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Direct Regulation of Hedge Funds: An Analysis of Hedge Fund Regulation After the Implementation of Title IV of the Dodd-Frank Act

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Direct Regulation of Hedge Funds: An Analysis of Hedge Fund Regulation After the Implementation of Title IV of the Dodd-Frank Act

By: Jacob Johnson[*]

I. Introduction

Title IV of Dodd-Frank was enacted in response to the global financial crisis of 2008 and the political pressure to be proactive and to prevent another financial crisis that followed.[1] However, this note argues that this increase in hedge fund regulation is, in part, unnecessary. Overall, this note will focus on the changes made to the Investment Advisers Act of 1940 ("Advisers Act") by the enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act,* H.R. 4173 2010 ("Dodd-Frank") and the benefits of an indirect regulatory strategy.

II. Hedge Fund Overview

A hedge fund is a private investment pool that is managed by a professional investment firm (also referred to as a "hedge fund manager" or "investment advisor").[2] The ultimate goal of a hedge fund is to provide returns to investors that do not necessarily mirror the returns of traditional stock or bond markets. Hedge funds differ from mutual funds because hedge funds do not seek "relative" returns, meaning hedge funds do not measure their success by comparison to a benchmark such as the S&P 500 stock index.[3] Rather, hedge funds seek "absolute returns," which means they aim to make positive returns regardless of how a certain benchmark is performing by employing a variety of sophisticated trading strategies in

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[1] Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank Act), Pub. L. No. 111-203, §§ 401-416, 124 Stat. 1376, 1571 (2010) (codified as amended at 15 U.S.C. § 80b-3, 15 U.S.C. § 80b-2).

[2] *Hedge Fund*, INVESTOPEDIA, https://www.investopedia.com/terms/h/hedgefund.asp (last visited Mar. 25, 2018).

[3] *Hedge Funds and Dodd-Frank Reform*, MANAGED FUNDS ASS'N., https://www.managedfunds.org/hedge-fund-investors/hedge-fund-advisor/. (Feb. 28, 2018).

securities, currencies and derivatives, amongst others.[4] Additionally, hedge funds are limited to high net worth investors and institutional investors. Therefore, the idea is that the increased regulation of hedge funds is not completely necessary because the sophisticated investors (i.e., institutional investors such as insurance companies, pension funds, banks, and other investment funds) do not need the same level of protection as an ordinary retail investor who may not understand the risks associated with hedge funds.

Throughout the course of this comment the following topics will be discussed in order to explain why the changes imposed by Title IV are unnecessary: (1) risks associated with hedge funds; (2) the Investment Advisers Act of 1940; (3) the failure of Long Term Capital Management and the implications of this failure; (4) an overview of the changes made after Title IV was enacted; (5) the impact of the *Private Fund Investment Advisors Registration Act of 2010* ("PFIARA") on examinations of registered investment advisers; (6) the problems with the current U.S. regulatory scheme; and (7) a possible solution of introducing indirect regulation.

Finally, this note argues that the indirect regulation of hedge funds is superior to the direct regulation of hedge funds exacerbated by Title IV of the Dodd-Frank Act. Mainly, direct regulation of hedge funds has proven to be failure in terms of curbing systemic risk, as can be seen by Long Term Capital Management. The indirect regulation of hedge funds places the regulatory focus on the counterparties of hedge funds in order to achieve the primary goal of regulating hedge funds. Indirect regulation of hedge funds will limit systemic risk because counterparties of hedge funds will be more careful and informed before entering into transactions with hedge funds.

III. RISKS ASSOCIATED WITH HEDGE FUNDS

One of the key risks associated with hedge funds are their speculative trading techniques, which use leverage (borrowed capital or equity for an investment) hoping that the profits made will be greater than the interest paid on the borrowed capital. In general, the use of leverage by a hedge fund is when the hedge fund uses both the investors' capital and the borrowed capital to make investments, which will either greatly increase

[4] Wulf Kaal & Dale Oesterle, *The History of Hedge Fund Regulation in the United States*, THE CLS BLUE SKY BLOG (Feb. 29, 2016), http://clsbluesky.law.columbia.edu/2016/02/29/the-history-of-hedge-fund-regulation-in-the-united-states/.

the potential gain, or greatly increase the potential loss from an investment.[5] Also, unlike mutual funds, hedge funds are allowed to take short positions or sell short. For example, this requires that the hedge fund borrow stock, and if the stock price declines before the hedge funds needs to give back the borrowed stock, the hedge fund makes a profit.[6] However, if the stock price increases the hedge fund must still replace the stock it borrowed and the losses are theoretically unlimited putting the investors at risk. This is a basic example of a speculative trading technique used by hedge funds cause a lot of concern regarding the hedge fund industry.

Further, one of the chief concerns regarding hedge funds is that they are not sufficiently transparent.[7] This concern stems from the fact that prior to the passage of Title IV of Dodd-Frank, many hedge funds qualified to be exempted from complying with the Advisers Act and therefore did not have to disclose their investment strategies or their books and records containing certain positions that some may be view as too risky.[8] The anti-regulation view held by many hedge funds is that without the ability to keep their trading strategies confidential, hedge funds would not be able to generate the massive returns that keep most them business.[9] Also, there are concerns over the level of risk-taking by hedge funds.[10] Hedge funds usually borrow from banks and when a hedge fund's strategy fails the losses are massive not only to the investors of a hedge fund but also for the banks and other lenders.[11] In 2004, as a result of the growth of the hedge fund industry and the risks involved, the SEC determined that hedge fund managers should register under the Advisers Act.[12] To ensure hedge fund managers registered their funds, the SEC adopted a rule requiring investment advisers of hedge funds to "look-through" the fund and counts as clients the fund's investors for purposes of the fifteen-client threshold.[13]

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[5] *Leverage*, INVESTOPEDIA, https://www.investopedia.com/terms/l/leverage.asp (last visited Mar. 25, 2018).

