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Hedge Funds: The Case Against Increased Global Regulation in Light of the Subprime Mortgage Crisis

Laszlo Ladi*

I. INTRODUCTION

The recent instability of global financial markets has prompted legislators and regulators to call for increased regulation of securities and investment funds.¹ This instability resulted from a combination of lax lending standards and poor valuation of subprime mortgages in the United States, and has led to massive losses on securities backed by subprime mortgages.² The effects of this crisis extended far beyond the United States because financial institutions marketed these subprime mortgage-backed securities to banks and investment pools throughout the world.³ Hedge funds, a particular class of less regulated securities, have borne much of the criticism, with many calling for increased scrutiny and regulation because many hedge funds invested heavily in the subprime mortgage-backed securities.⁴

This is nothing new; indeed, hedge funds have always been a popular target for regulators because of two key characteristics: (1) use of a high degree of leverage,⁵ and (2) lack of transparency.

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4. Germany’s finance minister, Peer Steinbrueck, charged that “[t]here is a sizable, remarkable number of hedge funds which are not behaving properly on the market.” Somerville, supra note 1. Further elaborating on the risks associated with hedge funds, he asserted that “[n]o expert that I have met up to now could exclude a potential financial crisis caused by all these leveraged impacts of hedge funds.” Id.

5. Leverage is defined as the “use of debt capital in an enterprise or particular financing to increase the effectiveness (and risk) of the equity capital invested therein.” MICHAEL
Regulators fear the leveraged nature of hedge funds and the systemic risk they may pose to the global financial market, especially in light of the near collapse of the Long-Term Capital Management (LTCM) hedge fund in the mid-1990s. Due to lack of transparency, regulators also face difficulties in determining whether and to what extent hedge funds hold questionable investments such as subprime mortgage-backed securities. Taken together, concerns over leveraging and lack of transparency make hedge funds a target for increased regulation, whether the losses are actual or merely hypothetical.

Although hedge funds are most commonly associated with the United States, their operation and effect is global. Individual investors may be solicited globally, and institutional investors such as investment banks may represent worldwide clients. While hedge fund managers are usually located in world financial capitals, the hedge funds themselves are often based offshore for tax purposes. Countries that allow hedge funds or hedge fund managers must determine the proper balance between decreased regulation to

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6. Leverage also increases the magnitude of failure in addition to making the equity capital invested more effective, and such large failures may cause harm to overall market confidence. Counterparties that trade with hedge funds and parties that provide services to hedge funds may also be harmed. In particular, it is feared that the collapse of a large hedge fund would cause the fund’s creditors to become insolvent, creating a cascading effect throughout the market.


attract hedge funds and increased regulation to protect investors and the domestic market. The United States and United Kingdom loosely regulate hedge funds and therefore continuously attracts many funds. In contrast, even after liberalizing their approach, Germany attracts fewer hedge funds because of its increased regulation. Analyzing the appeal of increased hedge fund regulation requires consideration of (1) what constitutes a hedge fund, (2) current and proposed hedge funds regulation, and (3) the reasons behind an increased demand for tighter regulations and whether the new proposals will satisfy the demands.

This Comment discusses the current regulatory frameworks in the United States, the United Kingdom, and Germany to determine whether the United States and United Kingdom should adopt increased regulatory measures—like those applied in Germany—to protect investors, minimize risks to the global financial system, and address primarily German concerns over aggressive hedge fund action against domestic companies. While current U.S. and U.K. regulations sufficiently protect sophisticated investors willing and able to assume the risk of hedge fund investments, regulators should redefine the qualifications for hedge fund investors to ensure continued protection. However, any increased regulation should stop short of requiring full public disclosure and limiting investment strategies, which would hinder growth in, and destroy the profitability of, the hedge fund industry.

Moreover, in spite of the current financial crisis, the United States and United Kingdom need not address in a comprehensive manner the systemic risk hedge funds present to the global financial community. Failure of any large financial institution—whether a hedge fund or investment bank—may cause systemic repercussions as losses spread to counterparties. The risk of such a failure is not unique to hedge funds. In minimizing this risk, hedge fund counterparties are better positioned than government regulators to effectively police hedge funds by preventing too much leverage. Government regulation in this area, as seen in Germany, severely restricts the industry and thus limits the available investment options in the market. With respect to systemic risk, regulators should instead focus on indirect regulation of hedge funds through closer regulatory scrutiny of counterparties and let the industry police itself. Increased scrutiny of hedge funds is useful, however, to heighten awareness of key risk areas in the industry, allowing hedge funds to better police themselves.
Part II of this Comment provides a basic overview of the hedge fund industry. Part III then describes and briefly compares the regulatory approaches of the United States, United Kingdom, and Germany. Next, Part IV analyzes the various approaches and argues that limited further regulation may be necessary in the United States and United Kingdom, but nothing like the comprehensive regulation applied to hedge funds in Germany. Finally, Part V briefly addresses the prospects for increased hedge fund regulation going forward.

II. OVERVIEW OF HEDGE FUNDS

This Part provides a basic overview of hedge funds, describing how they are structured, their disadvantages and advantages, and the current market for hedge fund investment. Hedge funds are typically defined as professionally managed pools of assets that are invested and traded in a wide variety of financial instruments. The term “hedge” distinguishes these funds from other professionally managed pools of assets, such as mutual funds and venture capital funds. However, hedge funds do not always successfully mitigate risks. In fact, hedge funds do not employ any single investment tactic. Some hedge funds target specific securities or industries, while others use complex strategies involving short sales and put and call options to hedge their risks.

Despite these differences, hedge funds are loosely regulated. Hedge fund managers are largely free to run their portfolios in a manner best calculated to achieve maximum returns. To offset this


11. SHARTSIS FRIESE LLP, supra note 10.

12. BARRY EICHENGREEN ET AL., HEDGE FUNDS AND FINANCIAL MARKETS: IMPLICATIONS FOR POLICY 2 (International Monetary Fund, 1998). Short sales involve the selling of securities the seller does not own in the hopes of repurchasing the security at a lower price. GREENWALD ET AL., supra note 10, at 537. A put option gives the holder the right to sell the investment at a specified price (the strike price). Id. at 477. A call option conversely allows the holder the right to buy an investment at a specified price (the strike price). Id. at 70.

13. See infra Part III.A–B (discussing the loose restrictions on hedge funds in the United States and United Kingdom). But see Part III.C (discussing the relatively tighter restrictions on hedge funds in Germany).

14. SHARTSIS FRIESE LLP, supra note 10, § 1.1, at 2. Although hedge funds and their managers are exempt from most United States federal securities laws, the managers are still
lack of regulation, investor participation is limited to wealthy individuals and institutional investors.\textsuperscript{15} In addition, wealthy individuals and institutional investors presumably have either access to an independent investment advisor or the financial sophistication necessary to offset risks associated with investing in securities lacking transparency.\textsuperscript{16}

Hedge funds typically charge a management fee equaling 2\% of the value of the managed assets. Additionally, hedge funds performing above a predetermined benchmark may charge fees up to 20\% of profit.\textsuperscript{17} While such fees may seem excessive, hedge funds are extremely profitable investment vehicles. Even in 2007, a volatile year for the financial markets, hedge fund returns were up 12\%, topping the 6.2\% return on the Standard and Poor’s 500 stock index.\textsuperscript{18} Hedge fund investments also serve as a professionally managed hedge against other investments. While many traditional investment banks, mutual funds and even hedge funds were heavily invested in the housing market in 2007, other hedge funds made bets against the housing market and as a result were very profitable.\textsuperscript{19}

Hedge funds have characteristic disadvantages that often warrant criticism. The main criticism of hedge funds is that they lack transparency. Even sophisticated investors cannot make good decisions without proper information.\textsuperscript{20} In addition, the information that hedge funds do provide to investors is often not particularly useful because hedge funds invest in complex assets that are difficult to value.\textsuperscript{21} Finally, hedge funds’ use of leveraged investments are subject to the anti-fraud provisions of the federal securities laws. SEC 2003 Report, supra note 9, at 72.

\textsuperscript{15} EICHENGREEN, supra note 12, at 12.

\textsuperscript{16} SHARTSIS FRIESE LLP, supra note 10, §§ 5.3.1.i, 5.3.2.iv, at 124–25. Although not required to disclose any information to their investors under the United States federal securities laws, some hedge funds provide periodic reports to their investors. These range from reports about the fund’s overall performance in a recent period to specific disclosures about each investor’s performance. SEC 2003 Report, supra note 9, at 50–51.

\textsuperscript{17} SEC 2003 Report, supra note 9, at 61; FSA 2005 DP, supra note 9, at 10; Mark Hulbert, 2 + 20, and Other Hedge Fund Math, N.Y. TIMES, Mar. 4, 2007, at 34.

\textsuperscript{18} Gregory Zuckerman, Hedge Funds Weather Stormy Year, WALL ST. J., Jan. 2, 2008, at R8.

\textsuperscript{19} Id.


\textsuperscript{21} Id.
magnifies the risk of loss and potential impact on the global financial community.\textsuperscript{22}

The benefits of hedge funds arguably are found in the same characteristics that are criticized. Although hedge funds invest in complex derivative assets that are difficult to value, these assets represent financial risks that other institutions wish to avoid.\textsuperscript{23} Moreover, hedge funds’ use of leveraged investments brings more liquidity to the global financial market.\textsuperscript{24} Thus, such use of leveraged investments magnifies both the risk of loss and the possibility of profit, making hedge funds attractive and profitable investment vehicles.

