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Financial Market Regulation after the Crisis: The Case for Hedge Fund Regulation via Basel III

Wulf A. Kaal, Ph.D., Mississippi College School of Law

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Hedge funds have been blamed for their part in the financial market crisis of 2008-09. The exact role and the scope of hedge funds’ involvement in the financial crisis is unclear. Regulators increasingly scrutinize the hedge fund industry worldwide. Regulation of hedge funds could help minimize moral hazard, social externalities and systemic risk generated by the hedge fund industry.

The paper evaluates recent regulatory changes including the US Dodd-Frank Act, the European Union Directive on Alternative Investment Fund Managers and other pertinent regulation. Using the methodological tool of New Institutional Economics, the paper provides an impact analysis of regulatory changes, de lege lata and de lege ferenda, with a special emphasis on, and historical analysis of, hedge fund registration rules and asymmetric regulation in Dodd-Frank and the AIFM Directive. Other pertinent issues discussed include moral hazard and its adverse effects on Counterparty Credit Risk Management in the aftermath of the 2009 bank bailout, the free-rider problem of CCRM and its potential to create externalities and the issue of systemic risk.

After analyzing the shortcomings of Basel II, the paper suggests that Basel III could introduce a charge for banks’ lending exposure to hedge funds, i.e. Basel III capital requirements for banks could introduce a charge for a bank’s assets based on its systemic risk contribution. Measuring the systemic risk contribution could include a measure for hedge fund lending exposure.
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I. Introduction

The collapse in the market for exotic financial instruments, the liquidity crisis in major financial institutions and the government bailouts in 2008-09 have undermined confidence in the functioning of financial markets and illustrates shortcomings in corporate governance and banking regulation. Hedge funds have been blamed for their part in the crisis and have become a scapegoat for the problems affecting many aspects of financial markets. Regulators worldwide increasingly scrutinize hedge funds. Regulation of hedge funds could help minimize social externalities generated by the hedge fund industry. Given the global scale of hedge fund activities and the dynamic nature of their trading strategies, however, it is unclear if and to what extent hedge funds generate social externalities. The role of hedge funds in the financial crisis is also unclear. After the collapse of Long Term Capital Management in 1999, most dealer-banks required full collateralization of hedge fund transactions. Accordingly, hedge funds were less levered than banks. The collapse of large hedge funds like Amaranth in 2007 and large redemptions by investors during and after the

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3 James Kanter, Tighter Rules for Foreign Hedge Funds Advance in Europe, N.Y. TIMES, May 17, 2010 ("Regulators and lawmakers worldwide are tightening their scrutiny of hedge funds and private equity firms on the grounds that they have been partly to blame for the worst financial crisis in a generation.").

4 See German / EU debate after the TCI’s attempt to take over Deutsche Börse, Kate Burgess, Suspect Strategies: Activism in the Hedge Fund Sector, FIN. TIMES, Jun. 22, 2010. See also “Locusts” debate, Markus Lahrkamp, Germany, Day of the Locusts?, HEDGE FUND J., March 2007 available at http://www.thehedgefundjournal.com/magazine/200703/commentary/germany-day-of-the-locusts.php. See also debate on hedge fund involvement in dark-pools, high-frequency, and algorithmic trading, A Few Minutes of Mayhem; America’s Stock Market Plunge, THE ECONOMIST, May 15, 2010 ("Another factor [in the debate] was the sudden retreat by the ‘high frequency’ firms whose algorithmic trading has come to dominate markets.").


6 Too Big to Swallow, THE ECONOMIST, May 16, 2009 (noting that after the failure of Long-Term Capital Management hedge fund there was flight to traditional banking).

7 Professionally Gloomy, THE ECONOMIST, May 17, 2008 ("After the collapse of Long-Term Capital Management in 1998, banks started scanning the counterparty horizon more carefully for risks from hedge funds. From now on they will look much more closely at each other.").

8 Paint it Black; Buttonwood, THE ECONOMIST, Oct. 20, 2007 (". . . . traders repeatedly get caught out by "unprecedented" market movements. The collapse of two hedge funds, Long-Term Capital Management in 1998 and Amaranth Advisors in 2006, were cases in point."); All at Sea: The Galleon Affair, THE ECONOMIST, Oct. 24, 2009 (noting that the case against Raj Rajaratnam, co-founder of Galleon, for insider trading could decrease the credibility of hedge funds).
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crisis\(^{10}\) did not cause systemic problems. And, hedge funds have fewer assets and less leverage than banks, making it less likely that hedge funds could cause the next crisis. Without the threat of systemic risk, it is unclear what the role of direct hedge fund regulation could be.

Nevertheless, recent regulatory initiatives in Europe and the United States attempt to address many perceived shortcomings of regulation and seek to harmonize international banking regulation more strenuously than before the crisis.\(^{11}\) Hedge funds are directly affected by registration requirements,\(^{12}\) passport regimes,\(^{13}\) caps on leverage\(^{14}\) and general disclosure requirements.\(^{15}\) Measures primarily intended to ensure the well functioning of financial markets, however, impact hedge funds as primary market participants. One measure intended to ensure the integrity of financial markets in Germany and the EU was the prohibition of naked shorts by the German Finance Ministry in coordination with the German Securities and Markets Authority (Bundesananstalt für Finanzdienstleistungsaufsicht – “BaFin”).\(^{16}\) The ban has impacted hedge funds more than many other market participants.\(^{17}\) The prohibition is, however, limited to trading in naked shorts of shares of a select group of banks, insurance companies and financial market intermediaries.\(^{18}\) The German Finance Ministry recently proposed a new Act to extend the time limit for the prohibition of naked short sales, thus, making it permanent, and the Ministry also proposed to extend the scope of

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\(^{10}\) Gregory Zuckerman & Ann Davis, *Hedge Funds' Heavy Metal – Red Kite Bet on Copper, Then Good Times End*, WALL ST. J., Feb. 8, 2007 at C2 (“If rival traders believe a firm will have to sell positions to meet investor redemptions, they can sell those investments ahead of time, increasing the pressure. Some traders made those moves last fall when it emerged that hedge fund Amaranth Advisors LLC was having problems.”).

\(^{11}\) Dodd-Frank & AIFM, see supra note 5.

\(^{12}\) See supra note 5 at § 410 (federal registration of investment advisers); Private Fund Investment Advisers Registration Act of 2009 (PFIARA), H.R. 3818, 111th Cong. (2009) at § 6(1) (registration and recording of venture capital funds).


\(^{14}\) Id. at sec. 16 (“It is considered necessary to . . . . to impose limits on the level of leverage that AIFM could employ . . . .”).


\(^{17}\) Dynamic trading strategies used by hedge funds often depend on the availability of naked shorts [___]. See also Warren Buffet’s suggestion to grandfather existing naked short positions in the US [WSJ___].

\(^{18}\) Id. (the entities included: “Aareal Bank AG, Allianz SE, AMB Generali Holding AG, Commerzbank AG, Deutsche Bank AG, Deutsche Börse AG, Deutsche Postbank AG, Hannover Rückversicherung AG, Hypo Real Estate Holding SG, MLP AG, Münchener Rückversicherungs-Gesellschaft AG.”).
the prohibition.\textsuperscript{19} These initiatives by Germany were instituted without consulting its European neighbors.\textsuperscript{20} In response to this action, the EU Commission has proposed legislation that would curtail the ability of single EU member states to unilaterally prohibit certain instruments.\textsuperscript{21} Before regulators in single EU member states can unilaterally put such measures in place, they will be required, under this proposed legislation, to consult the European Securities and Markets Authority (ESMA) and other EU ‘member states.’\textsuperscript{22} The proposed EU legislation would also give powers to EU member state authorities to restrict or ban credit default swaps subject to coordination by ESMA.\textsuperscript{23}

In a move likely to affect both financial institutions and financial markets, the German government also proposed publishing stress tests for banks in a unified and consolidated approach with other EU member countries.\textsuperscript{24} Stress tests for banks are intended to assess how well banks are prepared to deal with extreme market scenarios.\textsuperscript{25} While critics allege the publication of stress tests could lead to panic in EU capital markets, the Spanish Federal Reserve has already announced its intent to publish stress tests for banks.\textsuperscript{26} The former grand coalition government of Social Democrats and Christian Democrats in Germany had opposed the publication of such stress tests.\textsuperscript{27} A stress test study was published last year in the United States but may have been influenced by banking institutions. European banking regulators

\textsuperscript{20} Reinhard Höninghaus, Kein Zockverbot mehr im Alleingang – BaFin soll Maßnahmen gegen Leerverkäufe besser abstimmen – EU Gesetz im Herbst, FIN. TIMES DEUTSCHLAND, June 15, 2010, 16.
\textsuperscript{21} Id.
\textsuperscript{22} Id.
\textsuperscript{23} EU Press Release, Public consultation on Short Selling and Credit Default Swaps, MEMO/10/255, 14 June 2010 (the intent of the new rules is described as: “The intention is that the measures envisaged on short selling should: a. ensure Member States have the power to act to reduce systemic risks and risks to financial stability and market integrity arising from short selling and Credit Default Swaps, b. facilitate co-ordination between Member States and the European Securities Markets Authority (ESMA) in emergency situations; c. increase transparency on the short positions held by investors; and d. reduce settlement risks linked with uncovered or naked short selling. The options envisaged can be grouped into three types: a. Powers for competent authorities to temporarily restrict or ban short selling and Credit Default Swaps in emergency situations (subject to coordination by ESMA); b. Measures to increase transparency to regulators and the market about short selling positions, including those obtained through the use of derivatives; and c. Measures to reduce settlement risks of uncovered or naked short selling. The options under consideration also foresee powers for competent authorities to enforce the rules and the possibility of some limited exemptions (for market makers and shares whose principal market is outside the EU.”) (available at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/255&format=HTML&aged=0&language=EN&guiLanguage=en).
\textsuperscript{25} Id.
\textsuperscript{26} Id.
\textsuperscript{27} Id.
also perform stress tests on a regular basis.\textsuperscript{28} The German banking industry opposed the publication of stress tests but most EU member states seem to favor such publication on the premise that “stress tests will show that Europe has efficient mechanisms to solve problems in the financial sector.”\textsuperscript{29} Lenders to hedge funds who fail stress tests could impact the business of hedge funds.

Recently, in an effort to reduce risk taking, the EU Parliament approved rules to curtail bankers’ bonuses and reinforce banks’ capital requirements.\textsuperscript{30} Under these rules, bonuses would be linked to salaries and the cash portion of bonuses would be capped at 30\% of the total amount, or 20\% for particularly high bonuses.\textsuperscript{31} Bankers are also at risk of losing the remainder of the bonus if the bank’s performance erodes over three years following the bonus payment. Under the rules, banks that do not curtail the salaries of staff “whose professional activities have a material impact on the risk profile of the bank or investment firm,”\textsuperscript{32} will have to set aside more capital to make up for the risk.\textsuperscript{33} Notably, there has not been a similar development in the United States.

In the United States, Senator Charles Schumer’s (D-NY) proposed the Shareholder Bill of Rights Act of 2009, which set out corporate governance standards,\textsuperscript{34} required shareholder input in board elections\textsuperscript{35} and, most importantly, a shareholder vote on executive compensation disclosures.\textsuperscript{36} Schumer’s proposal also required that each public company board of directors establish a risk committee.\textsuperscript{37} Such a risk committee would be comprised entirely of independent directors and would be responsible for the establishment and evaluation of risk management practices. Other legislative proposals included the “TARP Reform and Accountability Act of 2009”\textsuperscript{38} which was introduced by Barney Frank (D-MA),

\begin{footnotes}
\item[\textsuperscript{28}] Id.
\item[\textsuperscript{29}] Ina Lockhart, Meike Schreiber und Christine Mai, Bund kommt Banken bei Stresstests entgegen, FIN. TIMES DEUTSCHLAND, June 17, 2010 (http://www.ftd.de/unternehmen/finanzdienstleister/ftd-bankentag-bund-kommt-banken-bei-stresstests-entgegen/50129578.html ).
\item[\textsuperscript{31}] Id.
\item[\textsuperscript{33}] Id.
\item[\textsuperscript{34}] Sec. 5 of the Shareholder Bill of Rights Act of 2009.
\item[\textsuperscript{35}] Sec. 4 of the Shareholder Bill of Rights Act of 2009.
\item[\textsuperscript{36}] Sec. 3 of the Shareholder Bill of Rights Act of 2009.
\item[\textsuperscript{37}] Sec. 5(5)(A) of the Shareholder Bill of Rights Act of 2009.
\item[\textsuperscript{38}] H.R. 384.
\end{footnotes}
the Chairman of the House Financial Services Committee, to harmonize and broaden executive compensation standards applicable to companies accepting government financial assistance. A more expansive version of the proposed law, known as the “Shareholder Empowerment Act of 2009,” was introduced by Representative Gary Peters (D-MI), on June 12, 2009. 