[6] Todd Zaun, *Goldstein v. Securities and Exchange Commission*, 1 J. BUS. ENTREPRENEURSHIP & L. 111, 130 (2007), http://digitalcommons.pepperdine.edu/jbel/vol1/iss1/6.

[7] Kaal & Oesterle, *supra* note 4.

[8] *Id.*

[9] Zaun, *supra*, 111.

[10] *Id* at 113.

[11] Kaal & Oesterle, *supra* note 4.

[12] William Sjostrom, Jr , *Brief History of Hedge Fund Adviser Registration And its Consequences for Private Equity and Venture Capital Advisers*, 1 HARV. L. REV., 39, 40 (Feb. 1, 2011) http://www.hblr.org/2011/02/a-brief-history-of-hedge-fund-adviser-registration-and-its-consequences-for-private-equity-and-venture-capital-advisers/.

[13] *Id.*

This development was significant because prior to this "look-through" rule, only hedge funds managed by the advisor counted as "clients." The specifics of the "look-through" rule commonly referred to as the "hedge fund rule" will be discussed in the section of this note titled, "*Failure of Long Term Capital Management and its Effect on Policy*," which explains the event that initially led the SEC to implement the hedge fund rule.

A. General Reasons Why These Risks Should Not be Left Unregulated Altogether

Some form of regulation is necessary to protect investors in the hedge fund sector. Although hedge fund investors are typically sophisticated and wealthy, they are still in need of protection. Even if an investor has sufficient technical skills to properly assess and value the behavior of their hedge fund manager it is still a nearly impossible task considering that no hedge fund manager discloses the necessary information to investors, which would allow them to monitor the fund's activity.[14] There are also investment companies, referred to as "funds of hedge funds," that focus on investing in other hedge funds.[15] Retail investors are able to buy shares of these funds of hedge funds, which effectively allows retail investors to indirectly invest in hedge funds.[16] In this regard, some form of regulation of hedge funds would indirectly benefit the retail investors who otherwise would not be able to monitor and assess their investments.

IV. THE INVESTMENT ADVISERS ACT OF 1940

Under the Investment Advisers Act of 1940 ("Advisers Act") many hedge fund advisers did not have to register their funds with the Securities and Exchange Commission ("SEC") because of the private adviser exemption.[17] This exemption applied to an investment adviser who: (1) had fewer than fifteen clients during the previous twelve months (small adviser exemption), (2) did not publicly hold itself out as an investment adviser, and (3) did not advise registered investment companies.[18] An "investment adviser" as defined by section 202(a)(11) of the Advisers Act

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[14] Marco Bodellini, *From Systemic Risk to Financial Scandals: The Shortcomings of U.S. Hedge Funds Regulation,* 11 BROOK. J. CORP. & COM. L. 417, 447 (2017).
[15] Matthew Lewis, *A Transatlantic Dilemma: A Comparative Review of America and British Hedge Fund Regulation,* 22 Emory Int'l L. Rev. 347, 358 (2008).
[16] Bodellini, *supra* note 14, at 448.
[17] Sjostrom, *supra* note 12, at 39..
[18] *Id.* Investment Advisers Act of 1940 (54 Stat. 847, 15 U.S.C. 80b-1 - 80b-2)

defines an investment advisor as any person or firm that: (1) for compensation; (2) is engaged in the business of; (3) providing advice to others or issuing reports or analyses regarding securities.[19] The phrase "for compensation" refers to the adviser receiving some sort of fee or commission for his or her services.[20] A person "engaged in the business" simply means that the person is providing some sort of investment advice regarding securities such as stocks, bonds, other funds, etc.[21]

Under the Advisers Act and prior to the passage of Title IV of Dodd-Frank, investment advisers, such as hedge fund managers, were able to qualify for the private adviser exemption even though their fund had more than fifteen investors because they only had to count as clients the funds they advised and not the individual investors in the fund. [22] In other words, hedge fund managers only counted entire hedge funds as clients as opposed to counting the individuals who have invested money within the hedge funds. This often allowed investment advisers to avoid registering with the SEC, which in turn allowed them to avoid the various provisions of the Advisers Act.[23] Investment advisers were therefore able to avoid provisions of the Advisers Act such as the requirement to disclose certain information to clients, maintain business records, allow the SEC to examine these books and records,[24] and make certain periodic filings with the SEC.

