

CLOSING THE HEDGE FUND LOOPHOLE: THE SEC AS THE PRIMARY REGULATOR OF SYSTEMIC RISK

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CARY MARTIN SHELBY*

Abstract: The 2008 financial crisis sparked a flurry of regulatory activity and enforcement in an attempt to reign in activity by banks, but other institutions have also been identified as potentially threatening to the stability of the financial markets. In particular, several empirical studies have revealed that systemic risk can be created and transmitted by hedge funds. In response to the risk created by hedge funds, Congress granted the Financial Stability Oversight Council (“FSOC”) authority under the Dodd-Frank Act of 2010 to designate hedge funds as Systemically Important Financial Institutions (“SIFIs”). Such a designation would automatically result in stringent capital constraints and limitations on liquidity risk on these non-bank institutions. Yet in over six years since FSOC has been granted this authority, it has failed to identify even one hedge fund as a SIFI. In the face of massive resistance and deregulatory initiatives introduced under the Trump administration, it is highly unlikely to do so in the near future. The inability of FSOC to regulate systemically harmful funds is particularly troubling because several post-financial crisis studies have revealed that systemic risk can still be created and transmitted by hedge funds. Given FSOC’s inability to close this hedge fund loophole, this Article argues that Congress should explore appointing the SEC as the primary regulator of hedge funds because: (1) hedge funds can still pose a systemic threat to the economy; (2) the transparency framework inherent in the federal securities laws can supply a more effective means for mitigating systemic risk than the prudential framework currently mandated for SIFIs; and (3) appointing the SEC in this regard would reduce the

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fragmentation of the current regulatory structure which has been extended and complicated by the creation of FSOC. Although the federal securities laws are typically used to promote investor protection, this Article posits that enhancing transparency to hedge fund counterparties and investors can decrease systemic risk by empowering such market participants to better protect themselves against risk. Enhancing protection in this manner could in-turn weed out systemically harmful funds from the marketplace, without imposing the severe capital constraints that would be mandated under FSOC's model.

INTRODUCTION

From a structural perspective, there is a clear distinction between banks and investment funds. Banks are financial institutions that hold deposits, extend credit to individuals and businesses, or assist with the financing needs of corporations and other clients.¹ Regulators have deemed these entities as being systemically harmful because the failure of a single bank could lead to simultaneous bank-runs and other financial calamities.² As a result, banks are subject to a robust system of prudential regulation that restricts the extent to which these entities can extend capital to third parties.³ Such rules include stringent capital and reserve requirements, constraints on liquidity risk, and several other mandates designed to reduce the likelihood of a bank failure.⁴

In contrast, investment funds are pooled vehicles that are invested in a basket of securities, bonds, and other instruments on behalf of large numbers of investors.⁵ Federal securities laws include mandated disclosure requirements for registered funds, which are rooted in investor protection principles.⁶ The Securities and Exchange Commission ("SEC") is the regulatory

¹ See Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 306 (1987) (describing banks as, "firms that provide a particular bundle of financial services" such as liquidity and lending services for a range of individuals and businesses).

² Onnig H. Dombalagian, *Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation*, 85 IND. L.J. 777, 782 (2010).

³ See generally *Regulations*, BD. GOVERNORS FED. RESERVE SYS., <http://www.federalreserve.gov/bankinforeg/reglisting.htm> [<https://perma.cc/3NRU-377R>] (providing a comprehensive overview of the regulations that apply to banking entities).

⁴ *Id.*; see also MICHAEL P. MALLOY, *PRINCIPLES OF BANK REGULATION* § 1.9 (3d ed. 2011) (describing broadly the current regulatory system for banks); Henry T. C. Hu, *Disclosure Universes and Modes of Information: Banks, Innovation, and Divergent Regulatory Quests*, 31 YALE J. ON REG. 565, 568–69 (2014) (describing new system of mandatory public disclosure of information).

⁵ See THOMAS P. LEMKE ET AL., *REGULATION OF INVESTMENT COMPANIES* § 1.01 (2016) (providing a description of investment company structures).

⁶ See *infra* notes 84–113 and accompanying text (summarizing the federal securities laws that apply to investment company structures).

body charged with effecting these laws.⁷ Although the failure of a particular fund could admittedly lead to massive investor losses, these entities were not historically viewed by regulators as being systemically harmful.⁸ Investors could previously absorb any losses associated with an investment fund failure and the fund's demise would not lead to correlated defaults of other funds or financial institutions.

In spite of these structural differences, financial innovation has significantly blurred the distinction between the activities of banks and investment funds, creating unique challenges for regulators. Private funds, such as hedge funds for example, have more flexibility to incur leverage and pursue innovative strategies, which can incorporate derivatives, illiquid instruments, and other exotic financial instruments.⁹ These flexibilities have created scenarios where funds can create and transmit systemic risk.¹⁰ They can now become "too big to fail," heavily interconnected with other financial institutions, or significant participants in the shadow banking industry.¹¹ For instance, the near failure of Long-Term Capital Management ("LTCM") revealed that a single hedge fund could become so highly leveraged and interconnected that its failure could expose its banking counterparties to significant losses, which could cripple the global economy.¹² Moreover, a series of smaller funds can create and transmit systemic risk given the industry's significant interconnectedness with insurance companies, prime brokers, and other hedge funds.¹³ In terms of the shadow banking industry, the securitization of debt instruments provided a means for hedge funds to participate in the transmission and distribution of credit, without being subject to significant regulation.¹⁴ During

⁷ *Division of Investment Management*, SEC, https://www.sec.gov/divisions/investment/investment_about.shtml [<https://perma.cc/W8L4-UFRW>] (describing the SEC's various roles in overseeing the investment fund industry).

⁸ See Dombalagian, *supra* note 2, at 782–83.

⁹ See *infra* notes 119–134 and accompanying text (summarizing common investment fund exemptions that permit private funds to pursue these flexibilities).

¹⁰ See *infra* notes 135–164 and accompanying text (explaining the various mechanisms through which hedge funds can create and transmit systemic risk).

¹¹ See *infra* notes 135–164 and accompanying text.

¹² See generally ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* (2001) (providing a detailed account of the near failure of Long-Term Capital Management, which was organized by two Nobel Prize winners who failed to predict the fund's demise as it had a debt to equity ratio of over twenty-five to one).

¹³ See *infra* notes 141–164 and accompanying text (summarizing empirical research that has investigated the interconnectedness of hedge funds).

¹⁴ Karin Matussek, *Hedge Funds Are Shadow Banks in Need of Regulation, Bafin Says*, BLOOMBERG (May 13, 2012, 6:01 PM), <http://www.bloomberg.com/news/articles/2012-05-13/hedge-funds-are-shadow-banks-in-need-of-regulation-bafin-says> (discussing how some European regulators view hedge funds as shadow banks and feel that they should be regulated as such). *But see* Andrew Baker, *Hedge Funds Are Not Shadow Banks: Shadow Banking Is the New Bogeyman*,

the period leading up to the financial crisis of 2008, hedge funds were avid participants in these OTC derivative markets.¹⁵

Scholars have long debated the appropriate regulatory body and framework to oversee these emerging systemic risk concerns.¹⁶ Some have expressed doubts with simply extending the SEC's authority over these entities and have suggested that systemically harmful hedge funds be subject to a degree of prudential regulation that would extend beyond the SEC's investor protection mandate.¹⁷ Another solution proposed by commentators is that a separate administrative body should be created to oversee all systemically harmful financial institutions, a power comparable to the authority granted to the Federal Stability Oversight Counsel ("FSOC").¹⁸ This "super-regulator" would use information collected from existing administrative agencies to regulate such institutions.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") reconciled this debate by creating a new regulatory framework for hedge funds under this extensive legislation.¹⁹ In regulating systemically harmful funds, the Dodd-Frank Act granted authority to a newly

But Don't Include Hedge Funds, FIN. TIMES 3 (May 15, 2011), <https://www.ft.com/content/611b8e26-7d8d-11e0-b418-00144feabdc0> (arguing that hedge funds are not significant participants in the shadow banking industry and further claiming that they are distinctly different from banks in that "[t]hey do not take deposits, do not undertake maturity transformation nor benefit from implicit or explicit taxpayer guarantees").

¹⁵ Daniel Fisher, *A Dangerous Game: Hedge Funds Have Gotten Rich from Credit Derivatives*, FORBES (Sept. 29, 2006, 12:40 PM), <http://www.forbes.com/forbes/2006/1016/040.html> [<http://web.archive.org/web/20160906124514/http://www.forbes.com/forbes/2006/1016/040.html>] (providing data on the participation of hedge funds in OTC derivative markets and specifically noting that "[h]edge funds account for 58% of the trading in [credit] derivatives").

¹⁶ See *infra* notes 165–184 and accompanying text (outlining the scholarly debate on the proper administrative authority that should be granted for systemically harmful hedge funds).

¹⁷ John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 776 (2009) (suggesting that, as part of a broader "regulatory consolidation," the Federal Reserve should be given authority to regulate hedge funds).

¹⁸ See, e.g., Ian Beattie & Sarah O'Connor, *Bernanke Calls for Powerful Regulator*, FIN. TIMES (Mar. 10, 2009), <https://www.ft.com/content/6d4f943a-0d6e-11de-8914-0000779fd2ac> (highlighting Bernanke's support of a new "super" regulator to oversee all systemically harmful institutions); Jeff Casale, *Industry Group Supports Systemic Risk Regulator*, BUS. INS. (Mar. 5, 2009, 12:00 AM), <http://www.businessinsurance.com/article/20090305/NEWS/200015653/industry-group-supports-systemic-risk-regulator> [<https://perma.cc/8USW-72F3>] (reporting on "[a] group of representatives of the insurance industry and other financial services companies [who] told a House panel Thursday that they support the idea of a systemic risk regulator as a means of stabilizing the current financial market and to prevent future collapse"); see also Hilary J. Allen, *Putting the "Financial Stability" in Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087, 1092 (2015) (arguing that regulators should be further consolidated "into a single well-resourced prudential regulatory agency" while also advocating for the termination of the FSOC).

¹⁹ See *infra* notes 185–210 and accompanying text (summarizing new registration requirements for hedge funds promulgated under the Dodd-Frank Act).

created administrative agency, FSOC.²⁰ This agency is “broadly charged” with promoting stability over the financial markets.²¹ In effectuating this mission, FSOC has the power to designate both “bank entities” and “nonbank entities,” such as hedge funds for example, as “systemically important financial institutions” (“SIFIs”).²² Once a nonbank entity is classified as a SIFI, it is then subject to enhanced regulation under the Dodd-Frank Act that would be similar to the prudential regulation typically imposed upon banks.²³ The Federal Reserve would then supervise and implement this enhanced regulation.²⁴ FSOC has since developed a comprehensive three-stage review process for determining whether nonbank entities should be designated as SIFIs.²⁵ In summary, entities that have at least \$50 billion in total consolidated assets can be designated as a SIFI if FSOC determines that it is a systemic threat after evaluating the following characteristics: (i) size, (ii) interconnectedness, (iii) substitutability, (iv) leverage, (v) liquidity risk and maturity mismatch, and (vi) existing regulatory scrutiny.²⁶

Critics have questioned whether the costs of designating a fund as a SIFI would exceed the benefits.²⁷ In terms of assessing the costs, if a hedge fund were designated as a SIFI and therefore subject to prudential regulation, it could destroy its ability to pursue its underlying strategy.²⁸ Imposing this degree of regulation could in turn hamper the returns of hedge fund investors. With these potentially destructive costs, there is a high likelihood that a hedge fund identified as a SIFI would sue FSOC for an arbitrary and capricious designation.²⁹ In terms of assessing the benefits of this framework, it is questionable whether a SIFI model can actually reduce the unique categories of systemic risk created by the hedge fund industry.³⁰ As discussed above, hedge funds must first have at least \$50 billion in total consolidated assets in order

²⁰ 12 U.S.C. § 5321 (2012).

²¹ *Financial Stability Oversight Council*, U.S. DEP'T OF THE TREASURY, <http://www.treasury.gov/initiatives/fsoc/Pages/home.aspx> [https://perma.cc/YL88-6WAE].

²² See Andy Winkler, *Primer: FSOC's SIFI Designation Process for Nonbank Financial Companies*, AM. ACTION FORUM (Sept. 3, 2014), <http://americanactionforum.org/research/primer-fsocs-sifi-designation-process-for-nonbank-financial-companies> [https://perma.cc/6QD7-GX2J] (explaining in detail how the SIFI designation process works under the Dodd-Frank Act).

²³ 12 C.F.R. § 1310.10 (2016).

²⁴ *Id.*; see also *id.* § 1310.02 (noting that “[t]he term ‘Board of Governors’ means the Board of Governors of the Federal Reserve System”).

²⁵ See *infra* notes 194–210 and accompanying text (explaining specific components of the five-factor test for SIFI designations).

²⁶ 12 C.F.R. pt. 1310, app. A.

²⁷ See *infra* notes 211–225 and accompanying text (evaluating notable criticisms to FSOC's authority over nonbank SIFIs).

²⁸ See *infra* notes 211–225 and accompanying text.

²⁹ See *infra* notes 211–225 and accompanying text.

³⁰ See *infra* notes 211–225 and accompanying text.

to be classified as a SIFI. Although this threshold may indeed capture funds that are deemed “too big to fail,” it will not capture smaller funds that are heavily interconnected with other financial intermediaries. Commentators have also queried whether FSOC could appropriately evaluate the complexities of the industry and have instead advocated for models that increase market efficiency.³¹ Because the information gathered by FSOC is deemed confidential, it will have a limited effect on increasing the efficiency of the hedge fund marketplace.

For these reasons, FSOC may never designate a hedge fund as a SIFI. Within the six years since the Dodd-Frank Act has been passed, FSOC has yet to do so. The council has encountered a variety of challenges such as deficiencies in the systemic risk data collected by the SEC, criticisms to systemic risk studies sanctioned by FSOC, and massive resistance to the SIFI designation process by numerous industry participants.³² Moreover, the new administration has introduced several deregulatory initiatives designed to repeal major portions of the Dodd-Frank Act.³³ It is not yet clear how these initiatives will impact FSOC’s authority to designate hedge funds as SIFIs. Even if these initiatives never come to fruition, the newly appointed chairperson of the council is Steven Terner Mnuchin³⁴ who is a former hedge fund adviser with deep ties to the industry.³⁵ His appointment could heavily influence the extent to which FSOC focuses on the hedge funds in pursuing its mission to ensure financial stability. As such, it is highly unlikely that FSOC will designate a fund as a SIFI in the near future even if its power is preserved under the Dodd-Frank Act.

This hedge fund loophole is problematic because the industry is predicted to grow significantly in coming years. Public pension plans account for close to thirty percent of the aggregate capital invested in private funds.³⁶

³¹ Michael T. Cappucci, *Prudential Regulation and the Knowledge Problem: Towards a New Paradigm of Systemic Risk Regulation*, 9 VA. L. & BUS. REV. 1, 30–32 (2014).

³² See *infra* notes 226–252 and accompanying text (providing in-depth account of FSOC’s failure to identify a fund as a SIFI).

³³ Fred Barbash & Renae Merle, *Trump to Order Regulatory Rollback Friday for Finance Industry Starting with Dodd-Frank*, WASH. POST (Feb. 3, 2017), https://www.washingtonpost.com/news/morning-mix/wp/2017/02/03/trump-to-order-rollback-friday-of-regulations-aimed-at-finance-industry-top-aide-says/?utm_term=.c379cf783b79 [<https://perma.cc/65EZ-PCFE>] (discussing the Trump administration’s plans for financial deregulation).

³⁴ *Secretary of the Treasury*, U.S. DEP’T OF THE TREASURY, <https://www.treasury.gov/about/Pages/Secretary.aspx> [<https://perma.cc/6DZ8-SNT5>].

³⁵ See Matthew Goldstein & Alexandra Stevenson, *Trump’s Treasury Pick Moves in Secretive Hedge Fund Circles*, N.Y. TIMES (Dec. 16, 2016), https://www.nytimes.com/2016/12/19/business/dealbook/steven-mnuchin-trump-treasury-hedge-funds.html?_r=0 [<https://perma.cc/G53F-QLQD>] (discussing Mnuchin’s relationship with the hedge fund industry).

³⁶ PREQIN, 2015 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT 8 (2015).

This figure will likely continue to grow as pension plans face funding challenges due to past market turmoil, swelling life-spans, and the simultaneous retirement of millions of baby-boomers.³⁷ Despite reports that the industry has failed to beat the markets, hedge funds will likely face increasing demand when the markets begin their inevitable descent.³⁸ Hedge funds tend to outperform the markets during times of market distress given their abilities to pursue flexible strategies such as short-trading and other hedging strategies.³⁹ Post-financial crisis studies have also found that systemic risk is still a growing concern in this niche industry.⁴⁰ As the industry grows, these systemic risk threats will likely expand in the coming years.

Given FSOC's inability to close this hedge fund loophole, this Article argues that Congress should explore appointing the SEC as the primary regulator of systemic risk because: (1) hedge funds can still pose a systemic threat to the economy; (2) the transparency framework inherent in the federal securities laws can supply a more effective means for mitigating systemic risk than the prudential framework currently mandated for SIFIs; and (3) appointing the SEC in this regard would reduce the fragmentation of the current regulatory structure that has been extended and complicated by the creation of FSOC.⁴¹ In making this argument this Article implicitly acknowledges that although financial innovation has blurred the distinction between private

³⁷ Christopher Swann, *Why Hedge Funds Still Make Sense for Pension Funds*, N.Y. TIMES (Mar. 10, 2015), <http://www.nytimes.com/2015/03/10/business/dealbook/why-hedge-funds-still-make-sense-for-pension-funds.html> [<https://perma.cc/ZZ6P-VJN6>] (discussing the reasons why pension funds need to reduce costs).

³⁸ See *infra* notes 127–129 and accompanying text (discussing how hedge funds often outperform declining markets).

³⁹ See *infra* notes 127–129 and accompanying text.

⁴⁰ See *infra* notes 262–269 and accompanying text (discussing recent studies that have explored systemic risk in the hedge fund industry).

⁴¹ For the sake of clarity, this Article does not argue that FSOC should be dismantled. It narrowly argues that its supervision over the asset management industry should be delegated to the SEC. FSOC's supervision over other nonbank entities could in fact be justified, particularly if the nonbank entities are exempt from federal oversight. The insurance industry for example is predominantly regulated by the states, irrespective of the push by certain interest groups to subject these entities to federal regulation. See *Proposed Federal Insurance Regulation*, NAT'L ASS'N INS. COMM'RS, http://www.naic.org/cipr_topics/topic_federal_insurance_regulator.htm [<https://perma.cc/7BAJ-5XSB>] (discussing basic structure of the insurance industry and how proposed federal regulation might change it). In terms of the multiple categories of asset managers, this Article limits its analysis to hedge funds for a variety of reasons. First, hedge funds are the category of private funds that pose the greatest systemic threat to the economy according to the empirical research in this area. See *infra* notes 135–164 and accompanying text. With respect to funds that are registered under the Investment Company Act of 1940, FSOC seems to have implicitly delegated its supervision over these entities to the SEC because registered funds are already subject to layers of regulation under the federal securities laws. See *infra* notes 84–104 and accompanying text.

funds and banks, this line has not yet been eliminated. The SEC is likely the ideal administrative agency to accommodate the fundamental differences between these industries, while regulating the increasing “publicness” of private funds in an effective manner.⁴²

Enhanced transparency is typically deployed under the federal securities laws as a mechanism to promote investor protection.⁴³ The relationship between investor protection and systemic risk, however, has been grossly neglected by researchers in this area.⁴⁴ This Article attempts to delve into this analysis by demonstrating the ways in which increasing transparency can serve to reduce systemic risk in the hedge fund industry. More specifically, it argues that enhancing market-wide transparency for hedge fund counterparties and investors can empower such market participants to better protect themselves against risk, thereby potentially weeding out systemically harmful funds. Hedge fund counterparties and investors are admittedly highly sophisticated prime brokerage firms, that often perform extensive due diligence on prospective investments.⁴⁵ Yet, these parties have frequently encountered difficulties in assessing the creditworthiness of funds given the complexity of their strategies and operations.⁴⁶ Even if they perform significant due diligence on a single fund, or multiple funds, they can still encounter difficulties

⁴² See generally Cary Martin Shelby, *Are Hedge Funds Still Private? Exploring Publicness in the Face of Incoherency*, 69 SMU L. REV. 405 (2016) (analyzing the ways in which the law should regulate the increasing “publicness” of hedge funds which includes systemic risk, hedge fund activism, third-party litigation funding, and investment in distressed economies).