As part of the most radical overhaul of financial regulation in the United States since the Great Depression, the Dodd-Frank Act attempts to address perceived shortcomings of regulation by dramatically increasing the degree of government supervision. Dodd-Frank creates a new “resolution”, or orderly liquidation, authority in which the Federal Deposit Insurance Corporation (FDIC) is given broad discretion to intervene between a financial institution and its creditors. Critics of the Act say that this institutionalizes the bailout process. Whereas European countries, including Germany, have been accustomed to a high degree of government intervention in the banking sector, including government ownership of some banks, the Dodd-Frank Act represents an acknowledgment in the United States that some financial institutions are too big to fail and that government oversight and windup authority cannot be limited to commercial banks and other deposit taking institutions. Large investment banks, insurance companies, investment funds and other firms have been rescued by the U.S. government, and the Act seeks to make that process more predictable and orderly. The Act also creates a new federal entity the Consumer Financial Protection Bureau. The Bureau regulates consumer lending, which was the origination point for much of the financial risk taking that precipitated the 2008 crisis in the United States (the Act, however exempts loans originated by auto dealer from the Bureau’s oversight). Consumer lending has been substantially less aggressive in Germany, making this aspect of financial reform less

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39 1766 PLI / Corp. 85.
40 Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173. The Dodd-Frank Act that was eventually passed by Congress and [signed by the President] includes many of these provisions in thousands of pages of text (the rules promulgated under the Act will surely be thousands of more pages). The Act is enormous and far-reaching and the author points out here only a few of its most notable provisions. The Act creates a new “super regulator”, the Financial Stability Oversight Council to oversee the financial industry and address future financial crises. The Council has the power to identify firms that threaten stability and subject them to stricter oversight by the Federal Reserve. The Federal Reserve and the Council can break up firms that have not responded to stricter oversight measures and continue to pose a threat.
41 See John B. Taylor, The Dodd-Frank Financial Fiasco: The Bill all but Guarantees Bailouts as Far as the Eye Can See While Failing to Address Real Problem Like Fan and Fred and our Outdated Bankruptcy Code, Wall Street Journal, July 1, 2010 (opinion article suggesting that the Act should have included reform of “Fannie Mae and Freddie Mac, the government sponsored enterprises that encouraged the origination of risky mortgages” as well as “reform of the bankruptcy code to allow large complex financial firms to go through a predictable, rules-based Chapter 11 process without financial disruption and without bailouts”)
42 Dodd-Frank, supra note ___, § 1011 (“Establishment of the Bureau of Consumer Financial Protection. . . shall regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws.”).
urgent there (most of the securitized mortgages and other consumer loans German banks lost money on were originated in the United States). Reckless borrowing by poorer EU member states has been the origination point in Europe for bad loans, and reform measures there are likely to focus on that aspect of the problem rather than on consumers.

Dodd-Frank bestows on federal agencies broad regulatory authority over the trading of derivative securities and other financial instruments that also were blamed for the financial crisis. Regulation of the over the counter derivatives market means that many of these instruments, including credit default swaps, will be traded through an organized clearing system that is intended to provide more transparency and liquidity. The Act requires bank holding companies to spin off riskier derivatives trading into separate affiliates. Earlier drafts of the legislation had even more sharply curtailed the ability of financial institutions to trade in derivative securities for their own account, but these provisions were scaled back after intensive lobbying by the banking industry. Hedge funds frequently employ these instruments in their trading strategies and the legislation, thus, impacts their business directly.

The Act also continues the federal government’s deep incursion into corporate governance that began in earnest with the Sarbanes-Oxley Act of 2002. Whereas Sarbanes-Oxley regulated the composition and responsibilities of audit committees, the Dodd-Frank Act requires a broad range of financial services firms also to have a risk committee. The Act requires all publicly traded nonbank financial companies supervised by the Board of Governors of the Federal Reserve System to have a risk committee. Also, all publicly traded bank holding companies with assets of more than $10 billion must have a risk committee. The risk committee is responsible for overseeing the firm’s risk management practices, and the committee must have at least one risk management expert having experience with similar firms. The Board of Governors of the Federal Reserve is empowered to decide how many independent directors must serve on the committee. The emphasis in U.S. corporate law, Sarbanes-Oxley and now Dodd-Frank on independent directors is not shared in many other countries including Germany. Skeptics worry that perhaps because of their lack of ties to the company, independent directors do not have access to the information they need to stop risks.

43 Dodd-Frank, supra note ___, §§ 610, 619 (“Lending limits applicable to credit exposure on derivative transactions, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions . . . . Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds.”).

44 QUOTE sec

45 Dodd-Frank, supra note ___, § 164 (“The Board of Governors shall issue regulations requiring each bank holding company that is a publicly traded company and that has total consolidated assets of not less than $10,000,000,000 to establish a risk committee”).
such as those that led to the 2008 financial crisis.\textsuperscript{46} The introduction of the risk committee would be significant change because most boards now delegate risk oversight to the audit committee (only about three percent of the S&P 500 companies have so far established a standing risk committee). This new committee could increase the size of the board and perhaps result in hiring of new staff for the risk management committee. This requirement also could result in more litigation if the composition of the risk committee or its alleged failure to do its job appropriately, becomes a basis for additional shareholder suits.

The Dodd-Frank Act is notable not only for its sheer length and the enormous power it bestows on the federal government, but also for what it did not do. It did not break up the largest banks in the United States, which would have been one approach to the “too big to fail” problem. It did little to help smaller and regional banks compete with the big banks. Because complying with regulation is burdensome and expensive, the Act may have raised the barrier for entry into the financial services industry. The Act did not restore the separation of commercial banking from investment banking that characterized the United States before repeal of Glass-Steagall in 1999 and that many observers, including former Federal Reserve Chairman Paul Volker, had recommended be restored. In some ways, Dodd-Frank may make the United States more similar to Germany and some other European countries that are dominated by a few gigantic banks which are allowed to do both commercial and investment banking but are told a lot about what they can and cannot do by the government.

As will be further discussed below, hedge funds and private equity funds are an important area of concern in Dodd-Frank. The Act restricts a banking entity from having an ownership interest in or be a sponsor of a private equity or hedge fund if such investments amount to more than 3\% of the bank’s Tier 1 capital or the bank’s interest is more than 3\% of the total ownership of the fund.\textsuperscript{47} Private equity and hedge funds with assets under management of $150 million or more will have to register with the SEC, although venture capital funds will be exempt from full registration.\textsuperscript{48} In the EU, the EU Commission has

\textsuperscript{46} QUOTE
\textsuperscript{47} Dodd-Frank, supra note ___, § 619 (“Notwithstanding any other provision of law, investments by a banking entity in a hedge fund or private equity fund shall . . . . be immaterial to the banking entity, as defined, by rule, pursuant to subsection (b)(2), but in no case may the aggregate of all of the interests of the banking entity in all such funds exceed 3 percent of the Tier 1 capital of the banking entity.”).
\textsuperscript{48} Dodd-Frank, supra note ___, §§ 408, 407 (“The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and has assets under
introduced the Alternative Investment Fund Manager Directive (AIFM Directive).\textsuperscript{49} The AIFM Directive introduces the possibility of harmonized requirements for entities engaged in the management and administration of alternative investment funds, i.e. European-wide regulation of hedge funds.\textsuperscript{50} It is, however, not just the hedge fund and private equity industries that the directive seeks to regulate, it is an attempt to gain regulatory oversight on a large share of “shadow banking system” that is presently unsupervised.\textsuperscript{51}

Despite their sheer length, the Dodd-Frank Act and the AIFM Directive appear to be mostly a patchwork of politically motivated rules without an attempt to understand the combined effects of deficits in different fields of regulation. The interdependence of corporate governance deficits and financial regulation has so far not been studied systematically.  Dodd Frank and the AIFM Directive approach the regulation of banks and hedge funds separately which results in asymmetric regulation of financial institutions (hedge fund regulation vs. bank regulation).\textsuperscript{52}

This paper offers an alternative approach to this form of regulation that would minimize asymmetric hedge fund regulation by introducing hedge fund regulation via Basel III. It shows that dissonant financial market regulation in the European Union and the United States is, for a variety of reasons discussed below, suboptimal and suggests that Basel III capital requirements for banks could include a charge for the particular bank’s lending exposure to hedge funds. Alternatively, Basel III capital requirements for banks could introduce a charge for a bank’s assets based on its systemic risk contribution. The paper does not suggest how such a charge should be calculated.


\textsuperscript{50} Id.


II. Methodology

The analysis of combined effects of deficits in different fields of regulation that impact the hedge fund industry and international financial markets can be improved with a well-defined set of methodological assumptions. Legal research in de lege ferenda problems should first identify problems of de lege lata regulation and should compare solutions for de lege ferenda proposals. In order to identify existing problems it is necessary to engage in an impact and comparative impact analysis of present regulation. Testable hypotheses should thereafter be formulated as a falsification test. The same holds true for the analysis of problem solutions. The methodological instruments of New Institutional Economics (NIE) supports impact analysis and comparative impact analysis of present regulatory structures as well as de lege ferenda solutions.\footnote{Ronald Coase, The New Institutional Economics, 140 Journal for Institutional and Theoretical Economics 229 – 231 (1984); Eiriki Furubotn and Rudolf Richter, Institutions and Economic Theory - The Contribution of the New Institutional Economics, 2nd ed. Ann Arbor (2005); Christian Kirchner, Public Choice and New Institutional Economics. A Comparative Analysis in Search of Co-operation Potentials, in: Public Economics and Public Choice, Contributions in Honor of Charles B. Blankart, ed. by Pio Baake and Raimald Borck, 19 – 37 (2007); Douglas North, Institutions, Institutional Change and Economic Performance, Cambridge, Mass. (1990); Rudolf Richter and Eiriki Furubotn, Neue Institutionenökonomik, 3. ed., (2003); Stefan Voigt, Institutionenökonomik, 2nd ed., Paderborn; Oliver Williamson, The Economic Institutions of Capitalism, New York (1985); Oliver Williamson, Transaction-Cost Economics: The Governance of Contractual Relations, 22 Journal of Law and Economics 233-61 (1979).} NIE is a – relatively – young offspring of economic theory focusing on the functioning and development of institutions (positive analysis) and proposals for improving existing institutions (normative analysis). Institutions are general rules or sets of general rules together with their enforcement mechanisms.\footnote{Furubotn/Richter, supra note __, at 7; Richter/Furubotn, supra note __, at 7; Stefan Voigt, Institutionenökonomik, 2nd ed., Paderborn (2005).} Legal rules as well as standards are regarded as institutions if they are enforced - it does not matter whether rules and standards are created by a legislator or by a private standard setter as long as they are enforced. Institutional economics emphasizes the importance of social norms, i.e. informal institutions as opposed to formal institutions. This approach is especially helpful in the analysis of corporate governance issues where social norms and formal institutions are often involved simultaneously. Limiting the analysis to a subset of formal institutions, e.g. legal institutions, would ignore important problems.

Institutional economics distinguishes between the game and the rules of the game. For instance, corporate governance would here be the game itself or as a set of rules for the game. Financial reporting would be distinguished from rules and standards on financial reporting. Traditional economics deals with the game itself. Institutional economics focuses on the impact of the rules of the game, i.e. institutions. With decision makers’ given preferences
institutional changes will lead to reactions of the addressees of such institutions. In order to predict such reactions institutional economics works with a set of assumptions. Some of the core assumptions are shared with neo-classical economics: scarcity of resources, methodological individualism, self-interested rational behavior. Other assumptions in institutional economics are modified: bounded rationality is replacing the assumption of full rationality and is being complemented by the assumption of opportunistic behavior. Behavioral economics has criticized the rationality assumption and offered new insights into how actors behave in different situations and settings. Institutional economics stresses that information is systematically incomplete.

