Hedge Funds and Systemic Risk:
A Modest Proposal

By

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A thesis submitted in conformity with the requirements for the degree of Master of Laws
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University of Toronto

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Master of Laws, 2011

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Abstract

This paper explores the economic rationales underpinning potential hedge fund regulation, and reviews the arguments about why rules aimed to mitigate systemic risk may be economically efficient. The paper presents a limited definition of systemic risk, and proposes that an international macro-prudential supervisory body be set up for the Ontario, U.S. and U.K. markets to collect systemically important information about hedge funds and to recommend policy changes in light of this information. The paper also reviews the proposed regulatory reforms in the United States that will apply to hedge funds, and argues that while helpful, such regulations are sub-optimal because they do not consider certain important characteristics of systemic risk.
Acknowledgements

I wish to thank Professor Edward Iacobucci for his guidance and valuable insights. I also wish to thank Eric Adelson for supporting me in the pursuit of my academic interests, and my parents for their unrelenting encouragement.

My sincerest gratitude to my wife Devra and my children Neeve and Kobi for their love, patience and support. I dedicate this thesis to them.
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1. Introduction

The significance of hedge funds has increased considerably in recent years. Indeed, hedge funds around the world currently hold approximately US$2 trillion in assets and are estimated to account for nearly half of the aggregate daily trading volume of the New York and London stock exchanges. Yet it seems that for this type of investment vehicle in particular, increased power has also lead to increased notoriety. The public perception that hedge funds operate in the “wild west” of the financial industry is constantly being reinforced, most recently with several high profile criminal cases involving hedge fund managers, such as the Galleon insider trading trial. The nature of these investment funds has not only created an “aura of mystery” which captures the public’s imagination, but it has also placed the activities of hedge fund managers squarely under the microscope of securities regulators globally.

In the aftermath of the global financial crisis of 2007/2008, many have rushed to vilify the actions of hedge funds as major contributors to the economic carnage. Yet an objective,
A critical review of the role of hedge funds in causing or extending the crisis suggests that any negative impact brought about by their activities was not particularly significant. Despite these conclusions, governments around the world have taken steps to introduce greater regulatory oversight on hedge funds and hedge fund managers.

What then, is the economic rationale behind this new regulation? A cursory analysis of many of the new and proposed rules that affect hedge funds and their managers in the United States and Europe suggests that regulators are primarily concerned with increasing investor protections. Specifically, concerns over increased exposure to hedge funds by retail investors, a lack of uniform disclosure standards and the fact that hedge funds employ risky “rogue strategies” such as leverage and short selling seem to be the driving force behind much

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7 Houman B. Shadab, “Hedge Funds and the Financial Crisis” (January 2009), Mercatus on Policy, No. 34, online: <mercatus.org/sites/default/files/publication/RSP_MOP34_Hedge_Funds_and_the_Financial_Crisis.pdf>. See also Robert G. Frucht & Tasneem S. Novak, “No Direction: The Obama Administration’s Financial Reform Proposal and Pending Legislation Proposing the Registration and Further Regulation of Hedge Funds and Private Pools of Equity are Overbroad and Fail to Address the Actual Risks that these Funds Pose to the Financial System” (2010) 29 Rev. Banking & Fin. L. 157 at 159.

8 The political rationale is often just as important to understanding the regulatory responses to the global financial crisis, but reviewing this is beyond the scope of this paper.

9 Both the United States Securities and Exchange Commission (“SEC”) and the European Parliament have also explicitly stated that investor protection is a major concern underpinning much of the new and proposed regulations with respect to hedge funds. See, for example, Mary Schapiro, SEC Chairman, Remarks given by at the SEC Open Meeting regarding Dodd-Frank Act Amendments to the Investment Advisers Act (22 June 2011), online: <www.sec.gov/news/speech/2011/spch062211mls-items-1-2.htm> (“In developing our registration rules and reporting requirements, we sought to obtain from all of these [hedge fund] advisers a meaningful collection of data that would aid investors and assist our regulatory and examination efforts”) [emphasis added]. See also Background note on the Alternative Investment Fund Managers Directive (8 November 2010), online: <europarl.europa.eu/en/pressroom/content/20101105BKG92028/1/html/What-is-the-reason-for-the-proposed-directive> (stating that one of the key regulatory aims is “enhancing protection for investors, by curtailing some of the riskier behaviour of [hedge funds]”).
of the regulatory reform. Moreover, the development of certain agency problems inherent to unregulated investment funds has increased the potential for material conflicts of interests to arise, further prompting investor-centric regulation. Regulators are also concerned with systemic risk that may develop due to the size and activities of hedge funds. Systemic risk refers generally to the potential that financial market shocks or failures could, regardless of origin, have significant negative effects on unrelated areas of the economy. Addressing such risk has historically been outside the scope of securities regulators’ responsibilities. However, some commentators have argued that the time has come for securities regulators to take responsibility for the management of systemic concerns.

This paper will review each of these rationales in detail and will argue that from an economic perspective, the protection against systemic risk, rather than a concern for investor interests, should be the primary goal of any regulatory policy relating to hedge funds. This paper will also suggest a modest, practical and achievable proposal for combating hedge fund-related systemic risk globally. I will argue that given the opaque and unquantifiable nature of

11 Sklar, supra note 10 at 3266-3270.
13 There are many different definitions of systemic risk in the academic discourse. This paper will propose and adopt a very narrow interpretation of systemic risk. See infra Part 3.1.1.
14 See, for example, Securities Act, (Ontario) R.S.O. 1990, c.S-5, s. 1.1 [OSA], which states that the purpose of the OSA is to protect investors and foster fair and efficient capital markets.
16 I will make this argument notwithstanding the uncertainty surrounding whether hedge funds currently contribute to systemic risk. Such uncertainty, however, is reflected in the modest nature of my proposal to mitigate systemic risk.
such risk, certain macro-prudential information regarding hedge funds and hedge fund
managers that relates to systemic issues must first be collected and analyzed in order to
establish meaningful concomitant policies to address such risk. In particular, information
relating to hedge fund leverage, derivatives positions and counterparty exposures is not
currently available, but is crucial to tracking the development of systemic risk cause by such
funds.\(^{17}\) Moreover, one of the striking characteristics of such risk is that it is no longer
confined to local economies.\(^{18}\) In other words, a political or financial crisis anywhere around
the world may have significant and lasting negative effects on unrelated market participants
here at home. This feature must be addressed in any meaningful solution as well.

Considering these factors, I will suggest that the most effective practical method to
combating systemic risk is through the formation of a single, international macro-prudential
supervisory body dedicated to collecting and analyzing systemically relevant information
about hedge funds. The body would oversee a new registration regime in at least the three
most important jurisdictions in which hedge fund managers operate; namely, the United
States, United Kingdom and Ontario, Canada.\(^{19}\) The system would require hedge fund
managers to provide, in sufficient detail, certain systemically important information to this
body, which will then be tasked disseminating relevant analysis to participating regulators and
governments and suggesting policy reform.

\(^{17}\) The SEC has proposed that certain US-registered hedge fund managers will be required to provide much of
this information as it relates to US entities. See infra Part 4.1.5 for more detailed discussion regarding the SEC
proposal.


\(^{19}\) Other important jurisdictions, such as Hong Kong and Australia, would be welcome and encouraged to join.
However, given the similarities in the hedge fund industries in the U.S., U.K. and Ontario, setting up the registry
within a reasonable amount of time would be best achieved by initially focusing on those three jurisdictions. See
infra Part 5.1 for details regarding this proposal.
The paper will be structured as follows. Part 2 explores what hedge funds are, how they are structured and what benefits they bring to financial markets and the economy as a whole, in order to establish the importance of structuring new rules which do not over-regulate (or which do not regulate the wrong problem). Part 3 introduces the key economic rationales for hedge fund regulation, and after establishing that hedge funds likely contribute to systemic risk, will suggest that any new regulations should be limited in scope to only mitigate such risk. Part 4 reviews the current and proposed state of hedge fund regulation in the U.S., U.K. and Ontario. Part 5 details my proposal for the new registration regime and macro-prudential supervisory body. The idea of creating such a body to oversee hedge fund-related systemic risk has been proposed by others, although typically without reference to international cooperation. For example, the U.S. Securities and Exchange Commission (“SEC”) recently proposed new Rule 204(b)-1 under the Investment Advisers Act of 1940\textsuperscript{20} (“Advisers Act”), which would require registered investment advisers to make substantial periodic filings on new Form PF with the SEC.\textsuperscript{21} In light of this important proposal, Part 5 also compares my suggestion with the current reforms proposed by the SEC, and suggests that given the global nature of systemic risk and the increased power and relevance of non-U.S. hedge fund managers, an international approach to mitigating systemic risk is optimal. Part 6 concludes.

\textsuperscript{21} See infra Part 4.1.5 for a more detailed discussion of the proposed U.S. regulations.
2. An Introduction to Hedge Funds

There is no formal, universally accepted definition of a hedge fund, although most hedge funds globally share certain common characteristics. This lack of a standard definition likely reflects the heterogeneous nature of hedge funds themselves, as most are designed to provide maximum flexibility in their structure and investment styles.\textsuperscript{22} The Ontario Securities Commission recently defined hedge funds as “[i]nvestment pools that use alternative investment strategies not generally available to traditional mutual funds such as taking both long and short positions and using arbitrage, leverage, options, futures, bonds and other financial instruments to capitalize on market conditions.”\textsuperscript{23}

An SEC Staff Report, on the other hand, suggests a definition based on what hedge funds are not. The report stated that the term “hedge fund” is generally “used to refer to an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act.”\textsuperscript{24} In Goldstein v. S.E.C., the District of Columbia Appeals Court noted that “[h]edge funds are notoriously difficult to define. The term appears nowhere in the federal securities laws, and even industry participants to not agree upon a single definition.”\textsuperscript{25} The Court adopted the definition of hedge funds set out by the President’s Working Group in the U.S., a body comprised of representatives from the Department of the Treasury, Board of

\textsuperscript{23} CSA Staff Notice 81-316 - Hedge Funds (2007) 30 OSCB 77 [81-316].
\textsuperscript{24} U.S., Staff Report to the United States Securities and Exchange Commission, Implications of the Growth of Hedge Funds (2003) at 3, online: <www.sec.gov/news/studies/hedgefunds0903.pdf> [SEC Report]. It should be noted that the recent amendments to the Advisers Act render this definition obsolete in respect of the registration of the fund. See infra Part 4.1.5 for further details.
\textsuperscript{25} 451 F.3d 873 at 874 (2006) [Goldstein].
Governors of the Federal Reserve System, SEC and Commodity Futures Trading Commission (“CFTC”), as “any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.”26 The U.K.’s Financial Services Authority (“FSA”) takes a broader approach, enumerating certain characteristics most commonly associated with hedge funds, including features relating to their legal structures, trading strategies, manager compensation and investor base.27

Some commentators have noted that the lack of a standard definition has made it more difficult to regulate hedge funds.28 Indeed, the lack of a common definition, as will be argued later in this paper, presents a unique challenge for any international-based solution for hedge fund regulation, since it may prove highly difficult to regulate an entity without a consensus amongst the relevant jurisdictions with respect to exactly what is being regulated.29 In order to overcome this challenge, a thorough understanding of how hedge funds operate in the market is necessary. Part 2.1 below provides a basic overview of hedge funds, including a brief description of some of their key characteristics. Part 2.2 explores the economic benefits that hedge funds provide in global markets.

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26 Ibid. at 875.
28 See for example David Schneider, “If at First You Don’t Succeed: Why the SEC Should Try and Try Again to Regulate Hedge Fund Advisers” (2009) 9 J. Bus. & Sec. L. 261 [Schneider] (arguing that a definition with objective elements is necessary in order for the SEC to effectively regulate hedge fund advisers).
29 See infra Part 5.3, which will review the possible ways to define the term “hedge fund” for the purpose of creating the proposed registration system.
2.1 Hedge Fund Characteristics

Most hedge Funds share similar structural characteristics which distinguish them from other investment vehicles, such as mutual funds, venture capital funds and private equity funds. This Part will describe briefly some of the more common of these features.

2.1.1 Hedge Fund Structures

In the United States, hedge funds have historically been structured to circumvent securities regulation by taking advantage of several exemptions and safe harbours.\textsuperscript{30} As such, and in contrast to regulated investment vehicles such as mutual funds, they are typically set up as limited partnerships (LPs) or limited liability companies (LLCs).\textsuperscript{31} Canadian hedge funds tend to be structured as LPs as well, although some are open-ended corporations or unincorporated investment trusts. In the LP structure, the fund manager will usually serve as the general partner for the partnership, and thus retain control over the management and operations of the fund, including the management of the investment portfolio (subject to any restrictions set out in the limited partnership agreement). Limited partners subscribe for units of the fund but are not entitled to direct or control its affairs. These structures are typically utilized for their tax efficiency (at the fund level) and to take advantage of limited liability for the benefit of investors.\textsuperscript{32} U.K. hedge funds managers employ slightly different legal structures, such as private investment partnerships and offshore investment corporations, which usually have similar limited liability and tax minimization features.\textsuperscript{33}

\textsuperscript{31} Ibid.
\textsuperscript{32} Ibid. at 812.
\textsuperscript{33} FSA, supra note 27.
Regardless of where hedge fund managers are domicile however, fund assets often reside in tax havens such as Bermuda and the Cayman Islands in order to minimize taxes and take advantage of a more lenient regulatory regime.\textsuperscript{34} Indeed, an estimated 65% of global hedge fund assets are in offshore funds.\textsuperscript{35} Moreover, critical investment fund administrative services, such as custodianship, transfer agency and brokerage arrangements are sometimes provided offshore as well.

2.1.2 Investor Base

As non-prospectus qualified investments, and given their structural complexity, hedge funds have a limited investor base.\textsuperscript{36} Historically, hedge fund investors have been high net worth individuals who were willing to accept higher risk and limited redemption rights (compared to mutual funds) in exchange for the potential to earn greater returns on their investments and for portfolio diversification benefits.\textsuperscript{37} However, a significant proportion of hedge funds’ investor base is now comprised of fund of hedge funds.\textsuperscript{38} These relatively new investment vehicles have increased retail investor access to hedge funds because they typically have lower minimum investment requirements compared to the hedge funds

\textsuperscript{34} SEC Report, \textit{supra} note 24 at ix. It is estimated that over 60% of global hedge fund assets are managed in offshore funds.


