

Regulating Hedge Funds

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Pressure is mounting to control hedge funds, managed pools of private money that use very sophisticated trading strategies in securities, currencies, and derivatives. The industry's size – hedge funds contain over \$1.5 trillion¹ – and the impact of the funds' trading strategies on securities markets² and on company operations³ has prompted regulators around the world to investigate the industry. The Securities and Exchange Commission recently promulgated a limited package of new rules, effective on February 1 of this year.⁴ More regulation may be coming.⁵ Congress has held hearings on hedge funds to see if the SEC rules are sufficient.⁶ Governments in Britain, France,

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¹ Michael Steinhadt, *Do You Really Need a Hedge Fund?*, WALL ST. J., Apr. 14, 2006, at A16 (noting a gulf between hedge fund performance and fund manager compensation).

² Robert C. Pozen, *Hedge Funds Today: To Regulate or Not?*, WALL ST. J., June 20, 2005, at A14 (suggesting a collapse of highly leveraged hedge funds may threaten the integrity of other financial institutions; hedge funds may play an aggressive role in campaigning for an overhaul of corporate governance).

³ *Id.*

⁴ See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

⁵ Kara Scannell, *Hundreds of Hedge-Fund Advisers Register With SEC*, WALL ST. J., Jan 28, 2006, at A3. See also Rita Raagas de Ramos, *Concerns Over Hedge Funds Rise as Market Volatility Rises Globally*, WALL ST. J., June 15, 2006, at C5 (Some financial experts believe that more regulation of hedge funds is needed to achieve financial stability. Mark Shipman, a partner at Clifford Chance, argues that a universal system of hedge fund regulation is necessary because hedge funds invest in global markets and are available globally. Peter Douglas, head of Alternative Investment Management Association in Singapore, suggests that current hedge fund regulation is virtually irrelevant because most hedge funds are located offshore in completely unregulated jurisdictions. He argues that marketing regulation would be a more effective way of protecting nonprofessional investors from hedge funds.).

⁶ See, e.g., *Hedge Funds and Capital Markets: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing and Urban Affairs*, 109th Cong. (2006) (Statement by Randal K. Quarles, Under Sec. for Domestic Finance) (stating that the Treasury Department will examine in detail whether the growth of hedge funds holds the potential to change the overall level or nature of risk in our markets).

and Germany and the European Union are also looking into whether special rules are needed for the industry.⁷

A hedge fund in the United States is defined by its niche in our federal securities acts. This is not randomly related to the flourishing of the hedge fund industry. Hedge funds owe a substantial degree of their success to their freedom from federal regulations on their formation, organization and trading practices. Tighten up hedge fund regulation and we threaten their competitive advantage. I would rather we loosen up the restraints on hedge fund competitors, such as mutual funds, and allow others to enjoy the trading advantages now enjoyed by hedge funds.

This short piece is on the merits of government regulation of hedge funds.⁸ The article begins with background information on hedge funds and the current state of their regulation. After sifting through the various reasons advanced for regulating hedge funds, and focusing on three in particular – short selling, leverage, and funds of funds, I argue that extensive direct regulation of hedge funds is unnecessary and may harm the country’s trading markets.

⁷ *Thorns in the Foliage; Regulating Hedge Funds*, THE ECONOMIST, Apr. 1, 2006 at 31 (In Britain, the Financial Services Authority has begun investigating the unfair treatment of investors and potential conflicts of interest among fund managers. France, Germany, and Ireland have adopted new regulatory structures that permit retail investment in hedge funds. The European Union commissioned an “expert group” to harmonize rules and taxation of hedge funds among member states.).

⁸ For recent articles on the regulation of hedge funds, see Roberta S. Karmel, *The SEC At 70: Mutual Funds, Pension Funds, Hedge Funds And Stock Market Volatility - What Regulation By The Securities and Exchange Commission Is Appropriate?*, 80 NOTRE DAME L. REV. 909, 949 (2005) (“In the absence of a new crisis involving derivatives, excessive leverage in the market or manipulative activities by institutional investors, it is unlikely that Congress, the SEC or any other financial regulator will decide to study and reform institutional investor behavior.”); Andrew M. Kulpa & Butzel Long, *The Wolf In Shareholder’s Clothing: Hedge Fund Use of Cooperative Game Theory and Voting Structures To Exploit Corporate Control and Governance*, 6 U.C. DAVIS BUS. L.J. 4 (2005) (“Fund managers are focusing on game theory voting models in order to predict how other voters will react to any given situation.”); Charlene Davis Luke, *Beating The “Wrap”*: *The Agency Effort To Control Wraparound Insurance Tax Shelters*, 25 VA. TAX REV. 129, 132 (2005) (“[I]nsurance companies - with the likely complicity of sophisticated, wealthy taxpayers - wrapped private placement hedge fund interests inside variable insurance products in order to defer tax on the ordinary income thrown off by such interests.”); David Skeel, *Behind the Hedge*, LEGAL AFFAIRS, Dec. 2005, at 28 (“As long as the pressure to take unreasonable risks and to show outsized returns continues, the basic integrity of the markets, and the investments of millions of Americans who think they have nothing to do with hedge funds, will be in danger.”).

Indeed, the dramatic growth of hedge funds is in part attributable to the current overregulation of registered investment companies. We should, therefore, not tighten the regulation of hedge funds but lighten the regulation of registered investment companies. I also argue, however, that the strengthening of some forms of indirect regulation of hedge fund leverage, principally limits on banks that lend to and are counterparties of hedge funds, may make sense.

I. WHAT IS A HEDGE FUND?

A hedge fund is a privately-held, privately-managed investment fund. The funds are designed to maximize their freedom to employ complex trading strategies by minimizing their regulation under various federal statutes. The most accurate definition of a hedge fund is a fund that is not registered under a list of specific federal acts. The funds are exempt from the public offering registration requirements of the Securities Act of 1933,⁹ the periodic reporting obligations of the Securities Exchange Act of 1934, and the registration requirements of the Investment Company Act of 1940.¹⁰ Until the new Securities Exchange Commission (“SEC”) rule changes that went into effect this year, most hedge funds were also exempt from the registration requirements of the Investment Advisers Act of 1940.¹¹

A hedge fund manager raises money from wealthy individuals and institutional investors using an exemption for “private offerings” under the Securities Act of 1933, Rule 506 of Regulation D.¹² Most hedge funds satisfy the exemption by marketing themselves only to “accredited investors,” institutional investors,¹³ insiders, or natural persons with a net worth of over \$1 million or income over \$200,000 for each of the last two years.¹⁴ Funds that use Rule 506 are prohibited from using any form of “general solicitation or general advertising.”¹⁵ The SEC applies a “pre-

⁹ See 15 U.S.C. § 77d(2) (2000).

¹⁰ See 15 U.S.C. § 80a-3(c)(7) (Supp. 2006); 15 U.S.C. § 80a-2(a)(51)(A) (2000).

¹¹ See 15 U.S.C. § 80b-3(b) (2000). See also Scannell, *supra* note 5.

¹² See 15 U.S.C. § 77d(2) (2000).

¹³ Banks, savings and loan associations, registered broker/dealers, investment companies, licensed small business investment companies, employee benefit plans, and other business entities and trusts with more than \$5 million in assets. 17 C.F.R. § 230.501 (2005).

¹⁴ 17 C.F.R. § 230.501(a) (2005). The funds can include up to thirty-five non-accredited investors who are sophisticated or have sophisticated advisers. In practice, however, hedge funds, in order to limit their liability exposure, rarely have clients who are not accredited investor clients.

¹⁵ 17 C.F.R. § 230.502(c) (2005).

existing, substantive relationship” test when deciding that the general solicitation rule has not been violated.¹⁶

A hedge fund’s goal is to remit to those investors a high rate of return on their capital contributions through sophisticated trading strategies in securities, currencies, and derivatives.¹⁷ If a fund manager is successful for fund investors, the fund manager is handsomely paid.¹⁸ The fund manager takes a one to two percent management fee and twenty percent of the fund’s profits (the carry).¹⁹ The top twenty-five fund managers last year grossed over \$130 million.²⁰ A successful manager usually establishes a number of distinct, follow-up funds. If a fund manager earns lackluster returns, the investors pull their capital and will not support a manager’s effort to raise new funds. Historically, the hedge funds operate with a very short “lock-in,” the amount of time an investor must commit money pledged to the fund.²¹ Those hedge funds that lose money, and many do, simply wither away. It is a raw “survival of the fittest” industry.

Moreover, a hedge fund is careful to avoid classification as a financial market player that is specifically regulated in the federal legislation. A hedge fund, for example, is not an underwriter, a market-maker, or a broker-dealer (market intermediary).²² A bank or investment subsidiary of an operating company is not a hedge fund.²³ Hedge funds are also careful, by having less than 500 investors, to avoid the periodic

¹⁶ A pre-existing relationship between the hedge fund and its client must exist at least thirty days before the investor may invest. E.g., IPONET, SEC No-Action Letter, 1996 WL431821, at *1 (July 26, 1996); Lamp Technologies, Inc., SEC No-Action Letter, 1997 WL282988, at *3 (May 29, 1997).

¹⁷ CITIGROUP ALTERNATIVE INVESTMENTS, HEDGE FUND PRIMER 2 (2004), available at http://www.smithbarney.com/pdf/HedgeFundPrime_0305.pdf (stating that hedge funds seek to generate attractive absolute returns regardless of the direction of capital markets, and listing a variety of hedge fund strategies).

¹⁸ Jenny Anderson, *Atop Hedge Funds, Richest of the Rich Get Even More So*, N.Y. TIMES, May 26, 2006, at C2 (Anderson explains that the magic behind the money is the compensation structure of a hedge fund. Institutions like endowments and pension funds have continually flocked to hedge funds, fueling the hedge fund boom.).

¹⁹ *Id.* See also SCOTT J. LEDERMAN, HEDGE FUNDS, IN FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS, 11-5 (Clifford E. Kirsch ed., 2000).

²⁰ Anderson, *supra* note 18.

²¹ See CITIGROUP ALTERNATIVE INVESTMENTS, *supra* note 17, at 7 (Most hedge funds specify a lockup period of six months to five years, during which an investment cannot be redeemed.). The short lock-in is a substitute for clients’ ability to sell their interests in a fund. Most hedge funds prohibit any transfer of client interests without the written consent of the hedge fund manager. Rule 506’s restrictions on resale are, therefore, not a problem.

²² *Id.* at 2 (Hedge funds are private, less regulated investment pools that invest in securities markets and derivatives on a leveraged basis. Hedge funds typically take the form of a partnership or limited liability corporation.). Hedge funds are “traders”, those that buy and sell securities for investment, not “dealers.”

²³ *Id.*

reporting obligations of Section 12 of the Exchange Act and SEC Rule 12g-1.

The most important regulatory exemption for hedge funds is found in the Investment Company Act of 1940, an act that regulates mutual funds. Hedge funds rely on one of two statutory exclusions in the definition of an investment company. Hedge funds either have less than 100 investors²⁴ or have only investors that are “qualified purchasers,” individuals who own over \$5 million in investments or companies with over \$25 million in investments.²⁵ A hedge fund, lying outside regulations for these entities, may use investment techniques that are forbidden to the registered investment companies.²⁶ The most notable technique that is more freely available to hedge funds than other specifically regulated financial entities is “shorting,” betting on decreases in value in asset classes.²⁷

Most hedge fund investment strategies are complex, involving a combination of several coordinated trading positions to make the desired market play. Several of the strategies have common names. In “convertible arbitrage,” for example, a hedge fund goes long in convertible securities (bonds or shares that are exchangeable for another form of securities, usually common shares, at a pre-set price) and simultaneously shorts the shares.²⁸ In “merger arbitrage,” a hedge fund buys target company stock and shorts the stock of the purchaser.²⁹ In “global macro” plays, a fund takes a long position in one country’s currency and shorts the currency of another (this is also done with government debt).³⁰ In “market neutral” plays, a fund takes offsetting long positions in undervalued companies and short positions in overvalued companies.³¹

There are now “funds of funds” (“FOF”s) that invest in a basket of hedge funds.³² Some of these funds are offered to the public, worrying regulators.³³

²⁴ See 15 U.S.C. § 80a-3(c)(7) (Supp. 2006).

²⁵ See 15 U.S.C. § 80a-2(a)(51)(A) (2000).

²⁶ ROBERT A. JAEGER, ALL ABOUT HEDGE FUNDS, 4-5 (2000) (Mutual funds must abide by SEC rules that provide limitations on leverage and short selling. Hedge funds have more flexibility with their investment strategies because they do not have to abide by these rules.).

²⁷ *Id.* See also CITIGROUP ALTERNATIVE INVESTMENTS *supra* note 17, at 6.

²⁸ IMF, GLOBAL FINANCIAL STABILITY REPORT, at 52 (Sept. 2004), available at <http://www.imf.org/external/pubs/ft/GFSR/2004/02/pdf/gfsr0904.pdf> (listing and defining various hedge fund strategies, including equity market neutral, convertible arbitrage, fixed income, distressed securities, merger arbitrage/risk arbitrage, equity hedge, sector composite, emerging markets, global macro, and short selling). See also SEC Staff Report to the SEC: *Implications of the Growth of Hedge Funds*, at 34-36 (Sept. 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

²⁹ IMF, *supra* note 28, at 52.

