De Facto Regulation of Hedge Funds Through the Financial Services Industry and Protection against Systemic Risk Posed by Hedge Funds—Part II

By Isaac Lustgarten

Hedge funds function as investors and lenders in all kinds of markets, supposedly with a more flexible investment mandate than mutual funds. Hedge funds can be registered with the Securities and Exchange Commission (SEC), like mutual funds. However, even the registered funds do not disclose much about their strategy, or at least an investor knows just as little about a registered hedge fund's potential investments and strategy as an investor would know about a mutual fund. Of course, hedge fund managers charge on a slightly different basis, but that is a small detail that any investment approach, such as a private account or a registered mutual fund, could replicate. Indeed, the minimum threshold for an investor to invest in a hedge fund could be replicated by a mutual fund or asset manager.

So, if a hedge fund can be and do almost anything, it is difficult to find an appropriate regulatory regime for the systemic risks that hedge funds pose.

The same is true of hedge fund regulation. Since hedge funds in fact are a composite of investment strategy, compensation, investor thresholds, disclosure approaches, etc., the regulatory regimes applicable to hedge funds are similarly an incoherent composite, as incoherent as the definition of hedge funds.

Moreover, the pendulum has swung in what hedge funds do and how they are perceived. In the past, companies often viewed shareholder activists as troublesome investors with axes to grind and single-issue agendas (with concerns about causes ranging from environmental protection to apartheid). Shareholder activism was the term applied to hostile acquirors. Now hedge funds drive shareholder activism, usually on value, compensation, performance, and other issues. In many instances, indeed, now shareholder activism is often portrayed as patriotic and not vulture-like opportunism.

Hedge Fund Manager Regulation in the United States

Basically, the state of US hedge fund regulation is as follows: There is (1) no systematic regulation of hedge funds, (2) light and insignificant regulation, and (3) supervision (as relates to systemic risk) of hedge fund managers and some investor protection regulation.

A US court has rejected regulation of certain hedge fund managers. Hedge funds themselves generally are structured and sold to be exempt from registration as an investment company by being sold through private placements under § 3(c)(1) of the Investment Company Act of 1940 (ICA) (for funds with fewer than 100 investors) and § 3(c)(7h) of the ICA (for funds where the investors are qualified purchasers).

In September 2003, the SEC staff issued a report, "Implications of the Growth of Hedge Funds," and recommended that:

1. Hedge fund advisers register as investment advisers and that the SEC look through to hedge funds and count each investor in each hedge fund as a separate client;
2. The SEC consider that all registered investment companies investing in hedge funds have policies

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and procedures to ensure that funds and banks value hedge fund interests properly, disclose layers of fees, and exercise vigilance in suitability requirements;
3. General solicitation in § 3(c)(7) funds be permitted;
4. The SEC and NASD monitor closely capital, introduction services provided by broker-dealers;
5. The SEC encourage investor education and hedge fund industry best practices; and
6. The SEC consider examining wider use of hedge fund investment strategies in registered funds.[1]

The SEC staff elaborated in its 2003 report and recommended that the SEC consider:

- Requiring hedge fund advisers to register as investment advisers under the Advisers Act, taking into account whether the benefits outweigh the burdens of registration;
- Revising its regulations under the Advisers Act to require advisers to provide a brochure specifically designed for hedge funds;
- Requiring certain registered investment companies to follow board-adopted valuation procedures;
- Requiring additional disclosure to be provided about layered fees of funds of funds;
- Monitoring whether suitability obligations are being met;
- Permitting general solicitation in § 3(C)(7) hedge fund offerings;
- Monitoring capital introduction services provided by prime brokers; and
- Issuing a concept release for examining wider use of hedge fund investment strategies in registered investment companies

The 2003 report also:

- Encouraged the hedge fund industry to embrace and further develop best practices;
- Suggested investor education;
- Noted that different registered investment company structures provide various benefits and challenges in the deployment of absolute return strategies;
- Noted that registered investment companies are subject to restrictions on leverage and short selling that hedge funds avoid; and
- Encouraged alignment of the investment adviser's interests with investors.