⁴³ See *The Laws That Govern the Securities Industry*, SEC, <https://www.sec.gov/about/laws.shtml> [<https://perma.cc/MJV7-U6Z8>] (discussing the purposes of registration under the federal securities laws).

⁴⁴ Although many scholars have failed to address this issue, some have engaged in thoughtful discussions on the integral relationship between investor protection and systemic risk. Professor Olufunmilayo Arewa from UC Irvine School of Law has expressed “the need for regulatory frameworks that comprehensively address systemic risk as a core aspect of both investor protection and market integrity and stability.” Olufunmilayo B. Arewa, *Trading Places: Securities Regulation, Market Crisis, and Network Risk* 63 (Northwestern Univ. Pritzker Sch. of Law, Law & Econ. Research Paper Series, Paper No. 09-01, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1324951; see also Erik F. Gerding, *The Subprime Crisis and the Link Between Consumer Financial Protection and Systemic Risk*, 4 FIU L. REV. 435, 436 (2009) (arguing that “consumer financial protection can, and must, serve a role not only in protecting individuals from excessive risk, but also in protecting markets from systemic risk”).

⁴⁵ See, e.g., Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 992–95 (providing data on the extensive due diligence undertaken by hedge fund investors and generally concluding that these investors can appropriately protect themselves); see also Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 287–88 (2009) (positing that hedge funds often provide extensive disclosures to investors and that the industry is generally trending toward increased transparency).

⁴⁶ See *infra* notes 293–312 and accompanying text (identifying some of the challenges that investors and counterparties have encountered in deciphering hedge fund strategies).

in optimizing hedge fund selections given the lack of standardization in how risk is reported.⁴⁷ Mandating standardized risk disclosures for hedge funds would essentially give investors and counterparties a mechanism to more easily identify high quality managers of risk. This could in-turn force systemically harmful funds out of the market. Standardized disclosures that are tailored to the proprietary needs of hedge funds could also be less disruptive to the hedge fund industry in comparison to prudential regulation, especially if the disclosures are carefully designed to protect proprietary information.

The disclosure items developed by the SEC should parallel the relevant factors that FSOC currently evaluates in determining whether a hedge fund would qualify as a SIFI. These factors are: (i) size, (ii) interconnectedness, (iii) substitutability, (iv) leverage, and (v) liquidity risk.⁴⁸ The SEC should also form a committee comprised of experts from a range of fields such as legal, finance, economic, and quantitative analysis, to effectively develop these disclosures which would be publicly available on the SEC's website. Such experts can provide creative mechanisms for standardizing these highly complex items. For example, network science can provide useful insights as to how to measure interconnectedness.⁴⁹

With respect to reducing the fragmentation of the current regulatory structure, the SEC has admittedly fallen short in preventing several scandals and frauds that have led to significant investor losses.⁵⁰ Nevertheless, this Article argues that lawmakers should instead dedicate resources to reforming existing agencies instead of creating additional layers of ineffective regulation that could lead to repeated failures, undue complexities, and wasted resources. The SEC is better situated to regulate systemic risk in this regard because of its historic expertise in regulating the asset management industry under the federal securities laws.⁵¹ And although the SEC has historically

⁴⁷ See generally Cary Martin, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry*, 86 ST. JOHN'S L. REV. 87 (2012) (arguing that the lack of standardized procedures for measuring the risks of hedge funds can make it difficult for investors to optimize hedge fund selections amongst the thousands of available options).

⁴⁸ 12 C.F.R. pt. 1310, app. A(II)(d)(1) (2016).

⁴⁹ Stefan Thurner & Sebastian Poledna, *DebtRank-Transparency: Controlling Systemic Risk in Financial Networks*, 3 SCI. REP., no. 1888, 2013, at 2.

⁵⁰ See *infra* notes 334–342 and accompanying text (highlighting the SEC's failure to prevent the severe investor losses that resulted from the Madoff scandal, even though he was registered as an adviser under the Investment Advisers Act of 1940).

⁵¹ See Mary Jo White, Chair, SEC, *The Investment Company Act and Investment Advisers Act Standing the Test of Time, Opening Remarks at the 75th Anniversary of the Investment Company Act and Investment Advisers Act* (Sept. 29, 2015), <https://www.sec.gov/news/statement/im-40-acts-75th-anniv-chair-white-09292015.html> [<https://perma.cc/6BCQ-RDXQ>] (discussing the SEC's long history of regulating the asset management industry).

been restricted to promoting investor protection, the agency is developing an expertise in managing systemic risk with respect to registered investment funds. The SEC now has a new division that is partially dedicated to mitigating systemic risk, it has implemented new stress-testing measures on registered funds, and it recently created tailored regulation to deal with the systemic threats posed by money-market funds.⁵²

This Article contributes to the expanding area of scholarship which generally explores the extent to which transparency can be used to mitigate systemic risk. For example, Professor Viral V. Acharya from the New York University Stern School of Business has recently proposed that dealers disclose their derivatives positions on a market-wide basis which would incentivize such dealers to efficiently lower their counterparty risk.⁵³ Professor Anita I. Anand from the University of Toronto School of Law sought to establish a clear connection between securities regulation and systemic risk.⁵⁴ This Article is distinctive in that it is the first to analyze comparable claims as a solution to FSOC's failure to regulate systemically harmful funds. It also provides a novel framework for standardizing systemic risk disclosures, and borrows concepts from network science such as "PageRank" and "DebtRank" to explore creative mechanisms for measuring interconnectedness.

Part I of this Article provides the foundational framework for the proceeding analysis.⁵⁵ It begins with a detailed description of the federal securities laws that apply to the investment fund industry.⁵⁶ It then highlights the fundamental differences between these laws, and the prudential regulations that further constrain banking entities.⁵⁷ Part II illuminates the primary problem addressed in this Article in that the distinction between private investment funds and banking entities began to blur.⁵⁸ Hedge funds could potentially create and transmit systemic risk, although they were exempt from significant regulation.⁵⁹ With this regulatory conundrum, Part II delves into the regulatory response encapsulated by the creation of FSOC.⁶⁰ Part II continues by

⁵² See *infra* notes 334–342 and accompanying text (providing a brief description of the SEC's new systemic risk measures, which coincide with the increasing relationship between investor protection and systemic risk).

⁵³ Viral V. Acharya, *A Transparency Standard for Derivatives*, in *BANQUE DE FRANCE, FINANCIAL STABILITY REVIEW* 81, 88–89 (2013).

⁵⁴ See Anita I. Anand, *Is Systemic Risk Relevant to Securities Regulation?*, 60 U. TORONTO L.J. 941, 944 (2010) (arguing that systemic risk is relevant to securities regulation and therefore that increased transparency is a valuable goal to be achieved by these laws).

⁵⁵ See *infra* notes 68–113 and accompanying text.

⁵⁶ See *infra* notes 84–104 and accompanying text.

⁵⁷ See *infra* notes 105–113 and accompanying text.

⁵⁸ See *infra* notes 119–269 and accompanying text.

⁵⁹ See *infra* notes 119–164 and accompanying text.

⁶⁰ See *infra* notes 165–225 and accompanying text.

dissecting the reasons behind FSOC's failure to designate a hedge fund as a SIFI, and concludes with a detailed description of the hedge fund loophole created by FSOC's inaction.⁶¹ Part III explores the solution presented in this Article.⁶² The SEC is likely the next best alternative to effectively regulate systemically harmful funds.⁶³ It further proposes that the transparency mandate provided under federal securities laws could serve to increase financial stability and reduce systemic risk.⁶⁴ Part III further explains how designating the SEC in this regard could reduce the balkanization of the current regulatory structure.⁶⁵

I. ORIGINAL LEGISLATION ENHANCES INVESTOR PROTECTION

This section is largely dedicated to outlining the contours of the federal securities laws. Investor protection harms plagued the investment fund industry during the period preceding the Great Depression, which incentivized Congress to pass laws that ensured the accuracy of information with respect to these entities. Part I begins by expounding on the particulars of these harms and summarizes the laws that are tailored to this industry.⁶⁶ It then concludes by explaining how these laws are distinctive from the prudential rules that apply to banks.⁶⁷

A. *Industry Growth Reveals Investor Protection Harms*

Investment funds such as mutual funds and money-market funds are a predominant savings mechanism for individual households. The Investment Company Institute has estimated that investment funds collectively manage over \$18.2 trillion for over 90 million individuals in the United States.⁶⁸ Households across the country rely on these entities to fund retirement, save for college, and support several other categories of expenses.⁶⁹ In fact, as of June 30, 2014, “[a]bout 64 percent of 401(k) plan assets were held in mutual funds such as equity, balanced, bond, and money market funds.”⁷⁰

⁶¹ See *infra* notes 226–269 and accompanying text.

⁶² See *infra* notes 274–342 and accompanying text.

⁶³ See *infra* notes 274–333 and accompanying text.

⁶⁴ See *infra* notes 274–333 and accompanying text.

⁶⁵ See *infra* notes 334–342 and accompanying text.

⁶⁶ See *infra* notes 68–104 and accompanying text.

⁶⁷ See *infra* notes 105–113 and accompanying text.

⁶⁸ INVESTMENT COMPANY INSTITUTE, 2015 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE U.S. INVESTMENT COMPANY INDUSTRY 6 (55th ed. 2015).

⁶⁹ *Id.* at 33.

⁷⁰ *Frequently Asked Questions About 401(k) Plans*, INV. CO. INST., https://www.ici.org/policy/retirement/plan/401k/faqs_401k [<https://perma.cc/ECK4-UPDN>].

As background, these entities are essentially pooled vehicles that are created by professional advisers who solicit investments from a large number of investors.⁷¹ Advisers then invest the resulting pool into a variety of financial instruments, which can include equities, bonds, and cash-instruments, with the hopes of earning a sizable return to distribute to investors.⁷² Owning a single mutual fund share could thus provide investors with automatic exposure to a wide variety of investments and companies. Investors often prefer these vehicles over investing directly into the stock market because of the immediate access to a diversified pool of instruments, as well as the provided expertise of the advisers.⁷³ Despite these benefits, investment fund investors are particularly vulnerable because they are entrusting fund advisers to appropriately manage their allocated capital. There is also a conflict of interest that exists between these two parties. Investors seek to pay the lowest fees possible so as to preserve their *pro rata* share of returns, while advisers desire the highest possible fees to maximize their own personal profits.⁷⁴

Even still, the investment fund industry experienced a profound growth spurt during the period preceding the Great Depression. As one source noted, “[p]rior to 1921 . . . only 40 investment trusts came into existence. During the next five years, 139 more were created, and in 1927 alone another 140 were established.”⁷⁵ This rapid growth however revealed the pervasive investor protection issues that such investors faced during this time period. Shortly following the stock market crash of 1929, a study administered by Congress revealed the full extent of the fraudulent schemes that permeated this industry.⁷⁶ For example, many fraudulent advisers would operate funds as Ponzi schemes, where instead of implementing a legitimate investment strategy, advisers relied on new investments to fund their fees.⁷⁷ Another popular scheme ensured that advisers maintained control over all major decisions with

⁷¹ DIV. OF INV. MGMT., SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION xvii (1992) [hereinafter PROTECTING INVESTORS STUDY].

⁷² LEMKE ET AL., *supra* note 5, § 1.01.

⁷³ See *Mutual Funds Can Help Lower Investing Risks*, VANGUARD, <https://investor.vanguard.com/mutual-funds> [<https://perma.cc/S4KH-3DLE>] (discussing the various benefits of investing in mutual funds over investing in the stock market).

⁷⁴ See PROTECTING INVESTORS STUDY, *supra* note 71, at 255–56 (explaining the 1940 Act’s governance of conflicts of interest).

⁷⁵ MAURY KLEIN, *RAINBOW’S END: THE CRASH OF 1929*, at 129 (2001).

⁷⁶ See Paul F. Roye, Dir., Div. of Inv. Mgmt., SEC, *The Exciting World of Investment Company Management*, Remarks at the American Law Institute/American Bar Association Investment Company Regulation and Compliance Conference (June 14, 2001), <https://www.sec.gov/news/speech/spch500.htm> [<https://perma.cc/NR84-2BJ8>] (discussing investment trust study that was published in 1936).

⁷⁷ John Morley, *Collective Branding and the Origins of Investment Management Regulation: 1936–1942*, 6 VA. L. & BUS. REV. 341, 353 (2012) (noting that “[s]ome funds turned out to be Ponzi schemes”).

respect to the pool.⁷⁸ They would do this by selling non-voting stock to the general public, while retaining voting stock for themselves at a lower price.⁷⁹ Fraudulent advisers would also unload their personal stock holdings into investment funds at unfavorable prices, take interest-free loans directly from the pool's net assets, or adopt inordinately complex strategies that exposed investors to excessive losses.⁸⁰ To make matters worse, disclosures with respect to the underlying strategies of investment funds were often minimal or non-existent.⁸¹ Even if disclosures were made to investors, advisers would regularly stray away from the provided strategy, or fail to sufficiently diversify the pool's investments as promised.⁸² According to the SEC, investors suffered extraordinary losses during the early 1930s as a result of these abuses.⁸³

B. Heightened Regulation Under the 1940 Act and the Advisers Act

The inaugural Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") were the first among a series of laws designed to federally regulate the public capital markets.⁸⁴ They are frequently referred to as the "truth in securities" laws because they mandate that companies disclose all material information with respect to any securities sold to the general public.⁸⁵ Congress refrained from passing legislation that would require regulators to investigate the merits of each particular offering. Investors are instead empowered to make optimal investment decisions through the mandated disclosure of material information related to various aspects of the underlying issuer. President Roosevelt stated in a 1933 speech to Congress that "[t]here is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important ele-

⁷⁸ See Roye, *supra* note 76 (observing that "investment companies were structured to ensure that they remained under the control of their sponsors" as opposed to their stockholders).

⁷⁹ THE PECORA REPORT: THE 1934 REPORT ON THE PRACTICES OF STOCK EXCHANGES FROM THE "PECORA COMMISSION" 339 (photo. reprint 2009) (1934) [hereinafter PECORA REPORT] (outlining the abuses of the American investment fund industry).

⁸⁰ *Id.*

⁸¹ *Id.* at 348; see also *The Regulation of Management Investment Trusts for the Protection of Investors*, 46 YALE L.J. 1211, 1215 (1937) (discussing criticism of the investment fund industry's lack of transparency).

⁸² PECORA REPORT, *supra* note 79, at 348–49.

⁸³ See Roye, *supra* note 76 (noting specifically that "[t]he SEC estimated that between 1929 and 1936, investment company shareholders lost 40 per cent [sic] of their investments").

⁸⁴ See *The Laws That Govern the Securities Industry*, SEC (Oct. 1, 2013) <https://www.sec.gov/about/laws.shtml#secact1933> [hereinafter *Laws That Govern*] (describing the major laws that regulate the securities industry in the United States).

⁸⁵ *Id.*

ment attending the issue shall be concealed from the buying public.”⁸⁶ Protecting investors from the ubiquitous abuses that led to the Great Depression was the primary goal of Congress in adopting the federal securities laws.

In effectuating this goal, Congress incorporated the views implicit in a well-known quote by Louis D. Brandeis. He famously stated, “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”⁸⁷ In other words, broadcasting information to large audiences can serve to uncover malfeasance and bad behavior. In the context of securities regulation, such useful information includes a detailed description of the company, the intended use of proceeds received from the offering, audited financial statements, and several other categories of information.⁸⁸ Any issuers that fail to disclose such information are potentially subject to the civil liability provisions under these laws.⁸⁹ Issuers that engage in fraudulent conduct could also face criminal liability.

In response to the particular abuses that pervaded the investment fund industry, Congress passed the Investment Company Act of 1940 (“1940 Act”), which includes extensive investor protection guarantees that extend beyond the initial round of federal securities laws.⁹⁰ The 1940 Act is similarly structured to protect investors from fraud, while equipping them with the necessary tools to make better decisions with respect to their investment fund allocations. Investment funds were already subject to regulation under the Securities and Exchange Acts, as they were required to register initial public offerings under the Securities Act, and file periodic reports under the Exchange Act. Nevertheless, Congress deemed these laws insufficient from an investor protection standpoint. Congress also found that protecting this discreet category of investors was of a “national public interest” because, among other reasons, the collective savings of the country was closely intertwined

⁸⁶ Franklin D. Roosevelt, *Message from the President—Regulation of Security Issues Presented to the Senate*, 77 CONG. REC. 937 (1933).

⁸⁷ LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 92 (1914).

⁸⁸ See Marianne M. Jennings, *The Efficacy of Merit Preview of Common Stock Offerings: Do Regulators Know More Than the Market?*, 7 BYU J. PUB. L. 211, 212 (1993) (explaining that “Congress created a system of pre-sale registration and approval for proposed offerings through the Federal Securities Act of 1933” and noting that it did so “[b]ased on the rationale that disclosure of a firm’s past events serves some value investors in making their investment decisions”); *Laws That Govern*, *supra* note 84 (discussing information that must be disclosed as part of the Federal Securities Act’s registration requirements).

⁸⁹ Securities Act, 15 U.S.C. §§ 77k, 771, 77q (2012); Exchange Act, 15 U.S.C. §§ 78j, 78ff (2012).

⁹⁰ See LEMKE ET AL., *supra* note 5, § 5.02 (outlining the arduous disclosure requirements that apply to registered funds); Roye, *supra* note 76 (outlining how the 1940 Act was a direct response to the misconduct that pervaded the early investment fund industry).

with the industry.⁹¹ Thus, the 1940 Act extends the SEC's investor protection mandate by expanding the transparency requirements provided under the Securities and Exchange Acts, restricting retail investor access to risky investments, and implementing extensive governance reforms to protect against the inherent conflicts of interest that exist between advisers and their investors.

With respect to transparency, funds that are registered under the 1940 Act must disclose detailed information regarding investment strategies, management fees, portfolio turnover, and several other items that are unique to investment fund structures.⁹² In terms of enhancing governance, the 1940 Act prohibits several categories of conflict of interest transactions between such registered funds and its related parties.⁹³ For instance, advisers are prohibited from directly transacting with the fund so as to prevent advisers from negotiating favorable terms to the detriment and exclusion of underlying investors.⁹⁴ The 1940 Act further mandates that registered funds be governed by a board of directors to effectively serve as a "watchdog" over the adviser to further protect against conflicts of interest.⁹⁵ In terms of restricting access to risky instruments, registered funds are broadly prohibited from incurring excessive indebtedness on behalf of the pool.⁹⁶ For instance, taking out a loan to bolster fund returns could potentially run afoul of the 1940 Act.⁹⁷ Trading in derivatives can also constitute indebtedness and violate the 1940 Act because derivatives are intrinsically leveraged instruments where one party will inevitably incur losses once the transaction closes.⁹⁸ Parties trading derivatives must also regularly post margin or collateral over the course of the transaction.⁹⁹ As a result, registered funds are heavily restricted from trading in derivatives.¹⁰⁰

⁹¹ See Investment Company Act of 1940, 15 U.S.C. § 80a-1(a)-(b) (2012) (listing various ways in which the investment fund industry affects the national public interest).

⁹² LEMKE ET AL., *supra* note 5, § 5.02 (outlining in great detail the many disclosure requirements that apply to registered funds under the 1940 Act).

⁹³ 15 U.S.C. § 80a-17(a).