³⁰ *Id.*

³¹ *Id.*

³² Dave Kansas, *Making Sense of Wall Street --- As Investment Choices Pile Up, Grasping Fundamentals Is Key; Hedge-Fund Boom Explained*, WALL ST. J., Jan. 14,

Hedge funds also structure their operations to avoid other regulations as well. Hedge funds also typically avoid the regulation of “commodity pools” by the Commodity Futures Trading Commission (CFTC). New CFTC rules exempt pools that sell only to sophisticated participants, “accredited investors” under Regulation D³⁴ or “qualified purchasers” under the Investment Company Act.³⁵ Hedge funds avoid regulation under Employee Retirement Income Security Act (ERISA) by limiting the ownership interest of any employee benefit plan to less than twenty-five percent of the fund.³⁶

II. THE VALUE OF HEDGE FUNDS

Timothy F. Geithner, President and Chief Executive Office of the Federal Reserve Bank of New York notes the positive role played by hedge funds:

Hedge funds play a valuable arbitrage role in reducing or eliminating mispricing in financial markets. They are an important source of liquidity, both in periods of calm and stress. They add depth and breadth to our capital markets. By taking risks that would otherwise have remained on the balance sheets of other financial institutions, they provide an importance source of risk transfer and diversification.³⁷

In a later speech Geithner noted that “Hedge funds, private equity funds and other kinds of investment vehicles help to disperse risk and add liquidity.”³⁸

The testimony of Patrick M. Parkinson, Deputy Director of the Division of Research and Statistics of the Federal Reserve Board, provides an example:

2006, at B1 (“Funds of funds” are pools of money gathered from individuals and institutions, which in turn are funneled into a group of hedge funds. This practice has opened the world of hedge funds to new, smaller class of investors.).

³³ *Id.*

³⁴ 17 C.F.R. § 4.13 (2005); 17 C.F.R. § 4.30 (2005).

³⁵ 17 C.F.R. § 4.13(a)(4) (2005).

³⁶ 29 C.F.R. § 2510.3-101(f)(1) (2006).

³⁷ Timothy F. Geithner, President and CEO, Fed. Reserve Bank of New York, Keynote Address at the National Conference on the Securities Industry: Hedge Funds and Their Implications for the Financial System (November 17, 2004), *available at* <http://www.ny.frb.org/newsevents/speeches/2004/gei041117.html>.

³⁸ Timothy F. Geithner, President and CEO, Fed. Reserve Bank of New York, Remarks at the Institute of International Bankers Luncheon in New York City (October 18, 2005), *available at* <http://www.ny.frb.org/newsevents/speeches/2005/gei051018.html>.

In various capital markets, hedge funds are increasingly consequential as providers of liquidity and absorbers of risk. For example, a study of the markets in U.S. dollar interest rate options indicated that participants viewed hedge funds as a significant stabilizing force. In particular, when the options and other fixed income markets were under stress in the summer of 2003, the willingness of hedge funds to sell options following a spike in the options prices helped restore market liquidity and limit losses to derivatives dealers and investors in fixed-rate mortgages and mortgage-backed securities. Hedge funds reportedly are significant buyers of the riskier equity and subordinated tranches of collateralized debt obligations (CDOs) and of asset-backed securities, including securities backed by nonconforming residential mortgages.³⁹

III. THE NEW SEC RULES REQUIRING THE REGISTRATION OF HEDGE FUND MANAGERS

As noted above, historically, hedge funds have operated in the exceptions and exemptions of the Securities Act of 1933 (there is no public offering),⁴⁰ the Securities and Exchange Act of 1934 (they are not publicly traded companies),⁴¹ the Investment Company Act of 1940 (they are not mutual funds),⁴² and, until recently, the Investment Advisers Act of 1940 (until this year they were not public investment advisers).⁴³

This is not to say that they have been “unregulated,” as many do. The anti-fraud provisions of the ‘33 and ‘34 acts apply with full force to the activities of the funds⁴⁴ and state laws against investor fraud apply as well.⁴⁵ Hedge fund managers cannot make false statements of material information (or use misleading material half-truth) when dealing with their investors or counterparties in trades.⁴⁶ Banking laws also restrict the activities of hedge fund lenders – banks – in significant respects.⁴⁷

³⁹ *The Role of Hedge Funds in the Capital Market: Hearing Before the S. Subcomm. on Securities and Investment, Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (May 16, 2006) (testimony of Patrick M. Parkinson, Deputy Director, Division of Research and Statistics of the Federal Reserve Board), available at <http://www.federalreserve.gov/boarddocs/testimony/2006/20060516/default.htm>.

⁴⁰ See 15 U.S.C. § 77d(2) (2000).

⁴¹ See 15 U.S.C. § 78c(a)(4) (Supp. 2006).

⁴² See 15 U.S.C. § 80a-3(c)(7) (2005); 15 U.S.C. § 80a-2(a)(51)(A) (2000).

⁴³ See 15 U.S.C.S. § 80b-3(b) (2000).

⁴⁴ See *id.* § 80b-6 (2000).

⁴⁵ See *id.* § 80b-3a(b)(2).

⁴⁶ See *id.* § 80b-6(1).

⁴⁷ See discussion *infra* pp. 28-30.

Thus far the SEC has responded to calls to regulate hedge funds with fairly mild registration requirements that took effect in February of 2006.⁴⁸ The SEC narrowed the traditional exemption under the Investment Advisers Act of 1940 enjoyed by the funds under the “private adviser exemption.” Section 203(b)(3) exempts an adviser from registration if it (1) has had less than fifteen clients in the past twelve months, (2) does not hold itself out generally to the public as an investment adviser, and (3) is not an adviser to any mutual fund (registered investment company).⁴⁹ An exempt adviser is still subject to the Act’s antifraud requirements⁵⁰ as well as Rule 10b-5 under the Securities and Exchange Act of 1934.⁵¹

For the purposes of the fifteen client exemption, until this year the fund itself counted as a single client for an adviser (and an adviser was its own client).⁵² A single hedge fund manager could advise fourteen different funds, each with multiple investors, and stay within the exemption. New SEC Rule 203(b)-(3)-2 contains a “look-through” rule. The section requires investment advisers to count each owner of a “private fund” as a client for the purposes of determining the availability of the private adviser exemption. As a result, the adviser of any hedge fund that has had more than fourteen investors during the past twelve months loses the private adviser exemption. Moreover, an adviser that advises individuals outside a fund must count those clients along with the fund investors in determining the number of advisees for the purposes of the section. There are special secondary “look-through” rules for a fund of funds.⁵³

The new rule carefully defines “private funds” that are subject to the “look-through” rule to exclude other pooled investment vehicles such as private equity funds and venture capital funds.⁵⁴ A company is a private fund only if the fund permits investors to redeem their money in the fund within two years of the time of investment. Private equity funds and venture capital funds typically require commitments of capital well in excess of two years. Hedge funds average lock-up period prior to the new rule was less than twelve months.⁵⁵ The new rule also carefully exempts

⁴⁸ Scannell, *supra* note 5.

⁴⁹ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279).

⁵⁰ 15 U.S.C. § 80b-6 (2000).

⁵¹ 17 C.F.R. § 240.10b-5 (2005).

⁵² A single hedge fund could have up to 499 investors and not register. Once a fund had 500 investors it had an obligation to register under section 12 of the Exchange Act, 15 U.S.C. 78h, and SEC Rule 12g-1, 17 C.F.R. 240.12g-1 (2006), if its assets were in excess of \$10 million.

⁵³ 17 C.F.R. § 240.10b-5 (2005).

⁵⁴ *Id.*

⁵⁵ Sanford C. Bernstein & Co., *The Hedge Fund Industry – Products, Services, or Capabilities*, BERNSTEIN RESEARCH CALL, May 19, 2003, at 5.

from the “look-through” rule investment adviser clients that are business organizations (insurance companies), broker-dealers and banks.⁵⁶

The new rule does not alter another exemption for the amount of assets under management. A United States hedge fund adviser is exempt if the fund holds less than \$25 million in assets.

With the exemption to the Investment Advisers Act lifted, hedge funds must now register with the SEC.⁵⁷ Registered advisers file a Form ADV. Part I discloses, among other things, an investment adviser firm’s name and location, the number of funds managed, the amount of assets under management (a set of financials), the method of compensation, the owners of the advisory firm, the number of employees, disciplinary history, affiliates of the firm (those who control or are controlled by the firm), types of clients, and other business activities and clients. Part II of Form ADV gives details on the manager’s business background, a basic fee schedule, potential conflicts of interest between the manager and the investors in the fund, and general information on types of investments and trading strategy. The name, education and previous five years of business experience of each member of the firm’s investment group must be included.

Once registered as an investment adviser, a fund manager is subject to discretionary SEC examinations of its books and procedures.⁵⁸ Registration also enables the SEC to screen hedge fund advisers for prior convictions or other professional misconduct.⁵⁹

Registered advisers must adopt compliance procedures, administered through an internal compliance officer, adopt and enforce a written code of ethics and a proxy voting procedure, keep specified client accounts and records, and furnish each client or prospective client with a written disclosure statement (Part II of Form ADV) containing a general description of trading practices.

Registration under the Advisers Act also requires investors in most hedge funds to meet minimum net worth standards of a “qualified client”

⁵⁶ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,073 (Dec. 10, 2004) (An entity is not a “private fund” unless it would be subject to the Investment Company Act but for the exception, which defines an “investment company” in either 3(c)(1) (a “3(c)(1) fund”) or 3(c)(7) (a “3(c)(7) fund.” Thus, most business organizations may be exempted from the “look-through” rule.).

⁵⁷ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

⁵⁸ *Id.* at 72,061 and n.85 (The staff’s examination may include review of the advisory firm’s internal controls and procedures; the staff may also determine the adequacy of these procedures for valuing client assets, placing and allocating trades, and arranging for custody of client funds and securities. The staff may further examine the adviser’s performance claims and delivery of its client disclosure brochure.).

⁵⁹ *Id.* at 72,078 (The Commission may screen the adviser and associated individuals, and deny registration if they have been convicted of a felony or otherwise have a prior disciplinary record subjecting them to disqualification. This is aimed at discouraging “scam artists” from entering the hedge fund industry.).

under SEC Rule 205-3.⁶⁰ Each investor must have a net worth of at least \$1.5 million or at least \$750,000 of assets with the adviser.⁶¹

The SEC releases on the new rules take the position that the intrusion on hedge fund operations is minimal. The SEC stresses that registration under the Investment Advisers Act does not require an adviser to follow or avoid any particular trading strategy, does not require or prohibit any specific investments, and does not require an adviser to reveal their specific trading strategies or disclose their specific portfolio holdings.⁶²

Previously unregistered hedge fund managers reported to the Wall Street Journal that the new regulations are not “slight” or “minimal.”⁶³ The new rules, some claimed, will cost their funds approximately \$500,000 a year.⁶⁴ Some managers have fretted about the potentially crippling time lost in a minute-to-minute, bet-the-house trading business when dealing with SEC examiners who do not understand the trading strategies and will take time to be educated.⁶⁵ Other managers wonder about the inevitable heightened exposure to private and public litigation that additional mandatory disclosures on technical matters, especially those on trading patterns, would bring.

The SEC’s response was to dismiss the claims with a hint of derision by noting that it was already applying the Institutional Investor’s Act to a number of hedge funds that were already registered under the Act (some voluntarily).⁶⁶ The SEC relied heavily on the comments of those hedge fund managers that were registered under the older rules, noting that those managers did not believe the rules were an intrusion on their investment operations.⁶⁷ Moreover, the SEC noted that it had no trouble understanding sophisticated trading practices of hedge fund operators.⁶⁸ The response of the SEC was a high-wire act: the agency was in the delicate position of both asserting that the new rules were necessary and would have positive consequences and that the new rules would have a minimal effect on hedge fund trading.

The new regulations will have some consequences. First, some hedge funds have increased their investor lock-in to over two years to avoid

⁶⁰ *Id.* at 72,064.

⁶¹ *Id.* (“Investor” in a private investment company that charges a performance fee.)

⁶² *Id.*

⁶³ Gregory Zuckerman and Ian McDonald, *Hedge Funds Avoid SEC Registration Rule - -- Some Big Firms Change Lockups, Stop Accepting New Investments To Take Advantage of Loopholes*, WALL ST. J., Nov. 10, 2005, at C1.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ Registration Under the Adviser’s Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,062 (Dec. 10, 2004).

⁶⁷ *Id.*

⁶⁸ *Id.* at 72,062 (stressing the existing responsibility to registered hedge funds, and that there is “nothing unique” that would make examination ineffective).

registration. The longer the lock-in the less control investors have over fund managers' activities. Second, some hedge fund advisers will move offshore to organize their funds.⁶⁹ The offshore funds must register if they have more than fourteen United States clients, but avoid some of the Act's requirements, specifically the compliance, custody and proxy voting rules. The SEC itself noted that seventy percent of hedge funds are organized offshore. And third, there will be more consolidation among hedge fund firms. Avoiding registration under the Investment Advisers Act provided a check on hedge fund mergers. Once most hedge fund advisers have registered the check on mergers largely disappears.⁷⁰

Moreover, the small seedling of new regulations will, no doubt, grow. The two commissioners that dissented argued, among other things, that the rules did not match the SEC policy arguments in justification.⁷¹ In other words, if the SEC is serious about its policy concerns, more tailored rules must follow.