Hedge funds have been petitioning the SEC to suspend its prohibition on a fund engaging in general advertising or solicitation on the ground that the SEC said in its 2003 report that there is "little compelling policy justification for prohibiting general solicitation or general advertising in private placement offerings of Section 3(c)7 funds that are sold only to qualified purchasers."[2]

SEC Attempt to Regulate Hedge Fund Managers

Rather than regulate hedge funds, the SEC decided to try to regulate hedge fund managers,[3] an approach that does not give any regulatory information about the systemic risks of hedge funds and that is viewed primarily as a form of investor protection. The SEC, using a risk-based approach, issued a rule change in 2004 generally requiring most hedge fund managers (managing more than $25,000,000 and with more than 15 investors) to register as investment advisers.

The DC Court of Appeals, however, overturned the rules and determined that the SEC exceeded its authority in doing so.[4] If the rule had been upheld, an investor could have viewed the following information about the hedge fund manager:[5]

- A background check of the manager and other key personnel who manage the fund;
- Financial conditions that may affect the manager's ability to meet its contractual commitments and perform its management functions;
- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the advisor, and applicable regulatory restrictions;
- Trading practices, including procedures by which the manager satisfies its best execution obligation, uses client brokerage to obtain research and other services (soft-dollars arrangements), and allocates aggregated trades among clients;
- The accuracy and completeness of disclosures made to hedge fund investors and regulators, including account statements;
- Procedures to safeguard client assets from conversion or inappropriate use by advisory personnel;
- The accurate creation of required records and their maintenance in a manner that secures them from all

unauthorized alteration or use and protects them from untimely destruction;
- The methods by which the fund markets its advisory services;
- Processes to value assets and assess fees based on those valuations;
- Compliance policies and procedures; and
- Business continuity plans.

The SEC said that it would not appeal the decision overturning the rule but would address its "unintended consequences." Still, 75 percent of the hedge fund managers are expected to remain as registered advisers.

So, on December 13, 2006, the SEC proposed two rule amendments affecting hedge fund advisers. The proposal would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled asset vehicle to make false or misleading statements or to otherwise defraud investors or prospective investors in that pool. The proposed rule would apply to all investment advisers to pooled investment vehicles, including investment advisers who are not registered under the Investment Advisers Act. The second proposed rule would expand Rule 501 of Regulation D, setting forth the definition of "accredited investor" to require that natural persons wishing to purchase securities issued by hedge funds or other pooled investment vehicles own at least $2.5 million in "investments" in addition to satisfying the existing criteria of the Rule. The proposed amendments apply only to natural persons.

The regulation of hedge fund managers also arises indirectly through the requirements of the Employee Retirement Income Security Act (ERISA). However, these requirements are for investor-protection purposes, not systemic risk purposes. A trend to allow unlimited pension fund investment in hedge funds also requires increased regulatory attention. If benefit plan investors own more than 25 percent of any class of equity in a hedge fund (disregarding interests held by the manager and its affiliates), a transaction between a prime broker to the fund and the transaction fund holding ERISA-regulated funds must be covered by a prohibited transaction exemption if the prime broker is to avoid exposure to significant penalties. In order to use the usual exemption, the manager of such fund must be a registered investment adviser (under either federal or state law) that meets a number of tests regarding minimum net worth, assets under active management, and diversity of client assets. Other restrictions apply with respect to related parties of the manager, as well as the qualification of specific transactions as they relate to the prime broker or its affiliates.[6]

The Impact of the Public Offering of Hedge Fund Manager Stock

The public offering of private equity and hedge fund manager stock will create a whole new dynamic with more trusts. Another form of hedge fund manager regulation—market discipline—has evolved now that hedge fund managers (Fortress, Blackstone)[7] have issued and publicly sold securities, and the Blackstone Group[8] has filed with the SEC to sell a 10 percent share of its management company. As a result of its SEC registration, the Fortress and Blackstone prospectus and subsequent SEC filings require some disclosure of the strategy and risks of the business. But the disclosure is the kind that most publicly held investment managers would make, with certain differences because of the hedge and private equity funds that Fortress manages. In any case, the disclosures have no value in determining the systemic risk posed by hedge funds, reveal nothing about the fund's strategy or risks, and are meant to protect investors in Fortress as the manager, not investors in Fortress' funds.