⁹⁴ See LEMKE ET AL., *supra* note 5, § 8.01 (listing ways in which certain individuals associated with the fund may not directly transact with it).

⁹⁵ PROTECTING INVESTORS STUDY, *supra* note 71, at 253.

⁹⁶ 15 U.S.C. § 80a-18.

⁹⁷ *Id.* § 80a-18(c). Section 18(f) however allows open-ended funds to borrow capital from a bank if, immediately after the bank borrowing, the fund's total net assets are at least three times total aggregate borrowings (300% asset coverage). *Id.* § 80a-18(f).

⁹⁸ See LEMKE ET AL., *supra* note 5, § 8.06(2)(b)(ii) ("The SEC and its staff generally view any transaction that exposes a fund's shareholders to a substantial degree of risk of loss through a leveraged investment to be a senior security or, at least, to raise senior security concerns under Section 18.").

⁹⁹ *Id.*

¹⁰⁰ The 1940 Act does provide some leeway for derivatives trading by registered funds if such contracts are sufficiently "covered" as defined under applicable rules. Fund advisers can "cover"

In conjunction with the 1940 Act, Congress simultaneously passed the Investment Advisers Act of 1940 (“Advisers Act”) which provides additional investor protection guarantees by subjecting investment company advisers to an additional layer of regulation.¹⁰¹ Advisers registered under this law have heightened fiduciary duties to act in the best interests of their clients in dispelling their accompanying investment advice.¹⁰² In addition, they must provide disclosures to their clients regarding their underlying advisory business. These disclosures include material information relating to their business practices, disciplinary history, certain conflicts of interest, and other material information.¹⁰³ Additionally, the SEC has the power to randomly inspect registered advisers to ensure compliance with these various provisions.¹⁰⁴

C. Distinction Between Investor Protection and Prudential Regulation

Overall, both the 1940 Act and Advisers Act expanded the SEC’s investor protection mandate with respect to the investment fund industry. As reflected in these laws, investor protection is usually enforced by increasing transparency to the broader marketplace. Enhanced transparency serves to protect individual investors by unveiling the truth behind their underlying investments. Even if investors fail to read mandated disclosures, the efficient market hypothesis postulates that a wide-range of market participants are instantaneously responding to this information, helping to ensure the accuracy of prices for publicly traded securities.¹⁰⁵ Mandated disclosure systems further deter issuers from engaging in fraudulent conduct because they are closely monitored by the SEC as well as by various market participants. The 1940 Act does utilize investor protection mechanisms that extend beyond simply enhancing transparency such as restrictions on leverage, derivatives, and il-

derivative contracts by earmarking or segregating liquid securities equal in value to the fund’s potential exposure from the leveraged transaction. Advisers can also cover an obligation by directly owning the instrument underlying that obligation. For instance, a fund that wants to take a short position in a certain stock can comply with the 1940 Act by owning an equivalent long position in that stock. These transactions must also be closely monitored by boards of directors and funds must consistently assess accuracy and completeness of their disclosure relating to derivatives. *Id.*

¹⁰¹ Investment Advisers Act of 1940 (“Advisers Act”), 15 U.S.C. § 80b-3 (2012).

¹⁰² See *Information for Newly-Registered Investment Advisers*, SEC, <https://www.sec.gov/divisions/investment/advoverview.htm> [<https://perma.cc/8PEW-2PL9>] (last modified Nov. 23, 2010) (outlining the fiduciary duty of investment advisers under current law).

¹⁰³ 15 U.S.C. § 80b-3(c).

¹⁰⁴ See *Information for Newly-Registered Investment Advisers*, *supra* note 102 (summarizing the compliance requirements for registered advisers).

¹⁰⁵ See generally Andrew W. Lo, *Efficient Market Hypothesis*, in THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS (Steven N. Durlauf & Lawrence E. Blume eds., 2d ed. 2007) (discussing the empirical research related to the efficient market hypothesis, which is admittedly inconclusive in certain respects).

liquid instruments. The SEC, however, has consistently reiterated that these provisions are designed to protect investors.¹⁰⁶

Although Congress acknowledged that the investment fund industry was closely tied to the national public interest in the 1940 Act, the tailored regulation was not specifically intended to mitigate systemic risk. This elusive term has yet to be defined by regulators, but it broadly refers to scenarios where the failure of a single financial institution could lead to a series of correlated defaults that serve to cripple the broader economy.¹⁰⁷ Institutions that fall into this category are commonly known as being “too big to fail.” Although the failure of a particular fund could admittedly lead to massive investor losses, these entities were not historically viewed by regulators as being systemically harmful. Investors could previously absorb any losses associated with an investment fund failure and the fund’s demise would not lead to correlated defaults of other funds or financial institutions.

In contrast, banking institutions were historically deemed as posing a systemic threat to the broader economy.¹⁰⁸ The failure of a single bank could lead to simultaneous bank-runs and other financial calamities the likes of which rippled through the global economy during the Great Depression.¹⁰⁹ Banks are consequently subject to a more robust system of regulation that extends beyond the transparency framework under the federal securities laws.¹¹⁰ These rules are commonly referred to as prudential regulation and they are specifically tailored to mitigate systemic risk by controlling the extent to which banks can extend capital to third parties. Prudential regulation thus mandates capital and reserve requirements, and includes governance mandates and detailed licensing standards to reduce the likelihood of a bank failure.¹¹¹ Banks are also overseen by a different group of regulators such as the Federal Reserve, and the Federal Deposit Insurance Corporation (“FDIC”).¹¹² This reflects a clear dividing line between investor protection and systemic risk from a regulatory perspective.¹¹³ Regulations previously made distinctions amongst the catego-

¹⁰⁶ *Laws That Govern*, *supra* note 84. The SEC specifically states on its website, “The focus of [the 1940 Act] is on disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations.” *Id.*

¹⁰⁷ See *infra* notes 135–140 and accompanying text (identifying prominent definitions of systemic risk proposed by regulators and scholars).

¹⁰⁸ Dombalagian, *supra* note 2, at 797.

¹⁰⁹ *Id.*

¹¹⁰ *Regulations*, *supra* note 3.

¹¹¹ See MALLOY, *supra* note 4, § 1.9; see also Hu, *supra* note 4, at 568–69 (describing various disclosure mandates that are generally applicable to banks).

¹¹² See Coffee & Sale, *supra* note 17, at 719 (listing the federal regulators of banks).

¹¹³ See Paredes, *supra* note 45, at 990 (“[T]he SEC has never principally been concerned with the kinds of systemic risks that hedge fund collapses pose. Systemic risk is a matter for other regulators such as the Federal Reserve and the Treasury Department.”).

ries of entities that created systemic risk, the administrative agencies charged with regulating systemic risk, and the regulatory tools used to mitigate systemic risk.

Yet as will be further discussed in Part II below, the emergence of systemic risk in the asset management industry has skewed the application of these traditional divisions. Numerous financial innovations have blurred the distinction between banking institutions and investment funds. Certain investment funds that are private in nature can now fall into the “too big to fail” category and their pervasive participation in the capital markets as increased their interconnectedness with a variety of financial intermediaries.

II. BLURRED DISTINCTIONS BETWEEN PRIVATE FUNDS AND BANKS

Financial innovation has blurred the distinction between private funds and banking entities, challenging the regulatory division between systemic risk and investor protection. Part II begins by explaining how the flexibilities granted to hedge funds under a web of exemptions created scenarios where these entities could become “too big to fail” and become heavily interconnected with other intermediaries.¹¹⁴ It proceeds by evaluating Congress’ response to this regulatory conundrum.¹¹⁵ FSOC was created under the Dodd-Frank Act to identify hedge funds that are systemically harmful.¹¹⁶ Any such funds would then be subject to the regulatory constraints that are imposed upon banks.¹¹⁷ Part II concludes by describing FSOC’s failure to identify a hedge fund as a SIFI, thereby creating a hedge fund loophole.¹¹⁸

A. Hedge Fund Strategies Create Systemic Risk Concerns

1. Prevalence of Hedge Fund Industry

Because investment fund laws were structured to protect investors, elite investors such as wealthy individuals and institutional investors were made free to invest in riskier strategies.¹¹⁹ These investors were deemed by courts and by regulators as having the resources to sufficiently protect themselves without the need for federal safeguards.¹²⁰ Thus investment funds that were

¹¹⁴ See *infra* notes 119–164 and accompanying text.

¹¹⁵ See *infra* notes 165–225 and accompanying text.

¹¹⁶ See *infra* notes 185–210 and accompanying text.

¹¹⁷ See *infra* notes 185–210 and accompanying text.

¹¹⁸ See *infra* notes 226–269 and accompanying text.

¹¹⁹ See *infra* note 121 (defining “elite investors”).

¹²⁰ See 15 U.S.C. § 77d(a)(2) (2012) (clarifying that the Securities Act only applies to “public” offerings); *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (holding that offerings that are restricted to investors who can “fend for themselves” are private in nature); 17 C.F.R.

exclusively offered to such elite investors¹²¹ were deemed private and were exempt from the arduous transparency, governance and access restrictions that would otherwise be mandated under the federal securities laws.¹²² Due to these exemptions, these private funds were often characterized by popular media as being opaque and highly exclusive.¹²³ Common categories of private funds include hedge funds, private equity funds, and venture capital funds.

With respect to the hedge fund industry, it is extremely heterogeneous as entities employ a multitude of strategies such as market neutral, global macro, opportunistic, emerging markets, and distressed securities, to name a few.¹²⁴ In contrast, registered funds, such as mutual funds and money-market funds, are quite constrained in terms of available investment opportunities due to the “access” limitations discussed in Part II.B.¹²⁵ Many registered funds focus their strategies on equities, bonds, and cash instruments.¹²⁶ In terms of guaranteeing absolute returns, the flexibilities afforded to hedge funds also allow

§ 230.501(a) (2016) (defining “accredited investors” as individuals with certain income thresholds or a high net worth requirements, or a variety of institutions that have been specified under this provision); Letter of General Counsel Discussing Factors to be Considered in Determining Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 285, 11 Fed. Reg. 10952 (Jan. 24, 1935) (specifying that the SEC will consider the relationship of offerees to the issuer in determining whether an offering is public).

¹²¹ For purposes of this Article, “elite” investors can include “accredited investors,” “qualified purchasers,” or any other category of investors that have been identified under the federal securities laws as having the resources to appropriately fend for themselves. Accredited investors include “any natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000” as well as a long list of institutions. 17 C.F.R. § 230.501(a). Qualified purchasers include family owned companies that own at least \$5,000,000 in investments as well as natural persons who own at least \$5,000,000 in investments. 15 U.S.C. § 80a-2(a)(51)(A)(i)–(ii) (2012).

¹²² If investment funds restrict investors to “qualified purchasers” then they are exempt from the leverage restrictions and other registration requirements promulgated under the 1940 Act. 15 U.S.C. § 80a-3(c)(7). Funds can also bypass these arduous requirements if they restrict the number of investors to 100 beneficial owners, and each such owner qualifies as an accredited investor. *Id.* § 80a-3(c)(1).

¹²³ See, e.g., Chris Arnade, *Hedge Funds: The Mysterious Power Pulling Strings on Wall Street*, *THE GUARDIAN* (June 1, 2014), <https://www.theguardian.com/money/2014/jun/01/hedge-funds-power-wall-street-pulling-strings> [<https://perma.cc/GX66-3AG8>] (“Hedge funds, to the regular citizen, seem shadowy and strange. Super secretive, absurdly paid, massive investment firms that manage, in total, close to \$2.2tn.”); John Cassidy, *The Great Hedge-Fund Mystery: Why Do They Make So Much?*, *NEW YORKER* (May 12, 2014), <http://www.newyorker.com/news/john-cassidy/the-great-hedge-fund-mystery-why-do-they-make-so-much> [<https://perma.cc/G5T4-TRGN>] (highlighting that “[t]he hedge-fund industry is famously secretive”).

¹²⁴ See Dion Friedland, *Synopsis of Hedge Fund Strategies*, *MAGNUM FUNDS* (Mar. 11, 2017), <http://www.magnum.com/hedgefunds/strategies.asp> [<https://perma.cc/Y6AH-UADM>] (detailing a number of different types of hedge fund strategies).

¹²⁵ See *supra* notes 96–100 and accompanying text (discussing “access” limitations).

¹²⁶ SEC, *MUTUAL FUNDS: A GUIDE FOR INVESTORS* 4 (2010).

them to employ protective strategies in declining markets.¹²⁷ For example, hedge fund adviser can liberally rely on short-trading to earn returns on investments that are declining in value.¹²⁸ These freedoms could have been a contributing factor in the hedge fund industry outperforming the mutual fund industry during the Great Recession.¹²⁹

Because of the flexibilities afforded to hedge funds, the industry has grown rapidly in recent decades.¹³⁰ Institutional investors such as pension plans, insurance companies, and endowments are increasingly relying on these vehicles to manage risk and earn returns.¹³¹ With their abilities to pursue the most innovative strategies, hedge funds are often considered a highly valuable component to investment portfolios.¹³² Some estimates have found that hedge fund advisers currently manage over \$3 trillion in the United States.¹³³ Others have predicted that the industry will grow to over \$5 trillion by the end of 2018.¹³⁴

2. Hedge Funds Can Become “Too Big to Fail”

In the midst of this massive growth however, various studies revealed that hedge funds could create and transmit systemic risk given their respective freedoms to trade in derivatives and carry unlimited leverage.¹³⁵ The

¹²⁷ See SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 33 (2003) [hereinafter IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS] (discussing various strategies made possible by hedge fund flexibility).

¹²⁸ *Id.*

¹²⁹ See Shadab, *supra* note 45, at 243–44 (arguing generally that hedge fund flexibilities allow such advisers to consistently outperform the broader markets). One estimate found that in 2008, “global equities lost 42 percent of their value while hedge funds worldwide lost a comparatively smaller 19 percent for their investors and with lower monthly volatility.” *Id.* (citing CREDIT SUISSE TREMONT, ONE FOR THE RECORD BOOKS: HEDGE FUND PERFORMANCE IN 2008, at 1 (2009)).

¹³⁰ See Cary Martin Shelby, *Privileged Access to Financial Innovation*, 47 LOY. U. CHI. L.J. 315, 326 (2015) (elaborating on the growth of the hedge fund industry).

¹³¹ See *id.* at 346–60 (providing broad overview of strategies and instruments that are simply unavailable to registered funds due to the 1940 Act restrictions).

¹³² *Id.* at 326.

¹³³ EVESTMENT, HEDGE FUND AUM AT \$3.13T AS ALLOCATIONS CONTINUE (2015), *available at* <https://www.evestment.com/resources/research-reports/2015-research-reports/global-hedge-fund-asset-flows-report—april-2015>.

¹³⁴ See Halah Touryalai, *Everybody Loves Hedge Funds, Assets Hit Record \$3 Trillion*, FORBES (June 25, 2014, 1:03 PM), <http://www.forbes.com/sites/halahtouryalai/2014/06/25/everybody-loves-hedge-funds-assets-hit-record-3-trillion> [<http://web.archive.org/web/20160213120442/http://www.forbes.com/sites/halahtouryalai/2014/06/25/everybody-loves-hedge-funds-assets-hit-record-3-trillion/#6fe0625c3fc8>] (citing a Citigroup report that makes such a prediction).

¹³⁵ See *infra* notes 144–153 and accompanying text (discussing various studies that have explored the threat of systemic risk generated by hedge funds).

original exemptions from regulation did not sufficiently anticipate that certain hedge fund strategies could have a spillover effect onto the general public. As briefly discussed above, systemic risk has not yet been defined by regulators. It vaguely refers to the risk that an institution's failure could lead to a sequence of calamities that debilitate the broader economy. Former Chair Mary Jo White of the SEC similarly referenced systemic risk as, "the likelihood that an entity's failure will cause a cascading failure across the financial system as a whole."¹³⁶ Early banking laws relied on similar notions of systemic risk, as the legislation was largely designed to prevent bank-runs, where market panics would cause consumers to simultaneously demand their deposits from multiple banks at a time.¹³⁷

In applying these basic notions of systemic risk to the private fund industry, highly leveraged hedge funds could create systemic risk by exposing its banking counterparties to corresponding risks of failure. This was evidenced by the near failure of LTCM in 1998.¹³⁸ LTCM was so heavily leveraged that it was set to default on over \$1 trillion of contracts with its investment banking counterparties.¹³⁹ This private entity essentially fell into the "too big to fail" category of financial institutions. The Federal Reserve was then forced to orchestrate a deal amongst these banks to prevent an economic collapse of epic proportions.¹⁴⁰ This single event signaled to the regulators that in spite of the limited investor protection risks created by hedge funds, they could still have a profound and lasting impact on the global economy.

3. Other Categories of Systemic Risk

In light of the recent financial crisis, scholars have attempted to expand notions of systemic risk to encompass a wider range of institutions and market activities. Professor Andrew Lo, for instance, has proposed that systemic risk "captures the linkages and vulnerabilities of the entire financial system, not just those of the banking system."¹⁴¹ In measuring systemic risk, Professor Lo suggests evaluating a variety of factors such as "leverage, liquidity,

¹³⁶ *Mitigating Systemic Risk in Financial Markets Through Wall Street Reforms: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. 23 (2013) (statement of Mary Jo White, Chair, SEC).

¹³⁷ Dombalagian, *supra* note 2, at 782.

¹³⁸ THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 12–14 (1999).

¹³⁹ *Id.* at 29.

¹⁴⁰ *Id.* at 13–14.

¹⁴¹ *Hedge Funds and the Financial Market: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 30 (2008) [hereinafter *Hedge Funds Hearing*] (written testimony of Professor Andrew Lo, Director, Laboratory for Financial Engineering, Massachusetts Institute of Technology, Sloan School of Management).

correlation, concentration, sensitivities, and connectedness.”¹⁴² Professor Steven Schwarcz likewise advocates for a more expansive definition that integrates both institutional and market systemic risk. He proposes that systemic risk be defined as:

[T]he risk that (i) an economic shock such as market or institutional failure triggers (through panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market volatility.¹⁴³

In applying these more expansive definitions, hedge funds that are not “too big to fail” could still create systemic risk through their interconnectedness with other financial institutions, their trading patterns, their sensitivities to market volatility, and through several other categories of activities. In 2007, Professors Lo and Amir E. Khandani published a case study that investigated the mysterious losses experienced by long/short equity hedge funds, which occurred in spite of stable prices within related equity and fixed-income markets.¹⁴⁴ The results of their study supported their hypothesis that:

[T]he initial losses . . . were due to the forced liquidation of one or more large equity market-neutral portfolios, primarily to raise cash or reduce leverage, and the subsequent price impact of this massive and sudden unwinding caused other similarly constructed portfolios to experience losses. These losses, in turn, caused other funds to deleverage their portfolios, yielding additional price impact that led to further losses, more deleveraging, and so on.¹⁴⁵

They further concluded that the losses experienced by these funds “provides the first piece of evidence that problems in one corner of the financial system—possibly the sub-prime mortgage sector and related credit markets—can spill over so directly to a completely unrelated corner: long/short equity strategies.”¹⁴⁶ As such, hedge funds have grown so interconnected that the collective losses of one subset of hedge funds can cascade into a completely

¹⁴² *Id.*

¹⁴³ Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008).

¹⁴⁴ Amir E. Khandani & Andrew W. Lo, *What Happened to the Quants in August 2007? 1* (Nat’l Bureau of Econ. Research, Working Paper No. 14465, 2008), available at <http://www.nber.org/papers/w14465.pdf> [<https://perma.cc/V9GQ-WFH9>].

¹⁴⁵ *Id.* at 1–2.

¹⁴⁶ Amir E. Khandani & Andrew W. Lo, *What Happened to the Quants in August 2007? 54* (Nov. 4, 2007) (unpublished manuscript), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1015987.

unrelated sector of strategies. Moreover, to the extent that there are multiple fund failures that result from heightened interconnectedness, hedge fund counterparties could be exposed to corresponding losses. Systemic risk can therefore be created by a large number of smaller hedge funds that are closely interconnected to other hedge funds and to other financial intermediaries.

