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From Systemic Risk to Financial Scandals: The Shortcomings of U.S. Hedge Fund Regulation

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FROM SYSTEMIC RISK TO FINANCIAL SCANDALS: THE SHORTCOMINGS OF U.S. HEDGE FUND REGULATION

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ABSTRACT

In the recent past, hedge funds have demonstrated that they can pose and spread systemic risk across the financial markets, and that their managers can use them to commit fraud and misappropriation of fund assets. Even if the first issue now seems to be considered a serious one by the U.S. legislature, which in 2010, as a legislative response to the global financial crisis of 2007-2008, enacted the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (Dodd-Frank), the current regulation still appears inconsistent and inappropriate to prevent and face it. By contrast, the second issue is not always considered as a real priority, since the only investors who are allowed to invest in hedge funds are sophisticated, wealthy, and/or institutional—namely, investors who do not need to be protected by regulation. However, this argument cannot be shared in light of the number of scandals that recently involved hedge funds damaging their investors, regardless of their level of sophistication and wealth. Although Dodd-Frank includes among its legislative purposes the protection of consumers from abusive financial services practices, its new provisions do not seem to be able to achieve this result.

This Article argues that the current rules are not appropriate, or at least are not enough, to address the problems that hedge funds can cause to investors and markets. This Article therefore proposes to consider the possibility of introducing new rules that can help prevent and counteract these issues; namely, self-set limits on the use of leverage, the mandatory involvement of a depositary-custodian with the task of controlling the adviser's activities, and the mandatory involvement of an external independent valuer with the task of evaluating the fund's assets on a periodic basis. Even though the application of these rules could be costly for the industry, this cost is reasonably motivated by very important legislative aims, such as investor protection and systemic risk prevention and counteraction.

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INTRODUCTION

Hedge funds have demonstrated the capability to create two main different kinds of issues. On one hand, they can pose and spread systemic risk across the financial markets, and on the other hand, their managers can use them to commit fraud and misappropriation of the fund's assets, which, in turn, can cause serious damages to the investors. Regarding the first issue, while some deny that a single hedge fund can have an impact on the market in terms of systemic risk[1] because they are usually not systemically important from the size point of view,[2] it seems that the majority of commentators now agree on their potential capability to pose and spread these types of risks.[3] Accordingly, evidence of the fact that they can generate systemic risks, even when they are not themselves systemically relevant, can be easily found by looking back at the quasi-failure of Long Term Capital Management (LTCM),[4] as well as at other significant

1. *See* Emily Kehoe, *Hedge Fund "Regulation" for Systemic Risk: Largely Impossible*, 14 J. BUS. & SEC. L. 35, 35 (2013) (noting that single "individual hedge funds may present little or no threat to the global economy"); *see also* Cecilia C. Lee, *Reframing Complexity: Hedge Fund Policy Paradigm for the Way Forward*, 9 BROOK. J. CORP. FIN. & COM. L. 478, 502 (2015) ("[E]ven if individual hedge funds are unlikely to pose systemic risks, continuous monitoring of the industry on the collective effects of their investment strategies and positions, along with their interconnectedness to the overall global markets, is necessary to safeguard financial stability.").

2. For an opposite point of view, see Anne Rivière, *The Future of Hedge Fund Regulation: A Comparative Approach United States, United Kingdom, France, Italy and Germany*, 10 RICH. J. GLOBAL L. & BUS. 263, 265 (2011) ("The size and complexity of hedge funds may make some of them systemically significant and likely to provoke chain reactions that could lead to a generalized collapse of financial markets.").

3. *See* Anita K. Krug, *Rethinking U.S. Investment Adviser Regulation*, 87 ST. JOHN'S L. REV. 451 (2013) (noting that, due to the huge amount of assets invested in hedge funds and their tendency to invest in risky activities, such as credit default swaps, these vehicles can contribute to the generation of systemic risks); Hossein Nabilou & Alessio M. Pacces, *The Hedge Fund Regulation Dilemma: Direct vs Indirect Regulation*, 6 WM. & MARY BUS. L. REV. 183, 188 (2015) (The authors argue that even though hedge funds can bring some benefits, they can also pose risks to financial systems and contribute to financial instability. This is mainly due to their size and leverage, but also their interlinkages with large complex financial institutions, so-called Large Complex Financial Institutions (LCFIs)); Wulf A. Kaal, *Hedge Fund Manager Registration Under the Dodd-Frank Act*, 50 SAN DIEGO L. REV. 243, 247–48 (2013) (pointing out that some studies suggest that hedge funds can destabilize the financial markets); Jón Daníelsson & Jean-Pierre Zigrand, *Regulating Hedge Funds*, FIN. STABILITY REV., Apr. 2007, at 29, 30 ("Hedge funds do . . . contribute to systemic risk whereby the failure of a systemically important hedge fund has the potential to create sufficient uncertainty in the markets for liquidity to dry up and for trading to cease with potentially costly consequences."); JOHN KAMBHU ET AL., HEDGE FUNDS, FINANCIAL INTERMEDIATION, AND SYSTEMIC RISK 11–12 (2007) ("If systemic risk is fundamentally about financial markets linkages to the real economy, then hedge funds create systemic risk to the extent that they can disrupt the ability of financial intermediaries or financial markets to efficiently provide credit.").

4. As an example, consider what happened to LTCM in 1998. *See* Luther R. Ashworth II, *Is Hedge Fund Adviser Registration Necessary To Accomplish the Goals of the Dodd-Frank Act's Title IV?*, 70 WASH. & LEE L. REV. 651, 669–71 (2013) ("A group of highly reputable traders formed LTCM in 1994. The fund had starting equity of $1.3 billion ($100 million of which was contributed by the general partners) and required outside investors to invest at least $10 million. At LTCM's peak, in 1997, the fund grew to larger than $7 billion after the fund made returns of

collapses.[5] Currently, the systemic risk issue seems to be considered a serious one by the U.S. legislature itself, which in 2010, as a legislative response to the global financial crisis of 2007-2008, enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank

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19.9% in 1994, 42.8% in 1995, 40.8% in 1996, and 17.1% in 1997. LTCM typically used an investment strategy that held long positions in bonds that it considered undervalued and short positions in bonds that it considered overvalued. Based on the yield spread between its positions in high and low risk bonds, LTCM would essentially bet on the spread to widen or narrow using derivatives contracts. In early 1998, LTCM became convinced, for a number of reasons, the yield spread between its high and low risk bonds was too wide; thus, LTCM bet on the yield spread to narrow. LTCM borrowed $125 billion from banks (on top of the fund's then $4.8 billion AUM) and increased its leverage ratio (debt-to-equity ratio) to more than 20-to-1. This leverage ratio, which is extraordinarily large for any hedge fund, would magnify gains or losses depending on the widening or narrowing of LTCM's yield spread. Later that year, a number of circumstances instilled fear in global bond investors and there was a 'stampede to quality' bonds. Thus, LTCM's yield spread widened (instead of narrowed) and the fund's failed bet was exposed. In September 1998, the Federal Reserve Bank of New York became worried about LTCM's creditors (including banks and securities firms) that would suffer losses as a result of LTCM's collapse. A creditor consortium, including the government, decided that the collapse of LTCM posed 'systemic risk' (due to the number of overexposed parties and the amount of money involved) and agreed to a bailout of over $3.6 billion. Systemic risk is defined as the risk that 'an economic shock such as a market or institutional failure triggers (through panic or otherwise) either the failure of a chain of markets or institutions or a chain of significant losses to financial institutions, resulting in increases in the cost of capital or decreases in its availability.' Systemic risk can be paralleled to a domino effect in which a trigger event (here LTCM's collapse) 'causes a chain of bad economic consequences' that have the potential to bring down other financial institutions and overall markets. LTCM's collapse was the first event that clearly demonstrated hedge funds could have systemic risk consequences. The magnitude of LTCM's exposure to other market participants showed that a massive hedge fund's failure could have devastating effects on the overall market."); *see also* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 681–82 (2000) ("The enormous size of the LTCM hedge fund placed its trading counterparties and creditors in a position to lose substantial amounts because they had extended excessive credit to LTCM, either through trading counterparty or lending relationships. Since LTCM's creditors and counterparties had allowed LTCM to build up dangerous levels of leverage, they faced the real possibility that LTCM would default on the credit obligations it owed them. To protect themselves from an LTCM default, some of the fund's creditors and counterparties created a consortium, which injected $3.6 billion in equity into LTCM in return for receiving ninety-percent equity stake in the fund. Banking regulators assisted LTCM creditors and counterparties in creating the consortium because they feared that LTCM's losses could cause financial shock to the markets if LTCM's seventy-five counterparties sought to liquidate their positions simultaneously in response to an LTCM default.").

5. *See* Kaal, *supra* note 3, at 245–46. ("Several spectacular hedge fund failures seemed to confirm that the failure of systematically important hedge funds could have the potential to create such uncertainty as to impede trading, and in a worst case scenario, could cause damage to the real economy.").

Act),[6] mainly to promote the financial stability of the United States and its markets.[7]

The second issue is not always considered a real priority on the basis of the assumption that the only investors who are allowed to invest in hedge funds are sophisticated, wealthy, and/or institutional;[8] namely investors who do not need to be protected by regulation.[9] In other words, the fact that these investors are sophisticated, wealthy, and/or institutional would itself mean that they are able to fend for themselves, and therefore there would be no need to enhance regulation and supervision.[10] This argument can be criticized, though, in light of the number of scandals that in the recent past

6. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 5, 11, and 15 U.S.C.). The Dodd-Frank Act, an abbreviated reference for the 'Dodd-Frank Wall Street Reform and Consumer Protection Act,' was signed into law on July 21, 2010. The part of the Act dealing with the hedge fund industry is Title IV entitled the 'Private Fund Investment Advisers Registration Act 2010' (PFIARA). *Id.* §§ 401–02.

7. More precisely, the goals that the Dodd-Frank Act declares to pursue are: "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices" and others. *Id.* § 401; Krug, *supra* note 3, at 451.

8. The fact that just these kinds of investors are allowed to invest in hedge funds is the legal effect arising from the application of a number of exemptions and exceptions promulgated in the main U.S. securities law acts which these vehicles usually enjoy in order to avoid strict regulation and supervision.

9. This is the position of many commentators. *See, e.g.*, Carl J. Nelson, *Hedge Fund Regulation: A Proposal to Maintain Hedge Funds' Effectiveness Without SEC Regulation*, 2 BROOK. J. CORP. FIN. & COM. L. 221, 222, 229 (2007) ("Hedge fund investors can adequately protect themselves since they are generally sophisticated investors" and additionally, "investor protection does not justify increased hedge fund regulation because hedge fund investors are a small, elite segment of the investing public."); Gibson, *supra* note 4, at 713–4 ("A review of existing federal regulation suggests that hedge fund regulation to protect investors is not necessary. Hedge funds typically limit their solicitation to institutional investors and persons with substantial net worth. Both of these groups are less in need of the regulatory protection provided by SEC and CFTC than the general investing public. Therefore, investor protection is not necessary to the extent that hedge funds are trading in securities or commodities . . . . [M]oreover, hedge fund investors can use the judicial forum to obtain legal redress for abusive or fraudulent practices perpetrated against them in connection with hedge fund trading activity. Hedge fund investors may also bring a private right of action against parties that have violated the federal securities laws in connection with hedge fund trading. Hedge fund investors are also protected by the antifraud provisions found within the securities and commodities laws. Moreover, hedge fund managers that are CPOs, while possibly exempt from certain ongoing compliance obligations under the CEA, remain subject to the broad anti fraud provisions found within the Act. All of these anti fraud provisions provide hedge fund investors with sufficient protection against fraudulent practices of hedge fund managers, obviating the need for federal regulation."); *see* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style and Mission*, 2006 U. ILL. L. REV. 975, 976 (2006) (arguing for default rather than mandatory rules for hedge funds); Kaal, *supra* note 3, at 244 (noting that "[h]edge funds' ability to invest in global markets without supervision and significant disclosure obligations was important for successful hedge fund launches, helped generate higher returns, and attracted investors").

10. However, it is worth noting that among the goals that the Dodd-Frank Act declares to pursue there is also the protection of the consumers from abusive financial services practices.

have involved hedge funds damaging their investors.[11] Additionally, due to a phenomenon called "retailization,"[12] today even investors who are neither particularly sophisticated nor very wealthy can potentially invest in hedge funds. These elements seem to be able to prove that an investor protection issue exists and, as such, it should be taken into consideration by the U.S. legislature. Although Dodd-Frank includes among its legislative purposes the protection of consumers from abusive financial services practices,[13] its new provisions—which will be deeply analyzed in the following sections—do not seem to be able to achieve this result.

This Article analyzes the rationale behind the new rules governing the U.S. hedge fund industry—as amended with the adoption of the 2010 Dodd-Frank Act—and argues that the current regulation is inconsistent and inappropriate to prevent and face the two main issues posed by these particular financial players, namely the creation and spread of systemic risk as well as the commission of fraud. Therefore, this Article proposes the introduction of new rules, such as limits on the use of leverage, the mandatory involvement of a depositary-custodian with the tasks of safekeeping the fund's assets and also overseeing the adviser's activities, and the mandatory involvement of an external independent valuer with the task of evaluating the fund's assets on a periodic basis. In fact, it is likely that such rules could help address and counteract the issues generated by the activities of these financial entities.

II. GENERAL OVERVIEW

For a long time, before the global financial crisis of 2007-2008, there was a vigorous debate surrounding the appropriateness of enhancing the

11. *See* SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter GROWTH OF HEDGE FUNDS]; *accord* Roberta S. Karmel, *Iosco's Response to the Financial Crisis*, 37 J. CORP. L. 849, 862–63 (2012) ("[A]buses and insolvencies by some hedge funds have demonstrated that investor protection is an issue."); *see also* Kaal, *supra* note 3, at 244; George Sami, *A Comparative Analysis of Hedge Fund Regulation in the United States and Europe*, 29 NW. J. INT'L L. & BUS. 275, 279 (2009); Paul M. Jonna, *In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation*, 45 SAN DIEGO L. REV. 989, 1008 (2008).

12. It is a process that makes hedge fund interests available even to unsophisticated and small investors. *See* Jonna, *supra* note 11, at 1007–08; Kaal, *supra* note 3, at 260; Thierry O. Desmet, *Understanding Hedge Fund Adviser Regulation*, 4 HASTINGS BUS. L.J. 1, 8–9 (2008) (explaining that due to this phenomenon called retailization, even less affluent investors have started to participate in hedge funds); Matthew Lewis, *A Transatlantic Dilemma: A Comparative Review of American and British Hedge Fund Regulation*, 22 EMORY INT'L L. REV. 347, 363 (2008) ("[T]he retailization of hedge funds unduly exposes unqualified investors to the risks hedge funds pose, through ineffective minimum investor requirements and increased participation by mainstream investment vehicles like pension funds.").

13. Among its legislative aims there is also "to protect consumers from abusive financial services practices." Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 5, 11, and 15 U.S.C.).

regulation and supervision of hedge funds and hedge fund managers.[14] However, despite some attempts made by the Securities and Exchange Commission (SEC)[15] up until the crisis, the U.S. hedge fund industry benefited from a substantial lack of regulation and supervision. This has been considered one of the reasons for the industry's success in terms of growth of the number of funds, the amount of assets under management,[16] and financial performance.[17] However, this has also been one of the reasons

14. *See* Nelson, *supra* note 9, at 221–22; Desmet, *supra* note 12, at 1; Jonna, *supra* note 11, at 991; Sami, *supra* note 11, at 275; Lewis, *supra* note 12, at 347; David Schneider, *If at First You Don't Succeed: Why the SEC Should Try and Try Again to Regulate Hedge Fund Advisers*, 9 J. BUS. & SEC. L. 261, 263 (2009); Gibson, *supra* note 4, at 681.

15. *See* Harvey Bines & Steve Thel, *The Varieties of Investment Management Law*, 21 FORDHAM J. CORP. & FIN. L. 153–54 (2016) (underscoring that the SEC in July 2004 proposed rule 203(b)(3)-2 to require hedge fund advisers with more than fifteen funds to register under the Investment Adviser Act of 1940. "The SEC cited three factors that caused the majority to be concerned with hedge fund advisers: (1) the growth in the number and size of hedge funds; (2) incidents of hedge fund advisers engaging in fraudulent activity, including exaggerated performance claims, payment of inappropriate commissions, and misappropriation of investor assets; and (3) the retailization of hedge funds, with smaller investors, pensioners, and other market participants directly or indirectly investing in hedge funds. The rule proposed that each owner of a private fund (that is, a fund that would have to register as an investment company but for the exemptions provided by Sections 3(c)(1) and 3(c)(7) of the Investment Company Act) that permits owners to redeem part of their investments within two years of purchase and that offers interests based on the expertise of the adviser be counted as a separate client for purposes of deciding whether the adviser has to register. The redemption provision of the definition of private funds was designed to exclude private equity funds from the registration requirement. The dissenters questioned the majority's premises, and encouraged those to be affected to submit comments to the SEC. The response was heavy, but the SEC, with the same division, adopted Rule 203(b)(3)-2, requiring advisers to most hedge funds to register by Feb. 1, 2006. The effect of the rule was not only to require registration, but also to require the newly registered advisers to adopt compliance provisions and subject them to SEC examination and other provisions of the Advisers Act. An advisory firm and the hedge fund it managed challenged the new rule before the Court of Appeals for the District of Columbia Circuit, which vacated the rule in *Goldstein v. SEC*. Although the court noted the substantive criticism of the rule made by the dissenting commissioners, its opinion focused on the language of the Advisers Act, particularly on the word 'client' in Section 203(b)(3), which, at the time, exempted advisers which had fewer than 15 clients during the course of the preceding 12 months. The Commission took the position that each investor in a hedge fund was a client of the fund's adviser. The court rejected this position as unreasonable or even arbitrary. On the basis of a far-ranging discussion of the use of the word 'client' in the securities laws and in commerce generally, the court concluded that a hedge fund adviser's only client is the fund, and not those who invest in the fund. Accordingly, the court concluded, the Commission could not deprive a hedge fund adviser of the exemption of Section 203(b)(3).").