The public offering of manager's stock leads to new potential conflicts and unwanted scrutiny. For this reason, Apollo Management plans to sell its stock pursuant to a Rule 144A private placement with registration rights involving less disclosure and fewer procedural hurdles. But the number of investors must be fewer than 500 investors for Apollo to retain its private status.[9] Och Ziff is also going public.

The concerns include (1) that the publicly held fund managers' attention will be diverted in part to the demands of a public company and (2) that fund managers may focus on quarterly earnings, which may affect when they buy or sell companies (earning fees when they buy and profits when they sell). The fees that fund managers earn also pose certain unique risks in a public context, besides the controversy over whether the 20 percent carried interest should be taxed at the rate of capital gains or as income.

In public companies, management fees are awarded a higher multiple of earnings than incentive fees, which means that bigger management fees translate to a better share price. The best way to raise the management fee is to manage more money which inevitably makes bigger returns harder. So, to help shareholders, the public firms need to run up management fees (gather more assets) and manage buying and exiting more carefully (to make the earnings more stable) and further diversify the income stream. None of those things are necessarily good for limited partners" invested in the funds the public firm manages.[10]

So, it is questionable whether public fund managers continue to have their interests aligned with fund investors.

Global (Non-US) Hedge Fund and Manager Regulation

The best summary of the status of hedge fund regulation around the world comes from the FSF 2007 Report. Interestingly, it appears that three jurisdictions, Italy, Canada, and Australia, apparently have capital adequacy requirements, but from the Report it is not clear whether the capital requirements apply to hedge funds or their managers. The following summarizes the Report on this subject.

In Germany, financial services supervision requires registration/licensing of hedge funds, audits terms and examines "the sales prospectus, the terms of the investors' contracts, the accounting, depository and administrative setup (involving in particular the sound calculation of the net asset value and the proper inclusion of prime brokers), and the evaluation of the individual portfolio manager's competencies with regard to the defined hedge fund strategy."

The Australian authorities regulate providers of "managed investment schemes," including hedge funds, and hedge fund managers are licensed and are subject to capital requirements.

In February 2007, the Canadian Securities Administrators proposed requiring the registration of fund managers, which would:

> focus on ensuring that fund managers: have the resources to carry out their functions, or to properly supervise the functions if they are contracted to a third party, and to provide proper services to investors; manage their conflicts of interest; have adequate capital and insurance to provide protection for investors and minimize the risk of loss and disruption to them; and have sufficient proficiency and integrity to carry out their functions.

In Italy, the combination of a ministerial decree in 2003 and central bank regulation in 2005 requires:

1. Registration by the Bank of Italy for hedge fund managers;
2. Initial and ongoing capital;
3. Organizational and internal control structure;
4. Certain disclosures; and
5. A minimum investment threshold.

Recently, supervisors have begun to work collaboratively to assess the risk-management practices of the financial intermediaries that deal most closely with hedge funds. For example, the Federal Reserve, SEC, UK FSA, BaFin, and Swiss Federal Banking Commission (SFBC) currently are engaged in an ongoing review of the management of counterparty exposures by core intermediaries, especially as these relate to hedge funds.

Operational Risk Rating of Hedge Funds as a Form of Regulation

Moody's has given a public rating to Sorin Capital Management LLC on operational risk based on the fund's back-office administration, regulatory compliance, risk reporting and control, legal and financial structure, and human resources criteria. The rating descriptions reflect the strength of valuation processes, the documentation, execution, enforcement of operations policies and procedures, the independence, proficiency, and qualification of key service providers, the level of compliance risk, the independence of internal risk reporting and control independent of portfolio management, and the result of background checks. Moody's looks to the independence and strength of the fund's valuation process. Moody's assesses the capabilities of Sorin's prime broker and the specific services provided. Moody's has said that several other funds are considering obtaining ratings.