Moreover, there is a political inevitability of additional rules. With each new hedge fund failure, and there will be failures, the SEC will face a harsh round of questioning over why the agency did not catch the problem. Hedge funds offer high returns in exchange for high levels of risk. In any given year some hedge funds will lose money and some will go out of business. One can be sure that hedge funds will continue to fail under the new rules and some of those that do will have engaged in fraudulent conduct.

A prominent reason given by the SEC for its new rules is the "deterrence and early discovery of fraud."⁷² If under the new rules the SEC fails to discover a substantial fraud, which at some point it will, the quick attack will be on the rules – that the rules are inadequate. The SEC's defensive response inevitability will be to successively grow its disclosure rules and structural requirements. I anticipate that sooner rather than later, the SEC will have a new section of rules devoted exclusively to hedge funds. The new rules, not the possible future extensions of the rules (the "slippery slope" position), are a problem.

⁶⁹ *Hedge Fund Operations: Hearing before H. Comm. On Banking & Fin. Servs.*, 105th Cong. 26 (1998) (Federal Reserve Board Chairman, Alan Greenspan) (expressing his concern that regulation of the hedge fund industry may compel a move of the industry overseas, which would diminish federal oversight).

⁷⁰ See *Hedge Fund Regulation May Force Consolidation*, PIPELINE 3 (June 15, 2003) (concluding that registration of hedge funds would impose significant burdens on smaller hedge funds); Arden Dale, *Small Mutual-Fund Firms Cry Uncle – New Rules Protect Investors, But They Can be a Burden; Cost of a Compliance Cop*, WALL ST. J., Sept. 13, 2004 at C15 (arguing that mutual funds that manage less than \$1 billion bear the costs of regulatory requirements).

⁷¹ See *Registration Under the Adviser's Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

⁷² *Id.* at 72,061-63.

IV. WHY ARE WE WORRIED ABOUT HEDGE FUNDS?

The buzz over hedge funds pulls at a wide variety of people who have different concerns.

1) People who fear concentrations of money see hedge funds as too large. Hedge funds have grown rapidly, both in number and size.⁷³ Hedge funds also tend to operate in loose cooperation, like wolf packs.⁷⁴

2) People who distrust the wealthy elite see hedge funds as the exclusive playground of a very wealthy elite class of investors.⁷⁵ These wealthy investors appear to be making double-digit returns not available to normal investors.⁷⁶

3) People who fear secret conspiracies see hedge funds as too shadowy.⁷⁷ Chairman Bernanke of the Federal Reserve System had described them as “opaque.”⁷⁸ The funds do not have to disclose their membership or their investment strategies, which depend on speed, cleverness and leverage.⁷⁹

⁷³ See, e.g., David A. Katz and Laura A. McIntosh, *Advice on Coping With Hedge Fund Activism*, N.Y.L.J., May 25, 2006, at 5 (Growing hedge fund financial clout - over \$1 trillion in assets - has caused increased hedge fund activism.).

⁷⁴ *Id.* (When one hedge fund takes a position in a company, other hedge funds will buy stock shortly thereafter. When hedge funds act in concert, their behavior is referred to as a “wolf pack” approach.). See also Kulpa and Long, *supra* note 8, at 4 (arguing that cooperative behavior among hedge funds allows hedge funds to raid companies in packs. Several hedge funds may combine their voting power to exert governance power over a firm or corporation.).

⁷⁵ See, e.g., Charles Stein, *The Smart Money is Going into Hedge Funds, But How Smart Is It?*, BOSTON GLOBE, October 24, 2004, at F1 (Hedge funds are only available to institutional investors and only the most wealthy individuals. However, the popularity of hedge funds may eventually undermine their performance by decreasing profit margins. Quoting Jack Meyer, president of Harvard Management, the investment arm of Harvard University, “The returns will gradually decline until they get to be very uninteresting.”); Peter Hess, *Hedge Funds Tighten Up*, SECURITIES INDUSTRY NEWS, June 20, 2005, available at 2005 WLNR 9747163 (Although hedge funds were once an elite vehicle available to only wealthy individuals, they are increasingly welcoming pension funds and institutions such as universities.).

⁷⁶ Stein, *supra* note 75, at F1.

⁷⁷ See, e.g., Joseph Nocera, *Offering Up An Even Dozen Odds and Ends*, N. Y. TIMES, Dec. 24, 2005, at C1 (Secrecy is the biggest problem with the hedge fund industry, stating, “It’s scary that nobody knows what hedge funds are doing, or how much they are leveraged; it conjures up visions of Long-Term Capital Management, which put a huge scare into the financial system when it blew up in the late 1990’s.”); Riva D. Atlas, *Hedge Fund Rumors Rattle Markets*, N. Y. TIMES, May 11, 2005, at C2 (stating that the secrecy of hedge funds as well as the collapse of LTCM have made a number of investors uneasy).

⁷⁸ Ben S. Bernanke, Chairman, Fed. Reserve Bd., Remarks at the Federal Reserve Bank of Atlanta’s 2006 Financial Markets Conference (May 16, 2006) (transcript available at <http://www.federalreserve.gov/Boarddocs/speeches/2006/200605162/default.htm>).

⁷⁹ *Id.*

4) People who do not like sharp lenders of last resort believe some hedge funds are vultures, demanding confiscatory terms from those in dire financial situations.⁸⁰

5) People who condemn risk-taking see hedge funds as a form of gambling.⁸¹ Hedge funds use heavy leverage to generate high returns. They borrow heavily from banks and other sources to fund their trading strategies.⁸² Many of the funds have shown spectacular returns while a few have been spectacular failures.⁸³ When their strategies fail, they can rake up huge losses for not only their members but also their lenders and counterparties.⁸⁴

6) People who suspect fraud whenever there is complexity find hedge funds too tricky.⁸⁵ News reports of their very sophisticated trading maneuvers do leak out. Hedge funds often play the short-side of the market, raising old prejudices against short-sellers. To some, the complex trading maneuvers border on cheating by taking advantage of holes in our laws and rules.⁸⁶ The SEC lists as one of its primary reasons for its new hedge fund regulations, a number of troubling incidences of fraud perpetrated by hedge fund operators.⁸⁷

⁸⁰ See, e.g., David J. Brophy, Paige Parker Ouimet, & Clemens Sialm, *Hedge Funds as Investors of Last Resort* (EFA Moscow Meetings 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=782791 (finding that struggling companies that receive financing from hedge funds significantly underperform struggling companies that receive funding elsewhere); Eric Altbach, *The Asian Crisis and the IMF: After the Deluge, The Debate (Part 2 of 2)*, JEI REP., May 1, 1998, available at 1998 WLNR 3612710 (Critics note that bailouts by the institutions such as International Monetary Fund encourage hedge fund irresponsibility and propagate financial crisis because lenders act knowing the IMF will absorb losses.).

⁸¹ See, e.g., Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 686-88 (2000) (The use of leveraging by hedge funds can result in tremendous profits or catastrophic losses, which can cripple segments of the financial market or even the market itself. Gibson concludes that limited regulation is necessary to prevent excessive use of leverage.).

⁸² *Id.*

⁸³ Karmel, *supra* note 8, at 943 (Long Term Capital Management was a hedge fund founded in 1994 by John Merriweather. On its board were two Nobel laureates in economics, including Myron Scholes and Robert Carhart Merton. LCTM maintained a risky portfolio that, as of the end of 1997, was leveraged twenty-eight to one. Although initially successful, it folded in 1998, losing over \$2.3 billion in several months.).

⁸⁴ *Id.*

⁸⁵ See, e.g., Daniel K. Liffmann, Note, *Registration of Hedge Fund Advisers Under the Investment Advisers Act*, 38 LOY. L.A. L. REV. 2147, 2168 - 69 (2005)

⁸⁶ See, e.g., Skeel, *supra* note 8, at 31 (arguing that the combination of low oversight, extravagant earnings, and performance based compensation has encouraged fraud in hedge fund investment); Liffman, *supra* note 85, at 2169-74 (Increasing popularity of hedge funds has been accompanied by more cases of fraud, a trend that hurts ordinary investors and poses dangers to world markets.).

⁸⁷ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056-57 (Dec. 10, 2004).

7) People who are suspicious of “get-rich-quick, guaranteed” come-on pitches believe that hedge funds may be duping their own investors with false promises of easy money.⁸⁸ Colleges such as The College of Wooster in Ohio have over eighty percent of their entire endowment in hedge funds, to the consternation of some of their alumni who wonder whether the college officials are overmatched when responding to hedge fund solicitations.⁸⁹

8) People who value market stability in the securities and currency markets worry that hedge funds add to market volatility that is unrelated to fundamental market values.⁹⁰ The funds contribute to market bubbles and panics.⁹¹

9) People with positions in traditional operating companies see hedge funds as threatening.⁹² Some hedge funds take an “activist” investor tack, pushing around the incumbent management in blue chip companies such as Time-Warner, Wendy’s, McDonalds, Knight Ridder, and General Motors.⁹³ These actions have aroused the attention and ire of main street management and their New York lawyers, a powerful and entrenched interest group.

⁸⁸ See, e.g. *Taking Stock*, MONEY MANAGEMENT, April 1, 2005, available at 2005 WLNR 5703984 (Hedge funds attract investors through promises of exclusivity, the best and brightest managers, and, most importantly, absolute returns.); Will Shanley, *Three Accused of Fraud in Hedge Fund; The Colorado Springs Men Are Arrested for Allegedly Bilking 350 Investors Out of \$750 Million from 2002-2004*, DENVER POST, May 17, 2006 at C-01 (describing a recent case where two men from Colorado Springs bilked \$7.5 million from hundreds of investors. The state securities commissioner stated, “Most investors were lured by the false promise of high returns.”).

⁸⁹ See, e.g., Anne Tergesen, *Big Risk on Campus: Portfolios at Harvard and Yale Have Smaller Colleges Moving Aggressively into Hedge Funds. They May Be Putting Their Endowments in Jeopardy*, BUSINESSWEEK, May 15, 2006, at 32 (The success of prestigious universities such as Harvard and Yale at investing their sizable endowments in hedge funds has caused many smaller universities to follow suit. However, many of these universities are inexperienced with sophisticated investment strategies and maintain endowments staffs of only two to three people.).

⁹⁰ See CHARLES P. KINDLEBERGER, MANIAS, PANICS, AND CRASHES (John Wiley & Sons, Inc. 2000) (1978) (When LTCM collapsed in 1998, the funds lenders were forced to write off losses, among them the Dresdener Bank, the Credit Suisse First Boston, and the Union Bank of Switzerland for \$700 million.).

⁹¹ *Id.*

⁹² See, e.g., Kulpa and Long, *supra* note 8, at 4.

⁹³ See, e.g., Avital Louria Hahn, *Retaking The High Ground; Companies Are Fighting Back Against the Shareholder Activism of Hedge Funds*, INVESTMENT DEALERS DIGEST, May 29, 2006 (explaining that some corporations have taken defensive measures against activist hedge funds. These strategies include “the adoption of bylaws that limit a shareholder’s ability to call a special meeting and/or require advanced notice for board nominations and other shareholder proposals.”); Brent Shearer, *Dangerous Waters For Dealmakers: Shareholder Sharks Are Using Their Clout To Influence Deals*, MERGERS & ACQUISITIONS, Mar. 1, 2006, available at 2006 WLNR 3500929 (naming Wendy’s, McDonald’s, and GM as the latest victims of hedge fund activism).

This combination of factors – large size, elite investors, big returns on high risks, speed, trading sophistication, attacks on established interests, secrecy, and periodic, spectacular failure – create an opportunity to foment popular fear of a new breed of shadowy financial monsters. The populist anti-hedge fund spin almost writes itself: a wealthy, backroom elite group of investors, driven by selfish greed, take excessive risks with cheater-style trading strategies that imperil the health of our banks and our corporations – our entire economy.⁹⁴ And popular fear creates a cry for government control that is heard by politicians courting voters.⁹⁵

Of the concerns, three stand out. One concern, our hostility towards short-selling, deserves special mention because of its strong history and current popular appeal. Two other concerns, leverage and FOFs, warrant special attention because they are very real problems.

V. SHORT-SELLING AND VOTE BUYING

Hedge funds primary market advantage has been that they could use trading strategies that “short” the market. Registered investment companies do not have such freedom. Mutual funds, for example, are permitted to short sell but under a heavy restriction; a mutual fund must cover any open short positions by setting aside cash or other liquid securities.⁹⁶

The traditional method of shorting the market is to borrow stock, sell the borrowed shares, hope the price drops, and repurchase shares at a lower price for return to the lender.⁹⁷ A trader can also short the market by using derivatives. For example an investor can short shares by purchasing a

⁹⁴ See generally, GARY WEISS, WALL STREET VERSUS AMERICA: THE RAMPANT GREED AND DISHONESTY THAT IMPERIL YOUR INVESTMENTS (2006) (detailing the various ways in which the financial industry, including “Wild-West style” hedge funds, preys on small investors). See also DANIEL REINGOLD CONFESSIONS OF A WALL STREET ANALYST: A TRUE STORY OF INSIDE INFORMATION AND CORRUPTION IN THE STOCK MARKET (2006) (exposing the unfair and often-illegal use of inside information on Wall Street).

⁹⁵ Amy Borrus, *A Guide to the Hedge-Fund Maze*, BUSINESS WEEK ONLINE, (Oct. 19, 2005), available at http://www.businessweek.com/bwdaily/dnflash/oct2005/nf20051019_1613_db016.htm (Tougher regulation is opposed by the hedge fund industry, whose money buys a great deal of influence on Capitol Hill. However, “no politician wants to be linked to a scandal-tarred industry.”).

