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Hedge funds-the necessary evil on the investment market?

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Introduction

With the recent financial instability on the global market, hedge funds, as major market players, have been put under scrutiny. They have been persistently accused of causing the current financial crisis through creating systemic risk. They are criticized on the basis of their leverage levels and short-selling practices. These accusations present the question of whether hedge funds are even capable of causing a financial crisis in general. The actuality of the topic and the heating debates surrounding it, is what turned my attention to hedge funds in the first place. Therefore, intrigued by the mystery surrounding the truth, I decided to concentrate my research on uncovering the true nature of hedge funds and the risks they possibly bring to the market.

This paper has a purpose to argue the positive nature of hedge fund industry. By introducing the reader to the main characteristics of hedge funds and their regulatory framework, I try to develope an argument in favor of hedge funds and their operations. The first research question my work answers is whether the current hedge fund regulation, both in the U.S. and in the E.U., is sufficient and what are the regulatory weaknesses. Another research sub-question is whether registration/authorization requirements and transparency standards are relatively harmful to the industry or not. The main research topic is whether hedge funds create systemic risk, and therefore were the source of the current financial crisis, or not. The tools hedge funds employ while implementing their operational strategies are also put under criticism and argued for. All the evidence presented in this paper was carefully selected to substantiate my thesis, that hedge funds are unnecessarily demonized and the attempts to subject them to more burdensome regulatory requirements are counterproductive. In the end, I develop the opinion, that hedge funds bring more benefits to the investment market than harm.

In Chapter I a general picture of hedge funds and their characteristics is drawn. Their origin, as well as development, is traced to the present time. Statistical data is also presented, while focusing on the most important features of hedge funds. Hedge fund managers, as an inseparable part of the hedge fund industry, are discussed both from psychological and professional point of view. Some of the most common misunderstandings of hedge funds are discussed and resolved. Briefly, I mention what kind of investors are typically allowed to invest in hedge funds and what asset allocation is most common for an investor’s portfolio. Hedge fund tools, such as the use of leverage and short selling, is also discussed. The risks and the benefits hedge funds bring to the economy are critically explained.

Chapter II depicts hedge fund structure in general: the legal organizational structure as an LLP or an LLC; the exceptions to that structure (for offshore hedge funds to be organized as a corporation for tax reasons); the difference between a single hedge fund and a Fund of hedge funds. The procedure of hedge fund’s introduction to an investors, the documentation a hedge funds offers its investors prior to and after investment and the preliminary due diligence on the targeted hedge fund, investors execute on their own, were all covered by Chapter II. Additionally, as important as the structure itself, the domicile of hedge funds is also considered. In order to observe the full picture of hedge fund structure, I also examined hedge fund hurdle rates and water marks as safeguards for investors, as well as hedge funds’ typically charged fees-a management fee of 2% and a performance fee of 20%. Last, but not least, a detailed analysis of hedge fund lock-up periods and redemption policy is included.

Chapter III is focused on hedge fund strategies and their specifics. All the main strategy groups are discussed thoroughly-event-driven, tactical, relative value and hybrid. Another categorization according to the function of the employed strategies is introduced- core diversifiers, risk reducers, risk diversifiers and return enhancers. The chapter is more concentrated on a few strategies and their sub-types due to their risk profile and potential systemic risk threat to the overall market. The correlation of every strategy of interest with the market movements is defined. The main idea of this chapter is to present to the reader the operational logic behind specific hedge fund strategies with the goal to explain the potential risks involved in employing that strategy from every perspective-market, counterparties, investors.

Chapter IV is a detailed research on hedge fund regulation around the world. It is mostly concentrated on the European Union and the United States regulation, but it also includes a summary of the regulatory situation in some other countries. The chapter compares the regulatory approach in the E.U and the U.S. as the home country of hedge funds. It explains the possible regulatory approaches towards hedge funds (both direct and indirect) and discusses the most appropriate, as well as the ones applied in practice. Most countries favor the indirect approach and regulate hedge fund managers and/or hedge fund counterparties (banks, prime-brokers, etc.). Not so common is to regulate hedge funds themselves or their investors. Supervisory bodies, transparency requirements, leverage limitations and registration/authorization burdens are thoroughly commented. The last part of Chapter IV discusses in more detail Solvency II and Basel III as an upcoming regulatory acts, which are expected to have great effect on hedge funds industry.

Chapter V brings to reader’s attention a variety of debates on hedge funds and their merits. It also presents some criticism on the contradictory nature of hedge fund industry. The issue of whether more regulation in the hedge fund sector is needed is commented from different perspectives. The opinions of renowned experts and politicians are included in support of my research questions on whether hedge funds have the capacity to cause systemic risk, respectively if they were the source of the current financial crisis. The opaque character of hedge funds is explored through evidence of both positive and negative externalities hedge funds produce. It is eventually concluded, that hedge funds do not have the power to cause a material effect on the financial system and they are wrongfully accused of causing the economic crisis, which was actually induced by the banking sector. It is argued, that the interconnectedness of both sectors is the reason hedge funds were put under suspicion in the first place.

Chapter I

The term „hedge fund“ does not have a universal definition. In the year 1949 after World War II, Alfred Winslow Jones, a 1923 Harvard graduate, 1941 Ph.D. graduate from Columbia University, was working on an assignment for Fortune magazine, investigating research on stock market forecasting. Having developed an interest in investing, Jones created the first “market neutral” fund. It is agreed in the hedge fund community, that Jones is the father of hedge funds, although similar structures existed long before him. Alfred Jones used for the first time short selling, leverage, and incentive fees in combination.[1]

Nowadays hedge funds use different legal structures, investment strategies and circle various

[1]James D. Spellman ,Hedge Funds How They Serve Investors in U.S. and Global Markets, (2009, Coalition of Private Investment Companies), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf

asset types, which makes it imprecise to invent a definition, which will unite the whole industry. It is possible though, to enumerate their most frequently found characteristics. Hedge funds represent investment pools, managed by a professional manager by engaging specific investment strategies. Hedge funds do not have to follow registration requirements like traditional funds. They are allowed to have a limited number of investors, with the requirement that they be either wealthy individuals, or institutional investors, able to fend for themselves. The management contract usually provides for a management fee of 2 % on the basis of the assets managed, and a performance fee of 20 % on the value increase of the fund. The difference with most traditional funds is that managers of hedge funds have invested a significant amount of money of their own. This is not just a standard rule but also a tool to align the interests of the investors with the interests of the manager and provide security for both of them.[2]

Many people think that hedge fund managers will try to maximize the performance fee by assuming high levels of risk. This is not true, though. First of all, the top hedge fund managers have invested their own money in the hedge fund, therefore if they take too much risk with the fund, they will put not only the assets of their investors at risk, but also their own money. What is more, making the logical assumption that hedge fund managers would want to stay in the business long term, they would prefer to take advantage of the compensation generated over their lifetime, than an opportunistic one-time compensation.[3]

Hedge fund managers are typically the people who take the initiative to establish the hedge fund. They have a vested interest in how well it performs. Managers are the ones who make the buy and sell decisions and sometimes execute the trades in smaller funds. Opportunities are being researched by the managers and decisions of the tools for the implementation of the strategy are being made by them.[4]

The term “hedge fund” is often confusing, because the name infers that there is hedging involved. The meaning of hedging is to mitigate the risk undertake. Most funds do not use hedging, but leverage, whether by using derivatives or by putting loans on their balance. Not all funds use leverage, though. The ones who do are called “speculative” funds, which is again imprecise since all funds use speculation as a tool. The managers usually determine freely the strategies they want to pursue.[5]

The people who invest in these funds are mainly “accredited” investors- institutional investors and “high net worth” individuals. They are being offered an investment privately, as opposed to a public offering. Usually a hedge fund uses the money it receives as investments to buy variety of securities and financial instruments, which it will later trade with. When investing, an investor would receive a private placement memoranda which contains the terms of the investment. Institutional investors typically perform “due diligence” of the fund and the manager who runs it.[6]

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[2] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[3] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[4] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[5] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202
[6] James D. Spellman ,Hedge Funds How They Serve Investors in U.S. and Global Markets, (2009, Coalition of Private Investment Companies), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf

There are as many hedge fund types, as the managers who control them. A variety of financial instruments, such as stocks, bonds, currencies, futures, options, other derivatives, and physical commodities are the primary investment targets of hedge funds. Some funds invest in illiquid assets - real estate, private equity, etc. It is disputable whether such funds are hedge funds, although it is true, that some hedge funds do hold these investments.[7]

The hedge fund industry is developing at a ferocious speed during the last decade. The proof is that since 1990, when there we only about 300 funds, the funds have grown to more than 10,000 today. Hedge funds are gaining popularity recently by operating more than $1.4 trillion in assets through onshore and offshore funds.[8]

Although hedge funds differ in size, composition, structure, culture, performance, and strategies employed, they have their similarities. They are constantly compared to mutual funds, but for no apparent reason. Hedge funds are smaller in asset size than mutual funds. Most hedge funds have assets under management of less than $10 million. Very few control assets greater than $5 billion. Approximately 75 percent of all hedge funds are younger than 10 years, which makes them relatively new. [9]

Hedge fund performance depends on the type of strategy the manager employs. Over different time periods one strategy may do well and another- not so well.[10]

Hedge funds are generally considered mysterious in terms of the strategies they employ, the financial instruments they trade and the objectives they aim at. There are so many misconceptions and discrepancies in the financial marketplace about hedge funds. That is no surprise because the truth is that hedge funds are surrounded with secrecy. However, many aspects of the “common” understanding about hedge funds are actually more fiction than fact.

It is true in general, that hedge funds can employ leverage. Leverage can magnify both a gain and a loss depending on the market situation. A common misunderstanding is, that hedge fund managers use leverage as a tool to maneuver to the extreme. On the contrary, many hedge funds do not employ leverage at all, while those that do employ leverage do so in order to take advantage of arbitrage opportunities. Still, hedge funds do not abuse leverage. It should be taken into consideration, though, that leverage can be not only harmful, but beneficial as well, depending on how well or poorly the investments in the fund are performing. [11]

Every investor is willing to take only a certain amount of risk depending on their goals and desires. These goals are sometimes related to wealth growth, wealth conservation, or both at the same time. Having a concept of what are you trying to achieve by investing, makes it easier to design an optimal portfolio. Hedge funds provide investors with the means to generate optimal portfolio returns because of their freedom to employ alternative investment strategies such as short-selling and leverage.[12]

The objective of hedge funds is to generate attractive positive returns, called absolute returns with long-term growth of capital. Absolute returns are positive returns above zero. The actual

[7] James D. Spellman ,Hedge Funds How They Serve Investors in U.S. and Global Markets, (2009, Coalition of Private Investment Companies), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf
[8] HedgeCo.Net, A Brief History, available at http://www.hedgeco.net/hedgeducation/industry-overview.php
[9] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[10] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[11] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[12] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

size of returns is of less importance. In order for that to happen, hedge funds must be either low or not correlated at all with the overall market performance. This means, that it does not matter whether the market is at its peak or low, in any case funds are independent. Hedge funds try to achieve a return, which exceeds the rate of inflation over a certain period of time. Being the first among the managers' society is a secondary consideration. In the hedge fund, industry managers do not typically measure their performance against other hedge fund managers, like mutual fund managers do, but they place emphasis on the absolute performance. Translated, this means, that managers will, most of all, attempt to deliver positive returns, rather than outperform their peers. Comparing against a benchmark with hedge funds is also fruitless because of the different styles or strategies they employ. Depending on the amount of risk a manager is willing to take, an aggressive fund will strive for 15 percent return or more annually, while an average-performing fund will bring returns of 10 percent annually.[13]

Traditionally, allocation between 0 and 20% is the standard ratio of hedge fund allocation in a portfolio. Some research has shown that allocations close to 60 percent should be invested in hedge funds, but not many share that view. [14]

It is popular with hedge funds to establish asset level limitations at which no new capital from any investors is accepted (new or current). The goal is to maintain easy manageable hedge fund, which allows the hedge fund manager to continue to employ his targeted strategy. Another advantage of keeping it small is the opportunity to profit from underused opportunities or market discrepancies.[15]

Hedge funds usually provide valuations once every six months or once a year. They have restrictive liquidity and redemption provisions. Hedge funds are not allowed to produce and distribute radio or television commercials for the general investing public in order to prevent exposure and consequently consideration of making an investment by non-sophisticated investors. That is why most hedge fund manager web sites are password protected.[16]

Hedge funds are pass-through entities when it comes to taxation. They do not pay taxes themselves but transfer all gains and losses to individual investors. Capital gains are taxed against the investor's personal tax rate. The frequency and amount of hedge fund investors' tax obligations depend on the type of the hedge fund. Hedge fund investors incur a second type of tax as well-ordinary income tax. The dividends and the interest received from the holdings in the hedge fund are being taxed under the income tax. [17]

With hedge funds, as with any other investment pools, there are inherent risks. Two primary sources of risk exist -systematic and unsystematic. Systematic risk is attributed to relatively uncontrollable external factors. Systematic risk results from conditions, events, and trends occurring outside the scope of the investment. This type of risk is very common with traditional investing as well. Unlike systematic risk, unsystematic risk is not attributed to external factors, but to the investment itself. This source of risk is unique to an investment. Together systematic and unsystematic risk create the total risk. Since the goal of asset allocation is to create a diversified portfolio, unsystematic risk is not relevant because it could be controlled and sometimes even totally excluded with diversification. Therefore, an optimal

[13] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[14] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[15] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[16] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[17] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

portfolio only possesses systematic risk. Given the ability of hedge funds to sell short securities, systematic risk can be highly reduced. In the end hedge funds face mainly investment-strategy risk and the implementation risk.[18]

Investing and risk are tied together. Risk and return are also connected. No gain comes without taking a risk. As already mentioned before, what determines the risk and the corresponding return for a hedge fund investor, is the strategy the manager uses and the skill of the hedge fund manager in implementing, monitoring, and managing that strategy.[19]

One of the largest institutional players targeting hedge funds for investment is pension funds. For pension funds and insurance companies risk is the uncertainty whether they can meet future obligations. Mutual funds, on the other hand, view risk as underperforming peer mutual funds and/or an industry benchmark, such as the Standard & Poor's (S&P) 500 Index.[20]

Three of the most popular indices for hedge fund performance are the S&P Hedge Fund Index, the Financial Times Stock Exchange and Morgan Stanley Capital International (MSCI). Comparing the hedge fund performance to a benchmark such as the S&P 500 is not enough. The S&P 500 consists of equity securities only. It will only provide a partial view of the actual performance level. Most hedge fund indices are based on information collected on a monthly basis from thousands of hedge funds. The data is collected and entered using either analyst entry or manager entry. One of the reasons why these indices are not reliable is the inconsistency of hedge fund managers in reporting to hedge fund databases. Some managers do not provide data, whereas others report data only to a selected few.[21]

Hedge funds are not the first choice for investment for most institutional investors. They do, however, provide a very compelling argument in favor of themselves- superior returns and diversification.[22]

Nevertheless, for pension funds and institutional investors comparison between hedge funds as an alternative investment and traditional investment benchmarks is crucial to help them make their choice.[23]

Choosing a hedge fund normally means picking the right manager. Investors seek managers skilled enough to generate returns higher than the market averages. When investors spot a manager who corresponds to their demands, they demand above-average returns. This leads us to the issue of capacity. Capacity is the ability of a manager and the strategy he uses to operate with the money he has invested in the fund for as long as he is producing absolute returns. There is strong competition on the market for hedge fund managers, which leads to more people exploiting fewer opportunities. In the end, the profit margins shrinks. This reality has led to managers taking on more risk than they should in order to keep up with the absolute returns rates. A problem of how to find a manager who can produce consistent absolute returns and, at the same time, abstain from taking excessive risk is currently the issue for

[18] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[19] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[20] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[21] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[22] Marco Avellaneda and Paul Besson, Hedge-funds: How big is big?, available at http://www.math.nyu.edu/faculty/avellane/HFCapacity.pdf
[23] Marco Avellaneda and Paul Besson, Hedge-funds: How big is big?, available at http://www.math.nyu.edu/faculty/avellane/HFCapacity.pdf

many investors.[24]

Hedge fund managers can use options and futures to either hedge their positions or speculate. Futures and options are both derivatives. Derivatives enhance efficiency of the market, no matter what market we are talking about- stocks, bonds, or even energy. A futures contract is an agreement between two parties to exchange an asset at a future date at its future price at the agreed moment. An option gives the buyer the right to buy or sell the underlying asset at a predetermined price over a predetermined time period. An option poses no obligation on the buyer to exercise it.[25]

Hedge funds, like any investment vehicle, have experienced both ups and downs. No matter, that the general impression of hedge funds is negative and that after careful examination of hedge funds this impression is easily overturned, it is only fair that both good and bad facts should be displayed.

Two of the most famous hedge fund collapses need to be mentioned in order to establish a truthful picture about the essence of hedge fund industry. The first one is the collapse of LTCM (Long-Term Capital Management) due to Russian government default in 1998 on its government bonds (GKOs).When LTCM was on the verge of bankruptcy the Federal Reserve Bank of New York offered a bailout. Fourteen major banks funded nearly $300 million each to generate a $3.625 billion bailout loan. The hedge fund existed until the year of 2000 when it had repaid all its debt. In the end, LTCM suffered $4.6 billion in losses during four months.[26]

The second important crisis in the hedge fund industry was the failure of Amaranth, which made close to $1 billion in profits during the one year prior to its demise. Amaranth initially declared that it had lost more than $3 billion as a result of declining natural gas prices. All in all, it created losses for about $6.6 billion.[27]

With all this said, a more precise picture of hedge fund nature can be drawn. Seeing hedge funds in general, perspective with its flaws and perfections is needed for one to comprehend the point I am trying to make with my observation. It is common fact, that hedge funds are a hot topic and have been one for several years now, but people have perverse opinions when it comes to the actual investment. All the newspapers and articles blaming the financial crisis on hedge fund industry have aided twisting people’s view of hedge funds. As impartial as I am trying to be, I must admit, that the preview of the industry and its general characteristics that I have given in this chapter is barely scratching the surface of what is the real content of hedge funds. I do believe, although, that by providing the reader with some basics would be beneficial for proving my point at the end.