\textsuperscript{36} For example, in Canada and the U.S., non prospectus-qualified investments may only be sold in the exempt market to investors who are “accredited investors” or who meet other limited exemptions, such as the minimum investment requirement. See \textit{infra} Part 4.1.1 and Part 4.3 for more details regarding this and other securities laws exemptions.

\textsuperscript{37} See Bacmann, \textit{infra} note 67 and accompanying text for a discussion about the diversification benefits of hedge funds.

\textsuperscript{38} SEC Report, \textit{supra} note 24 at 68. Fund of funds are a common investment structure which allow investors to invest in many different mutual funds, hedge funds or venture capital funds, thereby further diversifying portfolio holdings of investors.
themselves, making them easier products to invest in.\textsuperscript{39} Furthermore, large institutional investors such as pension funds, university endowment foundations, sovereign wealth funds and insurance companies, who often manage money on behalf of other retail investors or stakeholders, are becoming prominent hedge fund investors as well.\textsuperscript{40}

With the exploding popularity of fund of funds and the rise of institutional investors, some commentators have argued that hedge funds are undergoing a “retailization” phenomenon, whereby unsophisticated investors are being exposed to the riskier investment strategies of hedge funds indirectly.\textsuperscript{41} Retailization is one of the reasons oft provided for suggesting that increased investor protection should be a policy goal of investment fund regulators.\textsuperscript{42}

\textbf{2.1.3 Manager Compensation}

Hedge fund managers are typically compensated by charging their investors two types of fees. First, a management fee based on the aggregate value of the assets of the fund (typically 1-2 percent) is imposed. Second, hedge funds usually charge a performance fee of anywhere between 15 and 20 percent of the fund’s annual realized and unrealized gains.\textsuperscript{43} While this second fee is sometimes limited by the requirement that a manager reach some minimum benchmark performance before being entitled to a “carried interest” payment, this type of compensation structure has proven to be extraordinarily lucrative for top hedge fund managers. For example, in 2010, despite a weak global economy, the top 25 hedge fund

\begin{itemize}
  \item \textsuperscript{39} \textit{Ibid. at 69}.
  \item \textsuperscript{40} Pearson, \textit{supra} note 2 at 14.
  \item \textsuperscript{41} Sklar, \textit{supra} note 10 at 3264.
  \item \textsuperscript{42} This rationale will be reviewed in Part 3.2.1 below.
  \item \textsuperscript{43} Thierry Olivier Desmet, “Understanding Hedge Fund Adviser Regulation” (2008) 4 Hastings Bus. L. J. 1 at 6.
\end{itemize}
managers earned over US$22 billion in profits. Such fees attract highly intelligent and motivated individuals into the investment funds industry, but also create incentives for managers to take excessively high risks, since they share proportionally in profits but suffer little or no direct losses for failed investments. To mitigate this risk, investors often require that managers invest significant a amount of their own capital to better align their interests with those of other limited partners.

2.1.4 Investment Strategies

Hedge funds use a wide variety of investment styles, and often employ strategies involving high trading volumes and concentrated investments. Hedge funds are also highly flexible in that they are able to implement innovative investment strategies without being constrained by the requirement to disclose asset allocations to their investors prior to making investment decisions. For example, many hedge funds employ short selling strategies, which allow them to borrow securities from a lender that are then sold in the open market. If the

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45 Sklar, supra note 10 at 3266. As an example, suppose a $1 billion hedge fund with a 20% performance fee makes a highly risky investment. If the investment is successful and the fund increases in value by 50%, the manager will earn $100 million, plus the additional incremental management fees. If, however, the investment fails and the fund loses half of its value, the only immediate loss to the manager is the reduction in the incremental performance fee. Long term reputational damage may, however, reduce the incentives to make such speculative investments, but this may be less important to new managers.

46 Ibid.

47 SEC Report, supra note 24 at 34.


49 Douglas Cumming & Sofia Johan, “Hedge Fund Forum Shopping” (2008) 10 U. Pa. J. Bus. & Emp. L. 783 at 792 [Cumming]. This is in stark contrast to mutual funds, which typically must advise what their investment objectives and strategies are, and stick to these more constrained frameworks.

50 Schneider, supra note 28 at 267. Mutual funds are generally prohibited from short selling securities, with limited exceptions. For example, in Ontario, mutual funds may request an exemptive relief order to allow limited short selling to occur within a fund.
value of the securities declines between the time that the fund commences borrowing and the time that the fund repurchases the securities, a profit is made. However, if the value of the securities rises, the fund suffers a loss. Short selling is considered highly risky because there is theoretically no limit to the amount of potential liability for a poor investment.51

Hedge funds are also free to trade derivatives, which are typically used as a way to manage and transfer risk.52 For example, hedge funds may purchase currency forwards to passively mitigate currency risk, or interest rates swaps to reduce the credit risk of executing certain investment strategies. However, the use of derivatives involves counterparty risk, which is the risk that the one party to the transaction is unable to meet the terms and conditions of the derivative contract, thereby causing a corresponding loss to its counterparty. Such risk can become systemic in that certain institutions that are particularly exposed to derivatives may find themselves in financial stress should several counterparties suddenly default at once.53 These risks have grown so significant that Warren Buffett has called derivatives “weapons of mass destruction”,54 while others have blamed certain types of derivatives, namely structured debt and credit default swaps, for exacerbating the recent financial crisis.55 Hedge fund managers may also use derivatives for speculative purposes to

51 This is because there is no theoretical limit to how high a stock price may rise, leading to unlimited liability on behalf of short-sellers. In practice, most investment funds utilize stop-loss programs to limit potential liability should a security that is sold short rise in value.
52 Schneider, supra note 28 at 267. The ability of mutual funds to use derivatives, on the other hand, is limited and will depend on the jurisdiction of the fund.
53 Infra Part 3.1.1 below will discuss the nature of systemic risk in more detail.
55 See e.g. Anand, supra note 15.
increase their funds’ exposure to a particular asset class or currency, thereby further increasing the risk profile of a fund.\textsuperscript{56}

Finally, hedge funds are also unique compared to other types of investment funds in that they are not restricted from using significant amounts of leverage. Indeed, it has been argued that given the nature of the hedge fund industry, it is almost a necessity for funds to heavily leverage themselves to maintain competitive returns.\textsuperscript{57} Leverage may be obtained through direct borrowing from lenders, or through off balance sheet positions effected through the purchase of certain derivative products.\textsuperscript{58} However, excessive leverage makes an investment fund susceptible to market swings is highly risky, since leveraged funds must be able to repay any borrowed capital regardless of whether there are investment losses in order to remain solvent.\textsuperscript{59} The degree to which a fund uses leverage typically depends on its investment style.\textsuperscript{60}

\subsection*{2.2 Economic Benefits}

Hedge funds are risky investments, and as will be argued below, likely contribute to global systemic risk. However, in order to fully consider how to efficiently regulate such

\textsuperscript{56} For example, a manager may purchase currency forwards to place a speculative ‘bet’ on a particular countries currency in an attempt to enhance returns. Such strategies are rarely used by mutual funds, and if they are must be fully and plainly disclosed to investors prior to undertaking such positions.


\textsuperscript{59} There are several examples of hedge funds that have failed because they were excessively leveraged. Perhaps the most significant failure is Long Term Capital Management, which collapsed shortly after it lost most of its equity following the devaluation of the Russian Ruble. The fund is said to have borrowed over 25 times its actual capital holdings. See infra Part 3.1.2 for a more detailed discussion.

\textsuperscript{60} SEC Report, supra noted 24 at 37. For example, funds that primarily utilize an arbitrage strategy which aims to take advantage of small pricing discrepancies are often highly leveraged.
entities, it is important to understand their economic utility. Indeed, there is little doubt that hedge funds provide global financial markets with significant benefits, which must be considered by regulators prior to enacting any new rules. For example, hedge funds benefit the markets by contributing to market efficiency and improving asset pricing. This occurs because many hedge funds take speculative positions in risky or illiquid assets which are difficult to price, based on extensive research about the true value of these securities. These purchases, in turn, leads to more price efficient markets as securities move closer to their true value.

Hedge funds also provide liquidity to markets by virtue of the high volume of trading which they engage in. Liquidity is beneficial because it allows investors to more easily buy and sell securities without leading to significant changes in the prices of such securities. Improved investor confidence caused by more accurate pricing of illiquid assets further aids market liquidity, since overall participation in capital markets is increased. It should also be noted that historically, the provision of liquidity has been the exclusive domain of financial institutions, but given the reduced risk taking activities of banks with the migration towards the Basel II accord, hedge funds now play a very prominent role in enhancing liquidity.

Hedge funds also provide investors themselves with portfolio diversification benefits. This diversification occurs because the return correlations of hedge funds often fundamentally

61 Ibid. at 4.
62 Ibid.
63 Ibid.
64 Roach, supra note 10 at 174.
65 Ibid.
66 Bianchi, supra note 22 at 13.
differ from other asset classes, such as stocks or bonds.\textsuperscript{67} Where correlations between two asset classes are low, the returns provided by the first asset differ significantly from the returns of the other. As such, many institutional investors purchase hedge funds investments as a risk management strategy in an attempt to “smooth out” overall portfolio volatility.\textsuperscript{68}

From a corporate governance perspective, hedge funds also provide important contributions and financial discipline. Such funds have become important and high profile shareholder activists recently, launching proxy battles to oust poor management, commencing and blocking takeover bids and tender offers and even initiating shareholder litigation.\textsuperscript{69} Interestingly, hedge funds often take large positions in portfolio holdings \textit{in order to} become activists and complete value-enhancing transactions, rather than merely acting as \textit{ex post} activists.\textsuperscript{70} Empirical evidence suggests that on average, hedge fund activism is generally value-increasing when viewed as a whole.\textsuperscript{71}

Finally Bianchi and Drew argue that hedge funds contribute to the transfer and distribution of risk generally in financial markets.\textsuperscript{72} For example, in recent years, commercial and investment banks have shifted assets off their balance sheets through securitizations in order to meet Basel II and internal risk-management requirements. Hedge funds have been


\textsuperscript{68} Roach, \textit{supra} note 10 at 176.


\textsuperscript{70} \textit{Ibid.} at 179.


\textsuperscript{72} Bianchi, \textit{supra} note 22 at 14.
significant purchasers of such securitized assets, thereby contributing to increased global financings and the creation of several niche debt markets.  

3. Economic Rationales for Hedge Fund Regulation

Given the important market benefits that hedge funds provide, any attempt to regulate these investment vehicles should consider the potential economic consequences of doing so. For example, suppose regulation is enacted which immediately makes it impossible for hedge funds to utilize leverage. Within a very short period of time, many hedge funds would simply cease to exist, being unable to meet either their investment strategies or their profitability requirements. Such regulation would surely cause difficult short-term disruptions for investors, managers and third party service providers (such as prime brokers and custodians). The long-term impact to the economy, however, would likely be even more severe, since many of the important economic benefits that hedge funds provide would disappear along with the funds themselves.

What then, are the reasons for introducing new hedge fund rules? This Part will explore the key economic rationales for regulating hedge funds: increasing investor protection, maintaining efficient capital markets and reducing systemic risk. After reviewing from an economic perspective, this Part will conclude that the mitigation of systemic risk is the only economic rationale that justifies new rules. This conclusion sets up the foundation which underpins the establishment of a new registration regime proposed in Part 5 of the paper.

\footnote{Ibid.}
3.1 Rationale: Systemic Risk

One of the rationales often given by regulators and commentators in support of new rules on hedge funds is that additional regulations are required in order to mitigate hedge fund-related systemic risk.\(^7^4\) However, in order to determine whether there is a sound economic basis for this rationale, it is first necessary to determine, as precisely as possible, what systemic risk is and who it affects. Indeed, there is no single, formal definition of systemic risk. Allowing for too much ambiguity or vagueness in its characterization will ultimately confuse governing stakeholders when trying to assess whether hedge funds actually contribute to such risk and if so, how to mitigate their contribution. Part 3.1.1 below will therefore review the definitions of systemic risk in order to establish an appropriate framework for regulation. Part 3.1.2 will then assess whether hedge funds actually cause or contribute to systemic risk, and Part 3.1.3 will analyze whether a regulatory response is desirable.

3.1.1 What is Systemic Risk?

The term “systemic risk” is commonly used to describe the possibility of a series of correlated defaults among financial institutions that occurs over a short period of time, often caused by a single major event.\(^7^5\) Some commentators have attempted to specifically define systemic risk as “the potential for a modest economic shock to induce substantial volatility in asset prices, significant reductions in corporate liquidity, potential bankruptcies and efficiency

\(^7^4\) See, e.g. supra note 6 and accompanying text.

\(^7^5\) See e.g. Nicholas Chan et al., “Do Hedge Funds Increase Systemic Risk?” (2006) Q4 Federal Reserve Bank of Atlanta Economic Review 49 at 49 [Chan].
losses.” Others have suggested that systemic risk refers to the risk that “an economic shock such as market or institutional failure triggers (through panic or otherwise) either (X) the failure of a chain of markets or institutions, or (Y) a chain of significant losses to financial institutions, resulting in increases in the cost of capital or decreases in its availability”.

While these definitions are helpful, two important elements must be emphasized. First, given the rise in the globalization of financial services, systemic risk is now a “globalized” phenomenon. The interconnectivity between financial institutions and national economies increases the potential that a shock or crisis that emerges in one country will affect the economy of another, where the two are sufficiently interrelated financially. Of course, differences in prudential regulations and enforcement levels may affect the severity of a systemic crisis in different jurisdictions. However, as I will argue further below, a modern economy can no longer ignore the systemic concerns of its neighbours when considering its own interests.