V. FAILURE OF LONG TERM CAPITAL MANAGEMENT AND ITS EFFECT ON POLICY

One of the reasons the SEC wanted to increase hedge fund regulation was because of the collapse of the hedge fund, Long Term Capital Management, L.P. ("LTCM") in 1998.[25] LTCM had lost $4.4 billion of its $4.7 billion in capital, which not only hurt the investors of the fund, but exposed America's largest investment banks to over $1 trillion in default risks due to excessive leverage and risky trading strategies.[26] LCTM used

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[19] 15 U.S.C.S. § 80b-2(a)(11)
[20] *SEC v. Fife*, 311 F.3d 1 (1st Cir. 2002).
[21] *Id.* at 3.
[22] Sjostrom, *supra* note 12, at 39.
[23] *Id.*
[24] *Id.*
[25] Todd Zaun, *Goldstein v. Securities and Exchange Commission*, 1 PEPPERDINE J. BUS. ENTREPRENEURSHIP & L. 110, 118 (Nov. 11, 2007)..
[26] Stephanie Yang, *The Epic Story of How a 'Genius' Hedge Fund Almost Caused a Global Financial Meltdown*, BUS. INSIDER (Jul. 10, 2014, 4:26 PM), http://www.businessinsider.com/the-fall-of-long-term-capital-management-2014-

massive amounts of leverage to pursue its investment goals.[27] LTCM was known to be extremely secretive regarding its operations and the general partners withheld information about the strategies they were employing, which frustrated the numerous banks the hedge fund was working with because they were in the dark regarding how the capital they were lending was being put to use.[28]

One of LTCM's investment strategies was to hedge against a predictable range of volatility in foreign currencies and bonds.[29] Eventually, Russia devalued its currency and defaulted on its bonds, a risk event that registered outside of LTCM's statistical models had estimated.[30] Later, the U.S. and European markets dropped significantly and investors across the U.S. and Europe frantically sought security in Treasury bonds, which then caused long-term interest rates to decrease by a full point.[31] As a result, LTCM took devastating losses and had ended up losing 50% of the value of its capital invests. Eventually, the investment banks and other creditors who had extended credit to LTCM realized that the fund might default, which would likely result in negatively affecting the global financial market.[32] In order to avoid a global financial crisis, the Federal Reserve and about fifteen other prominent banks bailed out LTCM by investing $3.65 billion in exchange for 90% of the firm's equity, which left existing shareholder with a mere 10% holding.[33]

It was this example of the misuse of leverage by LTCM that led the SEC to create new registration requirements for hedge funds. According to the Advisers Act, the SEC had the ability change or remove rules and requirements relating to the regulation of hedge funds.[34] Therefore, on October 26, 2004, the SEC voted to modify the small advisers exemption portion of the Advisers Act.[35] Under the new rule, "hedge fund managers

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7?op=1/#riweather-set-up-his-own-hedge-fund-for-arbitrage-using-mathematical-models-to-predict-prices-stocked-with-industry-veterans-and-respected-academics-the-firm-launched-in-1994-with-125-billion-in-capital-2.

27 Zaun, *supra* note 25 at 119.

28 Yang, *supra* note 26.

29 Kimberly Amadeo, *What was the Long-Term Capital Management Hedge Fund Crisis?*, THE BALANCE (Aug. 12, 2017), https://www.thebalance.com/long-term-capital-crisis-3306240.

30 *Id.*

31 *Id.*

32 Justin Asbury Dillmore, *Leap Before You Look: The SEC's Approach to Hedge Fund Regulation,* 32 OHIO N.U. L. REV. 169, 171 (2006).

33 *Id.*

34 Zaun, *supra* note 25 at 116

35 Justin Asbury Dillmore, *Leap Before You Look: The SEC's Approach to Hedge Fund Regulation,* 32 OHIO N.U. L. REV. 169, 180 (2006).

that operate 'private funds'[36] will be required to count each shareholder, limited partner, member, other security holder or beneficiary of a private fund as a client."[37] Previously, the private adviser exemption allowed hedge fund managers to avoid registering with the SEC if they had fewer than fifteen funds as clients because individual investors did not count as "clients." Therefore, under this new requirement, all of the investors or shareholders of a private fund were each to be counted as separate clients of the hedge fund manager in counting towards the fifteen-client maximum stated within the small advisers exemption.[38]

A. Hedge Fund Rule Determined to be Invalid

The increased regulation proved very controversial because its definition of "client" was arguably at odds with the Congressional intent of the Advisers Act.[39] The term "client" is commonly meant to describe an individual or entity that receives direct advice from an investment adviser rather than inactive investors who simply invest in the hedge fund hoping the fund realizes a profit.[40] The important distinction is that most individual investors are simply contributing capital to hedge funds hoping to realize a profit and are not receiving investment advice. On the contrary, the client, which is a hedge fund in this case, is an entity receiving investment advice from the hedge fund manager. Individual investors are likely investing in the funds based on the fund managers' expertise and on the reputation of the fund itself. Moreover, the longstanding judicial interpretation the definition of "client" has been a person or entity that receives particularized advice.[41] However, the SEC implemented the hedge fund rule regardless of previous judicial interpretation of the term

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[36] Rule 203(b)(3)-2(d)(1) states that a "private fund" is defined to mean a company: (1) that would be an investment company under Section 3(a) of the Investment Company Act of 1940; (2) that permits investors to redeem any portion of their ownership interest within two years of the purchase of their interests; and (3) that offers interests in the private fund based on the investment advisory skills, ability or expertise of the investment adviser. Investment Company Act of 1940 (54 Stat. 789, 15 U.S.C. 80b-3(b)(3)).
[37] SEC Commissioners Approve Proposed Rules to Require Certain Hedge Fund Managers to Register with the SEC, BULLET POINT, Oct. 27, 2004, http://www.tanhelp.com/newsworthy/index/html.
[38] Zaun, *supra* note 25 at 114.
[39] *Id.*
[40] *Id.*
[41] *Id. See Lowe v. SEC*, 472 U.S. 181, 191 (1985).

client because it felt that the widespread misuse of leverage and speculation were issues large enough to warrant a change.[42]