Many of the modified assumptions have found their way into modern economic analysis of financial markets, and into modern theory of financial reporting. Decision makers in financial markets are confronted with asymmetric information, opportunistic behavior and a number of rationality anomalies. The analysis of combined effects of deficits in different fields of regulation impacting the hedge fund industry and predictions on expected reactions of market participants to changes in the institutional framework of hedge funds can be improved by taking into account the above-mentioned assumptions.

III. Hedge Fund Regulation in the Aftermath of the Financial Crisis

Regulators can use regulatory authority over entities that interact with hedge funds to regulate hedge funds indirectly or use a number of regulatory tools including registration, capital, leverage, margin and reporting requirements to regulate hedge funds directly.

[short intro for AIFM and Dodd-Frank and PFIARA]

1. The AIFM Directive

The EU Commission has introduced the Alternative Investment Fund Managers Directive (AIFM) and the Dodd-Frank Act. These directives provide a framework for regulating hedge funds and other alternative investment funds in the aftermath of the financial crisis.

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55 Voigt, supra note __, at 22 – 23.
56 Id. at 88 – 89; Furubotn/Richter, supra note __, at 5.
58 Voigt, supra note __, at 237 – 238.
60 Jens Wüstemann, __
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The AIFM Directive introduces the possibility of harmonized requirements for entities engaged in the management and administration of alternative investment funds, i.e. European-wide regulation of hedge funds. It is, however, not just the hedge fund and private equity industries that the Directive seeks to regulate, it is an attempt to gain regulatory oversight on a large share of “shadow banking system” that is presently unsupervised.

Due to substantial redrafting of proposed European Union rules for alternative investment funds, there are currently numerous different legislative texts of the AIFM’s directive circulating in the European Parliament and among member states. All of the competing AIFM Directive drafts require hedge funds to register with government agencies and obtain government authorization, they all involve capital adequacy requirements for hedge funds and require disclosures to regulators and their investors. In some jurisdictions, like the UK, some of the AIFM Directive requirements are already required by financial regulations.

a) Common Draft Objectives

The common objectives of the various versions of the Directive in circulation include:

(i) to ensure that all unregulated funds are subject to regulatory oversight;

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62 Id. at 1.1 (“. . . . the European Commission has committed to bring forward a proposal for a comprehensive legislative instrument establishing regulatory and supervisory standards for hedge funds, private equity and other systemically important market players.”)


65 Linda E. Rappaport, Global Financial Regulatory Reform Proposals, 908 PRAC. L. INST. 83, 85 (June 2010) (noting that though there are separate, revised drafts, the main proposals include: “. . . . Compulsory authorisation of fund managers located in the EU in order to manage funds; . . . ongoing reporting obligations to regulatory authorities; . . . . [and] additional disclosure obligations for managers engaging in high levels of leverage and limits on leverage (mainly affecting hedge funds).”)

66 Some states, like for instance the UK, regulate the managers of alternative funds aimed at institutional investors. Other states simply ignore them.
(ii) hedge funds are required to apply for authorization by the respective EU members state and then provide certain levels of disclosure to regulators and investors;\(^{67}\)

(iii) the various drafts of the Directive demand minimum capital requirements for hedge funds, a limit on leverage that hedge funds can have (depending on fund type) and standardization of hedge fund manager conduct, some Directive drafts also curtail hedge fund remuneration policies;\(^{68}\)

(iv) the valuation and depository requirements of the AIFM Directive would make it mandatory for assets to be independently valued and maintained by a depository bank. A depository bank could be held liable in case of financial problems;\(^{69}\)

(v) the extent of rules pertaining to funds and managers from non-EU countries is highly contentious. Some drafts would grant access to EU-based funds only but would allow individual member states the right to determine whether sophisticated investors can invest in funds managed outside the EU. Under this draft proposal, non-EU funds would have to apply to each member state country to do business.\(^{70}\) The parliamentary draft, on the other hand,

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Financial services: Commission proposes EU framework for managers of alternative investment funds, IP/09/669, (Apr. 29, 2009) (“To operate in the European Union, all AIFM will be required to obtain authorisation from the competent authority of their home Member State.”); Id. at 3.5.4 (Disclosure to Regulators) (“the AIFM will also be required to report to the competent authority on a regular basis on the principal markets and instruments in which it trades, its principal exposures, performance data and concentrations of risk.”).

\(^{68}\) Id. at 14 (“It is necessary to provide for the application of minimum capital requirements to ensure the continuity and the regularity of the management services provided by the AIFM.”); Id. at art. 22, art. 23 (these articles provide requirements related to assessment and disclosure of AIFs employing high levels of disclosure); Id. at 3.4 (“The proposed Directive contains the principles necessary to ensure that AIFM are subject to consistently high standards of transparency and regulatory oversight in the European Union . . . .”); Draft Report on the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending directives, COM (2009) 2014 at 12(c) (Nov. 23, 2009), available at http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&mode=XML&language=EN&reference=PE 430.709 (“In order to promote supervisory convergences in the assessment of remuneration policies and practices, the Committee of European Securities Regulators should ensure the existence of guidelines on sound remuneration policies in the AIFM sector.”).

\(^{69}\) There is significant disparity in member states and discourse over the depository rule as private equity funds usually sought and easily received exemptions. Investors in France, for instance, were harder hit by the Madoff scandal. Therefore, France is pushing hard for more investors’ protection. On the other hand, UK funds and investors view the proposal as too expensive. See Martin Arnold, Brooke Masters, & Niki Tait, Alternative Visions, FIN. TIMES, May 14, 2010, at 7 (“. . . . member states remain deeply split over the depository rule. France, where investors were badly stung by the Bernard Madoff fraud, is pushing hard for more investor protection, while UK funds and investors view the proposed rules as prohibitively expensive.”).

would focus on whether the home country of a fund is providing basic rules on transparency, taxation and money laundering.\textsuperscript{71} If these requirements should be fulfilled, the draft would allow non-EU funds to subscribe to EU principles via a "passport regime" and sell their funds in the EU.\textsuperscript{72} The parliamentary draft would probably be favored by the hedge fund industry.\textsuperscript{73} However, even that draft would burden the industry as funds would incur costs in satisfying the EU standards for their home countries regarding money-laundering, tax and transparency as well as the regulators from their home jurisdiction who would have to ensure that these non-EU-funds comply with EU rules.\textsuperscript{74}

It seems unlikely that all of these proposals will survive the reconciliation process.

\textsuperscript{71} Id. at ¶ 5 ("Mr Gauzes' revisions would also allow funds based outside the EU to gain passport rights if the jurisdiction in which they were housed met four conditions: concerning fiscal standards, rules on information exchange between supervisors, reciprocity and anti-money laundering rules."); JENNIFER WOOD, DECHERT, LLP, THE POTENTIAL IMPACT OF THE PROPOSED ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE ON INVESTMENT MANAGERS IN THE E.U. AND U.S., at 2 (Sep. 2009), http://www.dechert.com/library/The\%20Potential\%20Impact\%20of\%20the\%20Proposed\%20Alternative\%20In\nvestment\%20Fund\%20Managers\%20Directive\%20on\%20Investment\%20Managers\%20in\%20EU\%20and\%20US.pdf (listing the strict pre-conditions Member States must meet ". . . . to authorize a non-EU AIFM to market units under the Directive to professional investors in that Member State. . . .").

\textsuperscript{72} Harold S. Bloomenthal & Samuel Wolff, Proposed Directive on Alternative Investment Fund Managers, 10 Int'l Cap. Markets & Sec. Reg. § 1:160, (2010) ("[The Directive] will provide an "EU passport" for the marketing of those third country funds which comply with stringent requirements on regulation, supervision and cooperation, including on tax matters."); Martin Sjoberg, The Cutting Hedge, FIN. TIMES, June 17, 2010 (". . . . the new directive provides alternative investment funds with a passport allowing them to market their funds throughout all 27 EU member states once they are authorized in their home member state."); Draft Report on the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending directives, COM (2009) 2014 (Nov. 23, 2009), available at http://www.europarl.europa.eu/sides/getDoc.do?type=COMPAREL&mode=XML&language=EN&reference=PE 430.709 at ¶ 19 ("In order to ensure investor protection, the right for an AIFM to market AIF to professional investors in the Community on the basis of a single authorisation (the European passport for AIFM) should only be granted where the AIF is established in a Member State.").

\textsuperscript{73} Jim Baird, United Kingdom: Continued Controversy over the EU Alternative Investment Fund Managers Directive, MONDAM BUS. BRIEFING, July 15, 2010, at ¶ 8 (noting however, "At first glance, the Parliamentary Draft looks more positive in that it expressly extends the marketing "passport" to non-EU AIFM and AIF. However, the conditions that would apply are so extensive that it is doubtful whether these could be met, even by many developed jurisdictions.").

\textsuperscript{74} Id. at ¶ 11 (noting also, "A further difficulty under the Parliamentary Draft would be that the "passport" for non-EU AIFM and AIF would not provide for a single point of entry into the EU, as it does for EU AIFM. Instead, cooperation agreements would be required to be entered into between the relevant third country and each relevant Member State before a meaningful marketing network would be available.").
b) Impact Assessment of AIFM Directive Requirements

- The directive (and even a compromise amendment on third country access before the parliamentary committee) could effectively bar European institutions and individuals from investing with managers or funds domiciled outside the EU.\(^\text{75}\)
  - This could include hedge funds domiciled in traditional alternative fund industry centers such as the Cayman Islands, British Virgin Islands, Jersey, Guernsey, the United States, Canada, Switzerland, Hong Kong, Singapore, Japan, Australia and South Africa, will all be affected by this.\(^\text{76}\) This is not just an internal EU matter.
  - If investors are no longer able to select their investments form the best available products globally, there is also a risk that the directive could reduce investor choice, increase costs and lower returns.\(^\text{77}\)
    - Reduction of choice for EU investors could drive down returns for pension funds.
    - The restrictions and compliance costs that the Directive imposes on international investors with EU funds or managers could precipitate a reduction in returns and higher costs.
  - Implicitly, the directive could undermine Europe’s competitiveness.\(^\text{78}\)
  - The obstacles for non-EU funds and managers to access the EU market seem protectionist in effect, if not in intent.\(^\text{79}\)

\(^{75}\) *Commission Staff Working Document Accompanying the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives: Impact Assessment*, at 54, COM (2009) 207 (Apr. 30, 2009) (“AIFM domiciled in a third country will not be covered by the measure and will therefore not be able to market their AIF or to provide AIFM services in the EU under this Directive unless established/authorised in the EU in accordance with the proposed Directive.”).

\(^{76}\) Martin Sjoberg, *The Cutting Hedge*, FIN. TIMES, June 17, 2010 (“... the so-called third country issue. ... has generated much publicity and has caused the most discussion with many commentators predicting an exodus of hedge funds and investment talent from London to offshore centres such as the Cayman Islands and Switzerland.”).

\(^{77}\) KPMG Financial Services, *Feeling the Heat? Alternative Investment Fund Managers Directive – Asset Managers Global Survey*, at 11 (Feb. 2010) (noting that while 44% of investment managers surveyed feel that it is not yet proven that the AIFMD will impact returns because of a reduction in investment opportunities, 43% do believe that the AIFMD will). *Id.* at 12 (also noting that 54% of managers surveyed believe the AIFMD will increase costs, thus lowering returns, and only 10% believe there will be a minimal impact).

\(^{78}\) *Id.* (“a not insignificant 26% believe that non-EU jurisdictions which might offer comparatively fewer investment restrictions could be more attractive for this talent.”); European Private Equity and Venture Capital Association, *The Effect of the Alternative Investment Fund Managers Directive on investing in venture capital*, at 6 (Mar. 15, 2010) (reporting that when asked “If you could not invest in venture beyond Europe to what degree would you change your investment in the European venture capital asset class?” 33.3% of managers responded they would “reduce by over 1/3,” and 33.3% responded that they would “leave the venture capital asset class”).
o The directive’s closing of Europe’s borders may signal a change in Europe’s place as a global centre for financial services and as a destination for international investment.\(^\text{80}\)

o Discrimination against non-EU jurisdictions could provoke retaliatory action in non-EU jurisdictions.

o A lack of intra European cooperation or even retaliation could damage the European financial services industry and the whole European economy.\(^\text{81}\)

o The directive could impact small firms across Europe and could make it more difficult for new businesses to be created.\(^\text{82}\)

o Development banks investing in emerging markets could be affected.

o Funds in real estate and infrastructure investment in Europe could also be impacted because funds in these sectors would also be covered by the directive.

o Negative social consequences across Europe if investor’s investments were adversely influenced by a ban of investments in non-EU funds.

o European citizens may have to pay higher pension contributions and insurance premiums.\(^\text{83}\)

- Equivalency status for the jurisdictions impacted by the “no non-EU funds” provision

- The channel islands, Jersey and Guernsey, may be able to meet the demands of the Directive through obtaining equivalence status for the jurisdictions

\(^{79}\) JENNIFER WOOD, DECHERT, LLP, THE POTENTIAL IMPACT OF THE PROPOSED ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE ON INVESTMENT MANAGERS IN THE E.U. AND U.S., at 5 (Sep. 2009), http://www.dechert.com/library/The%20Potential%20Impact%20of%20the%20Proposed%20Alternative%20Investment%20Fund%20Managers%20Directive%20on%20Investment%20Managers%20in%20EU%20and%20US.pdf (". . . . an authorized AIFM is required to ensure that a custodian (i.e., depositary) is appointed to fulfill various safekeeping responsibilities in relation to the AIFs the AIFM manages. The AIFM is also required to ensure that the custodian is a credit institution having its registered office in the EU. . . . This would be unworkable for an international investment fund investing in non-EU markets.").

