



Berkeley Center for Law,
Business and the Economy

Financial Regulatory Reform and Private Funds

Anita K. Krug

July 13, 2009

For further information, contact BCBLE@law.berkeley.edu

The Berkeley Center for Law, Business and the Economy is the hub of Berkeley Law's research and teaching on the impact of law on business and the U.S. and global economies.

Financial Regulatory Reform and Private Funds

Anita K. Krug

The Obama Administration on June 17 released its proposals for restructuring the regulation of the U.S. financial regulatory system to address the weaknesses evident or perceived in the wake of the financial crisis and to “restore confidence in the integrity of our financial system.”¹ Congress now has the task of evaluating and, if deemed appropriate, implementing those proposals (collectively, the “*Proposal*”).

This paper argues that policymaking relating to private funds (and/or their investment advisers) arising out of the Proposal (or otherwise) that has as its goal mitigating systemic risk should avoid casting too broad a net and instead should be tailored based on specific portfolio activities that may give rise to systemic risks. Among other things, that approach will further the objective of protecting advisers’ trade secrets and entrepreneurial incentives.

After briefly summarizing the Proposal as it pertains to new legislation that would affect hedge funds, private equity funds, and other private funds (Section I), the paper discusses the goal (systemic risk mitigation) of that prospective legislation (Section II), proposes an approach for formulating it (Section III), and emphasizes that maintaining information confidentiality should be a paramount consideration in that process (Section IV).

I. *Summary of the Proposal as it relates to regulation of investment advisers to hedge funds and other private funds.*

The Proposal notes that private funds have proliferated in recent years and that the U.S. regulatory regime governing investment advisers does not require investment advisers that manage private funds to become registered with the SEC or any other federal regulatory authority. The Proposal further observes that, during the financial crisis, private funds’ “de-leveraging” caused “strain on financial markets.” It calls for regulators to obtain more information about private funds so that they can “assess potential systemic implications” of private funds’ activities. It also asserts, without support or elaboration, that there is “a compelling investor protection rationale to fill the gaps in the regulation of investment advisers and the funds that they manage.”

The Proposal would require investment advisers who manage hedge funds or other private funds to register as investment advisers with the SEC under the Investment Advisers Act of 1940, as amended (the “*Advisers Act*”).² In addition, those advisers would be required to report information to the SEC about the funds that they manage. That reporting requirement is intended to enable regulators to determine whether a fund’s or its adviser’s activities posed threats to systemic stability and to assess how private funds “are changing over time” and whether they

¹ U.S. Dept. of Treasury, *Financial Regulatory Reform: A New Foundation*, June 17, 2009.

² The Advisers Act and the rules under that Act constitute the current U.S. regulatory regime governing investment advisers. There is currently no oversight regulation of private funds; they, by definition, have been exempt from that regulation, in contrast to registered investment funds, which are governed under the Investment Company Act of 1940 and associated rules.

have become “so large, leveraged, or interconnected” so as to “require regulation for financial stability purposes.” The Proposal recommends that investment advisers’ disclosure of that information — which would include such things as “assets under management, borrowings, off-balance sheet exposures” — be done on a confidential basis. However, the SEC would share that information with the Federal Reserve, which, in turn, would determine whether any of the funds or fund groups about which it receives reports should be “supervised and regulated” as Tier 1 FHCs — *i.e.*, institutions deemed important from a financial stability perspective, such as lending institutions, insurance companies, and bank affiliates.

The Proposal also recommends that all funds managed by SEC-registered investment advisers be required to adhere to requirements relating to “disclosures to investors, creditors, and counterparties.” And it raises the possibility that some of the requirements to which investment advisers become subject may differ depending on the types of funds managed — presumably referring to hedge funds vs. private equity funds vs. venture capital funds and so on.

II. *The goals of financial regulatory reform involving regulation of private funds.*

Financial regulatory reform, as contemplated in the past few years, generally has had two central goals: mitigation of systemic risk and investor protection. The former is the primary goal of the Proposal’s measures relating to private funds and their advisers.

That focus is an obvious product of the financial crisis. In particular, systemic risk concerns arose most directly from the severe market downturns and prospects that the failure of certain large financial institutions, if permitted to happen, would ripple through the financial markets and beyond, potentially impeding or halting financial and economic activity. These concerns were evidenced at the onset of the financial crisis by the government’s prevention of Bear Stearns’ collapse and, later, its rescuing AIG and supplying other financial institutions with capital infusions.³ They were evident also in the SEC’s rulemaking, including to prohibit certain short selling activities in September and October 2008.

More indirectly, prevalent sentiment has it that there exists a “shadow” banking system” — a swath of financial institutions that are unregulated but that engage in activities that regulated financial institutions engage in — and that, given the lack of regulatory oversight, the activities within the shadow banking system, perhaps more than the activities of regulated financial institutions, contribute to systemic risk. Typically included as participants of this shadow banking system are affiliates of brokerage firms, insurance companies, and other regulated entities, along with private investment funds, including hedge funds and private equity funds.

Compounding the concern that certain types of financial institutions remain unregulated is the perception that the activities of many financial institutions (whether or not within the shadow banking system) are intertwined with one another to such an extent that one institution’s failure could set off a chain reaction, leading to additional failures. One example of this interconnectedness is that brokerage firms are often parties to each others’ transactions, and they

³ In the government’s view, AIG, having written substantial amounts of “long” credit default swap contracts, could not be permitted to default on those contracts because, among other dire consequences, its doing so would have triggered defaults by other financial institutions holding the “short” side of the swaps and the value of whose assets depended on the protection provided by the swap contracts.

are also counterparties to other financial institutions' transactions, which, for their part, enter into transactions with other brokerage firms and counterparties.