Banks and Brokerage Firms Are the *De Facto* Supervisors of Hedge Funds

This article has demonstrated that financial firms are the supervisors of hedge funds. To summarize, the President's Working Group (PWG) report attempts to address the risks discussed in this article by saying that:

> supervisors should clearly communicate [to the financial institutions they regulate, not to hedge funds] their expectations regarding prudent management of counterparty credit exposures, including those to private pools of capital and other leveraged counterparties, who are increasingly utilizing complex instruments, including certain over-the-counter derivatives and structured securities, such as collateralized debt obligations. Because key creditors and counterparties to pools are organized in various jurisdictions, international policy collaboration and coordination are essential.

The problem of systemic risk, however, remains. Ensuring that each financial services firms counterparty has and uses the proper risk-management procedures is not the same as a regulator's having a perspective on all hedge fund activities.

The PWG report says:

> The systemic risks that might arise from hedge funds involve both the "direct" risk to the core firms arising from their direct credit exposures to hedge funds, and the "indirect" risk that hedge fund actions (perhaps through the forced liquidation of positions) might cause a sharp deterioration in market liquidity and prices that causes distress at one or more of the core firms.

We see the latter occurring at the time of the writing of this article as funds and other financial institutions are liquidating CDOs collateralized by subprime mortgages, all securitized products, and even well-rated companies' stock (just to raise funds).

Therefore, the crucial element that is missing is that all the relevant information must be collected, masked (to protect confidentiality information from competitors), and made available to a regulator or the financial services industry "deputies."

Indeed, one counterparty (Bear Stearns) in a recent case[11] in connection with the bankruptcy of Manhattan Investment Fund (MIF) maintained that it did not know of improprieties in a hedge fund because it believed that the fund had relationships with other brokers. The court agreed that the existence of other prime brokerage relationships could be a legitimate reason for a prime broker not to know of all of a fund's activities, positions, or concluded risks but that such an argument was not supported by the facts in this case. The reality suggests that *de facto* supervision of hedge funds by banks and brokerage firms cannot completely account for systemic risk of a fund on the industry as a whole.

MIF made 18 transfers of money from its bank account to a Bear Stearns account at Citibank so that MIF could engage in securities trading, subject to margin requirements set by the federal securities law and increased by Bear Stearns risk managers. The transfers to Bear Stearns allowed MIF to continue short selling activities, because MIF increased the collateral posted with Bear Stearns, which then allowed MIF to borrow securities for its short selling activities. The court concluded that Bear Stearns should in essence repay the investors in MIF because Bear Stearns should have been aware (after reasonable due diligence) that MIF was misrepresenting to its investors that it was making a 20 percent return. When Bear Stearns questioned MIF's manager about the discrepancy between the fund's performance (down $180 million) and the statements made to investors, Bear Stearns apparently accepted, without further investigation, MIF's manager statement that Bear Stearns was one of eight primary brokers of MIF and that, therefore, Bear Stearns had an incomplete view of MIF's financial condition.

Regardless of whether Bear Stearns should have examined the fund further or notified a regulator about the alleged fraud, the most interesting aspect of this case is that no single financial firm as counterparty can have a complete, accurate, integrated view of a hedge fund's positions or risk exposure. This inability for a prime broker to monitor a fund underscores the inability of a regulator to have a picture of the risks posed by one fund or a collection of funds. It is significant that a counterparty to a hedge fund business would argue, and that a court would accept, the plausibility of the presence of other clearing firms as obscuring the ability of the prime broker or another counterparty to

know completely and accurately a fund's position. This confirms that no regulator could have an aggregate picture of any one fund's performance, let alone the performance of several funds or the industry or market participants with varying positions, which in combination pose systemic risks. Although perfect information is not necessary to regulation, there is a significant knowledge gap here.