Second, in order to avoid regulatory overreach, it is crucial that the definition of systemic risk is sufficiently differentiated from the concept of investment risk, lest regulators attempt to reduce potential financial losses. In order to do so, there must be, in my view, a clear link between the economic “shock” and the negative displacement in the actual economy. In other words, if the above referenced failures or significant losses do not lead to or contribute to actual reductions in general economic and financial activity, which in turn

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76 Paul Kupiec & David Nickerson, “Assessing Systemic Risk Exposure from Banks and GSEs under Alternative Approaches to Capital Regulation” (2004) 48 J. Real Est. Fin. & Econ. 123 at 123.
77 Schwartz, supra note 28 at 204.
79 Ibid.
affects unrelated third-party market participants, then such failures or losses are not systemic. Rather, under those circumstances, the risk is merely of a financial nature. This requirement suggests that losses are of a systemic nature where they are primarily caused by circumstances that are not reasonably foreseeable from the perspective of a moderately sophisticated and knowledgeable objective investor.\(^{80}\) Another way to think about this concept is that in a systemic crisis, the risk of loss cannot be “diversified away” by the typical experienced investor. Indeed, in such a crisis it must be that most relevant market actors cannot easily avoid negative financial repercussions.\(^{81}\)

The concept of an objective investor is important in determining whether a loss is due to poor investment decisions or whether systemic factors played a role. This is because from a practical perspective, it is simply not possible to define risk and formulate a regulatory response without considering what a reasonable investor would deem to be risky. Indeed, any investor might suffer a loss because their investment thesis does not work out, and some investors actually profit handsomely during systemic crises.\(^{82}\) Therefore, by definition, systemic risk cannot be regarded subjectively by each individual investor’s standards. However, where a loss is due to factors outside the contemplation of a reasonable investment

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80 See Shalomi H. Abraham, “Extended Comment: Is Systemic Risk Relevant to Securities Regulation?” (2010) [unpublished, on file with author] [Abraham]. See also Heidi M. Schooner, “Private Enforcement of Systemic Risk Regulation” (2010) 43 Chreighton L. Rev. 993 at 995 (arguing that identifying systemic risk is highly challenging, and noting the difficulty of knowing whether a systemic event would have occurred in the absence of intervention).


82 For example, John Paulson’s hedge fund Paulson & Co made a $15 billion dollar profit in 2007 alone, betting that a systemic crisis would develop in the United States. For a further description, see Gregory Zuckerman, The Greatest Trade Ever (New York: Random House, 2009).
thesis, and has nothing to do with the actual security itself, then in my view, such a loss is caused by systemic factors.

A theoretical example may be helpful to illustrate this point. Suppose an investor invests directly in collateralized debt obligations (CDOs) backed by U.S. mortgage-backed securities, and that the next day, the value of the CDOs drops precipitously due to a real or perceived weakness in the U.S. housing market. In this example, the loss to the investor is not a consequence of systemic risk, but rather a consequence of investment risk. This is because the asset class underlying the CDO (i.e. U.S. residential mortgages) has lost value, so the investor made a poor bet on the future worth of that particular asset. Moreover, the counterparty to that initial transaction bet the opposite way and was financially rewarded by avoiding a loss. Suppose instead that an investor buys shares in a manufacturing company (unrelated to real estate). Suppose further that the company’s lenders suddenly refuse to provide any credit for reasons unrelated to the company’s own financial management or cash flows, but rather because they have incurred huge losses following a financial shock, and are either too afraid or financially weak to provide any capital. If this refusal forces the company into bankruptcy because it cannot refinance its debt, I would argue that systemic risk played a significant role in the failure of the enterprise because the consequence of the risk (that is, the loss to the investor) was not reasonably foreseeable to even a highly knowledgeable

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83 Abraham, supra note 80.
investor. In other words, the financial loss had nothing to do with a weakness or failure of the actual business, but rather an unrelated factor, caused by an external shock.

Ultimately, there is economic utility in a transaction where one investor makes a bad bet and loses money while the investor on the other side of the transaction makes the opposite bet and earns money, since capital is being deployed efficiently. If however, a sufficiently sophisticated investor, acting rationally, loses money for reasons outside of his or her reasonable contemplation, then systemic risk has played a role in that loss, and it is much more difficult to associate this transaction with any positive economic outcome.

What then, are the types of actual financial shocks that might cause a systemic crisis which negatively affects the real economy? One of the most common examples cited is an event or series of events that leads to a failure of banks or other lending institutions, which are important sources of capital. Such a failure, or even the apprehension of such a failure, would deprive the market of capital, thereby reducing liquidity, raising costs and slowing economic activity. Moreover, a default of one bank may adversely affect the ability of its counterparties to meet their own obligations to other counterparties, further limiting the

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84 Ibid. The fact that the small business’s financial institution suffered huge losses following a shock, causing it to subsequently restrict its lending to clients, is certainly difficult to foresee.

85 The distinction between investment risk and systemic risk is not always so clear, and it may be that systemic risk is measurable more as a point along a continuum rather than as a risk that is completely distinct from investment risk. For example, any corporate debtor that relies on credit must consider the risk that it will not be able to refinance its loans. However, where strong companies are unable to do so because their lenders made terrible investment decisions and suffered significant losses after (or as part of) an economic shock, then it seems to me that this is more of a systemic issue than an investment risk. One may theoretically argue that no loss should be beyond the reasonable scope of a reasonable investor, and therefore all systemic risk is actually investment risk. However, this argument merely “assumes away” the distinction between systemic and investment risk, and does little to solve the potential problems of such risk.

86 This assumes that no material undisclosed information is used by the party profiting from the transaction.

87 Schwartz, supra note 18 at 199.

88 Ibid. at 198.
availability of credit, since banks are closely intertwined financially. This interconnectivity between banks is global, since banks lend to each other internationally. Thus, the failure of one lending institution may create a negative ripple effect on other lending institutions anywhere in the world. The failure of several banks and threatened failures of many others were partially to blame for the recent financial crisis.

Another example of a shock which may lead to a systemic crisis is any event which suddenly causes investor panic in the capital markets, which lead to substantial and immediate investment losses. These types of panics often lead to heavy losses for investors in the short term. They also tend cause investors to lose confidence in capital markets over longer term, and thus deprive the market of liquidity, thereby raising costs and negatively affecting the broader economy. The recent so-called “flash crash” of May 2010, where the Dow Jones Industrial Average fell by 9.2% in a matter of minutes, is but one example of such an event that negatively affected markets all over the world. A joint report issued by the SEC and CFTC blamed the crash on the execution of a single massive trade. Regardless of the

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89 Ibid. at 199.
90 Ibid.
92 See Ben Steverman, “‘Flash Crash’ Poses Further Uncertainty for Investors” Bloomberg Businessweek (10 May 2010), online: <www.businessweek.com/investor/content/may2010/pi20100510_892868.htm>.
93 Canada’s largest stock exchange, for example, also suffered a substantial decline during the crash. See David Pett, “TSX Froze 70 Stocks during Flash Crash” Financial Post (13 May, 2010), online: <canada.com/victoriatiemescolonist/news/business/story.html?id=e12da471-36ba-4681-acb1-1eade37fba90>.
reasons, scared investors withdrew significant sums from the capital markets following the crash.\textsuperscript{95}

Systemic risks may be interrelated as well. For example, in the recent financial crisis, the collapse in value of U.S.-based CDOs caused significant losses and write-downs among global banks (and in some cases, lead to bank failures), which reduced capital availability and hurt investor sentiment. With less access to credit and due to worrisome economic conditions, many corporations around the globe significantly cut employment costs, leading to a substantial rise in unemployment in some of the world’s most advanced economies. In turn, more downward pressure was placed on demand, and overall market liquidity was further reduced. Even given the narrow definition presented by this paper, there is little doubt that the recent economic crisis was a systemic one.

For the purposes of regulating systemic risk related to hedge funds, distinguishing between systemic and mere investment risk is crucial to avoid regulatory overreach. This is because if governments or regulators are given the task of mitigating systemic risk where such risk is broadly defined, there is a strong possibility that they will move to create regulations that mitigate \textit{investment} risk rather than systemic risk, in order to meet their new mandate. This would either do little to protect against what is truly systemic risk or it would add unnecessary transaction costs in the market.

3.1.2 Do Hedge Funds Cause Systemic Risk?

In order to ascertain whether new regulations on hedge funds are necessary to mitigate systemic risk, one must first establish that hedge funds cause or contribute to systemic risk in a materially sufficient way. In theory, hedge funds contribute to the development of systemic risk if their actions or failures cause or exacerbate economic shocks or institutional failures, which subsequently lead to negative economic consequences.\(^\text{96}\) They may do so by either directly, by disrupting the ability of financial intermediaries to efficiently provide credit, or indirectly, by sowing panic into the capital markets so as to interfere in the intermediation of credit and the availability of liquidity in the market. In this sub-Part, I will explore the direct and indirect ways in which such funds may contribute to systemic risks, and will argue that it is more likely than not that hedge funds do indeed increase such risk generally. In Part 5 however, I will argue that there is currently not enough information available to regulators to develop meaningful and economically efficient regulations to specifically combat such risk.

The most likely way in which hedge funds might contribute to systemic risk is not through their actions but rather as a consequence of their failures. This suggests that hedge funds are important players in the financial system, which of course, they now are. Consider what might occur following the collapse of one of the world’s largest hedge funds.\(^\text{97}\) First, the collapse may trigger or accelerate a steep decline in the prices of the fund’s portfolio assets, thereby causing a liquidity crisis.\(^\text{98}\) The decline in asset prices would occur because the liquidation of the fund would force its portfolio manager to try to sell its holdings off as

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\(^{96}\) See the description of systemic risk in supra Part 3.1.1.

\(^{97}\) For the purpose of this example, the reason behind the failure is not relevant.

\(^{98}\) Overmyer, supra note 81 at 2197.
quickly as possible, often at fire-sale prices. Under normal market conditions, these assets would be scooped up by bargain-seeking investors, causing prices to stabilize.\textsuperscript{99} However, if the collapse is so large as to create a systemic crisis, investors may be unable or unwilling to step in and buy these assets.\textsuperscript{100} The initial price decline would then encourage more asset holders to sell, leading to further price declines.\textsuperscript{101} Eventually, the price declines become so significant that no buyers emerge, causing liquidity to dry up and leading to “market gridlock”.\textsuperscript{102} In this type of environment, the value of collateral is reduced, and the ability and willingness of banks or financial institutions to extend credit to even worthy borrowers is drastically reduced, causing significant harm to the economy.\textsuperscript{103}

Second, this failed hedge fund is probably directly linked to several large financial institutions through those institutions’ counterparty exposures (such as prime brokerage services and as derivative contract counterparties).\textsuperscript{104} If these banks expect significant revenue reductions and counterparty losses due to the collapse of a fund, their current and expected capital ratios may be reduced, leading to a reduced tolerance to lend. Moreover, large commercial banks provide substantial liquidity to the hedge fund sector in particular, mainly through counterparty credit exposures and other financings.\textsuperscript{105} As such, other hedge funds


\textsuperscript{100} \textit{Ibid.}

\textsuperscript{101} \textit{Ibid.}

\textsuperscript{102} \textit{Ibid.}


\textsuperscript{104} \textit{Ibid.} at 11. Many derivative counterparties will “hedge out” a significant portion of their exposure to other counterparties, thereby limiting their own risk but spreading it to other financial institutions globally.

\textsuperscript{105} \textit{Ibid.} at 13.
may suffer potential collapses based not on the investment decisions of their managers but on factors related to their counterparty exposures with other lenders. Such failures would perpetuate a cycle of systemic issues in the global economy.

Now consider what might occur if the failed hedge fund in this example is highly leveraged. The use of leverage would likely amplify the extent of the losses of the hedge fund, increasing the pressure to sell off assets as quickly as possible and thus fuelling even greater losses of market liquidity.\(^{106}\) Moreover, as the fund would be unable to pay its debts, its direct creditors would suffer significant losses, thereby potentially decreasing the overall appetite in the market to lend to other hedge funds or to other creditors.

There are also important indirect systemic risks involved where a large hedge fund collapses. For example, the market instability caused by a large collapse may significantly affect overall investor confidence in capital markets, and thus reduce the level of borrowing available in the economy. Periods of high volatility, which may be caused or lengthened due to hedge fund activities or failure, may reduce lenders’ desires to extend credit. To some degree, the indirect systemic risks are not so much related to a failure of hedge funds themselves, but rather to the extent that such failures may negatively affect other market participants and thus jeopardize the viability of the capital markets as a whole.

The theoretical arguments as to why hedge funds contribute to systemic risk are supplemented by empirical data. For example, Chan \textit{et al} reviewed available aggregate and individual hedge fund data in an attempt to determine whether hedge fund failures have

\(^{106}\) Report of the President’s Working Group on Financial Markets, \textit{Hedge Funds, Leverage and the Lessons of Long-Term Capital Management} (1999) at 23. See also Chan, \textit{supra} note 75 at 75 (concluding that “the banking sector is exposed to hedge fund risks, especially smaller institutions, but the largest banks are also exposed through proprietary trading activities, credit arrangements and structured products, and prime brokerage services.”).
historically contributed to liquidity losses.\textsuperscript{107} They concluded that the global hedge fund industry likely contributes to systemic risk from both a liquidity and a banking exposure perspective.\textsuperscript{108} However, the authors emphasized that the risks are highly complex, and that more information is required in order to fully understand the dynamics of how hedge funds might contribute to a systemic crisis.\textsuperscript{109}

The near-failure of Long-Term Capital Management (\textquotedblleft LTCM\textquotedblright) also provides a historical illustration of how a hedge fund failure might leads to systemic issues. LTCM was a well regarded hedge fund founded by several Nobel laureates in 1994.\textsuperscript{110} It utilized highly aggressive trading strategies and a huge amount of leverage that left it susceptible to unfavourable swings in the market.\textsuperscript{111} In the summer of 1998, those unfavourable swings became pronounced as Russia defaulted on its bonds and the Russian Rouble was sharply devalued.\textsuperscript{112} As a result of the turmoil in the international bond market in which LTCM was heavily invested, the fund was forced to sell assets in its portfolio at a steep loss, and it quickly approached default.\textsuperscript{113} In August alone, nearly US$2 billion was wiped out from the fund’s assets.\textsuperscript{114}

