Hedge Fund Regulation – Quo Vadis?

By Franco Taisch and Alain Friedrich*

Unregulated investment funds – commonly known as hedge funds – have become important participants in today's globalised financial markets. Coincidently with the growth of the hedge fund industry, financial regulators all over the world have become aware about these opaque investment vehicles. Whereas there is a consensus about the potential benefits of hedge funds, it is also commonly agreed upon that unregulated investment vehicles may not only pose risks to their investors but also to the financial markets as a whole.

In attempting to find appropriate regulatory responses to issues such as investor protection and systemic risk, major hedge fund centres have so far concentrated on trying to find domestic solutions. Unfortunately, in the process, they have started to compete in a «race to the bottom» in which no jurisdiction intends to impose rules that are too strict and could potentially drive the lucrative hedge fund business away.

This article seeks to contribute to the discussion of hedge fund regulation. It proposes a new regulatory framework for hedge funds that counteracts international regulatory competition by recommending a set of international minimum standards for hedge fund regulation. These standards would need to be established by an international standard setting body and take the form of international soft law. In this way, they would not only ensure the necessary internationality of hedge fund regulation but also provide an efficient mean towards stopping the current regulatory competition, hereby securing financial stability and investor protection.

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I. Introduction

Hedge funds – the famous largely unregulated investment vehicles – have caught enormous media attention over recent years.[1] But not only the media is alerted, the industry's rapid growth,[2] the impact of the funds' trading strategies, particularly their ability to sell stocks short[3] and their activism in corporate

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1 A hedge fund consultant estimates that hedge funds are mentioned in around 1200 articles each day, see *Richard Wilson,* Hedge Funds and Media Exposure (2008), see <*http://richard-wilson.blogspot.com/2008/01/hedge-funds-and-media-exposure.html* > at 20 December 2010.

2 At the end of 2007, the worldwide hedge fund industry had around USD 2.5 trillion assets under management, see ZHAW/ GAM, Switzerland – A Growing Centre for Single Manager Hedge Funds: a Survey (2008), 8. In 2010, the world wide hedge fund industry was still estimated to have around USD 1.5 trillion assets under management, see BarclayHedge, Hedge Fund Industry – Assets Under Management (2010), see <*http://www.barclayhedge.com/research/indices/ghs/mum/HF_Money_Under_Management.html* > at 20 December 2010.

3 Short selling means selling an asset that one either does not have (naked short selling) or that one has (e.g. through borrowing) but does not own (covered short selling).

governance has also prompted regulators around the world to investigate the opaque investment vehicles. Although the recent financial crisis has struck hedge funds as severely as other market participants and the industry is said to have shrunk significantly,[4] the issue of increased regulation is still on top of many political agendas[5] and even the hedge fund managers themselves expect further regulation.[6]

This article seeks to contribute to the discussion of hedge fund regulation and proposes a new regulatory framework with internationally accepted *minimum standards for hedge fund regulation*. It argues that in order to prevent regulatory arbitrage, future hedge fund regulation standards must be international in scope and globally implemented.

The article discusses hedge fund regulation in three steps. First, it addresses what hedge funds are, what benefits they have and why the public and regulators should pay attention to them. Second, it gives a general overview of the current regulation of hedge funds in the UK and Switzerland. The overview is focussed on systemic risk and investor protection. Third and finally, the article outlines the cornerstones of a possible hedge fund regulation framework. We will conclude that international minimum standards for hedge fund regulation are both necessary and politically achievable. They would not only accomplish the necessary internationality within today's globalised financial system but also ensure that each country can *maintain its state sovereignty* and does not have to cede power to a global financial regulator.

II. What Are the Characteristics and Benefits of Hedge Funds?

Despite the enormous attention to hedge funds, there is *neither* an *industry-wide* recognised[7] nor any major country that offers a *statutory* definition of the term «hedge fund».[8] It appears that only the U.S. State Court of Appeals for the District of Columbia has so far given a judicial definition in 2006 by stating that a hedge fund is *«any pooled investment vehicle that is privately organized, administered by a professional investment manager, and not widely available to the public»*.[9] Historically, the term «hedge» is said to be invented by *Alfred W. Jones* who is credited with establishing one of the first hedge funds in 1949.[10] He developed the idea of *«covering long positions with short positions to hedge bets and offset shifts in the economy»*.[11] Today, the word «hedge» has however *lost* its *definitional value*. Hedge funds engage in a wide range of trading techniques that are far more sophisticated than the traditional long-short strategy employed by *Alfred W. Jones* in 1949.[12] It is generally recognised that a hedge fund can only be described and differentiated from other investment vehicles by its characteristics rather than by any legal structure or investment strategy.

A short seller expects prices to fall so that the short sale can be brought in at a profit before delivery has to be made, see *John Smullen/Nicholas Hand,* Oxford; Dictionary of Finance and Banking (3rd ed., 2005), 375.

4 It is estimated that the hedge fund industry shrunk between 50%–75% from its peak of around USD 2.5 trillion at the end of 2007 to well below USD 1 trillion, see *James Mackintosh,* Hedge funds cut down on size, The Financial Times (London), 11 January 2009. It seems, however, that assets under management are increasing again and currently amount to around USD 1.5 trillion, see above n 2.

5 As example, on 11 November 2010, the European Parliament has adopted the Alternative Investment Fund Managers Directive (AIFM Directive) which will enter into force after all EU Member States have implemented it in their own legislation by the beginning of 2013, for more see European Commission, Memo/10/573, «European Commission statement at the occasion of the European Parliament vote on the directive on hedge funds and private equity» (Brussels), 11 November 2010.

6 *Bob Ivry/Sijel Kishan/Ian Katz,* Hedge funds bet on regulations, The Washington Times (29 December 2008), see *<http://www.washingtontimes.com/news/2008/dec/29/hedge-funds-bet-on-regulations/?page=1>* at 20 December 2010.

7 See SEC, Discussion at the SEC Roundtable on Hedge Funds (14 May 2003) and *Andrew Crockett,* The evolution and regulation of hedge funds (2007) in: Banque de France, Financial Stability Review – Special issue on hedge funds 10 (2007), 19, 20.

8 See IOSCO, Final Report: The Regulatory Environment for Hedge Funds: a Survey and Comparison, Final Report (2006), 29.

9 Goldstein v. S.E.C. 451 F.3d 873 at 874 (D.C. Cir. 2006).

10 *Phillip M. Hildebrand,* Developments in the hedge fund industry, Speech delivered at the Swiss Finance Conference 2005 (Zurich, 4 February 2005).

11 *Carol J. Loomis,* The Jones Nobody Keeps Up With, Fortune (April 1966), 237.

12 The investment strategies are very diverse and not the subject of this paper. For more information, see *Francois-Serge Lhabitant,* Handbook of Hedge Funds (2006), 158 et sqq.

The following are the *key characteristics:*

(i) Hedge funds are mostly unregulated;
(ii) They are mostly incorporated in offshore jurisdictions;
(iii) The transparency of their investment portfolios is limited;
(iv) Hedge funds target specific investors;
(v) Hedge funds generally use leverage;
(vi) Hedge funds employ active asset management;
(vii) They aim for an absolute return;
(viii) Hedge fund managers typically invest in their own fund;
(ix) Hedge funds generally have a dual (yearly and performance-related) fee structure and
(x) limited liquidity.

Because the hedge fund industry is very diverse, the above characteristics cannot serve as final description of the industry but rather as an attempt to distinguish hedge funds from other investment vehicles. In fact, already the lack of a proper definition of hedge funds may *lead to difficulties* in establishing a future regulation scheme for hedge funds and particularly its ambit.

Hedge funds have different benefits. Whereas the comprehensively regulated sector of investment funds is often subject to restrictions, hedge funds generally have an *absolute investment freedom*. As a result, they have a *lower correlation* with the overall market,[13] offer investors a *diversification* opportunity and consequently a *reduction in portfolio volatility*.[14] However, while investors may substantially benefit from hedge funds, there are certain *caveats. First,* the potential diversification benefits are based on figures provided by hedge fund indices that are said to substantially *overstate* the returns und understate the risks of the hedge fund industry.[15] *Second,* the correlation between overall hedge fund returns and equity market performance has become stronger in recent years, indicating *decreasing* diversification opportunities.[16] Hedge funds do however not only provide benefits to investors but also to the *securities market as a whole*. They contribute to *market efficiency,*[17] to *enhanced liquidity,*[18] to *more accurate pricing* and significantly *increase risk management choices of financial market participants,* leading to lower costs of capital.[19] *First,* in contrast to traditional funds that usually try to «beat» a benchmark and thereby either track indices or follow narrow mandates, hedge funds enjoy the comparative advantage not to track but to be *flexible*. As a consequence, hedge funds *aid price discovery* through taking speculative trading positions based on extensive research about the true or future value of a security and consequently help to reduce *pricing inefficiencies* in the market. [20] Furthermore, hedge funds have become an important source of protection to regulated institutions (and other market participants[21]) by being *large sellers of credit insurance,* particularly in the market for *credit default swaps*[22].[23] Finally, *Daniels-*

[13] Low *market correlation* means that there is not a strong relationship between the performance of hedge funds and the performance of the market overall, see *Lhabitant* (n. 12), 518–526.

[14] *Houman B. Shadab,* The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection, in: Berkley Business Law Journal 6 (2009), 16.