⁹⁶ Securities Trading Practice of Registered Investment Companies, Investment Company Act of 1940 Release No. IC - 10666, 17 S.E.C. Docket 319 (April 18, 1979) [hereinafter Release 10666]. Mutual funds must also ensure that they have the ability to satisfy their redemption requirements under Section 22(e) of the Investment Company Act. See 15 U.S.C. § 80a-22(e) (2005). This limits the amount of cash they can use in the set aside.

⁹⁷ TOM TAULLI, WHAT IS SHORT SELLING? 3-4 (2004).

put option on the shares, selling future or forward contract on the shares, or engaging in a swap contract on the shares.⁹⁸

Short-selling, making money when a stock (or other security) falls in price, has always been controversial. There are two arguments against the practice. First is the long standing historic disdain for those who profit when others are suffering: A short seller is a “vulture” who makes money when asset values decline.⁹⁹ Since most investors are “long,” benefit when asset values rise, those who are short benefit when most others are suffering.¹⁰⁰ Managers of firms also do not like short sellers, who have a financial incentive to discover and reveal the company’s dirty laundry.¹⁰¹ The battles between managers and short sellers are the stuff of legend and continue today.¹⁰² Kenneth Lay, for example, the ex-CEO of Enron, blamed short sellers, among others, for the collapse of the company in his trial testimony (the jury did not buy it).¹⁰³

Second, those who short the market frequently engage in market manipulation.¹⁰⁴ Unscrupulous short traders in railroad stocks at the turn of the century spread false negative rumors about companies to drive their stock prices down.¹⁰⁵ Bribing journalists to print the lies was part of their modus operandi.¹⁰⁶ Angry speculators responded with “corners,” the purchase of so many shares that short sellers could not cover their positions.¹⁰⁷

Sometimes we fear that the manipulation is not driven by profit but by international conflict. In times of international conflict there has always been concern that a nation’s enemies could attempt to injure its markets.¹⁰⁸ The NYSE imposed special short selling regulations during World War I, fearing that the Kaiser would short our markets.¹⁰⁹ Following the terrorist attack on September 11, 2001, the SEC investigated whether Osama Bin

⁹⁸ Frank J. Fabozzi, *Shorting Using Futures and Options*, SHORT SELLING: STRATEGIES, RISKS, AND REWARDS 17 (Frank J. Fabozzi, ed., 2004).

⁹⁹ TAULLI, *supra* note 97, at 1.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 15 (After viewing Enron’s financial statements in October 2001, hedge fund manager James Chanos realized that Enron’s return on capital was very small, despite its aggressive profit reports. Guessing the stock was extremely overvalued, Chanos shorted it, making millions in the process.).

¹⁰² Holman W. Jenkins, Jr. *Short Sellers: Your 15 Minutes Have Arrived*, WALL ST. J., APR. 5, 2006, at A21 (discussing the efforts by the CEOs of Biovail and Overstock.com to attack short sellers in their companies stock).

¹⁰³ Chidem Kurdas, *Funds: ‘Talk to Us’*, HEDGEWORLD DAILY NEWS, 2006 WLNR 9092212 (May 26, 2006) (“Enron’s Ken Lay blamed short sellers for the debacle, but a jury has decided that the blame lies with him and his former colleagues.”).

¹⁰⁴ TAULLI, *supra* note 97, at 5-6.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ TAULLI, *supra* note 97, at v.

¹⁰⁹ *Id.*

Laden had shorted stocks before the attack.¹¹⁰ (The investigation turned up nothing.)¹¹¹

Governments have responded by attempting to regulate specially or even prohibit short selling. Until the 1850s, short selling was illegal in the United States.¹¹² Napoleon declared the practice “treason” when he felt that it interfered with his financing his military campaigns.¹¹³ In 1995, the Finance Ministry of Malaysia proposed that short-selling be punished by caning.¹¹⁴ As of December 2001, ten countries still prohibit all short selling.¹¹⁵

In the United States, we still suffer from a crackdown on short selling that followed the Great Depression.¹¹⁶ Section 10(a) the Securities Act of 1934 authorizes the SEC to regulate short selling,¹¹⁷ and the Investment Company Act of 1940 severely restricts the ability of mutual funds to short.¹¹⁸ The SEC responded by promulgating the “uptick” and “zero-plus-tick” rules, which prohibit the short selling of a stock on a United States exchange except at a price higher than the price of the last trade or at a price equal to that of the last trade if the previous price change was positive.¹¹⁹ The SEC is now experimenting with repealing the rule for widely traded stocks.¹²⁰

Other legal constraints affect short selling. The Federal Reserve Board’s Regulation T requires a margin of fifty percent on short sales as well as long positions in stock.¹²¹ There are also short sale prohibitions relating to specific market transactions: Rule 105 of SEC Regulation M prevents traders from covering short positions entered into before the effective date of a public offering with securities obtained in the public

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² E.g., J. EDWARD MEEKER, *SHORT SELLING* (1932).

¹¹³ TAULLI, *supra* note 97, at 1.

¹¹⁴ *Id.*

¹¹⁵ Arturo Bris, William N. Goetzmann, and Ning Zhu, *Efficiency and the Bear: Short Sales and Markets around the World* (March 13, 2006), available at <http://www.qwafafew.org/?q=filestore/download/378>.

¹¹⁶ See Charles M. Jones and Owen A. Lamont, *Short Sale Constraints and Stock Returns*, 66 J. OF FIN. ECON. 207 (2002).

¹¹⁷ 15 U.S.C. § 78j(a) (2000).

¹¹⁸ *Id.* § 80a-12(a) (2000). Changes in the Investments Company Act in 1977 have allowed mutual fund managers some freedom to short. Registered investment companies must set aside or segregate an amount equal to the daily price of the shorted securities less any non-proceeds margin posted under applicable margin rules. See Release 10666, *supra* note 96.

¹¹⁹ See 17 C.F.R. § 240.10a-1 (2006); SEC Rule 10a-1. See also NYSE Rule 440B; NASD Rule 3350.

¹²⁰ The SEC relaxed the uptick rules for approximately 1,000 actively-traded securities and for after-hours trading of any approximately 1,000 securities. The SEC is studying the impact of relaxing the rules.

¹²¹ 12 C.F.R. § 220.18 (2006).

distribution.¹²² Rule 14e-4 prohibits short tenders into public tender offers.¹²³

Hedge funds are not caught by the restrictions on mutual funds, are able to use derivatives to avoid the margin requirements, and pioneered procedures that reduce the direct costs of shorting.¹²⁴ The funds then used their ability to short by designing combination long/short trading strategies, hence the name “hedge,” that enabled them to make very sophisticated and nuanced bets on the price movements in the trading markets.¹²⁵ Most academics agree that hedge funds emergence as short sellers is positive, eliminating some of the market over-pricing due to the high costs of short selling.¹²⁶ Academics point to the success of hedge funds as evidence that mutual funds should be given more freedom to short.¹²⁷ They argue that government should avoid the reverse prescription, a new set of regulations that subject hedge funds to the same rules against shorting that apply to mutual funds.¹²⁸

The second complaint noted above, that short sellers frequently engage in market manipulation, is more serious. It is the source of some of the new literature that argues in favor of hedge fund regulation.¹²⁹ Yes, traders who short are tempted to spread false negative rumors, creating the “bear run.” But traders who hold long are tempted to spread false positive

¹²² 17 C.F.R. § 242.105 (2005).

¹²³ 17 C.F.R. § 240.14e-4 (2005).

¹²⁴ A short seller of stock must locate the shares, sell the shares borrowed, leave the proceeds of the sale with the lender as collateral, pay the amount of any dividend to the lender, maintain the position, locate shares to cover, and return the covering shares to the lender.

¹²⁵ WILLIAM J. CREREND, *FUNDAMENTALS OF HEDGE FUND INVESTING* 1 (1998). A hedge funds takes a long position by buying and selling securities that it owns. It takes a short position by selling borrowed securities with an expectation the price will go down before the hedge fund must pay for them.

¹²⁶ The classic studies are Edward M. Miller, *Risk, Uncertainty, and Divergence of Opinion*, 66 J. OF FIN. 1,151 (1977); Douglas W. Diamond & Robert E. Verrecchia, *Constraints on Short Selling and Asset Price Adjustment to Private Information*, J. OF FIN. ECON. 277 (1987). See generally, Steven Jones & Glen Larsen, *The Information Content of Short Sales*, *SHORT SELLING: STRATEGIES, RISK & REWARDS* 233 (Frank J. Fabozzi, ed., 2004). See also *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risks: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Financial Services Comm.*, 108th Congress (2003) (Testimony of Owen A. Lamont, Associate Professor of Finance, Graduate School of Business, University of Chicago) (stating that 270 companies that attacked short sellers had returns that lagged the market by forty-two percent over the following three years).

¹²⁷ Lamont Testimony, *supra* note 126.

¹²⁸ *Id.*

¹²⁹ See, e.g., Sherry M. Shore, *SEC Hedge Fund Regulatory Implications on Asian Emerging Markets: Bottom Line or Bust*, 13 CARDOZO J. INT'L & COMP. L. 563, 576 (2005) (suggesting that hedge funds were involved in market manipulation in Southeast Asian currency markets).

rumors, touting, and we penalize those that we catch; we do not prohibit the practice (which would, of course, make our stock markets illegal). Another illegal practice that has garnered a fair amount of media coverage is “naked shorting,” when a trader sells stock it does not own or has not borrowed.¹³⁰ The SEC has recently moved to tighten up its rules on naked shorting.¹³¹

The new wrinkle to the manipulation argument is an attack on “vote buying,” hedge funds using buying shares before a record date to vote them and using offsetting short positions to eliminate the economic consequences of their votes.¹³² The problem with the argument is that it is, well, false. The cost of buying votes is tied to the economic consequence of the votes.

When does a hedge fund buy votes? The classic case of vote buying happens in a contested takeover; the hedge fund buys votes in the bidder to vote for closing a deal while holding stock in the target.¹³³ To understand the strategy we need to set the stage. When a potential acquirer makes a bid for a target, the bid is often at a twenty-five percent premium or more over market price and the acquirer’s shares often drop two to five percent on the announcement. Bidder shareholders are not thrilled and target shareholders are ecstatic. Target shareholders, therefore, have an interest in whether the bidder shareholders will approve the acquisitions. Some dabbling by the target shareholders in bidder shares is enviable. They may buy a few bidder shares to prop up the price, but this is expensive. In the criticized new tactic, a target shareholder buys votes in the bidder without buying the shares, a much cheaper method of influencing the bidder vote.

¹³⁰ Since delivery of the stock is required three days from the sale, such a trader will purchase the stock and cover it if the stock goes down at the end of three days or just fail to deliver the stock if the stock goes up in price. Naked short selling is illegal except in limited circumstances, principally market-making activities. See SEC Div. of Market Regulation: Key Points About Regulation SHO (April 11, 2005), available at <http://www.sec.gov/spotlight/keyregshoissues.htm>. See also Randall Smith & Shawn Young, *NYSE Probes Whether Short Sellers Fueled Steep Decline in Vonage Shares*, WALL ST. J., June 9, 2006, at C1 (recent case of claims of naked shorting).

¹³¹ New Regulation SHO establishes “locate” and “close-out” requirements on broker-dealers to reduce failures to deliver. See SEC Division of Market Regulation, *supra* note 130. Equity securities that have an aggregate fail to deliver position for five days, totaling over 10,000 shares and equal to at least 0.5% of the issuer’s total shares are put on a “threshold security” list and brokers-dealers must close-out all failure to deliver positions open over thirteen days by purchasing the underlying securities. Until a position is closed out a broker-dealer may not purchase or clear a transaction in the stock without borrowing the shares or entering into an agreement to borrow the shares.

¹³² See Kulpa & Long, *supra* note 8, at 12.

¹³³ See generally Paul H. Edelman & Randall S. Thomas, *Corporate Voting and the Takeover Debate*, 58 VAND. L. REV. 453, 487 (2005) (developing a “realistic simulation of corporate voting and applying it a variety of settings” and concluding that “the current regulatory regime gives management too much discretion to reject unsolicited bids at the expense of shareholder wealth maximization”).

For an illustration of the tactic,¹³⁴ consider the takeover of King Pharmaceuticals by Mylan Laboratories. King and Mylan announced the signing of a merger agreement on July 26, 2004.¹³⁵ Mylan was to acquire King in a stock-swap, reverse triangular merger. King's common shareholders were to receive a fractional 0.9 Mylan common share for each King common share they held.¹³⁶ Mylan shareholders had to vote to approve the issuance of new Mylan stock for the deal. The exchange ratio represented a premium for King stock at preannouncement prices. On the disclosure of the merger, Mylan shares dropped in value and King shares increased in value and the prices of the two shares became necessarily linked. After the announcement, the *deal spread* between the trading market prices of a ninety percent of a Mylan common share and one King common share represented the market's assessment of likelihood that the merger would close; the smaller the spread the higher the probability the deal would close and the higher the spread the lower the probability that the deal would close. After the announcement, the spread between Mylan and King shares varied substantially day to day (even moment to moment) on the current news of the likelihood that the deal would close.