Regardless of the benefits and disadvantages of hedge funds, they have become a large factor in the global financial markets in recent years. Currently some estimate that hedge funds globally represent over $2 trillion in managed assets,\textsuperscript{25} and with the leveraged investments they make, their financial impact may be many times greater. In addition, hedge funds often make use of domestic investment banks to act as their prime brokers. The domestic investment banks frequently have custody of the hedge funds’ holdings and lend to the hedge funds to provide them with leverage.\textsuperscript{26}

III. HEDGE FUND REGULATION IN THE UNITED STATES, THE UNITED KINGDOM, AND GERMANY

The United States and United Kingdom attract significant onshore hedge funds and hedge fund managers,\textsuperscript{27} arguably, at least
in part, because both countries lack strict regulations. Conversely, Germany has attracted few hedge funds because it is a vocal advocate of increased hedge fund regulation.  

A. United States – Light Regulation with Investment Limited to Sophisticated Investors

In general, the United States philosophy regarding unregulated securities is that if a particular class of investors is “able to fend for themselves,” then statutory protection is of less importance. Thus, in the United States, regulation of hedge funds focuses primarily on limiting who may invest, rather than on how the hedge funds are managed or on elaborate disclosure obligations. This is an indirect regulation approach, characterized by examining the qualifications of investors, as opposed to direct regulation, which regulates hedge funds’ activities.

1. Exclusion from the Investment Company Act

Hedge funds often escape regulation and registration under the Investment Company Act of 1940 (Company Act) because they are excluded from the definition of investment company. Under section 3(c)(1), hedge funds are excluded provided they have fewer than 100 beneficial owners of their securities and do not make or propose to make a public offering. This exclusion reflects the view

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29. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (arguing that certain offerings to “persons who are shown to be able to fend for themselves” fall outside intended scope of established regulations).
31. See Investment Company Act of 1940, 15 U.S.C. §§ 80a-3(c)(1), (7) (2000). The Company Act regulates investment companies’ activities and requires them to register with the SEC. It focuses on the company’s investment objectives as well as the structure and operations of the company. Id. § 80a-8. Under the Company Act, the term “investment company” includes an issuer that is engaged or proposes to engage in investing, owning, holding or trading securities and holds or proposes to hold investment securities exceeding 40% of the value of its total assets. Id. § 80a-3(a)(1)(C).
32. Section 3(c)(1) excludes from regulation and registration “[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.” Id. § 80a3(c)(1). In determining the 100 beneficial owners, hedge funds that are incorporated offshore and rely on the 3(c)(1) exemption may exclude non-U.S. investors. SEC 2003 Report, supra note 9, at 11 n.33. Also, a corporation acting as an investor is counted as one investor in determining compliance with the 100-beneficial-owners test, unless the corporate investor owns 10% or more of the voting securities of the
that small, private offerings do not merit federal regulation. On the other hand, under section 3(c)(7) hedge funds are excluded if all of the beneficial owners of their securities are “qualified” investors, as defined in the Company Act. Currently, to be a qualified investor an individual must hold $5 million in investments. Hedge funds relying on section 3(c)(7) are also subject to the same restriction on public offerings of securities as section 3(c)(1), discussed above. Thus, the 3(c)(7) exclusion reflects the view that certain qualified investors can fend for themselves and do not need the protection of the Company Act.

2. Private offering exemption under the Securities Act of 1933

By avoiding public offerings, hedge funds qualify not only for exclusions under the Company Act, but for an exemption under the Securities Act of 1933 (1933 Act). The 1933 Act prohibits the public offering or sale of securities by an issuer unless a registration statement has been filed. An exemption from registration exists under Section 4(2) of the 1933 Act for “transactions by an issuer not involving any public offering.” To provide a safe harbor for a private offering, the SEC issued Regulation D, which provides three non-exclusive safe harbor exemptions—two are small offering exemptions and one is the private placement exemption under Rule
Hedge funds typically rely on Rule 506 to issue securities without registration. Rule 506 under Regulation D chiefly restricts issuers offering and selling securities from general solicitation and does not specify disclosure obligations if the securities are issued only to “accredited” investors. Thus, so long as hedge funds use only private methods in issuing securities and issue them only to accredited investors, they escape the registration and specific disclosure requirements of the 1933 Act.

3. The rise and fall of hedge fund manager registration under the SEC 2004 Rule

New securities laws often come in waves, typically in response to a financial crisis. For example, Congress passed the 1933 Act and the Securities Exchange Act of 1934 (1934 Act) in response to the Stock Market Crash of 1929 and the Great Depression. More recently, Congress enacted the Sarbanes-Oxley Act in response to accounting irregularities and fraud by such companies as Enron and WorldCom. A less severe financial crisis occurred in 1998 when LTCM nearly collapsed. LTCM invested primarily based on its own quantitative model, and when it failed was left with losses that were

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39. SHARTSIS FRIESE LLP, supra note 10, § 5.3.2, at 120.

40. 17 C.F.R. § 230.506. Rule 506 incorporates by reference Rule 502, which states, “neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising.” 17 C.F.R. § 230.502 (1982). While hedge funds may offer securities to non-accredited investors, they are limited in number to thirty-five such non-accredited investors. 17 C.F.R. § 230.506. An accredited investor is currently defined as an individual investor having a net worth (or joint worth with their spouse) of $1 million, or income of at least $200,000 (or at least $300,000 jointly with their spouse) in the last two years. C.F.R. § 230.501(a) (1982). In addition, certain institutional investors including banks, trusts, and partnership with assets in excess of $5 million are also accredited investors. Id. Most of these thresholds were initially established in 1982 and have not been updated to keep pace with inflation. SEC 2003 Report, supra note 9, at 15.

41. Shannon Rose Selden, (Self-)Policing the Market: Congress’s Flawed Approach to Securities Law Reform, 33 J. LEGIS. 57, 63 (2006) (noting that prior to Great Depression and these two laws, the exchange of securities was governed by states through “a patchwork of so-called ‘blue sky’ laws”).

42. See id. at 82–83.
magnified by leverage.\textsuperscript{43} Given the size and extent of its holdings, its inability to unload bad investments, and the potential harm to financial institutions worldwide, the Federal Reserve Bank of New York organized a private bailout.\textsuperscript{44} Although highly leveraged hedge funds such as LTCM may represent a systemic risk to the global financial market,\textsuperscript{45} no additional regulation resulted from the LTCM collapse.\textsuperscript{46}

In 2002, the SEC began a study of hedge funds and their activities. The study focused primarily on investor protection and concluded that the potential for fraud required a revision of the hedge fund rules.\textsuperscript{47} Largely in response to this study, the SEC changed its previous approach to hedge funds by enacting a new rule: Registration under the Advisers Act of Certain Hedge Funds Advisers (SEC 2004 Rule). The SEC 2004 Rule requires hedge fund managers to register under the Investment Advisers Act of 1940.\textsuperscript{48} Previously, hedge fund managers did not have to register because of an exemption for managers with fewer than fifteen clients, and a hedge fund was considered a single client.\textsuperscript{49} The SEC 2004 Rule looked instead at the shareholders of the fund to determine the

\textsuperscript{43} Erik J. Greupner, \textit{Hedge Funds are Headed Down-Market: A Call for Increased Regulation?}, 40 \textit{San Diego L. Rev.} 1555, 1557 (2003); see also Lowenstein, supra note 7.

\textsuperscript{44} Greupner, supra note 43.

\textsuperscript{45} See supra notes 6–9 and accompanying text.

\textsuperscript{46} U.S. regulators seemingly acknowledged some systemic risk from hedge funds but declined to regulate hedge funds’ use of leverage. For example, the President’s Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (PWG) argued in 1999 after the LTCM crisis that any problems with leverage were system-wide and not unique to hedge funds. In addition, the PWG concluded that hedge funds were effectively self-regulated through the counterparties such as the banks that provide loans to hedge funds. See Report of the President’s Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management 42–43, B-4 through B-11 (1999), available at http://www.ustreas.gov/press/releases/reports/hedgfund.pdf.

\textsuperscript{47} SEC 2003 Report, supra note 9, at x–xi.


\textsuperscript{49} Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (defining an investment adviser as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . .”). Although virtually all hedge fund advisers meet this requirement, by relying on the de minimis exemption under 203(b) and the current rules which count a hedge fund as one client, hedge fund advisers may manage up to 14 hedge funds in a year before registering with the SEC. Id. § 203(b)(3); 17 C.F.R. § 275.203(b)(3)-1(2)(i) (2006).
number of clients the manager represented. The primary motivation for requiring hedge fund managers to register was to collect data about the activities of hedge funds. The SEC acknowledged the need for further investor protections against fraud, and suggested that registration might effectively serve that purpose. Absent registration, fraud is only investigated and litigated after the fraud has occurred and the investors’ assets are lost. The SEC further stated that this registration was irrelevant to the investment strategies and activities of the hedge funds. The SEC dismissed the issue of market instability caused by hedge funds because collapses such as LTCM were too unusual to be a major concern.

Despite the seemingly minimal impact of the SEC 2004 Rule, hostility grew and following a challenge by hedge fund advisor Phillip Goldstein, the SEC discarded the rule in June 2006. In his lawsuit, Goldstein challenged the SEC’s practice of counting individual investors in a hedge fund as clients of the hedge fund manager. The court ultimately found no justification for the rule.