Chapter II

The way hedge funds operate is what makes them different from other investment pools. They are considered alternative investments because the tools they employ and the strategies they use when making investments and executing trades. Structure, though, is an important part of

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[24] Marco Avellaneda and Paul Besson, Hedge-funds: How big is big?, available at http://www.math.nyu.edu/faculty/avellane/HFCapacity.pdf
[25] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[26] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[27] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

their essence. The way they are organized determines their behavior even. Hedge funds are specific because their organizational features help align the interests of both the manager and the investors, which is unusual for traditional investment pools.

There are two possible scenarios when it comes to hedge fund structure-they are organized either as LLPs or as LLCs (in the US and their equivalents around the world). A third scenario exists but only when it comes to offshore hedge funds- as corporations. Most often hedge funds prefer the LLP structure. When hedge funds use the structure of a limited partnership, the manager is the general partner, who is responsible for the decision-making, and the investors are the limited partners. The liability for the limited partners is only up to the money they have invested, whereas the general partner has no limit to his liability and is therefore unlimitedly liable. That is why the general partner-the manager-is usually organized as a corporation or any other legal structure, which provides for limited liability.[28] In such a structure, the manager will no longer be personally liable but only to the extent of the assets of the legal structure under which he is operating.[29]

Hedge funds typically charge two types of fees-an investment-management fee and a performance-incentive fee. The typical performance-incentive fee is at the rate of 20%. One of the differences with hedge funds is that Funds of hedge funds (FoF) sometimes do not charge performance fee at all or they charge a lower performance fee (10-12%). The meaning of the performance fee is to motivate hedge fund managers to be attentive and “make smart decisions, initiate wise investment actions, and manage positions with the utmost care and skill”[30]. Hurdle rates are sometimes implemented as well. “The hurdle rate ensures that only gains above a certain rate will be charged the performance-incentive fee.”[31]More common, though, are high-water mark safeguards.

Hedge funds charge higher fees than managers of traditional funds do. A high-water mark means, “if a fund incurs losses, those losses must be recovered in subsequent periods before incentive fees can he charged on the profits”[32]. “The high-water mark is a safeguard established to protect investors from paying the performance-incentive fee twice on the same gains.”[33]

Hedge funds also impose certain liquidity restrictions that limit the ability of investors to exit. The lock-up period, during which investors are unable to withdraw their money from the fund, serves the purpose to ensure liquidity, at least to a certain extent, and to provide availability of operational assets. The lock-up period starts from the moment an investor deposits his money and continues for six months to two years depending on the specific hedge fund. Another liquidity restriction resurfaces with redemption. There is a requirement, that an investor should serve a notice before being able to withdraw any amount of his invested money. This notice period could be from one to three months. This notice serves the same purpose as the lock-up period. [34]

The waiting period after the given notice could be until the end of the quarter or less. Only

[28] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[29] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[30] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[31] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[32] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[33] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[34] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

after that period could the investor learn what the balance of his investment account is. The actual payment happens afterwards. The investor could be denied payment, though, depending on the manager's decision. The reasons for denial are usually to prevent harming the interests of the other investors. [35]

A popular provision when it comes to redemption is the so-called "liquidity gate" restriction. If at the end of the month or quarter the redemption requests exceed 20-25%, the excess amounts must wait until the next possible period. This is a precaution against a wave of withdrawals, which could lead to illiquidity and a possible collapse of the fund itself.[36]

The number of hedge funds is constantly rising, causing competition among managers. The desire to stand out and be noticed would drive managers to employing non-traditional thinking by concentrating on a particular area or niche, which has not been exploited yet or at least has not been overexploited. So far, managers have tried to get noticed by focusing on emerging markets as the newest and most fashionable niche.[37]

Furthermore, there are other factors, which influence hedge fund performance and reputation. Location is of great importance for both hedge funds and investors. Legally, location defines a great deal of a legal entity's possibilities in regard to clients, profits, taxation, employees (in this case managers) etc.[38]

Hedge funds choose their location carefully according to the economic conditions and taxation. Hedge fund location could differ from hedge fund manager location according to registration. "The country of domicile of the fund managers may influence fund location particularly in reference to countries with restrictions on the location of key service providers."[39]

Most funds are managed in countries such as the U.S. or the U.K. Hedge funds, organized as limited partnerships have their management of the portfolio as a function either within the fund, often a company, where the board of directors will be directly in charge of the management with a professional manager as an advisor, or they outsource the management and the administration to a third party- a professional asset manager.[40]

Offshore hedge funds prefer the corporate structure. The drawback is that generally, there is taxation for corporations, but on the other hand, offshore funds usually do not get taxed.
It is standard practice for hedge funds to operate two companies, which mirror themselves-an onshore and an offshore company. 60 to 65 percent of all hedge funds are organized as offshore funds. Most popular offshore locations are Cayman Islands, the British Virgin Islands, Bermuda, Ireland, and the Bahamas.[41]

The taxation with hedge funds is simple. They do not pay taxes themselves but instead they

[35] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[36] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[37] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[38] Douglas Cumming and Na Dai, A Law and Finance Analysis of Hedge Funds, (F.M.), available at: http://ssrn.com/abstract=946298
[39] Douglas Cumming and Na Dai, A Law and Finance Analysis of Hedge Funds, (F.M.), available at: http://ssrn.com/abstract=946298
[40] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202
[41] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

transfer all gains and losses to the investors. As simple as it is, it makes a difference what kind of hedge fund we are talking about by means of strategy. There are many types of hedge funds according to the style they employ.[42]

In addition, depending on whether the investor is an individual or an institution taxes differ. Individual investors generally hold taxable portfolios, whereas institutional investors hold tax-exempt portfolios.[43]

The fewer the regulatory burdens and the lower the taxes, the better performance hedge fund managers could expect. When there is less regulatory oversight, like there is in some offshore locations, it is harder for a manager to attract money. In such a situation, the track record of the manager plays a significant role, especially with institutional investors.[44]

There are a few demands that should be met in order for an investor to qualify as an accredited investor by the law: he should earn at least $200,000 annually in income for the past two years and have a reasonable expectation of doing so into the future; earn with his spouse at least $300,000 annually in income; and has a net worth of at least $2.5 million, excluding the personal residence and automobiles.[45]

Investors perform due diligence before identifying the perfect manager for their purposes. They monitor him for a certain period to get acquainted with his business behavior before making an investment. All the data the investors gather helps him make a qualitative and quantitative analysis of the implied risks of the particular hedge fund.[46]

Institutional investors usually use the services of a private investment company for that purpose. They demand extensive information about strategies employed, the risks involved, manager's background and fund performance variables.[47]

The standard documentation, that an investor would receive prior to making an investment, is: an offering memorandum, limited partnership agreement and a subscription agreement.
The most important conditions for an investment deal for a prospective client, though, are the liquidity restrictions, management and performance fees, and any applicable lockup periods.[48]

It is impossible when hedge funds are discussed to skip Funds of hedge funds. As the name suggests itself, Funds of hedge funds are closely connected to hedge funds. A solid source of capital for stand-alone hedge funds is Funds of hedge funds. Funds of hedge funds (FoF) are typically organized, as well, as limited partnerships or LLCs. What they do is they do not

[42] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[43] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[44] Douglas Cumming and Na Dai, A Law and Finance Analysis of Hedge Funds, (F.M.), available at: http://ssrn.com/abstract=946298
[45] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[46] James D. Spellman ,Hedge Funds How They Serve Investors in U.S. and Global Markets, (2009, Coalition of Private Investment Companies), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf
[47] James D. Spellman ,Hedge Funds How They Serve Investors in U.S. and Global Markets, (2009, Coalition of Private Investment Companies), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf
[48] James D. Spellman ,Hedge Funds How They Serve Investors in U.S. and Global Markets, (2009, Coalition of Private Investment Companies), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf

invest themselves the money investors provide, but rather they invest in many stand-alone hedge funds, and respectively the stand-alone hedge funds do the trades. FoF are sometimes regarded as a strategy from hedge funds' perspective.[49] I must say I do not agree with that classification, since FoF are not a simple strategy but a legal entity and an investment pool themselves. Also, FoF employ investment strategies themselves, which makes it contrary to simple logic that they could be considered a strategy themselves.

The strategy many FoF apply is to rebalance their investments frequently by liquidating some positions in one or more hedge funds and making an investment in new hedge funds. The biggest advantage of FoF is that they provide access to the hedge fund industry to investors who are otherwise unable to qualify for an accredited investor and invest directly in a hedge fund. Another plus on behalf of FoF is the fact that they provide their investors with access to very talented and gifted hedge fund managers, various strategies and built-in diversification. FoF in comparison to stand-alone hedge funds perform relatively equal. The benefit for investors in FoF, though, is that they receive diversification with a lot less research.[50]

FOFs typically invest in fifteen to twenty-five funds. FoF have three options as a registration status: either they do not register as an investment company under the Investment Company Act of 1940 and privately place their securities; or they register as investment companies under the 1940 Act and privately place their securities; or they register as investment companies and also register their offering of securities to investors under the 1933 Act. FoF prefer to have only institutional clients.[51]

Because of the structure and way of operation, FoF sometimes require longer lockup periods. This is necessary in order for FoF to be able to react to the requirements of the hedge funds they invest with.

In the hedge fund industry FoF and the inherent diversification they offer, relieves the risks of choosing the hedge fund with a losing strategy or an inexperienced manager who could lead the fund to bankruptcy. Another way to obtain the same diversification effect would be to invest in many diverse hedge funds by yourself but in that case there will be no one to take care of the post-investment monitoring. What hedge funds do is not only trade with winning securities but also manage risks. FoF and their managers have the expertise to pick lucrative hedge funds to invest with and create a low-risk combination of all the funds they invest with.[52]

Some FoF prefer to invest in many hedge funds, which employ one and the same strategy, while others invest in hedge funds with different strategies. FoF could also target either low-risk profiles with less volatility, or high-risk profiles with manageable volatility levels. Depending on that, FoF may provide higher or lower absolute returns for their investors.[53]

It is not only diversification, which makes it beneficial for investors to invest with FoF. FoF provide access to hedge funds and their managers, which are otherwise not accessible for some investors.[54]

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[49] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[50] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[51] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[52] Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)
[53] Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)
[54] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

For their additional service, FoF charge their clients the respective fees. The monitoring functions, which are included in FoF services along with risk management they provide, are being properly paid for by their investors. Although it may seem that FoF, charge less than hedge funds themselves that is only an illusion. Actually, an investor in FoF pays almost double, what they would pay had they invested directly in hedge fund. Once the investor pays fees to the FoF and second time, they pay fees to every hedge fund with which the FoF invests. This double taxation is the biggest drawback of FoF but it is somehow justified by the valuable professional services they offer. Bearing in mind that most investors, no matter how accredited they are, are not able to monitor and diversify their portfolio properly, FoF are extremely desired and needed. Hedge funds in general do not add liquidity to an investor's portfolio. FoF, likewise, are also illiquid with some exceptions. Just like the double taxation structure, there is a double illiquidity structure. FoF have their own liquidity restraints on top of every stand-alone hedge fund they invest with.[55]

It is hardly any news that hedge funds do not provide the general public with transparency. They claim that their strategies produce superior results in any market conditions and by doing so they justify the high performance fees they charge, they rarely provide investors with proper information about the actual positions they take on the market or how the stocks they operate with correlate with their portfolios.[56]

In this respect, the situation with FoFs is not especially different. FoF, of course, are more informed than investors with the strategies of the hedge funds they choose to invest with since they have regular contacts with the respective hedge fund managers and also they extend their courtesy as both are hedge fund managers after all. As much as they communicate among themselves, FoF still do not obtain that detailed information as to the specific trades of hedge funds and the securities they operate with.[57]

FoF provide investors with so vague information, that investors sometimes have no idea what are the hedge funds with which the FoF they chose invests.[58]

As the structure of both hedge funds and FoF is already been explained, there are a few points, which could be made in the same line of thoughts. Hardly is there any consistency as to the impression hedge funds leave in people's minds and the misapprehension, which often sticks with some investors and analysts. In respect of structure and organization of hedge funds, there are a few problematic aspects I would like to clarify from my perspective. There is no universal truth about anything, let alone hedge funds; nothing is black and white, but I still believe that as long as the arguments adduced support the respective view or belief, it is safe to say that whatever is claimed is true, at least partially.

Hedge funds are often compared with mutual funds. The truth is that hedge funds and mutual funds are more different than similar. Some of the main differences are that hedge funds are allowed to operate with any kind of financial assets, including derivatives. A main advantage on behalf of hedge funds compared to mutual funds is that they can employ short selling and leverage to any extend they wish. Unlike mutual funds, hedge fund managers' compensation depends on the fund's performance. Yet another distinguishing characteristic of hedge funds is

[55] Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)
[56]Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)
[57] Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)
[58] Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)

that they can restrict withdrawals from their investors.[59]

There is a misunderstanding of hedge fund behavior. People who are not so well acquainted with hedge funds tend to believe that they increase market volatility. A thorough investigation of hedge fund behavior shows, that not only they do not increase market volatility, but they actually enhance market liquidity. Traditionally investment funds buy securities when the prices are rising and sell them when the prices are falling. Hedge funds practice exactly the opposite. By doing the opposite, they create liquidity, which highly desired. Also they reduce price pressures in both falling and rising markets. In the end, it is clear, that hedge funds repress volatility.[60]

Great fear exists among investment analysts, that hedge funds create systematic risk. Hedge funds are known for their extensive dependence on research before they move to action. They research market information constantly and by doing so they improve the informational gaps, which exist. By knowing more, they are able to transfer that knowledge to the market prices by executing their trades. [61]

Hedge funds are investment pools, which are of interest for sophisticated wealthy investors, presumed to have the knowledge and the ability to calculate the inherent risks themselves. This characteristic of hedge funds is to be considered when debating implementation of stricter regulation. So far, the US has been preaching that markets can discipline hedge funds and therefore there is no need for further regulation. This assumption has proven mostly correct until the present day, but there are other considerations for direct regulation of hedge funds. It is not only important that hedge funds can function properly on the market themselves, but that there is enough information of their activities on the information market for the designated public. It is unjustified to accuse hedge funds of posing a threat to market integrity and creating systematic risk. All evidence points towards the opposite. Therefore, more regulation is neither needed nor wanted. By regulating hedge funds with stricter rules, a transition would be caused for most hedge funds to relocate to offshore tax havens.[62]

Hedge funds are not so easy to access even for wealthy individuals. The restrictions on advertising are also making it harder for investors to receive information about hedge funds and their strategies. Personal contacts with established hedge fund managers are basically the only way to enter the hedge fund world. Connections per se are valuable when it comes to making a contact with well-known successful managers. Sometimes it is even harder to get to a manager especially if he has already closed off his fund for investments. It has become standard practice for prime brokerage firms to host events where sophisticated investors could meet with famous and newly rising portfolio managers. Such firms are global banks like Citigroup and Deutsche Bank; brokers and investment banks such as Goldman Sachs, Morgan Stanley, and Bear Stearns. Events like that are invitational and target a selected group of people. In these meeting, the managers make small presentations of the funds they manage for a short amount of time. It is a very formal event where every respected investor wishes to be invited. For less risk-prone investors it is normal to choose a large successful established fund

[59] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[60] William P. Osterberg and James B. Thomson, The Truth about Hedge Funds, (May 1, 1999, Federal reserve bank of Cleveland), available at http://www.clevelandfed.org/research/commentary/1999/0501.pdf
[61] William P. Osterberg and James B. Thomson, The Truth about Hedge Funds, (May 1, 1999, Federal reserve bank of Cleveland), available at http://www.clevelandfed.org/research/commentary/1999/0501.pdf
[62] William P. Osterberg and James B. Thomson, The Truth about Hedge Funds, (May 1, 1999, Federal reserve bank of Cleveland), available at http://www.clevelandfed.org/research/commentary/1999/0501.pdf

and not an emerging one with less known manager. Even professional investors prefer recognized hedge funds with impeccable reputation.[63]

Institutional investors, especially pension funds, do not generally invest a big percentage of their assets under management with hedge funds. For such investors it is important that the hedge fund they are about to invest with is large enough and has a flawless track record and a long list of investors. The significantly large size of a hedge fund does not guarantee success. It is even better if the fund is smaller so that it could operate with some strategies, which are available to bigger funds. Statistically, there is not much of a difference when it comes to the correlation size-performance. Logic and research shows, though, that smaller funds take advantage of market inefficiencies easier and faster. Also, the limited amount and size of market discrepancies makes it more profitable for smaller funds to exploit them.[64]

All in all, hedge funds appear more appealing than not with the proper arguments put forward. All their specific features make them stand out and as everything, which bears a little bit of mystery for the ordinary person, it seems attractive. For all their advantages, I would say I would rather trust the hedge fund industry than not. The intelligent way of operation hedge funds utilize, every little possible problem considered in their structure and practices, all the precautions undertaken, the light regulation which is justified for all the reasons mentioned in this chapter, even though the lack of transparency and the excessive freedom they are granted by the authorities, it is evident hedge funds are a unique creation of the investment market. So exceptional, that it attracts too much attention and attention is not always desirable.

Chapter III

Hedge fund strategies are numerous and their classification differs depending on who is classifying them. The strategy a hedge fund employs determines the risk profile of that hedge fund and hence the expected returns profile. Once a person is acquainted with the main strategies, he would be able to understand the logic behind hedge fund investment.

Hedge funds cannot be compared even if they were to claim to employ the same strategy. It is extremely hard to divide hedge funds according to their strategies namely because they may seem to be using one and the same approach but they would never be alike.

Hedge funds are known to provide diversification due to their reported low volatility of returns and low correlations with the traditional stock and bond markets. Their average return index is higher compared to the return index of traditional investment vehicles. It all depends on the strategy the particular hedge fund uses, though. It is common that some strategies would produce lower returns and some –superior, compared to equities. No matter what the case is, hedge funds have low volatility and that is one of their greatest advantages. According to the function of the employed strategies, hedge funds can be divided into groups: risk reducers, core diversifiers, return enhancers and risk diversifiers.[65]

[63] Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)
[64] Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)
[65] Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)

Core diversifier strategies can be held as core positions to a diversified portfolio of hedge funds, or as additions to traditional long-only portfolios. As the name hints, risk reducers reduce portfolio volatility but they bring lower returns. They hide an inherent risk of unexpected losses, though. Return enhancers are controversial a bit because they would sometimes bring attractive returns, but also could bear losses or low returns. They have higher correlation with bond and equity markets. Risk diversifiers are better combined with return enhancer strategies.[66]

By knowing their general classification according to the risk and return, it is easier to assess the possible threats hedge funds could pose on the market as a whole. The close study of all general strategies is conducted for purposes of showing the actual problems, which hedge funds contribute to the market and the possibility of hedge funds affecting the market through their strategies employed in a way, that would be notable and able to disturb the economy.