Perry, an investment adviser to four hedge funds with \$11 billion under management and with substantial knowledge of both Mylan and King, undertook a very traditional risk arbitrage trading strategy.¹³⁷ Perry took a long position in the target, King, and an offsetting short position in the acquirer, Mylan. The strategy "locks in" the deal spread and pays when and if the deal closes. A corollary to the strategy is that if the deal spread increases, and an arbitrager is comfortable accepting the risk, the arbitrager unwinds the position on the smaller spread and reestablishes the lock-in at the higher spread. Perry did this on several occasions.

A second hedge fund, run by Mr. Carl Icahn, took an opposite position. His strategy is also well known but less frequently used. He made a bet that the deal would not close. He shorted King common shares and purchased a long position in Mylan common shares to profit should the merger fail to close. Moreover, he announced that he intended to actively

¹³⁴ Gossip on Wall Street is that target shareholders used the same tactic in the 2002 proxy fight over the \$24 billion merger of Hewlett-Packard and Company.

¹³⁵ Leila Abboud & Dennis K. Berman, *Mylan to Buy King Pharmaceuticals --- Deal Valued at \$4 Billion Gives Generic-Drug Firm Access to Branded Products*, WALL ST. J., July 26, 2004, at A3 (stating that Mylan's move was part of a larger trend of "generic-drug companies pushing into the branded-drug business").

¹³⁶ *Id.*

¹³⁷ Riskglossary.com, *Even Driven Trading Strategy*, http://www.riskglossary.com/link/event_driven_strategy.htm (last visited June 14, 2006) (In a traditional risk arbitrage strategy, the acquirer proposes to buy the target stock by exchanging its own stock for the stock of the target. The arbitrageur buys the stock of the target and short sells the acquirer. If the merger is successful, the target's stock is converted into the stock of the acquirer, and the arbitrageur completes the arbitrage by delivering the converted stock into her short position.).

use his voting rights from his Mylan shares to defeat the merger. In a Schedule 13D filing¹³⁸ and a Form 14A filing¹³⁹ (September 7, 2004), Mr. Icahn announced that he would vote his long position in Mylan, and solicit proxies from others to vote against the acquisition of King.¹⁴⁰

In response, Perry Corp. decided to buy shares in Mylan so as to vote them in favor of the deal and off-set, to some degree, Mr. Icahn's voting power. Perry recognized that the cost of the long position in Mylan would necessarily reduce the profits from his risk arbitrage position that depending on the deal closing successfully. Perry Corp. used two methods. First, it simply purchased and held Mylan shares. The purchase is termed a "box" because Perry did not use the newly purchased shares to cover its outstanding short obligations in Mylan stock.¹⁴¹ Second, Perry Corp. purchased Mylan shares and entered into offsetting equity-interest rate swap contracts on those shares with two international banks. In the swaps, Perry Corp., in essence, shorted the newly purchased Mylan shares and the counterparty banks took a long position in the shares. The banks in such transactions often diversify or offset their positions by themselves shorting the shares (borrowing and then selling the loaned shares). The banks then pass the rebate cost for borrowing the shares back to the counterparty (in this case Perry Corp). The rebate costs will rise as the cost for obtaining the borrowed shares rises in response to market pressures.

On October 28, 2004, King disclosed that it would have to restate previously issued financial statements and revisions to its third quarter projections. The market learned of Perry's long position in Mylan shares on November 12, 2004, in a Schedule 13F filing.¹⁴² On November 19, 2004, Mr. Icahn criticized the Mylan purchase of King as an "egregious mistake" and announced that it would make a public offer to purchase

¹³⁸ Mylan Laboratories Inc., Schedule 13D, (Sept. 7, 2004), <http://investor.mylan.com/phoenix.zhtml?c=66563&p=irol-sec>.

¹³⁹ Mylan Laboratories Inc., Form 14A (Sept. 7, 2004), <http://investor.mylan.com/phoenix.zhtml?c=66563&p=irol-sec>.

¹⁴⁰ *Health Care Brief-- Mylan Laboratories Inc.: Icahn Launches Proxy Fight Against Merger with King*, WALL ST. J., Oct. 15, 2004, at A11 ("Mr. Icahn urged Mylan shareholders to vote against proposed acquisition, saying the purchase premium 'is not justified.'").

¹⁴¹ When an investor "sells against the box," he shorts a security that he already owns but chooses not to deliver. Short sales against the box are like traditional short sales, but the investor holds on to the securities that he already owns. See Zachary T. Knepper, *Future-Priced Convertible Securities And The Outlook For "Death Spiral" Securities-Fraud Litigation*, 26 WHITTIER L. REV. 359, 368, n. 60 (2004) (citing Ralph S. Janvey, *Short Selling*, 20 SEC. REG. L.J. 270, 271-76 (1992)).

¹⁴² Mylan Laboratories Inc., Schedule 13F (Nov. 2004), <http://investor.mylan.com/phoenix.zhtml?c=66563&p=irol-sec>; see also *Group Including Perry Reports Mylan Stake, Favors Buying King*, WALL ST. J., Nov. 30, 2004, at C1.

Mylan stock at \$20 a share, qualified with numerous contingencies.¹⁴³ The deal spread widened immediately on the Icahn announcement.

On November 22, 2004, theDailyDeal.com, a well-known and widely followed open website, reported that Perry Corp. would vote its long position in Mylan in favor of the merger and, importantly, that the Perry Corp. position in Mylan was “hedged.”¹⁴⁴ The website concluded that Perry Corp. and other speculators “may not have any economic interest in the company.”¹⁴⁵ The website also detailed that Perry Corp. held a traditional risk arbitrage position in the two parties to the merger to “capture the spread.”¹⁴⁶ A follow-up article in the New York Times on November 28, 2004, contained the same information.¹⁴⁷ Perry Corp. filed a Schedule 13D on November 29, 2004, disclosing that it held 9.89% of Mylan’s common shares and, significantly, that the shares were “hedged” through short-sales (the box transactions) and through security-based swaps.¹⁴⁸ The market price of Mylan shares closed down 1.4% (18 cents down) on November 30, 2004, and the deal spread returned to levels evident in the stock price before Mr. Icahn’s announcement of a tender offer.

On January 12, 2005, Mylan announced that it did not expect to close the deal and on February 27, 2005, Mylan formally terminated the merger agreement.¹⁴⁹ By the end of March, Perry had unwound its positions, having paid \$5.7 million in costs to establish its short positions in Mylan shares suffering a substantial loss on its trading positions in both Mylan and King shares.

The argument against Perry’s actions focuses on its interest in Mylan; Perry has an incentive to vote its Perry shares against the interest of Mylan shareholders to gain on its King stock. We worry that a hedge fund that borrows shares, votes them, and returns them can vote the shares against the interest of the company without cost or retribution.¹⁵⁰ The

¹⁴³ Andrew Pollack, *Icahn Offers \$5.4 Billion For Mylan, Drug Maker*, N.Y. TIMES, Nov 20, 2004, at C3 (In a letter to Mylan directors, Icahn warned that the acquisition of King was an “egregious mistake” that would transform Mylan into a “much riskier hybrid focusing on branded products.”).

¹⁴⁴ Scott Stuart, *Funds get out the vote at Mylan*, THEDEAL.COM, Nov. 22, 2004, <http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle?StandardArticle&bn=NULL&c=TDDArticle&cid=1099927595678>.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ See Andrew Ross Sorkin, *For a Takeover Artist, One Bluff Too Many?*, N.Y. TIMES, November 28, 2004, at Section 3.

¹⁴⁸ Mylan Laboratories Inc. Schedule 13D, (Nov. 2004), <http://investor.mylan.com/phoenix.zhtml?c=66563&p=irol-sec>; see also *Group Including Perry Reports Mylan Stake*, *supra* note 143, at C1.

¹⁴⁹ *Mylan Abandons Pact to Purchase Drug Firm King*, WALL ST. J., Feb. 28, 2005, at B4 (stating that the companies could not agree on a revised deal and that Mylan and King mutually agreed to end the transaction).

¹⁵⁰ See Kulpa and Long, *supra* note 8, at 12.

argument is false because it omits the interest of the counterparty to the short position, the lender of the borrowed shares, or the counterparty to the swap. The rental fee charged by the lender of the shares, who will get the shares back after the vote, will take into account the likelihood that the shares as returned will be devalued. If a hedge fund is likely to vote to hurt a company, the fund must pay the lender for the right to do so. The rental charge on the shares should approximate the loss that the hedge fund would suffer if the fund had purchased the shares outright, voted them to hurt the company, and sold them, a tactic that is admittedly legal.

The King takeover demonstrates that risk arbitrage in stock swap takeovers can go both ways. An arbitrager can short¹⁵¹ the acquirer and go long in the target (the usual strategy), as Perry Corp. did, or go long in the acquirer and short the target (a more unusual strategy), as Mr. Icahn did. In the typical takeover a deal puts negative price pressure on the acquirer's stock and offers the target shareholders a price premium, the arbitrager who holds a normal position profits if the deal closes and the arbitrager who holds the unusual, reverse position expects to profit if the deal fails to close.

In the usual trading strategy, an arbitrager, in effect, purchases ("locks-in") the deal spread, the trading price of the target shares minus the trading price of acquirer shares that a target shareholder will receive if the deal closes.¹⁵² After the arbitrager established the locked-in position at a given deal spread, the gain or loss on the short position in the acquirer offsets any changes in price in the target. The deal spread at lock-in survives for the arbitrager assuming closing regardless of subsequent market based changes in the spread. When the deal closes, the arbitrager unwinds its positions and, in effect, is paid the spread and nets the trading costs incurred. If the deal fails to close, the arbitrager may win or lose dependant on the residual and now independent trading prices of the two deal participants. The profit or loss is magnified by the heavy leveraged inherent in the position. In the usual case, the price decline of the target shares after a deal collapses means that the arbitrager will incur substantial losses.

¹⁵¹ In the classic short position, the holder of the position borrows shares from a lender, sells the borrowed shares, and later covers the loan (returns shares to the lender) with new shares purchased in the market. If the share price has fallen from the date of sale to the date of cover, the borrower makes money.

¹⁵² For a more generalized discussion of risk arbitrage, see Roger J. Dennis, *This Little Piggy Went to Market: The Regulation of Risk Arbitrage after Boesky*, 52 ALB. L. REV. 841, 843-44 (1988) (analyzing the potential benefits of risk arbitrage); see Thomas Lee Hazen, *Volatility and Market Inefficiency: A Commentary on the Effects of Options, Futures, and Risk Arbitrage on the Stock Market*, 44 WASH. & LEE L. REV. 789, 794-95 (1987) (explaining regulation of risk arbitrage by the SEC); see Francesca Cornelli & David D. Li, *Risk Arbitrage in Takeovers in Takeovers* (Rodney L. White Center Working Paper No. 17-98), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=106708.

The arbitragers in both the usual and unusual positions merely change the profile of their economic interest in the transaction from a pure long or short position to a hybrid position dependent on the deal closing. The arbitragers' trades help drive market prices towards optimal fundamental (or informational) values and aid the liquidity and depth of the market during the post announcement, pre-closing period.

Each arbitrager has an incentive to vote the long position to make a profit. The holder of a normal position (Perry) will vote shares in the target for the deal and the holder of an unusual, opposite position (Icahn) will vote shares in the acquirer to stop the deal. They will do so even if information is available that they are not voting to maximize the stock price of the long position. In the usual position, for example, an arbitrager may vote target shares in favor of the merger even though a higher bid for the target shares is possible. In the unusual, reverse position, an arbitrager may vote acquirer shares, which the arbitrager owns, against the deal even if the deal information turns more favorable (target has newly discovered value). Typically both arbitragers will unwind their positions before the vote.

Each arbitrager's short position is not cost-free. The arbitrager must pay a "rebate" rate to borrow the shares.¹⁵³ The rebate rate increases when the stock goes "special," that is, when the borrowed stock is in short supply because of substantial short-side interest.¹⁵⁴ During routine times the net rate the borrower must pay the stock owner is nominal, less than twenty-five basis points (or .25%) per year. The stock is "general collateral."¹⁵⁵ When the stock price is under stress, the stocks routinely "go special" and the rebate prices increase substantially.¹⁵⁶ Information on which stocks have gone special is routinely, quickly, and widely distributed in the trading markets. One can, for example, check a popular web site, www.ShortSqueeze.com, for a daily posting of special stocks and an explanation of the heavy borrowing volume in any named stock. Common reasons for a stock going special are 1) general speculative disfavor of a perceived overpriced stock, 2) earnings announcement program trades, and 3) merger arbitrage – the case here.¹⁵⁷ Perry Corp. paid substantial fees, in the millions, to establish its short positions.

¹⁵³ Christopher C. Geczy, David K. Musto, & Adam V. Reed, *Stock Are Special Too: An Analysis of the Equity Lending Market*, 66 JOURNAL OF FINANCIAL ECONOMICS 241, 244 (2002).

¹⁵⁴ *Id.* at 246.

¹⁵⁵ *Id.*

¹⁵⁶ A recent Wall Street Journal article noted that the rebate prices of shares in Overstock.com and in Martha Stewart Omnimedia, Inc. had reached twenty-five and twenty percent of the share price respectively (2,500 and 2,000 basis points). See Jesse Eisinger, *Long & Short: It's a Tough Job, So Why Do They Do It? The Backward Business of Short Selling*, WALL ST. J., March 1, 2006, at C1.

¹⁵⁷ Geczy, Musto & Reed, *supra* note 153, at 246.