51. Id. § II(A). The SEC believed the burden on hedge fund advisors would be minimal and by so doing acknowledged that “the lack of regulatory constraints on hedge funds has been a factor in the growth and success of hedge funds.” Id. In general, hedge fund managers would be subject to the same disclosure and registration requirements as any other non-exempt investment advisor is under the Investment Advisers Act of 1940.
52. Deterrence of fraud was a principal goal, and SEC examinations would have focused on catching compliance problems at an early stage, identifying practices that are harmful to investors and unlawful. Id. at § II(B)(2).
53. The SEC noted that some hedge fund advisors had already voluntarily registered prior to the SEC 2004 Rule and in looking at their performance, stated “[w]e are not aware of any evidence that suggests that registration under the Advisers Act has impeded investment advisers’ performance, and commenters did not suggest that registration would have such an effect.” Id. at § II(A).
54. See SEC 2003 Report, supra note 9 (focusing on investor protection rather than market stability, even after the potential harm to market stability was show by the LTCM collapse). As the subprime mortgage crisis spread throughout the financial community in 2008, hedge funds have suffered along with the rest of the market and many have collapsed or closed. However, none have collapsed or nearly collapsed on a level of LTCM, where a bailout was necessary to prevent the spread of financial insolvency to the fund’s counterparties. Instead, such systemic risk from collapse or near collapse was associated with investment banks such as Bear Sterns, Lehman Brothers, as well as credit default swap provider AIG, which required public bailouts. Much of these firms’ problems can be attributed to leverage, and hedge funds still remain similarly at risk from too much leverage. But these examples illustrate that systemic risk from leveraging represents a system-wide problem not unique to hedge funds.
55. See Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).
56. Id. at 874.
57. Id. at 882–83.
The court also found no link between the number of investors in a fund and the underlying policy goal of the SEC 2004 Rule, which was to mitigate the increasingly national impact of hedge funds.\textsuperscript{58} Although the stated policy goal was market stability, the SEC 2004 Rule reflected concern about investor protection more than market stability. In response to the ruling, many managed-hedge funds that had previously registered under the rule revoked their registration once registration became voluntary.\textsuperscript{59} Currently, registration is voluntary and the overall scheme of regulation in the United States has reverted to its pre-SEC 2004 Rule state.

\textit{B. United Kingdom -- A Flexible Regulatory Agency Responding to Evolving Needs}

As in the United States, the United Kingdom has a general scheme that regulates who may invest in hedge funds, but has little or no regulation regarding fund management and reporting. In contrast to the SEC, the Financial Services Authority (FSA)—the regulatory agency charged with hedge fund regulation in the United Kingdom—is more willing to amend its regulations and solicit members of the hedge fund industry for proposals on how to improve regulation.\textsuperscript{60} Compared to the SEC, which relies on statutory provisions, the FSA is more flexible in its regulation of hedge funds because it outlines its general policies and identifies key areas of risk in discussion papers. The FSA also compiles comments on these discussion papers from various members of the hedge fund industry to create feedback statements. This process allows the FSA to quickly change its approach and explore new areas of regulation.

\textit{1. The 2002 discussion paper and investor protection}

The August 2002 discussion paper (2002 DP) first identified the marketing of hedge funds to U.K. citizens as an area of concern for

\textsuperscript{58} Id. at 883–84.

\textsuperscript{59} Kara Scannell et al., \textit{No Consensus on Regulating Hedge Funds}, WALL ST. J., Jan. 5, 2007, at C1.

the FSA.\textsuperscript{61} In its discussion, the FSA noted that hedge funds may not directly market themselves to the general public.\textsuperscript{62} However, public investors wishing to invest in hedge funds may deal directly with the offshore hedge fund or invest through an intermediary, such as an investment bank. In both cases, the investor loses FSA protection available for regulated investment schemes.\textsuperscript{63} A private party may also be ‘opted-up’ and categorized as an intermediary—thus allowing them to purchase unregulated securities—if a regulated firm makes a reasonable inquiry to determine whether the customer has enough expertise and understanding.\textsuperscript{64} This exception for sophisticated private investors is analogous to the exception for qualified investors in the United States, discussed above.

In addition to concern about unqualified investors, the FSA is concerned with regulating the management of offshore hedge funds by hedge fund managers based onshore.\textsuperscript{65} To manage offshore hedge funds, a manager must obtain authorization by satisfying strict threshold conditions.\textsuperscript{66} The threshold requirements focus on the systems and controls the managers have in place to protect their clients, which are usually hedge funds themselves and not the underlying investors.\textsuperscript{67} According to the FSA, the regulation of hedge fund managers is not “concerned with the risk profile of the fund itself, nor with its suitability for investors who may be introduced to it by the fund.”\textsuperscript{68} The FSA’s registration process involves a detailed look at (1) members of the governing body of the

\begin{itemize}
  \item \textsuperscript{62} Hedge funds are classified as unregulated schemes, which may not be freely marketed to the general public. However, they may be marketed to counterparties, intermediaries, and private parties in the market when a firm “has taken reasonable steps to ensure that the fund is suitable.” Id. at 13. In addition, offshore hedge funds not classified as collective investment schemes may, subject to regulation, offer company shares, which may result in the promotion of hedge fund shares. Id.
  \item \textsuperscript{63} Id. at 14.
  \item \textsuperscript{64} The FSA finds this practice to be rare and believes the firms undertaking an ‘opt-up’ are very cautious and careful in practicing due diligence. Id.
  \item \textsuperscript{65} Id. at 4.
  \item \textsuperscript{66} Authorization is required for managers if their business includes managing securities investment assets of another person or advising on the merits of buying or selling a securities investment. Id. at 16.
  \item \textsuperscript{67} Some of the relevant issues with respect to systems and controls include the resources and ability of the manager to operate the funds in line with hedge fund mandates, the adequacy of interaction with relevant counterparties such as the prime broker, appropriate information feeds for pricing, and adequate internal accounting. Id. at 16–17.
  \item \textsuperscript{68} Id. at 17.
\end{itemize}
hedge fund, (2) the manager and individuals making discretionary trades as to criminal activity, (3) adverse regulatory sanctions, and (4) even business failing.\textsuperscript{69} In its 2002 DP, the FSA credited this strict and inclusive registration process for the low rate of fraud among hedge funds managed in the United Kingdom compared to those managed in the United States.\textsuperscript{70}

In addition to concerns about investor protection, the FSA briefly addressed the effects of hedge funds on the global market. The FSA acknowledged the risk to market confidence and counterparties present in large, highly-leveraged hedge funds such as LTCM.\textsuperscript{71} Nevertheless, the FSA merely requires that the counterparties lending to these hedge funds practice better risk management.\textsuperscript{72} The FSA also acknowledged problems with valuation resulting from a hedge fund’s practice of short selling, but offers no solution to any systemic risk in the practice.\textsuperscript{73}

2. The 2005 discussion paper and systemic risk to global markets

In June 2005, the FSA published a discussion paper (2005 DP) which primarily discussed the systemic risk of hedge funds to the domestic and global financial markets. However, rather than propose new regulation, the 2005 DP merely solicited comments regarding its assessment of the risk posed by hedge funds.\textsuperscript{74} In the 2005 DP, the FSA once again addressed the risks posed to the financial system by highly leveraged individual funds such as LTCM in the late 1990s.\textsuperscript{75} The FSA asserted that the threat from such hedge funds had diminished due to better counterparty risk management and because

\textsuperscript{69} FSA 2005 DP, \textit{supra} note 9, at 57–58.

\textsuperscript{70} Id. at 57. By contrast, in the United States the SEC estimated that in the five years prior to the SEC 2004 Rule, the SEC brought 51 different cases in which the SEC asserted fraud by the hedge fund manager. SEC 2004 Rule, \textit{supra} note 48. The SEC estimated that investors and other parties were defrauded $1.1 billion. \textit{Id}.

\textsuperscript{71} FSA 2002 DP, \textit{supra} note 61, at 18. The near collapse of funds like LTCM may erode investors' confidence in the financial market as a whole and cause considerable harm to the counterparties that trade with hedge funds and provide services to hedge funds. \textit{Id}.

\textsuperscript{72} A number of international committees, including The International Organization of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision, provide relevant guidelines and good practices for counterparties providing credit and dealing with highly leveraged institutions such as hedge funds. \textit{Id.} at 19.

\textsuperscript{73} \textit{Id}.

\textsuperscript{74} FSA 2005 DP, \textit{supra} note 9, at 3–4.

\textsuperscript{75} \textit{Id.} at 20. The risk associated with such highly leveraged funds is a collapse or near collapse which would erode confidence in financial market as a whole and harm the counterparties that trade with and provide services to hedge funds. \textit{Id}.