16. *See* Kaal, *supra* note 3, at 244 (emphasizing that hedge funds' ability to invest in global markets without supervision and significant disclosure obligations was important for their success. From the opposite perspective, in fact, regulatory oversight could make it more difficult for such funds to generate absolute returns and therefore to attract investors); *see also* Kehoe, *supra* note 1, at 35–36 (noting that the use of leverage and the freedom to diversify the composition of their portfolios allow them to perform risky but potentially remunerative strategies; the author also observes that their success depends on factors that have the potential to create systemic risks).

17. *See* Kehoe, *supra* note 1, at 37 ("It is the flexibility of hedge funds, only possible because of a lack of regulation, which contributes to their financial prowess."); *see also* Scott V. Wagner, *Hedge Funds: The Final Frontier of Securities Regulation and a Last Hope for Economic Revival*,

for the high number of failures and scandals affecting the markets and investors.

Even if hedge funds were not deemed to be the cause of the global financial crisis of 2007-2008,[18] the U.S. legislature, as well as many other legislatures and financial regulators over the world,[19] have been concerned about their potential to pose and spread systemic risk across the markets.[20] This is due to their involvement in many different types of complex and risky transactions, performed with many different types of counterparties across many different jurisdictions.[21] The significant level of leverage

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6 J.L. ECON. & POL'Y 1, 7 (2009) ("The lack of regulation has been paramount to the hedge fund's success.").

18. *See* Andrew W. Lo, *Regulatory Reform in the Wake of the Financial Crisis of 2007-2008*, 1 J. FIN. ECON. POL'Y 4, 16 (2009) ("While the shadow banking system has no doubt contributed to systemic risk in the financial industry, hedge funds have played only a minor role in the current financial crisis, as evidenced by the lack of attention they have received in the government's recent bailout efforts."); Jim Buller & Nicole Lindstrom, *Hedging its Bets: The U.K. and the Politics of European Financial Services Regulation*, 18 NEW POL. ECON. 391, 392 (2013) ("It is widely accepted that banking sector, not the alternative investment industry, was primarily responsible for the global financial crisis."); *see also* Desmet, *supra* note 12, at 1.

19. *See* European Comm'n, Statement at the Occasion of the European Parliament Vote on the Directive on Hedge Funds and Private Equity (Nov. 11, 2010) (where it is possible to read the opinion of the President of the European Commission, who emphasized that "the adoption of the directive means that hedge funds and private equity will no longer operate in a regulatory void outside the scope of supervisors. The new regime brings transparency and security to the way these funds are managed and operate, which adds to the overall stability of our financial system. After important decisions on a new European supervisory architecture earlier this autumn, today's directive—which coincides with the G20 Summit meeting in Seoul—is another example of how the EU is leading the way in implementing our G20 commitments."). In 2011, the European Union adopted the Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011, the so-called Alternative Investment Fund Managers Directive (AIFMD), in order to enhance the regulation applied mainly to hedge fund managers. Recital (1) of the AIFMD states that "managers of alternative investment funds (AIFMs) are responsible for the management of a significant amount of invested assets in the Union, account for significant amounts of trading in markets for financial instruments, and can exercise an important influence on markets and companies in which they invest." Recital (2) of the AIFMD adds that "the impact of AIFMs on the markets in which they operate is largely beneficial, but recent financial difficulties have underlined how the activities of AIFMs may also serve to spread or amplify risks through the financial system. Uncoordinated national responses make the efficient management of those risks difficult." Recital (3) of the AIFMD emphasizes that "recent difficulties in financial markets have underlined that many AIFM strategies are vulnerable to some or several important risks in relation to investors, other market participants and markets." *See* Marco Bodellini, *The European Union Regulation on Marketing of Alternative Investment Funds: Another Step Towards Integration of the European Union Financial Market*, 37 BUS. L. REV. 208 (2016); Marco Bodellini, *The Marketing of Hedge Funds in the United Kingdom: Did the System Maintain its Attractiveness After the Transposition of the Alternative Investment Fund Managers Directive?*, 37 BUS. L. REV. 162 (2016).

20. The failure of two Bear Sterns hedge funds in 2007 is conventionally considered the beginning of the global financial crisis of 2007-2008. *See* Lee, *supra* note 1, at 490 ("The failure of two hedge funds sponsored by Bear Sterns in July 2007 sounded the first alarm of trouble. The subsequent run on Bear Sterns in March 2008 also involved its hedge fund customers and derivative counterparties.").

21. This is the position, among others, of Anne Rivière. *See* Rivière *supra* note 2, at 265 (pointing out that systemic risk is the risk of chain reactions of failures due to the deep

characterizing many such funds before the crisis[22] and the sector's large size and growth further increased this concern.[23] Additionally, some scandals involving hedge funds in the recent past had clearly shown that they could be used as a means to defraud the investors.[24]

Therefore, due primarily to the global financial crisis,[25] and to the aforementioned financial scandals,[26] the U.S. legislature decided to enhance the regulation and supervision of hedge fund managers by passing Dodd-Frank in 2010.[27]

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interconnections among different markets. Some hedge funds, nowadays, are large enough to potentially pose systemic risks); Dan Awrey, *The Limits of EU Hedge Fund Regulation*, 5 L. & FIN. MKTS. REV. 119 (2011) (emphasizing that the financial crisis of 2007-2009 had increased the idea that it was necessary to rethink the regulatory framework of the financial markets and institutions); *see also* Dirk A. Zetzsche, *Introduction: Overview, Regulatory History and Technique, Transition*, *in* THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE 3 (Dirk A. Zetzsche ed., 2012) (underscoring that the G20 decided to subject all participants in the financial markets to regulation).

22. Kaal, *supra* note 3, at 246 (underscoring that concerns regarding the excessive use of leverage by hedge funds led to increasing demands for enhancing the regulation); Maria Strömqvist, *Hedge Funds and Financial Crises*, 1 ECON. REV. 87, 89–90 (2009) ("The high degree of leverage entails risks for the counterparties of the hedge funds (for example the lenders) and the failure of a fund may therefore have contagion effects in the financial system."); Barbara Crutchfield George & Lynn V. Dymally, *The End of An Era of Limited Oversight: The Restructured Regulatory Landscape of Private Investment Funds Through the U.S. Dodd-Frank Act and the E.U. Alternative Investment Fund Managers Directive*, 25 FLA. J. INT'L L. 207 (2013).

23. *See* FIN. STABILITY OVERSIGHT COUNCIL, UPDATE ON REVIEW OF ASSET MANAGEMENT PRODUCTS AND ACTIVITIES (2016), https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf [hereinafter FSOC UPDATE] ("As of December 2014, U.S. pooled investment vehicles (excluding money market mutual funds) had approximately $25.8 trillion of assets. Mutual funds accounted for the largest share, with $13.1 trillion of assets, or fifty one percent of the total. Hedge funds accounted for the second largest share, with $3.4 trillion, or thirteen percent of total assets."); *see also* SEC. & EXCH. COMM'N, DIV. OF INV. MGMT, RISK & EXAMINATIONS OFFICE, PRIVATE FUND STATISTICS, FOURTH CALENDAR QUARTER 2014 5 (2015), https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2014-q4.pdf; *see also* Lee, *supra* note 1, at 486 ("[G]lobal hedge fund capital experienced 'the highest calendar year of inflows since 2007' to reach a record of $2.85 trillion at the end of 2014.").

24. *See* GROWTH OF HEDGE FUNDS, *supra* note 11, at 2–3; *accord* Karmel, *supra* note 11, at 862–63 ("[A]buses and insolvencies by some hedge funds have demonstrated that investor protection is an issue."); *see also* Kaal, *supra* note 3, at 260; Sami, *supra* note 11, at 275–76; Jonna, *supra* note 11, at 992–94.

25. *See* Joshua C. Dawson & Paul J. Foley, *Square Pegs Don't Fit in Round Holes: The Impact of the Dodd-Frank Act's Elimination of the Private Fund Exemption On Private Equity Fund Advisers*, 9 LIBERTY U. L. REV. 445, 466 (2015) ("The Dodd-Frank Act was a reaction to a major financial crisis.").

26. *See* GROWTH OF HEDGE FUNDS, *supra* note 11, at 2–3; *accord* Karmel, *supra* note 11, at 862–63; *see also* Kaal, *supra* note 3, at 260; Sami, *supra* note 11, at 275–76; Jonna, *supra* note 11, at 992–94.

27. It is worth noting that even before the crisis, the debate concerning hedge fund regulation and supervision was rather animated. Some huge collapses that occurred in the U.S. between the end of the 1990s (LTCM) and the beginning of the 2000s (Amaranth) enhanced the idea of the need for more regulation and supervision in this specific sector of the financial industry. For this reason, the SEC in the past tried to introduce rules imposing the mandatory registration of the hedge fund advisers. *See* Schneider, *supra* note 14, at 279–82 ("The 2003 SEC Staff Report

III. DEFINING HEDGE FUNDS

Before analyzing the regulation, it is worth understanding what hedge funds are from a financial point of view, given that many different collective investment undertakings, using diverse financial strategies, are considered in practice to be hedge funds. From a historical point of view, many agree that Alfred Winslow Jones established the first hedge fund in 1949.[28] The financial innovation introduced by Jones was to combine long positions with short positions in order to hedge against the market's movements.[29] The hedging resulted from the fact that a long position appreciates when the value of the held security rises, while a short position

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investigated the hedge funds industry and recommended that the SEC require hedge fund advisers to register under the Advisers Act. Despite a litany of public policy reasons, the SEC's statutory hook was the legislative history behind the private adviser exemption. The purpose of the private adviser exemption was to exempt advisers with a small number of clients because they posed little or no risk to national markets. The crafters of the private adviser exemption determined that investment advisers with fourteen clients or less had such a de minimis effect on national markets that it was unnecessary for the SEC to regulate them. The SEC, however, concluded that many hedge funds were using the private adviser exemption in contradiction of the exemption's intended purpose. Because hedge funds were rapidly growing in number and size, increasingly engaging in fraudulent acts, and offering their products directly or indirectly to a broader group of less sophisticated investors, the SEC decided that the hedge fund industry's potentially adverse implications on markets and investors justified a change of the interpretation of the term 'client.' In a 3-2 decision, the SEC Commissioners adopted the 2004 Hedge Fund Rule. The 2004 Hedge Fund Rule defined each owner of a private fund as a 'client' for purposes of determining whether the adviser satisfied the private adviser exemption. A private fund is defined as a company: (i) That would be an investment company under section 3(a) of the Investment Company Act of 1940, but for the exception provided from that definition by either section 3(c)(1) or section 3(c)(7) of such Act; (ii) That permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and (iii) Interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser. Because most hedge funds satisfy the definition of a private fund, the 2004 Hedge Fund Rule applied a 'look-through' to hedge funds. In contrast to the 1985 Safe Harbor Rule, which counted each fund as one client, the 2004 Hedge Fund Rule counted each investor as one client. Thus, many hedge funds advisers no longer satisfied the private adviser exemption under the Advisers Act and were required to register with the SEC. In 2005, Philip Goldstein, a co-owner of the investment advisory firm Kimball & Winthrop, challenged the enforceability of the 2004 Hedge Fund Rule. Goldstein argued that Congress unambiguously intended the term 'client' to mean the fund, and not the investors in the fund. Furthermore, even if the term 'client' was ambiguous, the SEC's definition was not reasonable because the SEC drastically exceeded the term's 'probability of meaning' and the SEC's adoption of the rule was arbitrary and capricious. The SEC responded that it was within its regulatory powers to apply a 'look-through' in the case of private funds. The SEC argued that the Advisers Act's use of the term 'client' was ambiguous and the SEC's interpretation was reasonable because it was 'consistent with the objectives of the Act, [and] it needed to close a loophole that had arisen due to changed circumstances since the safe harbor was adopted in 1985.' On June 23, 2006, the D.C. Circuit Court ruled in favor of Goldstein.").

28. *See* Nelson, *supra* note 9, at 223; Jonna, *supra* note 11, at 1008 ("Alfred Winslow Jones is credited as the first investor to start a hedge fund. Jones held short and long positions in stocks and sought to insulate himself against market fluctuation."); *see also* Lewis, *supra* note 12, at 360 ("Alfred Winslow Jones, the father of the hedge fund industry, founded the first true hedge fund in 1949.").

29. *See* Jonna, *supra* note 11, at 1008.

appreciates when the underlying security's value falls.[30] The combination of both of these positions in the same portfolio allows the investor to reduce the risk of losses.[31] Due to the great performance of the Jones fund, the concept of a "hedge fund" became increasingly popular.[32]

It is rather difficult to provide a precise definition of the term "hedge fund,"[33] as this expression comes from the financial industry and is used to refer to a broad variety of pooled investment vehicles performing many different financial strategies. It follows that there is no universal definition of a hedge fund.[34] Nevertheless, it is also true that there are some common features that can be taken into consideration to distinguish hedge funds from other types of collective investment undertakings. These common features have been used by international organizations to create "catch-all" definitions. For example, the International Organization of Securities Commissions (IOSCO) developed identification guidelines for hedge funds to cover funds that (1) are considered hedge funds under local law; (2) declare themselves to be one; or (3) display a combination of some of the following characteristics: (i) use of leverage; (ii) performance fees based on unrealized gains; (iii) complex strategies, which may include the use of derivatives, short selling, high frequency trading, and/or the search for absolute returns; and (iv) a tendency to invest in financial rather than physical assets.[35]

Usually, hedge funds are privately organized vehicles[36] that are administered and managed by professional investment managers; their interests are sold to wealthy and sophisticated investors, as well as to institutional investors.[37] This also means that they are usually not directly addressed to retail investors. As a legal effect, they are typically not publicly traded and therefore their interests are rather illiquid and quite difficult to value. Given that these are financial products offered to sophisticated, wealthy, and/or institutional investors, hedge fund managers usually require a high initial minimum investment and they often also fix a so-called lock-up period, during which the participants are not allowed to withdraw the money they have invested. This legal mechanism plays an

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30. Usually, short positions are obtained by short selling stocks.

31. *See* Jonna, *supra* note 11, at 1008.

32. *See* Ashworth, *supra* note 4, at 656–57.

33. *See* Schneider, *supra* note 14, at 264 (using the expression "defining the indefinable").

34. *See* Lee, *supra* note 1, at 484.

35. INT'L ORG. SEC. COMM'NS, REPORT ON THE SECOND IOSCO HEDGE FUND SURVEY (2013), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD427.pdf; *see also* INT'L ORG. SEC. COMM'NS, HEDGE FUNDS OVERSIGHT: FINAL REPORT (2009), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf [hereinafter FINAL IOSCO REPORT]; Karmel, *supra* note 11, at 851.

36. *See* Kehoe, *supra* note 1, at 38 (emphasizing that typically the fund is just one or two accounts, with no employees or corporate personnel).

37. *See* Rivière, *supra* note 2, at 266–67.

important role in allowing the managers to take long-term positions and invest in illiquid assets that sometimes can provide higher returns.[38]

The typical assets in which hedge funds invest are securities, including shares, bonds, and derivatives, and other illiquid assets, such as commodities and properties.[39] Some hedge funds are supposed to be particularly risky as they invest a significant amount of money in highly speculative financial products, such as collateralized debt obligations, credit default swaps,[40] and short sell securities—namely they sell securities that they do not own.[41] Often, even if not always, hedge funds are also characterized by a relevant level of debt that is used by their managers to increase certain investment positions with the intention of amplifying gains.[42] It is also commonly said that hedge funds are rather secretive and opaque financial players, as information about them is typically quite scarce.[43]

Furthermore, hedge fund investment strategies can vary significantly case by case; however, generally their managers seek to achieve absolute return, namely to gain profits regardless of the financial markets' performance. In fact, their goal is to generate so-called "alpha"—that is, the excess return of the fund compared to a benchmark index.[44] Therefore, the alpha shows by how much a fund outperforms the markets, which can serve as a measurement of the managerial skills.[45] Similarly, the remuneration structure is usually built in the same way. Typically, the managers receive a 1-2% fee calculated on the assets under management—a management fee—and used to cover the fund's operating costs, and a 15-25% fee calculated on the profits made in a given year—a performance fee.[46] Some of these elements, mainly the high level of leverage, the tendency to short sell stocks, and the use of derivatives may make the investment in hedge funds

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38. Robert Novy-Marx, *On the Excess Returns to Illiquidity* 1 (Ctr. for Research in Sec. Prices Univ. of Chi. Working Paper 2004).