\textsuperscript{107} Chan, supra note 75.
\textsuperscript{108} Ibid. at 75.
\textsuperscript{109} Ibid.
\textsuperscript{110} Roger Lowenstein, \textit{When Genius Failed: The Rise and Fall of Long-Term Capital Management} (New York: Random House, 2000) at 32 [Lowenstein].
\textsuperscript{111} Franklin Edwards, \textquotedblleft Hedge Funds and the Collapse of Long-Term Capital Management\textquotedblright (1999) 13 J. Econ. Persp. 189 at 197. It is estimated that LTCM created a debt to equity leverage ratio exceeding 25:1, with off-balance sheet liabilities of greater than US$1 trillion.
\textsuperscript{112} Lowenstein, supra note 110 at 144.
\textsuperscript{113} Ibid.
\textsuperscript{114} Ibid.
As losses continued to mount, LTCM’s counterparties began to realize the extent of their exposures, which grew to over US$5 billion in the aggregate if the fund collapsed.115 As such, they began insisting that LTCM put up additional collateral, and required that the fund mark-to-market its derivative positions, forcing the sale of even more assets at discounted prices.116 Shortly thereafter, the Federal Reserve Bank of New York became concerned that a default of LTCM would significantly harm investor confidence in global financial markets and lead to a systemic crisis:

Had Long-Term Capital [Management] been suddenly put into default, its counterparties would have immediately "closed-out" their positions. If counterparties would have been able to close-out their positions at existing market prices, losses, if any, would have been minimal. However, if many firms had rushed to close-out hundreds of billions of dollars in transactions simultaneously, they would have been unable to liquidate collateral or establish offsetting positions at the previously-existing prices. Markets would have moved sharply and losses would have been exaggerated…

Two factors influenced [the Federal Reserve Bank of New York’s] involvement. First, in the rush of Long-Term Capital's counterparties to close-out their positions, other market participants -- investors who had no dealings with Long-Term Capital -- would have been affected as well. Second, as losses spread to other market participants and Long-Term Capital's counterparties, this would lead to tremendous uncertainty about how far prices would move. Under these circumstances, there was a likelihood that a number of credit and interest rate markets would experience extreme price moves and possibly cease to function for a period of one or more days and maybe longer. This would have caused a vicious cycle: a loss of investor confidence, leading to a rush out of private credits, leading to a further widening of credit spreads, leading to further liquidations of positions, and so on. Most importantly, this would have led to further increases in the cost of capital to American businesses.117 [emphasis added]

116 Ibid.
Given these systemic concerns, and in order to avoid the erosion of investor confidence, the Federal Reserve Bank of new York brokered a settlement of LTCM’s debts.\textsuperscript{118}

3.1.3 \textit{Is a Regulatory Response Desirable?}

Theory and historical instances are helpful to understanding the relationship between hedge funds and systemic risk. As I have demonstrated above, it is highly likely that due to their size, structures and importance to the capital markets, hedge funds cause and contribute to systemic risk globally. For a systemic crisis arise, the \textit{size} of the shocks to the financial system must be sufficiently large,\textsuperscript{119} and it evident that hedge funds have grown large enough on an individual and aggregate level to make the mitigation of systemic risk an economically valid policy justification for regulation. Moreover, the ability to engage in systemically risky activities is to some extent unique to hedge funds. As an example, access to significant amounts of leverage is generally limited to hedge funds rather than other investment vehicles. Further, since hedge funds command such a large percentage of trading volumes on key stock exchanges, trade heavily in derivatives and often engage in highly risky investment strategies, the systemic concerns are even more pronounced when compared against mutual funds or private equity funds. Despite significantly more mutual funds in existence around the world, it is very rare for such funds to collapse, given the more stringent regulatory environment in which they operate. As such, particular attention should be paid to hedge funds rather than other types of investment vehicles in reviewing systemic risk.

\textsuperscript{118} Schwartz, \textit{supra} note 18 at 201.
\textsuperscript{119} \textit{Ibid.} at 203.
The question then becomes what to do, if anything, to prevent or mitigate such risk. Put another way, can the law be used in an economically efficient manner to stop parties to certain financial transactions (that is, transactions involving hedge funds) from adversely affecting market participants that are not parties to those transactions? In order to determine whether a particular regulatory response is desirable from an economic perspective, one must first weigh the benefits of such a response against its costs. The optimal result is not the complete elimination of systemic risk, because that would likely mean curtailing many of the economically beneficial characteristics that hedge funds provide. As Kambhu et al state, the goal of regulation should be the elimination of “inefficient” systemic risk that exceeds the socially optimal level.”120 If regulations could be crafted so as to reduce such “inefficient” risk, there is little doubt they should be enacted.

The problem, however, is that theory and historical examples can only offer a glimpse of where the next systemic crisis will come from. By the definition proposed in this paper, systemic risks are not reasonably foreseeable to the reasonably seasoned investor. Rather, expertise is needed to identify potential causes of such risk. In reality, it is unlikely that regulators today would know how to mitigate systemic risk arising from hedge funds in an economically efficient manner, since very little systemically important information is currently available to review, analyze and develop policy around. Even if such information were available, there is no guarantee that regulators would foresee the development of such risk. Regulators could coarsely impose strict limits on the use of leverage or exposure to derivative products, or could try to otherwise sever the links between hedge funds and other

120 Kambhu, supra note 103 at 9. To Kambhu et al, the notion of “inefficient” systemic risk is closely linked with market failures in counterparty risk management.
systemically relevant financial institutions, but the costs of these actions would almost certainly outweigh the benefits. In Part 5, I will explore several regulatory options and suggest a modest proposal which will help regulators and governments create efficient policies to mitigate systemic risk. My proposal will not advocate how to combat hedge fund-related systemic risk, but rather how to obtain the necessary information in order to do so.

3.2 Rationale: Investor Protection

In developed economies, securities laws are designed primarily for the protection of investors.121 Indeed, some of the most important securities law reforms have historically been developed by legislators following a financial crisis.122 The basic economic theory underpinning investor protection regulation is that by establishing minimum disclosure standards and basic rules of conduct that issuers and dealers must adhere to, overall confidence in the capital markets is strengthened. As the bargaining inequalities between investors and public issuers narrow and materially relevant information becomes available, investors are able to make better investment decisions and thereby allocate capital efficiently.123 This efficient allocation and confidence in the capital markets increases overall investment activities and liquidity, leading to an increase in the supply of capital raising opportunities for issuers, which in turn leads to other positive benefits to the economy as a

121 See e.g. OSA, supra note 14, s.1.1(a) which explicitly states that the goal Ontario securities legislation is to “provide protection to investors from unfair, improper or fraudulent practices”. See also Securities Act, infra note 156, § 2(b) (“Whenever pursuant to this subchapter the [SEC] is engaged in rulemaking...the [SEC] shall...consider...the protection of investors”).
122 For example, the Securities Act, infra note 156, which was enacted in the United States shortly after the major stock market crash in 1929, in part out of a desire to better protect investors.
whole. In other words, by requiring issuers to provide full and continuous disclosure and maintaining minimum standards of conduct, investor protection regulation increases transaction costs in the short term, but the long-term benefits of increased market participation and efficient allocation of capital outweigh such short-term costs. The law is used in a manner which ultimately reduces externalities.

Mutual funds are a perfect example of this theory being applied in practice. These investment funds are highly regulated in Canada, the United States and the United Kingdom, and have exploded in popularity over the last few decades, in part due to the stringent regulations placed on them. Mutual fund investors in can reasonably expect that investment managers will provide them with full disclosure about their funds and act in accordance with minimum standards which are well publicized and disclosed. In my view, these regulations have increased investor confidence, which is one of the primary reasons behind their popularity. In turn, this popularity has been very beneficial to capital markets. The question for regulators now, however, is whether the same economic benefits can flow if increased investor protection rules are applied to hedge funds.

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124 Firms raise capital in order to make large investments and pursue value-enhancing strategies. As such, capital raising has many benefits in the economy, including job and wealth creation, competition and innovation.

125 Oppold, supra note 115 at 840. Mutual Funds hold approximately US$18 trillion in assets globally.

126 This confidence is likely not only based on assumptions that funds will be profitable or successful in meeting their investment objectives, but also because the opportunities for success exist due to the investor protection rules which forbid certain illegitimate activities.
3.2.1 Why do hedge fund investors need protection?

As stated above, hedge funds can be highly risky investments and are typically not cleared by a prospectus, leading to reduced public disclosure. Investment managers almost certainly utilize hedge fund structures in part because it allows them to manage a flexible investment vehicle which avoids having to disclose material information publicly and which provides limited investor protection standards. This lack of oversight gives fund managers much greater latitude to engage in behaviour that may be improper. Moreover, hedge fund investment strategies and compensation structures enable and encourage hedge fund managers to take excessive risks under certain circumstances. The higher risk profiles and lower disclosure standards might partially explain the driving force behind investor protection regulations aimed at hedge funds.

Hedge fund structures also give rise to certain potential conflicts of interest. For example, conflicts may also arise by virtue of a hedge fund’s investor base. Many hedge fund investors are large institutions that invest pools of money as fiduciaries for other investors or stakeholders. In exchange for the potential of a large investment in a hedge fund, these investors often demand, among other things, the provision of better fund disclosure prior to and during the term of their partnership with the manager. As such, hedge fund managers often enter into “side letters” with large institutions, whereby certain additional benefits

127 While many hedge fund managers provide investors with offering memoranda which outlines basic fund information, the content of these documents is not prescribed by any legislation, and penalties for misrepresentations are, in some jurisdictions, more limited than misrepresentations in prospectuses.
128 Cumming, supra note 49 at 798.
129 See supra Part 2.1.3 and Part 2.1.4 for a more detailed discussion about hedge fund compensation and investment strategies.
130 See e.g. Roach, supra note 10 at 167-168.
131 See supra Part 2.1.1 for more information regarding hedge fund investor bases.
available only to them are negotiated. It is quite rare for hedge funds to disclose the contents of these side letters to other investors.\textsuperscript{132} As such, the potential for conflicts to arise may result in the form of preferential disclosure of material information and other rights being made available only to certain investors.\textsuperscript{133}

Conflicts may also arise because hedge fund managers often do not use of independent valuation and pricing agents.\textsuperscript{134} As such, managers may use subjective valuation processes, which give rises to the potential for them to manipulate fund performance by under-valuing losses and over-valuing current holdings.\textsuperscript{135} The incentive to do this stems not only from wanting to demonstrate performance excellence to attract and retain clients, but because carried interest calculations are based on fund performance.

Finally, the “retailization” of hedge funds, whereby unsophisticated retail investors invest directly and indirectly in hedge funds, is a growing phenomenon which may be exacerbating the regulatory pressures to impose new investor protection rules on hedge funds. Retail investors are not typically allowed into hedge funds. However, retail investors are gaining exposure to these investment vehicles by purchasing units of fund of hedge funds.\textsuperscript{136} In addition, investors may be indirectly exposed to hedge funds through their individual pension plans or other institutional investors that manage money on their behalf.\textsuperscript{137} As such,

\textsuperscript{132} However, there are circumstances where investors are able to negotiate ‘most favoured nation’ clauses in their subscription agreements which allow them to review other side letters that the hedge fund has entered into and select the applicable clauses that they wish to have apply to them. MFN clauses therefore allow investors to enjoy the benefits negotiated by other investors’ side transactions.

\textsuperscript{133} Cumming, supra note 49 at 795.

\textsuperscript{134} Ibid. at 798.

\textsuperscript{135} Ibid.

\textsuperscript{136} See supra Part 2.1.2 for more details.

\textsuperscript{137} SEC Report, supra note 24 at 82.
the desire amongst regulators to protect investors from the risks associated with hedge funds has certainly increased over the past few years.\footnote{The SEC in particular has expressed concerns about increases in pension plan investments in hedge funds because unsophisticated investors often have a significant portion of their retirement savings invested in such plans. See United States Government Accountability Office, \textit{Hedge Funds: Regulators and Market Participants are Taking Steps to Strengthen Market Discipline, But Continued Attention is Needed}, (January 2008) online: <www.gao.gov/new.items/d08200.pdf>.
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\subsection*{3.2.2 Investor protection possibilities}

How can regulators increase the protections available to investors from the dangers posed by hedge funds? There have been many suggestions put forth by commentators in recent years. Some have argued that the suitability requirements that determine whether investors may purchase hedge funds are too broad and need to be restricted.\footnote{See e.g. Schneider, \textit{supra} note 28 at 308 (arguing that the definition of an “accredited investor”, which is an investor that is legally allowed to purchase securities in the exempt market, should be revised). For more details regarding hedge fund investor eligibility, see \textit{infra} Part 4.} Others believe that requiring public company-level corporate governance standards will help protect investors from undue risks.\footnote{Pearson, \textit{supra} note 2 at 77.} Others still have suggested methods to limit or even eliminate hedge fund conflicts.\footnote{Sklar, \textit{supra} note 10 at 3299-3306 (suggesting two potential legal standards of conflicts regulation and arguing that an in-house conflicts committee should be set up for hedge funds to manage potential conflicts).} Yet the most obvious and frequently suggested solution to increasing investor protection is simply requiring and enforcing a much more substantial disclosure regime on hedge funds.\footnote{\textit{Ibid.} at 3308.} This disclosure would not only provide investors with up-to-date material information about their funds, but would also provide details of the potential conflicts of interests and risk factors that investors would be subject to.

It is beyond the scope of this paper to review all of these suggestions, and indeed, there may be minor amendments to specific rules in different jurisdictions which would help...
protect investors’ interests in an economically efficient manner. However, as I will argue below, any new rules that nudge hedge fund investments into a regulatory regime which requires specific and substantive disclosures be made to investors is not economically efficient.

3.2.3 Economic analysis does not support expanding investor protection rules

Despite the many potential conflicts of interest and risk factors that are uniquely applicable to hedge funds, it is difficult to justify mandating increased hedge fund disclosure in support of improving investor protections. This is because requiring such disclosure is both unfair and economically inefficient.

First, by virtue of their status as non-retail investors, hedge fund investors should be in a position to evaluate their investment decisions more robustly than typical retail investors.\footnote{Troy A. Paredes, “On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style and Mission” (2006) U Ill. L. Rev. 975 at 990.} The fact that some choose not to do so when making voluntary investment decisions, and are then surprised when they experience investment losses, should not, in my view, create costs that must be borne by hedge fund managers. Indeed, forcing hedge funds to make even partial prospectus-level disclosure merely shifts the cost burdens of investment due diligence from investor to issuer. Doing so may end up hampering this market, without providing the corresponding economic benefits, since investor participation (which is the driver of the economic benefits) is unlikely to increase due to strict limits on who can invest.\footnote{Abraham, supra note 80 at 8.} Investors of such exempt securities also factor in the lack of disclosure when considering the purchase price of hedge fund investments. As such, managers that provide greater disclosure should in
theory be able to demand higher prices per fund unit when raising capital. Thus, to force more value out of issuers and into the hands of investors makes little economic sense.