During the financial crisis, hedge funds also engaged in trading patterns that arguably transmitted systemic risk to investment banks, insurance companies, and commercial banks. Large scale redemption requests from investors forced hedge fund advisers to liquidate their underlying equity positions at fire-sale prices.¹⁴⁷ Some have estimated that “one in four hedge funds sold more than 40 percent of its equity portfolio, and the hedge fund industry liquidated about 30 percent of its stock holdings.”¹⁴⁸ Also, because hedge funds control a large portion of the trading activities on the public capital markets, these massive liquidations had a spill-over effect on other financial intermediaries.¹⁴⁹ As one source noted, “[w]hen a hedge fund must suddenly sell billions in assets to cover a loan or a margin call, it can set off a damaging chain reaction.”¹⁵⁰ An Economic Letter published by the Federal Reserve Bank of San Francisco similarly found that “[t]he sale of those assets increases the supply on the market, which drives prices lower, especially when market liquidity is low. This in turn leads to more margin calls on other financial institutions, creating a downward spiral.”¹⁵¹ This study concluded that “hedge funds may be the most important transmitters of shocks during crises, more important than commercial banks or investment banks.”¹⁵² The collective impact that hedge funds can have on asset prices is heightened by the increasing connectedness of the industry.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ A recent study found that:

Hedge funds are also dominant players in several markets: in 2005, by one estimate, they accounted for 89 percent of U.S. trading volume in convertible bonds, 66 percent of volume in distressed debt, 33 percent of volume in emerging market bonds and in leveraged loans, 20 percent of speculative-grade bond volume, and 38 percent of credit derivatives volume. By early 2006, their estimated share of credit derivatives trading had increased to 58 percent.

John Kambhu et al., *Hedge Funds, Financial Intermediation, and Systemic Risk*, FRBNY ECON. POL'Y REV., Dec. 2007, at 1, 5.

¹⁵⁰ Al Lewis, *The Systemic Risk of Hedge Funds*, WALL ST. J. (Apr. 19, 2014, 8:25 PM), <http://www.wsj.com/articles/SB10001424052702303626804579505673648422470> [<https://perma.cc/AYS3-UFSN>].

¹⁵¹ Reint Gropp, *How Important Are Hedge Funds in a Crisis*, FRBSF ECON. LETTER, Apr. 14, 2014, at 1, 3.

¹⁵² *Id.* at 2.

Another report found that hedge funds facilitated a “bank run” on their prime brokerage counterparties in 2008.¹⁵³ When Lehman Brothers Holdings failed in 2008, hedge fund advisers demanded tens of billions of dollars from other investment banks that held large sums of the industry’s capital.¹⁵⁴ Given the interconnectedness of the financial sector, hedge fund advisers rightfully feared that other banks would declare bankruptcy. This would in-turn freeze the assets of such banks’ underlying counterparties. As such, hedge fund advisers were indeed justified in withdrawing their fund assets from these troubled financial institutions. These simultaneous withdrawals, however, signaled a systemic risk event that mirrored the bank-runs by depositors that exacerbated the Great Depression.¹⁵⁵

Hedge funds have been identified by some commentators as being an integral component to the shadow banking industry,¹⁵⁶ which refers to a network of “financial intermediaries involved in facilitating the creation of credit across the global financial system but whose members are not subject to regulatory oversight.”¹⁵⁷ Credit was traditionally created and managed exclusively by large banking institutions that were subject to prudential regulation to protect the general public against systemic shocks. Prior to the 2008 crisis, innovative financial instruments such as credit default obligations (“CDOs”) and credit default swaps (“CDS”), allowed hedge funds to directly participate in these credit markets without facing the stringent regulation provided under traditional banking laws.¹⁵⁸ Hedge funds purchased and sold a sizable percentage of the complex derivatives that were closely intertwined with toxic

¹⁵³ DIXON LLOYD ET AL., RAND CORP., HEDGE FUNDS AND SYSTEMIC RISK, at xviii (2012).

¹⁵⁴ *Id.*

¹⁵⁵ *See id.* (“During 2008, hedge funds withdrew tens of billions of dollars in assets from investment banks. These withdrawals were essentially a run on the bank, analogous to bank runs by individual depositors during the Great Depression . . .”).

¹⁵⁶ *See, e.g.,* Owen Davis, *What Is Shadow Banking? Risky Sector at Center of Sanders-Clinton Debates*, INT’L BUS. TIMES (Jan. 5, 2016, 2:00 PM), <http://www.ibtimes.com/what-shadow-banking-risky-sector-center-sanders-clinton-debates-2250172> [<http://web.archive.org/web/20160520063902/http://www.ibtimes.com/what-shadow-banking-risky-sector-center-sanders-clinton-debates-2250172>] (noting that “hedge funds, private equity firms, money market funds, insurance companies, [and] payday lenders” have all been considered shadow banks); Matussek, *supra* note 14 (discussing how some European regulators view hedge funds as shadow banks).

¹⁵⁷ *Shadow Banking System*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/shadow-banking-system.asp> [<https://perma.cc/GZ2G-W3MN>]; *see also* STEVEN A. RAMIREZ, LAWLESS CAPITALISM: THE SUBPRIME CRISIS AND THE CASE FOR AN ECONOMIC RULE OF LAW 92 (2013) (noting that while “the shadow banking system allowed banks to enhance their profits by maximizing loan volume, the system lacked any substantial legal and regulatory structure”).

¹⁵⁸ *See* FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT, at xxiv–xxv (2011) (discussing the shadow banking system and its role in the 2008 financial crisis).

debt.¹⁵⁹ Some have estimated that in 2006, hedge funds controlled up to fifty-eight percent of the credit derivative markets.¹⁶⁰

Simply trading in these toxic instruments would not automatically trigger a systemic risk event. In fact, many commentators have critiqued the new regulation of hedge funds under Dodd-Frank because the banking industry predominantly created and sold the complex derivatives that exploited subprime mortgages.¹⁶¹ Many commentators, however, have also argued that hedge funds similarly increased systemic risk by contributing to the burgeoning subprime mortgage bubble. Professor Photis Lysandrou concluded that in spite of hedge funds playing a limited role in constructing subprime mortgage instruments:

[H]ad it not been for the hedge funds' intermediary position between the investors seeking yield on the one hand and the banks that created the high yielding securities on the other, the supply of these securities would never have reached the proportions that were critical in precipitating the near collapse of the whole financial system. There should not have been a mass market for the subprime-backed securities given that their complex and opaque structure broke all the rules of commodity exchange, and without the hedge funds such a market would not in fact have existed.¹⁶²

As reflected by this quote, these private entities provided a significant amount of liquidity with respect to CDS, CDOs and other the toxic derivatives that were intertwined with subprime mortgages.¹⁶³ They were often the parties that were transacting directly with banks in purchasing these instruments on a massive scale. In some cases, hedge fund advisers may have even resuscitated

¹⁵⁹ *Id.* at 191–92. In 2010, the Financial Crisis Inquiry Commission (“FCIC”) also conducted a survey on 170 hedge funds that collectively managed over \$1.1 trillion. *Id.* at 192. Within this group of funds, FCIC found that “of all the CDOs issued in the second half of 2006, more than half of the equity tranches were purchased by hedge funds that also shorted other tranches.” *Id.*

¹⁶⁰ Kambhu et al., *supra* note 149, at 5.

¹⁶¹ See, e.g., James Richards, *Repeal of Glass-Steagall Caused the Financial Crisis*, U.S. NEWS (Aug. 27, 2012), <http://www.usnews.com/opinion/blogs/economic-intelligence/2012/08/27/repeal-of-glass-steagall-caused-the-financial-crisis> [<https://perma.cc/NTT5-5LYC>] (arguing that big banks, not hedge funds, were responsible for the crisis).

¹⁶² Photis Lysandrou, *The Primacy of Hedge Funds in the Subprime Crisis*, 34 J. POST KEYNESIAN ECON. 225, 227 (2011). He further noted that “[w]ealthy individuals did not have the requisite expertise to participate in this market while liquidity and risk control considerations prevented institutional asset managers from having more than a limited participation.” *Id.*

¹⁶³ *Id.*

the demand for such instruments when the subprime mortgage bubble showed signs of deflating.¹⁶⁴

In summary, the federal securities laws did not anticipate the degree through which hedge funds could create and transmit systemic risk. A single hedge fund can create a systemic risk event if it is so highly leveraged that it becomes “too big to fail,” exposing its banking counterparties to significant losses. Moreover, a series of smaller funds can create and transmit systemic risk given the industry’s significant participation in various sectors of the financial markets. If a group of interconnected funds simultaneously sells assets in order to fund redemption requests and/or margin calls, such asset classes can experience significant price declines. Hedge funds can also contribute to the inflation of a toxic bubble given their unfettered access to derivative markets. Financial innovation has made it easier for this private industry to participate in the creation and transmission of credit, which further calls into questions whether the industry should be subject to regulation that is comparable to banks.

B. Systemic Risk Authority Granted to FSOC

1. Academic Discourse Regarding Administrative Authority

In response to these systemic risk harms, academics have long debated the need for systemic risk regulation over the hedge fund industry. Some are skeptical as to the need for such regulation and they have argued that the near-failure of LTCM was the last scenario of a hedge fund becoming too big to fail.¹⁶⁵ Industry stakeholders have argued that although other large funds

¹⁶⁴ See Jesse Eisinger & Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA (Apr. 9, 2010, 12:00 PM), <https://www.propublica.org/article/the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble-going> [https://perma.cc/RY27-VVM6] (explaining how a prominent hedge fund may have purposely resuscitated the demand for the riskiest subprime mortgage derivatives, while also entering into protective CDS trades unbeknownst to its banking counterparties); see also Stephen Gandel, *Even Housing Bears Bought Big Homes Before the Crash*, FORTUNE (Apr. 1, 2013), <http://fortune.com/2013/04/01/even-housing-bears-bought-big-homes-before-the-crash/> [https://perma.cc/YR6A-4LZV] (pointing out that even some hedge fund managers who bet against the housing market invested heavily in real estate before the crash).

¹⁶⁵ See Steven Mufson, *Hedge Fund’s Collapse Met with a Shrug*, WASH. POST (Sept. 20, 2006), <http://www.washingtonpost.com/wp-dyn/content/article/2006/09/19/AR2006091901388.html> [https://perma.cc/84DB-VP26] (noting that the failure of Amaranth Advisors LLC led to over \$6 billion of losses for hedge fund investors, but the losses did not spread to the broader economy); see also ROBERT W. KOLB, LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE 630 (2010) (acknowledging how the failure of Amaranth Advisors LLC did not result in cascading losses to hedge fund counterparties). But see Julie Creswell & Vikas Bajaj, *\$3.2 Billion Move by Bear Sterns to Rescue Fund*, N.Y. TIMES (June 23, 2007), <http://www.nytimes.com/2007/06/23/business/23bond.html> [https://perma.cc/UU4A-CDUP] (dis-

have since failed, investors have been able to fully absorb such losses without exposing the broader economy to cascading harms.¹⁶⁶ In contrast, other scholars are still concerned with the growing interconnectedness of the industry with multiple facets of the financial markets. Professor Lo summarized this issue as follows:

[Hedge] funds have become central to the global financial system, providing loans, liquidity, insurance, risk-sharing, and other importance services that used to be the exclusive domain of banks. But unlike banks—which are highly regulated entities . . . with specific capital adequacy requirements and leverage and risk constraints—hedge funds and their investors are relatively unconstrained.¹⁶⁷

Some recent empirical studies have similarly concluded that the increasing interconnectedness of the hedge fund industry could expose the broader economy to systemic harms.¹⁶⁸

Even if scholars agree on the need to regulate systemic risk in the industry, there is still considerable disagreement over the appropriate form of regulation. Resolving this question is particularly challenging given the fragmented nature of the regulatory system.¹⁶⁹ With respect to the federal securities laws, the SEC holds primary responsibility for regulating the securities industry and protecting investors, while the Commodity Futures Trading Commission (“CFTC”) regulates commodity futures markets and the bulk of OTC derivatives.¹⁷⁰ As a result, many investment vehicles which trade in both the securities and commodities markets, have to either separately register with or obtain exemptions from the SEC and the CFTC.¹⁷¹ These agencies further delegate certain regulatory functions to self-regulatory organizations such as the Financial Industry Regulatory Authority (“FINRA”)¹⁷² and the National

cussing the \$3.2 billion bailout of a Bear Stearns hedge fund and noting that the failure to take such action “could have exposed Bear Stearns and the market to substantial losses”).

¹⁶⁶ See Mufson, *supra* note 165 (noting the view held by some industry stakeholders that there is no systemic risk posed by the collapse of major hedge funds like Amaranth).

¹⁶⁷ *Hedge Funds Hearing*, *supra* note 141, at 36.

¹⁶⁸ See *infra* notes 263–269 and accompanying text.

¹⁶⁹ See IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 127, at 23–32 (identifying the layers of rules and regulations that hedge funds must consider in maintaining relevant exemptions).

¹⁷⁰ See Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. CIN. L. REV. 537, 537–38 (2009) (discussing the regulatory divisions between the SEC and CFTC).

¹⁷¹ See *id.* at 541 (“The United States now operates under a ‘functional’ regulatory system. Under this system, different regulators are appointed to regulate particular financial services, even if those services are offered by the same firm.”).

¹⁷² See *Registration and Qualification*, FIN. INDUS. REGULATORY AUTH., <https://www.finra.org/industry/registration-qualification> [<https://perma.cc/CCL2-LVKR>] (outlining registration requirements for broker-dealers).

Futures Association (“NFA”),¹⁷³ which create additional registration requirements for industry participants. With respect to the banking industry, the FDIC¹⁷⁴ and the Federal Reserve¹⁷⁵ are the administrative bodies charged with monitoring the banking system and monetary policies. The Federal Reserve must frequently work with the Department of the Treasury in ensuring the nation’s financial stability.¹⁷⁶

Selecting the appropriate administrative body to oversee systemically harmful hedge funds amongst this panoply of options is subject to significant debate and controversy. The SEC attempted to assert jurisdiction over the industry in 2004 with the passage of the now defunct Hedge Fund Rule which required certain hedge fund advisers to register under the Advisers Act.¹⁷⁷ In 2006, in *Goldstein v. SEC*, the DC Circuit notably ruled that the agency overstepped its administrative authority in adopting the Hedge Fund Rule, and it implicitly instructed Congress to undertake the task of regulating the industry.¹⁷⁸ Professors John C. Coffee and Hillary Sale have expressed concerns with simply extending the SEC’s authority in this regard. In particular, they have identified the SEC’s failure in implementing net-capital requirements over broker-dealers and suggested that systemically harmful hedge funds be subject to a degree of prudential regulation that would extend beyond the SEC investor protection mandate.¹⁷⁹ They have specifically suggested that “the Federal Reserve [be granted] authority to monitor and restrict the leverage of all financial institutions that are ‘too big to fail.’”¹⁸⁰ They reasoned that “banking regulators have the natural comparative advantage in this area. Cap-

¹⁷³ See *Registration*, NAT’L FUTURES ASS’N, <https://www.nfa.futures.org/NFA-registration/index.HTML> [<https://perma.cc/S6DB-VTUS>] (outlining registration requirements for professionals who trade in futures).

¹⁷⁴ See *FDIC Law, Regulations, Related Acts*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/regulations/laws/rules/> [<https://perma.cc/YP68-EPSJ>] (last updated Oct. 31, 2016) (providing an overview of the relevant laws overseen by this agency).

¹⁷⁵ See *Regulations*, *supra* note 3 (highlighting the regulations applicable to banking entities).

¹⁷⁶ See *Duties & Functions of the U.S. Department of the Treasury*, U.S. DEP’T OF THE TREASURY, <https://www.treasury.gov/about/role-of-treasury/Pages/default.aspx> [<https://perma.cc/TU6N-EXE6>] (last updated Apr. 22, 2016) (discussing major functions of the Treasury Department).

¹⁷⁷ *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

¹⁷⁸ See *Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006) (vacating the hedge fund rule).

¹⁷⁹ See Coffee & Sale, *supra* note 17, at 717 (agreeing with “suggestions for a reallocation of authority between the SEC and other financial regulators that moves the ‘prudential’ supervision of the ‘safety and soundness’ of investment banks to banking regulators, but maintains and consolidates authority for consumer protection and oversight of business practices within the SEC”).

¹⁸⁰ *Id.* at 776.

ital adequacy regulation, including the supervision of risk management, is the core business of banking regulators.”¹⁸¹

Other scholars have emphasized the need for consolidation of regulatory agencies because systemic risk can be transmitted through a variety of channels and financial instruments.¹⁸² Merging the CFTC and SEC could ensure more efficient oversight over systemically harmful strategies that may rely on a complex interplay of securities, futures, and OTC derivatives.¹⁸³ Another popular solution proposed by researchers in this area is to create yet an additional administrative body to oversee all systemically harmful financial institutions.¹⁸⁴ This “super-regulator” would use information collected from existing administrative agencies to regulate institutions that are deemed systemically harmful.

2. SIFI Designation Process for Nonbank Entities

Congress finally reconciled this debate with the passage of the Dodd-Frank Act, which created a new regulatory framework for hedge funds. It first reinstated the SEC’s previous Hedge Fund Rule by requiring many hedge fund advisers to register under the Advisers Act.¹⁸⁵ This law is yet another tool for the SEC to utilize in effectuating its investor protection mission and would thus have a limited impact on mitigating systemic risk.¹⁸⁶ For the sake of clarity, the Advisers Act does not include specific restrictions on leverage or derivatives trading. Its mandated disclosures are very limited in comparison to those required under the 1940 Act and the Securities Act. These laws would require more detailed disclosures with respect to the underlying fund such as total leverage, specific strategy descriptions, audited financial statements, and several other categories of information.

In regulating systemically harmful hedge funds, the Dodd-Frank Act granted authority to a newly created administrative agency called FSOC.¹⁸⁷ FSOC is comprised of ten voting members and five nonvoting members from

¹⁸¹ *Id.* at 777.

¹⁸² See Roberta S. Karmel, *The Future of the Securities and Exchange Commission as a Market Regulator*, 78 U. CIN. L. REV. 501, 533–34 (2009) (arguing that the SEC and CFTC should be combined into a single regulatory authority).

¹⁸³ See *id.* at 534 (asserting that consolidation would increase regulatory efficiency).

¹⁸⁴ See *supra* note 18 (listing various commentators that have proposed an additional administrative body).

¹⁸⁵ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010) (codified as amended at 15 U.S.C. § 80b-3(b) (2006 & Supp. IV 2010)).

¹⁸⁶ See *supra* notes 101–104 and accompanying text (outlining the investor protections created by the Advisers Act).

¹⁸⁷ See 12 U.S.C. § 5321 (2012) (establishing the FSOC).

various administrative bodies.¹⁸⁸ Voting members include Chairpersons of the SEC, CFTC, and the Federal Reserve.¹⁸⁹ Nonvoting members include state regulators such as a state insurance commissioner, banking supervisor, and securities commissioner.¹⁹⁰ FSOC's authority extends to "identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system."¹⁹¹ As previously noted, FSOC also has the power to designate both "bank entities" and "nonbank entities," such as hedge funds for example, as "systemically important financial institutions,"¹⁹² which would cause such entities to be subject to a degree of prudential regulation.¹⁹³

FSOC has since developed a comprehensive three-stage review process for determining whether nonbank entities should be designated as SIFIs.¹⁹⁴ Stage 1 is essentially designed to narrow the universe of entities that will be subject to more detailed evaluation under subsequent stages.¹⁹⁵ Entities that meet specific quantitative thresholds during this stage are subject to additional evaluation by FSOC in Stage 2. In order to surpass this stage, entities must first have at least \$50 billion in total consolidated assets.¹⁹⁶ Entities that fall into this category must then surpass at least one additional threshold related to gross national credit, total derivatives liability, and other quantitative thresholds that are mostly related to leverage.¹⁹⁷ Thus, hedge funds that have less than \$50 billion in total consolidated assets will never be subject to a SIFI designation.