Precedent for Delegation of Regulatory Function

The most important aspects of hedge fund supervision have been delegated by the banking and securities regulators to the financial services industry that they regulate. There are numerous precedents for this approach, but these precedents do not justify this approach in dealing with hedge fund industry systemic risk. The precedents largely are where regulators expect the banks and investment banks to identify suspicious transactions in which they are the bystander/witness, intermediary, or perpetrator (insider trading, money laundering, terrorism financing). In the area of systemic risks posed by hedge funds, the knowledge that one bank has about its transactions with a hedge fund is only part of the picture, since the fund has usually multiple counterparties. Moreover, of the various precedents for this delegation approach, only one of the approaches—the deputization of financial firms to deal with financial crimes and money laundering—attempts to bring the knowledge gained from individual deputies together. This may be a model for the possible supervision through the government or the market of hedge funds.

The banking and securities regulators delegate the hedge fund oversight function to banks and investment banks by recommending two things: (1) improved infrastructure at the bank or broker-dealer to deal with hedge fund risk and (2) new, more extensive procedures (including documentation netting and due diligence) to review hedge fund activities. Essentially, in order to ensure that hedge funds are not participating in excessively risky or inappropriate practices, the regulators expect financial firms to balance the demands of their fund clients against potential misuse by the funds of complex structured transactions and inadequately monitored day-to-day trading practices.

Banking and securities regulators have relied on financial firms to increase their knowledge of their hedge fund clients' operations and thereby protect the financial system. This approach, an *ad hoc* deputizing of the financial firms, is consistent with prior regulatory action in other arenas. The examples that follow show the strength and weaknesses of such approach:

- In the 1980s, bank regulators issued guidance to the banks about educating and disclosing to their swaps counterparties and ensuring or developing a case for suitability as a result of the Gibson Greeting and Procter & Gamble lawsuits against Bankers Trust and complaints by small municipalities in which certain bankers were accused of exploiting the ignorance of financial executives of commercial firms and municipalities who claimed that they were not educated about the swaps into their companies entered. Some have said that this also created a shield for bankers if they followed these procedures.
- Periodically, the bank regulators have even attempted to manage real estate investors, speculators, developers, and builders by relaxing or tightening guidelines that banks should follow in real estate-related lending.
- As a result of the scandals involving accounting manipulation (AIG, Enron, Brightpoint, PNC) and the alleged roles of financial firms in structuring transactions (called inaccurately "complex structured finance transactions") that burnished the financial statements of these companies through non-consolidation of off-balance-sheet vehicles where the risk of the vehicle remained as the risk of the company, bogus insurance transactions which were really for income smoothing, etc., the bank and securities regulators issued guidance to financial firms encouraging them to take a more active role to ensure that (1) these transactions are reflected and disclosed properly in their customer's financial statements, (2) bankers educate counterparties about the impact of the transaction, and (3) bankers review all relationships with the client to ensure the appropriateness and legality of the transactions. Indeed, the weakness of this approach resembles the weakness of trying to supervise hedge funds through financial services firms as deputies; an individual financial services firm may not, in the context of a complex structured financing transaction, have sufficient information to determine whether the single transaction it is contemplating is not part of a larger scheme to misrepresent the financial condition of the company.