[15] For an extensive overview see *Lhabitant* (n. 12), 25. For an empirical study, see for example, *Burton G. Malkiel/Atanu Saha,* Hedge Funds: Risk and Return (2005), 61 (6) Financial Analysts Journal 80, 88 stating that *«hedge funds are riskier and provide lower returns than is commonly supposed»*.

[16] *Noyer Christian,* Hedge funds: what are the main issues? (2007) in: Banque de France, Financial Stability Review – Special issue on hedge funds 10 (2007), 105, 106.

[17] Market efficiency requires that prices at all times reflect all available information, see *Smullen/Hand* (n. 3), 126.

[18] Hedge funds account for close to *half* the trading in most asset classes, see FSA, Discussion Paper 05/4, Hedge funds: A discussion of Risk and Regulatory Engagement (2005), 28.

[19] See *Hildebrand* (n. 10), saying that «[Hedge funds] *are a positive force in rendering global financial markets more liquid and therefore more flexible*». Similarly, *Jon Danielsson/Ashley Taylor/Jean-Pierre Zigrand,* Highwaymen or heroes: Should hedge funds be regulated? A survey (2005) 1 Journal of Financial Stability, 522, 523.

[20] However, there is little evidence on the extent to which hedge funds have these effects, see *Rene M. Stulz,* Hedge Funds: Past, Present and Future, Working Paper No 3, Charles A. Dice Centre for Research in Financial Economics (2007), 11.

[21] For a good and simplified overview how hedge funds help to allocate risks, see *Daniel Bernet Puntas,* Sind Hedge-Funds gut oder böse?, NZZ am Sonntag (Zurich), 12 June 2005.

[22] A credit default swap is an OTC bilateral agreement between a «protection seller» and a «protection buyer». The seller promises to compensate the protection buyer against an economic loss in a «reference asset», if a «credit event» occurs. In return, the protection buyer pays an upfront or a fee on a regular basis, see *Lhabitant* (n. 12), 147.

[23] *Timothy F. Geithner,* Hedge Funds and Their Implications for the Financial System, Speech delivered at the National Conference on the Securities Industry: Hedge

son et al.[24] argue that the unregulated nature of hedge funds actually *contributes* to financial stability in adverse market conditions. Indeed, whereas regulated investors often need to liquidate their risky positions only for regulatory reasons (e.g. Basel Capital Accord[25]), hedge funds may find it profitable to buy liquidated assets and thereby *create liquidity* and consequently stability to the market.

III. What Are the Concerns and Regulatory Issues?

The regulatory concerns surrounding hedge funds are numerous. The Swiss Financial Market Supervisory Authority *(FINMA)*[26] and the Financial Services Authority *(FSA)*[27] have put the regulatory issues under four main headings: (1.) *systemic risk,* (2.) *investor protection,* (3.) *market integrity* and (4.) *hedge fund activism.* [28]

1. Systemic Risk

A central concern of policymakers around the world is the systemic risk of hedge funds. *Systemic risk* refers to the risk that a hedge fund's failure to meet its obligations may trigger adverse consequences for a large number of other financial institutions, potentially leading to a destabilisation of the entire financial market.[29]

1.1 Transmission Channels of Systemic Risk

There are *two* potential *transmission channels* through which systemic risk could be propagated.[30]

On the one hand, the *direct exposure* of hedge funds to counterparties (e.g. prime brokers, lenders or investors) constitutes a *direct* potential transmission channel of systemic risk.[31] In particular, the relationship of hedge funds and major financial institutions through *prime brokerage services*[32] causes concern.[33] If systemically important financial institutions acting as prime broker dealers are complacent in their risk management and, for example, demand inappropriate collateral in credit relationships with hedge funds, they may suffer *major credit losses* in the event of a hedge fund (or a group of hedge funds) failure.[34] Subsequently, a large financial institution acting as a prime broker dealer may be at risk of collapse and could thus pose a threat to the entire financial system. On the other hand, systemic risk could also be *indirectly propagated*. This may happen through the hedge funds' behaviour in the market. As a result of the size of certain hedge funds[35], their actions can *ex-*

Funds and Their Implications for the Financial System (New York, 17 November 2004).

24 *Danielsson et al.* (n. 19), 535.

25 The Basel Capital Accords (Basel I, II and III) are recommendations on banking regulations, in particular in reference to capital adequacy of banks. They suggest that banks should have specific liabilities to cover a minimum amount of their capital at risk. Therefore, in adverse markets, banks often have to liquidate their positions in order to be above a specific threshold. For information about the Activities of the Basel Committee, see *Peter Nobel,* Swiss Finance Law and International Standards (2002), 310.

26 For the outline of the regulatory issues caused by hedge funds, see SFBC, Hedge Fonds: Marktentwicklung, Risiken und Regulierung, Positionspapier der Eidg. Bankenkommission (2007), 34.

27 *Callum McCarthy,* Hedge Funds: what should be the regulatory response?, Speech delivered at the European Money & Finance Forum (London, 7 December 2006).

28 Hedge fund activism has been in the media all over the world. In the US, The Economist ran a special report on shareholder democracy focusing on activism by hedge funds, see «Battling for Corporate America», The Economist (US), 11 March 2006, 69–71. In *Germany,* the national leader of the Social Democratic Party, *Franz Müntefering,* has called hedge funds «a swarm of locusts» and has prompted a worldwide discussion ever since, see *Benoit Betrand,* German deputy still targets locusts, The Financial Times (Europe), 14 February 2007.

29 *Roger Fergusson/David Laster,* Hedge Funds and systemic risk (2007), in: Banque de France, Financial Stability Review – Special issue on hedge funds 10 (2007), 45, 49.

30 SFBC (n. 26), 34.

31 *McCarthy* (n. 27).

32 Prime brokerage refers to services offered by investment banks to hedge funds such as the clearing of trades, acting as global custodian, margin financing, securities lending, risk reporting, collateral management and other services across the core functions of execution and operations, see *Lhabitant* (n. 12), 93.

33 *Phillip M. Hildebrand,* Hedge funds and Prime Broker Dealers: Steps towards a best practice proposal (2007), in: Banque de France, Financial Stability Review – Special issue on hedge funds 10 (2007), 67, 71.

34 *Nicholas Chan/Mila Getmansky/Shane M. Haas/Andrew W. Lo,* Systemic Risk and Hedge Funds, NBER Working paper No. 11200, National Bureau of Economic Research (2005), 1.

35 The biggest hedge funds have assets under management of around US 30 Billions. For a list of the world's biggest hedge funds, see Business Insider, The Biggest Hedge Funds In The World <*http://www.businessinsider.com/*

acerbate market volatility and can cause an abrupt *deterioration in market liquidity*.[36] In the same way, the failure of a large hedge fund or a group of funds may cause a serious reduction of market liquidity, particularly if they were *similarly positioned* in the market and exhibit *herding behaviour.*[37]

1.2 Factors That Might Contribute to Systemic Risk

Bearing these potential transmission channels in mind, there are certain *factors* that can *contribute to* or *mitigate* systemic risk.

One major factor that can increase systemic risk is the hedge funds' use of *leverage.*[38] Leverage stands for a situation where the amount of *money invested* or the *economic exposure*[39] is higher than the available equity capital.[40] Whereas leverage by itself is not a direct cause of a hedge fund collapse, it will greatly magnify potential losses and exacerbate its consequences in the market,[41] A striking example to illustrate the threat of systemic risk to the global financial markets with regard to hedge funds and their leverage was the near-failure of Long Term Capital Management (*LTCM*) in 1998.[42] As a result of the LTCM crisis, the use of leverage became one of the central issues in policy and industry discussions.[43] While commentators agree that leverage can yield important data about the vulnerability of a hedge fund, the actual measurement of leverage is difficult and highly complex.[44] Therefore, although recent studies have not clearly shown excessive leverage in hedge fund industry,[45] its real extent is virtually impossible to measure and the leverage issue should therefore remain one of the main concerns of policymakers.[46] Although LTCM should have been a wake-up call for the industry to stop using excessive amounts of leverage, the collapse of two Bear Stearns hedge funds in summer 2007 at the beginning of the financial crisis was again primarily precipitated by excessive borrowing. The funds were employing a leverage ratio of up to 60:1. As a result of their exposure in the US subprime mortgage market, they experienced large losses after the increase of delinquencies of US homeowners, ultimately leading to a loss of over 90% of their funds' value and large credit losses of their counterparties.[47] A second factor that can contribute to systemic risk is the *loss of market liquidity.*[48] If a large hedge fund or a group of funds

the-biggest-hedge-funds-in-the-world-2010-3> at 20 December 2010.

36 FSF, Update of the FSF Report on Highly Leveraged Institutions (2007), 11 and SFBC (n. 26), 34.

37 Herding behavior is defined as the phenomenon by which funds mimic other funds, despite the fact that their own private information or proprietary models suggest other strategies, see *Danielsson et al.* (n. 19), 531. For an empirical study, see *William Fung/David A. Hsieh,* A Primer on Hedge Funds (1999) 6 (3) Journal of Empirical Finance 309 who did not find any clear herding behavior among hedge funds.

38 *Hildebrand* (n. 10) states that increased competition in the industry is likely to lead to *«elevated levels of leverage».*

39 Economic exposure relates to the degree of risk taken on by a hedge fund in relation to its ability to bear this risk, i.e. the ratio of potential gains and losses to net worth, see *Lhabitant* (n. 12), 151.

40 This can either be done directly through formal debt such as bonds or credit lines or indirectly through buying or selling derivatives, taking so-called *«economic leverage»*, see *Lhabitant* (n. 12), 151.