If a nonbank entity exceeds the Stage 1 thresholds, it will then be subject to further evaluation under Stage 2. At this stage, FSOC analyzes the following six characteristics with respect to the nonbank entity: "size, interconnect-ness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny."¹⁹⁸ FSOC interpretive guidance provides possi-

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ See *Financial Stability Oversight Council*, *supra* note 21.

¹⁹² See Winkler, *supra* note 22 (discussing FSOC's SIFI designation process).

¹⁹³ *Id.*

¹⁹⁴ 12 C.F.R. pt. 1310, app. A(III) (2016).

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* at app. A(III)(a).

¹⁹⁷ *Id.* The additional thresholds are as follows: "\$30 billion in gross notional credit default swaps outstanding for which a nonbank financial company is the reference entity," "\$3.5 billion of derivative liabilities," "\$20 billion in total debt outstanding," a threshold leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1," and "a threshold ratio of total debt outstanding (as defined above) with a maturity of less than 12 months to total consolidated assets (excluding separate accounts) of 10 percent." *Id.*

¹⁹⁸ *Id.* at app. A(II)(d)(1).

ble metrics for each of these factors. For instance, interconnectedness “captures direct or indirect linkages between financial companies that may be conduits for the transmission of the effects resulting from a nonbank financial company’s material financial distress or activities.”¹⁹⁹ This could be measured by reviewing “[c]ounterparties’ exposures to a nonbank financial company”²⁰⁰ or “[n]umber, size, and financial strength of a nonbank financial company’s counterparties.”²⁰¹ FSOC uses these characteristics to determine whether a nonbank entity is vulnerable to financial distress, and whether an entity’s financial distress would adversely impact the broader economy.

The SEC assists FSOC in collecting pertinent information from hedge fund advisers in applying this six-category framework. This information is collected via a newly created Form PF, which further requires that hedge fund advisers report proprietary information to the SEC on a confidential basis.²⁰² Reported information can include a description of its assets under management, use of leverage, counterparty credit exposure, trading and investment positions, valuation policies and practices, types of assets held, and “such other information as the Commission . . . determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.”²⁰³ All hedge fund advisers that are required to register under the Advisers Act must also complete some variation of this Form PF.²⁰⁴

Once a nonbank entity surpasses Stage 2 review, it is then subject to additional evaluation by FSOC during Stage 3.²⁰⁵ If a nonbank entity enters into Stage 3, FSOC notifies such entity that it is being evaluated for a possible SIFI designation.²⁰⁶ FSOC then undergoes a more detailed analysis of the above six-factors and can then request additional information from the primary regulator or directly from the nonbank entity. At this stage, FSOC is largely assessing any factors that “could mitigate or aggravate the potential of the nonbank financial company to pose a threat to the United States.”²⁰⁷

¹⁹⁹ *Id.* at app. A(II)(d)(2).

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² See 17 C.F.R. § 275.204(b)-1 (2016) (requiring registered investment advisers who meet certain qualifications to file a Form PF annually).

²⁰³ 15 U.S.C. § 80b-4(b)(3) (2012).

²⁰⁴ 17 C.F.R. § 275.204(b)-1.

²⁰⁵ 12 C.F.R. pt. 1310, app. A(III)(c).

²⁰⁶ *Id.*

²⁰⁷ *Id.* Such factors include, for example, the “opacity of the nonbank financial company’s operations” and “a nonbank financial company’s resolvability.” *Id.*

If a SIFI designation is made during Stage 3, the nonbank entity can request a hearing contesting this finding.²⁰⁸ FSOC then discloses any final SIFI designations to the general public. FSOC, however, refrains from disclosing its detailed analyses that occur during the three stages preceding a SIFI designation.²⁰⁹ As briefly discussed above, a SIFI designation can be extremely disruptive as it exposes the underlying entity to enhanced prudential regulation by the Federal Reserve. Applying prudential regulation to a hedge fund could make it difficult, if not impossible, for the adviser to employ its underlying strategy. Should a SIFI fail, it would also enter into a receivership process that would be administered and supervised by the FDIC.²¹⁰

3. Predicted Shortcomings

Proponents of the SIFI designation process for nonbank entities have argued that it is the ideal mechanism for reducing the unique categories of systemic risk created by these entities. They have largely reasoned that highly leveraged entities that are creating negative externalities, similar to those created by banks, should be subject to comparable regulation.²¹¹ Many have further hypothesized that the prudential standards that would result from a SIFI designation could serve as a “best practices” model for the respective industry.²¹² This could in turn incentivize other institutions to adopt comparable standards.²¹³ A SIFI designation could even benefit the underlying fund because counterparties would be more willing to transact with firms that follow prudential standards.²¹⁴ Investors may be more willing to invest in such funds given the additional layers of protection provided by prudential regulation.

Even still, the critics of the SIFI designation process have gained more traction given the difficulties that FSOC has encountered in designating an asset manager as a SIFI, which will be further discussed in Part II.C. below. With respect to registered funds, they are already subject to layers of regula-

²⁰⁸ *Id.*

²⁰⁹ *See id.* (stating that “[t]he Council does not intend to publicly announce the name of any nonbank financial company that is under evaluation for a determination prior to a final determination with respect to such company”).

²¹⁰ Winkler, *supra* note 22.

²¹¹ *See, e.g.,* David Schneider, *If at First You Don’t Succeed: Why the SEC Should Try and Try Again to Regulate Hedge Fund Advisers*, 9 J. BUS. & SEC. L. 261, 307 (advocating that leverage limits be imposed upon hedge funds); *see also* Matussek, *supra* note 14 (noting the view of some European regulators that hedge funds can carry the same degree of risk as banks).

²¹² *See, e.g.,* Gregory S. Rowland, *Designation of Asset Managers and Funds as Systemically Important Non-Bank Financial Institutions*, INVESTMENT LAW., Apr. 2013, at 1, 5.

²¹³ *Id.*

²¹⁴ *Id.*

tion under the federal securities laws.²¹⁵ Although these laws were originally designed to enhance investor protection, they can be used to mitigate systemic risk as will be analyzed in Part III of this Article. In regards to private funds, the hedge fund industry has been vehemently opposed to the use of prudential regulation as a means to mitigate systemic risk because the costs of doing so could be detrimental to the operations of the fund. As one source noted:

The cost implications of being designated a SIFI could be ruinous for some firms. Unlike banks, hedge funds simply do not have the financial resources or infrastructure to handle the subsequent regulatory requirements they would be expected to adhere to. SIFIs could be forced to hold more capital, impose basic liquidity risk management standards, limits on liquidity risk, stress testing, living wills and limits on single counterparty credit exposures.²¹⁶

As asserted by this quote, if a hedge fund were designated as a SIFI and therefore subject to prudential regulation, it could destroy its ability to pursue its underlying strategy. Imposing this degree of regulation could in turn hamper the returns of hedge fund investors. This can become problematic if the benefits of imposing such regulation fail to exceed its extensive costs. With the potentially destructive costs of complying with prudential regulation, there is a high likelihood that a hedge fund identified as a SIFI would sue FSOC for an arbitrary and capricious designation.²¹⁷ This looming threat of litigation has likely stifled FSOC's ability to designate a hedge fund as a SIFI.

In terms of assessing the benefits of prudential regulation, commentators have questioned the degree to which the SIFI model can actually reduce the unique categories of systemic risk created by the hedge fund industry. As discussed above, hedge funds must first have at least \$50 billion in total consolidated assets in order to be classified as a SIFI. Although this threshold may indeed capture funds that are deemed "too big to fail," it will not capture smaller funds that are heavily interconnected with other financial intermediaries. As one source noted, "[although] reforms focus on the operations of the largest hedge funds . . . recent research has pointed to risks created by large numbers of small or medium-sized hedge funds that pursue similar strate-

²¹⁵ See *supra* notes 84–104 and accompanying text (summarizing the layers of federal legislation that applies to registered funds).

²¹⁶ Charles Gubert, *Regulation: the Unintended Consequences*, HEDGE FUND J. (June 2015), <https://www.thehedgefundjournal.com/news/regulation-unintended-consequences> [https://perma.cc/W9RV-SBX5].

²¹⁷ See *infra* notes 226–252 and accompanying text (discussing MetLife's recent victory in overturning its SIFI designation through the federal courts).

gies.”²¹⁸ Moreover, the empirical studies in this area have largely found that interconnectedness is the preeminent area of concern in terms of mitigating systemic risk as the near failure of LTCM was arguably the last instance of a fund becoming “too big to fail.”²¹⁹

Other sources have similarly questioned whether the SIFI designation process can appropriately capture the growing complexities of the financial markets. Michael Cappucci, who is currently the Senior Vice President at Harvard Management Company, identified FSOC’s potential shortcomings, stating that “[u]nder conditions of true complexity where unpredictability reigns, the knowledge required to fully understand—never mind forecast and effectively influence—a system exceeds that of any single person or group as august as one that comprises the FSOC.”²²⁰ He further noted that the best way to address the complexities of the markets that have created the unique categories of systemic risk discussed herein, is to improve overall market efficiency, as opposed to imposing prophylactic rules.²²¹ More specifically he stated, “The way to improve the functioning of the market through regulator proof rules is to pursue policies that promote market efficiency, with features like transparency, liquidity, and predictability; and discourage or eliminate the obstacles of market efficiency, like opacity, exogenous shocks, and unpredictability.”²²² As will be further discussed in Part III, creating a regulatory framework under the federal securities laws may be the best mechanism for improving market efficiency and thereby reducing systemic risk with respect to the asset management industry.

Prudential regulation has also been frequently categorized by commentators as a poor fit for the nuances and intricacies of the asset management industry.²²³ In applying this framework to investment funds, the Federal Reserve would invariably have to consult with the SEC, and other regulatory agencies, on how to do so. There is a risk, however, that “the Fed will give insufficient deference to the extensive experience and knowledge residing

²¹⁸ LLOYD ET AL., *supra* note 153, at 100.

²¹⁹ See *supra* notes 165–168 and accompanying text. Even still, a hedge fund can still become “too big to fail” under certain market conditions, particularly because the freedoms to incur unlimited leverage and engage in unlimited derivatives trading under the 1940 Act have not yet been lifted.

²²⁰ Cappucci, *supra* note 31, at 30.

²²¹ *Id.* at 32.

²²² *Id.*

²²³ See Joshua S. Wan, Note, *Systemically Important Asset Managers: Perspectives on Dodd-Frank’s Systemic Designation Mechanism*, 116 COLO. L. REV. 805, 815 (2016) (explaining the structural differences between banks and asset managers that would make prudential regulation impractical and/or unnecessary for asset managers).

with the existing regulators.”²²⁴ To the extent that the Federal Reserve fails to appropriately consult with regulators in this regard, this could increase the regulatory complexity that currently applies to the asset management industry. The creation of FSOC seems to have extended and complicated the patchwork of regulation that applies to the industry and it further fragments the regulatory structure. This growing phenomenon inevitably produces ineffective and redundant regulation.²²⁵ By and large, these critiques served as a forewarning to FSOC’s inability to apply the SIFI framework to investment funds.

C. Hedge Fund Loophole

1. FSOC Fails to Designate a Hedge Fund as a SIFI

Since adopting the detailed SIFI designation process for nonbank entities, FSOC has encountered numerous challenges in attempting to identify a hedge fund as a SIFI. These challenges relate to deficiencies in the systemic risk data collected by the SEC, criticisms to systemic risk studies sanctioned by FSOC, and massive resistance to the SIFI designation process by numerous industry participants. For instance, FSOC instructed the Treasury Department’s Office of Financial Research (“OFR”) to prepare a study to investigate whether the asset management industry contributed to systemic risk.²²⁶ The final report was published in September 2013 and it did in fact find that investment funds could create systemic risk through a wide range of activities such as the increasing use of leverage, and the risk of facing excessive redemption requests during times of financial distress.²²⁷

This OFR study, however, was severely criticized by a large number of industry participants, particularly because the study seemed to focus on registered funds that are already subject to layers of regulation under the federal securities laws.²²⁸ These laws include stringent restrictions on leverage, as

²²⁴ Douglas J. Elliott, *Regulating Systemically Important Financial Institutions That Are Not Banks*, BROOKINGS INST. (May 9, 2013), <https://www.brookings.edu/research/regulating-systemically-important-financial-institutions-that-are-not-banks> [<https://perma.cc/X3CS-ECL6>].

²²⁵ See generally Shelby, *supra* note 42 (arguing that the extensive patchwork of regulation that applies to the investment fund industry has made it difficult for lawmakers to regulate the increasing “publicness” of the industry).

²²⁶ See generally OFFICE OF FIN. RESEARCH, *ASSET MANAGEMENT AND FINANCIAL STABILITY* (2013) (reviewing the ways in which the asset management industry can threaten the stability of the economy).

²²⁷ *Id.* at 21–22.

²²⁸ See Chris Bruce, *Treasury Report on Asset Management Criticized in Early Feedback Sent to SEC*, BLOOMBERG BNA (Nov. 5, 2013), <http://www.bna.com/treasury-report-on-asset-management-criticized-in-early-feedback-sent-to-sec> [<https://perma.cc/Z7ND-VTS9>] (discussing early criticism of the OFR report); see also *Comments on OFR Study on Asset Management Issues*, SEC, <http://>

well as requirements that managers maintain a high percentage of liquid assets in order to fund frequent redemption requests.²²⁹ Many commenters similarly found that the study had no empirical basis for deeming these laws insufficient in managing the emerging systemic risk concerns identified by this report.²³⁰ Other commenters observed that the study did not appropriately distinguish amongst categories of fund strategies, each of which could potentially produce varying degrees of systemic risk concerns.²³¹ This fervent opposition also found support from the SEC community, as SEC Commissioner Donald M. Gallagher stated that the “OFR Report completely failed to provide a legitimate rationale for systemic risk designation.”²³² He further warned that “[the report’s] myriad inaccuracies and unsupported conclusions would make excellent fodder for the litigation that would be sure to follow any decision to designate asset managers as SIFIs.”²³³

Due to the deficiencies in the OFR report, as well as the rampant opposition repeatedly expressed by industry participants, FSOC announced during a meeting in July 2014 that it would “undertake a more focused analysis” of how the products and activities of the asset management industry as a whole contribute to systemic risk.²³⁴ In effectuating this task, FSOC published a study in April 2016 entitled, *Update on Review of Asset Management Products and Activities* (“FSOC Report”).²³⁵ The FSOC Report made clear distinctions amongst various categories of asset managers. It then provided a more thorough analysis of how each category could contribute to systemic risk.

www.sec.gov/comments/am-1/am-1.shtml [<https://perma.cc/8782-PP2N>] (last modified Sept. 14, 2015) (providing links to all comment letters received in response to OFR report).

²²⁹ See *supra* notes 84–104 and accompanying text (summarizing the layers of federal legislation that apply to registered funds).

²³⁰ See, e.g., Inv. Co. Ins., Comment Letter on Public Feedback on OFR Study on Asset Management Issues 3 (Nov. 1, 2013), https://www.ici.org/pdf/13_ici_ofr_asset_mgmt.pdf [<https://perma.cc/CJ3G-3LMC>] (“The OFR’s attempt to describe in broad terms the ‘activities’ of asset managers has the unfortunate effect of obscuring the regulatory protections to which registered funds are subject under the Investment Company Act of 1940, other federal securities laws, and related SEC regulations.”).

²³¹ Vanguard, Comment Letter on Public Feedback on OFR Study on Asset Management Issues 3 (Nov. 26, 2013), <https://www.sec.gov/comments/am-1/am1-30.pdf> [<https://perma.cc/2EKD-EVPS>].

²³² SEC, Comment Letter on Public Feedback on OFR Study on Asset Management Issues 5 (May 15, 2014), <https://www.sec.gov/comments/am-1/am1-52.pdf> [<https://perma.cc/LWA7-R8JF>].

²³³ *Id.*

²³⁴ Press Release, U.S. Treasury Dep’t Office of Pub. Affairs, Financial Stability Oversight Council Meeting July 31, 2014 (July 31, 2014), <https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031%202014.pdf> [<https://perma.cc/9AEH-CXUT>].

²³⁵ See generally FIN. STABILITY OVERSIGHT COUNCIL, FINANCIAL STABILITY OVERSIGHT COUNCIL UPDATE ON REVIEW OF ASSET MANAGEMENT PRODUCTS AND ACTIVITIES (Apr. 18, 2016) [hereinafter FSOC REPORT].

With respect to registered funds, the FSOC Report acknowledged that certain classes of mutual funds have increased their use of leverage in recent years.²³⁶ Alternative asset mutual funds, which heavily rely on derivatives to chase returns, have also grown in popularity.²³⁷ FSOC, however, seemed to approve of the SEC's recent proposals to strengthen the capital restrictions and liquidity constraints provided under the 1940 Act as a means of addressing these systemic risk concerns.²³⁸ So although the 1940 Act was originally designed to enhance investor protection, this is perhaps an implicit approval by FSOC to use this legislation as a means to mitigate systemic risk for registered funds. Moreover, proposing these rules was perhaps a strategic move by the SEC to prevent FSOC from designating a registered fund as a SIFI. Although FSOC could still presumably do so, it is highly unlikely particularly if the reforms proposed by the SEC are eventually adopted.

In regards to the hedge fund industry, the FSOC Report examined data retrieved from Form PF filings to examine the extent to which hedge funds are excessively leveraged.²³⁹ Although it concluded that a potentially troubling degree of leverage is concentrated amongst a small group of larger hedge funds, it identified several deficiencies in the systemic risk data collected via the Form PF. The report specifically found that the "Form PF does not provide complete information on the economics and corresponding risk exposures of hedge fund leverage or potential mitigates associated with reported leverage levels."²⁴⁰ The report further noted the limitations of the existing regulatory reforms in protecting against future financial crises. For example, the new clearing requirement for certain OTC derivatives does not equally apply to all financial instruments, and it has not been sufficiently test-

²³⁶ *Id.* at 19.

²³⁷ Sam Diedrich, 'Alternative' or 'Hedged' Mutual Funds: What Are They, How Do They Work, and Should You Invest?, FORBES (Feb. 28, 2014, 10:29 PM), <http://www.forbes.com/sites/samdiedrich/2014/02/28/alternative-or-hedged-mutual-funds-what-are-they-how-do-they-work-and-should-you-invest/#1097ab026200> [<http://web.archive.org/web/20170303084937/https://www.forbes.com/sites/samdiedrich/2014/02/28/alternative-or-hedged-mutual-funds-what-are-they-how-do-they-work-and-should-you-invest/#432e2ffe51bf>] (discussing recent developments in the mutual fund industry).

²³⁸ FSOC REPORT, *supra* note 235, at 21; *see also* Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (proposed Dec. 28, 2015) (to be codified at 17 C.F.R. pts. 270, 274) [hereinafter Use of Derivatives Proposed Rule] (proposing a rule to "provide an updated approach to the regulation of funds' use of derivatives"). *But see* Lisa Lambert & Trevor Hunnicutt, *Rule on Funds' Derivatives Use Unlikely This Year: U.S. SEC Commissioner*, REUTERS (Oct. 12, 2016, 12:24 PM), <http://www.reuters.com/article/us-sec-funds-derivatives-idUSKCN12C21W> [<https://perma.cc/R7C7-TD2T>] (predicting that "[t]he top U.S. securities regulator is unlikely to approve [the Use of Derivatives Proposed Rule]" under the shifting leadership of the SEC).

²³⁹ FSOC REPORT, *supra* note 235, at 15.