39. *See* Gibson, *supra* note 4, at 684 ("[H]edge funds invest in a broad array of financial products, including debt and equity securities, futures, options, over-the-counter derivatives, and foreign currencies.").

40. *See* George & Dymally, *supra* note 22, at 212.

41. *See* Nelson, *supra* note 9, at 235 n.127 (explaining that short selling or taking a short position mean "[b]orrowing a security (or commodity futures contract) from a broker and selling it, with the understanding that it must later be bought back (hopefully at a lower price) and returned to the broker").

42. *See* Kehoe *supra* note 1, at 37 (emphasizing that leverage and the possibility to largely diversify portfolio composition are some of the main reasons why hedge funds can outperform mutual funds).

43. *See* Barbara Crutchfield George et al., *The Opaque and Under-Regulated Hedge Fund Industry: Victim or Culprit in the Subprime Mortgage Crisis?*, 5 N.Y.U. J.L. & BUS. 359, 366 (2009) (defining the hedge fund industry as opaque and under-regulated).

44. *See generally* William A. Roach Jr., *Hedge Fund Regulation: "What Side of the Hedges Are You On?*,*"* 40 U. MEM. L. REV. 165 (2009) (arguing that generation of alpha is one of the significant features of hedge funds).

45. *See* Nabilou & Pacces, *supra* note 3, at 186.

46. Rivière, *supra* note 2, at 267.

particularly risky for their investors. Additionally, these elements cause hedge funds to have a potential impact on the financial markets in terms of posing and spreading systemic risk.[47] The layer of opacity and secrecy that typically characterizes these vehicles emphasizes both of these factors.[48] From the opposite perspective, many tend to underscore that hedge funds bring many benefits to the markets, particularly providing liquidity.[49]

Although for a long time a legal or statutory definition of the term "hedge fund" has been lacking,[50] currently, the so-called Form PF[51] defines a hedge fund as "any private fund having any one of these three common characteristics: (1) a performance fee that takes into account market value (instead of only realized gains); (2) high leverage; or (3) short selling."[52] It is worth emphasizing that this legal definition is rather helpful in order to clearly identify these funds and easily distinguish them from other types of collective investment vehicles.

IV. EXEMPTIONS AND EXCEPTIONS ALLOWING HEDGE FUNDS AND HEDGE FUND MANAGERS TO AVOID REGULATION AND SUPERVISION

Typically, U.S. hedge funds are established as limited partnerships or limited liability companies[53] in Delaware,[54] while many hedge fund

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47. *See* Krug, *supra* note 3, at 451 (noting that, due to the hedge fund's tendency to invest in risky activities, such as credit default swaps, these vehicles can help the generation of systemic risks); *see also* Kehoe, *supra* note 1, at 37 (emphasizing that regulators worry that over-leveraged hedge funds can impact the stability of the markets depending on their level of liquidity and market positions).

48. *See* George et al., *supra* note 43, at 363.

49. *See* Schneider, *supra* note 14, at 292–93 (listing the main benefits provided by hedge funds: "First, in contrast to many stocks and bonds, most hedge funds profit when there is less volatility in the market because hedge funds rely on historical price trends and arbitrage spreads. Second, hedge funds contribute to more efficient and more liquid markets because they exploit arbitrage spreads and other market miscalculations. Third, because hedge funds often invest in derivative instruments, hedge funds foster the financial markets' management and transfer of risk. Fourth, hedge funds allow investors to diversify their portfolio based on their appetite for risk"); *see* Rivière, *supra* note 2, at 270 ("Hedge funds bring benefits to the financial markets. Indeed, they are said to increase liquidity and enhance efficiency. For instance, hedge funds help provide efficiencies in pricing of securities in all market conditions thanks to their extensive research and willingness to make investments. Moreover, by providing a counterparty to institutions wishing to hedge their risks, hedge funds often help to disperse risk and lower volatility.").

50. It was commonly said that before the adoption of this reform there was no statutory definition of hedge funds. *See* Nabilou & Pacces, *supra* note 3, at 185.

51. Form PF is the form used by the SEC in order to gather data from investment advisers to assess systemic risk.

52. Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 76 Fed. Reg. 71,128 (Nov. 16, 2011) (to be codified at 17 C.F.R. pts. 275 and 279). Note that such definition is limited to the purposes of Form PF, and also adopted for Form ADV. *Id.* at 71,133 n.63.

53. *See* Lyman Johnson, *Why Register Hedge Fund Advisers – A Comment*, 70 WASH. & LEE L. REV. 713, 715 (2013); Lewis, *supra* note 12, at 351 n.29.

managers reside in New York, New Jersey, and Connecticut.[55] Historically, hedge funds and hedge fund managers in the U.S. have benefited from the various different exemptions and exceptions provided by the securities laws in order to avoid being strictly regulated and supervised.[56] The main securities laws that carry a potential impact on the hedge fund industry are: (1) the Securities Act of 1933;[57] (2) the Securities and Exchange Act of 1934;[58] (3) the Investment Company Act of 1940;[59] and (4) the Investment Advisers Act of 1940.[60]

A. THE SECURITIES ACT OF 1933

The Securities Act of 1933 focuses mainly on the offers and sales of securities made by an issuer to the public for the purpose of raising money.[61] The most relevant aspect of this legislation is the burden for the issuer to file a registration statement with the SEC. This statement is significant as it is potential investors' main source of information regarding

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54. Ashworth, *supra* note 4, at 660 (pointing out that these structures give hedge funds more flexibility in setting the relationships between the manager and the investors and additionally are particularly efficient from the tax point of view; however it is worth noting that many hedge funds are established in offshore jurisdictions such as Cayman Islands or British Virgin Islands, mainly for tax purposes); Johnson, *supra* note 53, at 715–16 ("Whether organized in a state in the United States or under the law of the Cayman Islands, hedge fund vehicles are not stringently regulated under any of these laws. Under U.S. law, moreover, notably Delaware, states have adopted a highly flexible, contractarian approach, allowing the fund sponsor to craft a deal document that contractually specifies investor rights. If it is not set forth in the partnership or operating agreement, investors do not have it, including ongoing access to full information. Moreover, the sponsors themselves can reduce or even eliminate their fiduciary duties, thereby removing even traditional state law safeguards for egregious adviser conduct.").

55. Lewis, *supra* note 12, at 351 n.29 (noting that the fund managers "are mostly based in the United States, with a concentration in New York City and in Greenwich, Connecticut"); Desmet, *supra* note 12, at 5 (noting that in 2005 "[i]n the United States the highest concentration of hedge fund advisers appears to be in Connecticut").

56. Ashworth, *supra* note 4, at 652 ("Hedge funds have avoided direct regulation under federal securities laws for most of their existence."); *see also* George & Dymally, *supra* note 22, at 209; Rivière, *supra* note 2, at 267; Kaitlin Curry Albiez, *Hedge Fund Oversight and Title IV: Less Than Meets the Eye*, 37 SETON HALL LEGIS. J. 145, 151–54 (2012); Sami, *supra* note 11, at 281.

57. *See generally* Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).

58. *See generally* Securities and Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2012)).

59. *See generally* Investment Company Act, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1–80a-64 (2012)).

60. *See generally* Investment Advisors Act, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1–80b-21 (2012)); *see also* Cary Martin, *One Step Forward for Hedge Fund Investors: The Removal of the Solicitation Ban and the Challenges That Lie Ahead,* 16 U. PA. J. BUS. L. 1143, 1150 (2014); Schneider, *supra* note 14, at 272; Gibson, *supra* note 4, at 688; Ashworth, *supra* note 4, at 662; Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 49, 60–61, 63–64 (2012); George & Dymally, *supra* note 22, at 219–20; Rivière, *supra* note 2, at 272–78; Albiez, *supra* note 56, at 150; Sami, *supra* note 11, at 282–86; Lewis, *supra* note 12, at 351–52.

61. *See* Schneider, *supra* note 14, at 272.

the issuer's business, properties, material legal proceedings, directors and officers, ownership, and financials. This legal obligation has to be fulfilled every time an issuer publicly offers securities. Usually, hedge fund interests are considered securities under the Securities Act,[62] because securities are broadly defined as notes, stocks, treasury stocks, futures, bonds, debentures, investment contracts, and many other financial instruments.[63] The catchall category of investment contracts qualifies hedge fund interests as a security, due to the Supreme Court's interpretation of "investment contract" as "an investment in a common venture premised on a reasonable expectation of profits to be derived from entrepreneurial or managerial efforts of others."[64]

However, Section 4 of the Securities Act also provides a number of exempted transactions, namely transactions where the issuer is not required to file a registration statement with the SEC. Typically, hedge funds benefit from the exemption laid down in Section 4(a)(2) of the Securities Act regarding "transactions by an issuer not involving any public offering," and called the "private offering exemption." The Securities Act does not define the concept of "public offering." To provide more clarity on the matter, the SEC issued the so-called Regulation D; here, the SEC added further details to clarify when a transaction is not a public offering. Rule 506 of Regulation D states that offerings of interests that are only addressed to purchasers who qualify as "accredited investors"[65] are exempt. This

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62. In fact, usually hedge funds are established as limited partnerships or limited liability companies. *See* Ashworth, *supra* note 4, at 660.

63. *See* 15 U.S.C. § 77b(a)(1) (2012). Under this section

> [t]he term 'security' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id.

64. *See* Ashworth, *supra* note 4, at 663–64 (citing United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975)) ("Note that the quoted investment contract test in Forman is derived from the original investment contract test in SEC v. Howey."). The original Howey investment contract test states, "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Id*. at 664 n.72. "Hedge funds offer their limited partnership and limited liability company interests to passive investors who receive nominal (or no) management authority-and because these investors expect profits from management (efforts of others), most hedge fund offerings qualify as investment contracts." *Id*. at 664.

65. Under 15 U.S.C. § 77b(a)(15)

> [t]he term 'accredited investor' shall mean—(i) a bank as defined in section 3(a)(2) whether acting in its individual or fiduciary capacity; an insurance company as defined in paragraph (13) of this subsection; an investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; a Small Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account, which is subject to the provisions of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser; or (ii) any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.

See 15 U.S.C. § 77b(a)(15). In addition, under 17 C.F.R. § 230.501(a)

> [a]ccredited investor shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person: (1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors; (2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940; (3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000; (4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer; (5) Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000. (i) Except as provided in paragraph (a)(5)(ii) of this section, for purposes of calculating net worth under this paragraph (a)(5): (A) The person's primary residence shall not be included as an asset; (B) Indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and (C) Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability; (ii) Paragraph (a)(5)(i) of this section will not apply to any calculation of a person's net worth made in connection with a purchase of securities in accordance with a right to

exemption allows hedge funds to raise money without limitation from an unlimited number of accredited investors.[66] The rationale behind this exemption lies in the fact that "accredited investors" are not considered as in need of protection as retail investors are, since they themselves are able to assess the riskiness of the investment in hedge fund interests and are powerful enough to obtain all of the information they want and need from the hedge fund manager. These are the main reasons why the U.S. legislature has considered it appropriate to exempt these kinds of offers from the rules of the Securities Act of 1933.[67]

Additionally, it is worth noting that with the adoption of the Jumpstart Our Business Startups Act (JOBS Act)[68] in 2012, the U.S. legislature also removed the solicitation ban for private companies that rely on the Regulation D Rule 506 exemption, such as hedge funds. For a long time, in fact, in return for the benefit of the "accredited investors offering exemption," private issuers such as hedge funds were largely restricted from advertising to the general public.[69] Now, consequent of this ban's removal, private issuers benefiting from this exemption can also engage in advertising activities aimed at soliciting prospective (accredited) investors.[70]

> purchase such securities, provided that: (A) Such right was held by the person on July 20, 2010; (B) The person qualified as an accredited investor on the basis of net worth at the time the person acquired such right; and (C) The person held securities of the same issuer, other than such right, on July 20, 2010. (6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; (7) Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in § 230.506(b)(2)(ii); and (8) Any entity in which all of the equity owners are accredited investors.

17 C.F.R. § 230.501(a) (2012).

66. *See* Martin, *supra* note 60, at 1151; *see also* Albiez, *supra* note 56, at 150; *see also* Sami, *supra* note 11, at 282–83; Lewis, *supra* note 12, at 352.

67. *See* Ashworth, *supra* note 4, at 664–65; *see also* Schneider, *supra* note 14, at 272–73.

68. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (codified as amended at 15 U.S.C. §§ 7201, 7213, 7262, 77a–77g, 77r, 78c, 78k-1, 78l, 78m–78n-1, 78o, 78o-6 (2012)).

69. *See* Martin, *supra* note 60, at 1145 ("This exclusion encompassed a wide range of both direct and indirect communications between private issuers and prospective investors. For example, a private issuer could lose its Rule 506 exemption by communicating any aspect of its underlying business to the press, mentioning a fund name in an interview, or maintaining informative websites regarding its offerings or investment strategies. As a result of this broad interpretation, many issuers, particularly smaller and emerging companies, faced significant hurdles in entering private markets.").

70. *See* Ashworth, *supra* note 4, at 665; *see also* Martin, *supra* note 60, at 1145.

B. The Securities and Exchange Act of 1934

The second piece of legislation that has a potential impact on the U.S. hedge fund industry is the Securities and Exchange Act of 1934. The Securities and Exchange Act is particularly important given that it created the SEC. Its focus is on so-called secondary market transactions, namely transactions where one investor resells securities that it owns to another investor. The Securities and Exchange Act states that certain companies (referred to as publicly-traded companies) must provide the SEC with periodic information. In particular, under Section 12(g), an issuer must register, disclose information, and submit periodic reports if it has more than $10 million in total assets and issues securities to 500 or more investors who are not accredited investors or to 2000 or more accredited investors. Although most hedge funds have total assets in excess of $10 million, many of them avoid triggering this provision by issuing securities to fewer than 500 non-accredited investors or to fewer than 2000 accredited investors.[71]

Additionally, Section 15 of the Securities and Exchange Act requires broker-dealers to register with the SEC.[72] The Securities and Exchange Act defines a broker as any person "engaged in the business of effecting transactions in securities for the accounts of others;" as such, hedge funds and their managers are generally not considered brokers because they do not effect securities transactions for the accounts of others, but rather engage in securities transactions for their own accounts.[73] On the other hand, a dealer is defined as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business." The definition of dealer provides a "trader exception" that exempts from its coverage one who buys and sells securities for his or her own account but not as part of a regular business. Hedge funds and their managers usually fall within the "trader exception," because they trade securities on their own account, rather than as a part of a securities business.[74]

C. The Investment Company Act of 1940

The Investment Company Act of 1940 is the most important piece of U.S. legislation governing pooled investment vehicles such as hedge funds. The Investment Company Act requires U.S. investment companies[75] to

71. Schneider, *supra* note 14, at 272–74.
72. *Id*.
73. *Id*.
74. *See* Gibson, *supra* note 4, at 692; *see also* Schneider *supra* note 14, at 274.
75. *See* 15 U.S.C. § 80a-3(a)(1) (2012) ("Investment company means any issuer which— (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business

register with the SEC.[76] Most hedge funds satisfy one or both of the requirements to be considered an investment company, as they are primarily engaged in the business of investing and more than 40% of their assets are invested in securities.

However, the rule imposing SEC registration has a number of exceptions, some of which hedge funds use in order to avoid the strict regulation and supervision arising from the Investment Company Act. First, any investment company that is not owned by more than 100 investors and does not plan to make a public offering of its securities is exempt.[77] Hedge funds generally do not make public offerings, so those hedge funds with fewer than 100 investors can take advantage of this exception.[78] Second, the Investment Company Act exempts investment companies exclusively owned by "qualified purchasers."[79] This allows hedge funds owned solely by qualified purchasers[80] to circumvent the registration requirement even if the fund has more than 100 investors.[81]

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of investing, reinvesting, or trading in securities; (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.").

76. *See id*. § 80a-8(a) ("Any investment company organized or otherwise created under the laws of the United States or of a State may register for the purposes of this title by filing with the Commission a notification of registration, in such form as the Commission shall by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors. An investment company shall be deemed to be registered upon receipt by the Commission of such notification of registration.").

77. *See id*. § 80a-3(c)(1) ("None of the following persons is an investment company within the meaning of this title: (1) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.").

78. *See* Ashworth, *supra* note 4, at 667.

79. Under 15 U.S.C. § 80a-3(c)(7)(A), none of the following persons is an investment company within the meaning of this title: "Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities." 15 U.S.C. § 80a-3(c)(7)(A).