\(^{80}\) Id. at 6 (noting that in requiring the depositary to have a registered office in the EU and “that the depositary’s liability towards investors is not affected by reason of the delegation to a third country depositary of all or part of its tasks is unlikely to encourage depositaries to agree to provide services to AIFs that invest these markets.”).

\(^{81}\) Commission Staff Working Document Accompanying the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives: Impact Assessment, at 57, 85 COM (2009) 207 (Apr. 30, 2009) ("Gaps and inconsistencies in approaches to the registration and authorisation of AIFM in the EU may impede the effective oversight of the sector and varying standards may provoke regulatory arbitrage between jurisdictions. . . . A majority of respondents are not convinced that a "purely" European response is likely to be successful. They feel that it may even have adverse effects on the European asset management industry, exposing it to regulatory arbitrage.").

\(^{82}\) Analysis: AIFM Directive Scares off EU Hedge Funds, FIN. TIMES, June 1, 2010 at 1 (asserting that the cost of the new regulations would be prohibitive for smaller firms).

\(^{83}\) The AIFM Directive: Another European Mess: Plans to Regulate Private Equity and Hedge Funds Takes Two Steps Forward, THE ECONOMIST, May 18, 2010 (". . . . legislators want to increase custodians’ liability for the assets they look after. Pension funds and other investors fear they will be charged a higher premium by custodians as a result").
impacted if the final version of directive does set out standards of equivalency under which funds from offshore jurisdictions could access the EU market.  

- However, even with an equivalency provision in the directive, the costs of operation for service providers in the channel islands would increase and in some cases make the operation unavailable. Thus, there is a risk that they could be penalized by the cost of meeting those equivalency standards.

- The draft directive’s provisions regarding the role of depositories, i.e. custodians:
  - The depository will be liable to the fund’s investors and the hedge fund manager for losses suffered by them as a result of the depository’s failure to perform its obligations under the AIFM directive.
  - Depositories may need to assess the risks and weigh up the risks and benefits of providing services to alternative investment funds within the EU. If this risk assessment turns out negative, the business of depositories and, implicitly, hedge funds may be affected.
  - The provisions have arguably been influenced by the losses suffered by French investors in the Bernard Madoff scandal and may be overreaching.
  - The role custodians of feeder funds based in Luxembourg and Ireland in the context of investor protection is the subject of ongoing legal action.

2. **Dodd-Frank Hedge Fund Rules**

In the largest overhaul of U.S. financial regulations since the 1930s, the Dodd-Frank

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84 Proskauer, *Client Alert: US Venture Capital, Private Equity and Hedge Fund Managers May Face Restrictions on Marketing to EU Investors Under Proposed AIFM Directive*, June 22, 2010 at 6 (“... it is likely that EU investors would not be subject to these prohibitions if they set up subsidiaries or affiliates outside of the EU in a jurisdiction such as the Channel Islands or Cayman Islands to make investments in non-EU AIFs.”).

85 European Private Equity and Venture Capital Association, *The Effect of the Alternative Investment Fund Managers Directive on investing in venture capital*, at 6 (Mar. 15, 2010) (“The AIFMD calls for the use of third-party depository to increase transparency of individual investments by management companies. Share certificates will need to be held by the depository for safe keeping. Draw-downs from investors will need to be held by the depository as will proceeds arising on the sale of a portfolio company. The cost implications are significant and of major concern to venture capital firms.”).

86 See [FN 9].

87 Commission Staff Working Document Accompanying the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives: Impact Assessment, at 54, COM (2009) 207 (Apr. 30, 2009) (also recognizing “... access to many AIF has traditionally been restricted to professional or institutional investors These restrictions take the form both of practical barriers to investment, e.g. the imposition of investment thresholds (... for example, from €125,000 (Ireland, Luxembourg)
Act,\(^{88}\) includes several important provisions on hedge funds. As part of this reform package, the Private Fund Investment Advisers Registration Act of 2010\(^{89}\) (PFIARA) was enacted on July 21, 2010. The legislation is intended to close the regulatory gaps and end the speculative trading practices that contributed to the 2008 financial market crisis.\(^{90}\) The Dodd-Frank Act restricts a banking entity from having an ownership interest in or be a sponsor of a private equity or hedge fund if such investments amount to more than 3% of the bank’s Tier 1 capital or the bank’s interest is more than 3% of the total ownership of the fund.\(^{91}\) Private equity and hedge funds with assets under management of $150 million or more will have to register with the SEC, although venture capital funds will be exempt from full registration.\(^{92}\) Most significantly, PFIARA requires that hedge funds with more than $150 million assets under management (AUM) register with the SEC as investment advisors and disclose to the agency information about their trades and portfolios.\(^{93}\)

a) The Long Way to Hedge Fund Registration

PFIARA could be the last chapter in a debate that started with the inception of the hedge fund industry in the 1960s. Before the SEC adopted the, now with PFIARA redundant, investment adviser registration safe harbor in Rule 203 (b) (3)\(^{94}\) in 1985, it had

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\(^{89}\) QUOTE

\(^{90}\) Sebastian Mallaby, *Wall Street Crackdown Bill Passed by Senate*, FIN. TIMES, July 16, 2010 (quoting Ben Bernanke: "The financial reform legislation approved by the Congress today represents a welcome and far-reaching step toward preventing a replay of the recent financial crisis.").

\(^{91}\) Dodd-Frank, supra note __, § 619 ("... in no case may the aggregate of all of the interests of the banking entity in all such funds exceed 3 percent of the Tier 1 capital of the banking entity.").

\(^{92}\) Dodd-Frank, supra note __, § 407, ("No investment adviser that acts as an investment adviser solely to 1 or more venture capital funds shall be subject to the registration requirements of this title with respect to a provision of investment advice relating to a venture capital fund."); Id. at § 408 ("The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each of such investment adviser acts as an adviser to private funds and has assets under management in the United States of less than $150,000,000.").

\(^{93}\) Dodd-Frank, supra note __, Sec. 408 (Exemption of and Reporting by Certain Private Fund Advisors) 111th Cong. (2010) ("IN GENERAL.—The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000.").

\(^{94}\) Investment Advisers Act §203(b)(3), 15 U.S.C. 80b-11(a) (2000). Under section 203(b)(3) of the Advisers Act, an adviser was exempt if it had less than 15 clients in the past 12 months, if it did not ‘hold itself out’ to the public, i.e. did not offer investment advisory services to the general public, nor act as investment adviser to a registered investment company or business development company. In calculating the number of clients under section 203(b)(3), a fund’s US and non-US clients had to be taken into account. Non-US fund managers only had to count their US clients. Under rule 203(b)(3)-1 of the Adviser Act, a limited partnership itself could be counted as a single client of the general partner or any other person acting as the investment adviser, provided investment advice to the partnership was based on the partnership’s objectives rather than on the needs and objectives of the limited partners. This rule also applied to an offshore fund in the corporate form, which may in general be treated as one client by an adviser.
been issuing a long line of no-action letters requiring an investment adviser to look through an entity and count each individual advisee or member as a separate client. Reliance on SEC no-action letters alone led to significant ambiguity. This ambiguity was further exacerbated by the continuing changes in the position of the Second Circuit. The Second Circuit from 1976 to 1977 had characterized the individual limited partners as the “clients” of the general partner. Later, the Second Circuit withdrew that characterization in Abrahamson v. Fletscher, holding that general partners of limited partnerships investing in securities were investment advisers, leaving unanswered the question whether the partnership, or each of the partners, should be counted as clients, which was later overruled on other grounds by TransAmerica Mortgage Advisors, Inc. v. Lewis.

Despite the establishment of a “look through rule” via SEC no-action letters, there was no registration requirement under the Adviser Act before the safe harbor was enacted in 1985, nor was there any registration requirement under the safe harbor rule after its enactment. Accordingly, the safe harbor permitted advisers to manage large amounts of securities indirectly through several hedge funds that would collectively have had hundreds of investors. More precisely, section 12 of the Exchange Act in combination with Rule 12g-1 requires registration of any issue with 500 holders of record of a class of equity securities and assets in excess of $10 million. Practically speaking this meant that a single hedge fund could have up to 499 investors. Moreover, under Rule 203 (b) (3) –1 (a), an investment adviser may count a legal organization as a single client so long as the investment advice is provided based on the objectives of the legal organization rather than the individual investment objectives of any owners of the legal organization. Until the SEC adopted the new rule, discussed below, there was considerable uncertainty whether advisers to

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96 Fed. Sec. L. Rep. (CCH) 95, 889, at 91, 282 n. 16.
97 568 F.2d 862, 872 n. 16 (2d Cir. 1977), cert. denied, 436 U.S. 913 (1978) (Circuit Judge Timbers, holding: “[.] that general partners of investment partnership were “investment advisers” within meaning of Advisers Act.”).
99 444 U.S. 11 (1979) (the Supreme Court, Mr. Justice Stewart, holding on certiorari, that there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract, but Act confers no other private causes of action, legal or equitable.).
101 17 C.F.R. 240.12g-1.
102 17 C.F.R. 275.203 (b) (3) –1 (a) (2)(i).
103 Id. (stating that:”[a] limited partnership is a client of any general partner or other person acting as investment adviser to the partnership.”).
unregistered investment pools were required to look through the pools to count each investor as a client, or could count each pool as a single client. 104 In the absence of a particular rule on the issue, rule 203 (b) (3) –1 was interpreted to generally allow an adviser to count each hedge fund as one client. Accordingly, combining the limits of Section 12 of the Exchange Act and Rule 12g-1 with Rule 203 (b) (3) –1, a hedge fund adviser used to be able to have 14 funds with 499 investors in each. This is a total of 6,986 investors.

In December 2004, the SEC utilizing its rule-making authority under the Advisers Act, 105 issued a final rule to require hedge fund advisers to register under the Advisor Act. 106 The rule was eventually issued only by a three-to-two vote, 107 and then overturned by the D.C. Circuit in 2006. 108 In adopting the hedge fund advisor registration rule, the SEC cited the growth of the hedge fund industry, retailization, “the broadening exposure of investors to hedge fund risk, and the growing number of instances of malfeasance by hedge fund advisers” as the main reasons why the previous regulatory scheme for hedge fund advisers was inadequate. 109 Among the most obvious arguments for its regulation, the SEC referred to possible prevention or diminishment of losses that hedge fund investors might otherwise experience as a result of hedge fund advisers’ fraud. 110 To support the regulation, the SEC referred to several studies that seem to suggest that hedge fund fraud was on the rise. The SEC also referred to the increased exposure of small investors as a result of the decrease in minimum investment requirements 111 and the additional dangers that are associated with this

105 Investment Advisers Act §211(a), 15 U.S.C. 80b-11(a) (2000). Section 211(a) asserts that the Commission may adopt rules “necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this title” and “may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons and matters.” Id. See also Investment Adviser Act, 15 U.S.C. §§ 80b-2(a)(17) (2000) (“The Commission may by rules and regulations classify, for the purposes of any portion or portions of this title, persons, including employees controlled by an investment adviser.”).
110 Id. at 72,078 (“Registration allows us to conduct examinations of hedge fund advisers, and our examinations provide a strong deterrent to advisers’ fraud, identify practices that may harm investors, and lead to earlier discovery of fraud that does occur.”).
phenomenon.  