41 Leverage is a «symptom» and not a cause of a crisis, see *Danielsson et al.* (n. 19), 529.

42 Simply put, LTCM gambled high with a balance sheet of USD 125 billion in assets, a leverage ratio of 25 to 1 and notional derivatives positions of over USD 1.5 trillion and after it failed, had to be bailed out by a consortium organized by the Federal Reserve Bank of New York because it was agreed that if LTCM defaulted, the following domino effect «might have led to a serious of dramatic and punishing events for LTCM's counterparties and the markets themselves», see President's Working Group on Financial Markets (PWG), Hedge Funds, Leverage, and the Lesson of Long-Term Capital Management (1999), 18.

43 Studies were undertaken by nearly every major central bank, regulatory agency, and international committee, see, e.g., US Government Accountability Office (GAO), Long-Term Capital Management, Regulators Need to Focus Greater Attention on Systemic Risk (1999); IOSCO, Hedge Funds and Other Highly Leveraged Institutions (1999) and PWG (n. 42).

44 See *Danielsson et al.* (n. 19), 529 stating that «it is impossible to measure the contribution of leverage to systemic risk with any degree of accuracy.»

45 *Patrick McGuire/Kostas Tsatsaronis,* Estimating hedge fund leverage, BIS Working Papers No. 260 (2008), 13 stating that «the estimate of leverage appears to be quite low.»

46 *Hildebrand* (n. 10) and *Noyer* (n. 16), 109.

47 For an overview of the collapse of the two hedge funds, see *Matthew Goldstein/David Henry,* Bear Stearns' Bad debt (11 October 2007) <*http://www.businessweek.com/bwdaily/dnflash/content/oct2007/db20071011_175964.htm*> at 20 December 2010.

48 Market liquidity refers to the ability to sell or unwind positions quickly without affecting their market price. In contrast to funding liquidity which refers to the ability of an investor to raise cash to meet its financial obligations, *market liquidity* is systemic and may be the *source of systemic risk,* see *Smullen/Hand* (n. 3), 241.

with similar trading positions *fails,* the liquidity in the respective market can be substantially reduced. This can lead to even further market disruptions when other institutions may, for regulatory reasons (e.g. Basel Capital Accords), be forced to engage in liquidations as well.[49] Such market liquidity shocks, possibly even coupled with excessive leverage, can have major systemic implications and could lead to great disturbances in the market.[50] A third factor that can indirectly trigger systemic risks is when a number of hedge funds hold similar positions *(crowded trades)* and decide to sell these assets at the same time *(herding behaviour),* thereby generating a contagion effect.[51] Such a pursuance of similar strategies *(style convergence)* may result from a communication between fund managers and can cause *one-way-markets* where several hedge funds enter or exit a market collectively, leading to a serious reduction of liquidity and *extreme market volatility*.[52] Further, *counterparty risk management,* the main factor to prevent a systemic crisis by reducing the exposure of a financial institution in the event of a default of counterparties (i.e. hedge funds) shows *signs of complacency*.[53] Although the Counterparty Risk Management Policy Group *(CRMPG)* continuously recommends steps to improve the current counterparty risk management issues[54] and the Financial Stability Forum *(FSF)* has named it one of its key focuses after the LTCM crisis,[55] there are several signs of erosion in market and counterparty discipline which greatly increases systemic risk.[56] The main reason can be seen in the *competitive pressure* in the prime broker dealer industry.[57] The recent financial crisis, for example, also originated *inter alia* in unsatisfactory risk management practices.[58]

2. Investor Protection

Besides systemic risk, there are several concerns about the protection of hedge fund investors. In Switzerland as well as in the UK, the main device to protect investors from the risks associated with hedge funds is *limiting the possibility to invest* or the *marketability* of hedge funds to *wealthy and knowledgeable investors*. The rationale behind is simple: a sophisticated investor can *«fend for herself»*.[59] She should be able to understand both the riskiness and complexity of a hedge fund investment and should not need external government regulation to protect her. However, two main counterarguments can be brought forward: *First,* the *information asymmetries* among the hedge fund and its investors demand regulatory intervention even in case of sophisticated investors. *Second,* the *increasing participation of retail investors* leads to new regulatory issues which regulators have so far insufficiently taken into account.

2.1 Qualified Investors Do Need Protection

The wide-spread opinion that sophisticated hedge fund investors do not need regulatory protection[60] can no longer be supported or, at least, is subject to adjustments. The assertion that qualified investors are able to look after themselves is based on the assumption that both parties – investors and the fund manager – are about of equal bargaining power.[61] Yet despite the fact that information about hedge funds and their in-

49 *Noyer* (n. 16), 106.
50 FSF (n. 36), 12.
51 *Danielsson et al.* (n. 19), 531.
52 FSA (n. 18), 29; *Hildebrand* (n. 10), states that a combined review of all facts provides *«tentative evidence»* that increased market volatility may be related to herding behavior of hedge funds.
53 *Hildebrand* (n. 33), 72 and SFBC (n. 26), 36.
54 There have been three Reports of the CRMPG, with the latest in 2008, see CRMPG, Containing Systemic Risk: The Road to Reform (The Report of the CRMPG III, 2008) <http://www.crmpolicygroup.org/> at 20 December 2010.
55 FSF, Report of the Working Group on Highly Leveraged Institutions (2000).
56 FSF (n. 36), 12.
57 Prime brokerage services constitute around 25% of the revenues across the investment banking industry and are estimated to increase further, see *Jean-PierreMustier/ Alain Dubois,* Risks and return of banking activities related to hedge funds (2007), in: Banque de France, Financial Stability Review – Special issue on hedge funds 10 (2007), 85, 87–88.
58 For the role of hedge funds in the financial crisis, particularly in the market for subprime mortgage-backed securities, see *Randal Doddl,* Subprime: Tentacles of a Crisis (2007), 44 (4) Finance and Development 15.
59 *Troy A. Parades,* On the Decision to Regulate Hedge funds: The SEC's Regulatory Philosophy, Style and Mission, (2006) University of Illinois Law Review 975, 991.
60 See, e.g., the Swiss legislator has introduced qualified investors because they are said to need less protection than 'normal' retail investors, see Botschaft zum Bundesgesetz über die kollektiven Kapitalanlagen vom 23. September 2005, BBl 2005, 6395ff., 6429.
61 *Harry McVea*, Hedge funds and the new regulatory agenda, (2007) 27 (4) Legal Studies 709, 725.

vestment strategies is increasingly accessible[62] and investors usually conduct extensive *due diligence,*[63] the widely acknowledged secretive nature of the hedge fund industry *militates* against the *ability* of wealthy investors *to protect* themselves. A striking example of the lack of sophistication of wealthy investors is the fraud case of *Bernhard L. Madoff* Investment Securities.[64] The sources of potential *information asymmetries* among hedge funds and its investors are numerous: hedge funds may freely diverge from their initially proclaimed investment strategy *(style drift)* without the investor's knowledge;[65] they are, as a result of the close relationship to prime brokers, prone to use so-called *«soft dollars»,*[66] causing the hedge fund to overcharge its investors. Finally, hedge funds also often use *«side pockets»,* i.e. mini-funds within the hedge fund that hold particularly illiquid assets.[67] A non-disclosure of side-pockets can be detrimental to investors. A manager could be tempted to move non-producing illiquid assets in the non-disclosed side pockets in order to maximize his performance fee on the better performing investments. These practices are only examples[68] of the *inherent information asymmetry* and are recognised by the *FSA*[69] and by *FINMA,* although under the heading of market integrity and, in particular, in relation to *portfolio valuation issues.*[70]

The most significant element of the information asymmetry among hedge funds and their investors is the fact that *accurate valuation* of the hedge fund's holdings and its performance is *difficult*[71] and with the absence of an available market price often *«marked to mode»*[72]. Positions are thereby valued according to counterparty quotes or by the hedge fund manager himself, neither of which are said to be fully independent.[73] Additionally, since the fund's performance is the basis for the manager's remuneration, there is a strong incentive to overstate returns and claim performance fees on a performance that does not in fact exist.[74] As a result, the International Organization of Securities

[62] The creation of hedge fund databases and indices (e.g. Hedge Fund Research, Inc. <*http://www.hedgefundresearch.com*>) has made both quantitative and qualitative information on hedge funds increasingly available to the public and thus has, at least, partially diminished the previous information asymmetry. See *Lhabitant* (n. 12), 479.

[63] Due diligence is a detailed internal analysis of a hedge fund by looking at its investment process and philosophy, style, approach, risk controls etc., see *Lhabitant* (n. 12), 573.

[64] *David Randall,* Rich investors «wiped out» by Wall Street fraud, The Independent on Sunday (14 December 2008), <*http://www.independent.co.uk/news/world/americas/rich-investors-wiped-out-by-wall-street-fraud-1066090.html*> at 20 December 2010.

[65] *John Horsfield-Bradbury,* Hedge Fund Self- Regulation in the US and the UK (2008), 9, <*http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/Brudney2008_Horsfield-Bradbury.pdf*> at 20 December 2010.

[66] «Soft Dollars» describe a transaction in which the broker-dealer provides the hedge fund manager with research or other services in return for commission usually paid for executing transactions, rather than a separate research or services fee, see *Jennifer Ralph Oppold,* The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach, (2008), 10 University of Pennsylvania Journal Business & Employment Law 833, 869.