Hedge funds speculate to maintain results. They depend on the information unknown to others, which their managers obtained. Information is a valuable commodity in hedge fund world. The secrecy is what a deal depends on and revealing the secret before execution would kill the benefits of the trade. Sometimes not only the potential profit would be lost but much more. Knowing how other managers are planning to act is profitable because then you can free ride on the price reflecting the expected behavior of the other traders. “Liquidity squeeze” is also a potential risk when the exposed trader tries to unwind his position.[67]

A manager would never willingly make public his strategy unless he decided he is no longer interested. Hedge fund managers do reveal some general information about their strategies but never go into details. In this way, the information cannot be used from others to profit on by free riding. [68]

Fung and Hsieh (1997) classify hedge fund strategies according to “style” and “location”. By “style” it is meant the kind of positions the fund manager is employing- long, short, event-driven, neutral. By “Location”, it is meant what asset classes are used for investment- currencies, equity, or fixed income.[69]

Other analysts and experts divide hedge fund strategies into two groups-directional and market neutral. Directional hedge funds are being led in their decisions by the market movement, while market neutral hedge funds have low correlation with equity and bond markets.

Most common categorization of hedge funds is according to the asset class they invest in-equities, fixed income or currencies. Following the geographical location of the assets they trade in, they could be European, emerging markets, US, global etc.

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[66] Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)
[67] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund-Strategies.pdf
[68] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf
[69] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

A lot of hedge funds do not limit themselves to one strategy. They employ different strategies simultaneously or at different times depending on market conditions and opportunities. Such hedge funds are multi-strategy.

The difficulty in creating a single universal system of hedge fund strategies appears to be their ever-changing strategies. With market development, hedge funds also modify their strategies and invent new ones.

One of the main hedge fund databases -Hedge Fund Research (HFR)-has 30 separate strategies listed but some of them are not that different. Even established databases cannot be considered a formal system of hedge funds.[70]

Hereby all the main tactical types and the belonging strategies, or at least the most distinctive ones, will be presented in a short and concise manner. It is not an economic analysis, rather a preview of them all to give the reader an idea of all the general fine points, which are to be criticized and defended later on. Also from a legal perspective, it is worth mentioning hedge funds strategies since they present great interest for legal advisors and lawyers both. Since hedge funds are not a popular legal subject but mostly economic, I believe it would be curious for people with legal background to get more involved with the details. Also, law is an instrument present everywhere in the market, therefore it is extremely connected to hedge fund activities as well. It is important to understand the logic behind hedge fund and their tactics, to know the legality of it. Hedge funds usually operate around the law without breaking any rules, mostly because of their light regulation. That is not the case in every part of the world, though. As we know, in some parts of the world selling short (one of the main characterizing tools of hedge funds) is not allowed.

Event-Driven Strategies

The first group of strategies to be considered is event-driven strategies. As the name shows, hedge funds which apply these strategies take advantage of to some extend predictable near-future situations such as mergers, acquisitions, other types of corporate restructuring, bankruptcy, stock buybacks, spin-offs, price discrepancies, etc. These types of strategies can be divided internally into four independent strategies: distressed securities, risk/merger arbitrage, opportunistic events and reasonable value.[71]

Event-driven strategies exploit corporate related events before or after they happen. After a detail analysis, a decision on the likelihood on the actual happening of the event in question is taken.

Event-driven strategies are popular mostly among hedge funds because traditional investment vehicles and their managers lack the expertise to analyze corporate events and that is what hedge funds' investors count on.

Event-driven strategies involve a lot of risk from unpredictability. The chances of the planned event not happening or not happening as planned are tremendous. This would mean huge

[70] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

[71] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

losses for the investors. That is why information and skills are crucial for assessing the chance of a corporate event of interest.[72]

Distressed securities is a strategy which tends to exploit the misfortune of companies. The idea behind this strategy is to profit from inefficiencies. This is an inherent characteristic of distressed securities along with illiquidity. All the risks, which influence distressed securities- investor unreasonableness, risk aversion, legal restrictions on securities, lack of interest from analysts, and insufficient research, are being exploited by hedge funds using this strategy.[73]

For distressed securities it is of greatest importance that the hedge fund manager has the knowledge and the skill to accurately assess whether the distressed company would be able to recover and reorganize successfully. The magnitude of the risks is only affordable to large institutional investors. It is a common practice for hedge funds investing in distressed securities to try to influence the reorganization process and thus control its investment. Larger investments in exchange for equity are not unknown. From this perspective, hedge funds are a positive force because they actually would do anything in their power to revive the company. In the end, it is a win-win situation for both hedge fund investors and the company at risk.[74]

Merger/risk arbitrage concentrates on mergers, acquisitions (takeovers). Such events like mergers and takeovers are highly speculative up to a point in time and because of this fact, the risk that a hedge fund takes when investing is vast. The legal risks involved with this strategy are the possibility that it might be blocked due to antitrust issues.
There is instability with merger/risk arbitrage opportunities, which are unpredictable[75]

Reasonable value strategy depends on securities "at discounts to their perceived value as a result of being out of favor or being relatively unknown in the investment community"[76]. This strategy resembles distressed securities but the operational securities present lower default risk.

Opportunistic events is the last one of all event-driven strategies. It is a strategy, which deals with exclusive events such as IPOs, seasoned stock offerings, earnings release surprises, new business awarded, addition or departure of key executives etc. Opportunistic events has low correlation with the overall equity or fixed-income markets.[77]

Opportunistic events performs best when the economy is performing well .Distressed securities, on the other hand, works best when the economy is weak . Event-driven managers

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[72] Barclay Global Hedge Fund Database, Understanding Event-Driven Investing, available at http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-event-driven.html

[73] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

[74] Barclay Global Hedge Fund Database, Investing in Distressed Securities, available at http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-distressed-securities.html

[75] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

[76] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

[77] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

in general must be competent and expertized in the field to provide reliability for their investors.[78]

Tactical/Directional Strategies

Half of all hedge funds use tactical strategies. They are the second big division of hedge fund strategies. Tactical/directional strategies rely on predictions of the market and its movement. Tactical-trading funds are considered as most volatile of all strategies.[79]

In order for these types of strategies to be efficient is of great importance that the hedge fund manager has the ability to forecast price movements and their timing. Hedge fund managers often concentrate on specific asset classes or market sectors. The advantage of these strategies is that they work equally as well in bear and bull markets.

Macro strategies are a big part of the tactical strategies group. They execute trades based on predictions of macroeconomic events such as "changes in interest rates, currency movements and stock market performance"[80]. Market trends, geopolitical issues, economic indicators and liquidity flows need all be analyzed to find the right opportunities. All types of markets are attractive for macro funds- foreign exchange, futures, fixed income, equity, no matter whether exchange-traded or over-the-counter securities.[81]

Leverage and derivatives are often used as tools from macro hedge funds. With these strategies, it is most important that the manager's forecasts are more accurate and precise than the other managers' forecasts. These hedge funds have freedom to operate on any market and with any type of security all over the world. Timing is of greatest importance also because forecasts are not satisfactory unless the timing of execution is calculated precisely.[82]
Returns are not stable partly due to illiquidity deals, but also because in emerging markets, where these kinds of funds also operate, there is greater correlation with the market. Emerging markets could be very profitable but also disastrous due to their less sophisticated political and legal systems. It is perceived, that macro hedge funds contribute to market instability.[83]

Global macro funds take aggressive positions with the potential to contribute to existing financial instabilities on the market. They take advantage of expected market developments legitimately but they sometimes try to influence these developments to guarantee success. They are able to do that via their large investments. The problem is that by employing their

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[78]Barclay Global Hedge Fund Database, Understanding Event-Driven Investing, available at http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-event-driven.html

[79] The Impact Of Hedge Funds On Financial Markets ,Paper submitted to House of Representatives Standing Committee on Economics, Finance and Public Administration's Inquiry into the International Financial Markets Effects on Government Policy, June 1999,available at http://www.rba.gov.au/publications/submissions/impact-hdge-fnds.pdf

[80] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

[81] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

[82] Joseph G. Nicholas, founder and chairman of HFR Group, Chapter I- Introduction to Global Macro Hedge Funds, available at http://media.wiley.com/product_data/excerpt/73/04717944/0471794473.pdf

[83] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

strategy, these funds influence the behavior of other market participants. Most international markets have precautionary measure but foreign exchange markets and over-the-counter (OTC) derivatives markets are harder to control due to decentralization.[84]

Sector-Specific is a strategy where the knowledge of the selected investment sector is of main importance. The tactic is to invest in a long holding of equities and sells short equities or equity market indices.[85]

Commodity Trading Advisors (CTAs)/Managed futures strategies focus on commodity and financial futures markets. Often do such hedge funds use sophisticated computer programs, created for the purpose. CTAs or commodity trading advisors operate by promising to buy or sell commodities at a future date. That is why the regulators refer to them as speculators. Sometimes they would "cash in before the delivery dates to book the profits or accept the losses if these become unbearable"[86]. Their strategy has low correlation with both the stock and bond markets, which connects them to hedge funds.

The long/short equity strategy is a strategy whereby hedge funds bet long on securities they believe will increase in value and take short positions on securities they believe will decline in value. The main purpose is reducing the overall portfolio risk through less market exposure. A strategy-specific disadvantage of this strategy is, that is no longer predictable how hedge fund allocation would affect total portfolio risk.[87]

Equity long-short strategies possess all the typical risks for hedge funds- huge potential losses, illiquidity, substantial fees. Their specific risks are hedge fund manager abilities- whether he could accurately predict the relative performance of two stocks. Inherent to equity long-short strategies is the risk losing a lot of money if the stock market declines sharply due to the long positions. To be on the safe side, it is best when the investor has confidence, that "their hedge funds follow strict rules to evaluate market risks and find good investment opportunities".[88]

Emerging Markets is about investment in securities from less popular and developed countries such as countries in Latin America, Africa, parts of Asia, Eastern Europe, and the former Soviet Union.[89] The possible hurdles here could be that regulations in some countries which do not permit short-selling or using leverage.[90]

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84 The Impact Of Hedge Funds On Financial Markets ,Paper submitted to House of Representatives Standing Committee on Economics, Finance and Public Administration's Inquiry into the International Financial Markets Effects on Government Policy, June 1999,available at http://www.rba.gov.au/publications/submissions/impact-hdge-fnds.pdf

85 Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

86 Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)

87 Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

88 Hedge Fund Strategy - Equity Long-Short, Barclay Global Hedge Fund Database. available at http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-equity-long-short.html

89 Tran, Vinh Q., Evaluating Hedge Fund Performance, (2006, Wiley, John & Sons, Incorporated)

90 Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

Emerging markets' most disturbing risk is the lack of transparency in these countries whose securities are the target of investment. This makes it extremely hard to evaluate investment opportunities. Additionally possible illiquidity and extreme volatility might become an existing problem. It is a great risk to intake for hedge funds since in case of a downturn in the market of interest, hedge funds would be forced to sell holdings from other healthy emerging markets to be able to redeem the investors who demanded their money back. Thus, hedge funds' actions would eventually affect markets which were originally unaffected.[91]

Market timing is a short-term oriented strategy. It exploits asset classes perceived to perform well in the near future. [92]

Selling short (dedicated short bias) seeks to profit from selling short borrowed securities with the objective to buy them back at a future date at profitable prices. This strategy is most effective in markets are declining. Usually the securities are borrowed from a brokerage firm, which later on are to be delivered back to the brokerage firm after buying them back at a lower price.[93]

This strategy is controversial and is highly criticized. There is the opinion that if a lot of market players start selling short, then the overall market value would decrease causing financial instability through panic (FEPS Q 269 and Mr Chapman Q 69). Blackrock established the opposite argument-it stated that short selling increases market liquidity and helps establishing the real value of securities, while at the same time lowers transaction costs (QQ 181, 190).[94]

Even the SEC itself acknowledged, "without short sellers, prices are wrong."[95]

Relative value strategies

Furthermore, relative value strategies must be observed. Relative value strategies take advantage of price discrepancies among related financial assets like debt and equity. They rely on long-term patterns, while at the same time take advantage of short-term discrepancies and thus they profit.[96]

The main tactic is to buy and sell related securities to hedge risk. In general, these kinds of strategies guarantee low volatility and low correlation with the market. Relative value strategies have a narrow gap of profiting and that is why hedge funds, which employ these

[91] Barclay Global Hedge Fund Database,Hedge Fund Strategy - Emerging Markets Fund, available at http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-emerging-markets.html
[92] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[93] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[94] European Union Committee - Third Report ,Directive on Alternative Investment Fund Managers, CHAPTER 2: What are alternative investment funds and what risks do they pose to financial stability?, available at http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeucom/48/4805.htm
[95] SEC, Concept Release: Short Sales. Release No. 34-42037. October 20,1999. 64 Fed.Reg. 57996, 57997. Available at: http://w w w.sec.gov/rules/concept/34-42037.htm.
[96] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

strategies tend to use more leverage in order to magnify their gains.[97]

Relative-value funds typically invest in fixed income and/or equity instruments. These funds are considered conservative because they limit their operations to low-risk arbitrage. After the era of LTCM, as a fund employing the same strategy, the general opinion has shifted and these funds are now considered very risky especially if they depend on leverage. Market-neutral funds are estimated to take 25% of hedge fund market and deal with around 20% of all assets available.[98]

Convertible arbitrage is the first relative value strategy to be considered. It operates with convertible securities, which could be either debt or preferred shares. Convertible arbitrage's operational tactics is to take a long position on the convertible bond and sell short company's shares. This move secures profit by "taking advantage of the undervaluation of the convertible bond, while reducing the exposure to the underlying stock price movement''[99].

Convertible arbitrage's risks come from the holding period. The tricky moment is being able determine the market conditions and estimate whether the predictions would be still valid at the moment the conversion would be possible. This is so, because with convertible bonds one must wait for a specified amount of time before being able to convert the bonds into stock. Unexpected events are also adding risks. There have been occasions in the past when the price for convertible bonds declined more than the stock price for no apparent reason. General Motors is a recent example when arbitrageurs suffered huge losses.[100]

It is common for convertible securities to be undervalued. Convertible securities are also illiquid which makes them not so attractive and less followed by analysts.

Convertible arbitrage is dependable on interest rate movements and credit spread changes, as well as regulatory holdbacks. By employing convertible arbitrage, hedge funds contribute to the liquidity of the convertible bond market. [101]

Fixed-income arbitrage strategies profit from the mispricing of fixed income securities. Mathematical models are often used to identify mispricing and manage positions.

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[97] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

[98] The Impact Of Hedge Funds On Financial Markets ,Paper submitted to House of Representatives Standing Committee on Economics, Finance and Public Administration's Inquiry into the International Financial Markets Effects on Government Policy, June 1999,available at http://www.rba.gov.au/publications/submissions/impact-hdge-fnds.pdf

[99] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

[100] Barclay Global Hedge Fund Database, Hedge Fund Strategy - Convertible Arbitrage, available at http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-convertible-arbitrage.html

[101] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf

Fixed-income arbitrage is a strategy which does not come with high returns but brings many risks. It is referred to as "picking up nickels in front of a steamroller." [102]

It is a lot like gambling but not as an amateur, rather as a professional gambler. The better the hedge fund manager knows the game, the more profits at the end of the game.[103]

Arbitrage is supposed to be risk-free. By definition it is the simultaneous trade of two related securities- one of them is being bought and the other-sold. The idea behind it is to profit from price discrepancies between the stock and the convertible bond tied to that stock. That is how through indirect hedges, hedge funds manipulate the share prices of related securities.[104]

The strategies, which involve arbitrage, help bring market prices to their optimal fundamental level. They also enhance liquidity and provide depth to the market during the pre-closing period.[105]

Equity-market-neutral strategy is about purchasing an equity security and selling short a related equity index. In this way, the systematic risk is neutralized. ”The objective is to capitalize on the perceived growth prospects of the equity issue and to minimize the risk of the market from driving down the price.”[106]Equity-market-neutral strategies do not correlate with the overall market performance. By hedging risk it all comes down to the specific trades executed.[107]

Hybrid hedge funds

Hybrid hedge funds are to be the last big group of hedge fund tactics. They are not an ordinary group of strategies since they do not represent separate strategies united by some characteristic but rather a mix, match and blend of strategies.[108] This group of hedge funds usually consists of values-based hedge funds, multi-strategy hedge funds and some authors consider Funds of hedge funds also a part of it. My personal opinion is that FoFs is not a hedge fund strategy but rather a separate legal and operational organization or body of hedge funds and that is why I do not intend to discuss it here. What is more, FoFs have already been considered in Chapter II as an organizational option.

Values-based hedge funds have become more and more popular these past few years. Basically, values-based hedge funds could employ any type of tools and strategies as long as they do not interfere with their faith. The only thing, which separates them from most hedge funds is their values- they would only trade with securities which are not against their valued principles. To be precise, they only trade either with certain types of investments or they are not allowed to trade with certain types of investments. These hedge funds are led by their religious beliefs and follow their moral principles. Some examples of values-based hedge fund types are: Catholic, Jewish, Islamic, Methodist, and Mormon etc. Their investment policy is recognized as socially responsible investing (SRI).[109]

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[102] Barclay Global Hedge Fund Database, Understanding Fixed-Income Arbitrage, available at http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-fixed-income.html
[103] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[104] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[105] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[106] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[107] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[108] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[109] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)

A multi-strategy hedge fund is according to its given name, a hedge fund, which uses more than one strategy either simultaneously or in rotation. It is possible that the fund manager would employ a few strategies with equal emphasis, or there will be leading and additional strategies. The more strategies employed which do not show results, the bigger the chances of loss. [110]

Conclusion

Convertible Arbitrage, Event-Driven, Emerging Markets, Fixed-Income Arbitrage, and Multi-Strategy include some of the most illiquid securities on the market. Equities and futures, on the other hand, provide liquidity for hedge funds, and therefore the strategies, which operate with those: Equity-Market-Neutral, Long/Short Equity, and Managed Futures, are boosting liquidity. Selling short (dedicated short bias) funds are probably characterized as the most liquid funds, because one can only short a security if they are liquid.[111]

Nearly 82% of all hedge funds employ long/short equity as one of the top three strategies, followed by event driven-53% and credit- 42%.[112]

Tactical/directional strategies rely on short selling which is a tool out of reach for traditional investing. Event-driven strategies and tactical strategies demand razor-sharp decisions and confidence, but most of all expertize. The manager is properly incentivized and motivated to use his best efforts to bring returns. Relative value strategies imply opacity, which is what preserves hedge funds' advantage over traditional investment vehicles. It is natural for hedge funds to employ tailored strategies since they are what gives them a competitive advantage over traditional funds.[113]

From this chapter it is important to deduct, that hedge funds do hide risks and there is no free lunch. They are speculative and exploitative and it seems as if they squeeze the market to the full sometimes. They do try to affect companies' decisions by buying stocks when it's a part of the strategy and they use calculations to make predictions and forecasts. They tend to play with securities without any care except producing returns. They may lack morals according to most people but they are not using illegal methods. Fraud among hedge funds is rare. It is usually a developing market situation, which can cause instability. Hedge funds occupy a very specific niche inaccessible to most investment companies and that is what brings their success.