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hedge funds themselves were not as large or as highly leveraged.\footnote{LTCM had around $1.4 billion in gross exposures and at one point was leveraged at a ratio of roughly 50 to 1. \textit{Id.}} The threat of many medium-size hedge funds likewise decreased because of better risk management by counterparties and the funds themselves.\footnote{\textit{Id. at 20–21.}}

One proposal discussed in the 2005 DP, which the FSA has since enacted, involves the monitoring of top hedge fund managers.\footnote{\textit{Id. at 41 (outlining the plan as part of the 2005 DP); Anderson, supra note 60 (discussing the plan, as implemented beginning in October 2005).}} In October 2006, the FSA appointed regulators to monitor the top twenty-five hedge fund managers in the United Kingdom.\footnote{Anderson, \textit{supra} note 60.} Although all managers are required to seek authorization, the FSA determines the frequency of ongoing audits and checks based on fund size.\footnote{\textit{Id.} Because the FSA only has a finite number of resources there should be increased focus on the few hedge funds whose funds and business model have a significant impact on the financial markets. For the other funds, the FSA would conduct broad scope thematic reviews in which the smaller hedge funds would occasionally participate, depending on their market and strategies. FSA 2002 DP, \textit{supra} note 61, at 41.} Thus, the top five managers are audited every quarter, the next twenty managers every eighteen months or so, and the remaining managers about once every three years.\footnote{Anderson, \textit{supra} note 60.} Still, detractors claim that the cozy relationship between the FSA and fund managers renders problematic the entire monitoring process. Managers know what to expect because the FSA outlines the key areas of risk frequently and encourages dialogue between managers and regulators, which raises the possibility of cronyism as regulators and managers develop closer relationships over time.\footnote{\textit{Id.}}

\begin{center}
\textit{C. Germany -- Regulation of Investment Strategies and Calls for Further Action}
\end{center}

German regulation of hedge funds stands in stark contrast to the approach and execution of the United States and the United Kingdom. Continental Europe is often characterized as a blockholder based economy, where the capital markets are weaker, bank finance is more prevalent, and firms focus on maximizing value to stakeholders.\footnote{Jens Köke & Luc Renneboog, \textit{Do Corporate Control and Product Market}
Kingdom are often characterized as market-oriented economies, where the capital markets are stronger, institutional and individual investors are more prevalent, and firms focus on maximizing returns to shareholders. Despite this backdrop of hostility to the capital market, Germany, with perhaps the strongest continental European economy, introduced a new legal framework for domestic hedge funds in the Investment Act of 2004 (Investment Act). Previously, Germany did not directly regulate hedge funds at all; instead, hedge funds had legal status based on an opt-in model with provisions that, for various practical reasons, hedge funds could not meet, which effectively rendered impossible the promotion of hedge funds in Germany. By contrast, the Investment Act authorized distribution of foreign single hedge funds and foreign funds of hedge funds in Germany via private placement. It also authorized domestic single hedge funds and domestic funds of hedge funds, but only allowed distribution of these securities through private placement. Finally, foreign investment funds consisting of hedge funds may, in certain cases, be distributed to the retail public.

Nevertheless, in all cases the hedge funds are required to register with the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), the regulatory agency charged with hedge fund regulation in Germany. For foreign investment funds consisting of hedge funds, registration will be denied unless the BaFin considers the home state regulation adequate, and the home state regulator is willing to comply with

\[ \text{Equation} \]

\[ \text{Equation} \]
Foreign and domestic investment funds consisting of hedge funds are subject to strict diversification requirements, and the top-level funds may not use leverage or short sales. Furthermore, a full sales prospectus with a risk warning is required for all investment funds consisting of hedge funds. While single hedge funds are not restricted in their use of leverage or short selling, they are limited in their use of enterprises that are not publicly traded (i.e., private equity) to 30% of the value of the fund. Along with the Investment Act, Germany also introduced the Investment Tax Act, which taxed non-transparent hedge funds at a much higher rate than those providing authorities with the necessary holdings data.

While the Investment Act liberalized hedge fund regulation in Germany, the regulatory scheme remains stricter than elsewhere. As a result, the number of hedge funds marketed in Germany is minimal. In 2007, a draft act was proposed to update the Investment Act, clarifying the use of prime brokers and easing some of the annual reporting requirements for single hedge funds. Additionally, Germany also plans to introduce a law to protect their

91. Id.
92. FRESHFIELDS, supra note 87, at 22. This simply means the leverage and short sales must take place in the underlying hedge funds that the fund invests in. Id. The diversification requirements are that the fund may not invest (1) more than 20% in a single target hedge fund, (2) in more than two funds from the same issuer or manager, and (3) in other funds of hedge funds. Id. at 21–22.
93. Id. at 22–23.
94. Id. at 20.
95. Simon Gray, Hedge Fund Liberalisation Starts to Bear Fruit, in HEDGEWEEK SPECIAL REPORT, HEDGE FUNDS IN GERMANY 2006, at 6 (2006), available at http://www.hedgeweek.com/articles/detail.jsp?content_id=30584&livehome=true. Initially, it was assumed that hedge fund managers would be unwilling to comply, but some funds of hedge funds have started to design funds that make use of their own families of single hedge funds because this would guarantee compliance with the transparency requirement. Id. This new taxation no longer discriminated against foreign hedge funds because all hedge funds had to report based on determinations of income and capital gains under German law. PWC 2007 Report, supra note 25, at 22.
96. See supra notes 83–86 and accompanying text; Gray, supra note 95. In addition, German hedge funds have not performed well. Stricter regulation in Germany relative to the United States and the United Kingdom has meant increased fees for investors. See Barbara Wall, After a Year on the Market, a Slow Start for Funds of Hedge Funds: Not Catching Fire in Germany, INT’L. HERALD TRIBUNE, Feb. 8, 2005, at 14. These increased costs and fees also explain the small number of hedge funds in Germany; after all, few managers are willing to put up with the increased regulation when it is easier and more profitable to operate their hedge funds from the United States or the United Kingdom. See Martin Steward, German Hedge Funds in a Fix, FIN. TIMES (U.K.), Apr. 7, 2008, at 19.
domestic companies against takeover and harassment by foreign hedge funds.\textsuperscript{98} German distrust of foreign hedge funds stems in part from incidents such as the attempted takeover of the London Stock Exchange by the German stock exchange Deutsche Börse in 2005. This proposed takeover failed largely because foreign hedge funds demanded Deutsche Börse pay out its cash reserves to shareholders rather than use the reserves in a takeover bid.\textsuperscript{99}

IV. HEDGE FUND REGULATION IN THE UNITED STATES AND THE UNITED KINGDOM NEEDS SLIGHT MODIFICATIONS, NOT DRASTIC CHANGES

Against this varied regulatory backdrop, the calls for increased regulation of U.S. and U.K. hedge funds come predominantly from countries like Germany, where there are only a few hedge funds. In 2007, Peer Steinbrück, Germany’s finance minister and chair of the G7 Finance Ministers Conference, called for an international code of conduct for the hedge fund industry.\textsuperscript{100} And German chancellor Angela Merkel, in her capacity as G8 President during 2007, stated that hedge fund regulation was at the top of her agenda.\textsuperscript{101} Nevertheless, not all regulators shared this enthusiasm for increased regulation. Indeed, some were unsure of the need for increased scrutiny, and nearly everyone outside Germany favored only indirect supervision of hedge funds.\textsuperscript{102}

However, the recent subprime mortgage crisis, which began in the United States and spread throughout the world, has in some ways vindicated the German calls for increased regulation. Given the interconnected and global nature of the financial markets, Swiss bank UBS wrote off over $3 billion in bad loans stemming from the U.S.

\textsuperscript{98} G. Thomas Sims, \textit{Germany to Introduce Hedge Fund Regulation; Effort Comes Despite Lack of EU Backing}, \textit{INT’L HERALD TRIBUNE}, May 9, 2007, at 15.

\textsuperscript{99} See as short-term speculators, hedge funds flush with cash invested heavily in the German exchange and demanded the exchange pay out its reserves to the shareholders, after which they removed their investment. The hedge funds were also able to block the proposed merger with the British exchange because they had the votes necessary to elect a new board. Carter Dougherty, \textit{Hedge Funds Derailed Deutsche Börse LSE Bid}, \textit{INT’L HERALD TRIBUNE}, Mar. 8, 2005, at 3.

\textsuperscript{100} Somerville, \textit{supra} note 1.


\textsuperscript{102} The Heavy Brigade, \textit{ECONOMIST}, May 26, 2007, at 82. These attitudes have no doubt changed to some degree with developments in the global economic crisis.
subprime mortgage crisis. The near collapse of two major Bear Stearns hedge funds further illustrated the specific effect of the crisis on the hedge fund industry. This near collapse was averted by a $1.6 billion infusion by Bear Stearns, the largest such bailout since LTCM. Another hedge fund in the U.K. also suffered large losses based on exposure to US subprime mortgages. At the same time, hedge funds have thus far not been involved in the public bailout of financial institutions such as Fannie Mae and AIG by the U.S. government. Hedge funds would seem to be unlikely bailout subjects, perhaps because hedge fund managers understand that any bailout funds would be accompanied by increased regulation, or because it would be politically unpopular to bail out this secretive industry. However, those in favor of regulation, such as German finance minister Peer Steinbrück, claim that the overall subprime mortgage crisis has vindicated the minority view in favor of increased global regulation of hedge funds.

Even if the recent market turbulence has shown a need for more supervision, no consensus exists about how to proceed. In general, any current and future regulation must focus on two main areas: (1) protection for investors, and (2) prevention of harm to domestic and global financial systems. In Germany, calls for increased regulation embody a third factor: protection of domestic corporations from takeover and other activist shareholder tactics used by foreign hedge funds. Given these concerns, this paper now examines these three factors—investor protection, market stability, and Germany’s domestic issue—to see whether the subprime mortgage crisis has in

103. Singer et al., supra note 3.
104. Davies et al., supra note 8.
105. Id.
109. Sims, supra note 98.
fact vindicated Germany’s calls for more regulation. Ultimately, the subprime mortgage crisis has not presented sufficient cause for concern to warrant specifically targeting hedge funds for increased regulation to protect investors and preserve market stability and market confidence. And the United States and United Kingdom are unlikely to adopt measures to address the German fear of aggressive hedge fund behavior causing trouble in U.S. and U.K. companies.