Second, even if it could be argued that shifting cost burdens from investor to manager is not inefficient, scarce regulatory resources would be required in order to ensure compliance and enforcement. In my view, using these scarce resources to assist investors that are high net worth individuals and institutional investors is itself inefficient and unnecessary, since those resources should be used to help protect investors who actually require the assistance and who may not be able to adequately protect themselves from unfair practices.

Third, the retailization of hedge funds is a red herring. This is because retail investors that buy fund of hedge funds are not exposed to the same degree of risk as investors who invest directly in hedge funds themselves, since the risks are spread among several different underlying investments. Fund of funds also do not have the same types of conflicts that hedge funds have. Moreover, investors that are exposed to hedge funds through their pension and endowment funds have the benefit of a professional investment manager to look after their portfolios. These pension managers owe fiduciary duties to their investors, and as such are required to use care and diligence in making investment decisions. Presumably then, they are adequately aware of the risks of investing in hedge funds and manage those risks accordingly. Thus, to suggest that somehow retailization requires a robust regulatory response to better protect investors is not convincing.

145 For example, there is much less subjectivity surrounding valuation of assets, since fund of hedge funds should just use the net asset values provided to them by their underlying hedge fund holdings in order to calculate fund values.
Finally, requiring full disclosure would reduce the effectiveness of hedge funds generally. Suppose, for example, hedge funds had to provide frequent disclosures of their portfolio investments. This would allow individual investors to attempt to copy hedge fund investment strategies without paying any fees to the manager who devised the strategy.\footnote{Laszlo Ladi, “Hedge Funds: the Case Against Increased Global Regulation in Light of the Subprime Mortgage Crisis” (2009) 5 Int’l L. & Mgmt. Rev 99 at 126 [Ladi].} Indeed, requiring such disclosure may actually \textit{increase} investor risks since it might encourage amateur investors from undertaking risky investment strategies.\footnote{Ibid.}

As I will demonstrate below in Part 4.1, much of the new United States and European legislation with respect to hedge funds leans heavily towards providing investors with greater disclosure, which in my view will negatively impact economic activity of hedge funds going forward. Disclosure concerns are so significant amongst hedge fund managers that some have even decided to \textit{close} their funds rather than comply. For example, shortly before the deadline for U.S. hedge fund managers to register with the SEC pursuant to several new rules, George Soros closed his flagship hedge fund to investors, citing the heightened regulatory regime.\footnote{Dominic Rushe, “George Soros to Close Hedge Fund Management Group to Outside Investors” \textit{The Guardian} (26 July 2011), online: <www.guardian.co.uk/business/2011/jul/26/george-soros-to-close-hedge-fund>.} As I have argued above, the negative economic impact of this and other potential closures is significant, and as such, an economic analysis does not generally support the view that investor protection regulation should be imposed on hedge funds.
3.3  **Rationale: Protecting Capital Markets**

The protection of capital markets in general is another economic rationale for hedge fund regulation. The theory behind this rationale is that efficient capital markets deploy capital in an optimal way, and therefore any entity or activity which threatens this efficiency should be regulated. This includes any activities that may damage investor confidence in the capital markets, such as insider trading and fraud.\(^{149}\)

Illicit activities, such as fraud, which negatively impact the capital markets are generally illegal in advanced economies, although certain local differences in regulation will apply to each jurisdiction. These laws should apply equally to any issuer or investment fund, and not just hedge funds. If, as some claim, the relatively opaque nature of hedge funds increases their propensity to engage in such illegal activities,\(^{150}\) the economically efficient regulatory response is to increase enforcement activities rather than creating new rules specific to hedge funds. Fraudulent activities by hedge fund advisors are a valid concern, but are generally addressed by existing regulations.\(^{151}\) As such, the economic rationale to protect the capital markets does not generally require the enactment of any new regulations, and as such, using this rationale to argue for additional hedge fund regulation is generally not convincing.

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\(^{149}\) This is not the same as protecting against systemic risk, although systemic risk may also affect capital markets negatively.

\(^{150}\) See e.g. McDonald, *supra* note 4.

\(^{151}\) Ladi, *supra* note 146 at 122.
4. The International Legal Framework

In order to propose new laws which can help mitigate systemic risks related to hedge funds, it is first necessary to understand the regulatory framework under which they currently operate. The regulation of investment funds is a dynamic area of the law, and recent updates and proposals have made the question of how to limit systemic risk quite topical. This Part will review this basic, high-level framework in three of the largest jurisdictions in which hedge fund managers are domicile\textsuperscript{152} - the United States, United Kingdom and Ontario, Canada. Since the U.S. is the jurisdiction that has the largest number of hedge fund managers (by number and by assets under management), I will begin my discussion there.

4.1 Hedge Fund Regulation in the United States

Not surprisingly, the United States has the largest and most diverse hedge fund market in the world.\textsuperscript{153} The growth of hedge funds in the U.S. is likely due in part to the unregulated nature of the industry.\textsuperscript{154} Without restrictions from government regulations, hedge fund managers had been able preserve proprietary information regarding their trading activities, maintain very low compliance and disclosure costs and command significant fees. Following the global financial crisis however, the U.S. Congress passed the Dodd-Frank Wall Street

\textsuperscript{152} Many hedge funds themselves are domiciled offshore in tax havens such as the Cayman Islands and Bermuda, while managers are located onshore. See supra Part 2.1.1 for a description of hedge fund structures.

\textsuperscript{153} See infra Part 5.4 for more details regarding the size of the U.S. hedge fund market in comparison to other jurisdictions.

\textsuperscript{154} Of course, other factors specific to the U.S. were important to the growth of that market’s hedge fund industry, including a relatively large investor base, liquid capital markets and a large supply of skilled money managers.
Reform and Consumer Protection Act \(^{155}\) ("Dodd-Frank"), which in part seeks to remedy the perceived regulatory gap. This sub-Part will briefly review the relevant rules in four of the key securities law statutes that relate to hedge funds. It will then explore what effect Dodd-Frank will have on hedge fund managers in the U.S. in respect of systemic risk.

4.1.1 *The Securities Act of 1933*

The U.S. Securities Act \(^{156}\) ("Securities Act"), which primarily regulates the initial distribution of securities, requires that any entity offering securities to the public register those securities with the SEC, subject to certain exemptions. \(^{157}\) Issuers must also file and distribute a prospectus containing all material information about the issuer and its offered securities. \(^{158}\) Since partnership units and shares of LLCs fall within the broad definition of the term "securities", hedge fund managers must therefore clear their securities by way of prospectus unless an exemption can be found. \(^{159}\) Hedge fund managers typically utilize section 4(2) of this Act, which exempts from the registration and prospectus delivery requirements any "transactions by an issuer not involving any public offering." \(^{160}\) There is no notice or regulatory approval required to take advantage of this exemption, commonly known as the "private offering" or "private placement" exemption. \(^{161}\) While hedge funds do not typically issues prospectuses, many provide investors with private placement memoranda (PPM) outlining information about the manager and the key investment objectives of the fund.

\(^{157}\) *Ibid.*, § 77e.
\(^{158}\) *Ibid.*, § 77j.
\(^{160}\) *Securities Act, supra* note 156, § 77d(2).
In order to utilize the private placement exemption, managers typically satisfy the requirements of Rule 506 of Regulation D (“Rule 506”) under the Securities Act,\textsuperscript{162} which establishes “safe harbor” criteria for the exemption.\textsuperscript{163} The most widely used safe harbor is the “accredited investor” exemption, which allows for securities to be sold without registration to investors who meet certain minimum wealth criteria.\textsuperscript{164} Hedge funds utilizing Rule 506 are restricted from using any form of general solicitation or general advertising.\textsuperscript{165}

\textit{4.1.2 The Securities Exchange Act of 1934}

The Securities Exchange Act (“Exchange Act”)\textsuperscript{166} regulates the trading of securities post-distribution, and contains several registration requirements which most hedge funds are able to find exemptions for. For example, since the Exchange Act requires securities dealers to register with the SEC, most hedge funds structure themselves to qualify as “traders” to avoid registration.\textsuperscript{167} Moreover, the Exchange Act requires that an issuer having 500 or more holders of record of a class of equity security and assets in excess of $10 million at the end of its most recently ended fiscal year register pursuant to this legislation.\textsuperscript{168} As such, most hedge fund managers do not allow more than 499 investors into any particular fund.\textsuperscript{169} Hedge fund managers also may be subject to the quarterly reporting obligations of Section 13(f) of the Exchange Act, which requires the disclosure of the name and value of portfolio holdings of investment funds.

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\textsuperscript{162} 17 C.F.R. § 230.506 (2008).
\textsuperscript{163} SEC Report, \textit{supra} note 24 at 14. Rule 506 is not the exclusive means of establishing entitlement to the private placement exemption. However, because to avoid uncertainty, many hedge funds tailor their offering and sale procedures to the criteria specified in Rule 506.
\textsuperscript{164} \textit{Ibid}.
\textsuperscript{165} \textit{Ibid}. at 16.
\textsuperscript{167} SEC Report, \textit{supra} note 24 at 18.
\textsuperscript{168} \textit{Exchange Act, supra} note 166, § 78l-(g).
\textsuperscript{169} SEC Report, \textit{supra} note 24 at 19.
\end{flushleft}
The Form 13F disclosure applies only to investment managers that exercise investment discretion of at least $100 million in equity securities.\footnote{U.S., 17 C.F.R. § 240.13f-1.}

4.1.3 The Investment Company Act of 1940

The Investment Company Act\footnote{U.S., 15 U.S.C §§ 80a-1 (2010) [Company Act].} (“Company Act”) is the primary U.S. federal statute governing investment companies, which are defined to include companies whose business is primarily comprised of investing or trading in securities.\footnote{Ibid., § 80a-3(a)(1).} The Company Act’s many substantive regulations are designed to stop investment firms from self-dealing at the expense of investors, and to assist unsophisticated investors in making informed investment decisions.\footnote{Shadab, supra note 125 at 253.} For example, investment companies that are not exempt (such as mutual funds) are strictly limited in the amount of leverage, derivatives and short selling they may utilize.\footnote{Company Act, supra note 171, § 80a-12 and § 80a-18.} Moreover, the Company Act contains several substantive provisions affecting a registered fund’s governance and structure, the types of investments it may purchase, how sales and redemptions must be processed and the valuation methodologies that must be used of the manager’s portfolio holdings.\footnote{Sklar, supra note 10 at 3281.}

Hedge Fund managers are keen to avoid these restrictions, and thus avail themselves to one or both of the key exemptions available under the Company Act. Under the first exemption, the definition of “investment company” does not include any issuer that is owned by less than 100 investors and which is not proposing to make a public offering of its securities.\footnote{Company Act, supra note 171, § 80a-3(c)(1).}
Second, a manager is exempt from the regulations if its funds’ outstanding securities are owned exclusively by “qualified purchasers”, which is a concept that is similar to the accredited investor, only with higher financial thresholds.\textsuperscript{177}

4.1.4 \textit{The Investment Advisers Act of 1940}

The Advisers Act regulates the activity of U.S. investment advisers,\textsuperscript{178} which are defined as “any person who, for compensation, engages in the business of advising others…as to the value of securities or as to the advisability of investing in, purchasing or selling securities.”\textsuperscript{179} Investment advisers with assets under management exceeding a certain threshold must register with the SEC\textsuperscript{180} and, among other requirements such as the preparation of a Code of Ethics and the designation of a Chief Compliance Officer, must complete a Form ADV.\textsuperscript{181} The Form ADV requires disclosure regarding the adviser’s business activities, the types of services offered, the firm’s fee structures, client base, broker discretion and any business activities that may be conflicts of interest. Part 2 of the Form also requires that much of this information be given in narrative form to investors of the funds. The Advisers Act also restricts the ability of registered firms to charge performance-based fees, subject to certain exceptions.\textsuperscript{182}

\textsuperscript{177} \textit{Ibid.}, § 80a-3(c)(7). The definition of a qualified purchaser includes, among others, a natural person who owns not less than US$5 million in investments and a person acting for its own account or the account of others that invests on a discretionary basis at least US$25 million in investments.

\textsuperscript{178} The terms “advisor” and “manager” will be used interchangeably throughout this paper.

\textsuperscript{179} \textit{Advisers Act, supra} note 20, § 80b-2(a)(11).

\textsuperscript{180} Dodd-Frank recently increased the threshold from US$30 million to US$100 million. However, under the new rules, registration is still necessary at the state level rather than with the SEC if assets under management are greater than US$25 million. See \textit{supra} note 155 and accompanying text.

\textsuperscript{181} U.S., C.F.R. § 275.204-3(a) (2008).

\textsuperscript{182} \textit{Advisers Act, supra} note 20, § 80b-5(a)(1).
Most hedge fund managers meet the definition of an investment adviser under the Advisers Act. Prior to Dodd-Frank, hedge funds were able to avoid providing the detailed disclosures required in the Advisers Act by accessing a key exemption for managers with less than fifteen “clients”, provided that managers did not hold themselves out as investment advisers to the public and were not advisers to any registered investment companies. 183 SEC rules considered the term “client” to mean an investment fund rather than an investor, and thus, advisers were able to manage up to fourteen hedge funds before being required to register under the Advisers Act. 184 In 2006, the D.C. Circuit Appeals Court rejected an attempt by the SEC to change its own interpretation of the term “client” such that it would require managers to “look through” the funds they advised and count as clients the actual investors themselves. 185 Only four years later, Dodd-Frank would revisit this question once again.

4.1.5 The Dodd-Frank Wall Street Reform and Consumer Protection Act

The recently enacted Dodd-Frank legislation provides for sweeping modifications to the U.S. financial system. Among other important changes, Dodd-Frank reorganizes the U.S. regulatory structure and imposes new restrictions on the activities of financial institutions. 186 This Act also brings hedge funds under closer scrutiny of the SEC and other regulators. 187

The most immediate and significant changes for hedge fund managers are the amendments to the registration criteria under the Advisers Act. In particular, Frank-Dodd requires that hedge funds with assets under management of between US$25 million and

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183 Ibid., § 80b-3(b)(3).
184 SEC Report, supra note 24 at 21.
185 Goldstein, supra note 25.
186 Overmyer, supra note 81 at 2204.
187 See Dodd-Frank, supra note 155, at Title IV and the provisions thereunder.
US$100 million register with their respective state securities commissions, and advisers with assets greater than US$100 million register with the SEC. More importantly, the Dodd-Frank eliminates the highly valuable “fifteen investor” exemption in the Advisers Act. As such, many hedge funds that previously avoided registration with the SEC will no longer be able to do so, meaning that those hedge fund managers will have to, among other things, complete form ADVs and provide the public with disclosure about their firms.

