulierung von Hedge-Fonds im Kapitalmarkt- und Gesellschaftsrecht} (Heinrich-Heine Univ. Düsseldorf, Faculty of L., Centre for Bus.&Corp. Law, Research Paper No. 1, 2006) at 6; \textit{see also} EC Directive Proposal.
\item See EC Directive Proposal, at 3.
\item See \textit{Hedge Funds, Systemic Risk, and the Financial Crisis of 2007 – 2008: Hearing on Hedge Funds Before the Comm. on Oversight and Gov. Reform, 111\textsuperscript{th} Cong. 1 (2008) (Written Testimony of Andrew W. Lo, MIT Professor), available at http://oversight.house.gov/story.asp?ID=2271 ("Before we can hope to manage the risks of financial crises effectively, we must be able to define and measure those risks explicitly.").
\end{enumerate}
\end{footnotesize}
A. Fraud, Conflicts of Interests and Getting a Bit More

In the wake of the current crisis, a significant amount of fraud has surfaced in the hedge fund industry, ranging from Bernard Madoff’s ponzi empire\(^\text{51}\) through fraud by managers of the hedge funds operated by Bear Sterns\(^\text{52}\) to primitive looting of investor assets by smaller hedge fund managers.\(^\text{53}\) If done efficiently and effectively, not causing much harm, erecting a regulatory structure preventing (rather than only penalizing) these kinds of fraud would be legitimate.

Managers managing several funds might find themselves in conflicts of interests, either because the interests of the funds themselves (i.e. also of their investors) diverge or because of the manager’s interest in fee collection.\(^\text{54}\) The same holds true for the investment bankers who manage clients' portfolios and may decide to invest into a hedge fund from which they obtain large fees for other services.\(^\text{55}\) Another type of improper behavior is so-called front-running, where a manager uses the fund assets to manipulate the market in order to reap personal profit. How to deal with such conflicts without disrupting HF operations beyond necessary might be readily apparent to neither a regulator nor the investors.\(^\text{56}\)

Another example of this type of risks, a specific type of behavior raising suspicion has been reported to occur in reporting monthly returns, where HFs are “much more likely to report marginally positive monthly returns than returns that are marginally negative”.\(^\text{57}\) This is done to retain investors, but it should not occur. However, even in such a specific case it is not clear, whether regulation should deal with this problem and how – sophisticated investors may be able to assume it away, contract

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51 See Woody Allen, Tales of Manhattan, NEW YORKER, Mar. 30, 2009 (describing how two former investors reincarnated as lobsters drove B. Madoff to plead guilty). Whether or not Madoff’s firm could be analyzed as a hedge fund, regulation should have caught it and the hedge fund classification is probably the closest to what it actually did (not suggesting that HF’s are ponzi schemes, though).


55 See Paredes, supra note 26, at 6 (noting that brokers may in such instances fail to make proper disclosure to their clients).

56 See Verret, supra note 17, at 814.

around it or just conclude that the cost of imposing limitations on this behavior might be higher than the collateral damage caused by the regulation.

Dealing with fraud and conflicts of interest through regulation could bring economies of scale, where it is more efficient than financial contracting at the level of individual HFs, as it can deal with the problems of free-riding and collective action. However, in order to realize these benefits, the regulation needs to be properly structured.

B. Vulnerable Investors?

 “[A] large share of the assets held by private equity and hedge funds is the property of pension funds and insurance companies.” As of the end of 2006, around 2.1% ($50.5 billion) of the U.S. pension assets were managed by hedge funds and this has been and will be growing despite the current crisis. This exposure of pension funds might require some HF regulation to respond to the concerns raised by the need of stability of the pension investments, despite the fact that pension funds are considered to be sophisticated investors who should be able to “fend for themselves”.

C. Systemic Risk

Systemic risk occurs where a collapse of one institution or one class of assets could “send shockwaves through the economy”, i.e. harm institutions exposed to this risk to an extent leading to a break-down of the financial system (or cause equivalent panic). Such event occurred, when Lehman Brothers filed for bankruptcy in September 2008. The Fed rescued Bear Sterns only a few months earlier because it perceived a systemic risk in its huge derivatives exposures. Although there is a

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62 See Paredes, supra note 26, at 23. This is, however, a claim based on the U.S. concept of securities regulation, which is based on retail investor paradigm. The European securities law recognizes a similar need for protection of, or rather efficient standard setting for, sophisticated investors as well.
63 See Lo, supra note 50, at 4.
64 If we assume that there is such thing as systemic risk, see contra Peter J. Wallison, Congress is the Real Systemic Risk, WALL ST. J., Mar. 17, 2009.
65 Fed’s rescue halted a derivatives Chernobyl, TELEGRAPH, Mar. 27, 2008.
general agreement that non-banks do not create major systemic risk, there is a case for taking systemic risk into account when designing regulation for AIFs.

Hedge funds may create systemic risk if a hidden web of interconnected contracts can lead, in a systemic event, to a drain on liquidity of the markets. A phenomena, which could increase this risk, is “herding”, i.e. a behavior, where a large number of hedge funds take the same positions. Some commentators argue that HFs create systemic risk through excessive use of leverage, but majority opinion sees HF leverage low enough, at least compared to other financial institutions. However, Lehman Brothers and Bear Sterns, as well as AIG, operated to a certain extent as collective investment undertakings, i.e. hedge funds, and exploded due to excessive leverage. The spectacular, but exceptional, 1998 collapse of Long Term Capital Management was caused by excessive, but improperly measured, leverage. Therefore, leverage may be a valid concern, if it becomes systemic (as it apparently did before the current crisis, despite being packaged in very complex instruments) and there should be a regulatory response. The response, however, needs to be nuanced: the traditional balance-sheet way of measuring leverage is inappropriate in case for hedge funds and unless the total market exposure becomes extremely huge, there is no material reason for regulatory intervention.

Another way in which hedge funds can exacerbate systemic risk is the fact that they make up a

66 See Llewellyn, supra note 58, at 20.
68 Leverage refers to the amount of debt a fund uses to finance its operation and the acquisition of its assets. It is usually referred to as a ratio, e.g. 3:1 referring to a situation where a fund has debts equal to 75% of the value of its assets, which results in the equity being worth 25% of the assets.
69 See Patrick McGuire, Kostas Tsatsaronis, Estimating Hedge Fund Leverage, Bank of Int'l Settlement Working Paper No. 260, 2008 available at http://ssrn.com/abstract=1333617 (concluding that hedge fund leverage is volatile and ranges between 4:1 and 10:1, which is much more than traditionally reported, but still less than many banks), see also Hung, supra note 25, at 2, King, Maier, supra note 6, at 2.
70 See Bernanke, supra note 11.
71 See Paredes, supra note 26, at 11 n. 26 (describing the systemic risk factor as caused by (1) the impact of LTCM's counter-parties effort to close their positions on other market participants and (2) the resulting uncertainty how far the prices will move).
72 See e.g. Group of 30 Report, at 12 (need to cooperate in defining the leverage), Oesterle, supra note 28, at 25 (“balance-sheet leverage is not adequate measure of risk..., Alternatives such as “value-at-risk”... offer more meaningful measures of risk, but have severe measurement problems.”), see also McGuire, Tsatsaronis, supra note69 (constructing a highly complex indicator of leverage and noting that it still does not seem to adequately measure leverage for some of the funds, given that it does not capture their complex investment strategies).
73 See accord Paredes, supra note 26, at 12.
large portion of trading in all markets, generally between 40 and 80 per cent. If they engage in trading bad assets, they can mislead other investors into belief that such assets are actually good. It seems that if hedge funds as a group contributed to the current crisis (and to the previous one in 2001) in any way, it was precisely by riding the bubble and buying the toxic assets only to off-load them just before the burst, which other investors were unable to do.

The proper regulatory response to systemic risk is not clear – it is difficult to define such risk, and when it appears, to spot it. Disclosure alone will certainly not be sufficient, as market participants have no reason to realize the threats. However, a structure, which gives the regulator responsible for monitoring systemic risk the right incentives and the power to engage in its monitoring and prevention, might be useful.