Although the SEC was attempting to protect investors, its method for doing so was inconsistent with Congress' intentions.[43] In June 2006, a federal court of appeals held, in *Goldstein v. SEC*,[44] that the look through rule exceeded the SEC's authority and was invalid. In *Goldstein,* Phillip Goldstein, a shareholder activist mainly participating in proxy battles, was the President of Kimball & Winthrop, Inc., the general partner of Opportunity Partners L.P.[45] Goldstein operated a $40 million hedge fund from the basement of his home and he petitioned review of an order of the SEC regulating hedge funds under the Advisers Act via the look through provision and the hedge fund rule.[46] Goldstein had two main theories that were meant to invalidate the hedge fund rule.[47] First, he argued that the hedge fund rule violates Congressional intent by regulating private investment entities and advisers, which Congress has expressly exempted from regulation under the Advisers Act.[48] Goldstein was arguing that the SEC overreached by attempting to rewrite the statute and create new law as opposed to simply modifying the rule. Next, Goldstein focused on the definition of "client" as used in the Advisers Act and argues that its definition is clear as interpreted by Congress and therefore, requires no further interpretation by the SEC.[49] Specifically, Goldstein is alleging that the hedge fund rule goes beyond its authority by changing the term "client" to include the individual investors, or shareholders, who have invested in the fund.[50] Instead, Goldstein claims that Advisers Act intended the term "client" to refer to the partnership or fund-entity itself. Even the SEC had previously interpreted "client" as referring to the hedge fund itself and so most hedge fund managers were exempt because almost all hedge fund managers managed fewer than fifteen funds.[51]

The SEC did not address Goldstein's arguments but rather emphasized that hedge funds needed to be regulated.[52] The SEC focused on the growth of hedge funds and the potential impact funds can have on the financial

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[42] *Id.*
[43] *Id.*
[44] *Goldstein v. S.E.C.,* 451 F.3d 873 (D.C. Cir. 2006).
[45] *Id.* at 874.
[46] *Id.*
[47] *Goldstein,* 451 F.3d at 874.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.* at 876.
[52] *Goldstein,* 451 F.3d at 877.

markets on a larger scale and how this was putting individual investors at risk.[53] Also, the SEC argued that hedge fund managers were actively involved in recent scandals (i.e., the LTCM failure) and retail investors were harmed by the far-reaching effects of the recklessness of these hedge funds.[54] Finally, the SEC argued that registration decreases the likelihood of illegal activity and investor abuse because by requiring hedge fund managers to register with the SEC, the SEC is ensuring that managers with a history of committing fraud will be dealt with immediately.[55]

The D.C. Circuit Court held that the hedge fund rule was arbitrary and capricious on its face and invalidated the SEC's attempt to regulate hedge funds by requiring registration.[56] The court sided with Goldstein by agreeing that even though the term "client" is not defined in the Advisers Act, the SEC has no right to imply its own definition simply by reasoning that it is ambiguous.[57] The court explained its position by pointing to a 1970 amendment which in the court's opinion, represents congressional understanding that investment company entities (such as a hedge fund), not the shareholders (individual investors), were the hedge fund manager's clients.[58] Moreover, the court said that an individual investor in a private hedge fund may benefit or suffer directly from the hedge fund manager's advice but the key difference is that the individual investor of a hedge fund does not receive that advice directly like that of a general retail[59] investment relationship.[60]

In sum, the court's decision was based on the idea that retail investors are not walking into the hedge fund's office and receiving specific investment advice from an investment representative of the fund.[61] For example, the hedge fund manager is not telling the investor how to spend his or her money because the investor made his or her own decision, without advice, to invest in the hedge fund.[62] The court further stressed

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[53] *Id.*
[54] *Id.*
[55] *Id.* at 876.
[56] *Goldstein,* 451 F.3d at 882.
[57] *Id.* at 878. (The court explained that just because there is no definition in the statute explicitly defining "client," that does not automatically render the meaning of "client" as being ambiguous).
[58] *Id.*
[59] A "retail investor" is a person who invests for their personal portfolio rather than for an organization or company. *See Retail Investor,* INVESTOPEDIA, *https://www.investopedia.com/terms/r/retailivnestor.asp*, (Feb. 28, 2018).
[60] *Goldstein,* 451 F.3d at 879.
[61] Zaun, *supra* note 25 at 127.
[62] *Id*. at 129.

this point by citing to the Supreme Court in *Lowe v. SEC*, which held that those engaged in the investment advisory industry will "provide personalized advice to a client's concerns," marking a conception of fiduciary relationship.[63] The Supreme Court in *Lowe* added that a direct, fiduciary relationship exists only between the adviser and the hedge fund, but not between the adviser and the investors in the fund.[64] The key takeaway from the decision in *Lowe* is that "personalized advice to a client's concerns" creates the fiduciary relationship and without an investment advisor providing personalized advice to an individual investor, the Adviser Act will not count the investor as a "client" of the fund.