Dodd-Frank also creates one important new exemption from the Advisers Act. Under the “foreign private adviser” definition, managers that (i) do not have a place of business in the U.S., (ii) do not hold themselves out to be investment advisers in the U.S., (iii) do not advise registered investment companies, and (iv) have fewer than fifteen U.S. clients and less than US$25 million invested by those clients, are exempt from the registration requirements.

Dodd-Frank also authorizes the SEC to require registered hedge fund managers to maintain and submit certain information to assess the systemic risk their funds may pose to the U.S. economy. The data the SEC may seek from a hedge fund manager includes, among other things, information relating to its funds’ assets, debts (including the concentration of such debts among particular creditors), investment positions and trading strategies. The

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188 Ibid., § 410. This presumably allows the SEC to focus its attention on larger hedge funds.
189 See infra Part 5.4, where I argue that an analysis of systemic risk relating to hedge funds ought to include the information collected from certain non-U.S. managers, and that utilizing international coordination is an optimal method of detecting and managing systemic risk. The foreign private adviser exemption is also problematic since it incentivizes non-U.S. managers to specifically exclude U.S. investors in order to avoid registration. As such, the promulgation of this rule will have negative consequences for the hedge fund industry and the U.S. economy.
190 Dodd-Frank, supra note 155, § 404.
191 Ibid.
SEC must then provide this data to the newly created Financial Stability Oversight Council (the “FSOC”), although must otherwise keep it confidential.

The SEC recently proposed that registered hedge funds prepare and file a “Form PF” in order to implement these requirements and facilitate the information gathering process.\textsuperscript{192} The proposed requirements separate hedge fund advisers by size between smaller advisers managing less than US$1 billion and large advisers managing more than US$1 billion.\textsuperscript{193} All registered managers are required to provide certain data regarding each hedge fund they manage, including disclosures on investment strategies, trading counterparty exposures, trading practices, assets under management, aggregate notional values of derivative positions, fund performance, the funds’ leverage positions and credit counterparties.\textsuperscript{194} In addition, large private fund managers would be required to provide aggregate information regarding duration of fixed-income holdings, investor information, portfolio turnover and their exposure by asset class, as well as certain additional enhanced disclosures.\textsuperscript{195}

It should also be noted that information that is collected under the Form PF may be used by the SEC for enforcement purposes.\textsuperscript{196} This fact is problematic for two reasons. First, it adds an investor protection element to a process that should be used exclusively to detect and mitigate systemic risk. By using the information to consider enforcement actions rather than only concentrating on systemic risk, the SEC is deploying scarce resources from an

\textsuperscript{192} Proposed Form PF, supra note 48.
\textsuperscript{193} Ibid. at 8075.
\textsuperscript{194} Ibid. at 8079.
\textsuperscript{195} Ibid. at 8080. This additional information includes, among other things, data concerning portfolio liquidity, concentration of positions, collateral practices, risk metrics, more detailed financing/leverage information, investor composition and the existence of and material terms of any side agreements between the hedge fund adviser and investors.
\textsuperscript{196} Ibid. at 8071.
economically efficient task to one that is economically inefficient.\textsuperscript{197} Second, the possibility of an enforcement proceeding raises concerns that hedge fund advisers will spend significant amount of time “managing” the information that is given pursuant to the Form PF, so to potentially de-emphasize data that may suggest minor or technical regulatory breaches. Ultimately, the threat of enforcement does little to encourage the free flow of information that is necessary to help detect systemic risk.

Once the data is delivered, the FSOC is tasked with determining whether the activities of a hedge fund “could create or increase the risk of significant liquidity, credit, or other problems.”\textsuperscript{198} If the FSOC determines that an issuer poses such a risk, it can recommend that the issuer’s primary regulator (such as the SEC or the CFTC) prohibit or more tightly control the systemically risky activity or impose prudential measures, which could include capital, liquidity, or leverage requirements.\textsuperscript{199} That primary regulator then has the option of accepting the recommendation and implementing the requirements, or explaining in writing why it did not accept the recommendation.\textsuperscript{200} Alternatively, FSOC could determine that a hedge fund poses a threat to the “financial stability of the United States” and should thus become regulated by the United States Federal Reserve, which may then impose its own prudential standards on that hedge fund (such as higher capital reserve requirements or limits to leverage).\textsuperscript{201} The effect of these powers is substantial. First, by requiring the SEC to justify its decision to not take any action, Dodd-Frank makes it difficult for the SEC to ignore the

\textsuperscript{197} See \textit{supra} Part 3.2.3 for a discussion on why investor protection regulations related to hedge funds are not economically efficient.
\textsuperscript{198} \textit{Dodd-Frank, supra} note 155, § 120(a).
\textsuperscript{199} \textit{Ibid.}, § 120(a) –(c).
\textsuperscript{200} \textit{Ibid.}
\textsuperscript{201} \textit{Ibid.}, § 113(a)(1).
FSOC’s recommendations, lest it be wrong and subsequently criticized again for failing to take seriously a problem that was made known to it. Second, since the FSOC can simply force a fund to be regulated by the Federal Reserve, the SEC may be rebuked in a very public manner for ignoring the FSOC’s recommendation.

It is widely recognized in the hedge fund industry that the reporting requirements in the proposed Form PF for large hedge fund managers are very onerous. Despite this, the SEC Form PF is a valuable proposal. Nevertheless, I will also argue in Part 5.4 below that given the global nature of systemic risk, the SEC proposal is flawed and incomplete because there is no mechanism or ability to collect information from many non-U.S. hedge fund managers. To deal with this concern, I will propose an international registry that would be, in my view, an optimal system to obtain information necessary to combat systemic risk.

4.2 Hedge Fund Regulation in the United Kingdom

The U.K. is the world’s second largest hedge fund market, and U.K. hedge fund managers are subject to a very different regulatory regime than their North American counterparts. Similar to the U.S., most U.K. hedge funds are actually domicile offshore, and therefore the FSA only has the ability to regulate managers located in the U.K.

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202 The SEC was stung by criticism that it failed to detect a massive $50 billion Ponzi scheme run by Bernard Madoff even after it was advised of certain concerns with Madoff, and would thus be highly sensitive to avoiding such critiques. See e.g. Peter Burrows, “How Madoff is Burning the SEC” Bloomberg Businessweek (31 December 2008), online: <www.businessweek.com/magazine/content/09_02/b4115024163467.htm>.


204 FSA Paper, supra note 2 at 15.
those managers, the FSA’s focus has been one of monitoring, information gathering and ensuring adherence to the FSA’s Principles for Businesses.205

In order to carry on business, hedge fund managers are required to obtain FSA authorization under the Financial Services and Markets Act (“FSMA”),206 since their activities fall within certain specified items enumerated in the FSMA Regulated Activities Order.207 There is no separate regulatory activity related to hedge fund management, and so FSA authorization is required for managers acting in their capacity as manager and investment advisor to their funds.208 FSA-authorized hedge fund managers are not limited operationally in executing any investment strategies, and are subject to light compliance requirements.209 For example, hedge fund managers must comply with the FSA’s Senior Management Arrangement, Systems and Controls rules, which spell out broad principles requiring the manager to establish and maintain systems and controls that are appropriate to its business.210 There are also broad “Dealing and Managing” rules which require managers to use best execution and timely trade allocations for their funds.211 Interestingly, these rules

207 Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (U.K.), 2001 No. 544. Items which are described in this Order require the authorization of the FSA. The activities of hedge funds generally fall within two items. In particular, Section 37 of this Order relates to having discretion to manage investments on behalf of clients and Section 53 relates to providing investment advice. Therefore, FSA authorization is required for hedge fund managers.
208 FSA Paper, supra note 2 at 16.
209 Ibid.
210 Ibid.
211 Ibid.
apply to the manager only rather than the fund itself, which is usually offshore.\textsuperscript{212} Finally, unlike the U.S. and Ontario, the U.K. allows limited retail investments in hedge funds, and does not prohibit general solicitations to the public.\textsuperscript{213}

The European Union (EU) has also proposed a law which will significantly affect U.K. hedge funds. The Alternative Investment Fund Managers Directive ("AIFMD") will require that hedge fund managers that meet certain size thresholds limit the amount of leverage they use for each fund, take certain risk management and controls measures, restrict remuneration of certain senior staff members and enhance disclosure to their primary European regulator as well as to investors.\textsuperscript{214} AIFMD, which appears to primarily be an investor protection law, was passed by the European Parliament in late 2010 and is scheduled to come into effect by EU member states in 2013.\textsuperscript{215} It may still undergo significant changes as specific regulations must still be considered and drafted.

The FSA has also continuously reviewed whether the regulations of hedge funds in the U.K. are sufficient to protect investors and U.K. capital markets. In a series of discussion papers, it weighed the positive economic benefits that hedge funds provided against the risks they posed, and declined to make any substantial changes to the current FSA rules.\textsuperscript{216} Moreover, the FSA’s approach to understanding and mitigating systemic risk is markedly

\begin{footnotesize}
\begin{enumerate}
\item[Ibid.]
\item See, e.g. FSA Paper, supra note 2.
\end{enumerate}
\end{footnotesize}
different from the SEC’s, seeking engagement with hedge fund managers rather than regulating from above. For example, the FSA has engaged hedge fund managers in information and non-supervisory discussions related to the hedge fund industry, in an effort to better understand industry trends and risks that may be developing.\textsuperscript{217} In October 2009, the FSA also launched a voluntary survey aimed at FSA-authorized hedge fund managers. This survey, which is conducted semi-annually, requests information similar to that required by the proposed SEC Form PF.\textsuperscript{218} The FSA publishes a report after each survey outlining its major findings and reporting on the potential for systemic risk. In the latest published report, the FSA estimated that an impressive 50 investment managers managing over US$390 billion participated in the survey.\textsuperscript{219}

\textbf{4.3 Hedge Fund Regulation in Ontario}

Securities legislation in Canada is currently governed by each province or territory, rather than by the federal government. However, various national instruments harmonize many of the important regulations affecting investment funds.\textsuperscript{220} As such, the regulatory regime in Canada with respect to hedge funds is, for the most part, the same in each provincial jurisdiction.

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\textsuperscript{217} Lewis, \textit{supra} note 213 at 376.
\textsuperscript{218} \textit{Proposed Form PF, supra} note 48.
\textsuperscript{220} See, for example, \textit{National Instrument 81-102 – Mutual Funds [NI 81-102]}, which sets out various investment restrictions, compliance obligations and disclosure requirements relating to registered mutual funds in Canada.
\end{flushright}
The Securities Act (Ontario)\textsuperscript{221} governs the distribution and sale of securities in Ontario. As a general rule, unless an exemption is available, securities in Ontario may not be distributed without the filing of a prospectus.\textsuperscript{222} One of the key exceptions to this rule is the “accredited investor” exemption, which is similar to the exemption in the Securities Act in the United States.\textsuperscript{223} Issuers who sell blocks of securities that have a minimum value of C$150,000 may also avoid the prospectus requirements.\textsuperscript{224} Hedge funds in Canada are sold primarily in the exempt market using one or both of these important exemptions. This allows Canadian hedge fund managers to avoid having to file a prospectus with the OSC and meet certain continuous disclosure requirements. Despite this, most Canadian hedge funds provide an offering memorandum to investors, which outlines some basic information about the fund and its objectives.

The OSA also provides that only registered persons may engage in the “business of trading in securities.”\textsuperscript{225} For hedge fund managers, this means that they must be appropriately registered with the OSC prior to engaging in any management services. There are several registrations that are applicable to these types of managers.\textsuperscript{226} First, hedge fund managers must register as an “investment fund manager”, which is a new registration category.\textsuperscript{227} The

\textsuperscript{221} OSA, supra note 14.
\textsuperscript{222} Ibid. at section 53(1).
\textsuperscript{223} See s.1.1 and s.2.3 of \textit{National Instrument 45-106 – Prospectus and Registration Exemptions} for details regarding the accredited investor exemption.
\textsuperscript{224} Ibid. at s.2.10.
\textsuperscript{225} OSA, supra note 14, s.25(1).
\textsuperscript{226} In 2009, the Canadian Securities Administrators, which is a body comprised of each provincial and territorial securities commission, finalized \textit{National Instrument 31-103 – Registration Requirements and Exemptions [NI 31-103]}. This major overhaul of registration regulations harmonized and modernized the registration requirements in all Canadian jurisdictions, and introduced significant new requirements on investment fund managers.
\textsuperscript{227} Ibid. at s.7.3.
term investment fund manager refers to a “person or company that directs the business, operations or affairs on an investment fund.” Second, since hedge fund advisers manage a portfolio of securities on behalf of the funds, they must register under the “portfolio manager” category. Third, to the extent that managers sell securities directly to investors using the exempt market, they must also register under the “exempt market dealer” category. Finally, there are several layers of registration for individual directors or officers of hedge fund managers as well.

