Hedge Funds and Improved Regulatory Inclusion: Myth or Reality?

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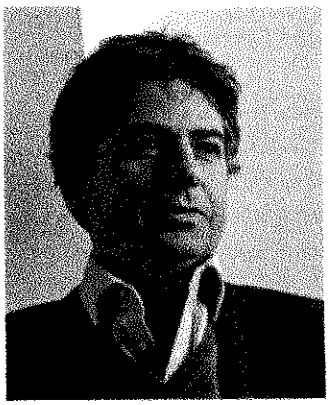

In 11 November, the European Parliament has voted through, with a very large majority, the Directive on Alternative Investment Funds Managers. At the time of writing, the Council is expected to formally approve the final text voted by the Parliament in a matter of weeks. The new Directive is expected to come into force in early 2011 and be transposed into national law and applied by 2013. This appears a remarkable step forward towards improved regulatory inclusion, since the adoption of the Directive means that hedge funds and private equity are going to be subject to direct regulation and oversight. This marks a dramatic changeover in the regulatory approach.

Indeed, full deference to private ordering coupled with some form of indirect regulation of the industry (i.e., mainly mandating prime broker's risk management practices) prevailed so far. In addition, for quite a long time, if only we consider that the first hedge fund was set up and operated by Dr Alfred Winslow Jones in the United States as early as in 1949.[1] Although the industry grew substantially in the following decades and dramatically in the last decade or so, it always proved successful in avoiding direct regulation (with the sole exception of the SEC Hedge Funds Rule approved in December 2004 and vacated by the Court of Appeal of the District of Columbia in June 2006 in *Goldstein*).[2] As Alan Greenspan put it at a testimony before the Congress in 1998 following the LTCM collapse, 'hedge funds are only a short step from cyberspace. Any direct US regulation restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under (US) jurisdiction: the best we can do is what we do today: regulate them indirectly'.[3] Ironically, still in May 2006, Ben Bernanke stated in turn that: 'direct regulation may be justified when market discipline is ineffective at constraining excessive leverage and risk taking but, in the case of hedge funds, the reasonable presumption is that market discipline can work. Investors, creditors, and counterparties have significant incentives to rein in hedge funds' risk taking. Moreover, direct regulation would impose costs in the form of moral hazard, the likely loss of private market discipline and possible limits on funds' ability to provide market liquidity'.[4] In Europe, there was so far no unified regulatory framework for alternative investment vehicles. Hedge funds and managers of private pools of capital were not granted, thus, the European passport. Albeit some civil law jurisdiction (like Italy) had enacted intrusive direct regulation of hedge funds, most of the MS refrained from direct regulation of funds. Some regulated the hedge funds' manager: notably the United Kingdom, by far the leading European home country for hedge fund management services.

The financial crisis hit severely also the hedge fund industry, prompting a reconsideration of the regulatory philosophy followed so far. In the United States, it is reported that over 1,500 hedge funds were liquidated,[5] and many blamed the hedge fund industry as one of the major 'enablers of exuberance'.[6] Not surprisingly, a strong move towards regulatory reform and better

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1 J.W. Verret, 'Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, a Self-regulation Proposal', *Delaware Journal of Corporate Law* 32 (2007): 799, 802.

2 *Goldstein v. SEC*, 451 F.3d 873 (DC Cir. 2006).

3 'Hedge Fund Operations: Hearing before the H. Comm. on Banking and Financial Services', 105th Con., 160–161 (statement of Alan Greenspan, Chairman, Federal Reserve System Board of Governors).

4 'Hedge Funds and Systemic Risk', Speech at the 2006 Federal Bank of Atlanta's Financial Markets Conference (Sea Island, Georgia), quoted by P. Jonna, 'In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation', *San Diego Law Review* 45 (2008): 989, 1012.