D. Regulatory or Market Failure?

The only empirical study of the HF regulation I was able to locate concludes that the information required by the mandatory disclosure regime introduced by SEC in 2006 was not material to well-informed capital market participants. Otherwise, the study is inconclusive as to the general benefits of the regulation. Law and finance research on HF regulation suggests that HF performance in countries which enable the distribution of HF investments with other products, e.g. life insurance (in so-called wrappers), is worse and the fixed fees charged by the HF managers are higher. An explanation by the lack of sophistication of retail investors is plausible. Lower performance tends to be correlated also with regulatory restrictions on the location of key service providers of hedge funds,

74 See Paredes, supra note 26, at 13.
75 See Brunnermeier, Nagel, supra note 1, at 2016 (describing how hedge funds rode – and exacerbated – the technology bubble, by being able to predict the break point and selling the bad assets early enough).
76 See Verret, supra note 17, at 827 (not providing any opinion on how to deal with systemic risk, as the SEC did not address it in its report).
77 Cf. Jonna, supra note 47, at 1014 (“In theory, direct hedge fund regulation would reduce systemic risk through a mechanism of mandatory disclosure, because participants would be aware of the risks involved and therefore would be able to act to reduce their risk before any sort of market failure.”) This is not at all clear. See accord Hung, supra note 25, at 11.
79 “Law and Finance” is a reference to the famous article by La Porta et al., Law and Finance, 106 J.POL. ECON. 1113 (1998), available at http://ssrn.com/abstract=139134 (suggesting and statistically demonstrating a correlation between certain parameters of corporate law and the quality of law enforcement and economic growth; arguing that markets find substitutes for missing legal investor protections by developing alternative mechanisms, such as concentration of ownership).
such as prime brokers and accountants. Regulatory requirements on minimum capitalization reduce the volatility of returns of small hedge funds. This suggests that regulation has a significant impact on HF operations. However, it is difficult to discern a clear pattern of market or regulatory failure responsible for any problems with hedge funds.

As of 2006, 86% of hedge fund managers were registered with the SEC or the Commodity Futures Trading Commission, i.e. subject to some kind of public oversight. This oversight did not help to prevent the above-mentioned fraud, was not supposed to combat systemic risk and probably did not help the protected investors. Therefore, it seems that the current regulatory structure is inappropriate.

III. EXISTING REGULATION

A. General Regulation

The safe harbors, under which HFs and AIFs developed carve them out from the general application of the Investment Company Act 1940 (the ICA). The act defines an investment company as “any issuer, which … is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities”.

Collective investment schemes, owned by less than 100 investors, which do not make public offerings of their securities, are exempted from the application of the ICA. Further to a 1996 amendment, schemes whose only investors are “qualified purchasers” (even if more than 100) are also exempted, a qualified purchaser being generally an entity with over $5 million of assets.

The ICA fully applies to regular investment companies, mostly known as mutual funds, and imposes on them multiple constraints, including on transactions with affiliates, leverage, derivative

81 Cumming, supra note 14, at 5.
87 See Shadab, supra note 5, at 12, 15 U.S.C. § 80a-18(c) (prohibiting creation of multiple layers of debt) and 15 U.S.C. § 80a-18(f) (requiring that leverage be not more than 1/3 of the value of the assets and that if the value of assets falls,
trading, liquidity, corporate governance, valuation of the portfolio and remuneration of managers.

The operation of hedge funds is fully dependent on being exempt from these requirements.

Under the Investment Advisors Act of 1940, any entity engaged in investment advisory services serving more than 15 clients (a fund is also a client) has to register with the SEC. The registration leads to numerous regulatory requirements, such as appointment of a chief compliance officer, reporting to SEC, being subject to its jurisdiction and specific bookkeeping obligations. In addition, performance fees may be subject to certain limitations. The costs of compliance with these requirements are reported to be substantial, for many funds around $500,000 a year.

Unless so registered, hedge funds are not obliged to maintain a particular accounting (other than for tax purposes), if it is not required by the corporate statute under which they are incorporated (or the applicable partnership law). However, investors usually require that HFs keep their books according to generally accepted accounting standards, i.e. U.S. GAAP or IFRS.

In 2006 the SEC issued a Adviser Act Rule 203(b)(3), which required HF managers to register whenever they served funds having in aggregate more than 15 investors (and more than $30 millions), as compared with the previous interpretations, under which the number 15 related to the

the fund fire-sells assets to reduce leverage).

88 See Shadab, supra note 5, at 13 (investment companies must fully hedge any short sale and some other derivative transactions).
90 See e.g. Jonna, supra note 47, at 998, Oesterle, supra note 35, at 23.
91 See Shadab, supra note 5, at 13.
93 See Oesterle, supra note 35, at 7 (discussing all the requirements resulting from registration, including disclosures, code of ethics and proxy voting procedures).
94 See Paredes, supra note 26, at 16; 17 C.F.R. §275.204(b) (relating to investment advisers having custody of client’s funds).
95 See Shadab, supra note 5, at 15 (if all the investors in the hedge fund are “qualified clients”, i.e. having more than $1.5 million in net worth or at least $750,000 managed by the manager, the manager may charge performance fees), 15 U.S.C. § 80b-5(b)(4), 17 C.F.R. § 275.205-3.
96 See Verret, supra note 4, at 807.
98 See Hung, supra note 25, at 13 (quoting from the President's Working Group's recommendations).
99 For a detailed review of the circumstances of this regulatory action see Paredes, supra note 26.
number of managed funds.\textsuperscript{100} The D.C. Circuit struck down this requirement as an unreasonable change in the interpretation of the statute.\textsuperscript{101} However, most HF managers who registered with the SEC under the rule remained registered. In 2006 alone, the SEC, under various sources of authority, performed some 320 inspections of hedge funds.\textsuperscript{102}

Hedge funds further rely on exceptions from the Securities Act of 1933 and Securities Exchange Act of 1934, in order to escape the obligation to file a registration statement (and to distribute a prospectus) for their securities and to periodically report on their operations, imposed by these acts on listed companies.\textsuperscript{103} The exceptions HFs rely on restrict them not to engage in “general solicitation or general advertising”, not to have more than 500 investors (including any qualified purchaser or accredited investors)\textsuperscript{104} nor more than 35 non-accredited, although sophisticated, investors.\textsuperscript{105} The exceptions require that investors be provided a disclosure document, usually represented by the private placement memorandum.\textsuperscript{106} The transferability of the shares in HFs is usually restricted, subject to approval by the manager. Transfer might be free, if made to qualified institutional buyers and a limited secondary market in the shares of VC and PE funds is developing.\textsuperscript{107} For HF investors, redemption is usually easier solution than sale.

Hedge funds trading in commodity futures might be also subject to registration as Commodity Pools Operators or Commodity Trading Advisors and to resulting regulatory requirements, such as registration with Commodities Futures Trading Commission, additional disclosure, reporting and book-

\textsuperscript{100} See e.g. Jonna, supra note 47, at 999.
\textsuperscript{101} Lukaj, Healy, supra note 10, at 5.
\textsuperscript{103} See Shadab, supra note 5, at 16
\textsuperscript{104} 15 U.S.C. § 78l(g) (2009) (obligation to register under the Securities Exchange Act 1934 for issuers with 500 or more shareholders); 17 C.F.R. § 240.12g-1 (exception from the obligation to register for issuers with less than $10 million of assets)
\textsuperscript{105} In order not to be obliged to register the securities under the Securities Act 1933, Section 4(2), 15 U.S.C. §77d(2) (exempting from registration any “transactions by an issuer not involving any public offering”), which is implemented by Regulation D, 17 C.F.R. §230.506 (limiting the number of non-accredited investors to 35, subject to each such investor having “such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment”) and 17 C.F.R. §230.501(a) (defining accredited investor as including any financial institution, any corporation with over $5 millions in assets and any individual with net worth exceeding $1 million). SEC proposed to increase this last limit to $2.5 million of investments in 2007, but this was not adopted, See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, at 2 n. 2, available at http://www.sec.gov/rules/final/2007/ia-2628.pdf
\textsuperscript{106} See Shadab, supra note 5, at 17
\textsuperscript{107} See e.g. GERALD T. LINS ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REG AND COMP § 5:23 (2008) (available in WestLaw, SECHEDGE)
keeping. HFs, however, often avoid registration with the CFTC. Most hedge funds rely on their prime brokers to fund their trading operation. Such loans, if provided by the broker-dealer, must be secured at least to the level of 50%. However, hedge funds are usually able to avoid this regulation.