VI. OVERVIEW OF THE CHANGES MADE AFTER THE ENACTMENT OF TITLE IV OF THE DODD-FRANK ACT

Included within Dodd-Frank is the *Private Fund Investment Advisors Registration Act of 2010* ("PFIARA"), which changes the registration requirements of hedge fund advisers by requiring certain unregistered investment advisers to register with the SEC under the Advisers Act.[65] Most importantly, PFIARA removed the private adviser exemption contained in the Advisers Act, which exempted advisers of private funds from mandatory registration who: "(1) had less than 15 clients during the preceding 12 months, (2) do not hold themselves out to the public as investment advisers, and (3) do not advise registered funds subject to the Investment Company Act of 1940."[66] PFIARA also made changes impacting the reporting, disclosure, and record keeping requirements of investment advisers in order to provide the SEC with information necessary to evaluate systemic risk.[67]

PFIARA removed the private adviser exemption from the Advisers Act, which means that hedge funds would likely have been better off had the SEC won in *Goldstein* because if the SEC had won, Congress might not have made changes to hedge fund registration requirements and left the

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[63] *Goldstein,* 451 F.3d at 880 (quoting *Lowe v. SEC*, 472 U.S. 181, 191 (1985)).
[64] *Id.*(quoting *Lowe v. SEC*, 472 U.S. at 208).
[65] Dodd-Frank Act, § 401.
[66] *The Effect of Dodd-Frank on Hedge Fund Managers*, INVESTMENT LAW GROUP (Aug. 18, 2010), http://www.investmentlawgroup.com/the-effect-of-dodd-frank-on-hedge-fund-managers/.
[67] Dodd-Frank: Title IV - Regulation of Advisers to Hedge Funds and Others, CORNELL LEGAL INFORMATION INSTITUTE (last visited Feb. 28, 2018) *https://www.law.cornell.edu/wex/dodd-frank_title_IV#.*

hedge fund rule in place.[68] Hedge funds would have been better off because Title IV of Dodd-Frank (PFIARA) effectively overruled the Supreme Court's decision in *Goldstein*, which resulted in more stringent regulations regarding hedge fund manager registration than the original hedge fund rule was.[69]. Section 408 of Dodd-Frank updates the Advisers Act and provides that "The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000."[70] Regarding private funds that do in fact satisfy the requirements of the new exemption, the Act provides that the SEC requires these investment advisers to maintain records and provide the SEC with annual or other reports, as the SEC determines necessary.[71]

Under the adviser registration form, advisers to private funds (i.e., hedge fund managers) will have to provide basic organizational information about the fund, such as the size, ownership, and advisor's services to the fund.[72] In addition, the SEC strives to improve its regulatory program by requiring all registered advisers to provide information about their advisory business such as the types of clients they advise, their employees, and their advisory activities.[73] Most importantly, the Act specifically requires the collection of information regarding the amount and types of assets under management, leverage, counterparty credit risk, trading and investment positions, valuation, side arrangements with investors, trading practices, and other information necessary for the protection of investors.[74] This information, in theory, will be used in order to prevent another LTCM-type failure resulting in risk of a global financial crisis. However,

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[68] Sjostrom, *supra* note 12, at 40. *See also* Goldstein, 451 F.3d at 873 (The look-through approach would not have deleted the private adviser exemption (small advisers exemption) altogether, but rather require that individual investors be considered as "clients" when determining the fifteen client rule).
[69] Kenneth Muller & Seth Chertok, *The Impact of Title IV of the Dodd-Frank Act on Investment Advisers*, BLOOMBERG LAW REPORTS (2011) *https://media2.mofo.com/documents/110124-title-iv-bloomberg.pdf.*
[70] Dodd-Frank Act, § 408.
[71] *Id.*
[72] U.S. SEC. & EXCH. COMM'N, *SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act*, (June 22, 2011) *https://www.sec.gov/news/press/2011/2011-133.htm.*
[73] *Id.*
[74] J.W. Verret, *Revisiting Title IV: Why Mandatory SEC Registration for Hedge-Fund Advisers Is Not Necessary*, GEO. MASON U.: MERCATUS CTR 93-103 (Apr. 2016), https://www.mercatus.org/publication/revisiting-title-iv-why-mandatory-sec-registration-hedge-fund-advisers-not-necessary.

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the problem with this is that the SEC does not have the resources or level of expertise necessary to organize, dissect, and understand this massive amount of information.

A. Obligations of Investment Advisers Registered with the SEC

This increased registration requirement now means that most hedge funds must register with the SEC, which is not the appropriate response because there are alternative regulatory approaches that would more effectively help solve any problems stemming from hedge funds. The obligations that flow from the passage of the Act are mostly burdensome and ineffective. Each of requirements associated with registration is discussed below.

In order to comply with the Advisers Act, registered advisers need to submit Form ADV. This form asks for basic information about the adviser, a history of the adviser, and requires an explanation of the hedge fund's structure.[75] The adviser must also implement a compliance program that contains written policies and procedures designed to prevent violation of the federal securities laws.[76] The compliance program is expected to detect potential risks and prevent violation of federal securities. Additionally, SEC filing requirements maintain that registered advisers must meet certain requirements in order to charge their clients a performance fee.[77] Registered advisers may not charge performance fees for the profit generated by the hedge fund unless the particular investor is a "qualified client."[78] A "qualified client" is one who has a net worth of $1.5 million dollars or places $750,000 under the advisor's control.[79] In theory, a qualified client is a sophisticated investor and understands the risks of investing money in a hedge fund.