Some of the most prominent benefits of hedge funds are that they reduce overall portfolio risk and volatility. They also bring higher returns compared to traditional investing.[114] They are natural diversifiers and some strategies are able to bring returns both in rising and falling

[110] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[111] Nicholas Chan,Mila Getmansky, Shane M. Haas, Andrew W. Lo, Systemic Risk And Hedge Funds, (March 2005, Working Paper 11200),available at http://www.nber.org/papers/w11200
[112] Ross Ellis, SEI Investment Manager Services, Shifting Hedge Fund Landscape: Where Institutions Put Fund Managers to the Test (29 Mar 2012), available at http://www.hedgefundsreview.com/hedge-funds-review/advertisement/2164767/sponsored-statement-sei-investment-manager-services
[113] Gregory Connor and Teo Lasarte, An Introduction to Hedge Fund Strategies, (International Asset Management Ltd, The London School of Economics and Political Science) available at http://www.iam.uk.com/press/lse-publications/An-Introduction-to-Hedge-Fund- Strategies.pdf
[114] James D. Spellman ,Hedge Funds How They Serve Investors in U.S. and Global Markets, (2009, Coalition of Private Investment Companies), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf

markets. Most strategies are not related to each other, which provides investors with greater choice to achieve their investment purposes.[115]

Chapter IV

Regulation as a means to control and deal with market risks is inevitable. Regulators are usually concerned with defining and putting straight boundaries to frequent phenomena, which present consistency; which could affect a significant quantity of people; whose quality is of such character as to be considered important and influential. Hedge funds, as any such investment pool of a great magnitude, have been present on the market for a long time and already have formed an impression in most regulators as to the regulatory route to be followed when defining and constraining them. Regulatory bodies all over the world have been striving to impose regulatory acts for more transparency on hedge funds. Financial trades of such scale as hedge funds are executing daily are in need of greater disclosure. Thus, systemic risk on the market could be easily monitored and controlled. On the other hand, hedge funds follow strategies, which could be negatively affected from too broad disclosure requirements.[116] Prime broker and custodians which interact with hedge funds daily have direct access to hedge fund assets which puts them in the position to verify the hedge fund's actual financial situation. Therefore regulating hedge funds' counterparties could ultimately mean more transparency for hedge funds.[117]

The purpose of the regulatory overview of hedge funds all over the world, and mostly in the U.S.-the home of hedge funds, is to reveal the current regulatory state and assess whether it is sufficient for systemic risk control and if not, what measure should be taken to better suit the regulatory base. Hedge funds have been often accused of creating or at least contributing to the financial crises in the recent years. By researching the current regulation it is easier to determine whether or not there is any truth to those allegations.[118]

The government uses regulation as a tool to impose its political visions. There is no proper regulation if the benefits derived from it do not outweigh the costs.

A direct approach to hedge fund regulation is less likely to succeed. History has showed that a "controlled instrument would reappear elsewhere under a new name and a new form". An indirect approach would be to reinforce counterparty regulation- regulate banks and prime-brokers, for example.[119]

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[115] Dion Friedland, Chairman, Magnum Funds, About Hedge Funds-Benefits Of Hedge Funds, available at http://www.magnum.com/hedgefunds/abouthedgefunds.asp#benefits
[116] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693
[117] Houman B. Shadab Professor, New York Law School, Hedge Funds and the Financial Crisis, (January 2009), available at http://ssrn.com/abstract=1564847
[118] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693
[119] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

On a national level, there have been various approaches towards hedge fund industry. The two basic ones are regulation of hedge funds as an industry and supervision of their activities.[120]

A popular approach these days towards hedge funds is not to deal with them directly but to regulate them through their managers. This is an effective approach since it captures any legal form in which the portfolios are managed, including those which are not strictly funds. For that reason US, UK and the EU all favor this regulation approach.

Almost in all researched countries, a hedge fund manager is subject to licensing and is, therefore, supervised. Managers' registration domicile may not correspond to hedge fund's location.[121]

If the systemic risk is to be considered and the potential threat to be assessed, it is beneficial to observe the collective position of all portfolios managed by the same managers.[122]

At first, to be able to assess the actual need of regulation and the necessary policy towards the industry, it is important to consider both the unfavorable and the favorable externalities hedge funds create and at the process of regulating, try to conserve the positive ones.

A financial system revolves around liquidity and maintaining a level of liquidity is the main goal of any market so that its participants would be satisfied.[123] As already mentioned, hedge funds are instrumental in liquidity maintenance.

Hedge funds are famous for their light regulation compared to other investment schemes. In most countries, hedge funds are subject to exemptions because they are offered only privately. Public fund are usually subject to strict regulations and hedge funds, therefore, are lightly regulated and benefit from exemptions because of their character.

The U.S. has a long history of providing exemptions for hedge funds. First, the rule was that if a hedge fund is offered to less than 100 investors, then there is an exemption. Later on, the term "qualified purchasers" was introduced stating that as such only physical or legal persons with great amount of assets qualified. Canadian investors must submit at least CAN $150.000 or have substantial amount of assets that they can prove somehow. In the UK, individual British investors must be "qualified" as well. Spanish investors must invest at least € 50.000 on top of being a "qualified" investor. There is also a 25-investors minimum. In France, there is also a minimum investment of $125.000 and requirements, which the investors must comply with. In Italy, € 500.000 is the amount of minimum investment. German intermediary banks are the only institution allowed to offer private placements to investors and that is why they are exempted. Both Switzerland and Japan must use authorized intermediaries.[124]

4.1 European Union and other countries regulation

[120] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693

[121] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

[122] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

[123] Hossein Nabilou, Market Failure in Hedge Fund Industry: A Need for Regulation?, available at http://ssrn.com/abstract=1990406

[124] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

First, an observation of the regulatory regimes in the countries in the European Union and some other countries around the world would be considered. As the second most important hedge fund center is in the E.U and Europe is gaining experience with fast pace, it is worthwhile to concentrate on the countries with larger hedge fund markets.

The European Union:

The last few years many states in the E.U have been focusing their regulatory efforts on the hedge fund market as a fast growing and with great demand from domestic investors.

The main points covered by the introduced regulatory acts include some structural aspects of hedge funds and distribution. To be precise, most member states have regulated the investment limits of hedge funds and/or have defined any applicable restrictions of investing in the fund itself. Provisions on whether or not hedge funds can be distributed privately or publically, as well as the conditions of foreign funds being offered in the member state are common.

By executing research of most of the countries in the E.U., I will try to point out the regulatory inconsistencies existing between member states. Some member states have set up a threshold for hedge fund investing, while others have not; there are member states with limitation on the number of participants in the fund; it is allowed to distribute hedge funds to the public in some countries, while in most –it is not. If public offering is allowed, then it is standard to establish stricter rules.[125]

In the EU there are two types of funds-UCITS (Undertakings for Collective Investment in Transferable Securities) funds and non-UCITS funds. The Directive 85/611/EEC, also known as UCITS (Undertakings for Collective Investment in Transferable Securities) was enacted by the European community in 1985. Hedge funds in the European Union generally do not fall within that directive due to their strategies.[126]

UCITS funds must comply with the UCITS Directive which permits these funds to sell to the retail market. The other funds which do not qualify under UCITS directive are called non-UCITS funds and include hedge funds, private equity funds, commodity funds and real estate funds. They are offered only to sophisticated, qualified investors.[127]

Hedge funds have many titles depending on the country. The Italians have named them "speculative funds", the Germans-"Sondervermögen mit zusätzlichen Risiken", "Collective Investment Schemes pursuing alternative investment strategies" under Luxembourg law, the French-"OPCVM contractuels" and "OPCVM de fonds alternatifs", and the Irish-"Professional investor schemes" and "Qualified investor schemes".[128]

The U. K. does not impose supervision for hedge fund but for managers of such funds. Many hedge fund managers are located in the U.K. but usually the funds they manage are domiciled in an offshore location. In Europe, London is the largest hedge fund managers'

[125] Hedge Funds Regulation in Europe-a Comparative Survey, (November 2005, Assogestioni & EFAMA), available at http://www.ethe.org.gr/files/pdf/_2005121143638.pdf

[126] Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)

[127] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[128] Hedge Funds Regulation in Europe-a Comparative Survey, (November 2005, Assogestioni & EFAMA), available at http://www.ethe.org.gr/files/pdf/_2005121143638.pdf

center, second worldwide after New York. In U.K., hedge funds are regulated through hedge fund managers' regulation.[129] The managers, who are located in the U.K., have to confine with MiFID and FSA rules. Hedge fund managers need authorization from the Financial Services Authority ("FSA") according to Section 19 of the Financial Services and Markets Act of 2000.[130] Therefore, the management firm is the one that has to comply with the capital requirements directive and the FSA rules on conduct of business.[131] Hedge funds do not prefer U.K. for registration for tax reasons, but still there are some hedge funds actually registered there. U.K hedge fund advisers are subject to MiFID(Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives) capital adequacy rules based on its activities.[132] It is possible for hedge funds in U.K. to be traded on regulated markets but they will have to make disclosures as if they were a listed company. The banks in their role as prime brokers and the institutional investors contribute to the information flow about hedge funds indirectly through their subjection to the FSA[133].

The FSA, the financial authority of the United Kingdom, acknowledges that hedge funds could create systemic risk only through their counterparties and not by themselves. The FSA stated, that "it is essential that firms do take risks, for without risks there will be no innovation or competition which are the basis for economic prosperity". The excessive regulation of hedge funds would reduce liquidity and impair diversification eventually leading to investors' detriment. The FSA is at the opinion that regulation should not be with the cost of positive externalities of hedge funds.[134]

In Germany hedge funds are customized - they could be investment funds or investment stock corporations. In the first case, they have a contractual nature and their structure is similar to U.S. hedge funds, while otherwise they have a corporate structure. The management of the fund is performed by a capital investment company with a license from the financial regulator ("BaFin") is obligatory prior to formation. Germans distinguish between single hedge funds and Funds of hedge funds. Only Funds of hedge funds can be offered publically, while single hedge funds are subject to private placements only. In any case, a prospectus is needed.[135] All the risks involved must be mentioned in the prospectus, later confirmed by BaFin along with other clauses. This is another precaution in favor of the investors. German hedge funds are not allowed to invest in raw materials or real property. If they invest in equities of non-listed companies, the stake should not exceed 30%. This is a diversification requirement. There are minimal capital requirements for hedge funds in

[129] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[130] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[131] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

[132] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[133] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

[134] Robert Falkner and Morgan Lewis, The Regulation of Hedge Funds-Is More Needed, and if so, Where?, (April 2009, The hedge fund journal), available at http://www.thehedgefundjournal.com/magazine/200904/technical/the-regulation-of-hedge-funds.php

[135] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

Germany. Foreign funds can only be distributed privately on the German market. There are no requirements regarding investors- either their number, or their qualification.[136] German law provides incentives to regulated "special funds" which offer exclusively to institutional investors.[137]

Italy's hedge fund market is lightly regulated. It is a busy hedge fund market, establishing rules for hedge funds among the first countries in Europe. Asset management companies need authorization by the Banca d'Italia. Hedge funds need authorization of the market regulator (CONSOB). There are no capital requirements for hedge funds, only for investment advisers. The same rules apply to foreign non-UCITS funds, which distribute on the Italian market.[138]

The requirements a fund must fulfill before receiving authorization are mostly in connection to disclosure. The structure, as well as the financial and trading activities of the fund, is supervised. They must disclose the traded asset classes, the investment procedure and documentation they provide their investors with, etc. In short, indirect regulation is also imposed by the central bank.[139]

In Italy, all the burdens a hedge fund must undertake are only prior to the grant of authorization. Afterwards the fund is subject to no supervision and can employ any strategy available to hedge funds. Hedge funds are only accessible to private wealthy investors and cannot be offered publicly.[140] There is a minimum subscription fee of € 0, 5 million contributions to the fund.[141] There is no limit to the number of investors.[142]

Like the German system, Spanish regime also provides, that single hedge funds can be offered to qualified investors only under the condition they invest at least € 50.000. There should be no less than 25 investors, though. Funds of hedge funds are publicly available if they have more than 100 investors. In Spain, registration with the CNMV is also necessary. CNMV does not only demand registering but also the hedge fund must obtain authorization to deal first. [143]

France does not regulate stiffly contractual hedge funds as long as the management company has obtained a license. In France, the Financial Security Act applies to hedge funds. No

136 Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

137 Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

138 Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

139 Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

140 Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

141 Hedge Funds Regulation in Europe-a Comparative Survey, (November 2005, Assogestioni & EFAMA), available at http://www.ethe.org.gr/files/pdf/_2005121143638.pdf

142 Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

143 Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

general solicitation is allowed and the notion of "qualified investors" is present as well. Registration for hedge funds is obligatory as well. The criteria for a natural person to qualify as a hedge fund investor, is as follows: either registration on records by the AMF or if at least two of the following criteria are met (i) the size of the investor's financial instruments portfolio exceeds €500000, (ii) the investor has carried out transactions which amounted €600 each at an average frequency of at least ten per trimester over the previous year or (iii) has worked for at least one year in the financial sector in a position that requires knowledge of securities investment.[144] Institutional investors are allowed to invest up to 10% of their capital in hedge funds. ARIA funds are another type of funds not accessible to everyone and subject to more regulation. Hedge funds established in other countries can take investments from French citizens if they have AMF authorization. AMF would issue such authorization if the level of disclosure of the hedge fund domicile country is equivalent to the level of disclosure in France.[145] Again, anti-fraud provisions apply pursuant to the European Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation.[146]

Luxembourg and Ireland are the domicile for many hedge funds. In Luxembourg, a hedge fund cannot be offered to the public. A hedge fund can be structured either as a common fund or as a specialized fund (SIF). SIFs are more flexible in some respects and they can invest up to 30% of the same issuer. "Well informed investors" can invest in them as well as institutional investors. The investment must be through a Luxembourg central administration agent and a depositary or a Luxembourg financial institution. Funds of hedge funds can invest no more than 20% in non-regulated funds.[147]

In Ireland UCITS is applied. According to UCITS there are funds which can be offered for sale in the European Union, and non-UCITS, which can be offered in a foreign country if the local regulation permits it. Non-UCITS funds such as Funds of hedge funds can be offered to retail investors. Hedge funds are a non-UCITS form. They qualify either as a Professional Investment Fund, or as a Qualifying Investor Fund, which is better for their case since it is more flexible. In any case, only wealthy and informed investors are allowed. Here as well a custodian from the country itself is required. The management should, as well, be provided with a license.[148]

Many countries have very few or no hedge funds at all established on their territory. The reason is that there is no existing regulation on hedge funds mostly because such countries are developing countries.

In Belgium, there are no hedge funds, as we know them, due to UCITS. Because disclosure

[144] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[145] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

[146] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[147] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

[148] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

and tax burdens are huge, there are literally no hedge funds there.[149]

In Denmark, only private investment in hedge funds is allowed and if the general public would be allowed to invest, then all national rules for securities would apply. Hedge fund managers must be licensed.[150]

Polish authorities have not imposed any rules on hedge funds, although there are a few hedge funds, which operate in the country.[151]

Greece is one of the countries with no regulation on hedge funds as well and that is why there are non-existent there.[152]

Croatia has no specific rules for hedge funds but general ones for all types of investment companies. Only private offering to qualified investors is allowed. Mostly institutional investors invest in hedge funds, though. The supervisory body Hanfa overlooks the management of hedge funds.[153]

In summary, hedge funds in the E.U. can take either a contractual form, or a statutory form. Not all legal systems have the option for hedge funds to be established both as open-ended and closed-ended structures.

The public offering of hedge funds is usually allowed in countries, which have restrictions on the manager's liberty to define the subject of the investment. This is common for Germany, Luxembourg, France and Ireland. [154]

All countries under research require that an authorized managing company with proof of manager's professionalism manage the hedge fund. In some countries, only registration is sufficient (Spain, France). In any case, authorization is even stronger regulatory requirement and form of control since it not only keeps record of registration, but also assesses whether the manager9 management company) is qualified and fit for its assigned functions.

A custodian for the fund's assets is also a requirement in the E.U. as opposed to U.S. and offshore funds. Separation of investor's accounts is not guaranteed without a custodian.

All Member States allow the employment of the services of a prime broker. Italy, Ireland and Luxembourg have specific requirements as to the characteristics of the prime-broker and the collateral to be provided by the hedge fund when using prime-broker's services.

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149 Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202
150 Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202
151 Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202
152 Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202
153 Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202
154 Hedge Funds Regulation in Europe-a Comparative Survey, (November 2005, Assogestioni & EFAMA), available at http://www.ethe.org.gr/files/pdf/_2005121143638.pdf

Foreign hedge funds are in principle allowed in all member states provided they fulfill some requirements. In Italy, the rules for domestic funds apply for foreign funds as well. In Germany, there is a restriction on public offering of foreign funds.[155]

Hedge funds can be organized under the law of contract in almost all countries in the E.U. A hedge fund could open-ended in almost all countries but there is the parallel possibility of a close-ended fund in some. All countries allow for both a single hedge fund, and a Fund of hedge funds existence.[156]

Most countries have limits either on the ratio of leverage (France, Spain and Switzerland) or on risk diversification.