Some other countries often regulate hedge funds more strictly. For example, the German Investment Act sets forth a detailed regulatory structure for hedge funds, although hedge funds might be, subject to some restrictions, set up also outside this framework. In UK, there is no direct regulatory structure imposed on the hedge funds themselves, but for instance the managers need authorization by the FSA.

B. Pension plan/mutual fund investments

In the U.S., most pension plans are subject to the 1974 ERISA legislation, which places some limits on the ability of plans to invest in hedge funds. If a hedge fund holds more than 25% of assets coming from pension plans (the calculation is rather complicated), the HF's assets will be deemed to be part of pension plan, imposing on the manager fiduciary duties to pension plan investors and a number of other limitations, including on the fee structure; also, the pension plan may need to redeem its investment.

Also, no more than 10% of a hedge fund's equity can be invested by another investment company (i.e. a mutual fund); otherwise the exemption from the ICA would not apply.

108 See Id., at § 11:2, § 11:3
109 See Oesterle, supra note 35, at 4
110 See Jonna, supra note 47, at 1025, and Federal Reserve Reg. T., 12 C.F.R. § 220.12 (2009) (setting forth various margin requirements according to the type of security)
111 See id., at 1026 (describing the practice of arranging loans through prime broker's foreign affiliate), 1030 (describing a practice referred to as “Joint Back-Office”, which enables exceeding the mandated amount of leverage)
112 See Cumming, supra note 12, at 4
113 See Spindler, Bednarz, supra note 48, at 8 n. 61 (noting, among others, the prudential supervision and need of authorization by BaFin, German Federal Financial Supervisory Authority, HF officers need to be certified by BaFin, HFs must prepare reports and cannot invest in real estate; insurance undertakings cannot invest more than 1% of their assets into HFs)
114 Id., at 18
115 Employee Retirement Income Security Act of 1974, 29 U.S.C. Ch. 18
117 See Shearman&Sterling, supra note 116, at 1, Lins et al., supra note 107, at §4:52
IV. A NEW REGIME?

A. Defining the Landscape

The above analysis identified three potential areas of concern in the hedge fund industry: systemic risk, fraud and protection of vulnerable investors. The current regulatory framework does not effectively address these concerns and rather restricts the business of hedge funds in an arbitrary way. A reform is on the horizon\(^{119}\) and on the political agenda,\(^{120}\) but there does not seem to be any consensus on the proper way to structure it, on what particular risks to focus and how to address them.\(^{121}\)

The industry is highly complex, diverse and quickly changing.\(^{122}\) It has been relatively efficiently in developing mechanisms for protection of investors and combating fraud\(^{123}\) (a failed hedge fund manager has almost zero probability of come-back).\(^{124}\) AIFs operate on an international scale; their trading, location and identity of investors and key personnel are not necessarily restricted to one country. Many U.S. HF managers operate their funds in a twin structure: an on-shore fund for U.S. and an off-shore fund for foreign investors.\(^{125}\)

Hedge funds are flexible and seem to be always ready, if need be,\(^ {126}\) to find a loophole in the existing regulation or simply move away in order to be free in their pursuit of profit.\(^ {127}\) Examples of such innovation around regulation may include “retailization” through funds of hedge funds (i.e.

\(^{119}\) See Lo, supra note 50, at 3 (“Financial markets do not need more regulation; they need more effective regulation.”) and id., at 10 (arguing for the need of public concern over hedge funds)
\(^{120}\) See Paredes, supra note 26, at 49 (hypothesizing that if hedge funds become $3 trillion industry, SEC will feel compelled to regulate) and see e.g. Hedge funds ponder Obama’s carrot, fear stick, AP, MSNBC, Mar. 25, 2009, available at http://www.msnbc.msn.com/id/29885047/
\(^{121}\) See Paredes, supra note 26, at 38 (what are the goals of regulation depends on value judgments), at 56 (crafting a regulatory system that achieves the goals is a stiff challenge)
\(^{122}\) See Davidoff, supra note 15, at 340, 355
\(^{123}\) See also Ford New Governance, at 30 (“regulation is not the only force pushing firms towards compliance”)
\(^{124}\) See Shadab, supra note 5, at 39 (noting that managers more often chose to liquidate funds because they did not meet performance expectations than because losses forced them to cease operations)
\(^{125}\) See Lins et al., supra note 107, at §9:1
\(^{126}\) See Cumming, Johan, supra note 57, at 5 (noting that hedge funds might want to signal to their investors that they are prudently by opting for more strict jurisdiction)
\(^{127}\) See e.g. Davidoff, supra note 15, at 340 (“…regulatory action is also more difficult as market provides ever more viable choices and the ability to structure capital needs to circumvent such regulation.”), Id. at 341 (“prohibitory or restrictive regulation will simply cause trading or investing in the relevant security to migrate to foreign or private markets.”), Id. at 362 (“The financial markets … respond to this demand [by ordinary investors] by engineering permitted investments with the characteristics that mimic hedge funds”), Id. at 365 (“Hedge funds have also responded to U.S. regulatory prohibitions by going abroad to publicly raise capital from retail investors.”).
mutual funds, which themselves invest in AIFs, but are accessible to public), creation of synthetic (virtual) HFs or arbitrage between the SEC and CFTC regulation of derivatives. Many hedge funds reacted to the SEC 2006 attempt to require their registration as investment advisers by changing their structure in order to meet the exception crafted in the rule for private equity funds. Therefore, it seems that standard methods of regulation, where a particular regulatory framework is designed by the government after consultation with the stakeholders, are not appropriate.

Proposals for hedge fund regulation range from refusing any regulation through calls for indirect or default-rules-based regulation to calls for full-fledged regulation. Most likely implemented are proposals suggesting a requirement of SEC registration, disclosure of certain basic information and provision, on a confidential basis, of more information to the regulators. However, further details, such as the potential regulatory requirements following from the registration (e.g. the need to appoint a chief compliance officer, as it happened after SEC imposed registration in 2006), are not discussed.

It is beyond the scope of this paper to discuss details of each of these proposals. However, a particular point of view on the discussion on HF regulation is worth mentioning. The salience of

128 See e.g. Jonna, supra note 47, at 1007, Oesterle, supra note 29, at 29 (discussing funds of hedge funds and their shortcomings), a similar phenomenon appears to be the approach of internet database providers to SEC’s requirement that hedge fund data be available only to “accredited investors” – upon on-line confirmation that the data is requested only for research purposes, anyone can gain access to any data, see e.g. Morningstar Expands Hedge Fund Initiative, Adding Hedge Fund Data to Morningstar.com and Advisor Workstation Office Edition, Research Reports to Morningstar Direct, June 26, 2006, available at http://corporate.morningstar.com.


130 The rule excepted funds with a lock-in period of more than two-year, generally believed to be used only by PE and VC funds, see Paredes, supra note 26, at 49.

131 See Jonna, supra note 47, at 1016, See Spindler, Bednarz, supra note 48, at 25 (referring to IMF as calling for indirect regulation). A brief answer to these calls is that indirect regulation will be much more likely over- or under-inclusive, inefficient and ineffective, than properly structured direct regulation, just because of the sole fact that it addresses an issue through intermediaries.

132 See Paredes, supra note 26, at 60 (calling for rules, from which the parties could opt out by reallocating their rights through contract). To briefly answer this, the overall reason for regulatory intervention is that the parties’ choice might cause externalities, such as systemic risk or imposition of costs on investors, such as pension funds, where public interest requires restricting managers’ choice.

133 See Spindler, Bednarz, supra note 48, at 25 (referring to Sanio, representative of the German regulator, as calling for internationally agreed direct regulation of the industry).

134 See Treasury Reform Outline.

hedge fund collapse stories (catch attention better than discussions about costs of regulation),

scapegoating (“HFs caused the crisis”), overconfidence (“we know how to regulate HFs”), quest for equality (“HF managers earn too much”), fear of unknown (“HFs are secret and too complicated”) and other psychological processes may be very important drivers of the calls for regulation. Although these concerns do not provide sufficient grounds to reject HF regulation in its entirety, they need to be taken into account. On the other hand, each type of intervention will be necessarily subject to heavy lobbying and pressures from the hedge fund industry. The theory of new governance addresses these issues and the model I propose takes these facts into consideration.