80. *See id*. § 80a-2(a)(51)(A) ("'Qualified purchaser' means- (i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission; (ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons; (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (iv) any person, acting for its own

Avoiding the application of the Investment Company Act is of great importance for hedge funds, because its rules would make it impossible for their managers to perform their typical financial strategies and would make the costs of compliance very high. In fact, under the Investment Company Act, investment companies: (1) must comply with the SEC's registration, disclosure, record-keeping, and periodic reporting requirements; (2) must enter into a written contract with the investment adviser; (3) at least 40% of the board of directors must be disinterested directors and the shareholders must elect at least half of the directors; (4) are prohibited from utilizing several investment tools, such as purchasing securities on margin, participating in joint trading accounts, effecting short sales, issuing senior securities, or using bank and margin loans to leverage their assets more than 300%; and (5) are prohibited from effecting a number of transactions with affiliated persons.[82] This is why almost all U.S. hedge funds rely on one of the two exemptions from the definition of investment companies under the Investment Company Act.[83]

D. The Investment Advisers Act of 1940

Finally, the Investment Advisers Act of 1940, from a different perspective, regulates the advisers to investment companies. Section 202(11) of the Investment Advisers Act defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[84] The main provisions of the Investment Advisers Act contain a number of obligations that require the advisor to:

> (1) file a Form ADV with the SEC, which requires disclosures regarding the fund's business practices and the manager's background, although the manager does not have to disclose details of the fund's investment strategies or trades; (2) deliver basic information to clients about the fund's business practices and the fund manager's background; (3) adopt procedures governing proxy voting by the hedge fund; (4) adopt a code of ethics; (5) develop a system of internal controls and compliance procedures to prevent violation of the Advisers Act; (6) appoint a chief

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account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.").

81. *See* Ashworth, *supra* note 4, at 667–68.
82. *See* Schneider, *supra* note 14, at 275–76.
83. *Id*.
84. 15 U.S.C. § 80b-2(a)(11).

> compliance officer, and . . . [(7)] maintain specified books and records and make them available to the SEC for examination and inspection.[85]

Before the adoption of Dodd-Frank in 2010, hedge fund managers managing fewer than fifteen funds were able to avoid registration with the SEC, taking advantage of the so-called "private fund exemption."[86] Through the enactment of Dodd-Frank, the legislature decided to remove this exemption, with the legal effect being that currently hedge fund managers have to register with the SEC as investment advisers if their assets under management exceed the threshold of $150 million. In contrast, if their assets under management are less than $150 million, advisors must register with their state regulatory authority. All this means that hedge fund managers with assets under management exceeding those thresholds are now subject to federal regulation and SEC supervision.

V. THE ISSUES ARISING FROM HEDGE FUND ACTIVITY

In the recent past, due to the lack of strict regulation and supervision, hedge funds have generated and spread systemic risk,[87] while their managers have sometimes used them to commit criminal acts mainly aimed at defrauding investors and stealing their money.[88]

A. THE CONCEPT OF SYSTEMIC RISK

There is no unique definition of systemic risk, even if this concept is almost always linked to cascading market failure situations.[89] By highlighting this aspect, it has been defined as the risk of chain reactions of failures,[90] also known as the "domino effect"—namely, the situation in which the failure of an entity causes the failure of other connected entities. Almost all of the definitions of systemic risk refer to "a trigger event, such as an economic shock or institutional failure, [that] causes a chain of bad

85. *See* Schneider, *supra* note 14, at 277 (quoting Paredes, *supra* note 9, at 988–89).

86. *See* Krug, *supra* note 3, at 453 ("The rationale for the client-based exemption was that an adviser that provides its investment advice only to a very small number of clients creates no particular threat to the regulatory goal of ensuring the integrity of the securities markets and arguably creates only a *de minimis* concern for the goal of protecting investors.").

87. *See* Kaal, *supra* note 3, at 248; *see also* Ashworth, *supra* note 4, at 670–71.

88. *See* GROWTH OF HEDGE FUNDS, *supra* note 11, at 2, 72–73; *accord* Karmel, *supra* note 11, at 856; *see also* Kaal, *supra* note 3, at 260; Sami, *supra* note 11, at 279; Jonna, *supra* note 11, at 1008–09.

89. *See* Kehoe, *supra* note 1, at 55–56.

90. *See* Rivière, *supra* note 2, at 292–93; *see also* Lee *supra* note 1, at 499 (defining systemic risk as "the risk that poses a threat to the entire financial system, either (i) directly through failure of, or significant losses in assets or liquidity to, one or more institutions, or (ii) indirectly through the effects of such events via the operation of financial markets. This concept is consistent with the G20's approach to post-crisis reforms pertaining to systemically important financial institutions and markets whose failure or severe distress may contribute to, or transmit, systemic risk.").

economic consequences . . . ."[91] Such consequences are significant losses, other failures, or even market volatility and terrific downfalls of entire financial markets. Essentially, it seems to be any large-scale default that results in the reduced availability of capital or credit across an industry, a market, or many different markets.[92]

The main sources of systemic risk are the traditional credit channel and the market-based channel.[93] In the credit market, systemic risk is inversely correlated with credit availability. As credit availability decreases, systemic risk increases. When credit-lending institutions start having difficulties, they cease providing capital and liquidity to the markets. As credit and capital become increasingly harder to find, the cost of borrowing increases, making loans prohibitively expensive and unaffordable. If the public perceives that a banking institution has serious liquidity problems, its depositors could be motivated to immediately withdraw their savings, exacerbating such problems and causing a situation called a "run on the banks."[94] A run on the banks can easily cause the failure of such banks and that in turn can have an impact on their creditors and counterparties, even pushing them to the point of collapse and creating the typical domino effect.

In specific regards to the market channel, systemic risk refers to the possibility that an abrupt and unexpected failure in one market will have an impact on other linked markets, "due to diverse and fragmented trading strategies and the interrelationships among large market-players."[95] In other words, systemic risk arises from the fact that a failure in one market can cause failures in others. In this case, the secondary markets become illiquid because there are too many sellers and not enough buyers, and the final result is that the markets are left in an extremely illiquid state.[96]

1. The Systemic Risk Issue in the Hedge Fund World: The Creation of Systemic Risk

Those who deny that single hedge funds can generate systemic risk usually argue that they are not systemically important financial players, as their size is typically not very large.[97] In these scholars' opinions, hedge funds' failures would not pose risks able to initiate a chain of other failures involving many other financial players.[98] This argument is strongly contradicted by what happened in 1998 to LTCM.[99] In fact, this hedge fund

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91. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 198 (2008).
92. *See generally* KAMBHU ET AL., *supra* note 3.
93. *See* Lee, *supra* note 1, at 500–01.
94. *Id.* at 504.
95. *See* Kehoe, *supra* note 1, at 55–56.
96. *Id.*
97. *See* Lee, *supra* note 1, at 501–02; *see also* Kehoe, *supra* note 1, at 35.
98. *Id.*
99. *See* FSOC UPDATE, *supra* note 23, at 15 n.60; *see also* George & Dymally, *supra* note 22, at 224–26.

was not extremely big in terms of capital, which consisted of $5 billion.[100] However, the leverage it carried was incredibly high, namely nearly twenty-five times the value of the capital (*i.e.* $120 billion).[101] This terrific amount of debt caused the fund itself to become systemically relevant, given that its failure would have hurt its investors, creditors, and counterparties, as well as the entire market. It is irrational to deny that a $120 billion[102] failure would not be able to affect the market, generating systemic risk.[103] This very awareness moved the Federal Reserve Bank of New York to coordinate a bailout performed by the main creditors of the fund in order to avoid the dramatic losses that the financial markets would otherwise have suffered.[104] This bailout rescued the fund, injecting $3.6 billion, but the investors lost the entire amount of their investments.

Such a case is particularly significant because it provides evidence that even financial players that are not particularly big can generate systemic risk, due to the relevant use of leverage.[105] Although the LTCM case is the most famous, there have also been other relevant hedge fund failures highlighting their potential to pose systemic risk.[106] The point is that while

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100. *See* Nelson, *supra* note 9, at 227.

101. *See* Ashworth, *supra* note 4, at 670–71; *see also* Nelson, *supra* note 9, at 227.

102. *See generally* FSOC UPDATE, *supra* note 23, at 1; *see also* Nelson, *supra* note 9, at 227.

103. *See* Kehoe, *supra* note 1, at 37 (remarking that over-leveraged hedge funds can impact the stability of the markets "depending on their [level of] liquidity and market positions").

104. *See* Rivière, *supra* note 2, at 293 (citing Banque de France, *Revue de la Stabilité Financière*, Numéro Spécial Hedge Funds, N° 10, 54 (Apr. 2007)) ("A study carried out by the Bank of France estimates that 17 banks would have collectively lost three to five billion dollars if LTCM had not been bailed out.").

105. *See* FSOC UPDATE, *supra* note 23, at 14–16.

106. Kaal, *supra* note 3, at 245–46, 246 n.5 (underscoring the following hedge fund failures: Amaranth, Bailey Coates, Bayou Management, Cromwell Fund, Philadelphia Alternative Asset Management, Marin Capital, Aman Capital Global, Tiger Funds, Eifuku Master Trust, Lyceum Capital, and Wood River Partners). In particular, after LTCM, the failures of Amaranth in 2006 and Bear Sterns hedge funds in 2007, are considered the most serious in history. *See* George & Dymally, *supra* note 22, at 226–29 ("Another dramatic collapse occurred in September 2006 when Amaranth Advisors lost $4.6 billion in a single week from the failure of a natural gas investment. They were the largest hedge fund collapse in history at the time. The hedge fund launched in 2000 as a multi-strategy hedge fund operating in Greenwich, CT and had offices in the United Kingdom, Canada, and Singapore. It has been estimated that by 2005-2006 over 80% of its profits were from energy trading. Minimum investments in Amaranth were $5 million. Investors included pension funds, endowments, large financial firms, insurance companies, brokerage firms, and high net worth individuals. As was done in the LTCM failure, a congressional subcommittee reviewed and received testimony on the overall impact of the funds collapse on the energy market and the economy. Some of the findings of the congressional subcommittee were: Amaranth Advisors LLC dominated the U.S. natural gas market in 2006. In August 2006, Amaranth traded natural gas contracts on the Intercontinental Exchange (ICE) rather than on the New York Mercantile Exchange (NYMEX) so that it could trade without any restrictions on the size of its positions. Amaranth's actions in causing significant price movements in the natural gas market demonstrates that excessive speculation distorts prices, increases volatility, and increases costs and risks for natural gas consumers, such as utilities, who ultimately pass on inflated costs to their customers. Current restraints on speculative trading to prevent manipulation and price distortions are inadequate. It is significant that Senator Levin (D-Mich), chairman of the investigations subcommittee, connected the implosion of Amaranth to the closing of the 'Enron loophole' that

hedge funds are usually providers of liquidity to the markets, in times of crisis they can be forced by their lenders to deleverage, particularly when their level of debt is extremely high.[107] This circumstance can contribute to market volatility and downfall, and in significantly serious situations even to systemic risk.[108] Hedge funds are believed to pose systemic risk mostly through the market channel due to the sophisticated, complex, and risky investment strategies that they usually employ, quite often combining many of these together. From an opposing viewpoint, it seems that they do not contribute much to the creation of systemic risk through the credit channel.[109] Obviously, the impact of a fund's default on the markets depends on its size, leverage, and position in the markets,[110] but it is evident that if the fund is big, highly leveraged, and has a lot of interlinkages with other financial players, its failure is much more likely to affect the market and even to generate systemic risks.

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exempts electronic energy exchanges from regulatory oversight. He also asserted that '[w]e need to put the cop back on the beat in all U.S. energy markets with stronger tools to stop price manipulation, excessive speculation, and trading abuses' which proved to be an accurate prediction of increased regulation for not only energy markets, but also in regard to reining in the excessively speculative actions of all PIFs . . . . The . . . implosion of the two Bear Stearns hedge funds in 2007 is an important PIF precursor to the tumultuous period during the time of the collapse of global financial markets. The failure of the two funds marked the beginning of a new era on Wall Street, although it took almost another six months for the parent corporation to fail and more than a year for the biggest financial disaster to occur the bankruptcy of Lehman Bros. The hedge funds had invested in collateralized debt obligations (CDOs) comprised primarily of mortgage-backed securities and had even leveraged themselves to make more investments in the same type of CDOs. In the securitization process, the mortgages had been pooled, bundled, and repackaged as debt securities in the form of CDOs. The CDOs included a substantial percentage of subprime loans in the pools. Not surprisingly, when the real estate market began to unravel and the default rate of subprime mortgage holders began to rise at an unprecedented rate, along with other events that negatively affected the economy, the CDOs held by the Bear Stearns hedge funds lost their value. At the time of the implosion of the two Bear Stearns funds, the parent company was the fifth largest U.S. securities firm in terms of market value. The parent company rescued one of its hedge funds with $3.2 billion in loans, the largest rescue of a hedge fund since LTCM. Investors in both hedge funds were told that they would get very little of their money back. Numerous lawsuits were filed including an SEC civil action against the top two former Bear Stearns hedge fund managers. The jury acquitted the managers in the government's criminal suit and the defendants agreed on the amount that they would pay to settle the SEC action.").

107. Kaal, *supra* note 3, at 248 n.13 (quoting Tobias Adrian et. al., *Hedge Fund Tail Risk, in* QUANTIFYING SYSTEMIC RISK 155 (Joseph G Haubrich & Andrew W. Lo eds., 2013)).

108. *Id.*

109. *See* Kehoe, *supra* note 1, at 57 ("When an institution is highly leveraged and it experiences more losses than it has surplus capital to repay, it becomes insolvent, and passes its losses on to its lenders.").

110. *See generally* Tomas Garbaravicius & Frank Dierick, *Hedge Funds and Their Implications for Financial Stability* (27 Eur. Cent. Bank Occasional Paper Series, Paper No. 34, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=752094.

a. Leverage

Leverage can be a useful component of an investment strategy.[111] However, its excessive use,[112] which sometimes characterizes hedge funds,[113] can represent, in combination with other factors,[114] one of the most significant sources of systemic risk, because a sequence of negative events can start with losses on leveraged market positions.[115] Liquidity shortages are the subsequent consequence, further exacerbated by asset illiquidity in stressed markets. This situation, if not supported by adequate liquidity reserves or borrowing capacity, can force a fund to default on its obligations to prime brokers and other financial institutions.

Typically, the use of leverage can result in tremendous profit if the financial entity makes more money than its borrowing cost; conversely, however, it can have disastrous results if the intermediary makes less than its borrowing cost. In the event of a loss, creditors may require the fund to provide more collateral to secure their loans, which may in turn require the fund to sell some of its assets to meet margin calls.[116] The consequent "fire sales" of the fund's assets can affect the market. In fact, if a highly leveraged hedge fund has amassed numerous positions in securities of the same kind, such tremendous sales can impact the segment of the market where these securities are traded and even the market as a whole. It follows that leverage is one of the main causes of systemic risk because without debt, the likelihood of cascading failures from institution to institution would be much lower.[117]

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111. *See* FSOC UPDATE, *supra* note 23.

112. *See* Kehoe, *supra* note 1, at 57.

113. Gibson, *supra* note 4, at 686–87 ("Hedge funds typically obtain leverage through direct financing, investment transactions such as purchasing securities on margin, taking short positions in securities, employing collateralized borrowing through repurchase agreements ('repos'), and executing derivatives transactions, many of which are collateralized.").

114. *See* FSOC UPDATE, *supra* note 23, at 15 n.108 (citing President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (1999)) ("The failure of Long Term Capital Management (LTCM) in 1998 and the liquidation of Amaranth Advisors in 2006, both large and highly leveraged hedge funds that came under significant stress over short periods of time with different outcomes, illustrate the interplay between leverage, size, and other factors."); *see also* Roger Ferguson & David Laster, *Hedge Funds and Systemic Risk*, BANQUE DE FRANCE FIN. STABILITY REV.: SPECIAL ISSUE ON HEDGE FUNDS, 45–54 (2007); *see also* Mila Getmansky, Peter Lee, & Andrew Lo, *Hedge Funds: A Dynamic Industry In Transition*, (Nat'l Bureau of Econ. Research, Working Paper No. 21449, Aug. 2015).

115. *See* Schwarcz, *supra* note 91, at 222.

116. *See* Gibson, *supra* note 4, at 687.

117. *See* Desmet, *supra* note 12, at 10 ("Some large hedge funds borrow so much money to finance their operations that an inability to meet their obligations due to sudden market reversals could endanger the financial markets. Some hedge funds also fail as a result of excessive leverage combined with a high concentration, which means that the fund invests all of its funds under management in very few positions while heavily borrowing for each dollar of invested capital.").

b. Derivatives

Additionally, the fact that hedge funds typically invest a significant amount of money in highly speculative derivatives,[118] such as collateralized debt obligations and credit default swaps, is considered an element that can pose systemic risks.[119] Since derivatives transactions mirror the effects of leverage, they present a potential source of systemic risk, which is amplified in the hedge fund industry due to high usage. "When hedge funds default on derivatives transactions, there is potential for heightened risk depending on the counterparty. This so-called counterparty risk is another source of market risk because the impact of a failed derivatives transaction depends on the counterparty's exposure to the financial markets."[120]

c. Short Selling

Short selling is one of the most controversial trading practices that hedge funds often engage in.[121] Short selling is believed to pose systemic risk through the market channel[122] and was criticized as contributing to the 2008 financial meltdown.[123] At the same time, it is not likely that a single hedge fund can impact the value of a well-performing security just by selling it. But, a group of hedge funds that act in concert could have the potential to depress the value of a profitable company's share due to combined short sales.[124] Nevertheless, when a hedge fund correctly believes that a business's stock is overvalued, a short sale is an effective means of price discovery that countermines inflated valuations. Additionally, a short sale requires the hedge fund to borrow the underlying security, thereby acting as a form of leverage, further increasing the fund's amount of outstanding debt.[125]

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118. *See* Schneider, *supra* note 14, at 267 ("Derivatives are 'financial contracts in which a payment or delivery depends on the underlying asset, interest rate, or index' without actually requiring the purchase of the underlying commodity or instrument.").