- Sarbanes-Oxley in a sense criminalized and reinforced the criminalization of secondary participants (not those involved in the underwriting process) who, in lay parlance, aided and abetted federal securities law fraud. Sarbanes-Oxley also codified the delegation to investment banks, lawyers, and other market participants of the supervisory function thereby of ensuring that public companies represent accurately and completely their financial condition by creating aiding-and-abetting liability to such other market participants.
- Probably the most extreme example (outside of the intervention by the US Treasury Department in restructuring of Latin American and other government debt) of government delegating the supervision function to the private sector occurred in the hedge fund context. An example of the deputization of banks, broker-dealers, and the financial industry by the Federal Reserve can be found in the near collapse of the hedge fund LTCM in 1998, resulting from deterioration in the creditworthiness of many emerging market bonds and corresponding large increases in the spreads between the prices of western government and emerging market bonds, contrary to LTCM's expectations. LTCM had difficulty meeting margin calls and finding high-quality collateral to maintain its positions. Due to growing concern about the effect that LTCM's failure would have on the financial markets, the New York Federal Reserve Bank invited a number of creditor firms to discuss a rescue package for LTCM, which competed with a package offered by Berkshire Hathaway, Goldman Sachs and AIG. Under the new package, which was ultimately accepted by LTCM's management, 14 prominent banks and brokerage houses agreed to invest US$3.65 billion of equity capital in LTCM in exchange for 90 percent of the firm's equity. Absent the rescue package, the failure of LTCM would have exposed the firms to a multi-billion-dollar default.
- The type of indirect delegated regulation and supervision we currently see in the hedge funds industry is very much like the regulation of investment banks or broker-dealers. Although there has been a gradual increase by the SEC in supervising investment banks for systemic risk purposes, the systemic risks posed by investment banks regulated by the Federal Reserve through its "deputies," the commercial banks that are counterparties to broker-dealers/investment banks. For example, although investment banks can function like banks in extending credit, opening deposits like cash management accounts, the Federal Reserve does not have jurisdiction to review the investment banks' activities or determine the impact on the money supply or economy. The Federal Reserve does this instead through its review of commercial bank lending and deposit activities.
- In terms of financial crimes, the Treasury Department has tried to obtain, through the financial services industry, a window into illegal activities (gambling, arms, drug, and other contraband activities, money laundering, terrorism, terrorism financing transactions with certain countries) by requiring financial services firms to comply with (1) anti-money laundering/know your customer rules, (2) foreign asset control regulations, and (3) filing of suspicious activities reports. FINCEN and the Treasury Department may have a picture of an entire financial crime scheme because under certain circumstances with certain protections financial services firms may share information with each other and with the government.

The last method of delegation is the only one in which the information is shared among financial services firms and with the government.

Guidance for Financial Firms to Conduct Due Diligence and Learn About Exposure to Hedge Fund Risk

Federal Reserve Board Chairman Bernanke summarized US hedge fund regulation as primarily arising from market discipline imposed by counterparties on hedge funds:

> Counterparties are another important source of market discipline. The principal counterparties of most hedge funds are large commercial and investment banks, which provide the funds with credit and a range of other services. As creditors, counterparties have a clear economic incentive to monitor and perhaps impose limits on hedge funds' risk-taking, as well as an incentive to protect themselves from large losses should one or more of their hedge-fund customers fail. Counterparties seek to protect themselves against large losses through risk management and risk mitigation. Risk management includes the use of stress tests to estimate potential exposure under adverse market

conditions; risk-mitigation techniques include collateral agreements under which hedge funds must daily mark to market and fully collateralize their current exposures.

Private counterparties may not fully account for risks to general financial stability. Thus, supervisors seek to ensure that hedge-fund counterparties—primarily very large commercial and investment banks—protect themselves and, in so doing, protect the broader financial system. Supervisors also monitor markets and key institutions, coordinate with their domestic and foreign counterparts, and work with the private sector to strengthen market infrastructures. For example, the Federal Reserve Bank of New York has been leading joint public-private efforts to improve the clearing and settlement of credit derivatives. Coordination of this type can improve market functioning and reduce risks to financial stability without harming market discipline.[12]

CPRMG Guides Financial Firms on Relationship with Hedge Funds

In response to the events involving Long Term Capital Management (LTCM) and as a result of the exposure that financial firms and investors face in their relations with hedge funds, regulators established the Counterparty Risk Management Policy Group (CPRMG), which in 1999 issued both domestic and international supervisory guidance aimed at improving banks' policies and practices with hedge funds and other highly leveraged institutions.[13] In 2005, the CPRMG issued a follow-up report (CPRMG II) with recommendations that, if followed, could affect hedge fund performance (either negatively because of increased margin requirements or positively because of cross-margining benefits) and the revenues of financial firms that do business with them.[14]