B. Why New Governance

The school of new governance (NG) describes some innovative trends in regulation and in provision of public goods, which are based on deconstruction of the traditional top-down command-and-control paradigm of governmental intervention. NG regimes are based on strong stakeholder participation, are dynamic and opened, constantly reevaluating themselves through wide collection of data on their performance and usually blur enactment and implementation into one fluid process. NG systems use any regulatory tools to realize regulatory goals, including soft law and private sector techniques, self-regulation and negotiated rule-making. In general, NG approaches focus on the actual interactions going on in the regulated system and vis-à-vis the regulator, rather than on the desired state of the world.

NG approaches get ground in particular in highly complex, diverse and quickly changing contexts, where the regulator often does not know how to reach its goals, or not even what the

136 See also Paredes, supra note 26, at 39.
139 Lobel Renew Deal, at 264 (describing the paradigm shift from the New Deal old-style top-down regulatory model to a governance-based model based on stakeholder participation, non-coerciveness, learning, etc.).
140 See Ford New Governance, at 5 (“third party stakeholders ... play a crucial role in establishing industry standards and filling in their content”).
141 See Chatzimanoli, supra note 16, Chapter III at 4 (“NG ... emphasizes processes and practices which, although having a 'normative dimension they do not operate primarily or at all through the formal mechanism of traditional command-and-control-type legal institution’”).
142 See Chatzimanoli, supra note 16, Chapter III at 32 (NG is concerned with spontaneous orderings in private sector).
143 See Ford New Governance, at 5 (“NG takes context seriously” [emphasis in original]), at 37 (quoting Edward Rubin, The Myth of Accountability and the Anti-Administrative Impulse, 103 MICH. L. REV. 2073, 2131 (2005)).
particular goals are. NG enables the regulatory response to be varied so that it can adapt itself to these environments and thereby increase voluntary compliance and prevent evasion. A particular concern of the NG theories is accountability of the new structures given their deviation from standard governmental procedures; such accountability is seen mainly through the process of giving reasons.

NG in financial markets regulation has most prominently been represented by the “More Principles-Based Regulation” adopted by the British Financial Services Authority and the approach adopted by the British Columbia Securities Commission in wake of failure of the principles-based “Bill 38”. Both these approaches are based on formulation of broad principles and the expectation that these principles will be filled in by content in repeated interactions between the regulator and the industry. I see two limitations for which these approaches might be inappropriate to regulate hedge funds: (a) they rely to a great extent on certain assumptions about the regulated environment (London City), and (b) the diversity and quantity of HFIs might prevent formulation of any clear principles and the development of the iterative implementation process due to the work-load requirements it would pose. Also, it seems that the principle-based regulation had been recently targeted by a stream of criticism and is slightly receding.

A particular feature of most of the NG regimes is that they are initiated by a motivated insider (either a progressive regulator or a group or activists) and not the result of multiple parties acting on the basis of incentives flowing from the distribution of legal rights by the legal system. In HF industry, this could be achieved by participants bargaining around the existing regulatory structure. However, the transaction costs associated with this are simply too high (development of the legislation, organizing to support it, lobbying for it, etc.). Therefore, the crucial question is how to distribute legal rights to create

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145 See Ford New Governance, at 7 (“NG theory cannot be a one-size-fits-all enterprise”).
146 See Chatzimanoli, supra note 16, Chapter III, at 24 (noting that the presence of accountability should prevent deviation by the regulator and classifying accountability as: external (towards some authority), internal (individual self-consciousness), as control (institutional architecture), as responsiveness (to the wishes of citizens) and as dialogue).
147 See Ford New Governance.
148 See Ford New Governance, at 34.
incentives, which will lead parties to develop an efficient NG system.  

The current regulation of hedge funds, and that of mutual funds much more, almost perfectly corresponds to the paradigm of the old-style top-down regulation, despite being, in the context of hedge funds, limited. However, the industry as a target of regulation almost perfectly requires an NG approach, including by the lack of clear objectives of regulation.

The hedge fund industry expects regulation and has recently generated a substantial body of best practice guides increasing the required standard of conduct, arguably to ward off intrusive and harmful regulation. However, these standards are usually too general to significantly alter the behavior of the hedge funds and also vary considerably. Also, if there is no reliable third party enforcing and interpreting the standards, the commitment by the fund to such standards might not be credible from the point of view of the investors. Therefore, this does not look as an appropriate answer to the concerns expressed above. As it seems that the regulatory and industry structure currently prevent an organic development of an effective NG regime, I propose a model that would alter the basic structural elements and create appropriate incentives to develop such a regime. However, before describing it, I briefly describe a model based on similar rationale introduced and later dismantled in the UK.

C.  Looking around the Shoulder – how the UK model (was) failed

In 1986, based on a model of 'self-regulation within statutory framework' proposed by

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152 See Ford New Governance, at 42 (“making those changes “stick” requires that catalysts for change be embedded in institutional arrangement”). Apparently, most corporate, bankruptcy and contract law operate in this fashion, i.e. that most of actual business is done by private ordering under the shadow of the law.

153 But cf. Ford New Governance, at 10 (“The U.S. Securities Act 1933 and Securities and Exchange Act of 1934 ... exhibit nothing like the detailed, rule-bound, 'command and control' approach so often now associated with bureaucratic sclerosis and ineffectiveness in other regulatory arenas.”) This apparently is not the case of the Investment Company Act of 1940.


155 Hung, supra note 25, at 12, Cumming, Johan, supra note 57, at 798.

156 Hung, supra note 25, at 7 (quoting e.g. the principle that “managers' disclosures should enable investors to evaluate the fund” and recommends disclosures “at least quarterly”, whereas most funds in the industry actually report monthly).

157 See e.g. Hung, supra note 25, at 8 (noting that the President's Working Group standards prohibits delegation of responsibility for investment valuation to a third party, whereas the MFA principles do not).
Professor Gower, UK enacted new regulation of financial markets. The model was modified during the legislative process and the balance between self-regulatory organizations (SROs) and the regulator, the Securities and Investments Board (SIB), was disrupted. Therefore, the resulting legislation created a messy scheme without clearly defined powers, incentives or expectations. The SIB itself was a hybrid entity and was required by the legislation to enact regulations for the vast field of the entire financial services industry, which resulted in a detailed and very criticized original rule book.

The SROs progressively claimed to be 'independent regulators' and the idea of self-regulation vanished. In 2000, the government merged all the SROs into a single regulator, the Financial Services Authority (FSA), arguing by unsatisfactory results of the self-regulation, in particular in respect of pension scandals. The old system was too ambitious and had fatal flaws from the beginning, in particular the lack of a strong regulator able to deal with the SROs. Nevertheless, the lesson was learned and the proposal made below addresses the most important concerns raised by the UK experience.

V. THE MODEL

The model proposed in this paper is based on the idea that there is no one single regulatory framework, which can be imposed on all the hedge funds or other AIFs. The variety of the fund structures, strategies and their social position require a varied approach. Also, jurisdictional issues complicate a thorough oversight and issues of international cooperation prevent any government from effectively impose a particular structure on the industry.

Implementation of this model would require enabling legislation altering most of the
regulations discussed above and giving regulators the powers required to put in place the structures described below. The legislation would create only bare-bones background under which the model would develop.

The model would allow multiple regulatory frameworks for private investment vehicles compete within an overall regulatory structure.165 A framework would consist of a set of rules for operation of the funds and, if necessary, be supervised by an institution (public or private) responsible for implementation and development of such rules.166 Each fund would be obliged167 to select a particular framework, but would then have to comply with such framework’s rules (such fund further a member fund),168 and disclose this framework to any investor or counter-party. The enabling legislation would set forth only basic goals (reduction of fraud, systemic risk and protection of vulnerable investors)169 and require SEC to ensure that each framework adequately pursues these goals.170 The assessment of the adequacy should be a matter of negotiation and, in case of controversy, of judicial determination.171

A framework would be subject to SEC approval before any hedge fund could opt to become bound by it and such approval would occur after detailed negotiation.172 Trade associations of hedge,

165 See Black Regulators, at 51 and also the model ascribed to Neil Gunningham and Darren Sinclair, Leaders&Laggards: Next Generation Environmental Regulation 13-40 (2002), as described in Ford New Governance, at 50.