Contrasting these benefits with costs associated with a registration requirement for hedge funds, the SEC emphasized that it was “sensitive” to the costs and benefits that result from the rule. In the section on cost benefits analysis to justify its rulemaking in Rule 203(b) (3)-2 under the IAA, the SEC identified, among others, the benefits to hedge fund investors by deterring fraud and curtailing losses, providing basic information about hedge fund advisers, and improved compliance controls. The SEC also saw benefits to mutual fund investors, other investors and markets, regulatory policy, and hedge fund advisers.

Commissioners Cynthia A. Glassman and Paul S. Atkins opposed releasing the final rule. Despite an emphasis by the majority on the risks of retailization, the dissenting commissioners pointed to the 2003 Staff Report, which found that retailization was not an issue and argued that the inflow of funds is already so rapid that hedge fund advisers had more to invest than they could handle and were in no need to solicit retail investors.

In Goldstein, the D.C. Circuit struck down the hedge fund rule as an instance of arbitrary rulemaking by the SEC. In vacating the rule, the D.C. Circuit underscored the substantive limits of agency rule-making power and rejected the SEC’s position that it had authority to determine the meaning of the term “client” where the term had not been otherwise defined in the Advisers Act. Many advisers who had previously registered under the rule decided to de-register. Reacting to Goldstein, the SEC dramatically expanded the fraud protection for investors and proposed to increase the “accredited investor” standards under Regulation D.

112 See Registration Under the Advisers Act, supra note__, at 72,057 (noting several sources acknowledging that hedge fund expansions attract investors that were previously too risk averse).
113 Id. at 72,078.
114 Id. at 72,078-79 (listing benefits to include a strong deterrent to advisers' fraud, identification of practices that may harm investors, earlier discovery of existing fraud, the ability to screen individuals seeking to advise hedge funds, and to deny entry to those with a history of disciplinary problems).
115 Id. at 72,089.
116 See SEC Staff Report, supra note ____, (“[T]he staff has not uncovered evidence of significant numbers of retail investors investing directly into hedge funds.”).
117 451 F.3d 873 (D.C. Cir. 2006).
118 Id. at 884 (“[T]he Hedge Fund Rule only exacerbates whatever problems one might perceive in Congress’s method for determining who to regulate. The Commission’s rule creates a situation in which funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the Advisers Act. This is an arbitrary rule.”).
119 Id. at 881-83.
121 Id. at 405.
b) PFIARA Revision of Accredited Investor Standards

In December 2006, in the aftermath of Goldstein, the SEC dramatically expanded the fraud protection for investors and proposed to increase the "accredited investor" standards under Regulation D. Regulation D defines the term “accredited investor” as a natural person whose individual net worth, or joint net worth with such person’s spouse, exceeds $1,000,000 at the time of the purchase or whose individual income exceeds $200,000 (or joint income with the person’s spouse exceeds $300,000) in each of the two most recent years and who has a reasonable expectation of reaching the same income level in the year of investment. The SEC proposal envisaged raising the numerical requirement in Regulation D by adding to the net worth or income test specified in rule 501(a) or rule 215, a requirement of ownership of at least $2.5 million in investments. The SEC’s reasoning that "natural persons may have indirect exposure to private pools," and “many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments," seems to suggest that retailization of the hedge fund industry was a major concern.

Preempting the SEC proposal, PFIARA revises the definition of "accredited investor" in Reg. D to exclude the value of a natural person’s primary residence for purposes of determining whether the person meets the $1 million net worth standard. PFIARA has a one-year transition rule. However, the SEC staff has indicated that this revision will take immediate effect. PFIARA’s preemption of SEC activity in this context is rather thorough,

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123 Id. at 405.
125 Id. § 230.501(a)(6).
126 Id. § 230.501(a).
127 Id. § 230.215.
128 SEC Proposed Rules, supra note__, at 414 (clarifying that in addition to other Regulation D requirements, an accredited investor must own not less than $ 2.5 million in investments, after inflation adjustment).
129 Id. at 404.
130 Id. at 409.
131 Id. at 405 (“As proposed, the term accredited natural person would include any natural person who meets the requirements specified in the current definition of accredited person, as that term relates to natural persons, and would add a requirement that such person also must own (individually, or jointly with the person’s spouse) not less than $2.5 million (as adjusted every five years for inflation) in investments at the time of purchase of securities issued by private investment vehicles under Regulation D or section 4(6).”).
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the SEC is prohibited from further adjusting the $1 million net worth standard for a period of four years following PRIARA’s enactment.\textsuperscript{134} 

[impact assessment de lege ferenda]

c) Impact Assessment of Hedge Fund Registration under PFIARA

Almost all hedge fund advisors comply with the private adviser exemption to earn and maintain exemption from registration as an investment adviser under federal rules.\textsuperscript{135} Without exemptions, hedge fund advisors would be subject to SEC inspections, books and record keeping requirements,\textsuperscript{136} disclosure requirements,\textsuperscript{137} code of ethics requirements,\textsuperscript{138} and significantly higher legal fees. PFIARA replaces the private advisor exemption with a general requirement that an investment adviser to any hedge fund or private equity fund must register with the SEC. PFIARA provides, however, exemptions for venture capital funds,\textsuperscript{139} foreign private advisers,\textsuperscript{140} advisers to hedge funds will less than $150 million AUM and other advisers with less than $100 million AUM. The latter two exemptions are of particular importance for this paper.

PFIARA exempts certain investment advisers who manage only private funds with

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\item \textsuperscript{134} It is unclear what role investment adviser registration with the SEC plays in the current environment. Some of the data made available to the author by Robert E. Place of the SEC's Investment Management Division highlights the importance of Goldstein v. Sec. & Exch. Comm’n, 451 F.3d 873 (D.C. Cir. 2006): “11,292 investment advisers are registered with the Commission with total AUM of $43 trillion. 1,845 or 16 percent of these advisers are identified by Form ADV as hedge fund advisers. 790 hedge fund advisers have registered since January 1, 2005 (and are still registered). 217 of these advisers have registered since the Goldstein decision (June 23, 2006). 169 hedge fund advisers are located outside the U.S. 11,710 private investment funds (“PIF”) identified; (10,029 PIFs once duplicate names are removed). $3 trillion in private investment fund assets identified; ($2.6 trillion in PIF assets once duplicate names are removed). 753 or 30 percent of the HF advisers that were identified on June 23, 2006, either withdrew their registration or had their registration cancelled. 382 or 15 percent of the HF advisers that were identified on June 23, 2006, have been reclassified as non hedge fund advisers because of changes they made to their Form ADV.” Email from Robert E. Place, Inv. Mgmt. Div., Sec. & Exch. Comm’n, to author (Dec. 10, 2008) (on file with author).
\item \textsuperscript{135} Id. § 275.204-2 (2008).
\item \textsuperscript{136} Id. § 275.204A-1 (requiring registered investment advisers to “establish, maintain and enforce a written code of ethics,” subject to some minimum requirements included in the rule).
\item \textsuperscript{137} Id. § 275.204A-1 (requiring registered investment advisers to “establish, maintain and enforce a written code of ethics,” subject to some minimum requirements included in the rule).
\item \textsuperscript{138} Id. § 275.204A-1 (requiring registered investment advisers to “establish, maintain and enforce a written code of ethics,” subject to some minimum requirements included in the rule).
\item \textsuperscript{139} Private Fund Investment Advisors Registration Act (PFIARA), H.R. 3818, 111th Cong. (2010), § 6. Investment advisers who manage only “venture capital funds,” are exempt under PFIARA. PFIARA requires the SEC to define the term “venture capital fund” within one year of its enactment. If the “venture capital fund” exemption will cover funds-of-funds that invest only in venture capital funds remains unclear. Advisers would still be required to certain disclosures and recordkeeping requirements that are to be defined by the SEC.
\item \textsuperscript{140} PFIARA supra note ___, at § 3. PFIARA exempts from registration a “foreign private adviser,” which is defined as an investment adviser that (a) has no place of business in the United States, (b) has fewer than 15 clients in the United States, (c) has less than $25 million in assets under management attributable to United States clients or investors in private funds managed by the adviser, and (d) does not hold itself out generally to the public as an investment adviser and does not act as an adviser to any registered investment company or business development company. For purposes of the requirements of clauses (b) and (c), investors in private equity funds (and not the funds themselves), and their commitments to such funds, are counted toward the 15 client/investor and $25 million thresholds. See [__].
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less than $150 million AUM in the United States from federal registration. Accordingly, advisers with less than $150 million AUM that had previously not registered under state law because they complied with federal law and were registered with the SEC, may now be required to de-register with the SEC and become subject to a state registration requirement. The administrative and compliance cost of de-registering from federal law and re-registering under state law may be significant and could harm the industry. Even advisers that do not have to comply with the federal registration under this PFIARA exemption will nonetheless be subject to certain disclosure and recordkeeping requirements to be defined by the SEC.

As a corollary to the federal registration requirement, PFIARA provides that an investment adviser that provides investment advice to clients other than private funds (e.g., an adviser with separate accounts) is not subject to federal registration. This exemption applies if the adviser has less than $100 million AUM and would be required to comply with state registration rules and register with (and be subject to examinations by) the state in which it maintains its principal office and place of business, i.e. existing state law de-minimis exemptions cannot apply. However, if not registering with the SEC precipitates that an advisor under state law is required to register with 15 or more states, then the adviser will be permitted to register under federal law with the SEC. Under PFIARA, the SEC has authority to define certain disclosure and recordkeeping requirements which will apply to advisers that are exempt from federal registration under this exemption.

Implicit in the PFIAAR exemption requirement for adviser with less than $100 million AUM is that state law de minimis exemptions do not apply. Attorneys advising hedge fund start ups, however, often use state law de–minimis exemptions to minimize costs to their clients and help them raise funds without registering with the SEC. Registering with the SEC and filing form ADV involves substantial administrative attention and attorneys fees can be very substantial. The quantity of start-ups and smaller hedge fund operations has not been formally quantified but cannot be underestimated. Hedge fund managers have incentives to bring in investors as soon as possible to make a new hedge fund operational, but it is vital in this process to keep the number of investors below fifteen.

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141 [___]
142 [___]
143 [___]
144 PFIARA supra note ___ (the purpose of which is “to amend the Investment Advisers Act of 1940 to require advisers of certain unregistered investment companies to register with and provide information to the Securities and Exchange Commission . . . .”).
Even though a "client" under the Adviser Act can include legal entities,\textsuperscript{145} hedge fund managers would probably want to make sure, especially in the start-up phase of a fund, that they maximize the counting of potential clients that would be excluded from the fifteen-client limit under federal law. Such clients could be retail investors who could qualify to invest under state specific \textit{de minimis} exemptions.

Under \textit{de minimis} exemptions in state Blue Sky laws, there could be several scenarios in which retail investors would be able to invest in hedge funds and hedge-fund-like-vehicles. There would probably also be several reasons why hedge fund managers would consider bringing in retail investors for a hedge fund under such exemptions. If the hedge fund manager wants to bring U.S. investors into the fund and the respective investors are residents of certain states, the fund manager would have to register as an investment adviser under the respective state laws if the state does not have a \textit{de minimis} exemption that exempts the manager from registration. Such registration under state law would require filing a Form ADV, used by the SEC to federally register certain investment advisers,\textsuperscript{146} with the appropriate state through the Investment Advisor Registration Depository, which would cause significant transaction costs. Especially in the start-up phase of a hedge fund, the manager may want to avoid such costs. The manager would also probably want to avoid having to worry about what kind of investors to bring into the fund and whether they would need to be qualified investors in order to be acceptable. The manager would probably also want to use existing investors in the fund as a form of advertising for the fund to bring in additional investors. Additionally, the manager would probably like to establish a track record and get the fund operational as soon as possible. Accordingly, certain state \textit{de minimis} investment adviser registration exemptions for investors could be an attractive alternative to federal laws for investment advisers, especially in the start-up phase of a hedge fund.