[67] A side pocket is often used as follows: Upon acquisition of illiquid assets, a portion of every investor's holding in the general portfolio is redeemed and exchanged for a portion of the newly issued shares representing the illiquid investment. Consequently, investors have two classes of shares, whereas they keep the original redemption rights in relation to the liquid portion of the general portfolio, they are obliged to hold the side pocket shares until the illiquid assets are liquidated, see *Lhabitant* (n. 12), 116.

[68] Another issue of conflict of interest are so-called *side letters.* They are agreements between the fund and favored clients that give the investor contractually binding assurances that modify the rights and entitlements of that particular investor. See also FSA (n. 18), 47.

[69] FSA (n. 18), 33.

[70] SFBC (n. 26) 43.

[71] FSA (n. 18), 48 and Securities and Exchange Commission (SEC), Implications of Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission (2003), xi <*http://www.sec.gov/news/studies/hedgefunds0903.pdf*> at 20 December 2010.

[72] «*Marking to model»* means that financial obligations are valued according to pricing models. This occurs when there is no current market price, in particular in relation to derivatives sold on the OTC market, *Smullen/Hand* (n. 3), 257.

[73] For hedge funds domiciled in Switzerland, the rules for portfolio valuation can be found in Art. 88 CISA. It states that investments with no current price must be valued at the price that would probably be obtained in a diligent sale at the time of valuation. The SFBC has also recognized the Swiss Fund Association, Guideline for the valuation and treatment of valuations mistakes in investment funds, published on 11 June 2001 as a minimum standard, see SFBC (n. 26), 43.

[74] See e.g. *Michael Herman,* Hedge fund chief accused of overstating assets by 2500%, The Times of London (London), 8 February 2007.

Commissions (IOSCO) among others[75] has published «Principles for the Valuation of Hedge Fund Portfolios» *(IOSCO Valuation Principles)*[76] which were welcomed by the FSA that noted that they *«should be used by hedge funds in valuing their investment portfolio»*.[77]

2.2 Retailization of Hedge Funds

Further concerns about investor protection stem from the increasing *«retailization»* of hedge funds, i.e. the ability of individual, unqualified investors to be exposed to investments in hedge funds, sometimes without their explicit consent.[78] *First,* it has become *easier* for retail investors to *invest in hedge-fund-like entities*. In Switzerland as well as in the UK so-called (registered) *«funds of hedge funds»*[79] or *Funds of Alternative Investment Funds* (FAIFs) as they are called in the UK, are treated differently than single hedge funds. For example, they are generally *allowed* to be marketed to retail investors. Yet despite the fact that funds of hedge funds are subject to investor protection regulations similar to mutual funds and extensive due diligence must be performed in selecting the underlying single hedge funds,[80] the issue of valuation practices in the underlying funds remains to be a concern. *Second,* the proportion of investments in hedge funds made by *institutional investors,* particularly pension funds has *increased greatly over the years*.[81] Although a pension fund itself is a «qualified» investor,[82] its *beneficiaries,* the people that ultimately take the risk, are most likely not and should be protected. *Third and finally,* retail investors increasingly invest in indices that replicate hedge fund performances.[83] Although such index trackers benefit the investor by not charging the exorbitant hedge fund fees, the biases in hedge fund indices[84] as well as the lack of clear valuation rules for hedge fund portfolios put investors at increased risk and therefore – in our view – necessitates legislative actions.

The factors leading to an *increased retailization* of hedge funds coupled with the *information asymmetry* among hedge funds and their investors illustrate that the current limited *regulation* of hedge funds with regard to investor protection, particularly regarding valuation issue, is *no longer sufficient*.[85]

3. Market Integrity

The third strand of regulatory concern relates to *market integrity* and issues such as insider trading, market abuse or market manipulation.[86] Despite the fact that the organisational structure of hedge funds[87]

75 Another example is Alternative Investment Management Association (AIMA), AIMA's Guide to Sound Practices for Hedge Fund Valuation (2007), <*http://www.aima.org/en/document-summary/index.cfm/docid/FC269E93-4A10-49D3-AC37B7892762EC23*> at 20 December 2010.

76 IOSCO, Principles for the Valuation of Hedge Fund Portfolios – Final Report (2007). For a discussion of the principles, see *Harry McVea,* Hedge Fund Asset Valuation and the Work of the International Organization of Securities Commissions (IOSCO) (2008), 57 International and Comparative Law Quarterly 1–24.

77 FSA, «FSA supports IOSCO Principles for the valuation of Hedge Fund Portfolios» (Press Release, 14 March 2007).

78 SEC (n. 71), 81.

79 Funds of hedge funds are funds that invest in a portfolio of different hedge funds (typically around 30–60 single hedge funds) to provide broad exposure to the hedge fund industry and to diversify the risks associated with a single hedge fund, see *Lhabitant* (n. 12), 479.

80 The FINMA authorization of funds of hedge funds primarily focuses on the due diligence process employed by the fund when selecting underlying single hedge funds. For an overview of the FINMA practices, see *Felix Lukas Stotz,* Die Regulierung von Hedge Funds in der Schweiz (2004), 26 et sqq.

81 According to the Credit Suisse Schweizer Pensionskassen Index, Swiss Pension funds have increased their allocation to alternative investments from 3% in 2006 to about 5% at the end of 2010. Furthermore, since 1 December 2009, pension funds are officially allowed to invest 15% of their assets in alternative investments, see Art. 55 (d) BVV2.

82 See Art. 10 para. 3 (c) CISA.

83 For example, see the Tracker Certificates *«HFRX Hedge Fund Style Rotation»* of the Vontobel Financial Products Ltd that are tradable on SIX Swiss Exchange and replicate a basket of different HFRX Indices (ISIN CH0023000000).

84 See *Lhabitant* (n. 12), 479 et sqq.

85 For other opinions, see *Carl J. Nelson,* Hedge Fund Regulation: A Proposal to maintain Hedge Funds «effectiveness without SEC regulation» (2007), 2 Brooklyn Journal Corporate Finance and Commercial Law 221, 230 where he argues that there is *no need* to protect sophisticated investors and *Steven M. Davidoff,* Black Market Capital (2008), Columbia Business Law Review 172, 267, who states that the developing black market of hedge fund-like investments and its adverse effects can only be prevented by making hedge fund investments available to all investors.

86 *McCarthy* (n. 27).

87 In particular, hedge funds are often not obliged to implement *«Chinese Walls»* (information barriers within a financial institution) in order to prevent the transfer of price-sensitive information from one department to an-

may make the occurrence of insider trading and market manipulation more likely, the concerns about integrity are *not specific* to the hedge fund industry.[88] Both, insider trading and market manipulation amount to criminal offences and are covered by current legislation.[89] Furthermore, whereas the issue of hedge fund portfolio valuation must be considered in upcoming regulatory actions in the field of hedge funds, fraudulent behaviour in general is not confined to the hedge fund industry. This has been nicely demonstrated by the recent fraud case of *Bernard L. Madoff Investment Securities* that in fact was *not* a hedge fund.[90]

The regulation of hedge funds with regard to market integrity issues seems to be sufficient. In our view, the emphasis should therefore be placed on the *enforcement of existing rules* rather than introducing new regulations that cannot be effectively implemented.[91] After all, fraudulent behaviour by some does not illustrate that there is a need for more regulation but rather the limits of the law and its enforcement.

4. Hedge Fund Activism

The last regulatory issue surrounding the hedge fund industry is the concern that hedge funds, as a result of them being shareholder activists, *adversely affect the companies they invest in*. Despite the fact that only a minority of funds actually pursue shareholder activism,[92] media attention all over the world has been exceptionally high and it is said that hedge fund activism remains popular despite the current uncertainty in the financial markets.[93]

4.1 Characteristics of Hedge Fund Activism

Hedge funds are more likely to be *active in governance* than other investors mainly because of the following reasons. *First,* the lack of regulation in relation to diversification allows hedge funds to concentrate their investments in a particular company and to use high leverage which in turn allows them to acquire more shares of and exert power in a company.[94] *Second,* the «lock-up» provisions of hedge funds provide them with the opportunity to invest a high amount of their assets in illiquid investments such as unlisted companies. *Third,* the fact that hedge fund managers participate in the fund's performance greatly encourages them to engage in potentially lucrative activist behaviour.[95] Additionally, in contrast to traditional institutional investors that practice an *ex post* activism by only intervening in a portfolio company's affairs if it underperforms or has a deficient governance regime, hedge funds are *strategic* and engage in *ex ante* activism by first identifying an appropriate target company and its weaknesses and then taking a position and becoming active.[96]

4.2 Potential Problems of Hedge Fund Activism

The potential problems of hedge fund activism are primarily said to be that hedge funds aim to achieve a *short-term profit* at the expense of long-term value creation.[97] Furthermore, the fact hedge funds are allowed to engage in short selling may encourage them to bet «against» the company, essentially working contrary to its needs and the other shareholders' goals.[98] However, there seems to be *no empirical evidence* for the assertion that hedge fund activism destroys value or is short term in focus.[99] To

other. In Switzerland, e.g., unregulated hedge funds are not subject to the FINMA Circular on Market Conduct and not obliged to implement such «Chinese Walls», see FINMA-RS 2008/38, N 4 and N 48.

88 *Noyer* (n. 16), 107.

89 As an example, in Switzerland, hedge funds are subject to the Swiss Criminal code and insider trading amounts to an offence under Art. 161 SCC and market manipulation is subject to Art. 161bis SCC.