166 The UK model after the 1990 reform revolved around Core Rules applicable to all industry participants and to which the rules promulgated by the SROs generally served in the following functions: detailing, clarifying, expanding, gap-filling and limiting (defining the scope of application), see Black Regulators, at 126.

167 See Verret, supra note 15, at 820 (“The government's role would be to make membership in the [self-regulatory organization] mandatory, or at least desirable, because only in that event will the equilibrium forces come into effect.”),

168 This seems to be the most important difference to the framework introduced in the UK in the FSA 1986, where the SROs were organized on a functional basis with each SRO grouping undertakings of a particular type and only undesired limited overlaps, see Black Regulators, at 69 and at 72 (the existence of an SRO in the respective area was a reason for refusal of authorization for a new SRO).

169 Cf. Black Regulators, at 107 (enactment, by SIB, of principles applicable to all the regulated entities, was rendered possible only when the private right of action for breach of these principles was eliminated and their enforcement was confined to disciplinary action; under the model proposed herein, SEC might develop a body of principles for approving a framework, but these will not be directly applicable to the member funds).

170 Cf. Black Regulators, at 82 (claiming that the fact that the SIB enacted an alternative regime for each regulated activity and that each SRO's rules had to provide an equivalent level of investor protection as the SIB's rules was one of the main weaknesses of the UK model) and, at 92 (the move to the 'adequacy' rule in 1990 had “huge symbolic significance . . . [as] it was the interpretation of the equivalency requirement which had become the source of SRO's frustration . . .[and the change was] viewed by many participants as the key change, facilitating the rest”).

171 See Sabel, supra note 144, at 13 (describing in education reform context, how the precise definition of adequacy would be the “joint product of the disciplined search for the desired result” and not readily apparent).

172 See Black Regulators, at 117 (describing how the SIB and Securities Futures Association negotiated a compromise with respect to a rule defining 'market counter-party' after the 1990 reform of the UK regulatory structure).
PE or VC funds, states in the U.S. (e.g. Connecticut – the home of many HFs), a foreign government173 or even a large hedge fund manager alone might be interested in proposing a framework and the SEC should encourage this.174 SEC would have an obligation to negotiate with every proponent, although it might be able to set forth some thresholds that a proponent has to meet. SEC would be under no legal obligation to approve any framework, but would have to give reasons for any such decision, subject to judicial review. SEC would be also able to enact its own frameworks, but subject to a requirement of non-discrimination against other frameworks. Fed would have the right to intervene in the framework approval negotiations with respect to issues of systemic risk.175

A regulatory framework could be approved as anything between a set of rules with an open mandate giving the member funds complete freedom, subject to some qualitative and quantitative limits (e.g. size up to $5 million), and a full regime of prudential regulation (for largest funds). The framework proponent could chose the proper regulatory tools, including principles, non-binding standards or comply-or-explain rules.176 Certain mobility between frameworks would be necessary and each framework would need to define conditions or entry and of exit by member funds. Funds, as they grow and change, would be able to change the frameworks in order to be part of the framework most appropriate for their business.

A framework could set for its member funds (and through them for such funds’ managers) any requirements, such as: disclosure,177 book-keeping,178 valuation,179 regulatory filings, limitations on the corporate structure (including location of headquarters or governing laws),180 compulsory use of a custodian bank, rules on conflicts of interest, corporate governance, fee structure or transactions with affiliates, risk management, capital adequacy (i.e. a requirement that the fund’s leverage does not exceed a certain limit), liquidity and finally, rules on redemption of investments, rules on the interpretation and enforcement of the framework (such as the power of the framework operator to investigate any charges of fraud against a member fund or powers to seize assets or to wind-down a

173 See Ford New Governance, at 53 (“One should resist trying to identify the right third parties ex ante.”).
174 See Verret, supra note 17, at 835 (recommending that SEC requests the Managed Funds Association to develop disclosure standards).
175 See Paredes, supra note 26, at 18 (noting that systemic risk belongs to the domain of Fed).
176 See Ford New Governance, at 36 (discussing the factors relevant for decision, whether to use rules or principles).
177 Cf. EC Directive Proposal, at 32, art. 20 (proposing imposition of some basic disclosure towards investors on all AIFs)
178 See Lo, supra note 50, at 2 (noting that a new type of accounting – risk accounting – needs to be developed).
179 See Sklar, supra note 54, at 3322 (suggesting federal specific regulation of valuation methods and arrangements)
180 Cf. EC Directive Proposal, at 24, art. 5 (requiring that the head office and the registered office of a AIF manager be in the same member state)
The frameworks should be also able to determine, whether and to what extent would investors have private rights of actions for violation of the framework's rules.\textsuperscript{182}

The agreement between the SEC and the proponent of the framework\textsuperscript{183} would set forth the rules of the operation of the framework, such as: prevention of conflicts of interest,\textsuperscript{184} funding, organizational requirements,\textsuperscript{185} amendments of the framework's rules (i.e. scope of SEC's power to approve any changes), reporting and methods of supervision of the member funds and of supervision of the framework by the SEC and, quite importantly, potentially some limits on the liability of the framework to its member funds and their investors.\textsuperscript{186} This agreement and the negotiations leading to its adoption would be public, so that proponents of other frameworks, members of the industry or other stakeholders could participate.

Based on SEC’s assessment of a framework’s safeguards or its performance, SEC would be able to grant a framework some concessions or impose limitations (as compared to the existing regulatory requirements),\textsuperscript{187} such as (a) the eligibility of investors having access to member funds (individuals subject to a wealth threshold, pension plans, insurance companies and maybe even public) or (b) access of the member funds to particular markets and counter-parties (authorization to engage in OTC derivative trading, access to exchanges or to trading with banks, insurance companies, access to Fed’s financing facilities).\textsuperscript{188} The ability to obtain these concessions (such as the freedom to accept more than 25% of pension plan funds) should motivate industry groups to negotiate with the SEC. In case of concessions in areas outside of the authority of the SEC (such as pension plans, access to Fed),

\textsuperscript{181} See Black Regulators, at 51.
\textsuperscript{182} See Black Regulators, at 87 (describing the fear caused by a statutory imposition of liability for any breach of SIB’s rules as a driver of reliance on detailed rules akin to a standard regulatory model).
\textsuperscript{183} The idea of negotiation of the structure of the SROs (similar to frameworks) and of the scope of regulator’s intervention seems to be missing from the 1980’s UK proposal, as described in Black Regulators, at 58 (“the [regulator’s] involvement was restricted in essence to initial recognition and ultimate revocation”).
\textsuperscript{184} An interesting example in this area comes from the exchanges, which are traditionally both regulators and service providers for their members, see Adam C. Pritchard, Self-regulation and Securities Markets, REG., Spring 2003.
\textsuperscript{185} See Verret, supra note 15, at 817 (discussing the 1996 settlement of price rigging claims between SEC and National Association of Securities Dealers, which established a self-regulatory organization run by NASD, subject to agreement on its organizational structure).
\textsuperscript{186} See Black Regulators, at 65 (describing how the issue of immunity of the self-regulatory organizations was a hot issue in the legislative process leading the Financial Services Act of 1986).
\textsuperscript{187} The use of the derogations as incentive mechanism is one of the most important differences vis-a-vis the UK model, as the Core Rules enacted by the SIB would not apply only in case where a derogation was enabled by the rule itself or where the SIB, usually reluctantly, granted it upon specific request, see Black Regulators, at 123.
\textsuperscript{188} See Ford New Governance, at 44 (on the notion of regulatory sticks and carrots and how this translates into firm culture).
the respective departments (Department of Labor, Fed) should participate in the negotiation (and further supervision of the framework) and their approval would be required to relax the respective regulatory constraint. The grant of such concessions would be subject to third party judicial challenge.

The enabling legislation should give the SEC also the power to threaten the market with more regulation, in order to bring the funds to the table. This could be, subject to Constitutional constraints on delegation of legislative power, either a default regulatory framework that SEC could impose on unaffiliated funds or a broad mandate given to SEC to impose any of a number of possible regulatory requirements upon such funds. The current regulation would be left in place and the SEC would have the power to grant exemptions when approving a framework.