The most recent regulatory act with disclosure requirement on a E.U. level is the AIFM directive which came into force on 21 July 2011. The AIFM Directive was proposed after the financial crisis in 2008-2009. The Commission explained its initiative with lack of disclosure and transparency among AIFs, thus increasing systemic risks.[157] EU has redrafted the directive many times to make it more adequate and effective.[158] The Alternative Investment Fund Managers Directive applies to hedge fund managers since it has a broad definition of alternative investment managers. Mostly it is about transparency, but AIFM also imposes minimum capital requirements and controls the use of leverage.[159]

It covers all EU-based and non-EU-based hedge fund managers, no matter whether they manage an EU or non-EU funds. The full implementation if the directive will happen in 2013 after establishment of some additional regulatory measures.[160]

The AIFM Directive tries to establish requirements for fund managers of alternative investment funds (AIFs) within the EU. AIF are considered all collective investment schemes without authorization under the Undertakings for Collective Investments in Transferable Securities Directive (UCITS). There is an exemption for managers of AIF portfolios with less than €100 million.

The AIFM Directive aims to mitigate risks by putting leverage restrictions. The E.U is in a great position to control leverage use by alternative investment funds. By placing leverage restrictions it is less likely that a fund would go bankrupt in cases of instability on the market.[161]

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[155] Hedge Funds Regulation in Europe-a Comparative Survey, (November 2005, Assogestioni & EFAMA), available at http://www.ethe.org.gr/files/pdf/_2005121143638.pdf

[156] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693

[157] European Union Committee - Third Report ,Directive on Alternative Investment Fund Managers, CHAPTER 2: What are alternative investment funds and what risks do they pose to financial stability?, available at http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeucom/48/4805.htm

[158] Wulf A. Kaal, Hedge Fund Regulation via Basel III, available at http://ssrn.com/abstract=1806252

[159] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[160] Eilis Ferran, The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis, (University of Cambridge and ECGI), available at http://ssrn.com/abstract= 1762119

[161] Dan Awrey, The Limits of EU Hedge Fund Regulation, (2011, LFMR), available at http://ssrn.com/abstract=1757719

Leverage is the use of debt to supplement investment. It can affect banks if an AIF goes into bankruptcy. In such a case if a bank was the provider of leverage to the AIF, the bank would also suffer losses. Only in the case of extreme levels of leverage by an AIF there is a chance that an AIF would contribute systemic risk through magnifying bank's exposure to risks.[162]

The effect of the directive is unpredictable, but the least to be said is, that it is unclear. Some of the requirements set out in the directive might become in conflict with national regimes or might be already existent in some countries. The idea is to mitigate systemic risk but the measures designed are not appropriate. It is a regulatory act inspired by politics and not so much by reason. No matter what the effect turns out to be, a positive outcome is not likely. [163]

Other countries:

Japanese hedge fund managers must register with FSA if their funds are offered to the public. Otherwise, only JFSA notification must be filed.

In Taiwan, hedge funds are contractual. Most hedge funds are established for that reason abroad. There are Koran funds, which resemble hedge funds. The Investment Commission monitors offshore hedge funds, which attract Taiwanese wealth. Taiwanese custodian for those funds is a must. Local hedge funds are restricted to 35 institutional investors. In cases of conflict of interest, an investment might be banned.[164]

In Switzerland, investment companies are regulated by the Swiss Federal Banking Commission (FBC) by means of specific sections in the Code of Obligations (1912) and the Law on Investment Funds (1994). It is preferable for hedge funds to be established as closed-end investment companies to evade harsh rules. Since 1994 law changes there are three possible classifications for funds- real estate funds, securities funds and "other funds (with special risks)". Hedge funds classify as the last ones. Some limitations as to the strategies available to hedge funds and the assets they can trade with are present, though. This does not apply to authorized hedge funds with the proper level of disclosure in their prospectus. Advertising in Switzerland is allowed for both onshore and offshore funds. Switzerland as a liberal country has no specific rules and limitations on the size of investment and also capital gains are free from taxation (L‟habitant, 2007). Closed-end funds investments not listed on the stock exchange are not allowed and managed accounts cannot be invested in as well.[165]Swiss managers are subject to registration. Foreign managers must only comply with money laundering laws.[166]

After 1997, hedge funds became public. This boosted hedge fund development vastly securing a front position for Swiss hedge fund investors.[167]

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[162] European Union Committee - Third Report ,Directive on Alternative Investment Fund Managers, CHAPTER 2: What are alternative investment funds and what risks do they pose to financial stability?, available at http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeucom/48/4805.htm

[163] Dan Awrey, The Limits of EU Hedge Fund Regulation, (2011, LFMR), available at http://ssrn.com/abstract=1757719

[164] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

[165] Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)

[166] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

[167] Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)

The Swiss have made an intelligent decision towards offshore non-authorized hedge funds. Foreign hedge funds can be taken advantage of only by qualified investors.[168] Although they cannot be advertised in public, upon request information on an unsolicited basis is available. Investors could also decide to subscribe to units of the fund on their own will. Since 2003, non-registered offshore hedge funds could offer and sell to institutional investors with a professional treasury in Switzerland (L‟habitant, 2007).[169]

There has been a newer regulation- the Federal Law for Collective Investment Schemes in 2007 was enacted according to L‟habitant (2007). The law was enacted to harmonize Swiss rules with UCITS III directive.[170]

There are countries where hedge funds are required to register along with traditional investment funds. More requirements would have to be obeyed if the fund is distributed to retail investors. Australia is one such country. A compliance plan has to be adopted, non-executive directors should be appointed, valuation procedures must be implemented and, also a disclosure statement must be submitted with the ASIC in case of retail distribution. There is a similar situation in Brazil as to Brazilian domiciled funds: registration, following rules on conflicts of interest and risk management, adoption of an agreement to comply with legal provisions. As to foreign funds, if they want to be considered by Brazilian investors, they must register with the proper securities authorities. They must also use the services of authorized brokers. In Canada there are two systems- either offerings are made with a full prospectus and are allowed to the general public with the regular publishing financial statements, or offerings are made without a prospectus only to accredited investors. The standard rules for managers' registration on minimum capital, proficiency and experience apply with prospects of the implementation of stricter rules. There are some provinces where the distributors are not subject to registration but this is coming to an end. [171]

On the other hand, there are states, which do not have direct regulation regarding hedge funds, but rather use other methods for control.

Overall, registration requirements for disclosure purposes are present everywhere in the researched countries. More experienced countries have stricter measures and more requirements towards hedge funds and mostly-hedge fund managers. Europe has basically decided to regulate hedge fund activities through their managers and they are the ones responsible for the general transparency level. In addition, foreign hedge funds are only allowed if they have an equivalent level of disclosure compared to the local one. In conclusion, this means that almost a comparable level of transparency exists in the E.U. zone, or at least in the countries where there are active hedge funds in the market.

4.2 US regulation

[168] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202
[169] Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)
[170] Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)
[171] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202

The United States of America are the place, where hedge funds originally appeared. As such, the U.S. has a long history of regulations, which relates to them. In the U.S., hedge funds are primarily regulated through their investors. Indirect regulations through other connected participants, such as prime-brokers and banks, are in effect.

Since 2004, the SEC has been making endeavors to regulate hedge funds. The SEC has four options towards hedge funds- either to maintain the current regulatory situation; or to regulate hedge funds directly; or to regulate hedge fund managers; or to regulate hedge fund investors. No matter what option it uses, they all bring risks, and either create problems, or leave them unsolved.[172]

The regulatory acts, which apply to hedge funds and along with them to mutual funds, as private investment pools, are the Investment Advisers Act of 1940 for investment advisers; the Investment Company Act of 1940, dealing with mutual funds; the Securities Act of 1933 for public offerings and the Securities Exchange Act of 1934, imposing disclosure and other requirements on public companies.[173] There are available exemptions for private investment pools which have less than 100 accredited investors and do not issue securities to the public. The restriction on the number of accredited investors for hedge funds was abolished by the National Securities Markets Improvement Act of 1996. Hedge funds do pay attention, thought, to keep the number of investors below 500 in order to qualify as a private offering under the Securities Act. Accredited investors could be considered individuals with at least $5 million net-worth or institutional investors with at least $25 million in capital.[174]

Hedge funds have been known to be treated similarly to mutual funds. Mutual funds are offered publically. That is why they are subject to many disclosure requirements. They cannot be compared and put in the same position as hedge funds. Hedge funds have their specificity, which exists due their tailored regulation. They are given a lot of freedom but they have also a few restrictions, such as not being subject to solicitation and being offered to accredited investors only. If stricter regulation is introduced, the inherent characteristics of hedge funds would be destroyed and they would not be able to provide the investors with their current benefits. They would more or less become a duplicate of other investment pools. Transparency is inherently not a trait of theirs. More disclosure, but with boundaries and considering hedge funds' interests, might be beneficial for investors. Too much disclosure, though, will threaten hedge funds' strategies and positions. Therefore, they will not be able to accrue profits as successfully as before.

The U.S. has created a set of acts, which regulate hedge funds one way or another. The Securities Act 1933 regulates the public issue of securities; the Investment Company Act 1940 defines what a fund is, the Securities Exchange act defines the distribution of securities and the CFTC laws determine the rules for whether or not a fund is a "commodity pool". All

[172] Troy A. Paredes, Paper No. 07-05-01,Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation, (May 3, 2007, Washington University of St. Louis), available at http://sssrn.com/abstract=984450

[173] Troy A. Paredes, Paper No. 07-05-01,Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation, (May 3, 2007, Washington University of St. Louis), available at http://sssrn.com/abstract=984450

[174] William P. Osterberg and James B. Thomson, The Truth about Hedge Funds, (May 1, 1999, Federal reserve bank of Cleveland), available at http://www.clevelandfed.org/research/commentary/1999/0501.pdf

these acts contain many exceptions for hedge funds which are usually applicable. In some states, blue-sky laws are applicable as well.[175]

Regulating hedge funds is completely different in Europe and in U.S. In U.S. and U.K. they use one approach and for the rest of the EU a French-German approach is used.

There are people who support the idea of establishing more safeguards since hedge funds are dealing with pension and mutual funds. Safeguards are already in action, though. There is a 30% threshold, which both pension funds and mutual funds cannot cross while investing with hedge funds and, also mutual funds must comply with diversification requirements under the Investment Company Act.[176]

The market actors who deal with hedge funds are usually sophisticated to make their informed decisions. Shares are distributed through registered broker-dealers unless they are distributed to people who take an important position in the fund or to institutional investors. Foreign brokers to U.S. are allowed to offer their services limitedly and under condition a U.S. broker-dealer supervises the foreign firm. In the end, only institutional investors can use solicitation.[177]
Broker-dealers and banks are financial institutions which have the means to conduct due diligence and determine whether the information they found is sufficient for their needs. No further need for disclosure to the general public is necessary hence.[178]

Hedge funds' leverage use is limited under Regulation T. Although Regulation T does not state exactly what the permitted leverage ratio is, it is conclusively deducted to be two or three to one.[179]

There have been many proposals for regulatory changes but most of them have been left unadopted. The Obama/Volcker's proposal is another regulatory attempt with the goal to reduce systemic risk by limiting the interconnectedness of financial institutions. The Obama/Volcker's proposal would prohibit banks from holding or investing in hedge funds and private equity funds.[180]

As financial institutions, hedge funds are subject to anti-money laundering requirements set out in Section 352 of the U.S. Patriot Act of 2001.

Sometimes hedge funds are subject to state regulations known as "Blue Sky laws". These regulations do not regulate hedge funds' operations but possibly regulate advisers, offers,

[175]Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)

[176] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[177] Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)

[178] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[179] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[180] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

sale of interests. They could impose additional stricter antifraud provisions and notice filing requirements.[181] Blue-sky laws are actually the state level of regulation compared to the federal one.

Starting with the particular acts, pertaining to hedge funds, the Investment Advisers Act of 1940 uses an alternative way to regulate the hedge fund industry by regulating hedge fund advisers. The IAA imposes fiduciary duties. The Investment Adviser's Act sanctions fraudulent activities towards investors in hedge funds. [182]Advisers must look after the best interests of their clients. Advisers "must disclose conflicts of interest, report personal transactions, keep records of their trades, institute, sustain and administer a code of ethics and must not engage in transactions which operate as a fraud''[183].

With the recent changes from the SEC the Investment Advisers Act of 1940 has tightened the qualification criteria for the "private adviser exemption." Under section 203(b)(3) an adviser is exempt from registration if he (1) has had less than fifteen clients in the past twelve months, (2) does not hold itself out generally to the public as an investment adviser, and (3) is not an adviser to any registered investment company.[184] A fund is considered as one client. Directly, this means that an advisor could manage up to 14 funds without registering, no matter how many people have invested in each fund.[185]

This act states that hedge fund managers are entitled to receive a percentage of the gains on behalf of the fund for their "qualified" investors, which is otherwise prohibited. [186]
Still the anti-fraud provisions apply, though. Rule 10b-5 of the Securities and Exchange Act of 1934 applies as well.

Many regulatory requirements have pressed some funds to relocate. Offshore funds have higher capital flows boosted by the tax exemptions in these locations. Usually a hedge fund outsources some functions to avoid fraud and escape liability in cases of abuse of duties.[187]

In 2006, there was a six-month period, during which hedge fund advisors had to register with the SEC under a new Rule203(b)(3)-2, because hedge funds had to count each investor in each hedge fund as a client. Small and new hedge fund managers could still be undetected but the general exemption had been lifted. There was a condition that if the lock-up period of the hedge fund was more than two years, hedge fund managers did not have to register. Otherwise, they had to file Form ADV with the SEC annually. The objective was to

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[181] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553
[182] Hedge Fund Law Blog, Hedge Fund Law – Summary of Hedge Fund Laws and Regulations, available at http://www.hedgefundlawblog.com/hedge-fund-law-summary-of-hedge-fund-laws-and-regulations.html
[183] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553
[184] Lisa C. Brice , Dodd-Frank Regulation Of Hedge Funds And Derivatives, (2010), available at: http://ssrn.com/abstract=1679187
[185] Troy A. Paredes, Paper No. 07-05-01,Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation, (May 3, 2007, Washington University of St. Louis), available at http://sssrn.com/abstract=984450
[186]Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)
[187] Douglas Cumming and Na Dai , Capital Flows and Hedge Fund Regulation, (September 2008), available at http://ssrn.com/abstract=1026683

increase transparency towards hedge fund managers.[188] As a consequence to the tightened rules, some hedge funds took precautions, such as imposing the two-year lock-in period to avoid registration or even relocated to an offshore location. Lock-in periods are of great importance since during their duration the investor cannot monitor his fund so easily.[189] The Federal Court of Appeal for the D.C Circuit vacated the SEC's "look-through" rule in the end.[190]

The Securities Act of 1933 has as a main purpose the registration of all "securities". Hedge funds, as vehicles, which operate with securities daily, would be typically caught by the act. Hedge fund managers, though, are exempt from registration of their trades under Section 4(2)- the private offering exemption. The section states that securities sold in a private offering to "accredited investors" do not need to be registered. [191] Hedge funds typically use Regulation D's Rule 506 safe harbor to carry out their offering.[192]

"Accredited investors" are considered both institutional and individual investors who can qualify as such under the statutory regulations. For an individual to be considered as an accredited investor a net worth (or joint net worth with the spouse) of more than $1,000,000 is needed or an income exceeding $200,000 in each of the past two years (or joint income with the spouse exceeding $300,000 in each of the past two years). It must be reasonably concluded that similar income would be available the upcoming year as well. For an accredited investor it is considered they can measure the risk of the investment and decide for themselves whether it is bearable.

A new proposition for "accredited natural person" was made by the SEC. It is a broader term than an "accredited investor"- the previous requirements must be met but also the investor must own at least $2.5 million in investments (individually or with their spouse).[193]

The "accredited investor" definition has a purpose of another precaution against risks posed by hedge funds to their investors. By establishing criteria for qualified investors, hedge funds are being indirectly constrained as a form of regulation. This constraint is effective enough to justify the shortage of disclosure in the hedge fund world. The character of the investors is believed to be a sufficient safeguard for the market participants.

Hedge fund managers are subject to fiduciary duties in any case. They must comply with antifraud provisions and fulfill the requirements of private offerings under Section 4(2) of the Securities Act. [194]

[188] Troy A. Paredes, Paper No. 07-05-01,Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation, (May 3, 2007, Washington University of St. Louis), available at http://sssrn.com/abstract=984450
[189] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[190] Mark J.P. Anson, The Handbook of Alternative Assets, (2006, Wiley, John & Sons, Incorporated)
[191] Hedge Fund Law Blog, Hedge Fund Law – Summary of Hedge Fund Laws and Regulations, available at http://www.hedgefundlawblog.com/hedge-fund-law-summary-of-hedge-fund-laws-and-regulations.html
[192] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553
[193] Troy A. Paredes, Paper No. 07-05-01,Hedge Funds and the SEC: Observations on the How and Why of Securities Regulation, (May 3, 2007, Washington University of St. Louis), available at http://sssrn.com/abstract=984450
[194] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

Regulation D puts an obligation to hedge funds to file a Notice of Sale with the SEC within 15 days of the first sale they make, and also follow Rules 506 and 501. [195]

Regulation D rules, as rules under the 1933 Act, provide a "safe harbour" under Section 4(2) of the 1933 Act. Regulation D gives the hedge fund a chance to escape Section 4(2) if compliance under the regulation is achieved. Rule 144 is also of interest for hedge funds since it allows the sale of certain restricted securities without registration.[196]

Hedge funds can take advantage of the "safe harbor" in Regulation D if they follow Rules 504, 505, or 506. Rule 506 is mostly applied by hedge funds since it does not have any provisions on the limits of the amount of capital raised. No solicitation and advertising is possible, though, and the client must be accredited.[197] "Accredited investors" are defined in Rule 501 of Regulation D:

1. a bank, insurance company, registered investment company, business development company, or small business investment company;

2. an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;

3. a charitable organization, corporation, or partnership with assets exceeding $5 million;

4. a director, executive officer, or general partner of the company selling the securities;

5. a business in which all the equity owners are accredited investors;

6. a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase;

7. a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year;

8. a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.[198]

For situations where more money are involved, the U.S. has implemented stricter rules- mandatory disclosure filings.