²⁴⁰ *Id.* at 20.

ed under varying market conditions.²⁴¹ FSOC also queried whether counterparties can fully assess the risks of transacting with hedge funds given the complexity of their strategies.²⁴² Due to these limitations, FSOC formed an interagency group to address the potential gaps in information, and to assess an optimal form of regulation for systemically harmful funds.²⁴³

FSOC published a report in November 2016 which documented the progress of this interagency group.²⁴⁴ It similarly found that hedge funds can create and transmit systemic risk “(1) by causing or contributing to significant disruptions of key financial markets through forced selling, or (2) by transmitting stress to counterparties that are large, highly interconnected financial institutions.”²⁴⁵ This report also identified the ongoing data limitations that prevent the interagency working group from assessing the true impact that hedge funds have on the markets. It specifically stated, “It is difficult to use certain existing regulatory data sources because reporting is not standardized across financial market utilities and regulatory agencies.”²⁴⁶

These transparency deficits are not likely to be resolved in the near future given recent initiatives to reduce regulation over private markets. More specifically, the new administration has introduced several deregulatory initiatives designed to repeal major portions of the Dodd-Frank Act²⁴⁷ and the newly appointed chairperson of FSOC is Steven Mnuchin who has deep connections to the hedge fund industry.²⁴⁸ Lee Reiners, the director of Duke University’s Global Financial Markets Center, recently predicted that this appointment could lead to “severe” consequences, because it would likely cause the FSOC’s research on the systemic risk threats posed by hedge funds to be “put on ice.”²⁴⁹ Although it is not yet clear how FSOC’s power will be impacted by these possible reforms, the deeply politicized nature of FSOC’s leadership will likely prevent the council from focusing on hedge funds.

In the meantime, the SEC cannot unilaterally act to regulate hedge funds in the same manner that it did with respect to registered funds. Because hedge

²⁴¹ *Id.* at 18.

²⁴² *Id.* at 20.

²⁴³ *Id.*

²⁴⁴ Press Release, U.S. Dep’t of the Treasury, Remarks by Deputy Assistant Secretary Jonah Crane at a Meeting of the Financial Stability Oversight Council (Nov. 16, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/jl0612.aspx> [<https://perma.cc/CU98-R8ME>].

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ Barbash & Merle, *supra* note 33.

²⁴⁸ Goldstein & Stevenson, *supra* note 35.

²⁴⁹ Lee Reiners, *Do Hedge Funds Threaten Financial Stability?*, FINREG BLOG (Jan. 26, 2017), <https://sites.duke.edu/theфинregblog/2017/01/26/do-hedge-funds-threaten-financial-stability> [<https://perma.cc/6DK4-FEEL>].

funds are exempt from the transparency mandates provided under the 1940 Act, the agency would need specific authority granted from Congress in order to create tailored disclosures. In addition, FSOC is highly unlikely to designate a hedge fund as a SIFI because of the heightened litigation risk associated with doing so. This litigation risk arises from the power of nonbank entities to request judicial review of a SIFI designation if the courts determine that FSOC acted in a way that is “arbitrary and capricious.”²⁵⁰ Industry participants initially viewed this standard as being an insurmountable hurdle for potential litigants. In 2016, however, in *MetLife, Inc. v. Financial Stability Oversight Council*, the U.S. District Court for the District of Columbia held that MetLife’s SIFI designation was arbitrary and capricious.²⁵¹ It did so because FSOC failed to consider whether the costs of imposing prudential regulation on MetLife would exceed the benefits of doing so.²⁵² FSOC would likely face comparable litigation costs if it were to designate a hedge fund as a SIFI, particularly because the industry has been vehemently opposed to the costs of prudential regulation. With all of the challenges that FSOC has encountered in regulating systemically harmful hedge funds, it is worth investigating whether a different framework administered by an existing regulatory agency could better handle the task.

2. Continued Systemic Threat of Hedge Funds

The inability of FSOC to designate a hedge fund as a SIFI, coupled with the SEC’s limited jurisdiction over the industry, has effectively created a hedge fund loophole. Aside from the minimal transparency mandate provided via Advisers Act registration, hedge funds that pose a systemic threat to the economy escape effective regulation. This is problematic for two reasons. First, in spite of recent reports that hedge funds cannot effectively beat the markets, the industry is likely to grow significantly in coming years. Second, post-financial crisis studies have predominantly found that systemic risk is still a growing concern in the hedge fund industry.

In assessing the growth of the industry, institutional investors are the primary investors in these private entities.²⁵³ It is admittedly difficult to predict the extent to which institutional investors will continue to rely on hedge

²⁵⁰ 12 U.S.C. § 5323(h) (2012).

²⁵¹ *MetLife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219, 230 (D.D.C. 2016), appeal docketed, no. 16-5086 (D.C. Cir. Apr. 20, 2016).

²⁵² *Id.*

²⁵³ See Chris Flood, *Hedge Funds Remain a Popular Choice for Institutional Investors: Institutional Investors Still Loyal Despite Dissatisfaction with Fee Performance*, FIN. TIMES (June 7, 2015), <https://www.ft.com/content/3d990070-0946-11e5-b643-00144feabdc0> (discussing continued popularity of hedge funds among institutional investors).

fund investments as an integral component to their underlying portfolios. Numerous reports have arisen regarding the inability of hedge funds to beat the markets, their excessive fees, and the undue complexity of their strategies.²⁵⁴ These concerns have prompted prominent pension plans, such as the California Public Employees' Retirement System ("CalPERS") for example, to completely liquidate their hedge fund allocations.²⁵⁵ Most recently, the New York City pension fund liquidated its \$1.5 billion hedge fund allocation due to concerns regarding "lagging performance, high fees and the riskiness of the asset class."²⁵⁶

In spite of these growing concerns, there is a strong likelihood that institutional investors will continue to pursue hedge funds, particularly during times of market distress. A 2015 study administered by J.P. Morgan found that ninety-four percent of such investors plan to maintain or increase hedge fund investments in the coming years.²⁵⁷ This anticipated growth could be related to the growing funding challenges that public pension plans are currently reconciling. These challenges have arisen due to past market turmoil, swelling life-spans, and the simultaneous retirement of millions of baby-boomers.²⁵⁸ Furthermore, hedge funds tend to outperform the markets during economic downturns given their increased freedoms to engage in short-trading and other "hedging" strategies.²⁵⁹ As one source noted, "Dislocated markets, bear markets, inefficient markets are where hedge funds tend to do best, and these have not been the overall conditions during the slow and fragile recov-

²⁵⁴ See SIMON LACK, *THE HEDGE FUND MIRAGE: THE ILLUSION OF BIG MONEY AND WHY IT'S TOO GOOD TO BE TRUE 1* (2012) (asserting that the returns collectively earned by hedge funds have not exceeded the risk-free rate of return provided by government issued treasury bills). *But see* Thomas Schneeweis & Hossein B. Kazemi, *An Academic Response to the 'Hedge Fund Mirage' 1* (Sept. 30, 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=2228851> (criticizing the methodologies utilized by the author of *The Hedge Fund Mirage*).

²⁵⁵ James B. Stewart, *Hedge Funds Lose Calpers, and More*, N.Y. TIMES (Sept. 26, 2014), https://www.nytimes.com/2014/09/27/business/in-calpers-departure-a-watershed-moment-for-hedge-funds.html?_r=0 [<https://perma.cc/6RNF-TLGQ>].

²⁵⁶ Martin Z. Bruan, *NYC Pension Votes to Scrap \$1.5 Billion Hedge Fund Portfolio*, BLOOMBERG (Apr. 14, 2016), <https://www.bloomberg.com/news/articles/2016-04-14/nyc-pension-votes-to-liquidate-1-5-billion-hedge-fund-portfolio> [<https://perma.cc/PVE8-7V2X>].

²⁵⁷ JP MORGAN, *CAPITAL INTRODUCTION GROUP INSTITUTIONAL INVESTOR SURVEY-2015*, at 60 (2015).

²⁵⁸ See Swann, *supra* note 37 (arguing that in spite of some valid concerns it is premature for pension funds to divest from hedge funds).

²⁵⁹ Mark Hulbert, *A Stock Market Top Is Likely Near as Investors Fail to Hedge*, MARKETWATCH (May 19, 2015), <http://www.marketwatch.com/story/a-stock-market-top-is-likely-near-as-investors-fail-to-hedge-2015-05-19> [<https://perma.cc/D5QT-N96Y>] (examining how hedge funds manage to outperform bear markets).

ery starting in 2009.”²⁶⁰ As such, the demand for hedge funds will likely grow when the markets inevitably start to decline.

With respect to assessing whether hedge funds still pose a systemic threat to the economy, the research is not entirely conclusive on this issue. The Financial Services Authority in London has recently determined that hedge funds do not pose a systemic threat to the economy.²⁶¹ Researchers have also encountered challenges in gathering relevant systemic risk data given the continued opaqueness of these private entities, which could potentially lead to inconclusive studies. Even with this limited data, a plethora of post-crisis studies have confirmed that private funds can indeed contribute to systemic risk for the same reasons discussed in Part III.A of this Article. International administrators, such as the Financial Stability Board (“FSB”) and the International Organization of Securities Commissions (“IOSCO”) have concluded that private funds could in fact enhance systemic risk irrespective of the existing regulations over counterparties and OTC derivatives. On March 4, 2015, the FSB and IOSCO published a consultation study which noted the following:

[I]t is still possible for an investment fund to become highly leveraged through derivatives that are not centrally-cleared, particularly if margining practices for the non-centrally cleared derivatives are inadequate. Hence leverage constitutes a central component in the analysis of the counterparty channel, particularly for those funds that are not subject to any restrictions and may build up significant leverage positions (e.g. private funds).²⁶²

In terms of assessing interconnectedness, an empirical study published in January 2010 sought to investigate the extent to which contagion exists with-

²⁶⁰ Brian Robinson, *How Pension Plans Can Build the Case for Hedge Funds*, PENSIONS & INVS. (Nov. 30, 2016, 2:01 PM), <http://www.pionline.com/article/20161130/ONLINE/161139991/how-pension-plans-can-build-the-case-for-hedge-funds> [<https://perma.cc/Q95X-KY8K>].

²⁶¹ See FIN. SERVS. AUTH., *ASSESSING THE POSSIBLE SOURCES OF SYSTEMIC RISK FROM HEDGE FUNDS: A REPORT ON THE FINDINGS OF THE HEDGE FUND SURVEY AND HEDGE FUND AS COUNTERPARTY SURVEY 1* (2011) (“The latest results suggest that the leverage of surveyed hedge funds remains largely unchanged and that their footprint remains modest within most markets, so that current risks to financial stability through the market channel seem limited at the time of the latest surveys.”). The Managed Fund Association (“MFA”) has similarly argued that the existing regulation of their investment bank counterparties, as well as the new clearing requirements for OTC-derivatives, sufficiently deters excessive leverage. Managed Funds Ass’n, *MFA Comments on Significantly Systemic Institutions* (Feb. 25, 2011), http://www.managedfunds.org/wp-content/uploads/2011/06/2.25.11-MFA.letter.on_.systemically.significant.institutions.pdf [<https://perma.cc/JPK4-EEN2>].

²⁶² FIN. STABILITY BD., *CONSULTATIVE DOCUMENT (2ND): ASSESSMENT METHODOLOGIES FOR IDENTIFYING NON-BANK NON-INSURER GLOBAL SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS* 33 (2015).

in the hedge fund industry.²⁶³ The study defines contagion “as correlation that cannot be explained by economic fundamentals,”²⁶⁴ and it found “very strong evidence of contagion in hedge fund returns.”²⁶⁵ An additional study published in November 2011 sought to further analyze potential linkages between hedge funds, banks, insurance companies, and broker-dealers.²⁶⁶ The study used empirical models to investigate the extent to which the returns of these distinct sectors are interconnected irrespective of their fundamental differences. It essentially concluded that “all four sectors have become highly inter-related, increasing the channels through which shocks can propagate throughout the finance and insurance sectors.”²⁶⁷ Thus, it is plausible that a systemic risk event that occurs at one particular hedge fund can quickly spread to other hedge funds, and to other intermediaries such as banks, insurance companies, and broker-dealers.

In response to this ongoing debate, Professors Wulf Kaal and Timothy Krause summarized the post-crisis research on hedge funds and systemic risk.²⁶⁸ In their review of the literature on this topic, they essentially concluded, “Despite the mixed evidence produced by government reports . . . , the majority of post-crisis evidence provided by leading financial economists suggests that hedge funds may play a role in introducing at least some systemic risk into the financial system.”²⁶⁹ With mounting evidence supporting the conclusion that systemic risk can be created and transmitted by hedge funds, and a strong likelihood that the industry will continue to grow, Congress should act expeditiously to resolve the hedge fund loophole created by FSOC’s shortcomings.

²⁶³ Nicole M. Boyson et al., *Hedge Fund Contagion and Liquidity Shocks* 1 (Jan. 1, 2010) (unpublished manuscript), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=884202##.

²⁶⁴ *Id.* at 25.

²⁶⁵ *Id.* at 26.

²⁶⁶ Monica Billio et al., *Econometric Measures of Connectedness and Systemic Risk in the Finance and Insurance Sectors* 1 (University Ca’ Foscari of Venice, Dept. of Economics Research Paper Series, Paper No. 21, 2011), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1963216.

²⁶⁷ *Id.* at 2.

²⁶⁸ Wulf A. Kaal & Timothy A. Krause, *Hedge Funds and Systemic Risk* 1–2 (2016) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2748096. *But see* Vikas Agarwal et al., *Hedge Funds: A Survey of the Academic Literature* 78–82 (Aug. 15, 2015) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2650919 (summarizing empirical research on whether hedge funds create and transmit systemic risk and concluding that the studies reveal mixed results as).

²⁶⁹ Kaal & Krause, *supra* note 268, at 2.

III. THE SEC AS THE NEXT BEST ALTERNATIVE

Given FSOC's inability to designate a hedge fund as a SIFI, this Article argues that Congress should explore appointing the SEC as the primary regulator of systemic risk because: (1) hedge funds can still create and transmit systemic risk as highlighted in the preceding section of this Article; (2) the transparency framework inherent in the federal securities laws can supply a more effective means for mitigating systemic risk than the prudential framework currently mandated for SIFIs; and (3) appointing the SEC in this regard would reduce the fragmentation of the current regulatory structure that has been extended and complicated by the creation of FSOC. Part III thus begins by investigating the underexplored role that transparency plays in ensuring financial stability and protecting against future financial crises.²⁷⁰ It then explains how enhancing transparency to hedge fund counterparties and investors with respect to systemic risk data could empower such market participants to better protect themselves against risk, which could, in turn, weed out SIFIs from the marketplace.²⁷¹ Part III concludes by expanding on the second component of this thesis as the SEC has historically managed the asset management industry over the past century.²⁷² Reforming existing regulators is perhaps preferable to the creation of new agencies that will likely produce duplicative and ineffective regulation.²⁷³

A. Federal Securities Laws as a Means to Mitigate Systemic Risk

1. Transparency Can Improve Financial Stability

As discussed in Part I of this Article, increasing transparency is the primary objective of the federal securities laws.²⁷⁴ In passing these laws, Congress sought to equip investors with material information related to prospective investments in publicly traded companies. Issuers that fail to disclose such information are subject to the civil liability provisions provided under these laws. Congress then appointed the SEC as the administrative body charged with effectuating this investor protection mandate. In addition to promoting investor protection, mandatory disclosure rules help to improve market efficiency by improving the accuracy of share prices and by boosting investor confidence. Shareholders quickly respond to publicly released in-

²⁷⁰ See *infra* notes 274–292 and accompanying text.

²⁷¹ See *infra* notes 293–312 and accompanying text.

²⁷² See *infra* notes 334–342 and accompanying text.

²⁷³ See *infra* notes 334–342 and accompanying text.

²⁷⁴ See *supra* notes 68–104 and accompanying text (outlining provisions of the federal securities laws).

formation, including the material information that is mandated under federal securities laws. As such, the underlying prices of publicly offered securities are more likely to reflect their true values. Investor confidence is also boosted through this mandatory disclosure system as investors are more willing to allocate their limited capital to a market that is fair and reliable, thereby increasing the liquidity of the markets.²⁷⁵

In a similar vein, improving transparency can be an effective regulatory tool in reducing systemic risk, especially considering that the financial crisis was uniquely characterized by information asymmetries amongst sophisticated market participants. During the crisis, investment banks repackaged toxic subprime mortgages into complex OTC derivatives that were exempt from significant regulatory oversight.²⁷⁶ Securitizing debt in this manner allowed banks to transfer the risk of the toxic subprime mortgages to other counterparties.²⁷⁷ This transfer, however, only served to spread the risk throughout the entire financial system as investors would purchase and often resell these complex derivatives without knowing the true value and/or risks posed by these instruments.²⁷⁸ Investors would rely on third-party credit rating agencies to produce valuations for OTC derivatives, many of which proved to be grossly inaccurate.²⁷⁹ This continuous chain of transactions is frequently referred to as the shadow banking system because it allowed entities to partici-

²⁷⁵ See Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407, 408 (2002) (“Without investor trust, our market would be a thin shadow of its present self. Suspicious and distrustful investors would refuse to exchange their hard-earned cash for such abstract and intangible goods as corporate securities. Instead, they would put their savings into tangible assets like gold or real estate, or under their mattresses.”).

²⁷⁶ JEFF MADRICK, *AGE OF GREED: THE TRIUMPH OF FINANCE AND THE DECLINE OF AMERICA, 1970 TO THE PRESENT* 376 (2011). OTC derivatives were excluded from SEC oversight because they are not considered securities as defined under the Securities Act. See 15 U.S.C. §§ 77b-1(b)(1), 78c-1(b)(1) (2012) (excluding swap agreements from the definition of securities). The Commodity Futures Modernization Act of 2000 further excluded these instruments from coverage under the Commodity Exchange Act. Commodity Futures Modernization Act of 2000 (CFMA), Pub. L. No. 106-554, 114 Stat. 2763, app. E (2000) (codified as amended in scattered sections of 7, 11, 12, and 15 U.S.C.).

²⁷⁷ See William W. Lang & Julapa Jagtiani, *The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance*, 38 ATLANTIC ECON. J. 295, 311–12 (2010) (“For many years, credit derivatives were viewed as an efficient means to transfer risk and promote financial stability.”).

²⁷⁸ See *id.* at 311–13 (explaining why many firms failed to identify the risk involved in these derivatives).

²⁷⁹ See Matt Krantz, *2008 Crisis Still Hangs Over Credit-Rating Firms*, USA TODAY (Sept. 13, 2013, 5:52 PM), <http://www.usatoday.com/story/money/business/2013/09/13/credit-rating-agencies-2008-financial-crisis-lehman/2759025> [http://web.archive.org/web/20160902232015/http://www.usatoday.com/story/money/business/2013/09/13/credit-rating-agencies-2008-financial-crisis-lehman/2759025/] (discussing failure of credit rating agencies to appropriately warn investors of risk prior to 2008 crisis).

pate in the transmission of credit without being subject to significant regulation.

One commentator identified the lack of transparency associated with the shadow banking industry as being the primary contributor to the crisis. According to Steve Denning, “After Lehman’s collapse, no one could understand any particular bank’s risks from derivative trading and so no bank wanted to lend to or trade with any other bank [N]o one could tell whether any particular financial institution might suddenly implode.”²⁸⁰ The opaqueness of these exposures essentially led to a run on financial institutions, because investors could not distinguish amongst the riskiness of these counterparties.²⁸¹ It also led to a severe credit crunch where banks completely froze their lending channels regardless of the credit-worthiness of the borrower.²⁸² Regulators encountered significant difficulties in untangling the complex chain of transactions that facilitated the crisis given the opacity these markets. Scholars across disciplines have advocated for enhanced transparency as a means to prevent a future crisis of this magnitude.²⁸³ Mary Schapiro, the former chairman of the SEC, has likewise stated that systemic risk could be mitigated by “the traditional oversight, regulation, market transparency and enforcement provided by primary regulators that helps keep systemic risk from developing in the first place.”²⁸⁴

Even with the passage of the Dodd-Frank Act, several commentators are still concerned that the continued lack of transparency with respect to OTC derivatives will inevitably lead to a future financial crisis. These criticisms warrant further investigation because the OTC derivatives market has continued to grow in recent years. Some have estimated that the notional value of OTC derivatives has grown from \$500 trillion in 2007, to close to \$707 trillion in 2011.²⁸⁵ The new clearing mandate under Title VII of the Dodd-Frank Act could introduce a degree of transparency and standardization for certain

²⁸⁰ Steve Denning, *Big Banks and Derivatives: Why Another Financial Crisis Is Inevitable*, FORBES (Jan. 8, 2013, 6:26 PM), <http://www.forbes.com/sites/stevedenning/2013/01/08/five-years-after-the-financial-meltdown-the-water-is-still-full-of-big-sharks/#dce49b554746> [<http://web.archive.org/web/20170307181549/https://www.forbes.com/sites/stevedenning/2013/01/08/five-years-after-the-financial-meltdown-the-water-is-still-full-of-big-sharks/#35c2fa872db9>].