A study by Christopher C. Geczy, David K. Musto, & Adam V. Reed found that as much as fifty percent of the raw merger arbitrage profits are lost to share lenders.¹⁵⁸ This supports the common sense notion that stock lending is, to an important degree, self-policing. In most acquisitions in the past ten years or so, the target shareholders receive a substantial premium over market price for their shares. The acquisition announcement is greeted with some skepticism by the shareholders of the acquirer, who worry that the acquirer has overpaid for the target, and with glee by the shareholders of the target, who enjoy the surprise premium. The cost of borrowing the acquirer's stock reflects the downward price pressure on the acquirer's stock generated by the announced takeover. In other words, the arbitrageur is paying substantially for shifting down-side risk to those who loan the arbitrageur shares in the acquirer.

We can generalize from the takeover situation to all situations in which an investor has an incentive to "buy votes." When an investor holds stock of an acquirer in an acquisition and fears that the board has initiated an imprudent investment, the investor has three options: investor can sell the stock, keep the stock and vote no, or keep the stock and hedge the risk of a yes vote by shorting the shares. In the third case the investor has no economic incentive to vote either no or yes; her true economic incentive is to abstain.

There are two inherent limits to this technique, one mechanical and one market based.¹⁵⁹ On the mechanical side, the investor is limited in the amount of stock that investor can hedge with traditional shorting by the finite amount of stock available. Investors can never hedge enough to get legal voting control (control of over fifty-one percent of the stock)¹⁶⁰ and, in practice, cannot hedge enough shares to get effective voting control (control with less than fifty-one percent of the stock). In practice, only a small percentage of most common stock is available to be borrowed and an investor will be limited inherently by the supply. The average of the amount of stock available for all loans to short traders is about five percent. In times of heavy shorting, the average can rise to around fifteen percent; in extraordinary cases the amount of available stock for shorts may touch

¹⁵⁸ *Id.* at 260.

¹⁵⁹ Academics who have written on the question do not seem to appreciate either of the limits. *E.g.*, Henry T.C.Hu & Bernard S. Black, *Hedge Funds, Insiders and Empty Voting: Decoupling of Economic and Voting Ownership in Public Companies* (U. of Texas Law Sch., Law and Econ Research Paper No. 53, 2006) (omitting a discussion of either).

¹⁶⁰ For example, if there are 100 common shares of company A, the investor is limited to capturing fifty percent of the vote. Investor can buy fifty shares and short fifty shares, borrowing fifty and selling the fifty so borrowed. But the purchaser of the fifty shares can vote them in her economic interest and, if need be, stymie the effort to get legal control.

twenty percent. Moreover, any one short trader cannot, of course, borrow all the stock available.

Swaps in which a counterparty is content to accept short-side risk are affected by the scarcity as most counterparties will diversify their risk by borrowing shares. Naked swaps, swaps in which a counterparty does not cover by borrowing shares, are rare (and when they exist are often only temporary). So even in swaps the finite amount of stock available to borrow has a limiting effect on a counterparty's willing to accept the long position.

In sum, the limited availability of stock that can be borrowed necessarily limits the hedging strategy around shareholder record dates. Ten percent or so, Perry Corp. held just under ten percent, represents a practical limit to the strategy. The ten percent practical limit coincides with the legal trigger, in section 16 of the Securities Act of 1933, of the short-swing profit give-back for ten percent shareholders on trades within any six month period. Hedge funds that trade quickly are careful to avoid the trigger.

The limitation on supply of stock that an investor can borrow also creates a market based self-correction mechanism. The investor must pay for the privilege of enjoying the economic incentive to abstain in the price of the rebate paid to the lender of the shares.¹⁶¹ Those who lend stock around record dates established for important votes understand well the risk they are absorbing.

An investor who has held the stock and hedged is in no different position than an investor who has sold the stock after the record date for the shareholder vote and has not coupled a proxy with the sale. Both investors have no economic incentive to vote and both have suffered a cost; the hedge investor has paid the price of the hedge and the selling investor has paid a price in the discounted value of the stock sold (the acquirer of the stock will pay less for the stock because it comes with a voting right at the next shareholder meeting).

The size of the rebate is related to the declining availability of borrowed shares, the market signals sent by short interest in the stock and the potential behavior of those who hold short positions. This last point deserves careful mention. Those who lend stock understand well that an investor could vote hedged shares against the economic interest of other shareholders if the investor has a personal stake in the outcome of the vote. An investor who buys shares and then shorts them so as to vote the shares free of economic consequence must anticipate a profit in excess of the rebate paid to the lender of the shares. For example, an investor may want to keep a position on the board of directors (to protect salary) or put incompetent relatives on the board. The risk of such an investor voting

¹⁶¹ An economist would note that the arbitrageur has paid the stock lender for shifting the down-side risk. The payment only makes economic sense if the arbitrageur can shift the down-side risk to those more willing to bear it (that is at a lower cost).

shares in its own interest will be included in the rebate charged by the lender of the shares. The risk is priced accordingly to the likelihood of the strategy's success and size of its cost. This is one of the reasons that borrowed shares will "go special" around shareholder votes and the rebates charged on loaned shares increase. Note, however, that the increase in rebates around share record dates, although significant are still relatively small, reflecting the market participants view that the risks of self-interested behavior are, on average, slight. Those who lend stock around record dates understand and price the risk.¹⁶²

In sum, the combination of the cost of the short position and the offset voting interest of other shareholders means that the hedging strategy around record dates is inherently very limited in its effectiveness for anyone seeking a personal benefit, unshared with other shareholders (or the firm). The most likely use of the technique will occur when an investor is convinced that the investor is correct on its assessment of how to vote to *increase* share value (or firm value), worried about others holding a flawed view of the future, and is willing to purchase a hedged position to increase its voting power to aid, not hurt the company.

A combination of risk arbitrage and hedging positions taken during takeovers that involve shareholder votes is a special case of the hedging discussion noted above. Indeed, the situation is less poignant perhaps because the opportunity to do risk arbitrage is more available than the opportunity to secure a board seat. For example, all shareholders in Mylan could, in theory, engage in deal risk arbitrage, directly or through an intermediary, once the deal had been announced. Again, the market self-corrects for such situations in the price changed for borrowing the shares. The price Perry Corp. had to pay for its short positions no doubt rose steadily, reflecting that the stock had gone special and that borrowers were changing special fees for loaning shares and accepting the down-side risk. Moreover, there was plenty of active voting interest in the Mylan stock by other shareholders. Perry Corp.'s trading strategy was not stimulated by a desire to steal a step on other shareholders. Perry's strategy was aimed at neutralizing the announced voting position of Mr. Icahn, who appeared after Perry Corp. had established its arbitrage position. We should let the market participants "duke it out" in such cases and not try to establish rules against shorting to buy votes.

In practice, when hedge funds short shares to hedge the effects of a vote on a long position, the fees charged are small because lenders believe, correctly, in all but isolated cases, that the funds will vote in the firm's interest, not against it, and that the funds just have a stronger incentive than the share owner/lenders to do so, given the funds' leveraged stake. It is the

¹⁶² Again, an economist would say that the payment only makes economic sense if the investor can shift the risk to someone more willing to bear it.

interests of the lenders that internalize the economic costs of voting the shares in the hands of the hedged owner.

VI. LEVERAGE: DIRECT REGULATION IS NOT THE ANSWER BUT INDIRECT REGULATION IS NECESSARY

Most hedge funds are heavily leveraged.¹⁶³ In essence, a fund increases its returns on deployed capital by using borrowed money alongside its own¹⁶⁴ or by using various derivative contracts rather than holding the underlying securities.¹⁶⁵ The amount of leverage used by a hedge fund depends on its investment strategy; arbitrage funds are more likely to use heavy leverage than activist funds for example. A 1999 study found that a majority of hedge funds were leveraged at less than two to one but that some were leveraged at more than thirty to one.¹⁶⁶

There are no legal limits on hedge fund leverage.¹⁶⁷ Registered investment companies, mutual funds, on the other hand, may use leverage but they operate under direct limits.¹⁶⁸ An open-end mutual fund, for example, must borrow only from a bank and is subject to a 300 percent

¹⁶³ See REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE AND THE LESSON OF LONG-TERM CAPITAL MANAGEMENT 11 (1999), available at <http://www.mfainfo.org/images/pdf/PWG1999.pdf>.

¹⁶⁴ Generally speaking, leverage is the use of financial instruments or borrowed capital to increase the potential return of an investment. Typically, financial leverage takes the form of a loan that is reinvested with the hope of earning a rate of return that is greater than the cost of interest. Therefore, the use of leverage creates the possibility of higher returns for the investor than would otherwise be available. However, the potential for significant loss is also greater because, if the investment fails, the investor loses his or her money and also must repay the loan. Thus, the use of leverage magnifies the potential for gains *and* losses. See Investopedia.com, Leverage, <http://www.investopedia.com/terms/l/leverage.asp> (last visited June 15, 2006).

¹⁶⁵ In a repurchase agreement ("repo"), for example, one side sells a security (often a United States Treasury obligation) at a specified price coupled with a simultaneous agreement to buy back the security on a specified future date, usually at a fixed or determinable price. Both sides are leveraged to changes in market prices that cause the replacement value of the transactions to rise above their value at inception. See Investopedia.com, Repurchase Agreement - Repo, <http://www.investopedia.com/terms/r/repurchaseagreement.asp> (last visited June 15, 2006). Many "funds of hedge funds" provide limited liquidity to their shareholders by offering to repurchase their securities twice per year. These repurchase agreements are made following tender offers in compliance with Rule 13e-4 of the Securities Exchange Act and Section 23(c)(2) of the Investment Company Act. See SEC STAFF REPORT TO THE SEC, *supra* note 28, at 71.

¹⁶⁶ REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, at 5.

¹⁶⁷ *Id.* at 3 (Hedge funds were exempt from regulatory restrictions on leverage or trading strategies.).

¹⁶⁸ See 15 U.S.C. § 80a-18(a)-(g) (2000).

asset coverage test.¹⁶⁹ Closed-end investment companies have less restrictive limits.¹⁷⁰ All investment companies may invest in derivatives that are inherently leveraged only if the company “covers” the transaction by setting aside liquid assets in an amount equal to the potential liability or exposure created by the transaction.¹⁷¹

Any limits on a hedge fund’s use of leverage come from the market discipline provided by creditors and counterparties.¹⁷² If a hedge fund takes substantial risks its creditors should respond by increasing interest rates or reducing the availability of credit to the firm.¹⁷³ Counterparty discipline comes through increased credit terms either directly, through trading, credit limits or initial margin, or indirectly, through credit spreads on transactions.¹⁷⁴ Moreover, lenders and counterparties themselves are subject to legal limits on risk exposure. Legal regulations affect the potential lenders and counterparties of hedge funds.

Hedge funds can create leverage by borrowing funds or by engaging in derivative¹⁷⁵ transactions with counterparties.¹⁷⁶ When borrowing money, lenders are subject to specific limits. A broker-dealer extending credit to a hedge fund must comply with the margin requirements in Regulation T issued by the Board of Governors of the Federal Reserve System.¹⁷⁷ Additional “maintenance margin” requirements are imposed by self-regulatory organizations.¹⁷⁸ Banks loaning money to hedge funds must comply with general limits under federal treasury regulations. An FDIC

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* (A closed-end company may issue a senior security that is a stock (preferred stock) if it maintains asset coverage of at least two hundred percent).

¹⁷¹ See Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,472 (June 22, 1987) (modifying Securities Trading Practice of Registered Investment Companies, Investment Company Act Release No. 10,666, Fed. Sec. L. Rep. (CCH) ¶ 48,525 (April 18, 1979) (the “senior security transaction” requirements)).

¹⁷² *E.g.*, REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, at 5 (Hedge funds are limited in their use of leverage only by the willingness of creditors and counterparties to extend such leverage.); *id.* at 25 (“The primary mechanism that regulates risk-taking by firms in a market economy is the market discipline provided by creditors, counterparties (including financial contract counterparties), and investors.”).

¹⁷³ *Id.* at 25.

¹⁷⁴ *Id.*

¹⁷⁵ Derivatives are financial instruments with values tied to the performance of assets (usually stocks or bonds) or to benchmarks (usually interest rates). A plain vanilla derivative instrument is a future – an agreement to buy or sell a specific commodity or financial instrument at a set price on a stipulated date.

¹⁷⁶ REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, at 5.

¹⁷⁷ 12 C.F.R. § 220.1-12 (2006).

¹⁷⁸ See, *e.g.*, NASDAQ, Inc., NASD Rule 2520 (c)-(d) (2006); NYSE, Inc., NYSE Rule 431(c)-(d) (2006).

insured bank, for example, may not make a loan of more than fifteen percent of its asset value to any one borrower.¹⁷⁹ More importantly, banks are subject to minimum capital requirements based on the risk characteristics of their assets, which include loans to and transactions with hedge funds.¹⁸⁰ Finally, bank supervisors monitor individual banks lending activities for risk appetite and risk management.¹⁸¹

A 1999 government study after the collapse of Long-Term Capital Management (LTCM) Fund found, however, that bank lending to hedge funds was acceptable.¹⁸² The LTCM Fund bankruptcy itself did not threaten the solvency of any United States commercial bank, although a LTCM liquidation could have significantly reduced quarterly earnings.¹⁸³ The 1999 government study found only that banks have given the fund credit terms that were too favorable given the funds high risk and that banks needed to tighten up with credit risk management systems.