119. *See* George & Dymally, *supra* note 22, at 212–13.

120. *See* Kehoe, *supra* note 1, at 58.

121. *See* Gibson, *supra* note 4, at 685 (arguing that hedge funds have the potential to impact the financial markets because they engage in active short-term trading); *see* INT'L ORG. SEC. COMM'NS, REGULATION OF SHORT SELLING FINAL REPORT 4 (2009) (according to which "there is also a general concern that especially in extreme market conditions, certain types of short selling, or the use of short selling in combination with certain abusive strategies, may contribute to disorderly markets").

122. *See* FINAL IOSCO REPORT, *supra* note 35, at 4 ("There is also a general concern that especially in extreme market conditions, certain types of short selling, or the use of short selling in combination with certain abusive strategies, may contribute to disorderly markets.").

123. *See* Kehoe, *supra* note 1, at 59.

124. *See id.*

125. *Id.*

d. Trading Volume

Another way that hedge funds impact the markets is that they perform half of the daily trading volume on the New York and London Stock Exchanges.[126] It is pretty obvious that in such a context they "make" the market and therefore can both strongly impact its performance and undermine its stability.

2. The Systemic Risk Issue in the Hedge Fund World: Spreading Systemic Risk

Hedge funds are also able to spread systemic risk that is created by other financial institutions;[127] this is because they often are involved in complex repo agreements and other like-bank activities.

a. Repo Agreements

A way to spread risks is through collateral rehypothecation. Rehypothecation occurs when an intermediary, holding securities on behalf of investors, uses these securities to obtain financing for itself.[128] In the context of the relationship between hedge funds and prime brokers, rehypothecation is the reuse of hedge funds' collateral by prime brokers in transactions with other financial intermediaries completely unrelated to the original transaction.[129] Though rehypothecation provides a source of inexpensive financing for financial institutions,[130] "such a practice is believed to be dangerous for financial stability, particularly if one looks at how the global financial crisis manifested itself—namely as withdrawals of collateral from investment banks such as Lehman Brothers."[131] The practice of rehypothecation gives rise to a number of concerns, the most important of which is systemic risk. Systemic risk originates from uncertainty deriving from falling collateral prices and potential runs on the banks by the firms whose collateral is being rehypothecated. A run by hedge funds might occur because of the uncertainty of prime brokerage business when they have rehypothecated the collateral. Unable to locate the collateral initially posted by hedge funds to prime brokers, hedge funds fearing or experiencing distress might suddenly run to close their position with their

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126. *See* Martin, *supra* note 60, at 50.

127. *See* Nabilou & Pacces, *supra* note 3, at 212; *see also* Lee, *supra* note 1, at 502.

128. *See* Steven L. Schwarcz, *Distorting Legal Principles*, 35 J. CORP. L. 697, 699 (2010).

129. *See* Manmohan Singh & James Aitken, *Deleveraging After Lehman-Evidence from Reduced Rehypothecation* 3 (Int'l Monetary Fund, Working Paper No. 09/42, 2009), https://www.imf.org/external/pubs/ft/wp/2009/wp0942.pdf.

130. *See* Christian A. Johnson, *Derivatives and Rehypothecation Failure: It's 3:00 PM, Do You Know Where Your Collateral Is?*, 30 ARIZ. L. REV. 949, 969 (1997).

131. *See* Nabilou & Pacces, *supra* note 3, at 232.

prime brokers. This may cause serious distress to the prime brokers[132] and, in particularly serious situations, it can impact the markets.[133]

b. Like-Banks Activities

The analysis of the recent global financial crisis has also shown that some hedge funds were involved in credit-intermediation activities by acting as shadow-banks. In the shadow-banking context, hedge funds were particularly active traders of complex financial instruments, such as collateralized debt obligations.[134] Additionally, they acted as credit risk repositories in the credit intermediation chain and engaged in corporate lending similar to banks.[135] Hedge funds' systemic risk potential in such parallel banking sector activity lies in their numerous interconnections in key markets, most notably the secured funding markets. This is because the shadow banking system offers a source of financing for hedge funds via market-based securities lending and repo transactions and through margin lending as part of the prime broker relationship.[136] Further risks arise because hedge funds are not obliged to comply with the capital adequacy requirements applied to banks; therefore, they are much less stable and less resilient than banks. This means that if they engage in credit activities and their debtors are not able to pay back the loans, they are much more likely than banks to get in financial trouble. As usual, these problems can be easily transmitted in turn to hedge funds' counterparties, generating so-called "contagion."[137]

3. Regulating Hedge Funds in Order to Counteract Systemic Risk

The global financial crisis has shown that recession is one of the most serious consequences arising from terrific downfalls of financial markets.[138] This is the main reason why all the sources of systemic risk—including hedge funds—have to be kept under control, which means making them subject to regulation and supervision. It follows that hedge funds' potential

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132. *See* FSOC UPDATE, *supra* note 23.

133. *Id*.

134. *See* Lee, *supra* note 1, at 505–06.

135. *See id.* at 506.

136. *Id.* at 508–09 ("Hedge funds are large users of repo and secured lending markets and, in doing so, connect multiple market participants across market segments. Further, in these transactions, prime brokers' rehypothecation of the collateral for the borrowed securities can create additional market risks and deepen the interconnections between the various participants in the shadow banking system.").

137. *See* FSOC UPDATE, *supra* note 23, at 8.

138. *See* Martin, *supra* note 60, at 59 ("Massive losses, manipulations, and abuses within the public capital markets adversely affect the broader national economy and often precipitate debilitating economic downturns.").

capability to create and spread systemic risk needs to be faced and counteracted with the adoption of effective new rules.

B. THE INVESTOR PROTECTION ISSUE

Some recent financial scandals involving hedge funds have demonstrated that in this sector a serious investor protection issue does exist.[139] These scandals represent the clearest evidence that this problem exists,[140] despite its denial by some commentators.[141] Indeed, due to the success of the hedge fund industry and the consequent boost in the number of these particular vehicles, the frequency of fraud has increased significantly.[142] The reality has shown many different types of fraud perpetrated by dishonest investment advisers and damaging their investors, and many hedge funds and hedge fund managers have recently been in the news for defrauding clients in a variety of ways.

1. Scandals Involving Hedge Funds

Between 1999 and 2004, the SEC brought over fifty cases charging hedge funds and their advisers or traders with defrauding investors of a total exceeding $1 billion.[143] "Half the advisers in these cases were managing more than $30 million or were otherwise subject to regulation" and nearly all the investor losses were caused by the larger hedge fund advisers.[144] Between January 2004 and January 2006, the SEC brought another thirty enforcement cases against hedge funds and their advisers.[145] These cases included "allegations of misappropriation of assets, portfolio dumping, misrepresentation of portfolio performance, falsification of experience and past returns, misleading disclosures concerning trading strategies, and improper asset valuation, among others."[146] Hence, the types of fraud perpetrated in the recent past by investment advisers in the hedge fund

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139. *See* GROWTH OF HEDGE FUNDS, *supra* note 11.

140. *See id.*; *accord* Karmel, *supra* note 11, at 862–63 ("Abuses and insolvencies by some hedge funds have demonstrated that investor protection is an issue."); *see also* Kaal, *supra* note 3, at 245; Jonna, *supra* note 11, at 1008–09.

141. *See* Nelson, *supra* note 9, at 222, 229–30, 240; Gibson, *supra* note 4, at 713–14; Kaal, *supra* note 3, at 250–51.

142. *See generally* GROWTH OF HEDGE FUNDS, *supra* note 11 (describing the fraudulent conduct of hedge fund managers); Kaal, *supra* note 3, at 245 (underscoring that the amount of fraud has increased as a result of the increasing access to hedge funds by retail investors); *see* Lewis, *supra* note 12, at 363 ("Recent increases in the number of reports of fraud committed by hedge funds could be indicative of wider, unreported fraud in the industry.").

143. *See* Sami, *supra* note 11, at 279; *see also* Lewis, *supra* note 12, at 365.

144. *See* Desmet, *supra* note 12, at 31.

145. Francesco Guerrera, Andrew Parker & Stephen Schurr, *Deadline Approaches As SEC Takes Clippers to Hedge Funds*, FIN. TIMES, Jan. 30, 2006, at 26.

146. *See* Desmet, *supra* note 12, at 31 (quoting Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,062–63 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 and 279)).

industry vary from: (1) exaggeration of the fund's past performance;[147] (2) misappropriation and stealing[148] of the fund's assets for personal use;[149] (3) "fabrication" of false audit reports;[150] (4) misrepresentation of the fund's returns and performance;[151] (5) Ponzi scheme conduct;[152] (6) misrepresentation of the fund's investment positions;[153] and (7) overvaluation and undervaluation of the fund's assets.[154]

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147. *See* Jacob Preiserowicz, Note, *The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?*, 11 FORDHAM J. CORP. & FIN. L. 807, 836–37 (2006); Desmet, *supra* note 12, at 32 (describing the scandal known as the Bayou Funds, where "[i]n late September 2005, the Commission charged Bayou and its management with fraud, alleging that they had attracted investors by exaggerating Bayou's performance"); *see generally* Complaint, SEC v. Samuel Israel III, (S.D.N.Y 2005) [hereinafter Complaint]; Press Release, Sec. & Exch. Comm'n, SEC Charges Samuel Israel III, Daniel E. Marino, Bayou Management, and Bayou Funds for Defrauding Hedge Fund Investors and Misappropriating Investor Assets (Sept. 29, 2005), http://www.sec.gov/news/press/2005-139.htm [hereinafter SEC Charges Samuel Israel III].

148. *See* Desmet, *supra* note 12, at 34 ("The Commission . . . charged the manager of Bingham Growth Partners L.P. with fraud for misleading investors concerning his fund's returns and for stealing from the fund's assets. He allegedly raised at least $460,000 from investors using fake returns."); *see also* Order, In the Matter of Barry Alan Bingham (No. 3012015), http://www.sec.gov/litigation/admin/34-52318-o.pdf; *see Atlanta Man Accused of Hedge Fund Scam*, CNNMONEY (Aug. 24, 2005, 10:19 AM), http://money.cnn.com/2005/08/24/markets/hedgefund_sec/.

149. *See* Desmet, *supra* note 12, at 32 (dealing with the Bayou Funds scandal and underscoring that "[t]he Commission charged Bayou and its management with fraud, alleging that they . . . had misappropriated millions of dollars in investors funds for their personal use."); *see* Complaint, *supra* note 147; SEC Charges Samuel Israel III, *supra* note 147.

150. *See* Desmet, *supra* note 12, at 32 (emphasizing that in the Bayou scandal "Bayou had claimed that its books had been reviewed by independent auditors when in fact they were certified by an accounting firm whose registered agent was none other than Bayou's chief financial officer. That accounting firm allegedly fabricated 'independent' audit reports to buy Bayou some time to make up its huge losses."); *see* Complaint, *supra* note 147; SEC Charges Samuel Israel III, *supra* note 147.

151. *See* Desmet, *supra* note 12, at 32 (underscoring that in the Bayou Funds scandal, "the Commission alleged that Bayou overstated its 2003 performance by claiming over $43 million in net gain from investment transactions even though trading records in fact showed a $49 million loss during that period of time"); *see* Complaint, *supra* note 147; SEC Charges Samuel Israel III, *supra* note 147.

152. *See* Desmet, *supra* note 12, at 34 (arguing that some funds involved in the cases enforced by the SEC had never traded. For example, HMC International, LLC was charged for being just a Ponzi scheme. The fund raised more than $5.2 million without trading for months. Similarly, the offshore fund, The Pembridge Group, was sued by the SEC which alleged it did not even exist); *see* Gregory Zuckerman, *SEC Charges Hedge-Fund HMC Principals of Fraud*, WALL ST. J. (Dec. 22, 2005, 12:01 AM), https://www.wsj.com/articles/SB113521812045129147; HMC Int'l, LLC, et al., SEC Litigation Release 19508, SEC (Dec. 21, 2005), http://www.sec.gov/litigation/litreleases/lr19508.htm; Jenny Anderson, *S.E.C. Accuses a New Jersey Hedge Fund*, N.Y. TIMES (Dec. 22, 2005), http://www.nytimes.com/2005/12/22/business/sec-accuses-a-new-jersey-hedge-fund.html; Treyton L. Thomas, et al., SEC Litigation Release 18957, SEC (Nov. 3, 2004), http://www.sec.gov/litigation/litreleases/lr18957.htm.

153. *See* Desmet, *supra* note 12, at 32–33 ("In October 2005, the Commission announced it was filing a lawsuit against Wood River Partners LP, Wood River Partners Offshore Ltd., and John Whittier, the funds' manager. The Commission alleged that Whittier made material misrepresentations regarding the oversight and diversification of the two hedge funds in question. Contrary to representations in offering materials concerning diversification, the funds had amassed a huge position in a single small-cap stock."); *see also SEC Hits Wood River Hedge*

2. The Need for Investor Protection in the Hedge Fund Sector

The argument that investors who can invest in hedge funds do not need to be protected by regulation, since they are considered able to fend for themselves,[155] certainly does not make the investor protection issue a false or merely theoretical problem. At best, this argument could be used to say that, even if the problem exists, there is no need to address it by enhancing regulation and supervision because hedge fund investors can manage it themselves. However, even this interpretation cannot be shared because it represents the implicit admission that such funds can potentially hurt their investors even if they are theoretically able to protect themselves, thanks to their financial skills and their wealth. It is also worth noting that it is no longer true that only sophisticated, wealthy, and/or institutional investors are allowed to invest in hedge funds. In fact, due to so-called "retailization," today investors who are not sophisticated, wealthy, or institutional can buy hedge fund interests. In other words, this phenomenon is represented by the possibility that even investors neither particularly sophisticated nor very wealthy can potentially invest in hedge funds.[156] This can happen in different ways, both directly and indirectly.

Funds with Fraud Suit, N.Y. POST (Oct. 14, 2005); *see* Complaint, SEC v. Wood River Capital Management, LLC et al., (S.D.N.Y. 2005).

154. *See* SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, STAFF REPORT TO THE U.S. SECURITIES & EXCHANGE COMMISSION 99 (2003), https://www.sec.gov/news/studies/hedgefunds0903.pdf.extra/hedgestudyfacts.htm (In that report, the staff recommended that the Commission "should consider requiring, through rulemaking, that all registered investment companies that invest their assets in hedge funds, including registered [funds of hedge funds], have policies and procedures designed to ensure that funds and their boards value their interests in hedge funds in a manner consistent with the requirements of the Investment Company Act."); Sami, *supra* note 11, at 288 (stating that one of the problems is connected to the way in which hedge fund advisers value the assets of their funds due to the lack of independence in the assessment process. This issue is serious as it can also impact the registered funds investing in hedge funds as they are not in a position to properly value their investments); *see* Desmet, *supra* note 12, at 34 (stating that Critical Infrastructure Fund falsely raised the value of its assets and Global Money Management, L.P. was alleged to have told the investors that its assets were worth nearly $100 million whilst the real value, according to the SEC, was around $11 million); *see also* Chad Bray, *SEC Sues Former Hedge Fund Manager*, WALL ST. J. (Sept. 28, 2005, 3:31 PM), https://www.wsj.com/articles/SB112793030746554717; SEC v. Joseph W. Daniel, SEC Litigation Release No. 19427 (Oct. 13, 2005); SEC v. Global Money Management, L.P. et al., SEC Litigation Release No. 18666 (Apr. 12, 2004).

155. This is the position of some commentators. *See* Nelson, *supra* note 9, at 222, 230, 240; Gibson, *supra* note 4, at 713–14; Kaal, *supra* note 3, at 250.

156. *See* Sami, *supra* note 11, at 279 (underscoring the growing exposure of smaller, unsophisticated investors to hedge funds); Jonna, *supra* note 11, at 1007 ("Through a process referred to as 'retailization,' hedge funds are made available to average small investors."); Kaal, *supra* note 3, at 245; *see also* Desmet, *supra* note 12, at 8–9 (explaining that due to this phenomenon called retailization, many non-wealthy investors have started to invest in hedge funds); *see also* Lewis, *supra* note 12, at 363 ("The retailization of hedge funds unduly exposes unqualified investors to the risks hedge funds pose, through ineffective minimum investor requirements and increased participation by mainstream investment vehicles like pension funds.").

3. The Shortcomings of the Sophisticated Investor Doctrine and the Effect of Inflation

First, the thresholds used to classify wealthy people as "accredited investors,"[157] who are allowed to invest in hedge funds, are no longer very high due to inflation.[158] In fact, it is difficult to argue that investors with $200,000 of income per year[159] are wealthy enough to protect themselves from the fraud or misappropriation that can be carried out by hedge fund managers.[160] Certainly this income does not make them sophisticated or wealthy enough to benefit from significant technical skills allowing them to properly assess and value the behavior of their hedge fund manager on an ongoing basis, in order to find out if some irregularities have been taking place. Nevertheless, arguably this level of income is deemed as adequate to consider a person as an "accredited investor," who for this reason is allowed to invest in hedge funds.[161]

This issue is magnified by the fact that usually hedge funds are rather opaque financial vehicles, meaning that typically their managers do not

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157. *See* 15 U.S.C. § 77b(a)(15) (2012); *see also* 17 C.F.R. § 230.501(a) (2013).