Investment adviser registration exemptions under state Blue Sky laws would probably not suffice to explain the phenomenon of retailization or justify any data insufficiencies. Theoretically, however, it appears to give some indication as to how previously unqualified investors would perhaps be able to gain access to the hedge fund world. A possible explanation for retailization gives only limited guidance for researchers. The quantification of the economic significance of retail investors in hedge funds would be important because such quantification would probably help researchers understand the origins of retailization. A data-

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\textsuperscript{145} \textit{Id.} § 275.203(b)(3)-1(a)(2).

supported determination of the origins of retailization, in turn, would probably help researchers understand if retail investors in hedge funds would warrant special regulatory attention.\textsuperscript{147}

Eighty-five percent of hedge fund assets under management globally are located in U.S. and U.K. jurisdictions.\textsuperscript{148} A majority of such fund assets may be located in the U.S. The analysis of \textit{de minimis} rules under Blue Sky laws could be a starting point to determine if and how retailization of hedge funds is taking place.\textsuperscript{149} In lieu of such analysis, some conclusions could perhaps be drawn from analyzing the existence of \textit{de minimis} rules in states with the highest percentage of hedge fund assets under management.\textsuperscript{150} This methodology is based on the assumption the higher the number of assets under management in a state, the higher the potential access rate for retail investors.\textsuperscript{151}

Before PFIARA, doing away with the private adviser exemption made investment advisors subject to SEC inspections, books and record keeping requirements,\textsuperscript{152} disclosure requirements,\textsuperscript{153} code of ethics requirements,\textsuperscript{154} and significantly higher legal fees. Scholars and industry representatives argued that his increased the cost of doing business for the hedge fund industry.\textsuperscript{155} PFIARA now makes it mandatory for investors to register with the SEC\textsuperscript{156} and does away with the private adviser exemption while creating other exemptions such as exempting "family offices" from registration.\textsuperscript{157} Nevertheless, investment advisers will have to comply with a litany of PFIARA requirements. For instance, investment advisers that are required to register as an investment adviser under federal law must

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\item \textsuperscript{147} \textit{Cf.} SEC Proposed Rules, \textit{supra} note \textsuperscript{\textcircled{1}}, at 401-07 (suggesting that the SEC has previously used retailization as an argument to justify hedge fund fraud rules).
\item \textsuperscript{148} \textit{HFWG, supra} note \textsuperscript{\textcircled{1}}, at 3.
\item \textsuperscript{149} States that have \textit{de minimis} exemptions would, in most cases, allow up to five investors to invest in hedge funds without qualification requirements for these investors and without requiring the hedge fund manager to register as an investment advisor.
\item \textsuperscript{150} \textit{IBISWORLD U.S. INDUSTRY REPORT, supra} note \textsuperscript{\textcircled{1}}, at 11-12 (referencing a table showing "Top 5 States by Income").
\item \textsuperscript{151} It is unclear if the percentage of assets under management per U.S. state would be correlated with the resident status of potential retail investors in hedge funds. Assuming that the majority or at least a significant percentage of total income of a hedge fund would perhaps be collected from investors who are residents in the state in which the respective hedge fund is registered, it would perhaps be possible to identify retail investors from such states who could have invested in hedge funds under such state's Blue Sky Law \textit{de minimis} exceptions.
\item \textsuperscript{152} 17 C.F.R. § 275.204-2 (2008).
\item \textsuperscript{153} \textit{Id.} § 275.204-3.
\item \textsuperscript{154} \textit{Id.} § 275.204A-1 (requiring registered investment advisers to “establish, maintain and enforce a written code of ethics,” subject to some minimum requirements included in the rule).
\item \textsuperscript{155} See registration discussion \textit{supra} at [____].
\end{enumerate}
\end{footnotesize}
register with the SEC using Form ADV. [ Cost of complying with requirements in ADV___] They have to adopt written policies and procedures to prevent and detect violations of the federal securities laws.\textsuperscript{158} [___ cost? Efficiency? Foreseeability? ____] and must appoint a Chief Compliance Officer.\textsuperscript{159} To ensure compliance with ethical business standards, PFIARA makes it mandatory for investment advisors to adopt a written code of ethics that complies with the federal securities laws.\textsuperscript{160} In particular, the code under PFIAR\textsuperscript{EA} must set forth standards governing personal securities trading by the adviser's personnel.\textsuperscript{161} Reinforcing insider trading monitoring, PFIARA requires that each registered adviser establish, maintain and enforce written policies to prevent insider trading. [In part to facilitate SEC inspections, registered investment advisers are required to maintain a long list of financial and other business-related books and records.\textsuperscript{162} It is unclear if the SEC would actually be able to evaluate all of the data that PFIARA requires to disclose upon inspection. [____].

In part as a reaction to the Madoff scandal, PFIARA requires registered investment advisers that have "custody"\textsuperscript{163} of client accounts to keep all client assets with a qualified custodian.\textsuperscript{164} Investment advisors also have to provide detailed statements detailing what assets are held by whom.\textsuperscript{165} Advisers must also obtain an annual surprise verification of client assets by independent accountants if their funds do not obtain audited financials complying with GAAP and distribute them promptly to investors.\textsuperscript{166} [____]

\textbf{[PRIARA further requires registered advisers to maintain records and provide}
confidential reports with respect to certain information related to systemic risk, such as the amount of assets under management, the use of leverage, including off-balance sheet leverage, counterparty credit risk exposures, trading and investment positions, trading practices, valuation policies, side letters and any other information the SEC and the systemic risk regulator deems necessary and appropriate. PFIARA provides a one-year transition period before the registration requirements under PFIARA take effect. Accordingly, investment advisers that previously relied on the private adviser exemption and that are required to register as investment advisers under PFIARA must register with the SEC by July 21, 2011 under the terms of PRIARA. However, given that the SEC has until July 21, 2011 to define the meaning of “venture capital fund,” it is possible that the SEC will issue rules extending this one-year transition period.

[ impact assessment ] PFIARA requirement of disclosure of hedge fund trading strategy etc. information to regulators – leakage by regulators could be a problem.

3. Impact Assessment of Asymmetric Regulation in Dodd-Frank and AIFM Directive

The US registration requirement is more stringent than various versions of the AIFM Directive, which require registration only at more than Euro 250 million AUM.

PFIARA, the AIFM Directive and other direct and indirect regulatory measures aimed at hedge funds are also based on the assumption that hedge funds played a role in the financial crisis. But, the role of hedge funds in the financial crisis has not been systematically studied or evaluated and remains unclear. After the collapse of Long Term Capital

Romano comment, supra note ___.

Report on the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending directives, art. 6(a) (March 2010), available at http://register.consilium.europa.eu/pdf/en/10/st06/st06795-re03.en10.pdf (when (…) the value of the portfolios of AIF managed by the AIFM exceeds EUR 250 million, the AIFM (…) must be required to provide an additional amount of own funds (…) which is equal to 0.02 % of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million but the required total of the initial capital and the additional amount must not, however, exceed EUR 10 million. . .).

See discussion supra at [___].
Management in 1999, most dealer-banks required full collateralization of hedge fund transactions\textsuperscript{174} and as a result hedge funds were less levered than banks for quite some time.\textsuperscript{175} The collapse of large hedge funds like Amaranth in 2007\textsuperscript{176} and large redemptions by investors during and after the crisis\textsuperscript{177} did not cause systemic problems.\textsuperscript{178} And, hedge funds have fewer assets and less leverage than banks, making it less likely that hedge funds could cause the next crisis. Without the threat of systemic risk, it is unclear what the role of direct hedge fund regulation could be. [___]

IV. An Alternative Approach to Hedge Fund Regulation

Regulators can use regulatory authority over entities that interact with hedge funds to regulate hedge funds indirectly or use a number of regulatory tools including registration, capital, leverage, margin and reporting requirements to regulate hedge funds directly.

Before the credit crisis of 2008-09, most jurisdictions did not claim direct regulatory authority over hedge funds. A significant number of hedge funds operate through off-shore centers and are, thus, outside the jurisdiction of many legislators. The problem of regulatory arbitrage, i.e. upon the imposition of direct regulatory measures by a particular jurisdiction hedge funds have an exit option - relocating to off-shore jurisdictions. This could have deterred regulators for some time from imposing stricter standards. Legislators also had disincentives to impose harsher requirements on the hedge fund industry because that could have meant losing franchise taxes and other business to off-shore centers. Transaction costs and the cost of regulation, i.e. compliance costs for funds, administrative costs and setup costs may also have played an important role in the lack of regulatory action before the crisis of 2008-09. Before PFIARA, the SEC made several attempts at regulation but failed.\textsuperscript{179} Regulators face an interesting dichotomy. On the one hand, their mandate is to protect investors and ensure the well functioning of markets. On the other hand, they do not want to over-regulate the industry and need to tailor regulation to entities that actually engage in activities that

\textsuperscript{174} See [___], supra note __, [___].
\textsuperscript{175} See [___], supra note __, [___].
\textsuperscript{176} See [___], supra note __, [___].
\textsuperscript{177} See [___], supra note __, [___].
\textsuperscript{178} [___]
\textsuperscript{179} See discussion supra at [___].
give rise to systemic concerns. The imposition of additional limitations on hedge funds may also impose unwarranted burdens on other types of private investment pools, such as venture capital funds and structured financings that do not raise the same concerns as hedge funds.

If direct measures are, indeed, misplaced,\(^\text{180}\) what could be the role of indirect regulation through Basel III? In other words, if we assume that hedge funds do not create systemic risk, why should bank lending to hedge funds be treated differently from bank lending to other market participants?\(^\text{181}\) Arguably, dealers have already reduced risks of lending to funds so there is no obvious problem for Basel III to address.\(^\text{182}\) International harmonization of banking regulation through the Basel Accords may have created certain challenges. Arguably, it led virtually all large banks to follow the same financial strategies, such as the selection of assets and investments and their securitization, the use of similar risk models.\(^\text{183}\) The harmonization of bank lending practices was therefore not restricted to one nation and did indeed create systemic risk.\(^\text{184}\) Most US investment banks and European

\(^{180}\) See discussion supra at [___].
\(^{181}\) See Roberta Romano, Comment on: “Financial Market Regulation: Banking Regulation, Corporate Governance, Financial Reporting Standards and Hedge Funds,” 3\(^{rd}\) International Conference on Law and Economics of Global Institutions at the University of St. Gallen, (on file with author).
\(^{182}\) Id. Contra Huw Jones, Basel Committee Says Agrees Bank Buffer Strategy, THOMPSON FIN. NEWS (Jul. 16, 2010) (reporting that the Basel Committee feels a Basel III is necessary to create stringent reforms ensuring banks have sufficient capital so as to prevent another taxpayer bailout).
\(^{183}\) Cf. Stavros Gadinis, The Politics of Competition in International Financial Regulation, 49 HARV. INT’L L. J. 447, 506 (2008) (asserting further that implementation of the Basel Accords has required uniformity in risk investment techniques and information technology, making it difficult for smaller banks to comply); Michael S. Barr & Geoffrey P. Miller, Global Administrative Law: The View from Basel, 17 EUR. J. OF INT’L L. 15, 21 (2006) (noting however, that Basel was intended to create international harmonization and was introduced specifically to reduce systemic risk from bank failures and to limit externalities that may lead to a lack of information sharing. Also noting that Basel has succeeded “in providing global public goods of information”); Salman Banaei, Global Governance of Financial Systems: The International Regulation of Systemic Risk, 7 DENV. J. INT’L L. & POL’Y 547, 552 (2007) (book review) (averring that the first and third pillars of Basel II promoted “dangerous homogeneity”). Contra Barr & Miller at 21 (proposing that the Basel committee mitigates transnational externalities by coordinating supervision over multinational firms and suggesting that this coordination, not harmonization, is what would prevent destabilizing actions by a country’s regulators).
\(^{184}\) Cf. Banaei, supra note ___ at 551 (asserting that the substantive rules set forth by the Basel accords do not limit systemic risk because they do not address the banking needs of less developed nations, and because Basel has an “imbalanced decision making structure”); Pierre-Hugues Verdier, Transnational Regulatory Networks and Their Limits, 34 YALE J. INT’L L. 113, 143 (2009) (pointing out that, “The debates surrounding the adoption of the Accord reveal that, even when faced with a collective action problem that requires cooperation to reduce systemic risk and improve global financial stability, national regulators take positions that reflect the interests of domestic constituencies. As a result, the adoption of common standards will require solving distributive problems where the interests of these constituencies diverge.”); Barr & Miller, supra note 181 at 16 (suggesting further that harmonization reduces flexibility, resulting in slower regulatory change and blocking regulatory competition). Contra Andre Scheerer, Credit Derivatives: An Overview of Regulatory Initiatives in the U.S. and Europe, 5 FORDHAM J. CORP. & FIN. L. 149, note 112 (2000) (The federal regulations which incorporated the Basel market risk amendments, have led many institutions to “significantly improve their risk modelling techniques, and, in particular their modelling of specific risk.”).
banks endorsed and implemented Basel II\(^ {185} \) and are, [consequently], mostly highly leveraged.\(^ {186} \) US banks that are still on Basel II or a hybrid of Basel I and II did poorly.\(^ {187} \) Conversely, Spanish banks pre-2010 performed better because their national regulators required more capital.\(^ {188} \) [___]

These trends have large implications for the reforms proposed in this paper. Greater harmonization of international banking regulation via Basel III is unlikely to lead to better outcomes and may well exacerbate future crises.\(^ {189} \) The Basel Accords produces globally similar business and regulatory strategies.\(^ {190} \) As a result of harmonization, when a policy turns out to be mistaken, distress is global.\(^ {191} \) For instance, in 2008, many financial

\(^{185}\) David Zaring, *International Law and the Economic Crisis: International Institutional Performance in Crisis*, 10 CHI. J. INT'L L. 475, 483 (2010) (noting that big U.S. and European banks were capitalized under the standards of Basel II, and specifically pointing out that the Basel committee set the standard followed by Bear Stearns and Lehman Brothers, which clearly was inefficient in keeping these banks solvent). *Contra* Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127, 133(2009) (suggesting that because Basel II only began a phased-in implementation in the United States in January 2009, it is too early to evaluate its effects).