Most bank exposure to hedge funds occurs from counterparty trading and other derivative activities.¹⁸⁴ Banks take the opposite side of swap transactions on currency or interest rates, for example. Counterparties manage their risk exposure to hedge funds through due diligence, collateral, credit limits, reporting requirements, and monitoring.¹⁸⁵ Banks establish risk profiles they are willing to undertake and develop risk management

¹⁷⁹ 12 CFR § 32.3(a) (2006). A bank may loan an additional ten percent of its capital to one borrower if the additional portion is secured by “readily marketable collateral.” Generally marketable collateral is anything that is fairly liquid or exchange traded. 12 CFR § 32.2(n) (2006). If a bank lends against secured United States Treasury bonds as collateral the amount does not count against the percentage limits. *Id.*

¹⁸⁰ The basic risk-capital regulations are contained in the 1988 Basel Capital Accord. While the 1988 standards do not break out high risk assets, such as loans to hedge funds, the new amendments to the Basel Accords will. *See generally* Federal Deposit Insurance Corporation, *Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back* (Jan. 14, 2003), available at <http://www.fdic.gov/bank/analytical/fyi/2003/011403fyi.html>.

¹⁸¹ In January 1999, the Basel Committee on Banking Supervision (BCBS) issued a set of recommendations on managing counterparty credit risks to hedge funds. Soon after the Federal Reserve, the SEC, the Treasury Department, and a group of twelve major banks formed a Counterparty Risk Management Policy Group (CRPG) that issued its own recommendations. *See* COUNTERPARTY RISK MANAGEMENT POLICY GROUP, IMPROVING COUNTERPARTY RISK MANAGEMENT PRACTICE (1999), available at <http://www.mfainfo.org/washington/derivatives/Improving%20Counterparty%20risk.pdf>. The BCBS recommendations are incorporated into Federal Reserve supervisory guidance and examination procedures.

¹⁸² REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, at D-1. The Working Group found that as of September 30, 1998, the aggregate bank direct lending exposure to hedge funds was less than \$4.3 billion at twelve banks identified to have hedge fund relationships. *Id.* The banks had total assets of more than \$2.6 trillion. *Id.*

¹⁸³ *Id.* at D-12.

¹⁸⁴ *Id.* at D-1.

¹⁸⁵ *Id.* at 7.

procedures.¹⁸⁶ Bank examiners supervise the safety and soundness of the bank's activities.¹⁸⁷ The LTCM failure led the OCC to issue new supplemental guidance for examiners in reviews of banks that act as counterparties to hedge funds.¹⁸⁸ A default by LTCM would have cost its top seventeen counterparties, for example, between \$3 billion and \$5 billion in losses.¹⁸⁹ Again, however, the 1999 government study found that aggregate bank counterpart exposure to hedge funds was within acceptable parameters.¹⁹⁰ The LTCM failure has led banks to tighten up their calculations of derivative and foreign exchange exposure.¹⁹¹

Concern over "excessive" leverage by hedge funds, however, is likely to lead to the heaviest pressure for new regulations for hedge funds.¹⁹² Discussions of any direct regulation of hedge fund leverage usually collapse when the participants get to the details. Balance-sheet leverage is not an adequate measure of risk¹⁹³ and would encourage avoidance behavior with off-balance sheet strategies. Alternatives such as "value-at-risk" (a ratio of potential gains and loss) to net worth offer more meaningful measures of risk but have severe measurement problems.¹⁹⁴ Any attempt to directly regulate leverage would likely be conservative, due to measurement problems, and put significant limits on hedge funds' ability to provide market liquidity. Direct regulation could also increase moral hazard costs as lenders and counterparties may relax their vigilance in reliance on the government rules.

So discussants move on to a familiar back-up regulatory system, mandatory disclosure. Here is where the pressure will grow on the SEC to augment its new higher profile in hedge fund regulation. Rules should

¹⁸⁶ See generally *id.* at D-1 to -10.

¹⁸⁷ *Id.* at D-1 to -2; see also *id.* at D-2 (Examiners may assess the "level and direction of risk", the "quality of risk management", as well as "risk profiles for various product offerings, business lines or activities...").

¹⁸⁸ See, e.g., O.C.C. Bulletin 99-2: Risk Management of Financial Derivatives and Bank Trading Activities (Jan. 25, 1999), available at <http://www.occ.treas.gov/ftp/bulletin/99-2.txt>; REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, D-2 n.2 (further sources of information).

¹⁸⁹ REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, at 17. The real danger was in the market disruption that would have been caused by the counterparty's efforts to limit their exposure by liquidating or covering their positions. There would have been significant movements in market prices and could have been a severe market liquidity crunch. *Id.* at 19-20.

¹⁹⁰ *Id.* at D-1. The Working Group found that hedge fund trading activating with money center banks represented less than four percent of the total \$27 trillion in total notional value of derivative contracts at the institutions. *Id.*

¹⁹¹ *Id.* at D-13 to -14.

¹⁹² *Id.* at 29 ("The central public policy issue raised by the LTCM episode is how to constrain excessive leverage more effectively.").

¹⁹³ *Id.* at 24 (the numbers do not reflect market, credit and liquidity risks).

¹⁹⁴ See *id.* (Problems include "faulty or incomplete modeling assumptions" or "narrow time horizons.").

force hedge funds to disclose additional information, they argue.¹⁹⁵ A “database” of hedge fund activity was the controversial suggestion of the President’s Working Group on LTCM.¹⁹⁶ The disclosure proposals all stem from the same finding that lenders and counterparties to LTCM had badly underestimated the risk of LTCM activities. Loans and transactions with LTCM had been under priced. Had lenders and counterparties held a more accurate view of the risk of dealing with LTCM, they would have charged more for loans and increased the spread on counterparty transactions. The increased charges would have limited LTCM’s ability to engage in risky trading. LTCM took advantage of cheap money.

The strongest database proposals require disclosure to the public. The President’s Working Group on LTCM made such a recommendation.¹⁹⁷ Various alternatives for a public database have been discussed since the 1999 Report. The alternatives include a fully public database, a system in which hedge funds submit position information to an authority that aggregates the information and reveals it to the market, and a database maintained by regulators on a confidential basis.¹⁹⁸

Milder proposals require private mandatory disclosure of specified information only to lenders or counterparties. The least intrusive disclosure proposals are indirect, acting not on hedge funds but on their counterparties and lenders, and require publicly-traded financial institutions that deal with hedge funds to disclose a summary of direct material exposures to all significantly leveraged financial institutions. The Working Group made both of these suggestions as well.¹⁹⁹ The disclosure requirements of the publicly-traded lenders and counterparties would require that such companies make information demands on hedge funds necessary to gather the data required.

The case has not been made for the mandatory disclosure direct regulation, requiring hedge fund disclosures either to the public or to enforcement agencies or to lenders and counterparties. However, indirect regulation, fine tuning the mandatory disclosure rules that act on lenders and counterparties of hedge funds, is necessary. The argument in support below begins with a description of market based responses to hedge fund risk that diminish the need for any direct regulation of hedge funds and

¹⁹⁵ *Id.* at 31 (The Working Group sees the need for “public companies, including financial institutions, [to] publicly disclose additional information about their material financial exposures to significantly leverage institutions, including hedge funds.”).

¹⁹⁶ *Id.* at 32. For criticism of this part of the Report, see The Financial Economists Roundtable, *Statement on Long-Term Capital Management and the Report of the President’s Working Group on Financial Markets* (Oct. 6, 1999), available at <http://www.luc.edu/finroundtable/statement99.html>.

¹⁹⁷ REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, at 32.

¹⁹⁸ Bernanke, *supra* note 78.

¹⁹⁹ REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, at 33–34.

concludes with a discussion of the need for some form of indirect regulation.

A current assessment of hedge fund leverage and its risk to our financial system comes from the speeches of Timothy F. Geithner, the President and Chief Executive Officer of the Federal Reserve Bank of New York. In a speech on November 17, 2004, he made several observations about the advances of our financial system since the collapse of LTCM in 1998.²⁰⁰ First, the number of hedge funds and the total assets under management has increased dramatically since 1998. Second, exposure of lender and counterparties to hedge funds is more diversified than in 1998. Third, lenders to and counterparties of hedge funds have significantly improved the quality of their risk management since 1998. Fourth, the capital in banks measured relative to their risk has stayed the same. And fifth, the infrastructure of our trading system, its clearing and settlement systems, is much stronger and more resilient than it was in 1998. In other words, market participants have responded to the LTCM crisis with market based corrections.

However, Geithner went on to suggest that there is room for further improvement in risk management assessment by banks and counterparties given the ever changing nature of hedge fund activities.²⁰¹ He also noted some “erosion” of standards in response to competitive pressures.²⁰² Geithner’s final recommendation is a reminder of how market forces work. He recommended that those dealing with hedge funds need a better due diligence process, demanding information from hedge funds on the nature and quality of their operations.

To the extent that information is not made available, and there seem to be a number of legitimate reasons why hedge funds may resist providing it and are sometimes successful in doing so, then it makes sense for the dealer to reduce the exposure it is willing to take to that fund. In general, credit terms should be calibrated to the quality of the information provided by the hedge fund counterparty. To the extent this is done is generally across those funds that are less transparent, have weak risk management disciplines and/or inadequate operational infrastructure, they will be able to take on less leverage, which would limit the potential risk they may pose in a disruptive event.²⁰³

²⁰⁰ See Geithner, *supra* note 37.

²⁰¹ *Id.* at 3.

²⁰² *Id.* at 4.

²⁰³ *Id.* at 3.

Geithner has, in later speeches, continued to encourage banks to develop new methods of risk management for hedge fund clients²⁰⁴ and for the new derivative products often traded by hedge funds (specifically credit derivatives).²⁰⁵ In his speech on credit derivatives, to the dismay of some hedge funds, he encouraged banks to “take a cold, hard look at [increasing] financing conditions and margin practice particularly with respect to hedge fund counterparties.”²⁰⁶ In essence, Mr. Geithner’s talks demonstrate a market that is adjusting successfully for hedge fund trading.

Ben S. Bernanke, Chairman of the Federal Reserve Board, has concerns about the practical implementation of a public database proposal:

I understand the concerns that motivate these proposals but, at this point, remain skeptical about their utility in practice. To measure liquidity risks accurately, the authorities would need data from all major financial market participants, not just hedge funds. As a practical matter, could the authorities collect such an enormous quantity of highly sensitive information in sufficient detail and with sufficient frequency (daily, at least) to be effectively informed about liquidity risk in particular market segments? How would the authorities use the information? Would they have the authority to direct hedge funds or other large financial institutions to reduce positions? If several funds had similar positions, how would authorities avoid giving a competitive advantage to one fund over another in using the information from the database? Perhaps most important, would counterparties relax their vigilance if they thought the authorities were monitoring and constraining hedge funds’ risk-taking? A risk of any prescriptive regulatory regime is that, by creating moral hazard in the marketplace, it leaves the system less rather than more stable.

A system in which hedge funds and other highly leveraged market participants submit position information to an authority that aggregates that information and reveals it to the market would probably not be able to address the concern about liquidity risk. Protection of proprietary information would require so much aggregation that the

²⁰⁴ Geithner, *supra* note 38.

²⁰⁵ Timothy F. Geithner, President and CEO, Fed. Reserve Bank of N.Y., Remarks at the NYU Stern School of Business Third Credit Risk Conference, NYC: Implications of Growth in Credit Derivatives for Financial Stability (May 16, 2006), *available at* <http://www.ny.frb.org/newsevents/speeches/2006/gei060516.html>.

²⁰⁶ *Id.* at 4.

value of the information to market participants would be substantially reduced. Timeliness of the data would also be an issue.

A public database of nonproprietary information could provide the public with a general picture of hedge-fund activity without creating the false impression that the authorities were engaged in prudential oversight of hedge funds. Such a public database might demystify hedge funds, but it would not address the central policy concern that opacity creates liquidity risk.²⁰⁷

However, indirect regulation, the regulation of financial institutions that deal with hedge funds, does make sense. I have already noted the capital adequacy requirements for banks that deal with hedge funds.²⁰⁸ This is a form of indirect regulation on hedge fund activity through the regulation of those that deal with hedge funds. Our banking system is designed to guard against bank failures. We have decided that we do not want banks to fail; individual depositors need protection and the risk of system wide contagion from any one bank failure is too great. Hedge fund failures, on the other hand, are a normal and expected part of the hedge fund business. With banks competing to deal with hedge funds, some banks, responding to competitive pressure, could agree to financial terms that jeopardize their solvency.²⁰⁹ To protect against bank failures, the government establishes minimum levels of acceptable risk that apply to all banks. Bank capital adequacy rules and the examiner system are designed to establish a floor on bank risk.²¹⁰

Another form of indirect regulation on hedge fund activity could be a disclosure rule that requires all public companies, particularly those that are financial institutions such as banks and insurance companies, to include a summary of their direct material exposure to hedge funds and other

²⁰⁷ Bernanke, *supra* note 78, at 5.

²⁰⁸ See discussion, p.25.

²⁰⁹ Both Geithner and Bernanke expressed concern over the “erosion in [bank] standards” in response to competitive pressures, reflected in a lowering of initial margin requirements and a relaxation in credit terms for hedge funds. See *supra* notes 37, 38, and 78 and accompanying text.