5 L.A. Aguilar, 'Hedge Fund Regulation on the Horizon – Don't Shoot the Messenger', Speech of the SEC Commissioner at the Spring 2009 Hedgeworld Fund Services Conference (New York, 18 Jun. 2009).

6 J. Taub, 'Enablers of Exuberance: Legal Acts and Omissions that Facilitated the Global Financial Crisis', Working Paper (September 2009), <ssrn.com/abstract=1472190>. The prevailing view denies though a major role to the hedge fund industry.

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inclusion of the industry within the regulatory framework gained momentum on both sides of the Atlantic and internationally.

In the United States, many bills requiring direct regulation of hedge funds were introduced in Congress starting from 2009. Both the Dodd-Frank Wall Street Reform and Consumer Protection Act (now Public Law 11-203 of 21 July 2010) and the Restoring American Financial Stability Act (introduced to Congress in April 2010) require hedge fund managers ('advisers') managing assets (exceeding, under the Dodd Frank Act, USD 150 million) either in private funds established in the United States or stemming from US private funds investors to register with the SEC, thereby eliminating the long-standing private adviser exemption. The Dodd Frank Act also permits the SEC to add to the existing record keeping and reporting obligations of registered investment advisers the requirements: (i) to maintain such records and file the same with the SEC 'as necessary and appropriate' to the public interest and for the protection of investors or for the assessment of systemic risk by the Council; (ii) to provide and make available to the Council systemic risk-related information concerning: (a) the amount of assets under management and use of leverage, including off balance sheet leverage; (b) counterparty credit risk exposure; (c) trading and investment positions; (d) valuation policies and practices of the fund; (e) types of assets held; (f) side letters; (g) trading practices, and (h) such other information that the SEC may deem necessary or appropriate, which may include different reporting requirements for different classes of fund advisers, based on the type and size of private funds being advised. The Act permits moreover the SEC to conduct periodic and, in its discretion, special examinations of records of private funds maintained by the advisor.

In Europe, the Alternative Investment Fund Managers Directive finally approved by the European Parliament in 11 November contains registration requirements – coupled, as noted, with the benefits of the European passport – and information and reporting duties towards investors and regulators. It also sets out provisions – yet unparalleled in the United States – on risk and liquidity management, on independent valuation providers and depositaries, and on the possibility for regulators to impose specific limits on hedge fund leverage. The Directive finds therefore necessary, *inter alia*: (i) to provide for the application of minimum capital requirements 'to ensure the continuity and regularity of the management services provided by the AIFM', since 'the ongoing capital requirements should cover the potential exposure of AIFM to professional liability'; (ii) to ensure that AIFM operate 'subject to robust governance controls' and be organized 'so as to minimize conflict of interest'. In this respect, it is correctly noted that 'recent developments underline the crucial need to separate asset safe-keeping and management functions and segregate investor assets from those of the manager'; (iii) to offer a 'reliable and objective asset valuation', 'for the protection of investor interests'; to this aim, it is required that 'the valuation of assets be undertaken by an entity which is independent of the AIFM'; (iv) to subject AIFM employing high levels of leverage in their investment strategies to special disclosure requirements regarding their use and source of leverage and, in certain cases, to specific limits on the level of the leverage. In fact, it is correctly acknowledged that these highly leveraged AIFM 'may, under certain conditions, contribute to the build up of systemic risk or disorderly markets'; therefore, 'the information needed to detect, monitor and respond to those risks' must be collected 'in a consistent way throughout the Community', 'be aggregated and shared' so as 'to facilitate a collective analysis of the impact of the leverage of those AIFM on the financial system in the Community as well as a common response'; once the use of high level of leverage could be detrimental to the stability and efficient functioning of financial markets, the Commission should be allowed to 'impose limits', either consisting in a threshold that should not be breached at any point in time or a limit on the average leverage employed during a given period.