\(^{186}\) Herald Benink & George Kaufman, *Turmoil Reveals the Inadequacy of Basel II*, FIN. TIMES, Feb. 27, 2008 (contending that the widespread implementation of Basel II coincided with the massive losses reported by big banks and suggesting that Basel II “creates perverse incentives to underestimate credit risk”). *Cf.* Francesco Cannata & Mario Quagliariello, *The Role of Basel II in the Subprime Financial Crisis: Guilty or Not Guilty* at 15 (Centre for Applied Res. in Fin. Working Paper Group, Paper No. 3/2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330417 (contrarily, proposing that while Basel II was a component of banks’ supervision, it alone cannot be blamed for the excessive risk taking and high leveraging of banks during the financial crisis because other supervisory components also had weaknesses): Pierre-Hughes Verdier, *Banking on Basel: The Future of International Financial Regulation*, 104 AM. J. INT’L L. 338, 340 (book review) (asserting however, that while most large US banks implemented Basel II, the banks resisted safeguards proposed by the banking agencies to protect against significant capital declines, which led to prolonged struggles among banking regulators, Congress, and the banks). *Contra* Krawiec supra note 185 at 155 (suggesting rather, that US banks are so highly leveraged because of the potential for great reward when resources are leveraged and risks are taken; and thus banks tolerate the risk, despite regulatory laws).

\(^{187}\) *Cf.* Zaring, supra note ___ at 484 (suggesting that Basel II played a role in the demise of America’s “big five investment banks,” thus calling into question the usefulness of the Basel Accord). *Contra* Pierre-Hughes Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT’L L. 113, 142 (2009) (stating that in 2007, U.S. Regulators announced Basel II would apply only to large international banks, and other banks would not be subject to Basel II if they chose to opt into advanced internal rating-based approaches).

\(^{188}\) *Cf.* Steve Slater, *UK Looks at System at Spain on Bank Capital*, RUTERS LONDON, Nov. 11, 2008 at 1, available at http://www.reuters.com/article/idUSTRE4AA6X920081111 (stating that Spain requires its banks to build up capital during strong economic times to safeguard against economic downturns). *Contra* Thomas Catan & Christopher Bjork, *The Madoff Fraud Case: Santander’s Clients React Coolly to Offer*, WALL ST. J., Jan. 29, 2009, at C2 (stating that though Spanish banks have had unusually large capital, two of Spain’s largest banks admitted that the Madoff and credit crises greatly affected their earnings).

\(^{189}\) Romano Comment, supra note _____. *Contra* We Need a Basel III for a New Order: Soros, ECON. TIMES, Apr. 11, 2008, http://economictimes.indiatimes.com/news/economy/indicators/We-need-a-Basel-III-for-a-new-order-Soros/articleshow/2942920.cms (arguing that Basel II must be reworked to overcome the serious financial crisis).

\(^{190}\) *Cf.* Barr & Miller, supra note ___ at 16 (noting that the Basel Accords could be viewed as “regulatory imperialism,” developing rules affecting nations that have no role in the development process). *Contra* Krawiec supra note ___ at 129 (noting that the Basel II Accord gives banks “an unprecedented amount of flexibility in choosing how to measure operational risk and the resulting capital requirement.”).

\(^{191}\) Verdier, supra note ___ at 358 (suggesting that the current global financial crisis is due in large part to harmonized capital standards implemented through the Basel Accord). *Contra* Cannata & Quagliariello supra note ___ at 15 (arguing that Basel II did not play a major role in the financial crisis, and if revised, it should include greater harmonization of enforcement, as opposed to radical changes).
Financial Market Regulation after the Crisis: The Case for Hedge Fund Regulation via Basel III

Institutions sold assets to improve their long-term prospects and free themselves from toxic papers. As a result, prices plunges and the same institutions were forced to sell more assets etc. Similar effects must be anticipated for greater centralization. Moving around regulatory boxes in response to crisis is a common US approach. It is cheap, visible and easily explainable to the general public. However, it has not been successful. The US legislator’s believe in the effectiveness of the new systemic regulator, to be created under Dodd-Frank, may be misplaced. Current forecasting models were unable to anticipate the crisis, let alone its depth.

Another major argument against indirect regulation is that if two banks give loans to hedge funds, neither has an overall view of what the hedge fund does and what the hedge fund’s risk exposure might be, i.e. CPCRM will not work effectively unless the bank has an exclusive relationship with the hedge fund that allows it to control the relationship.

[Counterarguments:
It is not harmonization through Basel III that made banks hold similar assets but profitability of these assets and investments in them. Harmonization is only a framework and is not synonymous with conforming rules and regulations. Basel is only a framework that enables efficient exchange between banks. Basel is only a result of experimentation.

Hedge funds can be indirectly regulated through transactions with counterparties and counterparty credit risk management of banks. Given the opaqueness of the

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192 See literature to Sarbanes Oxley - Sarbox, e.g. [__], [Papers by Ribstein; Romano; Bebchuck; Hansman; Kraakman; et al.
193 Viral V. Acharya, Failures of the Dodd-Frank Act, FIN. TIMES, Jul. 15, 2010 (asserting that the Act both fails to discourage individual firms from “putting the system at risk” and to regulate by function, as opposed to form).
195 See Eddy Wymeersch [__].
196 Anastasia Nesvetailova, The Crisis of Invented Money: Liquidity Illusion and the Global Credit Meltdown, 11 THEORETICAL INQUIRIES IN L. 125, 140-42 (2010) (proposing that the banking industry responded to Basel by “driving risky assets off the balance sheets,” instead of strengthening balance sheets by weighing the riskiness of their assets as was intended by the Basel Accords and further asserting that banks were acting out of an “aggressive search for profits.”).
197 See Kraweic, supra note __ at 173 (noting that Basel II calls for self-regulation, allowing the banks to be substantially involved in their own oversight, and is characteristically open-ended).
198 [__]
activities of hedge funds, the absence of a common measure with which to calculate leverage and exposure and the dynamic nature of hedge funds’ trading strategies, however, the counterparty credit risk management process is faced with significant information asymmetries. Information asymmetries, in turn, obstruct the efficient supervision of agents by their principals, i.e. moral hazard.\(^{200}\)

Given the constraints of information asymmetries and moral hazard, it would seem advantageous to regulate via an institution that is best equipped to address these constraints. Banks play a prominent role in financial markets and facilitate hedge fund investments as market makers, creators of complex financial products or lenders among others. They are well suited to reduce adverse selection and moral hazard problems in financial markets\(^{201}\) and have particular advantages over other financial intermediaries in solving asymmetric information problems.\(^{202}\) More specifically, banks’ lending practice and counterparty credit risk management may allow them to curtail excessive risk taking and as they would be in a position to use the threat of cutting off future lending to improve a hedge fund’s behavior.\(^{203}\) Banks also have advantages in reducing moral hazard because they can monitor counterparty credit risk at lower costs than individuals.\(^{204}\) Contracting with hedge funds in their lending practice, allows them to negotiate collateral requirements, specifying interest rates and other contractual terms. Thus, helping to sort borrowers into risk pools that may help reduce adverse selection and moral hazard incentives for borrowers to engage in excessively risky activities. Establishing risk pools also helps minimizing information asymmetries in their lending practice. Furthermore, banks as market makers and creators of hedge fund product and lenders are in a position to establish long-term relationships that allow for targeted information collection. Thus, further minimizing information asymmetries and facilitating efficient long-term monitoring and managing of hedge fund counterparty

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\(^{199}\) After the LTCM debacle, regulators recommend that banks and institutional investors tighten credit standards, limit counterparty credit exposure, improve procedures for estimating potential future credit exposures and stress testing and use collateral. (See PWG etc.)

\(^{200}\) Furubotn/ Richter, supra note __, at [____].

\(^{201}\) The traditional financial intermediation role of banking has been in decline in both the United States and other industrialized countries because of improved information technology that makes issuing securities easier. Nonetheless, banks continue to be important in the financial system.


credit risk. Banks’ unique position as hedge fund and financial market intermediaries qualify them as the primary institution to address asymmetric information- and moral hazard problems. They are ideally situated to address regulator’s primary concerns in the context of hedge funds activities.

This paper will not attempt to define how a charge in Basel III for the bank’s systemic risk exposure to hedge funds could be calculated? Questions such as whether all hedge funds are to be qualified as equally risky, whether all banks are lending to the same fund, how to take account of collateral etc. may be addressed in a separate paper.

- Was national financial architecture the source of the problem?
  - Institutions operating under decentralized (US) and centralized (UK) regulatory regimes followed same poor business strategies:
    - E.g. low quality loans
    - Poor decision – making on asset acquisitions
    - Mismatched assets and liabilities
    - Excessive leverage (with hindsight)
    - Risk models badly –off- the- mark
  - Both decentralized and centralized systems followed similar regulatory strategies and equally failed to avert crisis and panic
  - Different regulatory structures did not produce quicker or cleaner resolutions to the crisis.

1. Moral Hazard and its Impact on Indirect Regulation of Hedge Funds Via Counterparty Credit Risk Management

- The global financial crisis has precipitated a now deeply rooted presumption that taxpayer funds can be used by governments to bail out banks. This creates strong incentives for banks to take excessive risks, i.e. moral hazard. Hedge funds are not counterparties in government bailouts. However, if banks get bailed out, they may have less incentive to monitor their hedge fund lending activities or other hedge fund related business.

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2. **Systemic Risk and Externalities**

- Hedge funds could create systemic risk if they disrupt the banks from providing financial markets with credit.\(^{206}\)

- The inability of a hedge fund to repay bank loans impairs banks’ ability to provide credit to other market participants or liquidity to the financial system.\(^{207}\)

- The common exposure to market risk factors of banks’ proprietary trading desks and hedge funds could detrimentally impact their respective trading positions and, thus, the banking system or broader financial markets on a larger scale.\(^{208}\)

- Each institution / country that manages its own hedge fund generated systemic risk without considering the impact of its actions or inactions on the risk in the system as a whole creates externalities.\(^{209}\)

- Systemic risk and financial market stability generate an externality and public good / free-rider problem, i.e. banks are not incentivized to adequately monitor or limit hedge fund risk exposure due to their reliance on hedge fund credit risk management by other banks.\(^{210}\) Thus, there is a role for regulation to reduce inefficient systemic risk.

3. **Basel III Improvements**

In an attempt to prevent a recurrence of the recent financial crisis, the Basel Committee on Banking Supervision in its new Basel III capital accord introduced new worldwide liquidity and leverage standards.\(^{211}\) Central to the new rules is an attempt to prevent banks from using off-balance sheet vehicles and risk-weighting methods to hide the

\(^{206}\) John Kambhu, Til Schuermann, & Kevin J. Stiroh, *Hedge Funds, Financial Intermediation, and Systemic Risk*, FED. RESERVE BANK OF N.Y. ECON. POL’Y REV., Dec. 2007, at 7 (“. . . . hedge funds create systemic risk to the extent that they can disrupt the ability of financial intermediaries or financial markets to efficiently provide credit.”).