²⁸¹ *Id.*

²⁸² Sarah H. Wright, *Explaining the Credit Crunch*, NAT’L BUREAU FOR ECON. RESEARCH, <http://www.nber.org/digest/mar09/w14612.html> [<https://perma.cc/QR98-HLG3>].

²⁸³ See *supra* notes 31, 53–54 and accompanying text (listing scholars who have discussed the importance of transparency in the financial sector).

²⁸⁴ *Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Committee on Banking, Hous., and Urban Affairs*, 111th Cong. 70 (2009) (statement of Mary L. Shapiro, Chairman, SEC).

²⁸⁵ *The Derivatives Time Bomb*, PAPER BOAT (June 12, 2012), <http://paperboat.studiopod.com/2012/06/12/the-derivatives-time-bomb> [<https://perma.cc/D3QT-3GLQ>].

OTC derivative instruments. Yet, some scholars have argued that these new reforms could actually serve to concentrate systemic risk amongst these newly authorized central clearinghouses, as opposed to eliminating it from the markets.²⁸⁶ Moreover, several OTC derivatives are excluded from this new clearing requirement even though many such uncleared instruments “are often vital cogs in the risk management strategies of corporates, insurance companies, pension funds, sovereigns, smaller financial institutions and others.”²⁸⁷ These uncleared derivatives are indeed subject to new margin requirements under recent regulatory reforms, which can undoubtedly add an additional layer of protection against counterparty defaults.²⁸⁸ During a financial downturn, however, there is always a risk that the losses of a particular trade could greatly exceed the amount of any posted margin. Systemic shocks can also lead to wide-spread margin calls that perpetuate the liquidity spirals discussed in Part II.A.3. above.

The Volker Rule is yet another reform passed under the Dodd-Frank Act, which forces banks to eliminate its proprietary trading activities and to spin off any hedge-fund subsidiaries to outside parties.²⁸⁹ This reform, however, could perhaps have the following unintended consequence:

In the future, the hedge fund sector will only grow in size and importance, since the Volcker rule of the Dodd-Frank Act requires banks to spin off their proprietary trading desks and their internal asset management divisions into stand-alone hedge funds. As a result, hedge funds will be the only source of sophisticated and relatively unconstrained capital, thus making them perhaps the main liquidity providers across a variety of markets.²⁹⁰

²⁸⁶ See Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 226 (2013) (predicting that “[i]f a clearinghouse member with a large volume of contracts or a series of members whose transaction constitutes a significant volume of contracts should default, the clearinghouse may face insolvency or bankruptcy”).

²⁸⁷ INT’L SWAPS & DERIVATIVES ASS’N, SIZES & USES OF NON-CLEARED DERIVATIVES MARKET—AN ISDA STUDY 3 (2014).

²⁸⁸ Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016) (to be codified at 17 C.F.R. pts. 23, 140).

²⁸⁹ See Onnig H. Dombalagian, *The Expressive Synergies of the Volcker Rule*, 54 B.C. L. REV. 469, 469–70 (2013) (outlining the basics of the Volcker rule by stating that it “restricts U.S. depository institutions and their affiliates from engaging in proprietary trading, subject to certain enumerated exemptions, and limits their sponsorship of and investment in hedge funds and other private funds”).

²⁹⁰ Stephen Brown et al., *Hedge Funds After Dodd-Frank*, NYU LEONARD N. STERN SCH. OF BUS. (July 19, 2016, 3:41 PM), <http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/07/hedge-funds-after-doddfrank.html> [<https://perma.cc/K5Z6-U9FP>]; see also Linette Lopez, *The Financial Products That Blew up the Global Economy Are Sliding into the Shadow Banking System*, BUS. INSIDER (May 8, 2013, 11:11 AM), <http://www.businessinsider.com/hedge-funds-pick-up-credit>

The heightened capital requirements promulgated under Basel III will arguably have a similar effect on the hedge fund industry.²⁹¹ Although Basel III introduced higher capital requirements, and other stringent reforms for banking entities, there is some evidence that hedge funds are now playing a larger role in supplying credit and performing other functions in the credit intermediation process.²⁹² As these criticisms and unintended consequences continue to unfold, Congress, under the direction of its regulators, should vigorously investigate the extent to which increasing transparency can play a larger role in mitigating systemic risk.

2. Counterparties

With respect to the hedge fund industry, Congress should similarly investigate whether enhancing transparency could more appropriately address the unique systemic risk concerns discussed herein. Although FSOC has noted significant improvements in the leverage practices of hedge funds, the council expressed doubts as to whether hedge fund counterparties can fully understand the associated risks of transacting with these entities. The FSOC Report specifically noted that “individual counterparties may lack a complete picture of a fund’s exposures, as many hedge funds have relationships with multiple prime brokers and derivatives dealers.”²⁹³ Each of these dealers may also be subject to regulation by different agencies across a range of jurisdictions. As a result, “no single regulator has a complete window into the risk profile of hedge funds.”²⁹⁴ If regulators cannot effectively assess the risks of hedge funds, even with the new registration requirements promulgated under the Dodd-Frank Act, it is certainly plausible that financial intermediaries encounter comparable difficulties.

Hedge fund counterparties are admittedly highly sophisticated prime brokerage firms that often perform extensive due diligence on prospective relationships. Yet, lenders have frequently questioned whether they have sufficient expertise to assess the creditworthiness of funds given the complexity

derivatives-2013-5 [https://perma.cc/CZZ5-NDER] (noting that “because hedge funds are far less regulated than your average bank, they can pick up the assets that governments are forcing banks to get rid of—things like distressed corporate debt, mortgage backed securities, and all sorts of fun credit derivatives”).

²⁹¹ See BASEL COMM. ON BANKING SUPERVISION, *BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS* 54–59 (2011) (discussing Basel III’s increased capital constraints on banks).

²⁹² See generally Elias Bengtsson, *Investment Funds, Shadow Banking and Systemic Risk* (2016), 24 J. FIN. REG. & COMPLIANCE 60 (2016) (examining the increased role of investment funds in the credit intermediation process).

²⁹³ FSOC REPORT, *supra* note 235, at 18.

²⁹⁴ *Id.*

of their strategies and operations.²⁹⁵ One dealer specifically noted that “[t]he management and control of credit risks in the relationship between prime brokers and hedge funds represents one of the most challenging areas for the corporate credit function of investment banks.”²⁹⁶ These challenges frequently arise from the complex strategies employed by hedge funds, which are often dynamic in nature. Moreover, there is no standardized format for measuring or reporting the various types of risks generated by these strategies.²⁹⁷ Such risks can relate to leverage, volatility, liquidity, and interconnectedness.²⁹⁸ With respect to leverage for example, it is frequently incurred through the trading of securitized debt instruments, which are exempt from standardized reporting mechanisms. These OTC derivatives can pose the greatest threat to financial stability as they are often used to transform and redistribute debt to a large number of market participants. Overall, the lack of standardization can make it difficult for counterparties to effectively price and aggregate their collective risk exposures to hedge funds. A failure to appropriately assess risk in this regard can quickly spread to other financial institutions given the increasing interconnectedness of the markets.

In a similar vein, assessing the extent to which a particular hedge fund is interconnected with other financial intermediaries is also a difficult metric for counterparties to measure. They would need information on a fund’s exposure to other counterparties, and the extent to which funds are interconnected with other hedge funds, insurance companies, and broker-dealers. Even if counterparties request such detailed information, they are unlikely to receive it as it is probably deemed proprietary and confidential. Yet, interconnectedness is a highly informative risk metric because it affects the extent to which lenders are exposed to “counterparty risk externality.” This term has been defined by scholars as “the effect that the default risk on one contract will be increased if the counterparty agrees to any contract with another agent which increases the probability that the counterparty will be unable to perform on the first one.”²⁹⁹ If, for example, a hedge enters into a swap transaction with Prime Broker A, and the hedge fund subsequently enters into a comparable contract

²⁹⁵ See Anand, *supra* note 54, at 969 (discussing lender difficulty in determining counterparty risk during financial crisis).

²⁹⁶ Graham Rowlands, *From the Practitioner’s Perspective as a Prime Broker*, in MANAGING HEDGE FUND RISK FROM THE SEAT OF THE PRACTITIONER—VIEWS FROM INVESTORS, COUNTERPARTIES, HEDGE FUNDS, AND CONSULTANTS 121, 127 (Virginia Reynolds Parker ed., 2000).

²⁹⁷ See Martin, *supra* note 47, at 122 (highlighting that “[w]ith respect to hedge fund industry, there is no standardized mechanism for managers to calculate valuations or to assess risk, which makes hedge fund comparisons extremely difficult for investors”).

²⁹⁸ *Id.*

²⁹⁹ Viral Acharya & Alberto Bisin, *Counterparty Risk Externality: Centralized Versus Over-the-Counter Markets*, 149 J. ECON. THEORY 153, 154 (2014).

with Prime Broker B without notifying Prime Broker A, a failure to pay Prime Broker B could expose Prime Broker A to unforeseen losses. A lack of transparency with respect to additional trading relationships can make it difficult for counterparties to “charge price schedules that effectively penalize the creation of inefficient levels of counterparty risk.”³⁰⁰

Network science can provide useful insights as to how increased transparency could assist in identifying interconnected firms. Physicists have applied technology used by Google as a mechanism to identify firms that are highly connected.³⁰¹ This algorithm is commonly referred to as “PageRank” and it ranks the relevance of websites by measuring the extent to which they are linked to other websites.³⁰² Thus, when an internet user types a particular keyword into the Google search engine, the websites that are the most interconnected with others are the first to appear.³⁰³ In loosely applying this technology to banks, physicists have developed an algorithm called “DebtRank,” which similarly measures the extent to which financial institutions are interconnected with other institutions within a particular network.³⁰⁴ They used publicly available data with respect to Federal Reserve emergency loans granted to a subset of financial institutions to determine the interconnectedness of these entities. In order to effectively apply this algorithm to a large number of institutions on an ongoing basis, however, researchers would need access to publicly available information related to the indebtedness of each of these firms. As stated by additional researchers in this area, “[n]odes in a financial network, such as banks, cannot assess the true risks associated with lending to other nodes in the network unless they have full information on the riskiness of all other nodes.”³⁰⁵

A similar concept could be applied to the hedge fund industry to measure the extent to which each fund is interconnected with other intermediaries. Counterparties would then be incentivized to transact with funds that have a lower DebtRank so as to decrease their exposure to interconnected funds. Transacting with funds with a higher DebtRank would also increase the DebtRank of the counterparty, thereby decreasing its own attractiveness to other market participants. These incentives would effectively marginalize funds that are excessively interconnected. There are of course practical limita-

³⁰⁰ *Id.*

³⁰¹ Mark Buchanan, *How Google Can Avert the Next Financial Crisis*, BLOOMBERG VIEW (Aug. 7, 2012, 10:00 AM), <https://www.bloomberg.com/view/articles/2012-08-06/how-google-might-help-us-avert-a-financial-crisis> [http://web.archive.org/web/20170312204659/https://www.bloomberg.com/view/articles/2012-08-06/how-google-might-help-us-avert-a-financial-crisis].

³⁰² *Id.*

³⁰³ *Id.*

³⁰⁴ Thurner & Poledna, *supra* note 49, at 2.

³⁰⁵ *Id.* at 1.

tions in applying this framework to the hedge fund industry as these entities are even more opaque and heterogeneous than banks. It would also entail gathering confidential data from other categories of counterparties such as insurance companies and broker-dealers. Implementing such a widespread transparency mandate may not be politically feasible because each respective industry will strongly assert that such information is proprietary. As will be further discussed in Part III.A.4 below, however, the SEC could promulgate streamlined disclosure requirements that effectively consider the proprietary nature of fund strategies. It should also be noted that hedge fund advisers can be equally concerned with the creditworthiness of its funds' own prime broker counterparties. This Article, however, generally posits that enhanced transparency mechanisms should be equally applied to all entities that participate in the chain of transactions that comprise the shadow banking industry. A systemic threat could potentially originate within any of these entities along this chain of transactions.

3. Investors

Institutional investors such as pension plans, insurance companies, and endowments comprise the bulk of hedge fund investors. Although these investors are highly sophisticated and typically perform extensive due diligence on prospective investments, they have expressed comparable concerns in understanding the complexities of hedge fund strategies. For instance, certain OTC derivatives must be valued by intricate computer algorithms that could take days to produce a valuation.³⁰⁶ Because these valuations are not standardized, counterparties that are sitting on opposing sides of an OTC derivative contract could yield different values for the same interest.³⁰⁷ A 2009 study that was conducted by the United States Government Accountability Office concluded that "some market participants suggested that not all prospective investors have the capacity or retain the expertise to analyze the information they receive from hedge funds."³⁰⁸ Most recently, many institutional investors have publicly acknowledged their failures to properly assess the fees that are

³⁰⁶ Jennifer S. Taub, *Enablers of Exuberance: Legal Acts and Omissions That Facilitated the Global Financial Crisis 2* (Sept. 4, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1472190.

³⁰⁷ See CHARLES R. MORRIS, *THE TWO TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH 42* (2008).

³⁰⁸ U.S. GOV'T ACCOUNTABILITY OFFICE, *HEDGE FUNDS: OVERVIEW OF REGULATORY OVERSIGHT, COUNTERPARTY RISKS, AND INVESTMENT CHALLENGES 11* (2009).

charged by hedge fund advisers.³⁰⁹ Many such investors have lost millions of dollars in “hidden” hedge fund fees that were simply unaccounted for in their initial and ongoing due diligence of such funds.³¹⁰

In terms of measuring risk, hedge fund investors have encountered comparable challenges as described in the preceding section.³¹¹ This issue has been highlighted by Mark J.P. Anson, formerly a senior investment officer with CalPERS. He has specifically stated that “there is no standard platform for measuring risk and no standard format for reporting it. Different hedge funds map risk differently. Consequently, the risks of several hedge fund managers cannot be combined.”³¹² Thus, even if investors use considerable resources in investigating a single fund, or even a subset of funds, they still can encounter difficulties in optimizing their risk exposure to this industry. For instance, Hedge Fund A could earn the same returns as Hedge Fund B. Hedge Fund A, however, may employ a higher degree of leverage in order to produce the same returns as Hedge Fund B. Because reporting leverage is not standardized, investors could potentially select Hedge Fund A without knowing that Hedge Fund B could produce the same result without incurring the same degree of risk.

On its face, equipping hedge fund investors with standardized risk disclosures appears to be an investor protection issue. This interpretation would be consistent with traditional divisions between laws that enhance investor protection and those that reduce systemic risk. Equipping investors with a mechanism to appropriately price and manage risk, however, could serve to dis-incentivize excessive risk-taking by hedge fund advisers. More specifically, mandating standardized risk disclosures would essentially give investors a mechanism to more easily distinguish between “bad” and “good” managers of risk. Investors would likewise be incentivized to categorize advisers of systemically harmful funds as “bad” managers of risk as they could expose investors to excessive losses during an economic downturn. Such advisers

³⁰⁹ See Matt Taibbi, *Looting the Pension Funds*, ROLLING STONE (Sept. 23, 2016), <http://www.rollingstone.com/politics/news/looting-the-pension-funds-20130926> [<https://perma.cc/8T47-UT8U>] (discussing the hidden fees involved in hedge fund investment).

³¹⁰ See James B. Stewart, *Hedge Fund Math: Heads We Win, Tails You Lose*, N.Y. TIMES (Dec. 22, 2016), <https://www.nytimes.com/2016/12/22/business/hedge-fund-fees-returns.html> [<https://perma.cc/GB9E-Z5TY>] (explaining how hedge fund investors can actually lose money through fees).

³¹¹ See RICHARD HORWITZ, *HEDGE FUND RISK FUNDAMENTALS: SOLVING THE RISK MANAGEMENT AND TRANSPARENCY CHALLENGE* 143 (2004) (highlighting the secrecy and fragmentation of the hedge fund industry).

³¹² Mark J.P. Anson, *Hedge Fund Risk Management for Institutions*, in *MANAGING HEDGE FUND RISK: FROM THE SEAT OF THE PRACTITIONER—VIEWS FROM INVESTORS, COUNTERPARTIES, HEDGE FUNDS AND CONSULTANTS*, *supra* note 296, at 19, 21.

would therefore encounter more difficulties in soliciting investors and would effectively be pushed out of the market.

4. Framework

Outlining the specific structure of the systemic risk disclosure system proposed herein is largely outside the scope of this Article. Even still, this section provides preliminary thoughts on how the SEC should go about undertaking this task. First, the SEC should form a committee that is specifically dedicated to this complicated and unique endeavor. This committee should be comprised of experts from a range of disciplines, such as legal, economic, financial, banking, and quantitative analysis. Because the strategies and instruments traded by hedge funds are complex and perhaps poorly understood by regulators, the SEC should expand its knowledge base to experts outside the regulatory field. This committee could also be formed as a subset of the Division of Economic and Risk Analysis (“DERA”), which was created in September 2009 to “integrate financial economics and rigorous data analytics into the core mission of the SEC.”³¹³ DERA is well positioned to supervise this new committee as it has already engaged a variety of academic disciplines to assist the SEC in better understanding the evolving innovations under the agency’s jurisdiction.³¹⁴

The committee’s first task should entail determining the appropriate registration threshold for hedge funds that will be required to comply with this new transparency mandate. As it stands now, a hedge fund must have over \$50 billion in consolidated assets in order to be considered a SIFI. This threshold fails to capture smaller funds that could be heavily interconnected with other intermediaries. The registration threshold should be significantly lower than \$50 billion, although the committee should thoroughly investigate the costs and benefits of implementing such disclosure requirements for a wide range of funds.

In conjunction with developing this threshold, the committee should undertake the arduous task of developing the specific disclosure form that entities would use to report systemic risk data. The items on this form could in fact parallel the factors that FSOC currently evaluates to determine whether a hedge fund would qualify as a SIFI. As previously discussed, these factors are: (i) size, (ii) interconnectedness, (iii) substitutability, (iv) leverage, and (v) liquidity risk.³¹⁵ The committee would of course have to develop bright-line

³¹³ *About Division of Economic and Risk Analysis*, SEC, <http://www.sec.gov/dera/Article/about.html> [https://perma.cc/8D48-EBCZ] (last modified Jan. 18, 2017).

³¹⁴ *Id.*

³¹⁵ 12 C.F.R. pt. 1310, app. A(II)(d)(1) (2016).

and standardized methodologies for determining and disclosing these metrics. In developing a disclosure framework for interconnectedness, the committee could for example integrate the DebtRank concept explained in Part III.A.2.³¹⁶ Compiling the disclosures related to leverage would necessarily entail coordination with the CFTC because it has jurisdiction over many of the derivatives that would likely be incorporated into this calculation.

Considering the propriety needs of hedge funds is also an integral component of this analysis. To this end, the committee should explore creative reporting mechanisms such as reporting aggregated data, as opposed to detailed position data, or permitting time delays with respect to certain disclosures. A short and concise disclosure form would also be ideal, so that investors and counterparties can easily compare a large range of entities. The committee must necessarily determine the frequency that hedge funds must complete such reports which can be monthly, quarterly, or annually. Determining the appropriate consequences for failing to report such disclosures, or reporting false or misleading information, would be yet another task for the committee.