90 *Alex Berenson/Diana B. Henriques,* Look at Wall St. Wizard Finds Magic Had Skeptics, New York Times (New York), 12 December 2008 who say that «[…] *Mr. Madoff's firm was not a hedge fund*».

91 It is said that the complex trading strategies, the general lack of transparency and the fact that hedge funds often trade in opaque market segments already immensely complicate the implementation of existing rules, see SFBC (n. 26), 43.

92 *Marcel Kahan/Edward B. Rock,* Hedge funds in Corporate Governance And Corporate Control (2007), 155 (5) University of Pennsylvania Law Review 1021, 1046 n. 135 cites a study by J.P. Morgan that states that only about 5% of hedge fund assets are used for shareholder activism.

93 *Marco Becht,* Der Aktionärsaktivismus wird die Finanzkrise überleben, Neue Zürcher Zeitung (Zurich), 29 November 2008, 31.

94 *Horsfield-Bradbury* (n. 65), 18.

95 *Kahan/Rock* (n. 92), 1064 and *Thomas Werlen,* Hedge Fund Activism, (2006) 4 GesKR 261, 262.

96 *Kahan/Rock* (n. 92), 1069 and *Werlen* (n. 95), 262.

97 *Werlen* (n. 95), 262.

98 *Horsfield-Bradbury* (n. 65), 21.

99 *Alon Brav/Wei Jiang/Frank Partnoy/Thomas Randall,* Hedge Fund Activism, Corporate Governance, and Firm

the contrary, it has been said that if activism causes company managements to review and reassess their business strategies, corporate governance is actually *improved*.[100]

It seems therefore that the costs and potential benefits of hedge fund activism are not well understood and a definite opinion concerning regulation can not yet be made.[101] Nevertheless, in our view, every attempt to regulate hedge fund activism must take into account the benefits that hedge funds may bring to a company, its long-term prospects and corporate governance. Activist behaviour should thus not be excessively constrained.

IV. How Are Hedge Funds Currently Regulated?

The following overview discusses the regulation of hedge funds in *UK*[102] and *Switzerland*.[103] It analyses systemic risk and investor protection regulation as well as self-regulated standards of best practice. Market integrity and hedge fund activism issues are set aside.

1. Systemic Risk

In relation to systemic risk, both Switzerland and UK, in line with the entire international regulatory consensus, have in past years heavily relied on *strengthening market discipline* and thereby focused on the corrective effects of market controls and on regulating banks and other hedge fund counterparties.[104] The financial crisis has, however, prompted regulators to re-evaluate their approach to hedge fund regulation. Whereas FINMA[105] does not seem to have changed its view on hedge fund regulation, the FSA[106] has begun to consider tightening its rules and adopting a more rigid regulation scheme.

Earlier, after the LTCM crisis in 1998, regulatory recommendations made by international as well as national institutions were largely confined to indirect actions *(«indirect regulation»)* that aimed to improve *risk management practices* of hedge fund counterparties, *greater regulatory oversight over credit providers* and *improved disclosure*.[107] Somewhat surprisingly, official reports unanimously rejected direct regulation of hedge funds.[108] In the following years, the UK as well as Switzerland and other nations began to collaboratively assess the risk management practices of prime brokers.[109] Recently, the FSA has indicated that it will increase its scrutiny of hedge funds and monitor them closer in order to assess their system-wide risks.[110] For example, the FSA aims at gathering more information on hedge fund activities and does not preclude introducing further prudential regulation, particularly with regard to capital and liquidity rules.[111] FINMA, similar to the FSA, periodically requests information from the supervised financial institutions regarding their exposure to hedge funds and firmly believes in the *indirect regulation approach* with regard to systemic risk.[112] It also supports a *«Best Practice Proposal»*[113] made by *Hildebrand* in 2007 that focuses on strengthening the credit relationship between prime broker dealers and hedge funds and stands for a *self-*

Performance, Law & Economic Research Paper No. 07–28, Vanderbilt University, 2007.

100 *Thomas W. Briggs,* Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis (2007) 32 (4) Journal of Corporation Law 681. Similarly, the SFBC states in its white paper that hedge funds regularly support companies in financial difficulties, see SFBC (n. 26), 45.

101 *Briggs* (n. 100), 722.

102 The UK and the US account for around *80% of the world wide hedge fund market*, see ZHAW/ GAM (n. 2), 15.

103 The Swiss Government established the «Swiss Financial Centre Dialogue Steering Committee» which should recommend changes in the Swiss regulatory environment in order to make Switzerland more attractive to single hedge funds, see Swiss Federal Administration, Dialogue on Switzerland's financial centre: promoting collective investment instruments – early recognition of international developments (5 September 2008), <*http://www.efd.admin.ch/dokumentation/medieninformationen/00467/index.html?lang=en&msg-id=21168*> at 20 December 2010.

104 *Daniele Nouy,* Indirect supervision of hedge funds (2007), in: Banque de France, Financial Stability Review – Special issue on hedge funds 10 (2007) 95, 103.

105 *Daniel Zuberbühler,* Globalisierte Kreditkrise- Konsequenzen für die Bankenaufsicht, SFBC Annual Media Conference, Bern, 1 April 2008, 3.

106 FSA, The Turner Review – A regulatory response to the global banking crisis (2009), 7.

107 FSF (n. 55), 2–4.

108 See FSF (n. 55), 4; IOSCO (n. 43), 172 and PWG (n. 42), 42.

109 FSF (n. 55), 26.

110 FSA (n. 107), 7.

111 *Adair Turner,* Turner Review Press Conference, Speech delivered at the Turner Review Press Conference, London, 18 March 2009.

112 SFBC (n. 26), 5.

113 *Hildebrand* (n. 33), 67–76.

regulation regime on the level of the prime broker dealer.[114]

2. Investor Protection

Both jurisdictions analysed herein deal with the investor protection issue by *confining investments* in hedge funds to wealthy and sophisticated investors who are financially knowledgeable and by regulating hedge fund managers.

2.1 Marketing and Distribution of Hedge Funds

In very broad terms, the marketing and distribution of hedge fund products, in both jurisdictions, is *confined to wealthy investors* and is only allowed to be made on a *private placement basis*.

The UK and Switzerland – in contrast to the US – are mainly hedge fund *manager locations* and not hedge fund domiciles.[115] Therefore, hedge fund regulation in relation to investor protection focuses on the funds' *marketing activities.* In the *UK*, hedge funds are generally classified as unregulated collective investment schemes *(UCIS)*[116] and their marketability is very limited.[117] Basically, hedge funds are only allowed to advertise to *«professional clients».*[118] In *Switzerland*, *unregulated* hedge funds are not allowed to be marketed to the public.[119] They are only allowed to be offered on a *private placement* basis to *«qualified investors».*[120] This means that unregulated funds may only advertise *exclusively* to qualified investors and *only* use means of marketing that are usually applied to attract such investors (e.g. personal contact or «Road-Shows»).[121] *Regulated* and *authorised* hedge funds such as approved offshore hedge funds[122] or registered onshore *«funds for alternative investments»*[123] are allowed to be marketed to *any* investor. However, the fund's name, the marketing material and the prospectus must entail a notice regarding the special risks involved in the investment *(«warning clause»).*[124] Swiss regulation, in contrast to the UK, focuses on *transparency and risk disclosure* and does not forbid public distribution of hedge fund products that are authorised by FINMA.[125] Additionally, Switzerland offers a legal structure, the so-called *Limited Partnership for Collective Investment (LLP)*[126] that is particularly suitable for hedge funds as it has no investment restrictions[127] but consequently is only open to qualified investors.[128]

2.2 Regulation of Hedge Fund Managers

The regulation of hedge fund managers should ensure that investors in hedge funds are in «good hands». In Switzerland as well as the UK, hedge fund managers *must or may obtain authorisation* by the respective regulatory authority. In the UK, the Financial Services and Markets Act 2000 *(FSMA 2000)* requires every hedge fund manager to seek authorisation by the FSA.[129] The focus thereby lies on the manager's competence to manage financial assets, to conduct an appropriate risk assessment and

[114] Similarly *Nathan Bryce,* Hedge Funds, Liquidity and Prime Brokers' (2008) 13 Fordham Journal of Corporate & Financial Law 475–504.
[115] FSA (n. 18), 11 and ZHAW/ GAM (n. 2), 8.
[116] See FSA, Unregulated Collectives Investment Schemes: Good and poor practice report, 2010.
[117] For an overview of the marketing restrictions, see FSA, FSA Factsheet, Unregulated collective investment schemes, 2010, *<http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/ucis_factsheet.pdf>* at 20 December 2010.
[118] There are two types of professional clients: *per se* and *elective* professional clients. For further information on the distinction and characteristics of both, see COBS 3.5 in the FSA Handbook.
[119] For an overview of the meaning of *«public advertising»,* see FINMA-RS 08/8.
[120] For a list of qualified investors, see Art. 10 para. 3 CISA.
[121] See Art. 3 CISA and FINMA-RS 08/8, N 9.
[122] It is possible for offshore funds to obtain an approval by FINMA. Such approval is granted if the offshore fund fulfils all requirements that an onshore hedge fund must meet in order to be approved. After approval, the offshore fund is allowed to be marketed to *any* investor (Art. 120 CISA).
[123] Art. 71 CISA.
[124] Art. 71 para. 3 CISA in connection with Art. 102 CISO.
[125] SFBC (n. 26), 54.
[126] Art. 98 CISA.
[127] See Art. 103 para. 2 CISA in connection with Art. 121 CISO. For the particular suitability of the LLP for hedge funds see also *Adrian Dörig,* Das neue schweizerische Kollektivanlagegesetz 3 Recht der internationalen Wirtschaft (2007) 169, 172 and *Alexander Vogel/Daniel Schär,* Die Kommanditgesellschaft nach KAG als Anlagevehikel für Private Equity: Regulatorische und steuerliche Aspekte (2007) 6–7 Der Schweizer Treuhänder 479, 479.
[128] Art. 98 para. 3 CISA.
[129] Hedge fund managers regularly engage in the *managing of* and *advising on investments* and are therefore subject to authorisation, see s 37 and s 53 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI2001/544) (RAO).