Registrations under the above referenced categories are not particularly difficult to obtain. However, as registered entities, hedge fund managers must adhere to certain regulations relating to their conduct. For example, hedge fund managers must designate a chief compliance officer to establish and maintain policies and procedures for assessing compliance with securities regulation by the firm and by registered individuals. Registration also imposes certain financial requirements, such as minimum capital and minimum insurance obligations. Finally, hedge funds must provide the OSC with quarterly financial statements. That being said, hedge funds are not limited by the various investment restrictions that apply to Canadian retail mutual funds. It should also be noted that unlike the U.S. and U.K., there are currently no reporting requirements that hedge fund managers must (or are encouraged to) complete in respect of systemic risk. Indeed, in a recently published

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228 OSA, supra note 14, s.1(1).
229 Ibid., s.26(6).
230 Ibid., s.26(2).
231 For example, individuals acting as portfolio managers for hedge funds must register as “advising representatives” under NI 31-103, and complete certain accreditations prior to being eligible for registration.
232 See NI 31-103, supra note 226 at s.2.1(1).
233 The capital and insurance requirements vary amongst the different registration categories. In such instances, registered firms must adhere to the most onerous financial standards of their multiple registration categories.
CSA Staff Notice about hedge funds, systemic risk was not mentioned as an area of concern.\textsuperscript{234}

\section*{5. A Modest Proposal for Hedge Fund Regulation}

I have argued in this paper that hedge funds likely contribute to systemic risk globally. Moreover, from an economic perspective, the mitigation of systemic risk is the only rationale that justifies substantial new regulations relating to hedge fund advisers and the funds they manage.\textsuperscript{235} Of course, this statement is only true if these new regulations are themselves not economically inefficient. For example, it would not make sense to use the law in a way that reduces systemic risk but eliminates many of the positive benefits that hedge funds provide. Nor would it be efficient (or fair) to backstop direct investor losses from large hedge funds that are deemed to be “too big to fail” in order to avoid a potential systemic crisis. As such, the challenge faced by regulators is to find the right balance between systemic risk protection and the maintenance of those economic benefits.

According to the definition proposed by this paper, systemic losses are primarily caused by circumstances that are not reasonably foreseeable from the perspective of a moderately sophisticated and knowledgeable objective investor.\textsuperscript{236} As such, it is very difficult to determine whether systemic issues are developing, and if so, what the most effective ways of neutralizing them are. I have also suggested that systemic risk is a global phenomenon that cannot be dealt with without considering the build-up of risk in other jurisdictions, because a

\textsuperscript{234} See 81-316, supra note 23.  
\textsuperscript{235} See supra Part 3. Investor protection and the maintenance of efficient capital markets are, of course, important goals, but as I have demonstrated, they are not particularly relevant to hedge funds.  
\textsuperscript{236} See supra Part 3.1.1.
systemic crisis or failure of a hedge fund in another country may very well have negative economic impacts to the real economy here. Accordingly, how can any regulator effectively manage this type of risk?

It seems to me that given the nature of systemic risk as I have described it, regulators and governments simply do not have enough information or capability today to enact economically efficient regulations. Indeed, in most cases, regulators currently have just as much information as other average investors in the market, and no particular expertise to decipher the implications of available data. Moreover, even after the recent global financial crisis, there is less incentive for governments to track systemic risk compared to other investors, since those investors are liable to suffer significant financial losses if a crisis were to develop. These important factors must be considered in proposing any solution to mitigating hedge fund-related systemic risks. Below in Part 5.1, I will outline the details of my modest proposal. Part 5.2 will describe some of the key benefits of this proposal and will assert that it is an optimal model, and Part 5.3 will discuss the potential challenges with the proposal. Finally, Part 5.4 will compare my model to the recent SEC proposal which requires that certain hedge fund managers complete and file the Form PF.

5.1 The Hedge Fund Registry and Macro-Prudential Supervisory Body

This paper proposes that the optimal way to regulate hedge fund-related systemic risk is to establish a new, international macro-prudential supervisory body (the “Body”) consisting of industry experts, analysts and regulators from each of the three largest hedge fund markets.
in the world – the United States, United Kingdom and Ontario, Canada. The Body’s mandate would be twofold. First, it would gather and analyze systemically relevant information about hedge funds and their practices in the applicable jurisdictions. Second, where applicable, the Body would provide governments and regulators in these jurisdictions with non-public recommendations on how to revise securities regulations or other laws in order to mitigate any systemic issues that may be caused or exacerbated by hedge funds. The Body would also publish a publicly available report at least annually, which discusses general trends and potential areas of concern, in order to provide transparency and opportunities for investor and academic review.

Concurrent with the establishment of the Body, a new international hedge fund registration system would set up for hedge fund managers that are domicile in the participating jurisdictions. The rationale for the registry is to allow for the collection of systemically relevant information pertaining to each registrant, in order to assist the Body in carrying out its mandate. Each hedge fund manager located in the jurisdictions would be required to provide information semi-annually relating to each of its funds’ particular holdings, net assets, leverage positions, derivative positions, counterparty exposures (including the identity of the counterparties) and trading strategies. In this sense, this is a similar concept to the SEC’s Form PF proposal. However, unlike the SEC proposal, highly detailed information about various other items such as investor information, geographic concentrations, monthly performance statistics and risk metrics would not be required. Rather,

\[237\] Should a national securities regulator be created in Canada, then Ontario could be replaced by Canada as the third market.

\[238\] *Infra* Part 5.4 below will compare the two proposals in greater detail and will outline why the proposal offered in this paper is optimal.
the Body would have the *option* to require that certain hedge funds also provide such information, along with any other supplemental data that it may deem reasonably necessary in order to assess systemic risk. This additional information would likely be requested from larger managers, but the final decisions as to which managers must so disclose would be left to the Body. This flexible approach would allow the Body to obtain further details regarding areas of interest, but would avoid requiring all registrants from make substantial disclosures at significant cost (based solely on the size of the fund or manager) which may ultimately be meaningless in tracking systemic risk.

All information provided to the Body would remain strictly confidential, and could not be used under any circumstances for enforcement or other purposes. Indeed, the registry should be set up to allow hedge fund advisors to submit the required disclosure for each fund through a private identification number, which would remain anonymous unless additional information is requested by the Body or certain risk measures have been breached and specific actions are recommended to regulators.239 Regardless of any build-up of systemic risk, however, at no time would any of the filed information become publicly available. This is an important element because it provides hedge fund managers both the incentive and the confidence to provide the required disclosure in a timely and accurate manner.240

Another important mechanism of this proposal is that governments and regulators would not be bound by any of the Body’s recommendations. Governments would be free to accept, reject or modify any recommendation as they see fit. This flexibility provides each

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239 See Bianchi, *supra* note 22 at 24.

240 The high participation rates of the FSA’s voluntary hedge fund survey indicates that hedge funds are themselves concerned with systemic risk and would be willing to provide detailed disclosures on a confidential basis in order to help mitigate such risk.
governing stakeholder the ability to assess for itself whether the Body’s proposals are economically efficient and politically acceptable. However, the Body should strive to make clear, where appropriate, that a coordinated response to tackling certain systemic issues is optimal, and explain why this is so.\footnote{That is, the Body should take steps to explain in each report to regulators that the global nature of systemic risk may require an international response in order to effectively mitigate such risk.} Ultimately however, the decision to accept or reject the recommendations of the Body would be entirely up to the relevant jurisdictions’ applicable governing bodies.

Finally, in order to give legal effect to the Body and to ensure compliance by hedge fund managers, each jurisdiction will have to enact applicable enabling legislation that provides local regulators with the authority to require managers to comply with information requests. The registry will be most effective where the disclosure of systemically important information is not optional, and therefore legislators will need to take the necessary steps to ensure that managers domicile in their jurisdictions comply.

### 5.2 Benefits of the Model

Like in any proposal for regulatory change, there are pros and cons to my suggestion that an international body and registry system be set up to combat hedge fund-related systemic risk. In my view however, the positive benefits discussed in this sub-Part significantly outweigh potential concerns, which are reviewed in the next sub-Part below.

It should be noted that the information that will be required to be disclosed by hedge fund managers will be relevant in tracking systemic risk, and thus will help the Body recommend efficient policy changes, because it most closely relates to the specific factors that
could trigger the failure of a systemically important fund. I have argued that hedge funds may
directly trigger a systemic crisis by suddenly collapsing, either because the failure would
cause a significant decline in asset prices or because it would negatively affect the ability of
lending counterparties to generally provide credit.\textsuperscript{242} In each case, the failure leads to broader
negative economic consequences. Moreover, certain hedge fund investment strategies tend to
deliver more volatile returns and are thus riskier. It is these factors that are the key
considerations underpinning the proposed disclosure requirements.

Suppose for example that a very large, highly leveraged hedge fund engages in a risky
Managed Futures strategy\textsuperscript{243} and that three large banks with relatively low capital reserves
have significant counterparty exposures to this fund. This information is currently not readily
available to regulators, but the systemic risk posed by this fund is evident, since its failure
could cause its lending counterparties to fail. However, by using the proposed registry system,
the potential risks could be easily detected and the Body could recommend several courses of
action (ranging from requiring this particular fund to seek out new counterparties for any
additional derivative or credit positions to increasing the capital reserves of the banks). In
most cases however, it is unlikely that the task of identifying systemic risks will be so
straightforward, and therefore an in depth analysis of the data will have to be conducted by
the experts working for the Body.

\textsuperscript{242} See \textit{ supra} Part 3.1.2.
\textsuperscript{243} This strategy involves Commodity Trading Advisers (CTAs) that operate hedge funds which take long and
short positions in commodity, equity index and government securities futures, as well as options on futures.
Hedge funds which utilize these strategies have the highest average standard deviations of returns, and are thus
potentially the riskiest of all hedge funds. See Cumming, \textit{ supra} note 49 at 809.
The collected data will also help track trends that may point to the indirect contribution by hedge funds of systemically risky market conditions. As Chan et al suggest, there is currently a great deal of information that is not available but which could be instrumental in studying empirically whether indirect systemic risk related to hedge funds may be developing. For example, there is almost no quantitative information available regarding how hedge funds react to certain market shocks. This type of data could be used to carry out “stress tests” or to help structure new legislation that applies to hedge funds during a crisis situations. Moreover, having a data set which grows over time may be very helpful in determining longer term systemic trends which may not be easily recognized.

A coordinated international regulatory response is particularly important to counter systemic risk. Utilizing a single international organization removes concerns that systemic issues caused by hedge funds in one jurisdiction will not be taken into account in the analysis of systemic risks to another jurisdiction. In fact, the Body would collect information from the three jurisdictions in which approximately 90% of the world’s hedge fund assets are managed, thus providing the necessary scope to ensure that the global nature of systemic risk is considered. Using a single entity also partially removes incentives by regulators to “race to the bottom” of securities laws in order to entice hedge fund managers to remain domicile in a particular jurisdiction. This is because the Body will aim to propose, where applicable, coordinated responses to tackling systemic risk, and will consider as part of its mandate the

244 See U.S., Hedge Funds and the Financial Market: Hearing before the Committee on Oversight and Government Reform, 110th Cong., 2nd sess. (13 November 2008) at 35-36 (Andrew W. Lo, arguing that hedge funds continued search for better returns may have lead to risky market conditions).
245 Chan, supra note 75 at 51.
246 Pearson, supra note 2 at 63.
247 CityUK Report, supra note 203 at 2.
effect of any policy recommendations in each participating jurisdiction. Assuming the recommendations are accepted universally, incentives to forum shop by hedge fund managers should theoretically be reduced. Finally, a single organization is more efficient because it also allows for uniform disclosure requirements rather than different and potentially duplicative reporting obligations on hedge fund managers. As such, global managers will have certainty that they will not be required to fill out multiple, time-consuming reports to different regulators by virtue of a fractured reporting system.

This proposal also contemplates that systemic risk is not reasonably foreseeable to the objective investor, and that regulators around the world do not currently have the expertise necessary to understand how hedge funds contribute to such risk and how to effectively mitigate it. The Body would, over time, develop the particular expertise needed to properly assess systemic risk because it will have a limited focus. As such, building a specialized organization from the ground-up is more likely to succeed than drawing upon the scarce resources of local regulators in each country.

Finally, the proposal is highly flexible, in that it may easily expand to incorporate other jurisdictions, including Asian hedge fund managers, as they grow in size and economic significance. Indeed, while the above three jurisdictions were chosen because of their size and importance in the global hedge fund market, there is no reason why several other prominent countries cannot initially join the Body, so long as they are willing to require managers to conform to the disclosure rules, and a standard definition of the term “hedge fund” can be

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\(^{248}\) See generally, Cumming, *supra* note 49. Cumming concludes that there is little evidence which suggests that hedge fund managers engage in forum shopping due to international differences in hedge fund regulation, although concedes that the data available for empirical testing is somewhat limited.
negotiated. Ultimately, while including more jurisdictions make the Body’s work more complex, greater participation increases the data available for analysis and will help identify systemic risk globally.

5.3 Criticisms of the Model

The idea of creating a registry to collect information about hedge fund-related systemic risk has its critics. Perhaps among the most high profile is Ben Bernanke, the current Chairman of the Federal Reserve System in the United States. In a recent speech discussing whether any sort of hedge fund registry could be used to mitigate liquidity crises in particular, Bernanke stated:

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?...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.

It is probably uncontroversial to say that setting up an international registry system is more challenging and complex than organizing a local one, and therefore Bernanke’s commentary would apply to an even greater extent to the model proposed in this paper.

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249 See infra Part 5.4 for a discussion regarding the issues with defining the term “hedge fund” in respect of the proposal.

Bernanke’s comments must be addressed, and his point that the model may not work well is valid. Indeed, the nature of systemic risk is such that it is very difficult to detect and efficiently mitigate. While the Body would be comprised of experts that would attempt to develop effective means to manage such risk, it may not be able to identify systemic risk until a crisis has already developed. Moreover, even if the Body’s non-binding recommendations are used by governments, there is no guarantee that reforms will help mitigate fund failures, or that a hedge fund’s failure will not still lead to a systemic crisis.

While it is important to acknowledge the potential weaknesses of the proposed system, it should be noted that the goal of the model is not to eliminate all forms of systemic risk in the economy. Rather, the objective is to allow experts to focus on the most likely sources of systemic risk and to recommend ways to reduce those risks in an efficient manner. As such, it would not be necessary to keep daily or even quarterly updates on liquidity positions of hedge funds or to have real time access to a substantial amount of data, as Bernanke suggests. My proposal is merely a necessary starting point to a more robust regulatory regime, *should one become necessary*. Indeed, there may be cases where an objective cost-benefit analysis indicates that in the aggregate, it would be better to accept some systemic risk rather than carry out potential value-destroying reforms. However, without a specialized international organization that is dedicated to seeking out systemic risk, it is doubtful that these types of analyses will even be conducted.