A. Investor Protection -- Limiting Unregulated Funds to Sophisticated Investors

The U.S. and U.K. approach is to limit investment in private unregulated hedge funds to a limited number of sophisticated investors who can fend for themselves.\textsuperscript{110} Wealthy individuals can invest because they are either independently financially sophisticated or have access to a professional financial advisor. Institutional investors such as investment banks can invest because they are required by the nature of their business to be financially sophisticated.\textsuperscript{111} This characterization is especially significant because more and more the underlying hedge fund investors are not individuals but rather investment banks and pension plans.\textsuperscript{112} Where hedge funds are available publicly to retail investors, the regulation is greater. Regulators in the United Kingdom are working on allowing the offering of investment funds consisting of hedge funds to the retail public, even though the underlying hedge funds are not regulated by Britain and located offshore.\textsuperscript{113} This step would allow individual investors access to the higher returns hedge funds offer.

\textsuperscript{110} See SHARTSIS FRIESE LLP, supra note 10, §§ 5.3.1.i, 5.3.2.iv, at 124–25.

\textsuperscript{111} This is not to say that individual investors are not implicated. For example, an institutional investor, such as a pension plan that invests in hedge funds, is still dependent on individual investors and pensioners for their capital. But the institutional investor has sophisticated professionals managing the investment. And, more importantly, they have a larger source of capital than an individual investor and can thus invest in many different types of assets of varying risk and liquidity in order to offset any potential risk from the hedge fund investment.

\textsuperscript{112} FSA 2005 DP, supra note 9, at 13. On the other hand, there have been cases where very sophisticated financial professionals have lost huge sums of money. Most notably, in 1994 the Orange County, California treasurer, Robert Citron, announced losses of $1.5 billion after investing county funds aggressively in inverse floaters. Although this strategy had worked successfully for fifteen years, it turned disastrous as interest rates rose, and the county was eventually forced to declare bankruptcy. \textit{But see} Saul S. Cohen, \textit{The Challenge of Derivatives}, 63 \textit{FORDHAM L. REV.} 1993, 1994 n.6, 2007–08 n.73 (1995).

\textsuperscript{113} Christine Seib, \textit{Regulator Makes Funds of Hedge Funds Available to Retail Investors}, \textit{TIMES} (U.K.), Mar. 28, 2007, at 54.
However, to make up for the lack of regulation imposed on the underlying hedge fund, the fund managers of the top-level fund must be domiciled in the United Kingdom and subject to FSA registration and supervision, as discussed above in Part III.B.1.\textsuperscript{114} This two-tiered approach, treating public and private hedge funds differently, is not unique to hedge funds. In the United States, securities that are privately placed are not subject to registration.\textsuperscript{115} Although the United States does not allow public hedge funds, it generally recognizes that private and public offerings are different by not requiring private hedge funds to register.

In contrast, the German approach looks more at the hedge fund’s activities when considering appropriate regulations. Although there is no specific sophistication requirement for investors, the private placement of single hedge funds requires that investors be either institutions or wealthy individuals.\textsuperscript{116} The BaFin requires registration of all hedge funds and, in the case of investment funds consisting of hedge funds, looks at the regulation of the underlying hedge funds.\textsuperscript{117}

There are some differences in Germany between public and private hedge funds. While public hedge funds can be distributed to the public, private hedge funds can only be distributed through private placements. Private funds also have fewer restrictions on their activities.\textsuperscript{118} However, by requiring all hedge funds to be registered and looking at the activities of all hedge funds, the BaFin more heavily regulates hedge funds, both public and private, than either the United States or the United Kingdom. The two-tiered approach of differentiating between public and private hedge funds is maintained in Germany, but the overall scheme of regulation is simply more comprehensive than in the United States and United Kingdom.

Having defined the respective positions of the United States, the United Kingdom and Germany, and in light of the recent global economic crisis, the question then becomes: Is the overall scheme of

\begin{itemize}
  \item \textsuperscript{114} FSA, WIDER-RANGE RETAIL INVESTMENT PRODUCTS: CONSUMER PROTECTION IN A RAPIDLY CHANGING WORLD – FEEDBACK ON DP 05/3, at 13 (2006), available at http://www.fsa.gov.uk/pubs/discussion/fs06_03.pdf.
  \item \textsuperscript{116} See FRESHFIELDS, supra note 87.
  \item \textsuperscript{117} PWC 2007 Report, supra note 25. With foreign funds of hedge funds, BaFin looks to see if the home state regulation is adequate and requires the home state regulator to cooperate with BaFin. \textit{Id}.
  \item \textsuperscript{118} FRESHFIELDS, supra note 87.
\end{itemize}
regulation aimed at investor protection in the United States and the United Kingdom sufficient, or should it be increased toward the level of German regulation? There are several important reasons to resist the pressure for increased regulation. These include the following: (1) the negative effect of such regulation on the size and vibrancy of the hedge fund market, (2) the collateral disruption of current statutory schemes, (3) the already existing strong measures to protect against fraud in the industry, (4) the availability of better valuation principles for the United States to adopt in addressing valuation issues in the hedge fund industry, (5) the voluntary and inherently risky nature of financial investments, (6) the destruction of profitability through invasive regulation of common hedge fund strategies, and (7) the decreased effectiveness that would follow from full disclosure requirements. To fully protect investors from any remaining risks, the United States and United Kingdom can simply update their definitions of a qualified investor to ensure that hedge fund investors are truly able to fend for themselves.

1. Increased regulation negatively affects the size and growth of the hedge fund industry

Increased regulation of hedge funds as in Germany would appear to restrict the size and growth of industry. This was contemplated by FSA regulators in the United Kingdom who grappled with the issue of increased regulation in their 2005 DP. In addressing the evolving risks that hedge funds present, regulators were mindful that too much regulation may cause the hedge fund industry to move to a more lightly regulated jurisdiction.

119. It is surely possible to design a regulatory scheme that represents a compromise between the U.S. and U.K. regulatory schemes on the one hand, and the German regulatory scheme on the other. However, the most vocal calls for regulation of hedge funds seek disclosure and/or limitations on hedge fund strategy similar to ones in Germany or even greater.

120. FSA 2005 DP, supra note 9, at 65 (“We recognize the highly mobile and international nature of the hedge fund industry and are conscious that it would not be beneficial if regulatory action caused the hedge fund industry to move to more lightly regulated jurisdictions.”). While the funds themselves are already located offshore in exotic locations such as the Cayman Islands, the fund managers are still mostly located in London and New York. U.S. and U.K. regulators are thus aware and mindful that the managers may follow their funds offshore to the Cayman Islands or elsewhere. One such example of this flight to less regulation is Krom River, an $810 million commodities fund that shifted its offices from London to Switzerland in 2008 because Switzerland recently reformed its tax laws to attract more hedge funds. See James MacKintosh, *Krom Drawn to Switzerland by Lower Taxes and Lifestyle*, FIN. TIMES (U.K.), Sep. 8, 2008, at 19. London and New York have other
conclusion. London is second only to New York for location of hedge fund managers. Meanwhile, Germany remains a small market, drawing few hedge funds or hedge fund managers. In addition, the hedge fund industry provides important revenues for investment banks acting as the prime broker. This development is especially important in the case of London and New York, home to many of the world’s largest investment banks.

2. Increased regulation would disrupt current statutory frameworks

Besides the practical economic benefits of having hedge funds or hedge fund managers located domestically, important statutory reasons exist for resisting increased regulation of hedge funds. In the United States, the two-tiered approach to public and private securities, with respect to registration and disclosure requirements, exists for all securities. To carve out an exception for hedge funds would undermine the general scheme already in place, largely unchanged since the Great Depression. Updating the definition of a sophisticated investor to keep pace with inflation is worthwhile; however, to require disclosure and registration even when sophisticated investors are involved would be to say that no investors can fend for themselves. It seems unlikely that the SEC would take this approach, given its far-reaching implications. In addition to undermining the sophisticated investor exception, increased hedge fund regulation ignores the fact that hedge fund investment strategies, such as leveraging and short sales, are legal and, if

benefits to hedge fund managers besides a favorable regulatory structure, including access to a large potential client base and investment banks to act as prime brokers. However, too many changes in the regulatory structure may prompt managers to leave despite these other benefits, as was the case in the Krom River example.

121. FSA, Hedge Funds: A Discussion of Risk and Regulatory Engagement – Feedback on DP 05/4, at 3 (2006) (on file with author) [hereinafter FSA Feedback to 2005 DP].
122. Id., Gray, supra note 95.
123. FSA Feedback to 2005 DP, supra note 121, at 14.
125. An accredited investor is defined by net worth or income, but the numbers have not been updated since 1982 when they were initially set. See supra note 40.
126. The underlying theme of investor protection in the United States, as articulated in SEC v. Ralston Purina Co. and section 4(2) of the Securities Act, is that sophisticated investors can fend for themselves and thus are not in need of statutory protection. See discussion supra Part III.A.2 and note 37.
executed properly, can be good investment strategies when undertaken by individual investors.

3. Fraud in hedge funds is a valid concern, but already strongly addressed

Admittedly, because hedge funds often do not disclose their holdings, potential for fraudulent activity exists. Nevertheless, this is one area where all the regulatory agencies have taken a strong stand. In February 2006, the FSA fined Phillippe Jabre 750,000 GBP for insider trading while at a London-based hedge fund. In March 2007, the SEC charged fourteen Wall Street financial and legal professionals, including hedge fund managers, with insider trading. Although it would seem difficult to catch insider trading involving hedge funds because of the secrecy of their holdings, such schemes often involve outside parties. In the above March 2007 scheme, the insiders stole information from their own companies, Morgan Stanley and UBS, and passed it on to hedge fund managers. Thus, SEC and FSA regulators will likely be able to uncover instances of insider trading within hedge funds by looking for outside evidence of insiders stealing and sharing information, as in other cases of insider trading.