The regulatory emphasis in the new European framework is placed therefore on 'level 2' measures to be enacted by the Commission implementing the framework principles on conduct of business (herein included provisions on conflict of interest, risk management, and liquidity management), capital requirements, organizational requirements, delegation of functions, and transparency requirements. As stated in the Directive, 'these measures are designed to specify the criteria to be used by competent authorities to assess whether AIFM comply with their obligations' as regards all regulated aspects of their activity. It seems therefore that, in the European regulatory context, the Directive marks a very substantial swing of the regulatory pendulum from self-regulation to external regulation and supervision, with a strong emphasis on level 2 implementing measures adopted by the Commission. Moreover, if we take into account the parallel evolution of the European supervisory framework, we should also expect, eventually, an additional layer of external regulation consisting of a common rule book composed by level 3 technical standards proposed by the European Supervisory Authorities and endorsed by the Commission.

These regional reforms come alongside with a deep international reconsideration of the regulatory approach towards hedge funds. IOSCO, in its final report on hedge funds oversight published in June 2009, concluded that: (i) hedge funds and/or hedge funds managers/advisers should be subject to mandatory registration; (ii) hedge fund managers/advisers that are required to register should also be subject to appropriate ongoing regulatory requirements relating to: (a) organizational and operational standards; (b) conflicts of interest and other conduct of business rules; (c) disclosure to investors; (d) prudential regulation; (iii) prime brokers and banks that provide funding to hedge funds should be subject to mandatory registration/regulation and supervision; they should have in place appropriate risk management systems and controls to monitor their counterparty credit risk exposures to hedge funds; (iv) hedge fund managers/advisers

and prime brokers should provide to the relevant regulator information for systemic risk purposes; (v) regulators should encourage and take account of the development, implementation, and convergence of industry good practices, where appropriate; (vi) regulators should have the authority to cooperate and share information. In fact, as correctly noted by the ECB,[7] 'an internationally coordinated response is necessary given the highly international nature of the industry and the consequent risks of regulatory arbitrate and evasion'.

The question now is: out of conventional rhetoric, what new and better things can we expect from external direct regulation that has not been delivered so far by private ordering? To what extent does it matter, in the field, the divide between external direct regulation (embedded in 'command and control' rules) and self-regulation? For sure, experience showed that, in this sector, despite the claimed sophistication of both (wealthy) investors and counterparties, market responses proved in several occasions ineffective in coping with agency problems and with the potential of conflict of interest (the Madoff scandal being a fairly clear example of the inability of sophisticated investors to fend themselves); and not surprisingly so, since in the hedge fund industry, informational asymmetries are big and governance and monitoring rights contractually vested to investors and other counterparties are often insufficient. Deterrence is also weak: self-regulation is voluntary and the 'shame' associated to the voluntary deviation by a market player from the best practice recommended by the industry proved in fact a 'stigma' by far too weak. Moreover, the financial crisis showed that hedge funds can become a source of systemic financial instability because of their impact (especially through forced sales, when they are bound to liquidate positions because the market or fundamentals turn against them) on securities' market prices.[8] Likewise in this respect, market discipline alone was not (and cannot be) sufficient to develop a suitable remedy. The idea of reinforcing regulatory direct intervention is thus fully justified.

However, as aptly noted by IOSCO, no credible regulatory response can completely depart from market discipline either. In fact, at a closer look, to my mind at least, most of the theoretical differences between external regulation and self-regulation tend to evaporate in the financial sector. (a) As to the substantial content of the rules, best practices on hedge funds codified by self-regulatory bodies resulted so far (and have been often correctly criticized for being) too broad and vague, resembling thus more to general command and control principles than to detailed standards of conduct. In turn, financial law command and control rules – especially those set at level 2 or 3 by European supervisors – often depart from a principle-based approach and end up being overly detailed. In so doing, they tend to transplant and shape in the form of external rules the content of pre-existing market standards, with some minor amendments, if any. (b) As to the regulatory process, the ('coerced') self-regulatory exercise on hedge funds that occurred in the last two years or so on both sides of the Atlantic proved substantially influenced by a 'benign big gun' threat, that is the threat that the government would step in and would impose its regulation should the industry fail to respond properly to the self-regulatory exercise.[9] There was, thus, an indirect role for regulators and supervisors in shaping self-regulatory best practices. In turn, the conventional regulatory exercise responding to the market and institutional failures brought to light by the financial crisis is performed taking into account, and often simply incorporating in the proposed external rules, most of the indications stemming from the industry and already codified in its best practices. Both regulatory settings, albeit formally having private or public officials, as the case may be, in the 'driving seat' and following different rule making processes, may therefore be conducive to similar outcomes, in terms of substantive content of the rules.