on other adequate fund management requirements.[130] Similarly, hedge fund managers based in Switzerland either have a *general* obligation to obtain authorisation by the FINMA[131] (Swiss hedge fund managed in Switzerland) or *may* do so under certain conditions[132] (offshore hedge funds managed in Switzerland). If managers have to or choose to obtain authorisation, the manager must meet certain requirements which include *good reputation*, *proper management skills* and the possession of *specialist qualifications*.[133]

3. Self-Regulated Schemes

3.1 Numerous Attempts of Self-Regulation

In light of past developments in the UK,[134] it seemed that there was a move towards a self-regulation scheme for the hedge fund industry, particularly with regard to investor protection. The developments led to a number of industry-led attempts to circumscribe *standards for sound practices* in order to escape government regulation. There is a long list of standards,[135] ranging from the *Best Practices for the Hedge Fund Industry*[136] produced by the President's Working Group on Financial Markets and supported by the U.S. regulatory authorities to the *IOSCO Valuation Principles*[137] and probably the most important, the *«Hedge Fund Best Practice Standards»*[138] *(HFWG Standards)* drawn up by the Hedge Fund Working Group *(HFWG)* comprising 14 hedge fund managers, 12 of whom are based in the UK. Furthermore, in order to harmonize all industry standards, a group of hedge funds and financial market bodies launched *«Hedge Fund Matrix»*[139] in October 2008, an online platform that brings together all sound practices guides and provides the means to compare the core principles and thereby seeks to facilitate compliance.

The FSA's preference of self-regulation does not seem to have significantly changed after the financial crisis.[140] However, after the release of the *Turner Review*[141] in March 2009, there are signs that the FSA will start to increase its monitoring of hedge funds and gather more information in order to assess the fund's systemic impact and potential regulatory responses. *Hence,* it appears that before the financial crisis the UK had not been willing to jeopardize its position as a major hedge fund centre and still, after the crisis, remains reluctant to increase governmental regulation. Symptomatically, *Hector Sants,* the FSA Chief Executive, emphasized in 2008 that the *«*[*FSA*] *hope[s] that the UK remains an attractive location for managers to operate in and managers continue to be successful market participants».*[142] Although the effects of the current financial crisis may lead to further governmental regulation of hedge funds, it is far from certain. The competitive pressure to attract hedge fund business is still very high and several countries want to get a share of the trillion dollar in-

130 The FSA focuses on «(a firm's) *resources and competence to manage the assets of funds in line with its mandates from the operators of the underlying fund. This will include the need to have adequate interfaces with the Prime Broker and Administrator of the fund for reconciliation purposes, and appropriate information feeds for pricing and other market information. Also, a firm would need to show adequate internal accounting systems to ensure ongoing compliance with its financial resources requirements.»* See FSA, Discussion Paper 16, Hedge Fund and the FSA, 2002, 16–17.

131 Art. 13 para. 2 (f) CISA.

132 Managers of offshore hedge funds may obtain approval by the FINMA if the conditions in Art. 13 para. 4 CISA are met.

133 The general partner in the LLP must meet the same requirements. Additionally, significant equity holders of the general partner must provide evidence of good reputation and must not exert their influence to the detriment of prudent and sound business practice, see Art. 10 CISO and Art. 14 para. 1b CISA in connection with Art. 11 CISO.

134 FSA, Feedback Statement 06/02, Hedge Funds: A Discussion of Risk and Regulatory Engagement, Feedback on DP 05/4, 2006, 7, 30.

135 For a list of all industry standards, see *Alexander Ineichen/ Kurt Silberstein,* AIMA's Roadmap to Hedge Funds, 2008, 150.

136 PWG Asset Managers' Committee, Best Practices For the Hedge Fund Industry – Report of the Asset Managers' Committee to the President´s Working Group of Financial Markets. 2009.

137 IOSCO (n. 77).

138 Hedge Fund Working Group, The HFSB Standards, 2010, <*http://www.hfsb.org/sites/10188/files/final_standards _21_jan.pdf*> at 20 December 2010.

139 The group comprises the AIMA, HFSB, IOSCO, MFA and the Asset Managers' Committee of the US PWG, see <*http://www.hedgefundmatrix.com*> at 20 December 2010.

140 *Hector Sants,* The regulator's view of hedge funds and hedge fund standards, Speech delivered at the Hedge 2008 Conference, London, 22 October 2008, stating that the FSA intends to *stick with its «guiding principles of proportionality, and outcome-focused regulation»* and does *not* intend to increase regulation.

141 FSA (n. 106).

142 *Sants* (n. 140).

dustry, particularly in the current economic environment.[143]

3.2 Benefits and Disadvantages of Self-Regulation

The past has shown that self-regulation has the capacity to *react quickly* to industry changes.[144] This is particularly relevant for the hedge fund industry as the funds are generally designed to exploit regulatory gaps. Therefore, *fast adaptation* to industry changes is of *great importance* when trying to regulate hedge funds. Further, self-regulation is also said to be *efficient* by adequately *balancing the estimated costs and benefits* of the proposed regulation.[145] Some commentators have suggested that government regulation would likely lead to overregulation of the industry and hamper financial innovation, one of the main benefits of hedge funds.[146] In our view, however, *participation and involvement of industry representatives* in the formulation of a possible future regulation scheme would diminish the likelihood of overregulation and therefore preserve the positive effects of financial innovation. At last and most importantly, a self-regulation scheme for hedge funds possesses the capacity to be *international in scope*.[147]

Apart from these benefits, there are certain *disadvantages* of self-regulation schemes. *First,* the incentives of self-regulation organisations *(SRO)* are not necessarily aligned with the incentives of the parties that should be protected by regulation.[148] In case of hedge funds, there are ways in which the incentives of hedge fund managers are aligned with the market, particularly with regard to investor protection. One could say that hedge funds do «anything» to encourage investments. However, particularly in regard to systemic risk, hedge fund managers are *not* sufficiently incentivized to factor into their calculus the possible harm they can do to the markets as a whole. To put it bluntly, hedge fund managers only care about the survival and performance of their fund and not about their macroeconomic impact and ultimately, financial stability. To counter these problems, in our view, a future rule-making body must comprise *investor-, government- as well as industry-representatives*. Such a balanced composition would diminish the problem of having misaligned incentives and ultimately lead to rules that are *more accepted* than industry-made self-regulation standards.[149] *Second,* any self-regulatory scheme is *per se* voluntary and lacks enforcement mechanisms. For example, the *HFWG Standards* have been criticised for being too vague and therefore unenforceable.[150] Furthermore, in order to be truly recognised as an SRO, there must be a *sufficient number of members* in the organisation.

As a consequence, we believe that the current self-regulatory movement lacks the basic requirements to be able to adopt any enforceable regulations and thus does not (yet) have an effective impact on the hedge fund industry. Therefore, in our view, any future regulation scheme for hedge funds is in need of *clear and enforceable rules* and ultimately necessitates *government involvement*.

V. What are the Main Elements of a Future Hedge Fund Regulation Scheme?

1. Balancing Risks and Benefits

Any future regulation of hedge funds must be aimed at *preserving the hedge funds' benefits* while *achieving the public policy goals* of reduction of systemic risk and investor protection. Whereas on the one hand, the sophisticated investment strategies

143 For example, Switzerland aims to become more attractive for single hedge funds and *increase the international competitiveness* of the Swiss financial centre in general, see Swiss Banking Association (SBA), Vision 2015 – Switzerland among the top three centers of international finance worldwide, 2007.

144 *Jay W. Verret,* Dr Jones and the Raiders of Lost Capital; Hedge Fund Regulation, Part II, A Self-Regulation Proposal (2007) 32 Delaware Journal of Corporate Law 799, 818.

145 *Horsfield-Bradbury* (n. 65), 53.

146 For an empirical analysis of the effect of regulation on hedge fund performance, see *Douglas Cumming/Na Dai,* Capital Flows and Hedge Fund Regulation, 3rd Annual Conference on Empirical Legal Studies Papers, 2008.

147 *Horsfield-Bradbury* (n. 65), 55.

148 In the words of *Christopher Cox: «(there is an) inherent tension between an SRO's role as a business, on one hand, and as a regulator, on the other»,* see *Christopher Cox,* Keynote Address to the Columbia Law and Business Schools Cross Border Securities market Mergers Conference, Speech held at the Columbia Law and Business Schools Cross Border Securities Market Mergers Conference, New York, 10 December 2007.

149 For example, the HFWG Standards are criticised for having no investor representation, see *James Mackintosh,* Adviser Says Hedge Fund Code Needs To Be Tougher, The Financial Times (London), 3 January 2008, 15.