Institutional money managers, including hedge funds, must file quarterly a 13-F form to disclose their positions of more than $100 million or more on exchange-traded securities. This Schedule captures both U.S based hedge funds and offshore hedge funds. Since 13F captures

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[195] Mark J.P. Anson, The Handbook of Alternative Assets, (2006, Wiley, John & Sons, Incorporated)
[196] Hedge Fund Law Blog, Hedge Fund Law – Summary of Hedge Fund Laws and Regulations, available at http://www.hedgefundlawblog.com/hedge-fund-law-summary-of-hedge-fund-laws-and-regulations.html
[197] Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)
[198] Lisa C. Brice , Dodd-Frank Regulation Of Hedge Funds And Derivatives, (2010), available at: http://ssrn.com/abstract=1679187

only publically traded securities, derivatives traded in the OTC market are not captured. Thus, hidden ownership positions usually escape disclosure requirements. That is why hedge funds prefer OTC derivatives and equity swaps.[199]

Hedge funds with assets under management over $100 million must file 13-G 13-D forms. The same is valid for all kinds of investment funds.

Under Schedule 13-D and 13-G share lending and borrowing is caught. Borrowing (which comes with voting power) would most likely trigger disclosure under both Schedules.[200]

13-D forms are filed to provide the public with information as to public company's large shareholders and reveal why they have an interest in the company. These filings may be a sign of hostile takeovers, company breakups, and other change of control events.

13-D form is filed with the SEC when a fund has more than 5 percent beneficial ownership of the total outstanding shares of a company as an active investor.

On the other hand, a 13-G form is filed with the SEC when a fund has more than 5 percent beneficial ownership of the total outstanding shares of a company as a passive investor.[201]

Short positions do not trigger disclosure, no matter if in shares or derivatives.

Another regulatory act of concern to the topic is the Private Fund Investment Advisers Registration Act (PFIARA) of 2009 as an indirect hedge fund regulation. Its purpose is regulating hedge fund advisers. Following the adoption of the act, there is no more private adviser exemption under Rule §203(b)(3) of the IAA. The new rule is that hedge fund advisers with more than $30 million assets under management must register with the SEC. The exemption under IAA, stating that, if a hedge fund has 15 clients or less it does not have to register, is no longer available to hedge funds.[202]

Pursuant to PFIARA an accredited investor has a new definition than in Regulation D. PFIARA states, that the value of a natural person's main residence, when a determination as to the $1 million net worth requirement is made, should be excluded. All the data SEC receives from hedge funds due to their disclosure obligations is to be considered confidential. No one can guarantee the safe keep of such information, though. Any leakage would be detrimental to the hedge fund since the information is sensitive to the hedge fund trading activities.[203]

The introduction of the Dodd-Frank Act is another proof of the regulatory concern about hedge funds' disclosure level. This regulatory act adds another layer of disclosure and deprives hedge funds of some of the existent exemptions.

One of the changes introduced by the Dodd-Frank Act is the establishment of the Financial Stability Oversight Council. The Council's function is to monitor threatening activities to the

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[199] Henry T.C.Hu and Bernard Black, The New Vote Buying-Empty Voting and Hidden(Morphable) Ownership, (2006),available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=904004
[200] Henry T.C.Hu and Bernard Black, The New Vote Buying-Empty Voting and Hidden(Morphable) Ownership, (2006),available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=904004
[201] Scott Frush, Hedge Funds Demystified : a Self-Teaching Guide, (2008, McGraw-Hill Inc)
[202] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553
[203] Wulf A. Kaal, Hedge Fund Regulation via Basel III, available at http://ssrn.com/abstract=1806252

financial system of the U.S. and therefore control the systemic risk by putting restrictions when necessary towards banking activities with hedge funds. The Council must also take care of the hedge funds registration and disclosure requirements, especially with over-the-counter derivatives.[204]

The Dodd-Frank Act states that all hedge funds which fell under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 are deemed "private funds" and must register with the SEC. The exemption under Section 203(b)(3) of the Investment Advisers Act of 1940 has also been eliminated. Approximately 55 % of all hedge funds in the U.S. are registered with the SEC pursuant to these changes, which was the original idea of introducing the Dodd-Frank Act. Accredited investors must have a net worth of $1 million without the value of his main residence.

The Financial Stability Oversight Council demands records and reports from all registered hedge funds with the purpose of controlling systemic risk. The acquired information is to be kept confidential by the SEC.

The Dodd-Frank Act would affect both hedge fund and derivatives industries negatively. The predictions are the heightened margining would increase the cost of hedging and therefore affect liquidity.[205]

Derivatives are contractual financial instruments. Their value depends on the performance of the primary asset. They provide leverage by allowing hedge funds to hold larger positions but for less money compared to actually buying the underlying asset. Potentially derivatives bring huge profits but if the market collapses, the loss might be irreparable.

Swap, forwards, futures, options are all types of derivatives. By futures it is meant contracts to buy or sell an asset at some agreed time in the future at a fixed price on the day of signing the contract.

Derivatives are usually traded on over-the-counter markets because they are more complex than other securities. Usually they are traded between investors and financial institutions directly with no intermediaries. In OTC markets there is greater counterparty credit risk.[206]

Hedge funds are allowed to use derivatives to escape margin requirements. Also short selling is their greatest strength compared to mutual funds, for example, since they can react adequately to hedging opportunities. Leverage is also not directly limited with hedge funds. It could be affected only by creditors and counterparties, since they could take measures and increase interest rates or deny credit.

Banks must follow some capital requirements when they interact with hedge funds. By regulating financial institutions who invest in hedge funds, hedge funds themselves are being indirectly affected. [207]

[204] Lisa C. Brice , Dodd-Frank Regulation Of Hedge Funds And Derivatives, (2010), available at: http://ssrn.com/abstract=1679187

[205] Lisa C. Brice , Dodd-Frank Regulation Of Hedge Funds And Derivatives, (2010), available at: http://ssrn.com/abstract=1679187

[206] Lisa C. Brice , Dodd-Frank Regulation Of Hedge Funds And Derivatives, (2010), available at: http://ssrn.com/abstract=1679187

[207] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045

The Dodd-Frank Act is an indirect form, secondary type of regulation on hedge funds. It regulates banking institutions by restricting their ownership interest in hedge funds to 3 % of the bank's Tier 1 capital. The bank cannot be a sponsor of hedge funds with an investment more than 3 % or the bank's equity is more than 3 % of the overall ownership of the fund. As a newer regulatory act, the Dodd-Frank Act amends the Advisers Act. It demands transparency by registered advisors.[208]

The Dodd-Frank Act subjects hedge funds to disclosing "proprietary information"- trading data, strategies, etc. This information will not be made publicly available, though.[209]

The Hedge Fund Transparency Act of 2009, which was, after all, not enacted, was another attempt to impose registration and disclosure requirements on hedge funds. Had it been enacted it would have applied to hedge funds with more than $50 million in assets that meet the requirements of Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940.

Such hedge funds would have had to register with the SEC and maintain books and records the SEC may require. SEC would have been free to ask for any kind of information. That information would have been publicly available and searchable. The Transparency Bill is an alternative to the Investment Advisers Act. The difference is that with the Transparency Bill hedge funds themselves would have been exposed to regulation.[210]

The hedge funds Transparency Act is worth mentioning because it has one of the toughest disclosure requirements. As opposed to the Dodd-Frank Act, it does not even keep the proprietary information of hedge funds private. Under this bill, hedge funds' operational advantages could have been totally crushed. This is a good example of too aggressive regulation.

The next exemption-based act concerning hedge funds is the Investment Company Act which was adopted primarily to regulate mutual funds. This is an example of directly regulating hedge funds by imposing registration requirements. After all, this legislative act does not really led to transparency due to its provisions which discharge hedge funds of their duties. For hedge funds Sections 3(c)(1) and 3(c)(7) are most important since they provide exemptions. Those exemptions are highly important because they allow hedge funds to function with less supervision on behalf of the SEC. [211]

Under the Investment company act of 1940 a hedge fund manager has three choices. The hedge fund can be registered as an investment company under Section 3(a) of the Company Act. Alternatively, no registration would be needed if the exemption under Section 3(c)1 is followed- the hedge fund must have less than 100 investors. Section 3(c)1 provides an exemption from the definition of an "Investment Company" to an issuer with outstanding securities beneficially kept by not more than 100 investors and who does not offer them

[208] Wulf A. Kaal, Hedge Fund Regulation via Basel III, available at http://ssrn.com/abstract=1806252

[209] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[210] Anita K. Krug, The Hedge Fund Transparency Act of 2009,available at available at: http://ssrn.com/abstract=1682608

[211] Hedge Fund Law Blog, Hedge Fund Law – Summary of Hedge Fund Laws and Regulations, available at http://www.hedgefundlawblog.com/hedge-fund-law-summary-of-hedge-fund-laws-and-regulations.html

publically. This provision provides a gap in the law, which hedge funds take advantage of. The beneficial ownership of a fund permits them to have more investors in practice since it counts as beneficial ownership of one person and hence they can offer their services to an unlimited number of "Qualified Purchasers". If it can be proved, that the beneficial ownership was set up to circumvent the law though, then this exemption does not apply.[212]"Qualified purchasers" is a stricter definition than "accredited investors".[213]A third solution would be to escape registration under the exemption of Section 3(c)7, where the hedge can have an unlimited number of investors (practically limited to 499 persons by Section 12(g) of the 1934 Act), but the investors must be investors must have at disposal sufficient wealth or be institutional investors.[214]

Securities Exchange Act of 1934 for secondary trading of securities also applies to hedge funds with its anti-fraud provisions (Section 10(b)), but is not a fundamental regulation.[215]According to the Securities Exchange Act of 1934, a fund must report quarterly if it has more than 499 qualified purchasers or 100 accredited investors.[216]

Sometimes the SEC issues no-action letters to make known its positions towards some common situations. There have been a few no-action letters issued with regard to hedge fund managers.

Interpretive releases are also a popular way for SEC to express its view on hot topics. The interpretive releases may also interpret the federal securities laws and SEC's regulations.[217]

No-action letters and interpretive releases are important to the extent that they have a prediction nature. By reading them it is easier to guess what line of legislative acts would be followed by the SEC.

The Commodities Exchange Act (CEA) applies to hedge funds only in certain situations. It may not apply to a hedge fund if the hedge fund does not deal with commodities or futures. Otherwise, they are considered "commodity pools" and the hedge fund manager must register with the Commodities Futures Trading Commission (CFTC) as a commodity pool operator (CPO) or as a commodity trading adviser (CTA). [218] Even if a single transaction on commodity is executed, they are subject to the CFTC rules by the National Association of Securities Dealers ("NASD") rules and must comply with five sets of principles. The Employment Retirement Income Security Act ("ERISA") could also apply to hedge funds if 25% or more of the value of any class of equity is held by an employee benefit plan. In such a

[212] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[213] Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)

[214] Mark J.P. Anson, The Handbook of Alternative Assets, (2006, Wiley, John & Sons, Incorporated)

[215] Hedge Fund Law Blog, Hedge Fund Law – Summary of Hedge Fund Laws and Regulations, available at http://www.hedgefundlawblog.com/hedge-fund-law-summary-of-hedge-fund-laws-and-regulations.html

[216] Lisa C. Brice , Dodd-Frank Regulation Of Hedge Funds And Derivatives, (2010), available at: http://ssrn.com/abstract=1679187

[217] Hedge Fund Law Blog, Hedge Fund Law – Summary of Hedge Fund Laws and Regulations, available at http://www.hedgefundlawblog.com/hedge-fund-law-summary-of-hedge-fund-laws-and-regulations.html

[218] Hedge Fund Law Blog, Hedge Fund Law – Summary of Hedge Fund Laws and Regulations, available at http://www.hedgefundlawblog.com/hedge-fund-law-summary-of-hedge-fund-laws-and-regulations.html

case, they will be subject to the restrictions of an ERISA fiduciary.[219]There are some exemptions present, though. Registration is not necessary if the fund deals with "sophisticated" investors, which is mostly similar to the notion of a "qualified purchaser" under the Securities act.[220]The CEA sets the framework under which CTAs and CPOs must operate. The mentioned exemptions, which apply to hedge funds and exempt them from registration are provided under Rule 4.7 and rule 4.13.[221]

The tactic behind hedge funds' success is self-regulation. Self-regulation does not literally mean that hedge funds themselves would regulate one another but that the market would discipline their actions naturally. Also, there are organizations of hedge funds around the world which regulate the hedge fund industry. Such organizations are: the Hedge Fund Working Group in the UK, the Hedge Fund Standards Board (HFSB), in Europe the Alternative Investment Management Association (AIMA), the Managed Funds Association (MFA), the Asset Managers' Committee to the President's Working Group on Financial Markets in the US. They cooperate with the regulators in drafting bills and acts and also issue guidelines themselves.

When it comes to disclosure and bearing in mind that nowadays we live in a global world, it would be best if a global database of financial information would be created. It is burdensome and costly, but having information about leverage, value-at risk, collateral, liquidity needs, use of financial instruments and interconnectedness to other financial institutions would be priceless to the global market. It would benefit not only hedge funds, but rather all participants on the market.

The current legislative situation is conflicting around the world and contributes to forum shopping. Hedge funds, when faced with stringent regulation, momentarily find another jurisdiction with light regulation to move to. In this way, there is no solution for the systemic risk. Even for countries which are making efforts, it is impossible to deal with systemic risk by themselves if there is no universal support.

A global regulation of hedge funds seems unlikely but at least a set of basic rules would contribute appreciably to reducing systemic risk. International coordination is hard to achieve and political and financial conflicts would always implicate it.[222]

Indirect regulation through other sectors such as banking and insurance is costly. The establishment of a regulatory body has its organizational and operational burdens. On the other hand, market players would be frustrated by the compliance costs.[223]

Both in Europe and the U.S. hedge funds collapses have been used to excuse the adoption of stricter rules.

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[219] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[220] Opha Constant, Hedge Funds Regulatory Concerns: A Summary of the Most Influential Events and Consequent Regulation Changes, (2009, Bachelor thesis, Tilburg University)

[221] Hedge Fund Law Blog, Hedge Fund Law – Summary of Hedge Fund Laws and Regulations, available at http://www.hedgefundlawblog.com/hedge-fund-law-summary-of-hedge-fund-laws-and-regulations.html

[222]Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[223] Miles Francis Binney, Hedge Fund Regulation-In Response to the Financial Crisis, (2009, Warwick University), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669123

Too many regulative acts have been introduced in the U.S. and their provisions sometimes collide. Such is the case with the Dodd-Frank Act and AIFM Directive.[224]

Many hedge funds consider offshore locations like Bermuda or the Cayman Islands to avoid registration with the SEC. They are offered to non-U.S. investors only. At the end, U.S. investors suffer because they are not able to invest in these hedge funds. Regulation is contradictory. It could bring positive outcomes but it might also twist a situation even further.[225]

Both in U.S and in Europe there have been investor requirements. In the US, it was the rule of less than 100 investors at first, which afterwards was extended to "qualified purchasers", meaning wealthy natural persons or institutions. Canada also has a requirement that only accredited investors with a fixed net income or who passed a financial assets test, or make a minimum initial investment of Can $ 150.000 are allowed in hedge funds. In Spain, the individual investments have a minimum of €50.000 and could be offered to qualified or professional investors. Another requirement is the there should be at least 25 persons investing in the same fund. In Germany the system differs- Private placements are exempt only if made by an intermediary bank. The U.K. has established that individuals can invest in hedge funds through a "qualified investor scheme". France has also a fixed minimum investment of €125.000 and a requirement for wealthy investors. Italians' minimum initial investment is € 500.000. Switzerland and Japan both depend on authorized intermediaries. The Swiss have a supervisory body, which approves the prospectus.[226]

There are many regulatory requirements for hedge funds, which guarantee their reliability- they are subject to fraud prohibitions, insider trading, and price manipulation prohibitions. Hedge funds voluntarily make disclosures to their investors because they are well aware that this is the only way to keep them in the fund and attract new ones. Hedge fund counterparties such as banks and prime-brokers also monitor them on a daily basis and what is more, mandatory public disclosure to the authorities about large investments short sale positions are also performed.[227]

Regulators could directly regulate hedge funds through registration, capital, leverage, margin, reporting requirements.[228]

It is sufficient that there are registration or authorisation requirements for hedge fund managers as well as disclosure under confidentiality. Stricter regulation is not justified, though. The desire for more regulatory requirements might turn out counterproductive. [229]

Gradually hedge funds have come to appreciate the benefits of transparency and have started registering even on a voluntary basis. However, the limit to transparency is where hedge funds have to disclose proprietary information.[230]

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[224] Wulf A. Kaal, Hedge Fund Regulation via Basel III, available at http://ssrn.com/abstract=1806252
[225] Mark J.P. Anson, The Handbook of Alternative Assets, (2006, Wiley, John & Sons, Incorporated)
[226] Eddy Wymeersch, The Regulation of Private Equity , Hedge Funds and State Funds, (April 2010,Financial law institute), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202
[227] Houman B. Shadab Professor, New York Law School, Hedge Funds and the Financial Crisis, (January 2009), available at http://ssrn.com/abstract=1564847
[228] Wulf A. Kaal, Hedge Fund Regulation via Basel III, available at http://ssrn.com/abstract=1806252
[229] Robert Falkner and Morgan Lewis, The Regulation of Hedge Funds-Is More Needed, and if so, Where?, (April 2009, The hedge fund journal), available at http://www.thehedgefundjournal.com/magazine/200904/technical/the-regulation-of-hedge-funds.php

The current regulation on hedge funds in the U.S. and the E.U. is sufficient to deal with hedge fund externalities. Even the concerns about hedge funds being a source of systemic risk, have been addressed by imposing indirect regulation through hedge funds' counterparties. Indirect regulation of hedge funds is achieved through regulating primarily prime-brokers and banks as their counterparties.

4.3 Indirect regulation of hedge funds through counterparties

There are a few upcoming regulatory acts on behalf of hedge funds' counterparties which are of great interest to hedge funds themselves. Only the ones under greatest discussion would be mention in the following subpart.

By "counterparties" it is meant brokers, banks, and other securities dealers which operate as loan providers, or trade over-the-counter securities with hedge funds. Basically, under this definition falls every market participant, which executes a financial transaction with hedge funds in general. Banks are considered both as investors in hedge funds and as their counterparties, since they often provide loans to hedge funds. Insurance companies are also presented in this sub-chapter, although they are not exactly counterparties to hedge funds but their relationship is of an investor-investment pool. They are nevertheless discussed in this chapter, since the regulatory act of Solvency II on the insurance business would greatly affect hedge funds in the future by limiting the capacity of insurance companies to invest in hedge funds. If one considers hedge fund investors as a contractual party to hedge funds, then in a contractual relationship hedge funds and their investors are also to be considered counterparties as the opposite parties of a financial (investment) contract.