True, when private actors lead the (self) regulatory exercise, conceptually we are confronted with an interest-based regulatory framework, where the (certainly superior) technical expertise of the members of the private governing body called to enact the standards 'is generally instrumental to interest representation',[10] by contrast, when public officials lead the regulatory exercise, in practice we are confronted with a technocratic approach, where most of the substance, and in respect of secondary legislation also the form, of the legal rules depend on the legal and economic assessment made by civil servants charged with government or oversight functions in the sector. This bureaucracy, however, is not truly insulated from the market (due to the strong overlaps existing between political and economical oligarchies, due to 'sliding doors' from in and out the private industry, due to group pressure, and due also to herd effects, like the remarkable influence exerted on technocrats by prevailing ideological and academic views, which, however, are often far from being independent and are, one way or the other, market determined). Nor, especially in recent times, this bureaucracy does represent anymore, with few meritorious exceptions, a segregated social group with distinctive background, education, and deeply inoculated public mission.

Thus, despite the theoretically clear distinction between the private ordering and the external regulation set by a public institution, things look quite differently in practice. Having the last

7 Opinion of the ECB of 16 Oct. 2009 on the proposal for a Directive of the EP and of the Council on Alternative Investment Fund Managers, urging the EC Commission to continue the dialogue with its international partners, in particular the United States, to ensure a globally coherent regulatory and supervisory framework.

8 A. Engert, 'Hedge Funds – a Case Study of Emerging Transnational Regulation', Working Paper, 14–16.

9 *Ibid.*, 31.

10 F. Cafaggi, 'Rethinking Private Regulation in the European Regulatory Space', in *Reframing Self-regulation in European Private Law*, ed. F.Cafaggi (Kluwer Law Publ., 2006), 13.

say in formulating and enacting the rule is likely to matter less than expected. In addition, enforcement might be less distinctive than theoretically expected. If courts and supervisors take, as they should (to my mind, at least), the self-regulatory standards into account for determining liability and enforce such standards on an ongoing basis – construing the standard as the expected conduct, unless a deviation from the standard is justified by the principle of proportionality or by other objective good reasons – self-regulation would become, in practice, mandatory and would be enforced similarly to external regulation. In turn, supervisors are facing in practice severe limitations in the *ex ante* enforcement of their external rules, so that also conventional rules are often bound to be enforced *ex post*. In other words, the deterrence associated to self-regulatory and command and control rules might be in practice not very dissimilar.

All this suggests that, despite all the rhetoric surrounding the regulatory reform, self-regulation and external regulation are bound to coexist also in the frame of the newly approved Directive. Rightly so, if we consider that hedge funds' transnational rule making is biased by a fundamental government failure: the natural inadequacy of any national or regional institution, due to its asymmetric dimension and territorially limited sovereignty, to properly respond to the regulatory challenge posed by global investment vehicles 'only a short step from cyberspace'. Imposing hard law provisions not aligned with global standards would make the bastion also a prison.[11] An outcome that would contradict the true substance of the single market.

11 House of Lords, 'Directive on Alternative Investment Fund Managers, Volume I, Report', London, HL Paper 48-I 2010, para. 142 ('funds cannot get in and money cannot get out').