150 *Ibid,* 15.

involving leverage, short sales and derivatives make the financial markets more efficient, more liquid and allow an improved sharing of risk, some increasingly *complex aspects of financial innovation* may, on the other hand, *pose significant risks*. For example, whereas it might be true when *Shadab*[151] notes that flexible investment strategies can complement investor protection, it can also lead to *excessive risk taking* as it could be seen during the financial crisis.[152] Furthermore, investments in highly illiquid assets that are difficult to value increase the likelihood of mispricing and consequently fraud. Indeed, a lack of clear and mandatory rules for hedge fund portfolio valuation is likely to lead to *disparate and irregular valuation* which in turn expose investors to significant risks. *In short,* future regulation of hedge funds must therefore encompass a balance between both sides of the coin by *regulating as much as needed* but at the same time *preserving as much investment flexibility as possible.*

2. Efficiency, Effectiveness and Flexibility

A future regulation scheme for hedge funds must not only be *able to quickly react to changes* in the industry but also *take into account every jurisdiction's peculiarities*. On the one hand, the future regulatory scheme must be *able to respond to financial innovation*, new ways of trading and organisational developments without having to resort to tedious and bureaucratic processes. A way of merging effective regulation with fast adaptation processes must be found in order to keep up with the industry's tremendous pace in financial innovation and its flexibility.[153] Otherwise, any regulatory regime will, as some commentators already suggest, become 'almost instantly' outdated.[154] On the other hand, it is necessary that the future regulation scheme aims to provide *clear and concise rules*[155] but at the same time, does not try to achieve a «one-size-fits-all» solution that is neither effective nor efficient and might even increase systemic risk. Being regulated the same way may lead to failing the same way. Internationally agreed minimum standards for hedge fund regulation must therefore aim to appropriately combine specific *rule-based* hedge fund regulation where countries are obliged to implement certain provisions and a more *principle-based*[156] regulation that allows each country to implement rules according to its domestic needs.

3. Enforceability

Because the current industry-led self-regulation attempts have so far clearly lacked enforceability,[157] in our view, the introduction of exogenous public intervention through governmental involvement in the enforcement of rules is inevitable. However, whereas government involvement is unavoidable, the need for flexibility and expertise also necessitates the participation of *industry representatives* in the standard making process. Furthermore, enforceability on a global level can only be achieved through a *cooperation of all national regulatory authorities*. They must not only collaborate in establishing the standards but also in their subsequent enforcement, thereby ensuring state sovereignty. Indeed, *«[f]inancial globaliza-*

151 *Shadab* (n. 14), 9.

152 See FSF, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, 2008, 5 that states that the dramatic increase of financial technology led to a flawed perception of risk and therefore to increased risk taking <*http://www.financialstabilityboard.org/publications/r_0804.pdf*> at 20 December 2010.

153 For an example of the hedge fund industry's flexibility, see the SEC's attempt to amend the Investment Adviser Act of 1940 in 2004: The SEC wanted to avoid new regulation of private equity and venture capital funds and therefore inserted a two-year lockup provision in attempt to distinguish such entities from hedge funds. Hedge funds, however, changed their structures to include such two-year lock-ups almost immediately and once again «fitted the regulatory cracks». For more see *Gregory Zuckerman/Ian McDonald,* Hedge Funds Avoid SEC Registration Rule, The Wall Street Journal (New York), 10 November 2005, C1.

154 *Stephen H. Axilrod,* Comments on Public Policy Issues raised by Rescue of a large hedge fund, Long Term Capital Management, Speech prepared for a Hearing before the Committee on Banking and Financial Services of the U.S. House of Representatives Washington, 1 October 1998.

155 For example, the HFWG Standards as well as the PWG's Principles and Guidelines are criticized and said to be unenforceable because of their broad wording and their vague recommendations, see *Mackintosh* (n. 149), 15 and *Deborah Solomon,* Regulators' Hedge-Fund Approach: Hands Off, The Wall Street Journal (New York), 23 February 2007, C1.

156 See FSA, Principles-Based Regulation: Focusing on the Outcomes that Matter, 2007, 6.

157 See *Nouriel Roubini,* Ten Fundamental Issues in Reforming Financial Regulation and Supervision in a World of Financial Innovation and Globalization,2008, 5 who notes that *«market discipline has failed».*

tion and financial innovation are closely tied, with each trend promoting each other. As a consequence, global regulatory coordination and collaboration are more vital than ever».[158] *Global coordination and international approval* of a single set of minimum standards for hedge fund regulation *domestically enforced* and *effective* in all jurisdictions is thus the *most important* component of a future regulation scheme for hedge funds.

4. Internationality by Promulgation of International Soft Law

4.1 General Remarks

As a result of the hedge fund industry operating worldwide and the fact that hedge funds are often *not dependent on a particular location,*[159] require relatively few human resources and have little fixed assets, it is necessary to establish *globally accepted rules or standards* that govern the industry.[160] *Internationally agreed minimum standards* for hedge fund supervision would counteract *regulatory arbitrage*[161] and prevent funds from moving to other jurisdictions just because of more lenient regulatory treatment.[162] Furthermore, globally accepted rules would diminish the possibility of jurisdictions engaging in a *«race to the bottom»*[163] by making hedge fund regulation more and more lenient in order to attract funds at the expense of financial stability and investor protection.[164] Global minimum standards domestically implemented could thereby *diminish the macroeconomic risks posed by less demanding jurisdictions* and ensure that policy goals could be internationally pursued without regulatory competition. *In short,* worldwide *minimum* regulation standards would safeguard financial stability and at the same time enable governments to continue to employ other means to attract hedge funds, including different implementation of the minimum standards, different tax treatment or generally, through providing a better business environment for the funds.

4.2 How to achieve Internationality of the Standards

«Internationality» – the key element of any future minimum standards for hedge fund regulation – can basically be achieved in two ways: Either through a *single global financial (hedge fund) supervisor,*[165] as some European politicians[166] and commentators[167] in light of financial crisis demanded or by requiring states to adopt a set of *internationally harmonized regulation standards*.[168] In light of the reluctance

158 *Ben S. Bernanke,* Regulation and Financial Innovation, Speech delivered at the Federal Reserve Bank of Atlanta's 2007 Financial Markets Conference, Georgia, 15 May 2007.

159 *Crockett* identifies the increasing geographic spread of the hedge fund industry as one of the major trends, see *Crockett* (n. 7), 21.

160 An example of how independent of a particular location hedge funds are is the fact that during a period in the US in which hedge fund regulation seemed to be increasingly possible, a number of hedge funds threatened to leave the country, see *Jeff Sommer,* INVESTING; DIARY; Bermuda Isn't Fair, Hedge Funds Warn New York Times (28 May 2003).

161 Regulatory arbitrage means the setting up of hedge funds in jurisdictions with more lenient regulation in order to avoid the impact of a more rigid regulatory environment, see *Smullen/Hand* (n. 3), 347.

162 Whether hedge funds actually engage in regulatory arbitrage is highly debated and rather unclear, see *Douglas Cumming/Sofia Johan,* Hedge Fund Forum Shopping (2008) 10 (4) University of Pennsylvania Journal of Business and Employment Law 783.

163 In government regulation, a *«race to the bottom»* is a phenomenon that is said to occur when competition between nations leads to the progressive dismantling of regulatory standards (also called downward harmonization), see *Roubini* (n. 157), 9.

164 Regulatory competition among financial centers has significantly risen over the past years, particularly between London and New York, see *John Willman,* The City v. Wall Street: The Smart Money Is on (and in) London, The Financial Times (London), 27 January 2007, 11.

165 See *John Eatwell/Lance Taylor,* Global Finance at Risk: The Case for International Regulation, 2000 and more detailed: *John Eatwell,* The Challenges Facing International Financial Regulation, Paper presented at the Derivatives Study Centre Conference on The Economics of Financial Market Regulation, San Francisco, July 2001, and *Kern Alexander,* The Need for Efficient International Financial Regulation and the Role of a Global Supervisor (2001) 5 (1) Journal of Money Laundering Control 52, 59.

166 See *Phillips Leight,* Merkel and Sarkozy call for a global «economic security» council», 9 January 2009, <*http://euobserver.com/9/27373*> at 20 December 2010.

167 See *Jeffrey Garten,* 'Global authority can fill financial vacuum' The Financial Times (London), 25 September 2008 that, however, also states that the time of a Global Monetary Authority has *yet* to come.

168 *Fratianni Michele/John Pattison,* International Financial Architecture and International Financial Standards (2002) The Annals of the American Academy of Political and Social Science 183, 186 identify three possible regulatory models, two of which we mention and one that focuses on national regulatory competition and does not fulfill the requirement of internationality.

of the international community to cede power to a unitary global financial supervisor, the second option is more viable. In fact, the current *international financial markets regulation* is already largely based on such *non-binding* and *legally unenforceable* international standards and codes.[169] These standards and codes are promulgated by so-called *international standard-setting bodies*[170] and usually represent *minimum* requirements in given regulatory areas and are supposed to be implemented in jurisdictions worldwide.[171] They are usually *not based* on formally binding treaties and are therefore not legally binding.[172] In fact, the standards represent non-binding *«international soft law»*[173] and are accepted as the third main pillar of general international law, after treaties and customary international law.[174] Despite international soft law having no legally binding nature, its implementation in national law is strongly encouraged and incentivized by different means.