Regulators and the financial services industry itself appear to have determined that the current regulatory framework does not directly address the risks posed by hedge funds, either individually or systemically. As a result, the guidelines and best practices described later in this article have evolved to ensure that financial firms' dealings with hedge funds (in various capacities) protect financial firms as counterparties and the financial system, and therefore such hedge fund risks are addressed indirectly.[15] These guidelines and industry practices include documentation, due diligence, and the development of an internal infrastructure.

For example, in 2005 the Managed Funds Association (MFA) published in "Sound Practices for Hedge Fund Managers," covering:

1. Management and internal trading controls;
2. Responsibilities to investors;
3. Valuation policies and procedures;
4. Risk monitoring (including structure of risk monitoring, knowing the limit of models, and operational risks);
5. Regulatory controls;
6. Transactional practices; and
7. Business continuity and disaster recovery.

The MFA encourages hedge fund managers to share (subject to confidentiality agreements) risk and financial information with counterparties, develop and monitor several measures of leverage, limit potential operational risks (including reconciliation errors, data entry errors, fraud, system failures, and errors in valuation or risk measurement models), create a management environment providing for compliance with all rules and regulations, pursue a consistent and methodical approach to documenting transactions with counterparties to enhance the legal certainty of its positions, and establish best execution and soft-dollar policies.

The Alternative Funds Association and the Dublin Funds Industry Association have also published in September 2004 the "Guide to Sound Practices for Hedge Fund Administrators." There is also an "Alternative Investment Management Association of Managed Funds Association Sound Practices guide."

As stated, since hedge funds have tended not to disclose their investment positions and, more importantly, their strategies, financial firms can find it difficult to determine the extent of their risk exposure in engaging in lending and other transactions with hedge funds. In this context, CPRMG II recommended that banks and broker-dealers seek greater disclosure (transparency) from hedge funds in conducting counterparty credit assessments and monitoring prime brokerage relationships, including more measurement and reporting by

the funds. CPRMG II also recommended that financial firms:

Implement improved documentation policies and practices and new netting and closeout procedures;

1. Adopt policies for complex financial products;
2. Review client relationships;
3. Change trade execution practices; and
4. Improve risk management.

The G7 Finance Ministers and Central Bank Governors in their May 2007 FSF report recommended that:

- Supervisors act so that core intermediaries continue to strengthen their counterparty risk management practices;
- Supervisors work with core intermediaries to further improve their robustness to the potential erosion of market liquidity;
- Supervisors explore and evaluate the extent to which developing more systemic and consistent data on core intermediaries' consolidated counterparty exposures to hedge funds would be an effective complement to existing supervisory efforts; and
- Counterparties and investors act to strengthen the effectiveness of market discipline, including by obtaining accurate and timely portfolio valuations and risk information.

CPRMG II recommended that, through due diligence, financial firms should attempt to minimize exposure to hedge funds. Regulators want financial firms to focus on (1) fund managers' value-at-risk systems to measure and manage overall risk exposures, (2) firm-wide risk management guidelines, (3) stress-testing methodologies and scenarios analysis, and (4) regulatory compliance programs. This focus resembles that of Basle II. If a fund's manager is required to register with the SEC, a financial firm should also review the information that a registered manager is required to provide to clients. If the manager is not SEC-registered, a financial firm should consider requesting the information that the manager would be required to provide if it were.

A hedge fund's risk profile can change daily; therefore, it is important for fund counterparties to ensure that the fund's manager can effectively manage its business operations and risks on an ongoing basis.