The SEC and other regulators would be charged with monitoring the operation of each approved framework, generally by collecting reports, assessing them and if necessary, requesting the framework to enact changes to its rules or operation; however, the SEC would not have the power to impose its own rules over those of a particular framework. In policing a framework, SEC (and other regulators) would have the power to withdraw the concessions (such as increased investor access) or, in grave cases also the approval of the framework itself, including if the framework no longer meets the goals of the regulation. Such action would be subject to a preventive judicial review, so that a procedural, rather than a substantive resolution, of any disputes is put in place. Thus, the role of the courts in the model would be that of a neutral third party in policy disputes, generally getting the parties back to the table, instead of instilling fear by the threat of liability.

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189 This corresponds to what Charles Sabel describes as a “wicked problem”, one that requires drawing on the knowledge of multiple service providers and coordination across formal lines of jurisdiction, see Sabel, supra note 144, at 8.
190 See Ford New Governance, at 49 (on the idea of tripartism and giving third parties access to information, the negotiation and to judicial challenge of breaches).
191 See Ford New Governance, at 30 n. 118 (quoting Ian Ayres & John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (1992), at 35-41, as referring to the regulator's need for a “benign big gun”, or a heavy sanctioning option, to make less intrusive self-regulatory options viable).
192 U.S. CONST., art. 1.
193 See Black Regulators, at 82 (noting that SIB’s power to impose its own rules over those of the SROs created uncertainty and lead to the demise of the UK model, also because the SIB ended up writing a very broad code of regulation). Also, the UK model prevented the development of an iterative self-evaluating system.
194 See Black Regulators, at 75 (noting that the SIB in the 1986 UK scheme could dis-authorize an SRO only if it breached the recognition requirements – an approach possibly limiting the iterative approach to the interpretation of such requirements).
Any information collected by the SEC from a particular framework, but not regular reports on general performance, would be protected from public disclosure, unless the framework agreement set forth that it is public. Fed's task would be to use the data collected to develop models of systemic risk\textsuperscript{196} and also come back to the table with any results of such modeling.

A. Limited knowledge and resources of SEC

The SEC, as any regulatory agency, cannot have sufficient knowledge to propose, implement and innovate a regulatory framework in such a complex environment, as collective investment\textsuperscript{197} (that it has been doing it does not mean that it is a success).\textsuperscript{198} Even if it was possible to develop a sufficiently comprehensive set of regulations, the SEC would not have the resources necessary to run such a system.

The proposed model relies to a much lesser extent on the knowledge of SEC in allowing the market participants to design the framework. Each participant will come to the table with specific knowledge of the field he/she is active in with a necessity to share.\textsuperscript{199} In addition, once the system is in operation, it will generate substantial amounts of knowledge when each framework will be reviewing its own rules and discussing possible amendments with SEC.\textsuperscript{200} The SEC would serve as the “centralized information-gathering body that aggregates experience and permits comparative learning between industry actors”.\textsuperscript{201}

Further, the SEC and other regulators will be forced in negotiation with the frameworks to develop policy arguments to support their positions.\textsuperscript{202} To develop sufficiently powerful arguments, the

\textsuperscript{196} See Lo, supra note 50, at 4 (noting that no single measure of systemic risk might be appropriate, but that some kind of definition needs to be developed).
\textsuperscript{197} See Paredes, supra note 21, at 34.
\textsuperscript{198} See e.g. Hirshleifer, supra note 135, at 14 (discussing the limits on the capacity and knowledge of the agency), Verret, supra note 15, at 817 (referring to the settlement between SEC and NASD and stating that “The [SEC] had neither the time nor the ability to adequately innovate its regulatory response to the complexities of securities pricing…”).
\textsuperscript{199} See Ford New Governance, at 35 (“NG-style principles-based and outcome-oriented regulation spans the so-called “public/private divide”, incorporating industry experience and perspectives into a still-resilient regulatory capacity.”).
\textsuperscript{200} See Chatzimanoli, supra note 16, Chapter III, at 13 (“… a decision-making mechanisms which … have engaged various actors … in a deliberation process which is therefore non-hierarchical, informal and flexible, and which allows the discovery of knowledge and its dissemination back into this very atypical regulatory process in an iterative manner”).
\textsuperscript{201} See Ford New Governance, at 29.
\textsuperscript{202} See Ford New Governance, at 32 (describing how the regulator “must resist the temptation to seize the low-hanging fruit of easy, technical violation cases in favor of more important (and often more difficult) cases”). The question is how to motivate the regulator to do this.
SEC will have to engage in deep research and thus the model gives SEC the proper incentive to review the regulatory structure from a real efficiency perspective. The resources needed for this kind of research are apparently much smaller than resources needed for full-scale regulation of several thousands of hedge funds.

**B. Flexibility and experimentation**

The key to a successful regulation of any industry so based on innovation as the HFs is to enable the participants to preserve their business model; this entails in particular not forcing managers to disclose confidential information about their trading strategies, i.e. to preserve for them the gains from innovation. The model leaves the scope of information to be disclosed to negotiation.

With multiple regulatory frameworks operating at the same time and competing on the one hand for member funds and on the other hand for regulators’ favor, considerable innovation in meeting the challenges of regulation should occur. The results of such experimentation might be useful in development of many other areas of regulation, such as that of the mutual or pension funds.

The proposed model should not suffer from the effect of rigidization – the fact that once a regulatory structure is enacted, it is very difficult to dismantle or to amend it, even when it is suboptimal, as interest groups profiting from such structure oppose such change. It is not the self-regulation, but the possibility of competition and change, which should prevent this.

The UK model developed into a quasi-standard-regulatory structure within some ten years from its inception. The proposed model should prevent this, as, contrary to the situation in the UK, (a) there will be no substantive requirements in the model, (b) the frameworks will be competing among themselves and (c) there will be a strong regulator, the SEC, supervising the frameworks.

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203 See Lo, supra note 50, at 19 (describing the process of such analysis).
204 Cf. e.g. Proposed EC Directive, at 25, art. 9(1) (requiring that a HF discloses preferential treatment of an investor).
205 See Paredes, supra note 26, at 27 n. 74, Lo, supra note 50, at 7.
206 See Davidoff, supra note 15, at 355 (“… federal securities regulation … is less responsive to rapid changes in the structure and nature of capital markets. Moreover, there is a permanence to this gap as adaptation to new regulation is immediate due to financial innovation, but the regulatory process takes years to respond.”).
207 See e.g. Oesterle, supra note 35, at 8 (describing how SEC implemented the registration requirement in 2006 mainly on the basis of the comments of those hedge fund managers, who were already registered – i.e. those, who perceived the imposition of the registration requirement on the others as (a) a barrier to entry and (b) leveling the playing field for competition), see also Paredes, supra note 26, at 33 n. 87.
208 See Ford New Governance, at 21 (describing the digression of the self-regulation in case of brokers and dealers in British Columbia).
C. Involvement of stakeholders

Engagement of industry participants in the regulatory process is key to its success. Under the proposed model, each framework operator will have an interest in pointing out the weaknesses of other frameworks in order to attract to them (and divert from itself) regulators’ attention and to emphasize the qualities of its own framework. The member funds, as a group, will have an interest to maintain a framework with high reputation, so that the investors can reasonably (i.e. without implying moral hazard) refrain from some part of the due diligence.

By requiring the funds to group themselves, the regulator will be able to harness the power and potential of the informal networks in the industry. It is likely that the funds will group themselves along the lines of such networks and that in the end, the regulatory structure will closely correspond to the industry structure, which is a desirable, but usually unachievable, goal of regulatory systems. The industry seems to show signs of concern for public interest, so an invitation to engage in discussion about wider implications of their business should be welcome by hedge funds managers and should also provide an incentive to move from a “loophole” behavior and a “check-list approach” to law to an engaged approach seeking to find what is the right thing to do.

Although a failure of a HF is nothing exceptional, a framework should review failures and their reasons (especially with respect to fraud) and investors would be wary of frameworks, which have unreasonably high failure rates. The SEC would monitor this process and make sure that sufficient data is disclosed so that the effectiveness of each framework can be tested. This process of learning from failure is superior to a process, where only the regulator and individual investors are engaged in learning.