5. Potential Drawbacks

a. Herding

Even with standardized risk disclosures, there is still an inherent risk that investors will continue to allocate to profitable funds that pose a systemic threat to the economy. Advisers of such funds could easily be identified as “good” managers of risk, particularly during times of economic prosperity where speculative bubbles are more likely to arise. If this were to occur, there is a related risk that investors will “herd” towards such systemically harmful strategies to benefit from the potentially higher returns. Some scholars have described “herds” as investors and managers “that charge into risky ventures without adequate information and appreciation of the risk-reward trade-offs,” which often “results from an obvious intent by investors to copy the behavior of other investors.”³¹⁷

Institutional investors such as pension plans, insurance companies, and endowments, however, comprise the bulk of hedge fund investors³¹⁸ and they

³¹⁶ See *supra* notes 301–305 and accompanying text (explaining the concept of DebtRank).

³¹⁷ Sushil Bikhchandani & Sunil Sharma, *Herd Behavior in Financial Markets: A Review* 3–4, (IMF Working Paper No. 00/48, 2000), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=228343.

³¹⁸ *New MFA Infographic Highlights Diverse Hedge Fund Investor Base*, MANAGED FUND ASS’N (Sept. 10, 2014), <https://www.managedfunds.org/2014/09/new-mfa-infographic-highlights-diverse-hedge-fund-investor-base> [<https://perma.cc/6AW4-2FP6>] (specifying that “[h]igh-net

are typically held to higher fiduciary standards on behalf of their underlying constituents. These heightened fiduciary duties incentivize these investors to make rational investment decisions, which could foreclose the possibility of a herd forming within the hedge fund industry. Pension plans for example are subject to the *duty of prudence*, which requires that plan trustees utilize reasonable expertise and diligence in selecting investment allocations.³¹⁹ This essentially requires that pension plan trustees utilize reasonable expertise and diligence in selecting investment allocations for pension plan portfolios to protect beneficiaries from excessive losses.³²⁰ These fiduciary duties also induce institutional investors to diversify the risks of their underlying investments. Having access to standardized risk disclosures would provide institutional investors with an integral tool in optimizing their risk exposures across a larger range of hedge fund investments. Although a systemically harmful fund may be profitable in the short-run, hedge fund investors that are subject to stringent fiduciary duties must also consider the impact to long-term profitability.

The recent proliferation of lawsuits related to fiduciary breaches could further incentivize institutional investors to sufficiently evaluate risks as opposed to simply following a herd. For example, employees of M.I.T., Yale and NYU have recently sued plan administrators for “fail[ing] to monitor excessive fees paid to administer the plans and [] not replac[ing] more expensive, poor-performing investments with cheaper ones.”³²¹ In considering the proposed model herein, the standardized risk disclosures would be publicly available on the SEC’s website. As a result, the underlying beneficiaries of such institutional investors would have unfettered access to the information they would need in order to assert a fiduciary breach related to a “wrongful” allocation to a systemically harmful fund.

Mandating standardized risk disclosures could also reduce the category of herding related to the reputation of a particular adviser. This “reputation-based herding” occurs when an investor “[is] uncertain of the manager’s ability to pick the right stocks” and thus, conforms with the decisions of other investors in selecting optimal investments.³²² One study found that this kind

worth individuals [only] represent 9% of hedge fund investors and 3.6% of the total capital invested in hedge funds”).

³¹⁹ See, e.g., Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1104 (a)(1)(B) (2012) (requiring that pension plans subject to regulation under ERISA “shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries”).

³²⁰ *Id.*

³²¹ Tara Siegel Bernard, *M.I.T., N.Y.U. and Yale Are Sued Over Retirement Plan Fees*, N.Y. TIMES (Aug. 9, 2016), http://www.nytimes.com/2016/08/10/your-money/mit-nyu-yale-sued-4013b-retirement-plan-fees-tiaa-fidelity.html?emc=eta1&_r=0 [https://perma.cc/Y2DV-XSZM].

³²² Bikhchandani & Sharma, *supra* note 317, at 10.

of herding is more likely to occur in emerging markets “where the environment is relatively opaque because of weak reporting requirements, lower accounting standards, lax enforcement of regulations, and costly information acquisition, informational cascades and reputational herding are more likely to arise.”³²³ In many ways, the hedge fund industry is similar to these emerging markets as it is still largely opaque. Although many hedge fund advisers must now register under the Advisers Act, the requisite disclosures do not mandate the disclosure of systemic risk data to its investors. Hedge funds are also excluded from complying with Generally Accepted Accounting Principles in preparing its financial statements. Thus, the calculation of valuations, fees, and risk are not subject to a uniform and standardized reporting system. This can make it exceedingly difficult for investors to optimize hedge fund allocations, even if they utilize significant resources to investigate a subset of funds. Given these unique information asymmetries, there is a heightened risk that investors would allocate to advisers based on the reputation within this niche community, as opposed to sufficiently evaluating the risks of a large range of hedge funds. Mandating standardized risk disclosures could, therefore, mitigate this category of reputational herding as it would provide investors with a reliable mechanism for optimizing hedge fund allocations.

b. Proprietary Information

Mandating such a disclosure system could admittedly elicit considerable pushback from the industry as advisers would likely deem such information proprietary. To address these concerns, the SEC should explore creative reporting mechanisms such as reporting aggregated data, as opposed to detailed position data and/or trading algorithms, or permitting time delays with respect to certain disclosures. Implementing a mandatory disclosure system can also be less destructive than the severe capital restrictions imposed under the SIFI designation process. Hedge fund advisers might prefer providing such streamlined disclosures as opposed to complying with stringent capital restrictions that could destroy their abilities to pursue innovative strategies.

A mandatory disclosure system, which is well-tailored to the proprietary needs of hedge funds, could even benefit the industry by attracting more investors. They would perhaps be more willing to allocate assets to hedge funds because standardized risk disclosures would enable them to more effectively distinguish amongst the thousands of hedge funds that are currently available for investment. In a market where institutional investors such as CalPERS are withdrawing from the industry in droves, this benefit is certainly worth inves-

³²³ *Id.* at 27.

tigating. As discussed in Part III.A.3, many institutional investors have recently withdrawn their hedge fund allocations due to the difficulties of understanding the complexity of hedge fund fees and strategies. Relatedly, hedge fund advisers could use this as an opportunity to distinguish themselves from their peers particularly if advisers can produce comparable returns with lower degrees of systemic risk.

Some empirical research even suggests that transparency mandates could enhance the value of affected firms, which could obviously be a desirable result for hedge fund advisers. For example, one study examined the effects of the 1964 Securities Act amendments on firms that were required to comply with this new legislation.³²⁴ These amendments included mandatory disclosures for a certain subset of firms that traded OTC securities. The results of this study revealed the following:

Overall, the results suggest that the benefits of the 1964 Amendments substantially outweighed the cost of complying with this law as measured by stock returns. This implies that the affected firms were not managed to maximize shareholder value prior to 1964. . . . Regardless of the exact channel, these findings are consistent with the notion that mandatory disclosure laws can cause managers to more narrowly focus on maximization of shareholder value.³²⁵

Perhaps the increased scrutiny from both regulators and investors that results from the process of producing mandatory disclosures, forces advisers to more heavily prioritize shareholder value. In either case, the hedge fund industry could strongly benefit from the increased value that could result from complying with a mandatory disclosure system.

c. Limited Impact of Disclosures

Many commentators and scholars have criticized the effectiveness of disclosures for a variety of reasons. Some have asserted that investors simply do not read mandated disclosures, and even if they do read such disclosures, investors do not react rationally to the provided information.³²⁶ They may disregard warnings associated with investing in risky assets, or fail to process

³²⁴ Michael Greenstone et al., *Mandated Disclosure, Stock Returns, and the 1964 Securities Act Amendments* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 11478, 2005), available at <http://www.nber.org/papers/w11478>.

³²⁵ *Id.*

³²⁶ See, e.g., Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599, 603 (2013) (arguing in part that “many investors, even sophisticated investors, do not start with cautious or neutral presumptions about a security and do not carefully read the disclosure to appraise the security on its merits before deciding whether to invest”).

material information that may have a significant impact on their investments. In a similar vein, the “information overload theory” has emerged within this scholarly discourse which strongly suggests that regulators should pull back on disclosure requirements because investors have been “blinded by the light” with voluminous and perhaps unnecessary information that makes it difficult for investors to make optimal investment decisions.³²⁷

Hedge fund investors are distinctive from retail investors, however, in that they are mostly comprised of highly sophisticated investors who are bound by fiduciary obligations to select prudent investments. They are also more likely to access and process mandated disclosures, which has been supported by empirical research.³²⁸ With respect to the “information overload” theory, it is difficult to apply this theory to the hedge fund industry because it has been historically opaque. Hedge funds are distinctive from publicly traded companies in that they are typically exempt from the Securities Act, Exchange Act, and 1940 Act. Thus, hedge fund investors have not been overloaded with information mandated under the federal securities laws. The disclosures proposed herein would not alter this reality as the proposal emphasizes the need for a short and concise disclosure statement. In fact, institutional investors have been increasingly demanding additional transparency from hedge fund advisers given the complexity of the industry. As one survey noted, “In surveying 303 major institutional investors and 118 hedge funds . . . 55 percent of institutional investors would like additional transparency into their hedge fund investments.”³²⁹ Another survey found that “82 percent of respondents reported an increase in demand for transparency from investors, while 88 percent said investors are demanding greater due diligence.”³³⁰ The mandatory disclosure framework proposed in this Article can serve to meet the growing demand of institutional investors for greater transparency.

³²⁷ See generally Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003) (discussing the information overload theory and the possibility of a regulatory scale back). But see Elizabeth Warren, Comment Letter to SEC Chairman Mary Jo White (July 7, 2016), https://www.warren.senate.gov/files/documents/2016-7-7_Letter_from_Senator_Warren_to_Chair_White.pdf [<https://perma.cc/6WWL-T7LV>] (arguing that the “information overload” theory has no empirical support and further asserting that this theory benefits issuers to the detriment of investor protection).

³²⁸ See, e.g., Huang et al., *Institutional Trading Around Corporate News: Evidence from Textual Analysis 2* (May 30, 2014) (unpublished manuscript), available at [https://fisher.osu.edu/supplements/10/14251/InstTrading%20and%20News%2020140131%20\(RW%20Edits\).pdf](https://fisher.osu.edu/supplements/10/14251/InstTrading%20and%20News%2020140131%20(RW%20Edits).pdf) [<https://perma.cc/J3SC-5TDE>] (noting that “institutions’ trading advantage seems to stem from their ability to process information correctly, and in a highly timely manner”).

³²⁹ Mark Melin, *Hedge Fund Investors Eager for More Transparency*, VALUEWALK (May 21, 2015, 12:45 PM), <http://www.valuewalk.com/2015/05/hedge-fund-transparency>.

³³⁰ KPMG & ALT, INV. MGMT. ASS’N, *THE EVOLUTION OF AN INDUSTRY: 2012 KPMG/ AIMA GLOBAL HEDGE FUND SURVEY 5* (2012).

In addition, the mere act of calculating and disclosing systemic risk data could deter hedge fund advisers from engaging in excessive risk. Because many hedge fund advisers must now register under the Advisers Act, they are subject to random inspections by the SEC. Hedge fund advisers that report high systemic risk exposure could be subject to increased scrutiny by the agency. Relatedly, hedge fund advisers may also be incentivized to minimize systemic risk to avoid future regulation by Congress. If a systemically harmful hedge fund were to fail, additional regulations would likely follow given the draconian Congressional response that often results from a financial calamity. Recent studies have further demonstrated that mandated disclosures can have a positive impact on the quality of management. For example, one such study examined whether increased transparency regarding CEO compensation improved the effectiveness of board management.³³¹ The study ultimately found that “disclosure improves board effectiveness at monitoring executives and in strengthening the link between pay and performance”³³² and the authors reasoned that “[disclosure] facilitates the monitoring of management and hence causes managers to act more in the interests of shareholders.”³³³ Having to calculate and disclosure systemic risk data could similarly incentivize hedge fund advisers to more closely scrutinize the extent to which they engage in systemically harmful practices.

B. Reducing Fragmentation of Regulatory Agencies

Even if one agrees with the systemic risk disclosure framework proposed in this Article, many may argue that FSOC is the ideal regulatory agency to effectuate this task, particularly because the SEC has failed to prevent several notable scandals that led to crippling losses. The Madoff scandal is perhaps the most glaring example of the SEC’s shortcomings as Madoff’s Ponzi scheme flew under the agency’s radar for several years, even though he was registered under the Advisers Act and therefore subject to SEC inspections.³³⁴ Investors lost billions of dollars when Madoff’s Ponzi scheme eventually unraveled.³³⁵ Nevertheless, this Article argues that lawmakers should instead dedicate resources to reforming the existing agencies instead of creat-

³³¹ De Franco et al., *The Effect of Disclosure on the Pay-Performance Relation*, 32 J. ACCT. & PUB. POL’Y 319, 319 (2012).

³³² *Id.*

³³³ *Id.* at 320.

³³⁴ See Robert Chew, *A Madoff Whistle-Blower Tells His Story*, TIME (Feb. 4, 2009), <http://content.time.com/time/business/article/0,8599,1877181,00.html> [<https://perma.cc/PRA2-94QF>] (discussing how the SEC failed to flag Madoff’s fraudulent activity even though the signs were there).

³³⁵ *Id.*

ing additional layers of ineffective regulation that could lead to repeated failures, undue complexities, and wasted resources. With FSOC's failure to designate a hedge fund as a SIFI over the past six years, FSOC's jurisdiction over the asset management industry has likely produced these problematic results.

By and large, granting systemic risk authority to the SEC could serve to reduce the fragmentation of the regulatory agencies that has arguably led to inefficient and redundant regulations. As previously discussed, the regulatory structure is highly fragmented, especially in comparison to other jurisdictions. The SEC holds primary responsibility for regulating securities, while the CFTC regulates futures and derivatives. These agencies further delegate certain regulatory functions to self-regulatory organizations such as FINRA and NFA, which creates additional registration requirements for broker-dealers and future commission merchants. As a result, many investment funds have to either separately register with or obtain exemptions from each of these entities, as well as other regulatory agencies in international jurisdictions. With the creation of FSOC, investment funds are potentially subject to oversight by yet an additional federal agency. If a fund is designated as a SIFI, the Federal Reserve would also have oversight over the industry. This fragmented regulatory system has led to a complex web of rules and regulations that are often overlapping and inefficient.

Many scholars and regulators have advocated for further consolidation of regulators. Former SEC Commissioner Roberta S. Karmel has argued that consolidating the SEC with the CFTC would eliminate the jurisdictional battles that have hindered the effectiveness of these agencies.³³⁶ She further reasoned that a consolidated agency could more effectively regulate the growing complexities of the markets, and would better guard against the agency capture that has historically plagued regulators.³³⁷ The Department of Treasury similarly concluded that:

Product and market participant convergence, market linkages, and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient. To address this issue, the CFTC and the SEC should be merged to provide unified oversight and regulation of the futures and securities industries.³³⁸

³³⁶ Karmel, *supra* note 182, at 533.

³³⁷ *Id.* at 533–34.

³³⁸ U.S. DEP'T OF THE TREASURY, DEPARTMENT OF TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 11 (2008).

Creating additional agencies to regulate the continuous innovations of investment funds may serve to exacerbate the issues identified by these commentators. My future research will inevitably delve deeper into the potential benefits of a SEC/CFTC merger.

Many commentators may argue that the SEC is too politicized to undertake this task of developing standardized disclosures. For example, former SEC Commissioner Daniel M. Gallagher recently argued that the Dodd-Frank Act has created political divides within the agency as the many reforms mandated under this sweeping legislation are “ideologically driven rule-makings that reflect the partisan nature of the way the law was written.”³³⁹ FSOC, however, is also potentially deeply politicized as highlighted by Professor Christina Skinner.³⁴⁰ She specifically found that:

The binary design of the designation power also makes the SIFI label vulnerable to political pressure. In requiring regulators to sort financial institutions into two buckets—systemically risky and not—in effect, a binary mechanism enables the assignment of regulatory “winners” and “losers.” Given that the FSOC is spearheaded by the Treasury Secretary—a political appointee who reports directly to the Administration in power—one can readily see the potential for political factors to influence this sorting (that is, designation) process.³⁴¹

FSOC’s sweeping power to designate entities as SIFIs makes the possible politicization of this council even more troubling given the deleterious effect that such a designation can have on affected firms. The failure to designate a systemically harmful entity as a SIFI is also a troubling outcome that could result from the politicization of the council. Simply creating yet another agency comprised of regulatory chairpersons does not necessarily eliminate the risks of politicization. Congressional leaders should instead hold the existing agencies more accountable for effectuating its various mandates, and perhaps provide additional resources for the agencies to do so.

In terms of assessing the expertise of the SEC, the agency has regulated the investment fund industry over the past century. The SEC is intimately familiar with the specific nuances and complexities of investment funds, and it has expanded its knowledge over the private fund industry with the passage

³³⁹ Ed Beeson, *SEC’s Gallagher Blames Dodd-Frank for Politicizing Agency*, LAW360 (Aug. 4, 2015, 4:38 PM), <http://www.law360.com/articles/687055/sec-s-gallagher-blames-dodd-frank-for-politicizing-agency> [https://perma.cc/9SSZ-9C27].

³⁴⁰ Christina Parajon Skinner, *Regulating Nonbanks*, 105 GEO. L.J. (forthcoming 2017) (manuscript at 35), available at <https://ssrn.com/abstract=2740424>.

³⁴¹ *Id.*

of the Dodd-Frank Act. Industry participants such as advisers, lawyers, and accountants also have working relationships with the SEC, and imposing yet another regulator may create unanticipated costs for these parties that inevitably get passed down to underlying investors. Moreover, the SEC has the structural framework in place to easily incorporate an additional disclosure form into its mandatory disclosure system. This form would be publicly available on its website. Although the SEC is historically an investor protection agency, FSOC seems to have deferred to the agency in terms of utilizing the 1940 Act to regulate systemic risk in the registered fund industry.³⁴² Overall, the SEC has taken a larger role in regulating systemic risk in the financial markets. With the increasing relationship between investor protection and systemic risk, it is only natural that the SEC would expand its jurisdiction in this regard.

CONCLUSION

Financial innovation has blurred the distinction between private funds and banks. Academics have long debated how best to respond to this regulatory conundrum. Regulations previously made distinctions amongst the categories of entities that created systemic risk, the administrative agencies charged with regulating systemic risk, and the regulatory tools used to mitigate systemic risk. As it stands now, systemically harmful funds will in fact be regulated as banks if FSOC designates such fund as a SIFI. Yet, it is questionable whether the benefits of appointing a hedge fund in this manner would exceed the costs. Also, with the mounting challenges FSOC has encountered in utilizing this power, it is highly unlikely that a hedge fund will ever be designated as a SIFI. This has left a hedge fund loophole that existing regulators are preempted from closing.

In response to these challenges, this Article argues that the SEC should be the regulator appointed by Congress to close this hedge fund loophole. In granting the SEC the authority to undertake this task, this Article recognizes that although the line between private funds and banks has indeed been blurred, it has not been eliminated. The SEC is better positioned to accommodate the fundamental differences between these two industries as it has regulated the investment fund industry for over seventy-five years. Moreover, the transparency framework inherent in the federal securities laws can be deployed as a mechanism for more effectively reducing systemic risk, without disrupting the abilities of hedge fund advisers to pursue their innovative strategies. This assertion necessarily entails exploring the relationship between

³⁴² FSOC REPORT, *supra* note 235, at 21.

investor protection and systemic risk, which has been grossly neglected by researchers in this area. Nevertheless, this Article posits that standardizing risk disclosures for hedge fund investors and counterparties would provide these market participants with the necessary tools to better protect themselves against systemically harmful funds. This could in turn weed-out such funds from the marketplace. Developing appropriate disclosures would require experts from a range of fields such as economic, quantitative analysis, and finance. Creative solutions must be sufficiently explored given the complexities entailed in developing such disclosures. As financial innovations continue to unfold, researchers must continuously investigate these issues from a variety of perspectives.