The *first major group of incentives* to implement international standards is *market discipline*.[175] Market discipline should induce a state to observe the relevant international standards through a price mechanism. Countries that fail to adopt certain minimum regulation standards will suffer lower credit ratings, higher risk premiums[176] and therefore *higher funding costs* than complying sovereigns.[177] There is evidence that the naming of countries that lack sound financial regulation can lead to changes in its credit rating and higher funding costs.[178] Higher funding costs in turn increase the country's expenditures. By adhering to regulation standards, the states would receive a better credit rating and may consequently decrease its financing costs. In this context, the FSF legitimately emphasizes the importance of *raising market participants' awareness* of international standards and codes and consequently disseminates information on countries' observance to standards and encourages investors to factor the information provided into their risk assessment and their investment decisions.[179]

The *second major group of incentives* is a number of *official incentives* that are employed by international standard setting bodies to induce countries to comply with their standards. These types of official incentives include (i) peer pressure, (ii) «name and shame», (iii) surveillance activities and (iv) financial incentives.[180]

Peer pressure is most likely to be effective if countries with shared world-views and values form a kind of «community» that engages in the process of persuasion.[181] The bigger and more united the complying countries are, the more effective is their influence and power on the non complying states. Therefore, the more states accept the proposed minimum standards for hedge fund regulation, the more likely is their

169 *Kern Alexander/Rahul Dhumale/John Eatwell,* Global Governance of financial systems: the international regulation of systemic risk, 2007, 135.

170 Such organizations are, e.g., the Basel Committee on Banking Supervision, the IOSCO , the International Association of Insurance Supervisors (IAIS) or the Financial Action Task Force (FATF).

171 For an overview of the «International Financial Architecture, see *Fratianni/Pattison* (n. 168), 183.

172 The standard-setting bodies are often informally constituted, not recognized by the Vienna Convention on the law of treaties as they are «networks» of national regulators not states and are more like semi-secret 'gentlemen's agreements», see *David Zaring,* Informal Procedure, Hard and Soft, in International Administration, New York University Public Law and Legal Theory Working Paper No 12, New York University School of Law, 2006, 18.

173 International soft law in the context of financial regulation is defined as *«rules that are created by a group* of specifically affected states that have a common intent to voluntarily observe the content of such a rule with a view of potentially adopting it into national law or regulation», see *Kern et al.* (n. 169), 135.

174 *A.E. Boyle,* Some Reflections on the Relationship of Treaties and Soft Law (1999) 48 International and Comparative Law Quarterly 901, 901.

175 *Nilgün Önder,* International Harmonization of Financial Regulation and Emerging Market Countries in the Age of Global Finance*,* Paper prepared for the ISA Annual Convention, Honolulu, 1–5 March 2005, 3.

176 An investment in a country (e.g. via bonds) that does not adhere to certain minimum regulation standards is considered to be more risky than an investment in a complying state. Therefore, the country has to pay a higher risk premium to its investors in order to compensate for the increased risk inherent in its regulation system, increasing its funding costs.

177 *Kern et al.* (n. 169), 145.

178 IMF, Quarterly Report on the Assessments of Standards and Codes, 2002, in n. 10 quotes a Fitch rating study which states that there is «a highly significant relationship between the publications of ROSCs and changes in sovereign ratings».

179 See FSF, Final Report of the Follow-Up Group on Incentives to Foster Implementation of Standards, 2001, 14.

180 *Cruzio Giannini,* Promoting Financial Stability in Emerging-Market Countries: The Soft Law Approach and Beyond, (2002) 44 (2) Comparative Economic Studies 125, 153.

181 *Önder,* (n. 175), 3.

success. The *«name and shame»*- strategy is already used as a potent incentive to comply with standards and codes. For example, the Financial Action Task Force *(FATF)* has established a list of non-cooperating states regarding its anti-money laundering rules[182] or the Organisation for Economic Cooperation and Development *(OECD)* has created a list of jurisdictions that are regarded as tax havens.[183] Such *«name and shame»*-strategies put *political pressure* on non-complying states and are certainly an effective incentive to implement standards.

Further, *surveillance activities* of the International Monetary Fund and the World Bank under *Article IV Section 3*[184] of the *IMF Agreement* also play an important role in the soft law approach and its effectiveness. The Financial Sector Assessment Program *(FSAP),* introduced in 1999, is the most important of the surveillance activities conducted by the IMF and *inter alia* seeks to identify the strengths and vulnerabilities of a country's financial system. A by-product of the FSAP forms the Report on the Observance of Standards and Codes *(«ROSC»)* which gives a detailed assessment of observance of the 12 key financial sector standards and codes.[185] The ROSC is in theory *optional* for states. However, the IMF emphasizes its importance and accordingly pressures states to participate. Therefore, in order to be effective, future standards for hedge fund regulation must be *recognised by the FSF* as one of the Key Standards for Sound Financial Systems. In light of the importance of hedge funds for the financial markets, their size and the potential risks associated with them, this is a viable claim. Furthermore, as a consequence of the inclusion in the 12 Key Standards for Sound Financial Systems, the implementation of the regulation standards for hedge funds would be *assessed within the FSAP* and therefore would be subject to the regular surveillance activities of the IMF and the World Bank.

Finally, the most promising strategies for promoting compliance with international standards and codes is to make *financial aid* dependent on governments' observance of selected standards.[186] For example, the IMF currently *imposes conditions* on a state when lending money and makes loans conditional to a government's commitment to certain economic and financial policies *(«Conditionality»).* In recent years, the IMF has also begun to make loans conditional to the adherence to certain international regulation standards.[187] However, whereas the IMF plays a central role in providing developing countries or countries in financial need with access to capital and can therefore demand the implementation of standards in these countries, the IMF has *little power* to induce states to adopt them that do not need financial assistance. In fact, the IMF's ability to use financial penalties to enforce conformity with standards and codes is *restricted* to states that actually need financial help.[188] As a result, the IMF is toothless in its actions to influence domestic regulatory matters in developed countries.[189] Therefore, the standard setting process must ensure that these developed and influential states have *self-interest* in the proposed standards and their enforcement does not need to be 'forced' by the IMF.

182 Currently, there are no non-cooperative countries or territories (NCCT) on the list, but the FATF remains vigilant on international non-cooperation issues. See FATF, NCCT Initiative*, <http://www.fatf-gafi.org/document/51/0,3343,en_32250379_32236992_33916403_1_1_1_1,00.html>* at 20 December 2010.

183 OECD, List of Unco-operative Tax Havens, *<http://www.oecd.org/document/57/0,3343,en_2649_33745_30578809_1_1_1_37427,00.html>* at 20 December 2010.

184 According to this article, the IMF is empowered to «oversee the international monetary system in order to ensure its effective operation». This is said to include macro- as well as microeconomic surveillance, including the quality of domestic regulation, see *Eatwell* (n. 165), 9.

185 For an overview of the 12 standards, see Financial Stability Board, 12 Key Standards for Sound Financial Systems, 2010, *<http://www.financialstabilityboard.org/cos/key_standards.htm>* at 20 December 2010.

186 *Önder* (n. 175), 5.

187 *ibid.*

188 The fact that the IMF increasingly influences domestic regulatory matters is subject to criticism, see *Robert P. Delonis,* International Financial Standards and Codes: Mandatory Regulation without representation (2004) 36 International Law and Politics 563, 577.

189 *Schneider* criticizes that whereas the IMF should focus on key players of the financial market, it mainly conducts ROSCs in non-key players, *Schneider Benu,* Do Global Standards and Codes prevent Financial Crises? Some Proposals on Modifying the Standards-based Approach, Discussion paper No 177, United Nations Conference on Trade and development, 2005, 9.

VI. Conclusion

Discussions about further regulation of hedge funds have been around for quite some time and have not faded during the recent financial crisis. Whereas hedge funds provide the financial market with more liquidity and the investor with new investment opportunities, they can also pose significant risks. On the one hand, the hedge funds' *use of leverage,* particularly through complex OTC derivatives, their potential to engage in *herding,* their intrinsic *opacity* and the evident *complacency* in *counterparty risk management practices* of prime broker dealers have justifiably heightened concerns about their systemic risk. On the other hand, the *growing retailization* of hedge fund investments coupled with the inherent *information asymmetry* among the fund and its investors has also highlighted the need for regulatory intervention.

In attempting to find appropriate regulatory responses to these issues, major hedge fund centres have so far concentrated on trying to find *domestic* solutions. Unfortunately, in the process they have started to compete in a *«regulatory competition»* in which no jurisdiction wants to impose rules that are too strict and could potentially drive the hedge funds away. This is where the proposal for *international minimum standards for hedge fund regulation* comes into play. In our view, such standards in the form of *international soft law* embody the ideal solution to the complex question of hedge fund regulation.

First, international minimum standards for hedge fund regulation set out by an international standard setting body comprising different nationalities would be *internationally recognised*. *Second*, globally accepted minimum standards for hedge fund regulation would ensure that concerns about systemic risk and investor protection could be adequately addressed and that *regulatory competition* between jurisdictions to the detriment of financial stability and investor protection could potentially come to an end. *Third and finally,* international minimum standards for hedge regulation would represent *international soft law* that would need to be implemented in every country's national legislation in order to be enforceable. In fact, the issue of domestic implementation of *non-binding international rules* represents the *main obstacle* on the way to international minimum standards for hedge fund regulation. Nevertheless, we believe that the current approach towards encouraging national adoption of internationally agreed regulation standards has worked well. By focusing on two kinds of incentives, *market* and *official incentives,* it has had great success and might also be successful in case of hedge fund regulation.