VII. DODD-FRANK ACT'S IMPACT ON REGISTERED INVESTMENT ADVISERS

Section 914 of Title IX of the Dodd-Frank Act mandated that the SEC conduct a thorough study aimed at understanding the need for enhanced examination and enforcement resources for investment advisers (the

[75] 17 C.F.R. § 275.203-1 (2005).
[76] 17 C.F.R. § 275.206(4)-7.
[77] 17 C.F.R. § 275.205-3 (2004)
[78] *Id.*
[79] *Id.*

"Study").[80] Section III of the Study examines the impact of Dodd-Frank on the SEC's examinations of registered investment advisers, which are performed by the Office of Compliance Inspections and Examinations ("OCIE"). This sub-section will describe the OCIE's role and duties regarding the SEC's investment adviser examination program. The next section will discuss the number and frequency of examinations of registered investment advisers performed by OCIE staff between October 1, 2004 and September 30, 2010. The final section will discuss the impact of the Dodd-Frank Act on examinations of registered advisers as explained in the SEC's "Study on Enhancing Investment Adviser Examinations."[81]

A. OCIE's Role and Duties Regarding the SEC's Investment Advisor Examination Program

The SEC, through OCIE staff is charged with examining registered investment advisers' books, records and activities with the goal of improving compliance, preventing fraud, monitoring risk, and informing regulatory policy.[82] OCIE conducts examinations of high-risk investment advisers, examinations based on tips or complaints, and examinations referred to as "special purpose reviews," which are risk-targeted sweeps covering a wide range of regulated entities and limited in scope on specific areas of concern within the financial services industry.[83] These examinations of registered investment advisers focus on detecting violations of federal securities laws as well as ensuring that advisers have proper compliance controls in place.[84] OCIE also examines exchanges, clearing agencies, and investment advisers that are affiliated with a broker-dealer.[85] OCIE conducts its on-site examinations with teams of "specialized staff," but the Study does not go into further detail regarding the OCIE personnel.[86] A limited examination is said to take a few days, while a more comprehensive examination might take several weeks or months to complete.[87] The Study adds that comprehensive examinations of larger advisers with more complex operations as well as examinations

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[80] U.S. SEC. & EXCH. COMM'N, *Study on Enhancing Investment Adviser Examinations*, 1 (2011), https://www.sec.gov/news/studies/2011/914studyfinal.pdf.
[81] *Id*.
[82] *Id.* at 2.
[83] *Id.*
[84] *Id.*
[85] *Id.* at 6. (study claims that as of October 1, 2010, 22% of all registered investment advisers had an affiliated broker-dealer).
[86] U.S. SEC. & EXCH. COMM'N *supra* note 81.
[87] *Id.*at 6.

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of higher-risk advisers often take longer and require more staffing.[88] Interestingly, the "comprehensive examinations" that take longer and require staff with "special expertise" are described in the Study as mutual fund complexes and hedge funds pursuing complex investment strategies.[89] It does not seem plausible that OCIE has the necessary manpower and staff with the requisite "special expertise" to effectively examine and monitor the vast amounts of registered mutual funds and hedge funds. OCIE's only response regarding how it will examine complex operations is by stating that it will take longer and require specific staff members for areas requiring special expertise.

B. Examination of Registration Investment Advisers Between October 1, 2004 and September 30, 2010

The Study explains that the number and frequency of examinations of registered investment advisers is a function of the number of registered investment advisers and the number of OCIE staff.[90] During the six-year period between October 1, 2004 and September 30, 2010 the number of registered investment advisers increased and the number of OCIE staff dedicated to examining registered advisers decreased, which resulted in a decrease in the frequency of examinations.[91] The Study reported that the number of registered advisers increased 38.5%, from 8,581 advisers to 11,888 advisers and the assets managed by the registered advisers grew 58.9%, from $24.1 trillion to $38.3 trillion.[92] Accordingly, not only did the number of registered advisers increase and the number of OCIE staff dedicated to examining registered advisers decrease, but also the advisers' assets under management increased by 9.1%. Further, over the six-year period the number of OCIE staff decreased 3.6%, from 477 staff to 460 staff and the Study adds that staff even fell as low as 425 staff between September 30, 2007 and September 30, 2008.[93]

Following from the above statistics, the Study reported that the number of examinations decreased 29.8%, from 1,543 examinations in 2004 to 1,083 examinations in 2010.[94] This decrease in examinations performed by OCIE can be attributed to the increase in the number of registered

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[88] *Id.*
[89] *Id.*at 22.
[90] *Id.*
[91] *Id.* at 8.
[92] U.S. SEC. & EXCH. COMM'N *supra* note 81, at 8.
[93] *Id.* at 10.
[94] *Id.* at 14.

advisers, the decrease in OCIE staff, and the fact that OCIE devotes most of its resources to examinations of higher-risk advisers, which takes more time.[95] These statistics indicate that the SEC and OCIE do not have the resources necessary to achieve their goal of improving compliance and monitoring risk. Furthermore, the Study does not discuss anything regarding the adequacy of the examinations or whether or not the examinations are performed correctly and diligently by staff members who are able to understand the information they are gathering.

C. Impact of the Act on Examination of Registered Investment Advisers

The Study predicted that the number of SEC-registered advisers would grow from 8,358 advisers to 10,897 advisers in five years, and the amount of assets they manage would grow from $38.5 trillion to $49.5 trillion.[96] Later, in 2016 the OCIE reported in its "Examination Priorities For 2017" letter, that the OCIE oversees more than 12,000 investment advisers with nearly $67 trillion in assets under management.[97] Also, in 2016 OCIE shifted 100 broker-dealer staff examiners to the Investment Adviser Examination program, which increased the total number of OCIE staff dedicated to examining only investment advisers to over 600 people.[98] However, simply increasing the number of staff members focusing on investment advisers is not enough. OCIE needs investigators who understand the inner workings of private funds and how they operate. Overall, the lack of resources and specialization by the OCIE raises concern regarding the effectiveness of these examinations in monitoring risk.