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209 See Verret, supra note 17, at 817 (discussing self-regulation and providing a game-theoretic model demonstrating that participants will have an interest in abuse-free self-regulatory framework), and Ford New Governance, at 22 (describing how the brokers and dealers sought themselves a more efficient method of dealing with fraud).
210 Cf. Paredes, supra note 26, at 61 (suggesting that in a voluntary registration system for hedge funds managers the fact that a manager is not registered may raise suspicion). This might not work where the registration leads to an either/or imposition of a number of requirements or where the investors don’t have data to evaluate the performance of each particular requirement explained away by the manager.
211 See Chatzimanolli, supra note 19, Chapter II, at 6.
212 See Kate Julian, Dept. of Hoopla, Makeover, THE NEW YORKER, Apr. 13, 2009, at 25 (describing beneficiary events organized by hedge fund managers to help prevent child abuse).
214 See Ford New Governance, at 31 (describing a process called “root cause analysis”, which “involves asking a series of nested questions about a particular failure, each of which is meant to deepen the response to the last”).
215 See Lo, supra note 50, at 2 (describing the process of learning from disasters in airline industry through the National Transportation Safety Board).
The frameworks could also engage, within the development of the network, third-party organizations, such as socially responsible mutual funds (or their associations) or other certifying bodies, in order to obtain a(n easier) certification for their members from these organizations. This could further strengthen the participatory process leading to the enactment of a framework and thus add to the model democratic legitimacy.216

The establishment of frameworks can also help overcome some contracting problems. For example, many large financial institutions were forced, in the current crisis, to incur huge losses by rescuing hedge funds or securitization vehicles that they established and managed (taking them “back on their balance sheet”) in order to save their reputation.217 This was a step that they were not supposed to take according to the original deal and, some would argue, also as prudent financial institutions. If the institution and its investors could at the outset commit not to seek or enable such step, these losses may have been transferred to the investors and the financial institutions would not have failed (nor needed government aid). However, such commitment is unlikely to occur in a world without a third party policing it via regulation; courts cannot do that.

D. Location, jurisdiction and qualification

1. Qualification

The current regulation suffers from continuous discussions over its scope of application (does the registration requirement apply to HFs?).218 Under the proposed model, these problems will disappear, as each fund will belong to a particular framework. If the proposed regulatory model is then extended also to other collective investment and similar vehicles (mutual funds, securitization vehicles),219 even more questions of qualification will be eliminated.

The regulation would be addressed to funds and not to their managers, as the managers would be easily reachable by the framework’s rules. This is more appropriate as the qualification of the funds

216 See Chatzimanoli, supra note 19, Chapter III, at 22 (noting that participation is a strong “guiding criterion for determining regulatory legitimacy”; procedural fairness might be another one).
217 See e.g. Clark, Goldman Sachs bails out hedge fund with $3bn, FIN. TIMES, Aug. 14, 2007, King, Maier, supra note 31, at 15.
218 See e.g. the issue applicability of the Investment Adviser Act 1940 to the hedge funds, supra part III.A at p. 13, or the entire regulatory structure around the applicability of the Rule 144A. The Proposed EC Directive does not even aspire to define AIFs beyond “collective investment undertaking”, see Proposed EC Directive, at 20, art. 3(a).
219 See Oesterle, supra note 35, at 31 (discussing whether there is a need to alter the regulatory constraints on the mutual fund industry).
is easier to draft in the legislation and the source of any risk is the fund and the operations of the
managers with the funds’ assets, not the manager itself.

2. Location

The classic regulation assigns regulatory authority either on the basis of location of the
principal office or place of registration of the regulated entity. Other regulators often intervene if the
regulated activity has effects within their jurisdiction. A seamless internationally coherent regulatory
regime would therefore have to be fully uniform. This is obviously politically impossible. Regulation
by any one government, even the U.S. government, may fail to reach its objectives. However, the
proposed model could reach its full effect also if adopted only unilaterally by any country. Foreign
regulators would be open to submit their regimes, even if not based on a similar paradigm, to SEC for
approval. In addition, as soon as multiple nations adopt the model, any framework approved by the
most relevant regulators will be able to operate globally. Forum shopping will become more difficult
and regulatory constraints on HF business less onerous.

Under the model, a regulator with the practical ability to exert jurisdiction would be
authorized, but also obliged, before any regulatory intervention, to participate in the negotiation leading
to the adoption of the framework. The authority of a regulator to monitor a framework and to intervene
in case of non-compliance will be based on a contract, rather than on classical sources of jurisdiction,
the problems of location and jurisdiction will largely disappear. An official of SEC will thus easily find
herself investigating the performance of an association of Chinese hedge funds in London.

The model will need to be adopted on a reasonable scale, i.e. on the level of the federal
government in the U.S. or the E.U., so that there is a centralized body preventing too many

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220 See Spindler, Bednarz, supra note 48, at 15 (noting that foreign hedge funds are free to raise money from German
investors through private placements).
221 See Lins et al., supra note 15, at § 9:17 (SEC subjects any off-shore HF to the requirements of the Investment
Company Act of 1940, but counts only the investors located in the U.S. into the thresholds).
222 See Chatzimanoli, supra note 16, Chapter II, at 14 (noting the “practical unfeasibility, cumbersomeness and political
impossibility of total harmonization” even at the EU level of financial regulation, which is much more harmonized
than in the global context).
223 See e.g. Alan Greenspan, Private-sector refinancing of the large hedge fund, Long-Term Capital Management, 105th
visited Apr. 7, 2009).
224 The EU would need, for such a purpose, a strong financial regulator. As long as it does not, the FSA would be
reasonable to claim its say in the process.
inconsistencies and defects and also coordinating the entire system. Also, the model requires quite a huge scale to be able to generate efficiencies. However, it will not need to exclude any AIFs from the benefits of worldwide operations.

3. **Subject-matter Overlaps and Conflicts**

An important issue in the regulatory model is its interaction with other regulatory structures. The proposed model does not provide a substantive solution, but leaves it opened to negotiation between the various agencies (Department of Labor, Fed, SEC, CFTC) and creates a structure of incentives to get these parameters right. Such interaction could bring lot of benefits. In addition, the overlaps would be streamlined into the frameworks functioning as transmission centers between various regulators and the member funds, which would reduce the costs of compliance. The area of entity-level regulation of hedge funds is particularly apt for this approach also because there is no need to regulate third parties, i.e. to subject to regulation entities, which cannot be reached by contract. Therefore, these regulators, whose primary concern is not hedge funds, should accept the arrangement. Obviously, this would have to be enabled by the legislation introducing the model.

**E. Transparency, benchmarking and accountability**

The SEC and other regulators would be required to define, on the basis of the collected data, the benchmarks for measuring success of regulatory frameworks (e.g. volatility for funds focusing on management of pension assets) and propose amendments to those frameworks, which they find to be out of tune with the rest of the market. As most of this framework-level documentation would be public, the transparency of the entire system would be substantial.

This process will serve also as the main accountability mechanism.

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225 See Group of 30 Report, at 8 (addressing U.S., which lacks such a structure: “For those countries lacking such arrangements, a framework for national-level consolidated prudential regulation and supervision over large internationally active insurance companies should be established.”).

226 See Segal, supra note 18, at 3 (noting that “for self-regulation to be effective, it needs to be properly integrated into the overall regulatory framework”, which is relevant, although the model is not a pure self-regulation).


228 See Group of 30 Report, at 10 (“Countries should reevaluate their regulatory structures with a view to eliminating unnecessary overlaps and gaps in coverage and complexity, removing the potential for regulatory arbitrage, and improving regulatory coordination.”) I think this is neither doable nor desirable, see Ahdieh, supra note 227, at 868.

229 Cf. Pritchard, supra note 184, at 38 (noting the limits of self-regulatory jurisdiction of exchanges in respect of insider trading).