Since hedge funds have been accused of creating systemic risk it is fair to provide argumentation as to whether they actually are able of doing so. Systemic risk is the risk of failure on the financial markets. Banks are the main source of systemic risk because of their exposure to many other sectors and to other banks. The chances of a long-only hedge fund causing systemic risk are slight. Such failure would only affect the investors of the fund. Hedge fund strategies which involve leverage and derivatives, on the other hand, are capable of creating counterparty risks for banks and prime-brokers. The collateral levels hedge funds provide to their counterparties are not sufficient to cover the possible losses on a hedge fund default. Only in case of a collapse of a highly leveraged, derivatives dependant hedge fund, is there the possibility of the hedge fund creating systemic risk. [231]

On the basis of this statement, the following regulatory acts have implemented some safeguards against the possible exposure of hedge funds' counterparties to hedge funds. Here the project of Solvency II and Basel III would be the focus of my attention. Solvency II concerns the insurance sector, while Basel III- the banking sector. Both sectors are conducting business with hedge funds and that is why they would be affected in case of a hedge fund default.

Solvency II has gained its separate discussion position since it is highly criticized and contradictory. It is not an effective regulation, but an upcoming one, which interferes to a

[230] Houman B. Shadab, The Challenge of Hedge Fund Regulation, (Mercatus Center), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=978539

[231] Robert Falkner and Morgan Lewis, The Regulation of Hedge Funds-Is More Needed, and if so, Where?, (April 2009,The hedge fund journal), available at http://www.thehedgefundjournal.com/magazine/200904/technical/the-regulation-of-hedge-funds.php

significant extent with the hedge funds sector by indirectly constraining the insurance industry, as counterparty, from investing in hedge funds by making it too costly.

The Solvency II Directive 2009/138/EC is an EU Directive that codifies and harmonizes the EU insurance regulation. Solvency II deals mostly with capital requirements which EU insurance companies must have available in cases of emergency. Thus, the insolvency risk of an insurance company is brought to a minimum. Solvency II is planned to be implemented by 1 January 2014.[232]

Solvency II affects hedge funds two-sidedly. The high capital charges to hedge funds might cause insurance companies to stop investing in the hedge fund sector. Since insurance companies will have to keep available 49% of the amount of their total hedge fund investments it is expected that most insurance companies would withdraw from the hedge fund industry and demand redemptions.[233]

The only way for insurance companies to escape these capital requirements is to adopt an internal model. If the insurance firm can show that the risks in investing with hedge funds are less than 49% of the capital, then they could argue holding less capital. Pursuant to Solvency II a lot of insurance analyst positions will open for analysts competent in the sphere. Hedge funds would be the first to rush into hiring such experts so that they can secure their investors.[234]

Another drawback for hedge funds would be the disclosure requirements. If an insurance company decides to follow the internal model, then it would have to report more detailed information and on a more frequent basis.

There is no exact data as to what percentage of all hedge fund assets come from the insurance sector. In any case, if insurance companies seize investment in the hedge fund sector pursuant to the implementation of Solvency II, the impact would be noticeable.[235]

To respond to the new demand coming from Solvency II, both hedge funds and funds of hedge funds would have to make some adjustments. The planned capital holding obligations for insurance companies investing in hedge funds do not take account of the difference between the numerous hedge funds strategies. They establish the same percentage for capital charges no matter what the actual risks of the particular hedge fund and its applied strategies are. Sometimes the percentage is way too high and does not reflect the risks at all. It is also unfair to set such a high percentage for hedge fund investment compared to the percentage set

[232] Will Wainewright, Impact Assessment: Getting to Grips with Solvency II, (11/01/2012 , HFM Week), available at http://www.hfmweek.com/features/1704072/impact-assessment-getting-to-grips-with-solvency-ii.thtml

[233] Will Wainewright, Impact Assessment: Getting to Grips with Solvency II, (11/01/2012 , HFM Week), available at http://www.hfmweek.com/features/1704072/impact-assessment-getting-to-grips-with-solvency-ii.thtml

[234] Will Wainewright, Impact Assessment: Getting to Grips with Solvency II, (11/01/2012 , HFM Week), available at http://www.hfmweek.com/features/1704072/impact-assessment-getting-to-grips-with-solvency-ii.thtml

[235] Will Wainewright, Impact Assessment: Getting to Grips with Solvency II, (11/01/2012 , HFM Week), available at http://www.hfmweek.com/features/1704072/impact-assessment-getting-to-grips-with-solvency-ii.thtml

for equity investments. It all leads to the conclusion that hedge funds as alternative investments are considered riskier.[236]

Only by using internal models, could insurance companies have the authority to measure the actual inherent risks and establish proper capital charges. This would be the choice of many insurance companies, but other may prefer relinquishing their hedge fund investments due to compliance costs. [237]

The foundations of Solvency II were first set in 1970s by Solvency I. Solvency I has a fixed-rate capital requirement (percentage of technical provisions, turnover or previous claims) and does not consider the intrinsic risks of an insurance company. Operational risks, legal risk, reputational risk must also be taken into consideration when calculating the total risks. It is also necessary that the assets under insurance be valuated properly according to their asset class, whether stocks, corporate bonds, commodities or other types.[238]

The basic objective of Solvency II is to be more economically oriented than its predecessor Solvency I. In Solvency I asset and liability valuation was accounting-based, while in Solvency II the method of market valuation is used.

The EU goal is to set solvency requirements for insurance companies to protect them as a precaution in case they underestimate the risks taken. Thus also risk-management would be considered more seriously. From perspective it would all lead to control and lessening of systemic risk on a more global level, while at the same time it would also affect insurance companies positively by encouraging them to be cautious and make more precise estimation when they take-up new clients.

Solvency II provisions follows EU's Lamfalussy process: level 1 - framework directive (proposed by the European Commission and validated by both the European Parliament and the European Council); level 2 - implementing measures (proposed by the European Commission and validated by the European Commission with the consent of the European Parliament); level 3 - guidance regarding day-to-day supervision (CEIOPS); and level 4 - enforcement of directive (European Commission).[239]
Similarly to the Capital Requirement Directive for Banks (Basel III), the Solvency II framework uses a three-pillar approach.[240]

Quantitative requirements, solvency capital requirement (SCR) and minimum capital requirement (MCR) are considered in the first pillar. The SCR represents the level of capital

[236] Ernst and Young, The Impact of Solvency II on Asset Managers, (2011), available at http://www.shinnihon.or.jp/industries/financial-institutions/insurance/solvency2/topics/pdf/2011/The-Impact-of-Solvency-II-on-asset-managers-January-2011.pdf
[237] Ernst and Young, The Impact of Solvency II on Asset Managers, (2011), available at http://www.shinnihon.or.jp/industries/financial-institutions/insurance/solvency2/topics/pdf/2011/The-Impact-of-Solvency-II-on-asset-managers-January-2011.pdf
[238] Nicholas J., founder and chairman of HFR Group, Chapter I- Introduction to Global Macro Hedge Funds, available at http://media.wiley.com/product_data/excerpt/73/04717944/0471794473.pdf
[239] Mathieu Vaissié, Senior Portfolio Manager, Lyxor AM, Solvency II : A Unique Opportunity for Hedge Fund Strategies, (January 2012), available at http://faculty-research.edhec.com/servlet/com.univ.collaboratif.utils.LectureFichiergw?ID_FICHIER=13288859742
[240] Mathieu Vaissié, Senior Portfolio Manager, Lyxor AM, Solvency II : A Unique Opportunity for Hedge Fund Strategies, (January 2012), available at http://faculty-research.edhec.com/servlet/com.univ.collaboratif.utils.LectureFichiergw?ID_FICHIER=13288859742

an insurance company must have in order to “absorb significant unforeseen losses and give assurance to policyholders that payments will be made as they fall due”. It is much more complex and includes many more risks which are actually material for insurance business, contrary to Solvency I. MCR is the level of capital, below which the supervisory authority will automatically interfere because the financial resources are not satisfactory.[241]

The second pillar considers the qualitative requirements for the corporate governance and risk management of insurance companies.

Disclosure requirements are specified in the third pillar for stimulating transparency and nurture market discipline.

The Solvency II directive has taken into consideration a 99.5% probability of survival over a one-year period when calculating the SCR. The SCR of an insurance company is affected mostly by the local statutory accounting standards. In this respect Solvency II is offering better harmonization.

The Solvency capital requirement (SCR) of hedge fund strategies is Solvency II is somehow punitive. It does not take into consideration the collective risk exposures due traditional investment approach. Actively-managed portfolios must be assessed in a proper manner without transferring the traditional assessment methods directly.

The established solvency capital requirement of 49% is not adequate to the actual risks involved with hedge fund investment. 25% would be more appropriate for a diversified hedge fund allocation.[242] The proposed percentage would be satisfying from both risk-adjusted performance and capital efficiency point of view.

The intent of the Solvency II directive is to “establish Solvency requirements that are better adapted to the risks that are actually taken on by insurance firms and encourage the latter to better evaluate and control their risks”.[243]

With the current formulation of Solvency II it is less likely that insurance companies would continue hedge fund investment. Most likely they would prefer to invest with traditional investment vehicles due to the lower capital charge-39%. Thus, Solvency II is navigating insurance companies towards fixed income instruments which without proper diversification from alternative character might not be the best solution from a financial stability point of view.[244]

Another indirect effect on hedge funds would have Basel III. Like Solvency II, Basel III regulates hedge funds through other market participants who interact with them. The hedge

[241] Mathieu Vaissié, Senior Portfolio Manager, Lyxor AM, Solvency II : A Unique Opportunity for Hedge Fund Strategies, (January 2012), available at http://faculty-research.edhec.com/servlet/com.univ.collaboratif.utils.LectureFichiergw?ID_FICHIER=13288859742
[242] Mathieu Vaissié, Senior Portfolio Manager, Lyxor AM, Solvency II : A Unique Opportunity for Hedge Fund Strategies, (January 2012), available at http://faculty-research.edhec.com/servlet/com.univ.collaboratif.utils.LectureFichiergw?ID_FICHIER=13288859742
[243] Mathieu Vaissié, Senior Portfolio Manager, Lyxor AM, Solvency II : A Unique Opportunity for Hedge Fund Strategies, (January 2012), available at http://faculty-research.edhec.com/servlet/com.univ.collaboratif.utils.LectureFichiergw?ID_FICHIER=13288859742
[244] Mathieu Vaissié, Senior Portfolio Manager, Lyxor AM, Solvency II : A Unique Opportunity for Hedge Fund Strategies, (January 2012), available at http://faculty-research.edhec.com/servlet/com.univ.collaboratif.utils.LectureFichiergw?ID_FICHIER=13288859742

fund industry has a synergetic affiliation with the banking sector. Thus, it is only logical that hedge fund risk exposures would reflect materially on the banking sector creating a new source of systemic risk.[245]Although full implementation is expected in 2019, Basel II would limit hedge funds' availability of leverage. Basel III regulates the banking sector by restricting the lending exposure to hedge funds. Banks would have to limit their Tier I Capital to 3% of unweighted assets according to the new regulatory rules. This would be the only source of capital, which would have to absorb possible losses. The banks would be less exposed to hedge funds' failure risks. On the other hand, some hedge fund strategies would be severely affected because they depend on the immediate availability of capital. If the banks do not extend their line of credit, hedge funds would be left without alternative, but to pursue other strategies. Thus, some strategies would slowly start to disappear from the investment scene affecting hedge fund industry as a whole.[246]

After LTCM most banks already started requiring full collateralization of their hedge fund transactions. This lead to hedge funds reconsidering their leverage levels which are currently much lower than the banks' leverage ratios.[247]

The idea of Basel III is to increase the capital requirements for counterparty risk and also control systemic risk. No implementation would be needed since the banks would have to decide on their own whether to join the framework or not. Once they have joined, they would be responsible towards the other banks joined the framework and their compliance would be sanctioned internally as well. Since no implementation would be required, there would be no implementation costs, which is a great advantage of the regulatory project. Indirectly hedge funds' level of leverage would be affected. Banks are also ideal candidates for information recipients. By establishing strict rules for information disclosure prior to a loan, the bank would be able to mitigate systemic risk and assess moral hazard risks as well. By demanding more transparency, banks would assist a further reduction of the capital-leverage ratio of hedge funds.[248]

LTCM failure is the reasoning for most hedge fund regulation campaigns. LTCM was extremely leveraged and thus affected the bank sector as well. Not only are hedge funds popular for their high levels of leverage, but banks as well. Therefore, both sectors pose systemic risk and require the same level of regulatory severity. That is the argument some people are pushing forward as a justification for the regulatory attempts on hedge funds.[249]

I must say I completely disagree with this argument, since hedge funds are either not leveraged at all or have a low level of leverage. The banking sector is leveraged at a ratio about from 12 to 1 to 17 to 1.[250] With this said, the previous argument lost its power. Bearing in mind all arguments in this chapter, it is safe to conclude, that hedge funds are in no need for regulation. They have reached a satisfactory and yet not damaging to their operations level of transparency and it has been proved, that not hedge funds themselves, but rather banks are the source of systemic risk. Hedge funds are not capable of causing a financial crisis and, with the

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[245] Nicholas Chan,Mila Getmansky, Shane M. Haas, Andrew W. Lo, Systemic Risk And Hedge Funds, (March 2005, Working Paper 11200), http://www.nber.org/papers/w11200
[246] Wulf A. Kaal, Hedge Fund Regulation via Basel III, available at http://ssrn.com/abstract=1806252
[247] Wulf A. Kaal, Hedge Fund Regulation via Basel III, available at http://ssrn.com/abstract=1806252
[248] Wulf A. Kaal, Hedge Fund Regulation via Basel III, available at http://ssrn.com/abstract=1806252
[249] European Union Committee - Third Report ,Directive on Alternative Investment Fund Managers, CHAPTER 2: What are alternative investment funds and what risks do they pose to financial stability?, available at http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeucom/48/4805.htm
[250] Houman B. Shadab Professor, New York Law School, Hedge Funds and the Financial Crisis, (January 2009), available at http://ssrn.com/abstract=1564847

existing strict banking restrictions to deal with hedge funds, it is even less possible to accuse them of even contributing to one.

Chapter V

States are in the position to affect and control public perception of what choices are open to society. Certain choices might be presented as impossible in order to convince the general public of the rightfulness of other choices to manipulate politics. International constraints could be used by the state to explain the unsuccessful attempts from regulatory perspective. It is common, that some regulatory proposals appear theoretically correct and appropriate for the specific situation, but when implemented they prove to be inefficient and sometimes detrimental even.[251] Recently, regulating hedge fund managers and counterparties has become a regulatory trend. Regulatory acts are becoming more and more irradical, though. They are not substantiated by reasonable need, rather by other political and financial interests.

Hedge funds are often referred to as "opaque" because they do not provide extensive information about their portfolios and even if they do, it is not timely. This opacity is mostly true for the general public. Hedge funds provide different information to different recipients- whether investors, a counterparty, a regulatory authority, or a general market participant. Regulators are generally concerned with transparency for the investors' sake. Counterparties need also have adequate level of disclosure from hedge funds to be able to manage the risks they assume. The regulatory concern during the recent years has been not only investors' information access but also market available information. This concern has been growing since information about hedge funds affects liquidity. Credit and liquidity risks have the closest connection to hedge funds. As parts of systemic risk as a whole, credit and liquidity risks are interconnected although their presence at the same time is not necessary.

The availability of information could in some situations help prevent otherwise unexpected liquidity declines. Hedge funds may not create liquidity swings intentionally but in any case, access to the proper information would be sufficient to control such swings.[252] Hedge funds' proprietary information could be valuable if collected aggregately. The value of such information could be highly reduced due to protection issues. Since hedge funds are assessed by their performance, and performance is a function of information, regulators would be affecting hedge fund performance by imposing more transparency requirements.

Hedge funds' most valuable information is the information about their strategy implementation. Having to disclose this kind of information would be fatal both for hedge funds and for hedge fund investors. [253]

It is acceptable to define the level and nature of disclosure contractually. Investors, due to their sophistication and qualification, should be able to assess themselves whether to enter into business with hedge funds or not. If they estimate that the information they are provided with by their hedge fund is not satisfactory, they are free to walk out on the deal. What is

[251] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693

[252] Chairman Ben S. Bernanke, Hedge Funds and Systemic Risk, (May 16, 2006), At the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, Sea Island, Georgia

[253] Anne C. Rivière , 2010,The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

more, disclosure is primarily meant for investor protection and not for control of systemic risk.[254]

From an economic point of view disclosure is only voluntary to the point the benefits equal the costs. With more disclosure investors would be happier, thus they would be willing to pay higher fees. Counterparties would be also more satisfied and the trust level would rise, leading to less need for collateralization. Mandatory disclosure is costly not only for implementation reasons but also because of the information exposure to competitors. [255]

On the other hand, hedge funds are known to have influenced many takeovers by acquiring from 20% to 50% of the equity of a target. It is their purpose to control a takeover at times in order to control their profits. Their manipulative nature has proved detrimental at times and that is why an appropriate level of disclosure is stimulated. The talent of hedge funds is exploiting the weakness of the market. The regulators should concentrate on counterparty risk if they want to control systemic risk posed by hedge funds. This approach would exclude possible moral hazard risks by monitoring through a private database. Market participants are in the best position and have the proper means to help monitor hedge fund activities. [256]

Systemic risk and market misconduct are the two reasons for concerns when it comes to hedge funds. Systemic risk would be an actual problem if hedge fund industry were to create such stress on the market, so as to spill all over other investors and investment sectors.[257] It is important to keep in mind, when assessing the possible hedge fund potential for systemic risk, that “the absolute size of an institution is not the predicate for systemic risk; it is rather the size of its debt, its derivatives positions, and the scope and complexity of many other financial relationships running between the firm, other institutions, and the wider financial system”.[258]

Systemic risk cannot be entirely avoided, but it can be controlled and limited. The attempts on totally preventing it “would stifle innovation without achieving the intended goal”.[259]

Innovation is the competitive advantage of hedge funds. More regulatory burdens would deprive hedge funds of their ability to innovate.[260]

The rules on the market are quite simple. Anyone could execute trades to their liking as long as they do not cross regulatory boundaries. Hedge funds are in the financial position to buy and sell quantities of securities, which could affect market prices and thus manipulate the

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[254] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[255] Houman B. Shadab, The Challenge of Hedge Fund Regulation, (Mercatus Center), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=978539

[256] Chairman Ben S. Bernanke, Hedge Funds and Systemic Risk, (May 16, 2006), At the Federal Reserve Bank of Atlanta’s 2006 Financial Markets Conference, Sea Island, Georgia

[257] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693

[258] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[259] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[260] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

market itself. This could pose a risk to other market participants who lack the quality of market information available to hedge funds. Hedge funds are not considered as influential as other larger investment pools to be able to affect market movement. There are some factual proofs, which point to the contrary. Such occasions have been put forward as a justification to demand more transparency on hedge fund activities. [261] It is disputable, at least, whether hedge funds could have a material impact on the market performance even in a distressed period.