CPRMG II suggests that, once financial firms have more exacting standards for the overall due diligence process, they should adjust credit terms on the basis of those higher standards, especially when there has been innovation in the manner in which credit is extended. For example, hedge funds now commonly seek committed facility credit arrangements that provide contingent credit (to protect the hedge fund from the need to liquidate positions too quickly) and seek value-at-risk (VaR) margining that incorporates the favorable effects of netting margin requirements across multiple products.[16] Financial firms that offer committed facilities and VaR margining to hedge funds in this manner should scrutinize the effect that these and other innovations have on their exposures and adjust credit terms accordingly.

Moreover, with the information thus obtained, financial firms should improve their risk measurements of a hedge fund's activities and then:

- Require increased collateral to address credit quality;
- Implement robust credit models that are stress-tested to project impacts on liquidity;
- Be alert to the potential for excessive leverage in the system (arising from a liberalization of credit terms, increased use of credit facilities under pre-existing terms, or the development of new structures that facilitate the taking of leveraged positions in new forms);
- Determine what actions are appropriate and take into consideration individual counterparty and sector risk issues;
- Ensure that their risk measures and analyses comprehensively capture the full range of actual and contingent exposures, such as loan commitments;
- Report periodically to senior management regarding commitments and collateral polices and practices; and
- Monitor exposure on a frequent basis.

The regulators encourage this form of risk mitigation because it addresses their fundamental concern to avoid the failure of a financial institution because of its transaction with a hedge fund.

Notes

1. 2003 SEC Report, "Implications of the Growth of Hedge Funds."
2. Jenny Anderson, "Hedge Funds Walk a Hard Line Between Silence and Sharing," *NY Times*, Feb. 9, 2007, p.C7.
3. 17 C.F.R. Parts 275 and 279.
4. In Goldstein v. SEC, 371 U.S. App. D.C. 358. the D.C. Court of Appeals in June 2006 vacated the SEC's rule of 2004 requiring most hedge fund managers to register under the Investment Adviser Act, which requires registration of an adviser if it has more than 14 clients and holds itself out to the public as an investment adviser by looking through the funds the managers advised and counting the investors in the fund as clients.
5. Based on SEC Rules 204-3, 206(4)-4, 206(4)-7 and the requirements of Part II of Form ADV (which sets forth the routine information that a registered adviser is required to provide to clients).
6. US Department of Labor Prohibited Transaction Class Exemption 84-14 and US Department of Labor Prohibited Transaction Class Exemption 81-6. A proposed amendment to this exemption would also allow such a transaction with certain offshore broker-dealers.
7. Fortress Investment Group LLC, 34, 286,000 Class A Shares.
8. The Blackstone Group, 133,333,340 Common Units, Reg. File No. 333-138514, Reg. No. 333-141504.
9. Andrew Ross Solcin and Michael de la Merced, "Buyout Firm Said to Seek a Private Market Offering," *NY Times*, Aug. 18, 2007, p.C3.
10. Jenny Anderson, "The Old Money in Private Equity Isn't Ready to Welcome the New," *NY Times*, July 20, 2007, p.C5.
11. Man. Investment Fund, Ltd. v. Bear Stearns Sec. Corp., 359 B.R.510 (Bankr., S.D.NY. 2007).
12. Remarks by Chairman Ben S. Bernanke at the New York University Law School, New York, NY, Apr. 11, 2007.
13. *See* Report of the Counterparty Risk Management Policy Group 1999.
14. *See* "Toward Greater Financial Stability: A Private Sector Perspective," Report of the Counterparty Risk Management Policy Group II (July 27, 2005).
15. *See, e.g.*, (1) Managed Funds Association (MFA) "2005 Sound Practices for Hedge Fund Managers," (2) Alternative Funds Association and Dublin Funds Industry Association September 2004, "Guide to Sound Practices for Hedge Fund Administrators," and (3) "Alternative Investment Management Association of Managed Funds Association Sound Practices Guide."
16. There has been a trend for some time, encouraged by regulators, for financial firms and their counterparties to enter into netting arrangements not only within a single product (*i.e.*, a loan, swap, option, or other derivative product) but also among different products and even with affiliated entities.