158. *See* Nelson, *supra* note 9, at 239 ("Currently accredited investors include those that earn over $200,000 a year or have over $1 million in net worth. These numbers were formulated over twenty years ago and are outdated. The number of people meeting this threshold has increased significantly because of inflation. Thus, those eligible to invest in hedge funds are more in number and less wealthy than those of twenty years ago in real terms."); *see also* Lewis, *supra* note 12, at 364 ("As inflation has increased and segments of the population have become wealthier, the restrictions on the level of investor that can invest in hedge funds have become outdated. Specifically, the definition of accredited investor has not changed even though the real value of the required minimum assets has decreased. For example, the recent stock market boom has left many investors with the requisite net worth and capital to nominally qualify as investors in hedge funds, despite the fact that their actual qualifications to do so have not changed. As a result, many investors who previously could not invest in hedge funds are now becoming investors. The SEC believes that the availability of hedge funds to the 'merely affluent' exposes too many otherwise unqualified investors to potential losses that could cripple their finances. In other words, the 'merely affluent' investor might invest in a hedge fund without fully understanding or appreciating the risks involved, due in part to the limited disclosure required of the hedge fund."); *see also* Preiserowicz, *supra* note 147, at 841; Erik J. Greupner, *Hedge Funds are Headed Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1576 (2003).

159. *See* 17 C.F.R. § 230.501(a)(6) (2013) (noting that a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year is considered as an accredited investor).

160. It is worth noting that even if investors with income of $200,000 USD per year are considered accredited investors and, as such, eligible to invest in hedge funds, most managers prefer to limit the offering of their funds' units to richer investors in order to benefit from the other exemptions and exceptions of U.S. securities laws. For a different interpretation see Lewis, *supra* note 12, at 379–80 (arguing that some newly established hedge funds are trying to target accredited investors. For this reason, according to the commentator's point of view, the SEC should revise the definition of "accredited investors.").

161. *See* Martin, *supra* note 60, at 56 ("[I]n order to uphold investor protection as a viable mechanism for maintaining the integrity of the markets, the assumptions that support the sophisticated investor exemption must be consistently reexamined by both researchers and regulators.").

disclose much information to the investors.[162] The commentators who do not consider that as an issue argue that the investors can negotiate the conditions of their participation with their hedge fund manager, including the type and the amount of information that the manager must provide them.[163] Even if that could be theoretically true, it is appropriate to emphasize that investors with $200,000 of income per year do not have such bargaining power in negotiating with the hedge fund manager, because, presumably, the amount of money that they can invest is not so relevant to the manager.

Further, most hedge funds rely on the so-called "qualified purchasers exemption" under Section 3(c)(7) of the Investment Company Act of 1940 to avoid the application of its rules. Consequently, only natural persons owning not less than $5 million in investments can buy their securities. Even though a natural person owning that amount of investments is supposed to be richer than a natural person with $200,000 of income per year, under the definition of accredited investor it is not certain that such a natural person is also much more sophisticated and able to properly understand and assess this kind of investment. As a result, both these categories of investors are likely to be "unarmed" in relation to their hedge fund managers.

4. Funds of Hedge Funds

In recent times, funds of hedge funds have become rather popular.[164] These are investment companies that are specialized in investing in hedge funds, but their main feature is that even retail investors can buy their units or shares.[165] This means that retail investors can easily invest in hedge funds—even if indirectly—through such funds of funds. It is obvious that

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162. *See* Rivière, *supra* note 2, at 265.

163. *See* Nelson, *supra* note 9, at 240 (arguing that sophisticated investors have the power to control hedge fund managers due to the fact they can threaten to redeem huge amounts of capital).

164. *See* Lewis, *supra* note 12, at 358 ("Funds of funds are hedge funds that invest solely in other hedge funds. Funds of funds are gaining popularity because they provide access to investments in a variety of supposedly carefully selected, well performing hedge funds and have a diversifying effect on portfolios. Further, funds of funds require relatively low investment minimums because most funds of funds are registered as closed-end investment companies under the ICA and are not limited in number of investors. Investors in such funds, however, must still be considered accredited investors or qualified purchasers to comply with exemptions that allow for the charging of performance fees."); Laura Edwards, *Looking Through the Hedges: How the SEC Justified its Decision to Require Registration of Hedge Fund Advisers*, 83 WASH. U. L. Q. 603, 611 (2005); Rory B. O'Halloran, *An Overview and Analysis of Recent Interest in Increased Hedge Fund Regulation*, 79 TUL. L. REV. 461, 470 (2004); Desmet, *supra* note 12, at 9 ("U.S. funds of hedge funds that are registered with the Commission as investment companies do not require that investors be accredited and accept investments as small as $25,000."); *see also* Nelson, *supra* note 9, at 221 ("Funds that invest in other hedge funds to spread risk, called funds of funds, have increased hedge fund accessibility for those who do not meet the investment thresholds traditional hedge funds usually require.").

165. *See* Lewis, *supra* note 12, at 358; Edwards, *supra* note 164, at 611–12.

investment companies are institutional investors.[166] As such, presumably, they can benefit from the financial skills of their managers, which in turn means they should be able to properly assess the quality and the honesty of the hedge fund managers as well as the hedge funds in which they invest. Furthermore, typically their assets under management are significant and this factor should give them much more bargaining power in their relationship with the hedge fund managers, allowing them to obtain all necessary information.

Nevertheless, from the opposite point of view, the increasing popularity of this type of fund creates the opportunity for a growing number of retail investors to indirectly invest in hedge funds. This circumstance "swallows" the meaning of the wealth thresholds, which are used to define both accredited investors and qualified purchasers. In fact, by introducing these thresholds, the legislature has intended to allow only investors who are above them to invest in hedge funds, while through funds of hedge funds these thresholds are practically circumvented, since the money of retail investors is indirectly used to buy hedge fund securities. Consequently, from a practical perspective, the assumption that hedge fund investors are only sophisticated, wealthy, and/or institutional has begun to have an increasing number of exceptions.

5. Pension Funds, Retirement Funds and Pension Plans Investing in Hedge Funds

That pension funds, retirement funds, and pension plans have been investing a tremendous and growing amount of money in hedge funds further demonstrates that it is no longer true that only sophisticated, wealthy, and/or institutional investors are allowed to invest in hedge funds.[167] In this regard, the aspect to take into consideration is that the money they invest is the money of workers that will have to be given back to them after their retirement. Given that these pension funds, retirement funds, and pension plans manage the money of workers who can be mainly

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166. Likewise, banks and insurance companies, even registered investment companies, are considered accredited investors. *See* 15 U.S.C. § 77b(a)(15) (2012); *see also* 17 C.F.R. § 230.501(a) (2013).

167. *See* Jonna, *supra* note 11, at 993 ("[P]ension funds, the largest institutional investors, which invest retirees' money, are increasingly investing those assets in hedge funds to boost returns. The number of U.S. corporate defined-benefit pension funds investing in hedge funds has been increasing throughout the last several years, and the percentage is expected to continue increasing."); *see also* Lewis, *supra* note 12, at 363–64 ("Pension funds and other retirement investment vehicles, which are available to the public at large, increasingly invest in hedge funds. Pension fund managers are under pressure to provide handsome returns to ensure comfortable nest eggs for millions of employees in both the public and private sectors. As a result, pension fund managers are lured by hedge funds' historically outsized returns and promises of non-correlation with the wider investment environment. Also attractive to pension fund managers are the diversifying effects of hedge funds on investment portfolios.").

classified as retail investors, it is possible to argue that in this way retail investors indirectly invest in hedge funds.

There is no doubt that pension funds, retirement funds, and pension plans are institutional investors with managers who have sophisticated financial skills, making them able to assess and carefully check the hedge fund managers' behavior and the hedge fund performance on an ongoing basis. However, what recently happened to some huge retirement funds should encourage serious reflection on the risks arising from hedge fund managers' bad behavior and their potential to harm retired people, who certainly are not necessarily sophisticated, wealthy, or institutional investors.[168] Further, the previous argument regarding funds of hedge funds is also true for pension funds. In fact, allowing pension funds to invest the money of workers and retired people in hedge funds causes the same circumvention of the thresholds laid down in the definitions of accredited investors and qualified purchasers. The reason for these thresholds is that natural persons who are considered as relatively wealthy are allowed to make riskier investments; due to their economic condition, they can take a risk to lose the money they have invested. Obviously, this argument cannot be used for pension funds, so it would be appropriate to reflect about the legislative consistency between the use of these thresholds to allow investments in hedge funds and the fact that pension funds invest a huge amount of workers' and retired people's money in these risky financial vehicles.

6. Why Would Sophisticated, Wealthy, and Institutional Investors Not Deserve Protection?

The fact that an investor is sophisticated, wealthy, and/or institutional does not automatically mean that they can avoid being defrauded by their hedge fund manager.[169] In fact, it is rather difficult, even for investors who have these features, to stop managers' illegal or unethical conduct, as many recent scandals have proven.[170] These features are just the ex ante demonstration that the investor is considered able to assess and take the financial risks arising from a risky investment. On the contrary, however,

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168. *See* Jonna, *supra* note 11, at 993–94, 1018 ("Some pension funds have lost substantial amounts of retirees' money by investing in hedge funds, such as the San Diego County Retirement fund, which lost $100 million after Amaranth Advisers collapsed in 2006 . . . . The San Diego Employees' Retirement Association has alleged that the hedge fund repeatedly misled it about its strategies and activities in the marketplace.").

169. *See* Martin, *supra* note 60, at 51 ("Many wealthy people, pension trustees and portfolio managers turned out to be just as incompetent as any amateur. This is a group of people defined by statute as 'accredited' or 'sophisticated' investors. The farce is that there is no test, license[,] or registration required to be 'accredited' as a 'sophisticated' investor.").

170. *See* GROWTH OF HEDGE FUNDS, *supra* note 11, at 2–3; *accord* Karmel, *supra* note 11, at 862–63 ("Abuses and insolvencies by some hedge funds have demonstrated that investor protection is an issue."); *see also* Kaal, *supra* note 3, at 244; Sami, *supra* note 11, at 279; Jonna, *supra* note 11, at 1008.

the possession of these characteristics is not enough to make the investors able to prevent or protect themselves from fraud committed by the fund managers, as the Madoff scandal demonstrated.[171] Although Madoff was neither a hedge fund manager nor a hedge fund, but rather was just a broker-dealer, it is difficult to deny that the same scandal could also occur in the hedge fund sector. Therefore, this case represents the best evidence that investment advisers can defraud even wealthy, sophisticated, and/or institutional investors, despite their financial skills and economic status.[172]

7. Regulating Hedge Funds in Order to Protect Their Investors

It is clear from the above arguments that the investor protection issue should be seriously considered. In addition, new rules aimed at avoiding the possibility of such situations occurring again in the future should be taken into consideration.

VI. GENERAL OVERVIEW OF NEW RULES APPLIED TO HEDGE FUND MANAGERS

Dodd-Frank was passed mainly in response to the global financial crisis; in 2010, the U.S. legislature passed Dodd-Frank with the aim to better monitor and address systemic risks. The Dodd-Frank Act also claims to aim to protect consumers from abusive financial services practices, such as fraud and other misconduct performed by financial intermediaries, such as hedge fund managers. Regarding the hedge fund industry, the main measure adopted by Dodd-Frank to reach its legislative goals in Title IV, named PFIARA,[173] has been to oblige managers of private funds[174] with assets under management above $150 million to register with the SEC under the Investment Advisers Act of 1940, in the same way as the investment advisers to registered investment companies. PFIARA introduced the duty of registration with the SEC for such investment advisers by removing from the Investment Advisers Act of 1940 the exemption allowing a manager managing fewer than fifteen funds to avoid

171. George & Dymally, *supra* note 22, at 230 n.130 (In the Madoff scandal, "[m]any of the Madoff depositaries were located in Luxembourg where the laws were more lenient than in some of the other Member States. Madoff used the depositaries in the perpetration of his fraud because the 'banks and others that were supposed to be safeguarding the assets of Madoff-related funds . . . had in fact delegated their responsibility for the assets to Mr. Madoff.").

172. *See* Martin, *supra* note 60, at 52 (underscoring that the Madoff case "resulted in over $20 billion in aggregate losses to wealthy and institutional investors. This scandal was riddled with distressing stories of prosperous individuals who had little to no financial acumen losing their entire fortunes to Madoff's Ponzi scheme. In many cases, instead of doing their due diligence, these investors simply relied on Madoff's reputation for guaranteeing high returns and attracting other prominent investors.").

173. PFIARA is an acronym for Private Fund Investment Advisers Registration Act.

174. *See* 15 U.S.C. § 80b-2(a)(29) (2012) ("The term 'private fund' means an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3), but for section 3(c)(1) or 3(c)(7) of that Act.").

the registration requirement.[175] Obviously, registration with the SEC makes these managers subject to the rules of the Investment Advisers Act and to the supervision of the SEC itself.

Further, Dodd-Frank created the Financial Services Oversight Council (FSOC) and granted it the task of monitoring the financial industry for systemic risks.[176] It also introduced the so-called Volcker Rule, which prohibits proprietary trading and banking entities' investments in and sponsorship of hedge funds and private equity funds. The aims of these provisions are: (1) addressing problems arising from hedge fund interconnectedness with large complex financial institutions (LCFIs); (2) preventing cross-subsidization of private funds by depository institutions having access to explicit and implicit government guarantees; and (3) regulation of conflicts of interest in the relationship between banks, their customers, and private funds.[177]

A. REGISTRATION WITH THE SEC AND THE OBLIGATION TO DISCLOSE DATA AND INFORMATION

The Dodd-Frank Act mandates hedge fund adviser registration in order to increase record keeping and disclosure.[178] The threshold taken into consideration for SEC registration is $100 million. However, pursuant to a rule that the SEC adopted under the Dodd-Frank Act, an adviser that manages only private funds, such as a hedge fund, need not register with the SEC if its assets under management are below $150 million—again, as long as the adviser is otherwise subject to regulation by the relevant state or states.[179] Hedge fund advisers obliged to register with the SEC have to file

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175. *See* Dodd-Frank Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571–74 (2010) (codified as amended at 15 U.S.C. § 80b-3 (2012)) (providing the exemptions for hedge fund adviser registration under the Investment Advisers Act of 1940).

176. *See* Ashworth, *supra* note 4, at 683.

177. *See* Hossein Nabilou, *Addressing Interconnectedness of Hedge Funds with Large Complex Financial Institutions: Is the Volcker Rule Panacea?* (Ludwig Maximilians Universität München, Working Paper, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_ id=2329335.

178. *See* FSOC UPDATE, *supra* note 23 (The Council emphasizes that "[t]he financial crisis of 2007-2009 demonstrated the need for clear accountability for the stability of the U.S. financial system. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established the Financial Stability Oversight Council (Council) to bring together, for the first time, the financial regulatory community to identify and respond to emerging threats to financial stability. Consistent with its mandate, the Council monitors all sectors of the financial services marketplace to identify potential threats to U.S. financial stability and, where appropriate, takes steps to address those threats.").

179. *See* Krug, *supra* note 3, at 454 ("An adviser that manages one hedge fund with three investors and, separately, the assets held by three individuals in three separate brokerage accounts is subject to the $100 million threshold. However, if those individuals instead placed their account assets in the hedge fund, the $150 million threshold would apply."); *see also* Kaal, *supra* note 3, at 264–65 ("The Dodd-Frank Act created the category of 'mid-sized investment advisers.' A midsized adviser is generally defined as an investment adviser with between $25 and $100 million USD in AUM that is subject to registration and examinations with the state in which it maintains its principal office and place of business. Dodd-Frank delegates responsibility for midsized

the Form ADV and Form PF.[180] The data collected by the SEC through Form ADV is important in order to protect investors and assess the risks posed by investment advisers.[181] This form is made up of two parts. Part 1 mainly concerns information about the investment adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events the adviser or its employees have experienced. Part 2 is divided into two sections, A and B, both of which are intended for distribution to the investors. Part 2A is called the brochure and must contain information regarding the investment adviser's business, funds managed, conflicts of interest, and risks in the investment strategies. Part 2B is the brochure supplement and focuses on the advisory personnel employed by the fund advisers.[182]

All of the information disclosed under Form ADV is fully available to the public.[183] In contrast, the data collected by the SEC through Form PF is used mainly to assess the systemic risks posed by hedge funds, and remains confidential due to its proprietary and sensitive nature. However, this information can be shared by the SEC with other agencies, such as FSOC. Given that smaller financial vehicles typically are less likely to pose relevant systemic risks, the SEC requires hedge fund advisers to provide different kinds of information on the basis of their assets under management. So hedge fund advisers with assets under management between $150 million and $1.5 billion (so-called small private fund advisers) have to file just Section 1 of Form PF, while hedge fund advisers with assets under management over $1.5 billion (so-called large private fund advisers) have to file both Sections 1 and 2 of Form PF.[184]

Section 1 is divided into three subsections: (1) subsection 1A requires registered hedge fund advisers to provide basic information about any hedge funds they manage; (2) subsection 1B asks for more detailed information about each fund, such as each fund's gross and net assets, the aggregate value of its derivatives positions, and its use of leverage;[185] (3)

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investment advisers away from the SEC to state regulatory authorities. Midsized advisers that do not fall under the SEC registration requirements are instead required to register with the state securities commissioner or similar agency in the state of their principle place of business. In some states, however, registered advisers are not subject to examination. The SEC will oversee midsized advisers in those states that will not provide appropriate oversight.").