Many hedge funds employ leverage but the collateral to support their positions is often insufficient. Leverage can magnify both gains and losses. A possible risk related to leverage positions is that when due to adverse changes in market prices "the market value of collateral is reduced, credit is withdrawn quickly, and the subsequent forced liquidation of large positions over short periods of time can lead to widespread financial panic".[262]

The OECD argues, that "the use of leverage is a mainstay of some hedge fund strategies, with the degree of leverage a function of the manager's appetite for risk, the riskiness of the bets involved, and the "costs" of leveraging". The IMF estimates that 30 % of all hedge funds do not use any leverage, and that only 16 % use reasonable levels of leverage. In contrast, Goldman Sachs and Financial Risk Management Ltd suggest that average leverage is about 2. Information from Commodity Pool Operator (CPO) filings indicate, that most reporting hedge funds have balance sheet leverage ratios of less than 2-to-1.[263]

Hedge funds help increase the volume of trading by using strategies, which involve active trading. Thus, securities are traded at their fair value without causing instability to the market. There are strategies, though, which are highly correlated and could lead to market distress. The leverage they employ could affect the market in a more sufficient way, but most countries have adopted regulations which limit the employment of leverage. Therefore, hedge funds' ability to cause crisis on the investment market is controlled and constricted. [264]

In fact, the rich palette of hedge fund strategies creates market opportunities and contributes to price efficiency.[265]

Hedge funds have at their disposal many trading opportunities. They employ highly technological means to take advantage of these opportunities when needed and are flexible enough to afford themselves to frequently shift their focus from one geographical market to another. Globalization therefore is of great importance on the hedge fund scene. The more universal rules exist, the fewer boundaries on the global market. Globalization would contribute not only to hedge funds' success and mobility, but also to all trading activities on the market by any participant.[266]

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[261] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693

[262] Nicholas Chan,Mila Getmansky, Shane M. Haas, Andrew W. Lo, Systemic Risk And Hedge Funds, (March 2005, Working Paper 11200), http://www.nber.org/papers/w11200

[263] The Impact Of Hedge Funds On Financial Markets ,Paper submitted to House of Representatives Standing Committee on Economics, Finance and Public Administration's Inquiry into the International Financial Markets Effects on Government Policy, June 1999,available at http://www.rba.gov.au/publications/submissions/impact-hdge-fnds.pdf

[264] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693

[265] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045

[266] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693

Regardless of the regulatory approach character, a harmonized system would be more efficient for risk management than the current systems, which are overloaded with regulatory acts and proposals. Even worse, some of these acts are actively colliding with one another creating regulatory chaos.

Currently, hedge funds are policed by their counterparties through stricter credit terms. Banks can either directly restrict hedge funds through trading, credit limits or initial margin, or they can do that indirectly through credit spreads on transactions. There are certain risk limitations imposed by the law.[267]

Counterparties are able to control hedge fund exposure through conducting due diligence, demanding collateral, setting credit limits, imposing reporting requirements, and monitoring.[268]

The roots of the financial crisis are the banking sector and the poor regulation of mortgages and credit institutions. Hedge funds do not invest big amounts in mortgages and had nothing to do with banks' risky loans.[269]

Banks are conflicted because of their profitable business relationships with hedge funds- they receive commissions, fees and trading profits.[270]

Hedge funds could create systemic risk only through the credit channel (banks) or by aggressive, high-volume trading of highly correlated strategies.[271]

Academics, as well as organizations like the International Monetary Fund, believe that by operating on the credit market hedge funds contributed stability and efficiency.[272]

By buying distressed securities from struggling companies, mortgage-backed securities, during the financial crisis, hedge funds kept asset prices from declining even further. Thus, many possible bailouts were avoided.[273]

Hedge funds are harmful to the market through their trades involving distressed debt. They are known to have used their position as creditors to obtain insider information about the company at hand and then use that information in their trades. Another approach for hedge funds is to sue for immediate repayment right after buying the distressed debt.[274]

[267] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[268] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[269] Houman B. Shadab, Professor, New York Law School, Hedge Funds and the Financial Crisis, (January 2009), available at http://ssrn.com/abstract=1564847
[270] Randall Dodd, founder and director for Financial Policy Forum in Washington D.C., Hedge Fund Regulation, G-24 Policy Brief No. 5, available at: http://ssrn.com/abstract=1652502
[271] Eilis Ferran, The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis, (University of Cambridge and ECGI), available at http://ssrn.com/abstract= 1762119
[272] Houman B. Shadab, Professor, New York Law School, Hedge Funds and the Financial Crisis, (January 2009), available at http://ssrn.com/abstract=1564847
[273] Houman B. Shadab, Professor, New York Law School, Hedge Funds and the Financial Crisis, (January 2009), available at http://ssrn.com/abstract=1564847
[274] Randall Dodd, founder and director for Financial Policy Forum in Washington D.C., Hedge Fund Regulation, G-24 Policy Brief No. 5, available at: http://ssrn.com/abstract=1652502

Although not the biggest in size, hedge funds are of great importance to the overall market because they operate with huge amount of assets. They have the means to shift their investment positions as frequent as they wish and thus are able to affect market prices. They are generally low correlated with the overall market performance and that makes them popular.[275] Hedge funds tackle with pricing imperfections and greatly increase liquidity on the market.[276]

"By trading on the basis of sophisticated and extensive market research, hedge funds provide markets with price information that translates into pricing efficiency," said George E. Hall, Chief Investment Officer of Clinton Group.[277]

It has been acknowledged worldwide, that hedge funds did not cause the recent financial crisis. Most of the allegations thrown at them were, that volatility, short selling, empty voting, short-termism, activism, tax avoidance and risky behaviors associated with them, intensified market stability. It has now been proved, that not hedge funds, but rather the banking sector is responsible for the market crisis.[278]

Hedge funds not only had nothing to do with the financial crisis, but they helped relieve its impact.[279]

Hedge funds' defaults are not the leading argument when it comes to assessment of hedge fund value. They have created so many positive externalities such as risk management on the market and stimulating capital formation, that it is impossible to judge them by their few collapses.[280]

Even though hedge funds did not contribute to the current financial crisis, regulators are still trying to impose stricter regulation. That is mainly due to their desire to reduce systemic risk and their goal to bring more transparency for investor protection.[281]

The U.S. approach is to regulate hedge fund advisers partially, while the U.K. regulates them completely; others prefer to concentrate on hedge funds themselves- Germany, while France uses both approaches.[282]

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[275] The Impact of Hedge Funds on Financial Markets ,Paper submitted to House of Representatives Standing Committee on Economics, Finance and Public Administration's Inquiry into the International Financial Markets Effects on Government Policy, June 1999,available at http://www.rba.gov.au/publications/submissions/impact-hdge-fnds.pdf

[276] Rhys Bollen , Setting International Regulatory Standards for Hedge Funds – part 1,(2010), available at http://ssrn.com/abstract=1756693

[277] James D. Spellman ,Hedge Funds How They Serve Investors in U.S. and Global Markets, (2009, Coalition of Private Investment Companies), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf

[278] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[279] Houman B. Shadab, Professor, New York Law School, Hedge Funds and the Financial Crisis, (January 2009), available at http://ssrn.com/abstract=1564847

[280] Troy A. Paredes, Paper No. 06-03-02 On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission, (March 24, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=893190

[281] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

More regulation is sometimes justified with the investor protection rationale. It does not represent a good argument, though, since investors are supposed to be sophisticated and able to fend for themselves. It is clear from the beginning of their investment relationship with hedge funds, that hedge funds are not a registered investment vehicle and pose a significant amount of risks. Still, investors prefer hedge funds because they bring greater returns.[283]

They bring efficiency and absorb financial risks. Without the flexibility in their regulatory frame, such benefits would be unreachable. They help disperse risk and lower volatility.[284]

Investors can protect themselves by performing due diligence prior to investing in hedge funds. They cannot be responsible for policing hedge funds, though, since that could mean a conflict of interest, because sometimes the condemnable actions hedge funds undertake might bring profits to these same investors.[285]

Accredited investors have another safeguard- they are being assessed by Markets in Financial Instruments Directive (MiFID) in the European Union and in the "offering questionnaire", under which hedge funds assess the level of sophistication in the United States.[286]

The flexibility hedge funds are given by the law to change strategies when the market situation requires them to, is a safeguard both for investors and for the market itself. There is no evidence that hedge funds caused the financial crisis. They are currently producing great returns to their investors as well, which leads to the conclusion there is no need for more regulation on hedge funds. Even the opposite, more regulation might be detrimental to investors, the least. If leverage was to be restricted, this could lead to market instability since hedge funds would not be able to employ strategies which require leverage. Such strategies reduce market fluctuations.[287]

Hedge fund investing is not riskier than investing in any mutual fund or corporation. It is even safer when markets are performing poorly. As a whole hedge funds do not employ leverage in excess and do not overload with derivatives either. Fixed income arbitrage hedge funds have the highest average leverage ratio of 4:1 but they represent only 7 % of all hedge funds. Investment banks and securities firms, on the other hand, have a 20:1 leverage ratio.[288]

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[282] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[283] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[284] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[285] Randall Dodd, founder and director for Financial Policy Forum in Washington D.C., Hedge Fund Regulation, G-24 Policy Brief No. 5, available at: http://ssrn.com/abstract=1652502

[286] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[287] Houman B. Shadab, Professor, New York Law School, Hedge Funds and the Financial Crisis, (January 2009), available at http://ssrn.com/abstract=1564847

[288]Houman B. Shadab, The Challenge of Hedge Fund Regulation, (Mercatus Center), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=978539

The Federal Reserve Bank of Cleveland stated that hedge funds tend "to reduce, not increase, the volatility of price" through the untraditional approaches and bets they take. Some researchers have found that hedge funds could actually prevent a financial bubble.[289]

SEC Commissioner Kathleen Casey, the chair of the IOSCO Technical Committee, also defended hedge funds in the release of the IOSCO report Hedge Funds Oversight: Final Report in June 2009: "Securities regulators recognize that the current crisis in financial markets is not a hedge fund driven event. Hedge funds contribute to market liquidity, price efficiency, risk distribution and global market integration."[290]

Liquidity on the market is the ability to process large trading volumes without affecting prices. It is attractive to investors because it provides them with flexibility and trading. Liquidity is two-dimensional-the range of liquid securities and their amount.[291]

Hedge funds also employ short selling. Short selling is controversial. It has often been criticized because it takes advantage of the bad condition of the company whose shares are being sold. It is considered a manipulative practice. For these reasons, it is curious to know, that it was illegal in the United States until the 1850's.[292] No matter how controversial, hedge funds, employing short selling, are completely legal nowadays. As such, it has been agreed, that short selling provides liquidity, drives down overpriced securities and increases market efficiency. The market cannot function properly without short sellers.[293]

Most hedge funds have not been engaged in any fraudulent activities. The few hedge fund collapses are mere exceptions to the general rule that hedge funds are operating legally. Hedge fund managers are very responsible individuals with reputation to protect. Even if there are cases where hedge funds are excessively leveraged and thus creating systemic risk, the positive effects of hedge fund's flexibility are prevailing –creating liquidity and efficiency on the market.[294]

Hedge funds also create value for shareholders of the companies they invest in by implementing management improvements in their business strategy. Active hedge funds may take action towards the company's management, assess a merger or acquisition, amend the capital structure, vote for dividends and buybacks, etc.[295]At times hedge funds are being criticized for these exact same initiatives. The criticism is based on the presumption that they influence company's business only as a means to create returns and disregard shareholders' interests.

Alon Brav, a Finance Professor at Duke University shares the contrary opinion, that: "Hedge funds provide an example of effective shareholder activism".[296]

[289] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[290] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[291] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[292] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[293] James D. Spellman ,Hedge Funds How They Serve Investors in U.S. and Global Markets, (2009, Coalition of Private Investment Companies), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf
[294] Troy A. Paredes, Paper No. 06-03-02 On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission, (March 24, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=893190
[295] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045
[296] Dale A. Oesterle, Regulating Hedge Funds, (June 2006), available at http://ssrn.com/abstract=913045

Another report on the global banking crisis by Lord Adair Turner, Chairman of the UK Financial Services Authority, found that "hedge funds did not play a significant role in the crisis."[297]

Furthermore, Maria Strömqvist with the Swedish Riksbank observed: "To simplify somewhat, we can say that the hedge funds have been affected more by the present financial crisis than they have affected it."[298]

On the other hand, President Barack Obama called them "speculators" who were "refusing to sacrifice like everyone else" and who wanted "to hold out for the prospect of an unjustified taxpayer-funded bailout" when it is known that not a single hedge fund was bailed out. German Chancellor Angela Merkel and French President Nicolas Sarkozy have also joined efforts fighting the "predators". Gareth Murphy from the Bank of England, on the other hand, noted that there was not even one public bailout of a hedge fund.[299]

With all the critic towards hedge funds, at the end of the day no one can argue, that : "Hedge funds are an essential tool in the financial systems toolbox. Without them financial markets would not be as efficient, and risk diversification would be far less effective."[300] No matter how many politically important persons criticize them, hedge funds have proved that they will not forsake their positions on the investment market. On the contrary, they are even more motivated to conquer higher positions in the market evolutionary system.

Conclusion

This research paper is focused on an economic topic but emphasizes on the legal aspects of hedge funds. It explores the position of hedge funds, based on the allegations, that hedge funds were a source of the current financial crisis. By a thorough analysis of the regulatory framework of hedge funds, their investors and counterparties, it strives to prove that the hedge fund industry should be considered a valuable participant on the investment market. Hedge funds have drawn to themselves a lot of attention recently due to the accusations on their part of being a major source of systemic risk. Their methods and tools have been severely criticized and condemned. My approach is to familiarize the reader with all the necessary information about hedge fund origins, structure, strategies and regulation with the purpose of presenting evidence, which supports my thesis. As impartial as I could be, given my personal convictions, I argue that hedge funds are a unique financial instrument, which deserves more trust and a neutral assessment. In Chapter I, I introduce the most important features of hedge funds, which gives the reader the general perception of hedge fund operational characteristics with the purpose of establishing later on, that their tactics could not inflict harm and rather bring efficiency on the market. In Chapter II, I present the structural characteristic of hedge

[297] Lord Adair Turner, The Turner Review: A Regulatory Response to the Global Banking Crisis. available at: http://w w w.fsa.gov.uk/pages/Library/Corporate/turner/index.shtml.

[298] Maria Strömqvist, "Hedge Funds and the Financial Crisis of 2008." ,(March 2009,Riksbank Economic Commentaries),available at: http://www.riksbank.com/upload/Dokument_riksbank/Kat_publicerat/Ekonomiska%20kommentarer/2009/ek_kom_no3_eng.pdf

[299] Anne C. Rivière, The Future of Hedge Fund Regulation: A Comparative Approach:United States, United Kingdom, France, Italy and Germany, (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553

[300] Miles Francis Binney, Hedge Fund Regulation-In response to the financial crisis, (2009, Warwick University), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669123

funds with the idea to show the reader that hedge funds are a well-organized, safeguarded product, which is trustworthy from both investors' and market's perspectives. Chapter III allows me to emphasize on the strategic methods employed by hedge funds in their every-day operations, thus proving, that there are practically no fraudulent activities and the risks involved with hedge fund operations are not market-influential to the extent of causing substantial instability. Chapter IV is more legally focused, because I discuss the regulatory approaches in the U.S. and the E.U. mostly, taking into consideration the upcoming regulatory acts. Based on the facts presented, this chapter supports my statement, that no further regulation on hedge funds is needed and the authorities must concentrate on hedge funds' counterparties instead. The present regulation is satisfactory and any modifications might prove detrimental to positive hedge fund externalities. With Chapter V, I put to the reader's attention a debate-like content. I offer opinions and statements of well-known experts and regulators, as well as politicians. Since regulation is sometimes politically influenced, such opinions are of great value for my research questions. Chapter V allows for an impartial judgement on behalf of the reader, but still has the inclination of hedge fund acquittal of their presumable fault of causing the financial crisis, which I completely support.

As a result of the extensive research I have conducted, I have come to conclude, that hedge funds are a much needed market diversifier, which creates liquidity and effective security pricing. The alleged threat, which hedge funds pose to the market, has been clearly proved to be a function of the banking sector. Banks and similar institutions have been undoubtedly acknowledged as the official source of the current financial crisis. Hedge funds were unfortunate enough to be connected to banking institutions as their loan providers and hence the reason for their indictment. Another deduction of the facts is, that hedge funds are not capable themselves of creating a sufficient amount of systemic risk so as to affect the market movements and cause overall market stress. Any market instability could be attributed to the lax regulation of banks and other counterparties hedge funds deal with. Hedge funds have been subject to an appropriate level of regulatory requirements- their transparency level is adequate and no further rules in that respect are justified since that could lead to a disturbance of hedge fund industry as a whole. In most countries, hedge fund managers are subject to registration and/or authorization, which as an indirect form of hedge fund monitoring is sufficient for control over hedge fund actions. It is no secret, that namely hedge fund managers are the ones, who are the driving force of hedge fund strategies. The upcoming regulation, policymakers are preparing for the banking and insurance sectors, would be another safeguard against hedge fund exposure, even though unnecessarily punitive. My firm conviction is, that hedge funds are investment structures, which bring great benefits to the investment market and the attempts to undermine them through accusations and further regulation would be counterproductive to the whole financial market. Any hedge fund collapses, which are used to cast doubt, that hedge funds bring substantial risks to other market players, are only a neglectful fragment of other sectors' misconduct.

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