4. Valuation problems and available principled remedies

Another area of concern relating to investor protection is the difficulty in valuing many of the assets hedge funds invest in. For example, hedge funds using short sales have difficulty in valuing any gains or losses on such holdings. Unlike insider trading, no outside parties are involved, and thus the valuation of the hedge funds’ holdings is largely at the discretion of the hedge fund manager. Potential exists for both honest miscalculation as well as outright fraudulent valuation.

Compounding matters, hedge fund managers are paid in relation to the value of the holdings. This provides further incentive to

129. Id. Insiders provided information to hedge funds about UBS-analyst upgrades and downgrades ahead of their public release and information about corporate acquisitions involving Morgan Stanley’s investment bank clients. Id.
misrepresent the value of their holdings. Typically, hedge fund managers charge management fees that correspond solely to the amount of holdings under management, as well as performance-based fees that correspond to investment returns. In both cases, incentives exist for the manager to misstate or misrepresent the value of the holdings in order to receive higher fees.

While the SEC acknowledges this problem exists, and is inherent in hedge funds alone, it offers no solution. Conversely, the FSA has announced support for valuation standards for hedge funds adopted by the International Organization of Securities Commission (IOSCO). Although these standards only become binding if a national securities regulatory agency adopts them, they represent a step in the right direction. Currently the IOSCO principles are primarily directed at investors, who are advised to remain vigilant against hedge funds that value assets in violation of these principles. Further cooperation among the various securities regulatory agencies across the globe is necessary to achieve an international standard for hedge fund asset valuation. An international standard is necessary, whether the IOSCO principles or something else, because hedge funds have become so global in their structure. In addition, such international standards of valuation are not major changes that would change the investment tactics or disclosure obligations of hedge funds, thus avoiding much opposition from the hedge funds themselves.

5. Investment is voluntary and inherently risky

Difficulties in valuing unconventional investment strategies, such as short sales, are unique to hedge funds, because other professionally managed investment pools, such as mutual funds, only use conventional investment strategies. Nevertheless, the risk of loss is common to all speculation in the financial markets, whether the

130. Hedge funds typically charge fees of 2% of the assets under management and 20% of the gains, if any, above a predetermined benchmark. SEC 2003 Report, supra note 9, at 61; FSA 2005 DP, supra note 9, at 10.
131. Donaldson, supra note 20 (noting that because they have unique investments such as short sale positions, which are not valued by market, managers may be creative in valuing them).
speculation is done individually or by a professional manager.\textsuperscript{133} Furthermore, such speculation is completely voluntary and the risk of loss is generally proportional to the potential for gain. The U.S. statutory scheme reflects the policy view that investment in the financial markets is voluntary and inherently risky. The protections provided by the 1933 Securities Act and 1934 Securities Exchange Act are minimal, only providing the investor with the information necessary to make informed decisions.\textsuperscript{134}

While hedge funds are risky investments, perhaps among the riskiest, they still fit within the risk versus reward relationship fundamental to all of financial economics. The recent subprime mortgage crisis that has spread throughout the financial community further reinforces the riskiness of investment, even in traditional, more regulated institutions. In the United Kingdom, the Northern Rock bank required £3 billion in a bailout from the Bank of England after suffering heavy losses based on subprime mortgages from the United States.\textsuperscript{135} Although Northern Rock had enough assets on hand to cover its liabilities, the resulting losses caused a credit squeeze when other banks became nervous.\textsuperscript{136} However, it should be noted that the most staggering losses in this subprime mortgage crisis were by investments banks with more traditional and regulated investments, such as Citibank and UBS, rather than hedge funds.\textsuperscript{137}

\textsuperscript{133} In fact, the relationship between risk and reward (i.e., that reward is a positive function of a security’s risk) is fundamental to all of financial economics. Edward S. Adams & David E. Runkle, \textit{Solving a Profound Flaw in Fraud-on-the-Market Theory: Utilizing a Derivative of Arbitrage Pricing Theory to Measure Rule 10b-5 Damages}, 145 U. PA. L. REV. 1097, 1113 (1997).

\textsuperscript{134} Through its registration requirement, the SEC insures that investors receive financial and other significant information when securities are publicly offered for sale. Securities Act of 1933 § 7, 15 U.S.C. § 77g (2000); Moreover, the SEC protects investors from misrepresentation, fraudulent or deceitful action in connection with the purchase or sale of a security. 17 C.F.R. § 240.10b-5 (1948). Thus, an investor merely receives information needed to make their own valuation of the security and determine whether the security was worth investing in. Losses are only returned to the investor to the extent the investor can show the loss resulted from fraud.

\textsuperscript{135} Chris Giles et al., \textit{£3bn Lent to Northern Rock}, FIN. TIMES (U.K.), Sep. 22, 2007, at 1.


\textsuperscript{137} Reilly & Taylor, \textit{supra} note 3; Singer et al., \textit{supra} note 3.
6. Limiting investment strategies would destroy profitability

The most comprehensive regulatory scheme that would ensure maximum investor protection would be to directly regulate hedge funds by examining and perhaps limiting their investment strategies. Currently, the regulatory scheme in Germany regulates hedge funds in such a direct way. Investment funds consisting of domestic and foreign hedge funds are limited in their use of investment strategies, such as leveraging and short sales.\textsuperscript{138} German funds that are registered, however, are not limited in their use of leveraging and short selling, but are limited in their use of private equity.\textsuperscript{139} Such invasive regulation may protect investors by limiting the riskiness of hedge funds, but it also destroys what makes hedge funds uniquely attractive and profitable investments. While hedge funds were late to arrive in Germany, the strict regulation imposed on them by the German government partly explains their lack of success.

7. Full disclosure reduces the effectiveness of hedge funds

Although requiring hedge funds to disclose the full extent of their holdings would improve investor protection, it would also limit hedge funds’ investment strategies and effectiveness. Supreme Court Justice Louis Brandeis once wrote that “[s]unlight is said to be the best of disinfectants,”\textsuperscript{140} and in this respect disclosure of hedge funds’ holdings might protect investors from excessively risky investment and/or fraudulent activities. Understandably, hedge funds managers are vehemently opposed to any disclosure of their holdings. In the United States, managers such as Phillip Goldstein, who successfully challenged the SEC’s 2004 registration rule, are opposed to any disclosure, even claiming their portfolio amounts to “intellectual property.”\textsuperscript{141} There is even some speculation that LTCM’s collapse can be explained in part by the rise of copy-cat hedge funds with similar quantitative investment models going after the same investments as LTCM, thus reducing their profitability and forcing LTCM to make newer, riskier investments.\textsuperscript{142}

Because too much money chasing the same investments reduces

\textsuperscript{138} See supra notes 91–93 and accompanying text.

\textsuperscript{139} See supra text accompanying note 94.

\textsuperscript{140} D. BRANDEIS, OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT 92 (1914).

\textsuperscript{141} Scannell, supra note 59.

\textsuperscript{142} See generally LOWENSTEIN, supra note 7.
the profitability of the investments, professionally managed investment pools, such as hedge funds, desire secrecy.\textsuperscript{143} Requiring full disclosure of hedge funds’ holdings would allow any individual investor to copy the hedge funds’ investment strategy, and make the same investments without paying any fees to the professional manager who devised the strategy.\textsuperscript{144} Furthermore, because more investors are making the same investments, the investment becomes less profitable for the hedge fund. Finally, public disclosure of the holdings and strategies of a highly profitable investment vehicle might encourage amateur investors to undertake risky strategies, learned from the disclosure, about which they understand very little, and without the benefit of professional managers to protect and minimize the risk. Thus, any gains in investor protection from increased disclosure are offset by losses in profitability\textsuperscript{145} for hedge funds and potential harm from amateur individual investors undertaking risky strategies. While the policy of favoring profitability over investor protection may seem politically unpopular, regulators should remember that profitability is what draws sophisticated investors to hedge funds.

\textbf{8. Update the definition of qualified investor to ensure adequate protection}

The end result of increased regulation of the types described above would be that hedge funds in their current form would likely cease to exist or move to jurisdictions that regulate more favorably. At the same time, however, a further examination of requirements to

\textsuperscript{143} There may be situations where an investment’s success depends on the market’s participation in the investment, but hedge funds can solve this problem through appropriate publicity. More often, a hedge fund will desire secrecy because otherwise the market’s participation will drive the price up (or down, depending on the strategy), reducing potential profits. Put another way, hedge funds often operate on arbitrage principles, seeking to capitalize on the market’s inefficiencies. These inefficiencies are often minor, and participation by other investors may correct these inefficiencies and reduce the hedge funds’ potential profit. The problem of too much capital chasing investments often occurs when interest rates set by central banks are low, thus making available too much cheap capital for investment. See Floyd Norris, \textit{Too Much Capital: Why It Is Getting Harder to Find a Good Investment}, N.Y. TIMES, Mar. 25, 2005, at C1.

\textsuperscript{144} While mutual funds and other investment vehicles are more transparent and disclose their positions to the public, they are fairly simple and straightforward. By contrast, hedge funds often operate using complex quantitative models.