²¹⁰ The SEC’s regulation of securities firms and the CFTC’s regulation of commodity futures merchants pose the same basic problem. The SEC and the CFTC are responses for ensuring that these firms, when they deal with hedge funds, follow prudential risk management practices in their counterparty and credit relationships. See REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, at 34. Chairman Bernanke is worried about the risk management practices of “prime brokers,” broker-dealer firms that provide financing, back-office accounting, trade execution and clearing and settlement services for hedge funds. See Bernanke, *supra* note 78, at 3.

significantly leveraged financial institutions.²¹¹ Such a rule would be designed to protect the investors of public companies. We have decided that the investors of public companies deserve specific, detailed information in periodic reports. It would be a corruption of the requirement to permit such companies to invest in privately-held companies, hedge funds, and then not reveal the details of their investments. It is a regulatory problem similar to the regulation of banks in the sense that when a more heavily regulated entity invests in a lightly regulated entity the regulated entity should not, by such investing, escape or modify its regulatory obligations.

The present SEC rules do not provide specifically for disclosures about exposure to hedge funds. SEC rules could provide for such disclosures in the Management Discussion and Analysis (M, D, & A) or Description of Business segments of the periodic financial statements. Such disclosure would be consistent with existing SEC financial disclosure philosophy.²¹² Investors of publicly-traded companies ought to have all material information disclosed in ways are meaningful to intelligent investors. After LTCM, and with the continued notoriety of leveraged hedge funds, some disclosure of exposure to hedge funds, if significantly leveraged, would seem to be a needed evolution of current disclosure practice.

A special case of the indirect regulation through disclosure requirements acting on financial intermediaries that deal with hedge funds is the “fund of hedge funds” or “retailization” controversy. The SEC has long been concerned with those investment funds that invest in hedge funds, the funds of funds. FOFs “typically invest in fifteen to twenty-five funds.”²¹³ They come in three forms, defined by their registration status. Some are not registered as investment companies under the Investment Company Act of 1940 and privately place their securities.²¹⁴ Some FOFs are registered as investment companies under the 1940 Act and privately place their securities.²¹⁵ Some FOFs are registered as investment companies and also register their offering of securities to investors under the 1933 Act.²¹⁶ Most FOFs, even those with interests registered as public offerings under the 1933 Act, are offered only to institutional investors.²¹⁷ A few new FOF mutual funds have been be offered to the public, however.²¹⁸ All investment advisers to FOFs registered as investment

²¹¹ REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 163, at 33.

²¹² *See generally* 17 C.F.R. § 200 (2006).

²¹³ SEC STAFF REPORT TO THE SEC, *supra* note 28, at 67.

²¹⁴ *Id.* at 68.

²¹⁵ *Id.* (“40 Act only Registered”).

²¹⁶ *Id.* (“dual registered”).

²¹⁷ 69 Fed. Reg. 72,054, 72,057 (Dec. 10, 2004).

²¹⁸ Approximately 52 hedge funds offered or planned to offer shares to the public as of 2004. *Id.*

companies must also register under the Investment Advisers Act.²¹⁹ With the new SEC rules, those FOFs that are not investment companies will probably also have to register as investment advisers.²²⁰ There is no minimum initial investment requirement for clients of FOFs with registered investment advisers. Since FOFs typically charge a performance fee, however, all fund investors must satisfy the definition of a “qualified client” under SEC Rule 205-3. Rule 205-3 requires that each investor generally have a net worth of at least \$1.5 million or have at least \$750,000 of assets under management with the adviser.²²¹

The SEC is concerned about the quality of the FOF disclosures.²²² The first concern is about double (or even triple) fees.²²³ Investors in a FOF are subject to fees and expenses at both directly, at the FOF level to the FOF adviser, and indirectly, at the fund level to the individual fund advisers.²²⁴ A registered FOF, for example, usually pays its investment adviser an asset-based management fee of one or two percent of assets under management and a performance allocation on the capital appreciation that can be as much as twenty percent, and the underlying funds also pay similarly structured investment fees.²²⁵ Registered FOFs, however, do not disclose the actual or estimated fees indirectly incurred by the FOF through its investment in the underlying hedge funds.²²⁶ The SEC wants investors in registered FOFs to be informed of the layered fee arrangements.²²⁷

²¹⁹ Investment Advisers Act of 1940, 17 C.F.R. § 275.203A-1 (2005).

²²⁰ See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,071 (Dec. 10, 2004). (Advisers to a FOF must look-through the “top tier” hedge fund to count its investors as clients for the purposes of meeting the private adviser exception.) The threshold of fourteen clients would likely be exceeded, thus requiring registration as an Investment Adviser.

²²¹ With the new rules, a private hedge fund that has a FOF investor must look through the FOF and count its investors as clients for the purpose of meeting the fourteen client threshold. A FOF investor then means most all the underlying funds will have to register under the Advisers Act.

²²² SEC STAFF REPORT TO THE SEC, *supra* note 28, at 99 (“The staff believes that disclosure of the expenses of both the fund in which the investor invests and the funds in which a fund of funds invests is important to provide meaningful information to investors.”).

²²³ *Id.* at 100 (expressing a concern over the lack of any limit on the amount of fees that may be charged by hedge fund advisers).

²²⁴ Thus, an investor may incur indirect fees at the level of the individual hedge fund regardless of whether the fund of funds performed poorly. *Id.*

²²⁵ *Id.* at ix.

²²⁶ Form N-22, 17 C.F.R. § 274.11a-1 (2005) (Registration Statement of closed end management investment companies).

²²⁷ See SEC STAFF REPORT TO THE SEC, *supra* note 28, at 99; see also Fund of Funds Investments, Investment Company Act Release No. 33-8297, (June 23, 2004), available at <http://www.sec.gov/rules/proposed/33-8297.htm> (proposing an amendment to Form N-2).

The second concern with FOF disclosures is the transparency of the funds' investment positions.²²⁸ A registered FOF must disclose, in semiannual shareholder reports, the fund's financial statements and portfolio holdings.²²⁹ Registered FOFs fulfill this disclosure obligation by listing hedge funds in which the registered FOF has invested, but they do not identify the securities in which the underlying hedge funds have invested.²³⁰ Registered FOFs must also disclose valuation information on their positions in underlying hedge funds and the FOF's general investment strategy.²³¹ The valuation disclosures will necessarily reveal general information about the underlying hedge funds' portfolios. The SEC has stopped short of mandating specific valuation procedures but is soon to require that FOFs have valuation procedures in place.²³²

There appears to be an upcoming clash between hedge funds who want their trading strategies to remain confidential and the SEC who, when a FOF is marketed generally, want a FOF to disclose to its investors more details about the practices and portfolio of the underlying funds. The push to regulate FOFs may be the backdoor method of forcing hedge funds to make more public disclosures about their trading positions and portfolios.

VII. RELAXING THE REGULATION OF MUTUAL FUNDS

The staff of the SEC, in its September 2003 Report on hedge funds, ended by suggesting that the SEC explore enabling registered investment companies, mutual funds, to use some hedge fund strategies.²³³ The suggestion was a good one, but it does not appear that the SEC will act on it. The staff noted that hedge funds had more freedom to short the market,²³⁴ engage in more leverage,²³⁵ and use more innovative organizational structures.²³⁶ Discussions of the advantages of hedge fund short selling and leverage are noted above.²³⁷ The third category, organization structure, deserves separate mention. The staff noted the many organizational features used by hedge funds that may not be used by investment companies.²³⁸

²²⁸ SEC STAFF REPORT TO THE SEC, *supra* note 28, at 81.

²²⁹ Investment Company Act, 17 C.F.R. § 270.30e-1 (2005).

²³⁰ The new SEC rules forcing more of the underlying hedge funds to register under the Investment Advisers Act will provide only very general information on those funds' investment practices and portfolio securities.

²³¹ SEC STAFF REPORT TO THE SEC, *supra* note 28, at 71.

²³² *See id.* at 99.

²³³ *Id.* at 103-113.

²³⁴ *Id.* at 107.

²³⁵ *Id.*

²³⁶ *Id.* at 104-106.

²³⁷ *See* discussion, pp. 15-18, 26-28.

²³⁸ SEC STAFF REPORT TO THE SEC, *supra* note 28, at 104-106.

The “lock-up” used by hedge funds are prohibited to open-end investment companies that must honor redemption requests within seven days.²³⁹ Open-ended investment companies may hold no more than fifteen percent of their assets in illiquid securities.²⁴⁰ Closed-end investment companies, on the other hand, do not issue redeemable securities and may hold illiquid securities, but cannot engage in continuous offerings and often have trouble raising additional assets.²⁴¹ Most significantly, investment advisers to investment companies may not charge an investment company a performance fee.²⁴² Hedge funds rely heavily on performance fees, up to twenty percent of a fund’s capital gains and appreciation, to provide fund advisers incentives to produce absolute returns to the fund.²⁴³

The restrictions on investment company short selling, leverage and organizational structure create a substantial disincentive for such companies to engage in so-called “absolute return” investment strategies, strategies that are independent of the aggregate value of the market. Most investment companies, on the other hand, buy and hold types of securities and their returns are judged by whether they best a passive benchmark index.²⁴⁴ Mutual funds that want to engage in “absolute return” strategies must be FOFs, holding a portfolio of hedge funds. All but a very few of such FOFs are available only to institutional or wealthy investors.²⁴⁵ Other countries give their investment companies more trading freedom.²⁴⁶ To stay competitive in the global financial markets, we need to reassess whether the trading restrictions on our mutual funds, investment companies, make sense in the modern markets.

VIII. CONCLUSION

The irony of the hedge fund regulation movement is that financial economists have, for over seventy years, been decrying, first, the lack of independent shareholder involvement in the management of public firms and, second, the lack of swift capital reallocation in American industry. Hedge funds do both, more effectively than any financial institutions in American history perhaps, and we should not recoil in fear over the innovation. Hedge funds are a competitive advantage in the world’s

²³⁹ *Id.* at 105.

²⁴⁰ *Id.* at 105, n.333.

²⁴¹ *Id.* at 105-106.

²⁴² Investment Advisers Act, 15 U.S.C. § 80b-5(a)(1) (2000).

²⁴³ SEC STAFF REPORT TO THE SEC, *supra* note 28, at 109.

²⁴⁴ *Id.* at 36.

²⁴⁵ *Supra* note 175.

²⁴⁶ See Financial Services Authority, *Hedge funds and the FSA* 21-22 (Discussion Paper No. 16, 2002), available at <http://www.abanet.org/intlaw/hubs/programs/Annual0313.01.pdf> (discussing Hong Kong, Singapore and Switzerland).

markets; we should not act to stifle them. Trading markets controlled to be comfortable are markets that are sucked of their social value.

The lesson of hedge funds may be the reverse of the critics' claims. They have identified a regulatory gap in operating freedom afforded between hedge funds and that afforded registered investment companies. To close the gap we should not reduce the trading freedom of hedge funds but increase the trading freedom of registered investment companies (particularly on short selling). Some regulatory fine tuning for hedge funds is necessary, but it is indirect, involving rules operating on those regulated entities that deal with hedge funds – banks and publicly traded financial institutions – to protect the integrity of their regulatory systems.

IX. ADDENDUM

After the article was written, a panel of the United States Court of Appeals for the District of Columbia decided the Goldstein v. SEC case.²⁴⁷ In an opinion by Judge Randolph, the court held that the SEC rules requiring hedge funds to register under the Investment Advisors Act of 1940 were “completely arbitrary.”²⁴⁸ The court vacated the rules.

The court was troubled by the SEC’s argument that “client” meant one thing when determining to whom an adviser owed fiduciary duties (to the fund itself) and another when determining whether an investment adviser must register under the act (the investors and the fund are clients). Moreover, the court held that the SEC policy arguments for the rule, focusing on the national scope of hedge funds, did not justify registration based on number of clients:

The number of investors in a hedge fund ... reveals nothing about the scale or scope of the fund’s activities. It is the volume of assets under management or the extent of indebtedness of a hedge fund or other such financial metrics that determine a fund’s importance to national markets.²⁴⁹

SEC Chairman Christopher Cox, in response to the decision, asked the staff to prepare a “set of alternatives for our consideration.”²⁵⁰ The SEC could appeal the decision, rewrite its rules to satisfy the court’s concerns, or seek an amendment to the Investment Advisers Act from Congress. The new rules or a new amendment may impose more searching regulations than those contained in the voided rules. If so, the hedge fund industry may view this as a Pyrrhic victory.

I am surprised by the court’s opinion because it does not accept the SEC argument for a bright-line test for hedge fund regulation. Even though I do not favor the policy judgments behind the new rule I do not believe them to be “arbitrary.” The SEC is using a client rule as a surrogate for catching most large hedge funds. A test dependent on the size of hedge fund assets under management would have substantial measurement problems at the margin and necessarily be arbitrary at the margin as well. The SEC chose a test that catches most of the funds it wants to catch and

²⁴⁷ Goldstein v. SEC, No. 04-1434, 2006 U.S. App. Lexis 15760 (D.C. Circuit June 23, 2006) (Randolph, J.).

²⁴⁸ *Id.* at *7.

²⁴⁹ *Id.*

²⁵⁰ Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in Phillip Goldstein, et al. v. Securities and Exchange Commission, (June 23, 2006), available at <http://www.sec.gov/news/press/2006/2006-101.htm>.

the court rejected the test. A better test is possible, the court noted. This is, of course, most always the case for any given regulatory rule and this open-ended standard for court rejection may let the court be “arbitrary” in what rules it will vacate. The court showed very little deference to the SEC here. It is a signal that the SEC is short on its political capital with the D.C. Circuit perhaps.