The SEC's plan to increase investment adviser registration and its examination of these investment advisers through the OCIE is an ineffective regulatory approach and will ultimately be more harmful than helpful. Hedge funds employ complex strategies in order to achieve absolute returns in all market environments and it is unlikely that the OCIE has the resources or expertise to comprehend these strategies disclosed by registered hedge funds. The OCIE lacks the resources and expertise to

[95] *Id.* at 15.
[96] *Id.* at 19-20.
[97] OFF. OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC. & EXCH. COMM'N, *Examination Priorities for 2017,* 1 (2016), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.
[98] *SEC Speaks 2017 – OCIE Had Something To Say*, LEXOLOGY, (March 1, 2017), https://www.lexology.com/library/detail.aspx?g=f25977b5-8a0a-4c1f-ac97-4f41ee7c5778.

properly monitor investment advisers and the complex investment strategies the advisers' hedge funds employ. Former Federal Reserve Chairman, Alan Greenspan articulated this problem by stating, "[b]y the time of detection, hedge funds would have long since moved on to different strategies."[99]

This level of mandatory disclosure required of all registered investment advisers has harmful effects on the financial system. Hedge funds are inherently secretive regarding their positions and strategies because they do not want competitors stealing their long-term trading strategies, which would hinder their competitive advantage. This goal to maintain secrecy is in conflict with the disclosure requirements. This level of disclosure is unnecessary compared to other aspects of the financial system where disclosure does not negate the purpose of the industry's existence.

The entire financial system benefits from the hedge fund industry for numerous reasons. First, hedge funds are one of the main sources of creating liquidity in the market, which makes markets more efficient due to large capital injections.[100] This increased liquidity in the markets leads to more financial options for investors and allows for new ways to hedge investments, which reduce overall risk.[101] Second, hedge funds add value to the markets because of their potential influence over companies, which is necessary to invoke changes in management necessary to generate value.[102] A number of hedge funds become activist shareholders acquiring a minority equity position in a corporation.[103] Activist shareholders, such as hedge funds, advocate for changes within the corporation such as reducing costs, increasing leverage, or divesting certain businesses.[104] Finally, hedge funds contribute to global stability during a financial crisis by acting as a counterparty to systemically important financial systems.[105] Hedge funds assume risks that would otherwise have a negative impact on

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[99] Alan Greenspan, Chairman, Federal Reserve Board, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (July 20, 2004).

[100] Hui-Wen Hsiao, *Join the Party but Don't Ruin it: Analysis of Pros and Cons of Hedge Fund Regulations*, 4 NAT. TAIWAN UNIV. L. REV. 55, 79 (March 2019).

[101] DAVID STOWELL, INVESTMENT BANKING, HEDGE FUNDS, AND PRIVATE EQUITY 234 (2d ed. 2013).

[102] Hsiao, *supra* note 101, at 79.

[103] STOWELL, *supra* note 102, at 269.

[104] *Id.*

[105] Hsiao, *supra* note 101, at 79-80.

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the global financial system if not transferred from these large institutions' balance sheets.[106]

VIII. PROBLEM WITH THE CURRENT U.S. REGULATORY SCHEME

The problem with the current hedge fund regulatory system set forth by PFIARA is that it does not prevent the spread of system risk or protect investors from illegal activity by hedge fund managers. The relevant new rules introduced by PFIARA are the mandatory registration with the SEC of hedge fund managers with over $150 million of assets under management[107] and the duty to disclose certain investment information to both the SEC and investors. The goals of PFIARA are to further investor protection and reduce systemic risks created and accelerated by hedge fund activity.

In order to promote investor protection, PFIARA requires that hedge fund advisers must now file Form ADV with the SEC.[108] Form ADV is the official registration form an investment adviser must file with the SEC. The goal of Form ADV is to protect investors by creating risk profiles of investment advisers.[109] PFIARA aims to satisfy its goal of better assessing systemic risk posed by hedge funds by requiring hedge funds to submit a Form PF to the SEC.[110] Form PF contains data on each fund managed by a hedge fund manager and requires that the manager include his or her investment strategies, the percentage of the fund's assets managed using high-frequency trading strategies, each fund's gross and net assets, the value of its derivative positions, and its use of leverage amongst other things.[111] The SEC does not have the expertise nor the resources to properly analyze this information and ultimately fails to reduce systemic risk posed by the hedge fund industry.

However, the goals of PFIARA can be met without mandatory registration and thus, the SEC is not using its resources efficiently. Hedge funds and their excessive use of leverage are often the main cause of systemic risk. Requiring mandatory registration with the SEC results in

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[106] Timothy F. Geitner, *Hedge Funds and Their Implications for the Financial System*, FED. RES. BANK OF N.Y. (Nov. 17, 2004), https://www.newyorkfed.org/newsevents/speeches/2004/gei041117.
[107] Bodellini, *supra* note 14, at 458.
[108] Luther R. Ashworth II, *Is Hedge Fund Adviser Registration Necessary to Accomplish the Goals of the Dodd-Frank Act's Title IV?,* 70 WASH. & LEE L. REV. 651, 687 (Jan. 1, 2013).
[109] *Id.*
[110] *Id.* at 688-689.
[111] *Id.*at 690.

an increase of disclosed information regarding hedge fund activity. The SEC still needs to bridge the gap between this new information by enforcing some standard relating to leverage. Not only is there a disconnect between the influx of information regarding hedge fund activity and effective enforcement by the SEC, the information the SEC is receiving may not be accurate. The SEC has stated that the data collected in Form PF is not consistent between investment advisers and could be misleading.[112] The inconsistency arises because investment advisers take different approaches and assumptions made when disclosing the information required by the Form PF.[113] Some of the complaints related to Form PF have been that the questions are ambiguous and that there has been little guidance by the SEC to clarify the manner in which the Form PF should be completed.[114] Ultimately, the problem with Form PF and the SEC's general information collecting ability is that there a lack of a uniform approach in providing the required information. The SEC relies on the investment advisers to value their fund's assets and derivate positions, which is difficult to do and requires some subjectivity.