\textsuperscript{145} The transaction costs of increased disclosure have made German hedge funds more expensive than their U.S. and U.K. counterparts, thereby reducing their profitability. See Steward, \textit{supra} note 96.
be an investor in a hedge fund in the United States and the United Kingdom is necessary to limit investment to those investors who are actually qualified to fend for themselves. Currently, in the United States, a qualified investor in a §3(c)(7) hedge fund must have investments worth $5 million. In the United Kingdom, a private party may be “opted-up” and categorized as an intermediary, allowing them to purchase unregulated securities. This process requires a regulated firm to inquire into the private parties’ financial sophistication to determine their ability to understand the investment.

Raising these requirements and making it more difficult for private parties to invest would shift investment in hedge funds to primarily institutional investors such as investment banks and pension funds, or even investment funds of hedge funds. Such institutional investors ultimately benefit the same underlying consumers, who instead of investing directly with the hedge fund, invest with the investment bank, who may in turn invest in a variety of hedge funds and other investments. The underlying investors receive the benefit of another layer of financially sophisticated analysts and advisors to manage the investment. In reality, this shift has largely already begun, with individuals making up an increasingly smaller percentage of the capital source for hedge funds, and pensions and other institutional investors making up an increasingly larger percentage. But regulators should resist more invasive efforts to regulate hedge fund strategies or impose full disclosure requirements.

B. Market Stability and Market Confidence -- More Valid Concerns

While the United States seems focused on investor protection, as evidenced by its SEC 2004 Rule and its lack of action after LTCM, market stability is perhaps the bigger concern with regard to hedge funds. In the United Kingdom, the most recent discussion paper by the FSA largely focused on the ways in which hedge funds threaten financial stability and market confidence. In Germany, regulators such as Peer Steinbrück fear that hedge fund losses could spread, one
by one, to other counterparties, much like domino blocks.151 While Germany shares the FSA’s concerns regarding market stability and confidence, they have not articulated these concerns as clearly as the FSA. For this reason, the following will mostly focus on the FSA’s 2005 DP, as it applies to the global hedge fund industry. In general, what contributes most to regulators fears about market stability are hedge funds’ lack of transparency regarding their investments and their use of highly leveraged investments, which magnify their losses or gains. While hedge funds do put market stability and market confidence at some risk, they do not present any more risk than larger, more conventional financial parties, especially when those parties are engaged in risky behavior and unsound practices, as was the case in the recent global financial crisis.

1. Market stability

The first fear articulated by the FSA in the 2005 DP, is the fear that a large, highly leveraged fund with heavy losses will lead to market instability.152 Such a fear is best exemplified by the losses on the scale of LTCM in 1998 and Amaranth Advisors in 2006, both requiring an industry-wide bailout.153 Early on in the more recent subprime mortgage crisis, German finance minister Peer Steinbrück felt the crisis vindicated his earlier advocacy of further hedge fund regulation.154 Perhaps Steinbrück felt heavy losses by hedge funds on the scale of LTCM were imminent or that the crisis illustrated the great potential for such losses. Thus far, however, no such large losses occurred relating to hedge funds on the scale of LTCM.155 After LTCM and Amaranth Advisors, the SEC did not address the issue of market stability, perhaps viewing such occurrences as isolated and rare. Or perhaps more importantly, the government still feels that the risk of hedge fund leveraging causing a domino effect in the

151. Somerville, supra note 1.
152. FSA 2005 DP, supra note 9, at 20 (discussing the risk of hedge funds to market stability primarily through the impact on counterparties and overall market confidence).
153. Amaranth Advisors lost $6.6 billion on energy trading in 2006 and required a bailout by a third party that included Citadel Investment and JPMorgan Chase. Although Amaranth’s overall losses were larger than LTCM’s, the threat to the financial market was not as great. Gretchen Morgenson & Jenny Anderson, A Hedge Fund’s Loss Rattles Nerves, N.Y. TIMES, Sep. 19, 2006, at C1.
155. See supra note 54.
financial system is best guarded against by the hedge funds’ counterparties. In other words, the prime brokers that provide hedge funds credit should police hedge funds to ensure they do not borrow too much.

While there have been no major hedge fund losses relating to subprime mortgages on the scale of LTCM, there have been some smaller losses. Two Bear Stearn hedge funds, as well as the London-based Cheyne Capital hedge fund, are notable examples of hedge funds with large losses on subprime mortgage investments. Nevertheless, neither the Bear Stearn funds nor the Cheyne Capital fund required outside intervention from others in the industry or from the government, as was the case with LTCM.

Additionally, the FSA already acknowledges that such large losses are rare and isolated, and that it is instead more likely that a cluster of medium-sized funds making the same incorrect investments will lead to market instability. The primary reason the FSA believes that a cluster of medium funds poses a greater risk is that they may have common strategies and collective losses; and, if those common strategies fail, their losses may equal or exceed the losses of one large fund such as LTCM. In the 2005 DP, the FSA examined one such occurrence, noting that a credit rating downgrade of General Motors and Ford led to similar losses in a number of hedge funds and their counterparties. The FSA argued that larger losses were not felt, and a financial crisis did not develop, because risk management by the funds themselves, as well as their counterparties, had improved.

In the subprime mortgage crisis, hedge fund losses were similarly minimal. And although a financial crisis did develop, it is attributable more to other financial parties and to the lending practices of the institutions issuing underlying mortgages than to the strategies

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156. See supra note 46.
157. See supra note 46.
158. Davies et al., supra note 8; Lindsay, supra note 106.
159. FSA 2005 DP, supra note 9, at 20.
160. Id.
161. Id.
162. One area of constant systemic risk observed by the FSA involves the usual hedge fund practice of using multiple prime brokers. Although the margin arrangement of a hedge fund may be adequate for one broker, the hedge fund may split their illiquid position among multiple prime brokers who are unaware of the others’ role. Id. at 21.
employed by hedge funds. A return of volatility or uncertainty to the financial markets arguably provided new opportunities for hedge funds. Hedge funds’ structure and strategies allow them to benefit during such unstable and turbulent times. Hedge funds can use short sales, they can invest in unique and exotic derivative financial products, and they can hedge their bets in one investment with bets in other investments. A well-run hedge fund is diversified, flexible, and prepared for financial crisis through hedged investment positions. Since hedge funds have many investment options, and because they are not transparent in their holdings, it is highly unlikely that many hedge funds will have the exact same holdings. Although many hedge funds had similar losses on subprime mortgage based investments, the losses revealed that, in fact, different hedge funds had different investments.

Regulators in the United States are focused on the underlying assets, the subprime mortgages and the lending practices involved, as candidates for new regulation. Although some hedge funds had poor strategies, in that they had too much invested in one type of subprime mortgages or did not properly hedge their bets, problems with the underlying assets is what ultimately caused the large losses.

2. Market confidence

After addressing issues with market stability in the 2005 DP, the FSA regulators next addressed investors’ confidence in financial markets, which may decrease after significant financial events, such as the collapse or near collapse of a large hedge fund. In fact, the impact on market confidence may be greater than the actual losses of the hedge fund. The losses and the subsequent investor fallout from the bad news may lead to liquidity problems as investors seek to exit their investments, and banks may become reluctant to lend, causing general chaos in the financial markets. FSA regulators pointed out that these liquidity problems can spread throughout the financial

163. Some of the new rules for lenders proposed by the Federal Reserve include prohibiting a lender from lending without considering the buyer’s “ability to pay from sources other than the home’s value,” and prohibiting a lender from relying on a buyer’s income that has not been verified. Damian Paletta & James R. Hagerty, Fed’s New Rules on Mortgages Draw Hostility, WALL ST. J., Dec. 19, 2007, at A1.

164. FSA 2005 DP, supra note 9, at 27. Liquidity is the ability of group, business or organization to meet its financial obligations. Often the ratio of current assets to current liabilities is a measure of liquidity. However, there is no specific ratio that indicates a firm is no longer liquid, and what is considered dangerously illiquid has changed over time and from place to place. GREENWALD ET AL., supra note 10, at 341–42.
markets, causing great harm, because losses often spread to counterparties as well. For example, more hedge fund capital is coming from investment funds consisting of hedge funds, and the failure of one hedge fund may lead to the withdrawal of capital from other funds, causing a domino effect.\footnote{165 \textit{FSA 2005 DP}, \textit{supra} note 9, at 22.}

Additionally, different hedge funds with similar strategies and risk management models could all choose to exit the same position at the same time, thereby causing liquidity problems.\footnote{166 Id. at 30.} Moreover, a hedge fund’s source of leverage may also dry up, as a prime broker may be obliged to withdraw capital to cover its own exposures right at the time capital is most needed for the hedge fund.\footnote{167 Id. at 31 (advocating primarily against reliance on one prime broker as a protection against such a liquidity problem).} Hedge funds are increasingly seen as the vanguard of market developments because they are able to quickly respond to market changes. As such, other investment vehicles may be likely to follow hedge funds, worsening any market-wide liquidity problems.\footnote{168 Id. at 27.}

The potential for losses throughout the financial community as a result of a hedge fund’s collapse or near collapse is great, but such ripple effects are hardly unique to hedge funds. The current subprime mortgage crisis has exacerbated liquidity issues, as evidenced by the U.K.-based Northern Rock bank requiring a government bailout after liquidity dried up. But this liquidity crisis cannot be attributed to one particular type of financial institution or device, such as hedge funds.\footnote{169 See Giles et al., \textit{supra} note 135; Reilly & Taylor, \textit{supra} note 3; Singer et al., \textit{supra} note 3.} In addition, the FSA has assessed the risk of such a domino effect—where there are large losses when many hedge funds exit an investment at the same time—as relatively low.\footnote{170 \textit{FSA 2005 DP}, \textit{supra} note 9, at 36.} Hedge funds have such a wide variety of risk management plans and strategies that it is unlikely they will all exit an investment at the same time.