230 See Segal, supra note 18, at 4 (“Self-regulation must have vigorous accountability mechanisms. The old-style model
whom and how each particular framework and also the general regulator231 will be accountable – in an experimentalist governance system, such as the proposed model, cannot be based on the traditional principal/agent relationship, where the agent (administrative body/framework) reports to the principal (parliament/regulator) on the fulfillment of the tasks described in the legislation. Rather, accountability is more fluid in the process of giving of reasons, reporting of outcomes and subsequent deliberation. The principal still retains the authority to dismantle or alter the regulatory structure. However, the accountability becomes multidimensional – the agent, rather than reporting on concrete results, describes the process employed, the lessons learned and new knowledge implemented and more stakeholders participate in the process.232

Mechanisms of accountability should prevent regulatory capture, with respect to private frameworks as well as to the regulators. The safe-guards described above should be sufficient to prevent capture of a particular framework by its member funds: supervision by regulators, competitors and investors of the frameworks' member funds. A capture of the regulator by a framework should be also more difficult than in the current regime, as it would have to be either (a) a publicly disclosed agreement to laxer regulatory standards, compared to other frameworks, or (b) passivity of the regulator in case of lax enforcement of its own rules by a framework. While the former situation is improbable, where the entire process is subject to judicial review, the latter could be a major concern. However, as multiple regulators would have the right to intervene (at least in respect of granting concessions) and as such laxity would not go unnoticed in the industry, other frameworks could easily challenge such situation.233 Organizing the challenges on the level of frameworks will reduce the free rider problem, as the number of competing frameworks will likely be relatively small. On the other hand, it is unlikely that all the regulators would simply abandon their tasks in respect of all the frameworks.

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231 See discussion of accountability in Black Regulators, at 68, where she concludes that the Securities and Investments Board, which had in the UK model a position comparable to that of the SEC in my model, was held accountable principally to the parliamentary committees.

232 See Sabel, supra note 144, at 12.

233 See also Verret, supra note 17, at 822 (assuming a voting mechanism within a self-regulatory organization and demonstrating that competition would lead the regulated entities to adopt an abuse-preventing regulatory regime).
F. Costs and benefits

1. Overheads: Costs and Reality

A principal question for any proposal is who will pay for it and whether it is worth the money.\(^{234}\) For frameworks designated for small funds (which would consist only from a set of rules and would be mostly administered by the SEC), the cost of development of the framework (i.e. the time and expenses of those industry representatives involved) would be relatively minor and could be easily borne by the respective trade association. Operation of such frameworks would be to a large part ensured by the SEC or local regulators, but the degree of regulatory supervision would be minimal.

Implementation of frameworks for larger funds should, on the other hand, substantially reduce the costs of compliance and increase the trade opportunities for the funds by eliminating some restrictions and imposing new restrictions mostly where they cannot prevent legitimate value creation. Therefore, these funds should be ready to pool their resources and engage in the negotiation necessary to develop a proper framework. In addition, once a framework would be established as an institution, it could create value for the funds (and be paid for it) by providing additional services.\(^{235}\)

For instance, compliance of most funds with the ERISA 25% limit must be specifically assessed with respect to “each class” of equity. A class of equity is a tricky concept, and an investor having somewhat specific rights against the fund might be considered a separate “class of equity.”\(^{236}\) As almost every hedge fund has investors with specific rights or individually negotiated investment contracts, compliance with this requires continuous assessment and legal advice – and the risk of non-compliance might still not be fully eliminated. If a framework was certified so that its member funds were free to accept any amount of pension plan funds, the costs and risks of compliance with this requirement would be eliminated.

2. Regulatory competition?

The proposed model acknowledges the existence of regulatory competition\(^{237}\) and builds on its

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234 Cf. Verret, supra note 17, at 834 (referring to the example of RiskMetrics in the area of corporate governance, which managed to develop a self-sustaining model), See Ford New Governance, at 37 (“Our concern should be to adopt the effective system with the lowest overall social costs, not the lowest costs to industry alone.” [emphasis in original]).

235 Cf. Verret, supra note 17, at 835 (noting that a self-regulating organization could sell consulting services to the funds).


237 See Davidoff, supra note 15, at 366 (noting that “European exchanges are rapidly developing regulatory architecture to
benefits, such as spurring innovation\textsuperscript{238} and inciting lax regulators into action.\textsuperscript{239} Theoretically, the model overcomes the standard arguments against regulatory competition, while maintains those factors, which are positive. It is improbable that a “race to the bottom”\textsuperscript{240} would develop, as several regulators would monitor each framework. Simultaneously, peer and stakeholder pressure on a “bad” framework to align itself\textsuperscript{241} would face much lower barriers than in a traditional regulatory competition scenario, where the competing regimes are separated by geographical borders.

On the other hand, the traditionally discussed barriers to the “race to the top”,\textsuperscript{242} i.e. the inefficiency of the voice and exit mechanisms, would be strongly diminished by the easy possibility for each member fund to change its regulatory framework. As at least some of the frameworks would be governed by their member funds (and if not, a new one could be always created) and at least some of the investors would be represented in the negotiation of the frameworks (and even if not, they can surely vote with their feet/wallets), also the voice condition seems to be satisfied.\textsuperscript{243} Rather than increasing transaction costs, the model would reduce them, as the frameworks relevant for funds operating globally would be global.\textsuperscript{244} In addition, the model would also enable specialization, i.e. that a particular regulatory framework would specialize in a particular type of funds.\textsuperscript{245} Available empirical research seems to indicate that current international regulatory competition outcomes are compatible
with this argument.\textsuperscript{246}

3. \textit{Systemic Risk?}

The proposed model cannot itself deal with systemic risk.\textsuperscript{247} However, by providing the regulators concerned with systemic risk (Federal Reserve, European Central Bank) with an opportunity to intervene in the development of the agreed frameworks, request information they reasonably consider necessary for assessment of systemic risk and be involved in further revisions of the frameworks, the model does much more than the existing regulation or any of the proposals discussed above.\textsuperscript{248}

The model could give Fed the power of veto over any framework, which does not provide it with information \textit{necessary} to evaluate systemic risk posed by the member of the framework. The burden of proof that the information is \textit{necessary} would be on Fed (though, large deference should be given by courts to Fed’s modeling of systemic risk). Such limitation of the veto power would enable Fed to intervene under the label of “systemic risk” only if it really had something to say.

VI. \textbf{Conclusion}

Cristine Ford, in the conclusion of her review of new governance in financial markets regulation, remarked that “Persistent learning, self-reflection, and continual reinvention at the operational level are more fundamental than elegant design.”\textsuperscript{249} While this is certainly true, in settings where these conditions do not exist and the motivation to bring them about seems to lack, a proper design might be the necessary and missing element, which will lead stakeholders and the regulators to engage in a constructive development of new regulatory structures.

For all the emphasis on private parties being involved in the development of the regulatory

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\textsuperscript{246} See accord Cumming, Johan, \textit{supra} note 57, at 5 (concluding that data suggests that hedge funds pursuing riskier strategies select jurisdictions with more stringent regulations).

\textsuperscript{247} See \textit{e.g.} Verret, \textit{supra} note 17, at 838 (stating this and suggesting that Federal Reserve maintains “vigilance in this area”).

\textsuperscript{248} See Segal, \textit{supra} note 18, at 8 (as the Deputy Chair of the Australian Securities and Investments Commission noting that: “we need the co-operation of such [self-regulatory] schemes to report systemic problems to us so as to ensure that they do not work in isolation, but help ensure the system as a whole is effective ”).

\textsuperscript{249} Ford New Governance, at 55.
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structure, it still needs to be seen as a public law framework, as long as the content of the regulatory frameworks required by the supervising regulators does not become negligent in comparison to the content developed by the market participants from their own initiative. In the latter case, the true nature of this layer of law, still belonging into the realm of compulsory self-regulation, will become subject to real question. However, this is an outcome completely consistent with the theory of new governance and should be welcome as an instance of government positively orchestrating private action into independent value creation.

250 See Chatzimanoli, supra note 19, Chapter III, at 15 (“notwithstanding the location of (some of) public (‘regulatory’) powers in ‘private hands’, these powers ... are still public in nature.”).

251 See Chatzimanoli, supra note 19, Chapter III, at 29 (“a new normative order is emerging, which is different from and can be proposed as an alternative to[,] the law”) I would not go that far, but I agree that many traditional legal concepts are being displaced, but cf. Id., at 36 (“[NG] overcome[s] the reference to the almighty of the state, in geographical terms (since [it] recognize[s] the blurring of the national with the international ...); in functional terms ([it] embrace[s] the interaction of public with private actors)... “).