\(^{207}\) Id. at 11 (“Credit exposure to hedge funds may create externalities in the banking system or broader financial markets in several ways. If the potential exposure amounts to a significant share of bank capital, for example, then a large shock to hedge funds could weaken banks and impair their ability to provide liquidity to the financial system or credit to borrowers.”).

\(^{208}\) Id.

\(^{209}\) Id. at 10 (“market failures include agency problems, externalities, free-rider problems, moral hazard, and coordination failures. We emphasize that these concerns apply more generally to many types of credit provision, but are likely more acute where information problems are most severe, where banks are eager to capture a share of a growing market, and where potential profits are encouraging stiff competition. Hedge fund exposures fit this description quite well.”).

\(^{210}\) Id.

\(^{211}\) Id.
true size of their balance sheet. At the same time, the Basel Committee simplified certain core definitions\textsuperscript{212} The new rules will, however, be in a test phase until the end of 2017.\textsuperscript{213} All of the 27 member countries have already signed up to the new principles.\textsuperscript{214}

The Committee is proposing that banks hold buffers of capital above the regulatory minimum – large enough that they remain above the minimum in periods of significant sector-wide downturns.\textsuperscript{215} The new principles would require banks to limit tier-one capital, the only capital that can be counted on to absorb losses, to 3 percent of unweighted assets.\textsuperscript{216} At the same time, the Basel committee softened its prohibition on counting the equity held by minority shareholders in overseas subsidiaries towards tier one capital.\textsuperscript{217} The minimum capital requirement is less onerous than feared by the banking industry. Banks will not have to publish their ratios until 2015 and will not have to comply with the 3 percent minimum until the end of 2017.\textsuperscript{218} To help restrain credit growth when it is perceived as excessive the Committee proposed that the buffer system might be used in a macro prudential framework – the buffer would rise and fall in a countercyclical manner.\textsuperscript{219}

To avoid a repeat of the Lehman Brothers collapse, regulators want banks to have enough liquid assets to survive a 30-day crisis. For the liquidity coverage ratio, however, the Basel committee eased up its definition of how severe the outflows in a crisis would be\textsuperscript{220} and allowed banks to count corporate bonds of a high quality towards their stockpile in addition to cash and government bonds.\textsuperscript{221} However, the committee still wants banks to hold more long-term assets to match long-term liabilities\textsuperscript{222} while acknowledging that the proposal needs work and will not be implemented before 2018.\textsuperscript{223}

\textsuperscript{212} [___] cite to core definitions that were changed in Basel III.
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• Minimum capital requirements
  ○ Better prudential filters
  ○ mark to model valuation
  ○ separation of financial reporting and banking regulation
  ○ anti-cyclical minimum capital requirements?
  ○ large banks’ minimum capital requirements?225
  ○ no over-regulation of commercial banks

• Systemic Risk Issues
  ○ Define ‘systemic risk’ by focusing on the exposure of other financial institutions226
  ○ Rescuing ‘systemic banks’ a non-problem227
  ○ Focus on protection of affected banks

• Re-organization of failed banks

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224 Adrian Blundell-Wignall & Paul Atkinson, Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity, 2010 OECD J.: FIN. MARKET TRENDS Issue at 10 (2010) available at http://www.oecd.org/dataoecd/42/58/45314422.pdf (the Committee is proposing that banks hold buffers of capital above the regulatory minimum – large enough that they remain above the minimum in periods of significant sector-wide downturns. . . . The Committee is proposing that the buffer system might be used in a macro prudential framework to help restrain credit growth when it is perceived as excessive – the buffer would rise and fall in a countercyclical manner.”).

225 Peter Miu, Bogie Ozdemire, & Michael Geisinger, Can Basel III Work? Examining the New Capital Stability Rules by the Basel Committee, McMaster University De Groote School of Business (Feb. 2010) available at http://ssrn.com/abstract=1556446 (“. . . . the Basel Committee has proposed that a buffer range should be established above the minimum capital requirements such that, if Tier 1 capital should fall into the buffer range, [Financial Institutions] would be constrained in the total amount of discretionary earnings distributions.”).

226 Standard & Poor’s Global Credit Portal, Basel III Proposal to Increase Capital Requirements for Counterparty Credit Risk May Significantly Affect Derivatives Trading, Mar. 4, 2010, http://www.bis.org/publ/bchs165/sppcr.pdf (“. . . . increasing capital requirements on counterparty risk provides a strong incentive for banks to push more OTC derivatives transactions through qualified clearing houses (against which zero capital charges are expected to apply under the proposal). Because most nonfinancial intermediary market participants are not likely to become general clearing members in clearing houses, we believe that banks will still offer trades and collect fees from such participants, but more hedges are likely to be transferred to exchanges and clearing houses. Although we expect that this could reduce counterparty risk overall, it might also introduce systemic risks posed by the clearing houses themselves. . . . Because clearing houses typically impose initial and variation margins to general clearing members, we expect that banks likely will seek to reprice increasing costs to end users, possibly increasing the overall cost of hedging interest-rate and currency risks for these participants.”).

227 BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: PROPOSED ENHANCEMENTS TO THE BASEL II FRAMEWORK (2009), at 16, http://www.bis.org/publ/bchs150.pdf (“Pillar 1 capital requirements represent minimum requirements. An appropriate level of capital under Pillar 2 should exceed the minimum Pillar 1 requirement so that all risks of a bank – both on- and off-balance sheet – are adequately covered, particularly those related to complex capital market activities. . . . While all banks must comply with the minimum capital requirements during and after such stress events, it is imperative that systemically important banks have the shock absorption capability to adequately protect against severe stress events.”).
4. The Case for Hedge Fund Regulation via Basel III

The model of the relational or incomplete contract provides for a governance structure that allows parties to solve problems if and when they arise, emphasizing collaboration and reinforcement of the relationship itself. The model recognizes that preset rules and regulations may not always encapsulate the parties’ needs and could be outdated as markets evolve.228 Banks are ideally positioned to deal with asymmetric information and moral hazard issues pertaining to hedge funds. Basel III is anticipated to improve inefficiencies of Basel II and provides a voluntary standard.

Systemic risk, moral hazard, information asymmetries and externalities would ideally be minimized through indirect regulation, i.e. through counterparty credit risk management of banks in their lending practice with hedge funds. Basel III will control the lending practice of banks with hedge funds. To minimize systemic risk in the lending practice of banks to hedge funds, the New Basel III Accord could add a provision establishing capital requirements for banks that include a charge for the particular bank’s lending exposure to hedge funds.229 Alternatively, capital requirements for banks could introduce a charge for a bank’s assets based on its systemic risk contribution and measuring the systemic risk contribution could include a measure for hedge fund lending exposure.

228 BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR (2010), http://www.bis.org/publ/bchs164.pdf (“The Committee therefore is announcing for consultation a series of measures to raise the quality, consistency, and transparency of the regulatory capital base. In particular, it is strengthening that component of the Tier 1 capital base which is fully available to absorb losses on a going concern basis, thus contributing to a reduction of systemic risk emanating from the banking sector.”).
229 European Banks Poised to Win Reprieve in Basel on Capital Rules, BUSINESSWEEK (Jul. 12, 2010) available at http://www.businessweek.com/news/2010-07-12/european-banks-poised-to-win-reprieve-in-basel-on-capital-rules.html (“The Basel III proposal attempts to fix the shortcomings of an earlier revision, known as Basel II, which was initiated by lenders in the late 1990s and lowered capital requirements by as much as 29 percent for some banks. The new rules would tighten control of what goes into the banks’ calculation of risk, redefine what counts as capital and impose higher charges against holdings such as derivatives.”).
Indirect regulation via Basle III could address problems of lacking jurisdictional authority and, thus, jurisdictional arbitrage because Basle III will be a framework for banks worldwide. Also, Basle III would replace a disarray of disjointed regulation by countries worldwide and would lower transaction costs. The AIFM Directive cannot achieve that as it is limited to the members states of the EU. The AIFM Directive would also likely increase transaction cost for Member States of the European Union as they would have to implement and enforce the AIFM Directive rules. There will also be significant cost for investors to comply with the passport regime of the Directive. Implementing a charge for the particular bank’s lending exposure to hedge funds or measure the systemic risk contribution deriving from hedge fund lending exposure under Basle III would not require any implementation. It would merely be the responsibility of the participating banks to comply with the framework. Hence, implementation and transactions costs for national regulators would be avoided. Regulating hedge funds by providing specific rules in Basel III addressing hedge funds’ systemic risk and lending practices avoids burdening the hedge fund industry worldwide because there would be no costs for registration and reporting, otherwise required by the AIFM Directive and the US regulation introduced by the Obama administration.

Regulation through Basel III would also address issues of systemic risk problems because Basle III will not only regulate and alter credit standards of banks but also hedge fund’s level of leverage.\textsuperscript{230} [Presumably credit markets would be saver ...]. Issues of moral hazard would be addressed because additional disclosures in Basel III would probably be necessary to introduce a charge for the particular bank’s lending exposure to hedge funds or measure the systemic risk contribution deriving from hedge fund lending exposure. This, in turn, could further reduce the capital leverage ration of hedge funds. Presumably, the moral hazard problems after the bailout of Long Term Capital Management and the bank bailout in the aftermath of the credit crisis of 2008-09 (banks had disincentives to monitor their counterparty credit risk exposure with hedge funds if they could rely on taxpayer funded bailouts) would be less likely to occur.

\textsuperscript{230} \textsc{Bank for International Settlements, Basel Committee on Banking Supervision, Consultative Document: Strengthening the Resilience of the Banking Sector (2010), at 15, http://www.bis.org/publ/bcbs164.pdf} (The Committee is introducing a leverage ratio requirement as well as the following proposal: “Going forward, banks must determine their capital requirement for counterparty credit risk using stressed inputs. This will address concerns about capital charges becoming too low during periods of compressed market volatility and help address procyclicality. The approach, which is similar to what has been introduced for market risk will also promote more integrated management of market and counterparty credit risk.”).
Basle III will also likely introduce stricter standards for banks and may disallow the calibration of banks own capital requirements and counterparty credit risk exposure and may curtail banks’ using their own risk measurement tools.

A major constraining factor on effective supervision is the complex trading-, investing- and corporate structure of active international hedge funds. Because of these complex structures, both of Hedge Funds and financial intermediaries, most regulatory authorities base their judgment of hedge fund generated market risks on somewhat inadequate information. However, hedge fund trading strategies are mostly based on the interpretation of certain market environments and require a level of confidentiality. Their profitability may be directly correlated with the level of confidentiality. If other market participants trade along or are enabled to anticipate certain transactions by a hedge fund due to required disclosures, the respective hedge fund may not be able to fulfill its mandate of maximizing shareholder’s value as its absolute returns may be negatively affected.

Indirect hedge fund regulation via a capital charge for a bank’s exposure to hedge funds in Basel III could minimize information asymmetries while enabling hedge funds to remain exempt from disclosure and transparency requirements. Only banks that subscribe to Basel III would be required to reveal such information.

- What approach should be taken to regulatory reorganization?
  - Regulatory overhaul undertaken in rapid response to crisis should be sunsetted231
    - Require legislature to revisit authorization of any new agency or consolidated agency in 4-5 years, and vote to maintain its existence
    - Minimizes risk of unintended consequences from acting with very limited information (definition of crisis environment), when inaction not acceptable politically.
    - Forces evaluation when will have better understanding of causes of crisis and hence of appropriate solutions.

231 See Romano, supra note __. Comment on Financial Market Regulation: Banking Regulation, Corporate Governance, Financial Reporting Standards and Hedge Funds, 3rd International Conference on Law and Economics of Global Institutions at the University of St. Gallen, (on file with author).
V. Conclusion

• Moral Hazard
  – 1990 LTCM bailout
• Most reports emphasize systemic risk, transparency and leverage
• Resulting emphasis on CCRM
  – 2009 Bank bailouts
• Adverse effect on CCRM / disincentive to monitor hedge fund risk exposure
• Undermines indirect regulation of hedge funds
• Systemic Risk
  – Hedge funds may disrupt banks from providing financial markets with credit
  – Common exposure to market risk factors impacts markets
• Externalities
  – Externalities if each institution manages its own hedge fund generated systemic risk
  – Free-rider problem of CCRM creates externalities
• Basel III capital requirements for banks could include a charge for the particular bank’s lending exposure to hedge funds
• Basel III capital requirements for banks could introduce a charge for a bank’s assets based on its systemic risk contribution.
  – Measuring the systemic risk contribution could include a measure for hedge fund lending exposure.