Finally, just as diversification of investments is useful, the FSA also warned against relying too much on a single prime broker, or on a small number of institutional investors, as liquidity problems may arise.\footnote{171 Id. at 31–32.} Diversification, in many forms, is thus an effective tactic to
minimize the impact of bad news on the hedge fund industry and, by extension, the broader financial system.

3. Other proposals relating to market stability and market confidence

The FSA seems focused on open dialogue with the hedge fund industry and understanding how the industry works. To that end, the FSA has conducted a ‘hedge funds as counterparties’ survey to better understand the relationship between hedge funds and prime brokers, identify highly leveraged funds, and gauge the risk tolerance of the parties involved.\(^{172}\) This survey is similar in purpose to the failed SEC 2004 Rule in the United States, which required registration of hedge funds, primarily so the SEC could gather information about how hedge funds operated.\(^{173}\)

Another proposal by the FSA focused on surveying prime brokers to identify hedge funds with multiple prime brokers, enabling prime brokers to determine the full extent to which a hedge fund is leveraged.\(^{174}\) This survey is particularly important because hedge funds increasingly use more than one prime broker to minimize the risk of their operating capital being withdrawn, and prime brokers may not be know the extent of the involvement of other prime brokers.

In addition to the efforts by national regulators to understand and regulate hedge funds, the international community has become aware of the increasingly global nature of hedge funds and has accordingly made some recommendations. In 2000, the Financial Stability Forum (FSF) met and made recommendations for regulators on how to approach hedge funds—or, as the FSF called them, “Highly Leveraged Institutions.”\(^{175}\) The FSF recommendations, including better counterparty risk management and better disclosure requirements, were not new. However, they represented a global approach to hedge funds, recognizing the

\(^{172}\) See id. at 24.

\(^{173}\) SEC 2004 Rule, supra note 48, § 2A (“Requiring hedge fund advisers to register under the Advisers Act will give us the ability to oversee hedge fund advisers without imposing burdens on the legitimate investment activities of hedge funds.”).

\(^{174}\) FSA Feedback to 2005 DP, supra note 121, at 31.

\(^{175}\) See generally FINANCIAL STABILITY FORUM, REPORT OF THE WORKING GROUP ON HIGHLY LEVERAGED INSTITUTIONS (2000), available at http://www.fsforum.org/publications/r_0004a.pdf. The FSF is an international forum seeking to maximize financial stability and is composed of senior officials from national finance authorities, such as central banks, as well as international financial, regulatory and supervisory institutions.
interconnected nature of the global finance community and the potential for a domino-like effect as losses spread. Such cooperation is necessary because a strong approach in one nation, such as in Germany, merely leads to hedge funds avoiding such a nation, opting instead for jurisdictions with more favorable regulatory schemes.

C. Germany’s Principal Problem -- Domestic Concern over Foreign Takeovers

Although Germany is fearful of risks that hedge funds present to global market stability, another main concern is largely domestic. Fear of 1980s-style corporate raiding and hostile corporate takeovers is a driving factor, particularly because hedge funds are characterized in Germany as largely American and British inventions. The failed 2005 takeover of the London Stock Exchange by Deutsche Börse, thwarted by the actions of hedge funds, is an example of this fear realized.176

Germany’s calls for increased regulation, as articulated by Peer Steinbrück, address issues of investor protection and market stability. They do not, however, address this fear of bullying by hedge funds. Instead, there needs to be action by German regulators on the domestic front regarding shareholder advocacy. This concern is separate from the traditional concerns of investor protection and market stability, and can be addressed without invasive regulation of hedge fund investment strategies or disclosure methods. In fact, Germany is already intent on passing a law requiring that hedge funds and other private equity holders of 10% or more of a German company make their intentions clear.177

Similar laws in the United States and the United Kingdom are highly unlikely for two reasons. First, there have been few instances of shareholder activism by hedge funds to the degree seen in the failed Deutsche Börse takeover. Second, the response to the Deutsche Börse situation was largely political. Even though such situations are rare, public outcry from the event was great, fueled by the characterization of hedge funds as locusts from the United States and the United Kingdom that descend upon German companies and

176. See Julia Kollewe, Deutsche Bank Chief Attacked as the ‘Locust’ Stripping Germany Bare, INDEP. (U.K.), May 19, 2005, at 52.
177. See Sims, supra note 98.
strip them bare, costing Germans jobs.\textsuperscript{178} Although this characterization is disputed by the hedge fund industry, even if it were true, the United States and United Kingdom would not likely want to regulate their own creatures.

\textbf{V. WHAT ARE THE CHANCES OF FURTHER REGULATION?}

Even if regulation is not necessary, regulators will sometimes adopt regulations for political reasons to appease the public. In the United States, as noted earlier, new securities regulations often follow major financial crises.\textsuperscript{179} With respect to hedge funds, LTCM provided the best reason for the SEC to change its approach; however, the lukewarm response embodied in the SEC 2004 Rule, if it can in fact be called a response to LTCM, showed that the SEC did not feel compelled to make any significant changes to its regulatory approach. More recently, hedge fund losses in the subprime mortgage crisis were minimal, and in fact hedge funds did well overall in 2007.\textsuperscript{180} Thus, the SEC has no current reason to change its approach. In the future, the failure of multiple large, highly leveraged funds on the scale of LTCM could be the catalyst for new regulation. But such failures have historically been rare and isolated events.

In the United Kingdom, the FSA continues to evolve in its response to hedge funds much more quickly than the SEC in the United States. It instead seems focused on identifying and explaining the key areas of risk to provide hedge funds with the tools necessary to regulate themselves. Although it has studied hedge funds extensively, the FSA is unwilling to either regulate hedge funds’ investment strategies or require more disclosure.\textsuperscript{181} Both the United States and the United Kingdom are mindful of the fact that hedge funds and their managers will seek out jurisdictions with less regulation if their regulation becomes too strict. Having hedge funds and managers located near world financial capitals such as London and New York is beneficial to counterparties, such as prime brokers, and the FSA and SEC are mindful of the cost to their brokers if hedge funds leave.

By contrast, in Germany hedge funds have never been very

\textsuperscript{178} See \textit{id}.

\textsuperscript{179} See supra Part III.A.3.

\textsuperscript{180} See Zuckerman, supra note 18.

\textsuperscript{181} See FSA 2005 DP, supra note 9, at 65.
prevail. For this reason, German regulators can afford to experiment with stricter regulation. While it is much harder to say whether Germany will continue to advocate and practice strict regulation on hedge funds’ investment strategies, in the end it seems irrelevant. Since hedge funds are mostly located elsewhere, they can only advocate that other nations reign in hedge funds more. Since it seems that a significant part of Germany’s motivation for further regulation was a purely domestic concern, other nations may not be willing to regulate hedge funds located in their jurisdiction unless Germany provides a more compelling reason. Regardless, Germany’s regulatory scheme on hedge funds remains an interesting contrast to the much looser regulatory schemes of the United States and the United Kingdom, and the effect of increased regulation on hedge fund development and profitability should be studied further.

VI. CONCLUSION

Hedge funds are an easy target for criticism and blame because they are opaque about their investment strategies, offer a high rate of return, and limit access to large institutional investors or the wealthy. The broad and casual usage of the term “hedge fund” to denote any professionally managed fund that is not available to the general public also contributes to a misunderstanding of what they are and how they work. In Germany, hedge funds are seen as creatures of the United States and the United Kingdom that feed on German companies, stripping them of assets, and costing Germans jobs. The catastrophic failures of highly leveraged funds such as Long Term Capital Management in 1998 and Amaranth Advisors in 2006 further provide detractors with ammunition to attack all hedge funds, irrespective of critical differences from these two extreme examples.

In spite of the critical calls for increased regulation, major changes to the current regulatory scheme in place in the United States and the United Kingdom are not necessary. By requiring hedge funds to limit investment to private parties with the necessary sophistication and wealth to fend for themselves, investor protection is adequate. On the other hand, regulators should keep the definition of a qualified investor current. With regard to market stability and market confidence, the SEC should continue to advocate better risk management by the funds themselves and by their counterparties. To this end, the SEC should issue guidance more frequently to hedge funds and counterparties and establish an
open dialogue with them, much like the FSA does. Finally, hedge fund events that could upset market stability and market confidence are extremely rare and isolated, making them difficult to plan and prepare for—regardless of the preventative regulations put in place.

The effects of a major increase in hedge fund regulation in the United States and United Kingdom would be harmful because increased regulation would likely destroy what makes hedge funds uniquely profitable investments. By requiring disclosure or limiting investment tactics, hedge funds would become less profitable, their ability to bring liquidity to markets would be hindered, and investors seeking alternative investments would be forced to look elsewhere. More likely, hedge funds would simply just leave the United States and United Kingdom and relocate to more favorable jurisdictions, such as the Cayman Islands. The importance of hedge funds to prime brokers located in London and New York underscores the impact hedge funds have on the financial community as a whole.

In the end, it is important to remember that investment is a voluntary and inherently risky venture. Rewards correspond with risk. Hedge funds provide professionally managed pools of investments that satisfy the high-risk and high-reward appetite of certain investors with the sophistication and wealth necessary to understand the consequences of their investment.