Finally, the increased disclosure requirements limit the effectiveness of hedge funds and therefore preclude the benefits hedge funds bring to financial markets. Moreover, the increase in direct U.S. regulations inhibiting the hedge funds' freedom will lead to hedge funds eventually moving abroad.[115] If a mass exodus such as this occurs, investors will have no protection under the U.S. federal securities laws.

IX. SOLUTION: INDIRECT REGULATION OF HEDGE FUNDS VIA SELF-REGULATING PRIME BROKERS

Indirect regulation is based on the regulation of the creditors and counterparties that provide financial services to hedge funds.[116] In other words, the indirect regulation of hedge funds is done through the direct

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[112] Wulf A. Kaal, *The Systemic Risk of Private Funds After the Dodd-Frank Act*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 163, 190 (2015).
[113] *Id.*
[114] *Id.* at 191.
[115] *Hedge Fund Operations: Hearing Before the House Committee on Banking and Financial Services*, 105th Cong. 160-61 (1998) (statement of Alan Greenspan, Chairman, Federal Reserve System Board of Governors) http://www.federalreserve.gov/boarddocs/testimony/1998/19981001.htm. *See also* Randy Haight, *Community of Support: Moving Toward Indirect Regulation of the Hedge Fund Industry,* 3 J. MARSHALL GLOBAL MKT. L. J. 1, 3 (2014).
[116] Hossein Nabilou and Alessio M. Pacces, *The Hedge Fund Regulation Dilemma: Direct vs. Indirect Regulation*, 6 WM. & MARY BUS. L. REV. 183, 206 (2015).

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regulation of other market participants such as creditors and counterparties of hedge funds.

"Prime brokers" are the key counterparties to hedge funds and generally belong to a division of large investment banks.[117] Prime brokers offer numerous services to hedge funds on a daily basis including: providing credit to finance funds' leverage positions, providing margin credit to finance purchases of stock, borrowing stock from other hedge funds on behalf of hedge fund clients to support short positions, and as intermediaries in funds' securities transactions.[118] Prime brokers are in the best position to evaluate the fund's risk exposure because they are able to determine the liquidity of the fund's positions and the amount of leverage currently being employed by the fund.[119] Regulating these prime brokers would ensure that they are properly monitoring a fund's transactions and amount of leverage. Otherwise, prime brokers are incentivized to ignore certain risk markers and look the other way if a hedge fund is engaging in risky behavior in order to maintain their prosperous business relationship with the hedge fund.

A self-regulatory body of prime brokers would be able to implement an agreed upon method of risk management in order to deter prime brokers from offering favorable credit terms or offering low margin requirements in order to attract more hedge fund business.[120] Further, an organization of prime brokers would be able to combine a particular hedge fund's market positions, considering most hedge funds use multiple prime brokers.[121] This also better addresses the PFIRA Act's goal of preventing systemic risk because it puts the responsibility of monitoring leverage on the prime brokers who have the expertise and resources to do so. These disclosures would help reduce systemic risk while also keeping hedge fund trading information and investment strategies confidential.[122] A self-regulating organization of prime brokers would have the necessary information on a particular hedge fund's market positions and amount of leverage. This body would be able to identify problems before they happen.[123] If a self-regulatory organization of prime brokers consolidated

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117 *Prime Brokerage*, INVESTOPEDIA, https://www.investopedia.com/terms/p/primebrokerage.asp (last visited Dec. 15, 2018.

118 Nathan Bryce, *Hedge Funds, Liquidity, and Prime Brokers*, 13 FORDHAM J. CORP. & FIN. L. 475, 492 (2008).

119 *Id.* at 493.

120 Hossein Nabilou and Alessio M. Pacces, *supra* note 109, at 228.

121 Nathan Bryce, *supra* note 119, at 498.

122 *Id.* at 495.

123 *Id*. at 497.

a particular hedge fund's market positions and information regarding its use of leverage, any particular prime broker would have the necessary information to identify certain risks and avoid or limit extending credit to the fund.

In order for this proposition to succeed, the self-regulating organization would need to be able to sanction and punish prime brokers who are not conducting proper risk management practices. For example, a fine against a prime broker would need to be large enough so it exceeds the short-term benefit of a primer broker extending credit to an overleveraged hedge fund.[124] Otherwise, there would be no deterrent if the wrongful action was still profitable.

X. CONCLUSION

The increased disclosure requirements set forth by PFIARA does not increase investor protection or reduce systemic risk posed by hedge funds. The use of excessive leverage by hedge funds is the main contributor to system risk and any regulatory regime should be focused around monitoring hedge funds' use of leverage. PFIARA changed the registration requirements of hedge fund advisers by mandating hedge funds with over $150 million of assets under management to register with the SEC under the Advisers Act. However, the SEC does not have the expertise or available resources to analyze the disclosed information and use that information to protect investors and reduce systemic risk. A potentially better regulatory strategy would be to regulate hedge funds indirectly by regulating the hedge funds' prime brokers. The creation of a self-regulating organization of prime brokers would help prevent systemic risk by requiring prime brokers to monitor the leverage and overall risk profiles of their hedge fund clients and refrain from extending credit if need be.

[124] *Id*. at 498.