180. *See* Kaal, *supra* note 3, at 264 (emphasizing that even "advisers with less than $150 million AUM have to maintain records and provide the SEC with annual reports or any other reports that the SEC deems appropriate or necessary to protect investors").

181. *See* Ashworth, *supra* note 4, at 687.

182. *See* Kehoe, *supra* note 1, at 64–65.

183. *See id.*; Ashworth, *supra* note 4, at 687.

184. *See* Ashworth, *supra* note 4, at 689–91 ("The SEC estimates that the $1.5 billion threshold will capture 'over 80% of the U.S. hedge fund industry.'").

185. This subsection also asks for the percentage of the funds equity held by the five largest equity holders. It is designed to allow the FSOC to monitor certain systemic risks for the broader private fund industry.

subsection 1C gathers data on each separate hedge fund managed by the adviser, such as "each fund's investment strategies and the percentage of the fund's assets managed using high-frequency trading strategies."[186]

Section 2 of Form PF[187] is aimed at gathering further data concerning "relevant areas of financial activity that have the potential to raise systemic concerns." Under Section 2A, large private investment advisers are required to give very detailed reports on the value of "assets invested (on a short and long basis) in different types of securities and commodities (e.g., different types of equities, fixed income securities, derivatives, and structured products)."[188] Section 2B requires further disclosure on each separate hedge fund managed with a net asset value over $500 million at the end of any month in the prior fiscal quarter. Advisers must disclose information such as portfolio liquidity, large institutional positions, posting of collateral by counterparties, leverage, and internal risk assessments. Large private fund advisers have to report this data every three months, while small private fund advisers are required to do so just once per year.[189] After collecting all this information, the SEC gives this data to FSOC, which in turn uses it to monitor the hedge fund activities and analyze the generation and spreading of systemic risks.[190]

B. THE INVESTMENT ADVISERS ACT OF 1940 COMPLIANCE RULES

Due to the fact that registered investment advisers are subject to the rules of the Investment Advisers Act of 1940, now even hedge fund managers "must adopt a detailed compliance network with procedures that are 'reasonably designed to prevent violations of the Act itself.'" For this reason they "must employ a competent chief compliance officer to oversee all the compliance activities . . . formulate a code of ethics [as well as] procedures to prevent insider trading, client privacy policies, and substantive proxy voting standards."[191]

186. In addition, advisers have to identify each hedge fund's top trading counterparties and information on trading and clearing practices. Section 1C is designed to enable FSOC to monitor systemic risk that could be transmitted through counterparty exposure, track how different trading strategies are affected by and correlated with market stresses, and follow the extent of private fund activities conducted away from regulated exchanges and clearing systems.

187. This section must only be filed by large private fund advisers.

188. This should help the FSOC monitor different asset classes typically held by hedge funds and show trends in hedge funds' exposures.

189. *See* Mark D. Flood, Philip Monin & Lina Bandyopadhyay, *Gauging Form PF: Data Tolerances in Regulatory Reporting on Hedge Fund Risk Exposures* 8 (Office of Fin. Research, Working Paper No. 15-13, 2015); Ashworth, *supra* note 4, at 691 ("Small Private Fund Advisers of hedge funds have to report less information, less frequently, than Large Private Fund Advisers. This is because, from a systemic risk monitoring perspective, the SEC does not think additional information or more frequent reporting is justified for hedge funds smaller than $1.5 billion.").

190. *See* Flood, Monin & Bandyopadhyay, *supra* note 189, at 6.

191. *See* Kehoe, *supra* note 1, at 46–47.

C. THE SEC'S ANTI-FRAUD RULE

After the failed attempt to impose the mandatory registration of hedge fund managers in 2004,[192] the SEC adopted an anti-fraud rule in 2007 that applied to all investment advisers, regardless of their registration with the SEC under the Investment Advisers Act of 1940.[193] Rule 206(4)-8(a)(1) of the Investment Advisers Act of 1940 prohibits investment advisers, including those advising hedge funds, from making false or misleading statements to investors or otherwise defrauding them.[194] In addition, the rule specifies that the SEC can bring enforcement actions against investment advisers who defraud current or prospective investors in hedge funds.[195]

The introduction of this rule can be considered a legislative response to the many financial scandals involving hedge fund managers who were not registered with the SEC.[196] In fact, when such a rule was introduced in 2007, hedge fund managers used to avoid the application of the Investment Adviser Act of 1940 due to the private fund exemption. Thus, to deal with this situation, the SEC determined that this rule had (and still has) to apply to both registered and non-registered investment advisers.

D. THE SEC'S CUSTODY RULE

Under the Investment Advisers Act, every hedge fund manager now "shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe."[197] In order to counteract managers' acts of misappropriation and stealing of fund assets, the SEC in 2010 issued a new version of the so-called "custody rule."[198] This rule mandates investment advisers to involve a qualified custodian in the asset management service, in order to safe keep client funds and securities. Qualified custodians are mainly banks and

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192. *See* Bines & Thel, *supra* note 15, at 152–55.

193. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 17 C.F.R. pt. 275 (2007).

194. *See* Albiez, *supra* note 56, at 168; *see also* Ashworth, *supra* note 4, at 678–79 ("The SEC noted that it 'would not need to demonstrate that an adviser violating [the Hedge Fund Anti-Fraud Rule] acted with scienter [(knowledge or intent to deceive, manipulate, or defraud.']. The SEC decided that using a negligence standard for determining the liability of fraudster hedge fund advisers is appropriate under the Hedge Fund Anti-Fraud Rule.); *see also* Kaal, *supra* note 3, at 251 n.23 (quoting Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,757 (Aug. 9, 2007) (to be codified at 17 C.F.R. pt. 275)) ("The rule clarifies that an adviser's duty to refrain from fraudulent conduct under the federal securities laws extends to the relationship with ultimate investors and that the Commission may bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in those pooled investment vehicles.").

195. *See* Sami, *supra* note 11, at 296.

196. *See* Lewis, *supra* note 12, at 363–68; Sami, *supra* note 11, at 296; Desmet, *supra* note 12, at 24–25.

197. *See* 15 U.S.C. § 80b-18b (2012).

198. 17 C.F.R. § 275.206(4)-2 (2010).

brokers-dealers registered under section 15(b)(1) of the Securities and Exchange Act. If the investment adviser is a broker-dealer registered under the Securities and Exchange Act, it can act as a qualified custodian with regard to the funds that it manages (so-called self-custody).[199] The rule also defines the concept of custody by emphasizing that it "means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them."[200]

The qualified custodian has to maintain the client fund and securities "[i]n a separate account for each client under that client's name, or [i]n accounts that contain only its clients' funds and securities, under [its] name as agent or trustee for the clients"[201] and has to send "an account statement, at least quarterly, to each . . . client for which it maintains funds or securities, identifying the amount of funds and type of each security in the account at the end of the period and setting forth all transactions in the account during that period."[202] Even more importantly, under the same rule the client funds and securities have to be "verified by actual examination at least once during each calendar year . . . by an independent public accountant, pursuant to a written agreement, . . . without prior notice or announcement" to the manager.[203]

It is worth noting that even before 2010 there was an SEC rule mandating investment advisers to involve a custodian to safe keep the client's assets. The problem at that time was mainly the fact that hedge fund advisers usually escaped the application of the Investment Advisers Act altogether, benefiting from the private fund exemption, which allowed them to also avoid the application of the SEC's custody rule. Given that the custody rule now applies to all registered hedge fund managers, the level of investor protection seems to be slightly increased compared to the past.

VII. THE SHORTCOMINGS OF U.S. REGULATION

The global financial crisis of 2007-2008 made clear how financial markets are interconnected and how financial entities, also benefiting from

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199. *See id.* § 275.206(4)-2(a)(6).

200. *See id.* § 275.206(4)-2 ("You have custody if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services you provide to clients. Custody includes: (i) Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them; (ii) Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and (iii) Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.").

201. *Id.*

202. *Id.*

203. *Id.*

lack of regulation and supervision, can easily generate and spread systemic risk. Even if hedge funds were not considered the cause of the financial crisis, they played a significant role in transmitting systemic risks from the U.S. financial markets—where they mostly operated—to the markets of other countries. Additionally, a number of financial scandals involving the U.S. hedge fund industry have shown how advisers can use these financial vehicles to defraud their investors in a variety of ways. The U.S. legislative response to both of these issues was the adoption of the Dodd-Frank Act in 2010, particularly Title IV (PFIARA), which is focused on the investment advisers to private funds such as hedge funds.

However, although Dodd-Frank was adopted in order "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices . . . ."[204] it is not certain whether the new provisions concerning hedge fund managers will be enough to address the stated legislative aims. Frankly, it seems excessive to even speak of hedge fund regulation in the U.S., since the only rules impacting hedge funds are the ones introduced by PFIARA regarding the registration of managers and the disclosure of data to the SEC and investors, in addition to the general rules introduced in 2007 prohibiting all investment advisers from committing fraud and the SEC's custody rule introduced in 2010.[205]

Even if all these provisions represent a step forward compared to the past, they can hardly suffice to prevent the creation and spread of systemic

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204. *See generally* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 5, 11, and 15 U.S.C.)

205. *See* George & Dymally, *supra* note 22, at 222–23 ("Following the Goldstein decision, the SEC adopted Rule 206(4)-8 as an amendment to the Advisers Act in order to enforce action against advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicles. Under the new rule, advisers of pooled investment vehicles are prohibited from making false or misleading statement to, or otherwise defrauding, investors or prospective investors in those pooled vehicles. A prime example in which the SEC alleged a violation of Rule 206(4)-8 is the complaint against Stanley Chais, a California based broker-dealer who solicited and raised approximately a billion dollars from investors for Bernard L. Madoff's Ponzi scheme. Madoff, who was previously charged with SEC fraud violations, employed the assistance of several 'feeders" of investment funds to solicit investors because "he [Madoff] was too successful to trouble himself with marketing to new investors.' One of those feeders was Chais who managed three funds valued at close to $1 billion, all of which were invested with Madoff. In 2009, the SEC charged Chais with fraudulent conduct based on misstatements and omissions concerning his management of the Funds' assets under the Securities Act, including violations of Section 10(b) of the Exchange Act and Rule 10b-5. The SEC's complaint against Chais alleged that Chais held himself out as an investment wizard with 40 years of experience when, in fact, he was no more than an unsophisticated investor who simply turned all of the funds' assets over to Madoff while charging the funds more than $250 million in fees for his purported 'services.' Chais made claims to the funds' investors that he formulated and executed the funds' trading strategy when, in reality, it was Madoff who managed all of the funds' assets. Most of the funds' investors were unaware that Chais invested with Madoff until after Madoff's arrest. In January 2011, the SEC dropped all charges against Chais after his death at age 84.").

risks and they will likely be unable to adequately protect investors from illegal or unethical conduct on the part of dishonest managers.[206] The most important new rules introduced by the Dodd-Frank Act are: (1) the mandatory registration with the SEC of investment advisers with more than $150 million of assets under management and (2) the duty to disclose a significant amount of data to the SEC and investors. However, if its legislative goals are to achieve financial stability and grant investor protection, how can these new provisions suffice?

It is not clear if the mandatory registration with the SEC and the consequent duty of disclosing information will be enough to address the creation and spread of systemic risks. In fact, in this regard, the U.S. regulation seems to be more focused on mandating the SEC to gather data and information and less on seeking to eliminate or at least reduce systemic risks.[207] However, it seems that one of the main reasons why these financial vehicles create and spread systemic risks is the excessive use of leverage. Therefore, to effectively address this problem, it would be necessary to act directly on leverage through the introduction of specific new rules.

In regards to the investor protection issue, even if the Dodd-Frank Act claims to aim at protecting consumers from abusive financial services practices, it is difficult to see which of its new rules are focused on the protection of investors. If it is certainly true that the disclosure of data and information by hedge fund managers to the SEC and investors increases the level of transparency of the industry, at the same time investors will hardly be able to benefit from the knowledge of these elements in order to avoid being defrauded by investment advisers. Moreover, it is commonly said that the SEC does not have a sufficient number of officials who can use this data in order to properly supervise the hedge fund industry.[208]

Additionally, both the anti-fraud rule and the custody rule seem to be a sort of "blunt sword," unable to properly protect investors. The anti-fraud rule is insufficient to prevent the commission of fraud because it simply provides the prohibitions and the relative sanctions, but it does not introduce legal mechanisms allowing these prohibitions to effectively work by preventing illegal conduct. For example, classifying and regulating murder as a crime, and thereafter providing penal sanctions for the criminal, is clearly not enough to avoid homicides. To try to reach this result, it is also necessary to have police on the streets in addition to many other different kinds of security measures that are able to prevent their

206. Namely, the two legislative goals that the Dodd-Frank Act declares to pursue.

207. Kehoe, *supra* note 1, at 38.

208. *See* Schneider, *supra* note 14, at 291 ("[T]he SEC has limited resources to inspect hedge fund advisers."); *see also* Nelson, *supra* note 9, at 222.

occurrence. For the same reason, in order to avoid fraud, it is necessary to increase the security measures in place in the asset management process.[209]

Furthermore, even though it is true that the custody rule was promulgated in order to counteract the occurrence of serious fraud and misappropriation, some critical elements are still in place. In particular, it seems that allowing investment advisers to self-custody the fund's assets could make it easy for them to act in conflict of interests. In fact, it is obvious that if the assets are in the physical possession or at the disposal of the managers, it is much simpler to steal or misappropriate them. Additionally, the fact that the custodian does not have specific powers to control the activities of the managers and stop them in case of illegal behaviors—such as fraud or misappropriation—is a further serious shortcoming of the regulation.

Finally, it seems to be inappropriate to give the managers the possibility to self-assess the fund's assets.[210] In fact, they are in the position of having an evident conflict of interest, given that they may want to overvalue or undervalue the assets for their own benefit. For them, it could be advantageous to decrease the value of the assets when an investor wants to redeem their interests in the fund in order to give them back less money; in the same way, it could be advantageous to increase the value when their fees have to be determined, as they are calculated on the basis of the assets under management and the profits gained by the fund. At the same time, the misrepresentation of the fund's performance and returns can fraudulently attract more investors, showing a situation to be better than it really is and allowing managers to charge undue fees. Hence, even with regard to the investor protection issue it seems to be appropriate to reflect on the introduction of some new rules.

VIII. POSSIBLE SOLUTIONS TO ADDRESS THE SHORTCOMINGS

Systemic risk in the hedge fund world is often connected with excessive use of leverage.[211] Therefore, in addition to the disclosure of data, it would

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209. *See* Schneider, *supra* note 14, at 291 ("The SEC's current enforcement strategy using the Advisers Act's antifraud provisions is inadequate because enforcement, without the tools for early detection such as disclosure and examination, is reactive rather than proactive to fraudulent activity. In many cases, the harm has already been committed, such that the SEC is punishing the wrongdoer rather than preventing the wrong.").

210. *See* Sami, *supra* note 11, at 303 ("Currently, the United States relies solely on hedge fund managers' valuation processes, and does not require independent evaluation of these processes."). The author also emphasized that "[t]he [SEC] Staff's main concern was the lack of independent review over the process through which hedge fund advisers value their funds' assets. This deficiency not only raised questions about the true value of a hedge fund's assets, but also raised concerns about the ability of registered funds (that invest in hedge funds) to accurately value their interests in hedge funds." *Id.* at 288.

211. *See* Gibson, *supra* note 4, at 705–06 ("Regulation limiting use of leverage by hedge funds could be justified because excessive leverage usage, combined with a hedge fund's tendency to

be helpful to think about the appropriateness of limiting the level of debt of such financial vehicles, since it can have a strong impact on financial stability.

With regard to the investor protection issue, looking back at the main financial scandals hurting an incredible number of investors, it is possible to discern that the most common types of fraud were (1) misappropriation of the fund's assets and (2) overvaluation or undervaluation of the fund's assets, performance, and profits. So, in addition to the disclosure of data, the antifraud rule, and the custody rule, it would be wise to consider the possibility of reinforcing the role and the powers of the custodian and providing the mandatory involvement of an external independent valuer with the task of assessing the fund's assets on a periodic basis. Thus, in light of the two main issues posed by hedge funds, this Article proposes to introduce some new rules aimed at counteracting or at least minimizing them.

The rules that could be useful to introduce are: (1) self-imposed leverage limits; (2) mandatory appointment of a depositary-custodian with more tasks and powers; and (3) mandatory appointment of an external independent valuer. The first rule is mainly aimed at addressing systemic risks, while the others aim at preventing the commission of fraud by managers that could seriously harm investors.

A. SELF-IMPOSED LEVERAGE LIMITS

It could be helpful to state that the investment adviser must set a limit on the amount of leverage that can be used for each fund, based on the financial strategies that the adviser intends to perform, and then respect such a limit.[212] Leverage is a powerful instrument that is able to increase the

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employ large-scale, aggressive trading strategies, could potentially disrupt the functioning of financial markets, on a domestic as well as global level. In a volatile market, highly leveraged hedge funds are much more vulnerable to failure because any loss incurred by the hedge fund could deplete, or completely subsume, the existing capital of the hedge fund. Massive liquidation of assets by the various creditors and counterparties of a troubled hedge fund simultaneously could cause market prices to decline, creating very thin markets in which the various creditors and counterparties compete with one another to obtain the best price for the liquidated collateral. Declining market prices not only injure those creditors and counterparties directly involved, but also affect market participants not affiliated with the hedge funds. Hence, employing leverage increases the possibility that a hedge fund's losses could be transmitted to its creditors and trading counterparties and also be transmitted to other market participants unaffiliated with the hedge fund.").