Bernanke’s concern that an information registry might increase moral hazard amongst market participants, and thus create a system that is less stable, is unwarranted. Systemic

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251 See *supra* Part 3.1.1.
issues develop based on hedge funds’ unique characteristics and are driven primarily by investment considerations. It is therefore highly unlikely that a fund manager will make riskier investment decisions or take on more leverage than is necessary merely because a government or quasi-governmental organization is concerned with systemic risk and requires that certain disclosures be made. Moreover, the possibility that specific macro-prudential regulations may be enacted which directly relate to a specific fund or fund counterparty will likely act more as a deterrent to reduce risky activities, rather than an incentive to increase them.

Apart from Bernanke’s concerns, there are other potential criticisms of the proposed model. For example, practical issues with setting up an international body need to be contemplated. Consider, for example, the debate about how will such a body be funded. Should the jurisdiction which has the most hedge fund managers pay the most, or should costs be allocated based on exposure to systemic risk, thus giving countries with the most to gain from the Body left to incur the highest costs? Should hedge funds themselves shoulder some of the cost burdens, since they indirectly benefit from this proposal? If so, how much? These questions require an agreement amongst participating jurisdictions, and obtaining such an agreement may pose a significant challenge which takes a considerable amount of time. Schwartz argues, however, that since a common regulatory scheme for financial risk can be applied in the banking context with the Basel II and Basel III accords, a “single regulatory

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252 This is in contrast to a situation where governments agree to backstop risk in the event of a failure, because it would incentivize hedge fund managers to make extremely risky investment decisions. However, such an approach would likely be highly inefficient and politically improbable, and thus unlikely to be recommended by the Body, except perhaps in the most extreme circumstances.
approach thus appears feasible for mitigating systemic risk” globally. Moreover, there is currently a strong appetite amongst different governments to work together and formulate coordinated solutions to global problems. For example, in 2009 the Group of Twenty (G20) pledged to work together and do “whatever is necessary to…strengthen financial regulation to rebuild trust.” The G20 went on to establish a new Financial Stability Board which is tasked with, among other things, promoting financial stability globally by promoting collaboration among governments and other quasi-governmental organizations.

Another potential concern is that there is no agreed upon legal definition for term “hedge fund” in the U.S., U.K. or Ontario. As such, questions may arise as to whether the registry fairly and effectively applies to the investment vehicles that should be providing the Body with information. While this is a reasonable concern, there are several options for effectively dealing with this issue. First, the Body can create a precise definition of the term “hedge fund” that is carefully crafted to include most such funds in each jurisdiction. This definition would likely have to incorporate most of the key characteristics discussed in Part 2.1, such as a limited investor base, flexibility in respect of investment strategies and two-tiered compensation structure. Moreover, in order to avoid being too broad, and for simplicity reasons, the definition could also carve out certain other types of investment funds, such as private equity and venture capital funds. This structure would give some certainty to managers as to whether or not they are subject to the requirements. However, using a global

253 Schwartz, supra note 18 at 246.
254 G20, The Global Plan for Recovery and Reform (2 April, 2009) at 1, online: <www.g20.org/Documents/final-communique.pdf>. Of course, pledging to enact financial reform and actually doing it are two different things. My point however is that there is currently a stated desire amongst the governments of the world’s largest economies to work together to achieve reform, and this should be taken advantage of.
255 G20, Declaration on Strengthening the Financial System (2 April 2009), online: <www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf>.
definition would be an inflexible option and may inhibit the ability of other jurisdictions to join the registry system, since the definition may have to be re-negotiated if a new entrant were to join the Body. The second option would be to simply allow each jurisdiction to define for itself what a hedge fund is, on the consent of the other jurisdictions. This would allow for minor local differences to be accommodated, while ensuring that the general concept of a hedge fund is captured for the purpose of providing data to the Body. It would also allow for the greatest flexibility in admitting new jurisdictions, and would remove incentives for hedge funds to structure (or restructure) themselves in a manner which avoids the registration requirements due to loopholes which may be created by using a global compromise.

Despite these valid concerns about my proposal, I argue that setting up a global expert body that collects and analyzes information in order to consider efficient legal reforms to combat hedge fund-related systemic risk is an optimal model, albeit not a perfect one. There are several alternatives that commentators have proposed, such as setting up a hedge fund “Superfund” which would collect a tax from hedge funds, the proceeds of which would be used to purchase distressed assets during a systemic crisis. In my view, this proposal would create a moral hazard that encourages hedge funds to make highly risky investments, since managers would know that there are significant sums of money reserved to purchase the “toxic” assets of their funds should that become necessary. Moreover, applying a tax might

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256 For example, the Canadian Securities Administrators recently published proposed amendments to NI 81-102, which regulates the Canadian mutual funds, to allow for a limited amount of short selling under certain conditions (see Notice of Proposed Amendments to National Instrument 81-102 Mutual Funds and to National Instrument 81-106 Investment Fund Disclosure and Related Consequential Amendments, O.S.C. CSA Notice, (2010) 33 OSCB 5833). As such, using a global definition that distinguishes hedge funds from other investment vehicles based on the ability to short sell would not be applicable in Ontario. However, by allowing each jurisdiction to set its own definition, this proposed amendment would not raise any concerns.

257 Superfund, supra note 6.
significantly lower hedge fund returns, and would be almost impossible to apply globally. Another proposal is to create an independent organization tasked with conducting an *ex post* review of the causes of large hedge fund failures.\(^{258}\) In my view, trying to actively mitigate crises before they occur rather than studying previous ones is a far more effective use of resources, and will have greater economic benefits. Moreover, the Body would almost certainly look at any systemic failures in its continuous review of risk, and therefore this proposal can simply be incorporated into its mandate.

### 5.4 Comparing the SEC Proposal

There are some key similarities between the model I suggest in this paper and the SEC proposal.\(^ {259}\) For example, each system identifies the importance of collecting macro-prudential information prior to the enactment of any specific regulations meant to reduce the likelihood or severity of a systemic crisis. Each model also creates a new entity that is tasked with analyzing the information provided to it and recommending courses of action to mitigate systemic risk. However, there are certain material differences which I believe make my proposal the optimal model.

For instance, as I have discussed in Part 4.1.5 above, there are potential issues with allowing the information collected in the Form PF to be used for enforcement purposes. I have also noted in the same Part that the Form PF requires that large hedge fund managers provide extra disclosures about their funds. The theory behind requiring additional disclosure


\(^{259}\) See *supra* Part 4.1.5 for details on the U.S. proposals.
is that the failure of a larger fund is far more likely to cause a systemic disturbance compared to the failure of a smaller fund, and thus supplementary information is desirable. While this is understandable, setting an arbitrary size limit might encourage hedge fund managers to simply structure themselves to avoid additional regulation. For example, managers may simply cap the size of their funds and start new parallel funds with the same investment objectives once a certain size threshold is met, thereby avoiding the disclosure rules. Arbitrary size thresholds also do not consider situations where the strategy of a fund makes it systemically important. For example, a hedge fund which just misses the size threshold but which is highly leveraged and invests heavily in illiquid exotic assets theoretically poses a greater systemic risk than a larger fund that only makes long investments in large domestic issuers. On the other hand, the model I propose offers a flexible approach, whereby the Body may require certain disclosures if it considers the risk posed by a fund to be systemic, based on the initial set of information provided. This approach is less costly for both issuers and regulators, and should therefore be considered by the SEC.

The most glaring issue with the U.S. model, however, is that it does not adequately consider the global nature of systemic risk, since foreign managers may be able to avoid the requirement to provide the SEC with systemically relevant information by virtue of the new “foreign private adviser” exemption in Dodd-Frank. While this is a limited exemption, by creating a system which may exclude systemically important foreign hedge funds, the SEC proposal ignores the possibility that the activities or failures of those funds may lead to or

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260 Proposed Form PF, supra note 48 at 8076.
exacerbate a systemic crisis in the United States.\textsuperscript{261} Given the increased interconnectivity of financial institutions globally and the greater prominence of foreign hedge funds today, this may be a significant gap. Indeed, the share of global hedge fund assets managed out of North America today is barely two-thirds, meaning that a significant number of hedge funds will be exempt from filing Form PFs.\textsuperscript{262}

Perhaps if the SEC proposed this model ten years ago, when almost 90\% of the world’s hedge fund assets were managed out of the United States,\textsuperscript{263} this critique would not have been applicable. However, since a substantial portion of hedge fund managers are no longer located in the U.S., ignoring the systemic risks their funds may pose is sub-optimal.\textsuperscript{264} The heightened disclosure requirements under the form PF may also encourage hedge fund managers to forum shop to less restrictive jurisdictions, further decreasing the U.S.’s pre-eminence in the hedge fund sector. Alternatively, foreign hedge fund advisers may simply conclude that it is in their interest to exclude U.S. investors altogether in order to meet for the definition of “foreign private adviser” and avoid SEC-mandated disclosures.

While this gap is not ideal, U.S. regulators can attempt certain measures to reduce the likelihood of missing systemically important information about foreign hedge funds. Unfortunately, each of these alternatives is problematic. For example, the FSOC may seek out publicly available information on non-U.S. hedge funds in order to assess their contribution to

\begin{footnotes}
\item[261] Overmyer, supra note 81 at 2213.
\item[262] CityUK Report, supra note 203 at 2.
\item[263] Ibid.
\item[264] It should be noted that some of the non-U.S. hedge fund assets not managed by U.S. managers will still have to report systemically important information since they will not fall under the narrow definition of a foreign private advisor under Dodd-Frank.
\end{footnotes}
However, not only would this be a difficult and time consuming process, but such effort would probably be insufficient in making accurate determinations as to whether such risk is developing because so little information is available. As such, the effectiveness of any recommended macro-prudential regulations may be significantly undermined.

On the other hand, the SEC can attempt to obtain the missing systemically relevant information through international cooperation with other regulators. However, there are both limitations and inefficiencies to doing so. First, reporting obligations in non-U.S. jurisdictions are different, and no other country has proposed that hedge funds disclose the level of detail required under the Form PF. As such, even assuming the SEC is provided full access to information collected by foreign regulators, it may have to spend significant resources reviewing data which does not conform to U.S. standards and which may be lacking. Second, foreign authorities will be very reluctant to provide the SEC with this information, because it may be used for enforcement purposes and since the FSOC has the authority under limited circumstances to require U.S. supervision and regulation of foreign nonbank financial companies, including hedge funds. These powers, which may be used where the FSOC believes that such foreign organizations are systemically risky, will surely act as a significant disincentive for information sharing between the SEC and other regulators. Even if a foreign regulator would agree to share information with the SEC, the quid pro quo would likely be that some data on U.S. hedge funds would have to be shared. This would almost

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265 Overmyer, supra note 81 at 2213.
266 Ibid.
267 Even AIFMD, which may require substantial additional disclosure once implemented, is not intended to provide the level of disclosure proposed in the Form PF.
268 See supra Part 4.1.5 describing the features of Dodd-Frank.
269 Ibid.
certainly alarm U.S. based hedge fund managers given the sensitivity of the data provided. As such, it is unlikely to expect that international cooperation in conjunction with the SEC proposal will provide regulators with the tools necessary to adequately find hedge fund-related systemic risk.

Finally, in order to reduce the likelihood of missing systemically important information about foreign hedge funds, the U.S. Congress can narrow the “foreign private adviser” exemption by requiring that any large hedge fund manager anywhere in the world file a Form PF, even if its funds have no U.S. investors at all. Overmyer suggests that ideally, the exemption be removed altogether and that all foreign hedge funds with a connection to the U.S. register with the SEC.\(^{270}\) He also suggests that the penalty for non-compliance could be to bar hedge funds “from trading in U.S. markets or engaging in financial transactions with U.S. entities.”\(^{271}\) This proposal is also problematic. First, collecting and analyzing information about every hedge fund in the world with a connection to the U.S. would significantly increase the administrative burdens on the SEC. Not only would collecting such information be challenging, but determining which hedge funds must comply would be a complicated and time consuming task. Second, non-U.S. regulators would not benefit from the collection of this information, and would therefore not have the opportunity to consider macro-prudential regulations to combat systemic risk in their jurisdictions. As such, this U.S.-centric approach still fails to consider the global nature of systemic risk. Finally, it is unrealistic, from both a political and regulatory perspective, for the SEC to force non-compliant investment funds out of U.S. markets, since most trading is done through third-party brokers. Even if it were

\(^{270}\) Overmyer, supra note 81 at 2221.

\(^{271}\) Ibid. at 2223.
possible, an economic analysis strongly suggests that enforcement would not be worth the effort. The costs of enforcement would be very high and would deprive U.S. issuers with sources of capital, while the benefits are unknown, since the collected information may reveal that foreign hedge funds do not even pose a systemic risk. As such, the SEC model will likely not provide adequate data on hedge fund-related systemic risks, notwithstanding the steps that could be taken by U.S. regulators to try to obtain more information.

The model I propose, on the other hand, will ensure that the information necessary to analyze systemic risk is obtained in an efficient manner. By including U.K., U.S. and Ontario advisers in a single model, my proposal will obtain systemically relevant information from managers controlling almost 90% of all hedge fund assets around the world.\textsuperscript{272} Moreover, my model will have the flexibility to expand as other hedge fund markets grow in prominence. Given the benefits of this model and the potential concerns with the SEC proposal, the SEC should consider foregoing a U.S.-centric approach. Indeed, it is curious that U.S. legislators did not attempt to seek a more comprehensive international strategy to collecting and analyzing hedge fund-related data. The decision to forego such an approach likely reflects a realistic assessment that crafting an international solution would be a challenging and time consuming process, and that American regulators thus preferred a less optimal solution today than the potential for a superior solution tomorrow. However, the payoff in respect of a global model would be worth the effort.

\footnote{272 CityUK Report, \textit{supra} note 203 at 2.}
6. Conclusion

I have argued in this paper that an economic analysis suggests that regulators should be concerned with hedge fund-related systemic risk, even where such risk is narrowly defined. On the other hand, proposals to increase protections of hedge fund investors should be ignored. Given the features of systemic risks and the characteristics of the hedge fund industry today, I suggest the establishment of a new registration system and the creation of a specialized expert body to analyze the development of systemic risks and propose macro-prudential regulations. However, it should be noted that there are limits to fighting systemic risk. The key is to mitigate it smartly, efficiently and in a coordinated manner, while not stifling the freedom to create wealth and pass along economic benefits. My proposal is a modest yet optimal first step. However, to the extent the U.S. ultimately adopts the proposed Form PF, this would be a welcome, if incomplete, first step to preventing or reducing the impact of the next systemic crisis.
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