212. A rule imposing self-set limitations to the use of leverage has been introduced in the E.U. system by the Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 (AIFMD). *See* George & Dymally, *supra* note 22, at 262 ("One of the strategies widely used by AIFMs, which magnified the exposure of the AIFs during the financial crisis, was high leverage ratios. Funds reach those high levels of leverage when they engage in various forms of borrowing activities, which create stress within the AIF financial structure to meet its obligations during a market downturn. The Directive addressed this particular type of risk by requiring that AIFMs disclose specified leverage information to investors including the amount of leverage

impact of a financial intermediary on the market in terms of posing systemic risk; so the fact that managers would have to self-set their own limits and respect them seems to be an effective legal provision. To make it even more effective, it would be useful to provide the SEC with the power to intervene if the manager violates the self-set limits when this violation can generate systemic risks, obliging them to lower the level of leverage according to the self-set limits within a reasonable amount of time.

In determining this limit, investment advisers should demonstrate reasonableness with regard to the financial strategies that they intend to perform and the financial instruments and the markets in which they want to invest. In this regard, some general principles could be set directly by the SEC. For example, hedge funds employing financial strategies that are particularly risky, such as massive purchases of speculative derivatives, aggressive use of short selling, and concentration of significant parts of the portfolio in a small number of positions, should self-set and respect leverage limits that should be lower than the ones set by hedge funds employing less risky financial strategies, such as corporate activism.

There are different methods to calculate the amount of leverage of an entity. The ones used by FSOC are: (1) borrowing divided by net asset value (borrowing/NAV); it provides a measure of credit exposure relative to shareholder assets but does not measure synthetic leverage obtained through derivative investments; (2) gross asset value divided by net asset value (GAV/NAV); it provides a measure of financial leverage obtained through the use of cash borrowings (including repo, prime brokerage borrowing, and other secured and unsecured borrowing), but only includes the market value of derivatives and thus may understate synthetic leverage; and (3) gross notional exposure divided by net asset value (GNE/NAV); it provides the summed absolute values of long and short notional positions. This third measure incorporates financial and synthetic leverage, but has limitations. First, the summing of long and short positions ignores favorable effects of hedging or offsetting positions, which may reduce risk. A related shortcoming is that it treats all notional derivative values equally when calculating leverage levels, so it does not capture differences in risk exposure across different classes of derivatives. However, notional exposure on Form PF is adjusted for certain derivative instruments; funds report delta-adjusted values for options and 10-year bond equivalent values for interest rate derivatives.[213] In order to get a more consistent picture of

employed and that they submit reports on leveraging levels and other relevant leveraging information to competent authorities. AIFMs must set a maximum level of leverage, which they employ on behalf of each AIF managed. When it is deemed necessary and after proper notification has been given, the competent authority of the relevant home Member State shall impose limits on the level of leverage that AIFM may employ, or place other restrictions on the management of an AIF.").

213. FSOC UPDATE, *supra* note 23, at 16.

the debt situation, it would be helpful to combine all of these methods, as each of them is able to show different aspects of the phenomenon.

It is rather likely that the proposal to set a leverage cap for investment advisers will be strongly criticized. Many will say that leverage is useful to provide liquidity to the markets and counteract financial shocks, allowing funds to take contrarian positions in distressed markets.[214] In addition, it also allows hedge fund investors to make more significant profits. In the past, others have argued that the best way to counteract the excessive use of leverage by hedge funds was "the exercise of greater market discipline" by lending institutions,[215] meaning that it would be much better to put these limits on the hedge fund counterparties, mainly their prime brokers.[216] However, such a provision would not be effective given that hedge fund managers could easily "swallow" it by using prime brokers established outside the U.S., for instance in the United Kingdom, who are not subject to U.S. regulation.

To demonstrate that such measures are not enough to prevent this problem, it suffices to look at the terrific level of leverage many financial institutions of every kind carried before the global financial crisis of 2007-2008. Therefore, even if some of these arguments are understandable from the industry standpoint, the priority of the financial regulation should be to seek to prevent such a crisis from occurring again. It is hard to deny that one of the main reasons for the global financial crisis was the inconsiderate use of debt, not only by hedge funds, but in general by many different financial institutions. Moreover, so long as limitations on the use of such a powerful instrument as leverage can help avoid global meltdowns, or at least make them less painful, it seems wise to consider their introduction in the regulation.[217]

In this regard, a reasonable compromise between this fundamental aim and the one of the industry to use leverage could be found in the provision

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214. *See* Nabilou & Pacces, *supra* note 3, at 193 ("Due to pro-cyclicality of capital requirements, in times of market distress, most financial institutions facing leverage constraints are likely to deleverage and possibly cause fire sales and asset price downward spirals. Hedge funds, however, can step in and buy the assets. This function can mitigate and smooth the effects of shocks to asset prices in distressed markets, but leverage requirements would most likely undermine the beneficial contribution of hedge funds to the stability of financial markets."); *see also* Gibson, *supra* note 4, at 706 ("Public regulation imposing capital and margin requirements on hedge funds to constrain their use of leverage would be an inefficient and unnecessary means of addressing systemic loss. Restricting the use of leverage by hedge funds would impair the financial markets. Leverage allows hedge funds to buy and sell assets against prevailing market prices, thus providing liquidity to those markets.").

215. *See* Gibson, *supra* note 4, at 706–07.

216. *See* Nabilou & Pacces, *supra* note 3, at 207–08 (arguing that the best solution to address the creation and spreading of systemic risks in the hedge fund industry is through indirect regulation, namely, regulation of the hedge fund counterparties, like the prime brokers).

217. *See* Martin, *supra* note 60, at 110 ("[T]he possibility of imposing specific limitations on hedge funds' leverage exposure and speculative trading activities should be further explored, since overindulgence in these undertakings could expose the general public to excessive harms.").

to self-set limits that have to be fixed on the basis of a number of criteria, such as the financial strategies used by the manager, the types of assets purchased by the fund, and the markets in which it invests. A rule like this could allow the managers to pursue their financial goals while simultaneously helping to avoid unmanageable debt situations, such as that occurred in the period before the crisis.

B. THE INDEPENDENT DEPOSITARY-CUSTODIAN

The mandatory involvement of an independent depositary-custodian is a measure that has been recommended even by IOSCO.[218] This rule appears very useful to avoid cases of misappropriation of fund assets, given that in this way funds are physically segregated and held by a third institution that has to be independent from the hedge fund and hedge fund manager.[219] In fact, as the Madoff case has shown,[220] albeit in the broker-dealer sector, investments are placed in jeopardy if independent custodians do not properly safeguard the fund's assets.

A custody rule is already in place under the federal securities laws, but to make this rule really effective it should be mandated that there can be only one depositary-custodian for each fund managed by every investment adviser and, above all, that such a custodian is responsible for properly controlling and overseeing all the manager's activities. In other words, the role and function of the depositary-custodian should be rethought. Its involvement in the asset management process should be viewed as a means to grant more protection to the fund's investors. To get this result, it is necessary to provide through new rules more functions and powers to the depositary-custodian. Practically speaking, this goal could be reached by giving the custodian the power to control before and execute after the orders transmitted by the manager, only if these orders are compliant with the law, as well as with the fund's instrument of incorporation and the investment contracts. In other words, in order to move the fund's assets, for example buying or selling securities, the investment adviser should pass through the depositary-custodian, who would know in advance the purposes of the investment choices of the fund manager. In this way, the custodian could understand in advance if the real reason for these orders is to steal the assets or to commit other kinds of fraud, and if so, the custodian could stop the transaction.

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218. *See* INT'L ORG. SEC. COMM'NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION (2010), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf [hereinafter SECURITIES REGULATION] (mentioning among its principles the concept of segregation, by saying that there should be adequate segregation and protection of client monies and assets); *see also* Karmel, *supra* note 11, at 849.

219. The rationale behind this rule is represented by the crucial need to separate asset safekeeping and management functions, and to segregate investor assets from those of the manager.

220. George & Dymally, *supra* note 22, at 230 n.130.

This means that the function of the depositary-custodian should be redefined as a sort of independent controller involved in the service in order to protect the interests of the investors. To do so, in addition to the custody of the assets, the task of this controller should be to oversee the activities performed by the investment adviser in order to find out—if possible in advance—and prevent irregularities of every kind such as fraud, theft, and misappropriation.

In more detail, the depositary-custodian should: (1) monitor the fund's cash flows, (2) ensure that investor money and cash belonging to the fund are booked correctly on accounts opened in the name of the fund, (3) safe keep the fund's assets, (4) verify the ownership of all the fund's assets, (5) oversee that all payments made by the investors upon the subscription of units or shares have been received and have been booked in cash accounts opened in name of the fund, (6) oversee that the sale, issue, repurchase, redemption, and cancellation of units or shares of the fund are carried out in accordance with the fund's instrument of incorporation and the investment contracts, (7) oversee that the value of the units or shares of the fund is calculated in accordance with the fund's instrument of incorporation and the investment contracts, (8) carry out the instructions of the investment adviser, unless they conflict with the law, the fund's instrument of incorporation, or the investment contracts, (9) oversee that in transactions concerning the fund's assets the price complies with the market values, (10) oversee that the fund's income is used in accordance with the fund's instrument of incorporation and the investment contracts, (11) check the consistency between the number of units or shares issued and the subscription proceeds received, and (12) check that the external independent valuer's asset valuation is done properly and carefully.

The result would be a working structure of the hedge fund built on the basis of the so-called "investment triangle model," with the three corners being: (1) the investors, (2) the asset manager, and (3) the depositary-custodian, with the fund itself in the center.[221] This means that the asset manager decides the investment strategies while the custodian holds the assets on behalf of the fund, monitors the behavior of the manager, and intervenes in case of violation of the law, the fund's instrument of incorporation, or the investment contracts, in order to grant more protection to the investors.

To avoid serious conflicts of interest, the prime brokers should not be appointed as custodians, since they typically act as counterparties to hedge funds and therefore they cannot at the same time act in the best interest of

221. The "investment triangle model" is the working structure of the European Union Undertakings for the Collective Investment in Transferable Securities (UCITS schemes) under the UCITS Directive. *See* Marco Bodellini, *Does it Still Make Sense, From the EU Perspective, to Distinguish Between UCITS and Non-UCITS Schemes?*, 11 CAP. MKTS. L.J. 528 (2016); *see also* Zetzsche, *supra* note 21, at 13.

the fund, as should be required of a custodian. Given that to properly perform this important function the custodian needs a certain amount of information, the contract between it and the hedge fund should regulate the flow of this information. As already provided by the SEC's custody rule, it seems appropriate that the function of custodian can be performed only by banks and broker-dealers. However, it should be prohibited for the investment advisers to act as a custodian of the funds they manage.

The need for a depositary-custodian with this role and these types of powers is clear given the scandals from the past; the need lies in the assumption that the SEC does not have enough human resources to oversee the entire hedge fund industry.[222] For this reason, it is necessary to develop other ways to protect investors. One of these alternative ways could be to amend the Investment Advisers Act and the SEC's custody rule, introducing provisions aimed at giving the depositary-custodians new functions and empowering them to act properly and effectively in the interest of investors, like a kind of independent legality controller involved in their interest.

The hedge fund industry will likely strongly criticize this proposal, as it will cause a significant increase to the costs of compliance. Even if the involvement of a depositary-custodian with this kind of function would cause a significant increase in costs, it is likely that its subsequent effect would be an increase in confidence on the part of investors towards these financial vehicles. In fact, if this mechanism works, fraud and misappropriation should become less frequent. This could mean that many new investors would be willing to invest in hedge funds with the result that these new compliance costs would be covered by the increase in the assets under management.

C. THE EXTERNAL INDEPENDENT VALUER

The obligation to involve an independent valuer with the task of evaluating the assets of the fund on a periodic basis is particularly useful to avoid inappropriate assessment of the assets' value as well as misrepresentations of the fund's performance and returns.[223] The risk that this provision seeks to address is represented by the potential interest of the

222. *See* Schneider, *supra* note 14, at 291 ("[T]he SEC has limited resources to inspect hedge fund advisers."); *see also* Nelson, *supra* note 9, at 222.

223. *See* SECURITIES REGULATION, *supra* note 218 (including among its principles a mention of this concept, by saying that there should be robust valuation process); *see generally* Karmel, *supra* note 11; *accord* Sami, *supra* note 11, at 303–04 ("One way of ensuring investor protection is through independent, third party valuation of hedge funds' assets, especially when hedge funds are heavily invested in illiquid assets. Currently, the United States relies solely on hedge fund managers' valuation processes, and does not require independent evaluation of these processes. Although Principle 9.2 of the 2007 PWG Report advises managers to comply with 'industry sound 'standards'' in establishing valuation procedures, it seems that the onus is placed on the shoulders of investors, creditors, and counterparties to inquire into a fund's valuation procedures.").

manager to increase or decrease the valuation of the assets based on their own convenience.[224] To effectively counteract this risk, it seems appropriate to provide that the valuation of the fund's assets has to be done by an external independent valuer without any kind of relationship with the fund or the fund manager, in order to avoid conflicts of interest that could potentially damage the position of investors. Typically, either financial intermediaries or independent accounting firms would be the most reliable industry participants to provide this kind of service.

CONCLUSION

This Article seeks to demonstrate that there is a need for new hedge fund rules aimed at avoiding the creation and spread of systemic risk, on the one side, and protecting the investors from fraud and theft on the other. It is likely that this Article's proposal to enhance the regulation and supervision of hedge funds by introducing new rules and empowering the SEC will be strongly criticized by many scholars and the industry itself. It is quite foreseeable that the industry will take a position against this proposal as its first effect would be an increase in the costs of compliance that both the investment advisers and the hedge funds would have to bear, while simultaneously decreasing investment freedom. Additionally, many commentators will argue that more regulation and more supervision are not necessary because hedge fund managers and hedge funds are already subject to them. They will justify this statement by saying that there are already in place anti-fraud rules, provisions on the custody of the fund's assets, as well as the duty to register with the SEC and disclose a great deal of data and information. Further, in light of this proposal, the industry could potentially react by threatening to move abroad to jurisdictions where the regulations are more lenient.[225]

However, these arguments cannot be shared as the current rules are inappropriate, or at least are insufficient, to address the problems that hedge funds can cause to investors and markets. Also, the industry's threat to move abroad can be easily counteracted, because as long as the main market to sell hedge fund interests is the U.S. market, the U.S. legislature

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224. *See* George & Dymally, *supra* note 22, at 262 ("Investors suffer losses when there is an inaccurate valuation which leaves them with a diminished pool of assets when they redeem. Also, fund managers have an incentive to overvalue the assets when their remuneration is partially dependent on their value.").

225. Desmet, *supra* note 12, at 26 ("[O]verregulation in the U.S. markets will result in hedge fund advisers relocating offshore, where they would face less regulatory scrutiny."); *see also* Gibson, *supra* note 4, at 706 (arguing that introducing limits to the use of leverage "would probably only result in the emigration of hedge funds offshore to countries with less restrictive regulation. The movement of hedge funds to offshore locations would frustrate any ability of the U.S. financial regulators to monitor their trading activity, which, nevertheless, would continue to impact the U.S. markets. Private regulation achieved through the exercise of market discipline, both by hedge funds and by those with whom they trade, can provide a more effective means of constraining the use of leverage.").

and regulators will have the power to impose the rules that they think are appropriate. And if the investment advisers want to access this market they will be obliged to respect these rules. Even though the application of these rules can be costly for the investment advisers, this price is reasonably motivated by very important legislative aims such as investor protection and systemic risk prevention.

Beyond the interests of the hedge fund managers, an advanced and well-functioning financial market is predicated on the confidence of investors.[226] Investors can only be confident if the regulation demonstrates the ability to minimize the opportunities for financial intermediaries to cheat and defraud them,[227] and to negatively impact the markets by creating instability. This is why financial regulation is so important in general and why hedge fund regulation is necessary regardless of the features and skills of the investors who are allowed to buy interests in these financial entities.

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226. *See* Martin, *supra* note 60, at 1186 ("If investors believe that regulators are appropriately monitoring fraud, conflicts of interest, and other financial abuses, then they would be more willing to invest in various markets. Limited investor confidence can eventually constrain liquidity by pushing investors out of the capital markets into safer investments, such as treasury bonds. This can lead to decreased gains for existing stockholders, lower amounts of spending, other major cutbacks by companies, and slower economic growth.").

227. *See* Lynn A. Stout, *The Investor Confidence Game* 21 (UCLA Sch. of L., Research Paper No. 02-18, 2002), http://ssrn.com/abstract_id=322301 ("American investors must believe that somehow the legal system constrains these individuals sufficiently that the benefits of investing outweigh the risks. They must believe that the regulators are regulating, and the watchdogs are watching. In other words, investors may not need to trust *people* before they are willing to give up their hard-earned dollars. But they must at least trust *the system*.") (emphasis in original).