In addition, many financial institutions' activities are deeply intertwined with the markets more generally. They are intrinsic participants in various market risk transfer transactions. In the housing market, for example, these institutions enabled the structured credit market, which, in turn, enabled mortgage lenders to transfer most of the risk to which they would otherwise have been subject, which created incentives for those lenders to fund profitable mortgages, without evaluating whether the mortgagors had any reasonable means of meeting their payment obligations. The result was the improbable housing bubble that eventually burst, draining wealth worldwide and imperiling financial institution liquidity.

Hedge funds (and other private funds) engage in some of the types of activities that have given rise to systemic risk concerns.

For example, hedge funds have been significant participants in the credit default swap (CDS) markets, not only as protection buyers (holding the "short" side of the contract) but also as protection sellers (holding the "long" side of the contract). CDSs basically insure against defaults or the occurrence of other "credit events," such as bankruptcy, failure to pay, or debt restructuring, relating to designated assets or instruments — asset-backed or other debt securities, for example. Hedge funds that are CDS protection sellers are at risk of having to satisfy their obligations to pay out on CDS as the designated instruments decline in value or become completely valueless.

Hedge funds have also been significant participants in options, futures, and other types of derivative instruments. In addition, hedge funds and private equity funds have engaged in many of their activities on a leveraged basis, through borrowing cash from their "prime brokers" (using their assets as collateral) or other banks or brokers or otherwise through credit facilities or similar arrangements. That leveraging, in addition to permitting those funds to transact in assets and investments worth potentially far more than the capital contributed by their investors, obligates them to pay the associated principal and interest.

All of these "obligating" activities not only serve to increase leverage in the broader economy. They also constitute a form of leverage for the funds engaging in them, giving rise to certain types of obligations that may be more or difficult for the funds to meet, depending on the market environments in which the funds pursue their activities. And therein lies the source of possible systemic risk. In the most simplistic of descriptions, the risk is that, in periods of market distress, funds that hold these obligations may default on their obligations, thereby directly impacting those to whom the obligations are owed. Or they may, with relative rapidity, seek to "de-leverage," to reduce the amount of their obligations, using whatever opportunities and at whatever prices may be available to them at the time. Depending on the rate and extent of that process, the effects can be quite far reaching, as "implosions" of large, leveraged funds have demonstrated in the past. Whether this risk is "systemic" is a product of the size of the obligations along with the interplay of who the counterparties are, what the obligations are, and what market assets or economic sectors they derive value from.

Because of these types of activities, private funds carry the potential to contribute to systemic phenomena. Accordingly, regulators should have, and are now seeking, a better handle on what private funds do and how they do it.

III. *Formulating legislation addressing private funds as contributors to systemic risk.*

To the extent the regulatory proposals to date have expressly addressed systemic risk concerns created by hedge funds and other private funds, they typically have centered on certain restrictions or limitations relating to fund portfolio activities and net capital. In particular, proposals thus far have encompassed mandating net capital thresholds, limiting leverage that funds may employ, requiring funds to disclose their portfolio activities to regulators, and regulating credit default swaps and other derivative instruments presently beyond the CFTC's or the SEC's purview. The Proposal, similarly, revolves around disclosure of portfolio-related information. And, like the proposals preceding it, it does not evince a particular concern with establishing a connection between those sorts of requirements and actually achieving systemic risk mitigation.

That may not be surprising. Economists have for years been studying market phenomena and relationships in efforts to understand the conditions sufficient or necessary for precipitous and adverse changes to liquidity and credit and to develop predictive models that might be employed to prevent financial crises of the sort markets worldwide have recently experienced. For example, some economists have formulated models to help show how "market liquidity and funding liquidity are mutual reinforcing, leading to liquidity spirals."⁴ Others have developed models to predict "financial contagion,"⁵ to show how "banking panics are related to the business cycle,"⁶ and to elucidate "the interaction between risk management practices and market liquidity."⁷ Still others have developed models of credit risk in "complex counterparty relationships."⁸

However, recent broad awareness of how sweeping adverse adjustments to liquidity and credit markets threaten financial stability came about not as a result of the lessons those academic analyses and models might provide but, rather, as a result of the escalation of systemic risk into systemic failure. The urgency behind mitigating systemic risk appears based, at least in part, on speculation and mere assumptions about the causes of recent systemic failures. Policymakers' immediate experience with the consequences of systemic risks and systemic failures may render their impulse to act understandable, but it does not automatically justify policies predicated on the bare assertion that they will address the maladies that have befallen the financial system.

⁴ Markus K. Brunnermeier & Lasse Heje Pedersen, "Market Liquidity and Funding Liquidity," NBER Working Paper Series, Working Paper No. 12939, Feb. 2007.

⁵ Franklin Allen & Douglas Gale, "Financial Contagion," *Journal of Political Economy*, vol. 108, no. 1, 2000; Albert S. Kyle & Wei Xiong, "Contagion as a Wealth Effect," *The Journal of Finance*, vol. LVI, no. 4, Aug. 2001; Laura E. Kodres & Matthew Pritsker, "A Rational Expectations Model of Financial Contagion," *The Journal of Finance*, vol. LVII, no. 2, Apr. 2002.

⁶ Franklin Allen & Douglas Gale, "Optimal Financial Crises," *The Journal of Finance*, vol. LIII, no. 4, Aug. 1998.

⁷ Nicolae Gârleanu & Lasse Heje Pedersen, "Liquidity and Risk Management," AEA Papers and Proceedings, vol. 97, no. 2, May 2007.

⁸ Henri Schellhorn & Didier Cossin, "Credit Risk in a Network Economy," FAME Research Paper No. 106, Mar. 2004.

The absence of solid, empirically-tested conclusions about systemic risk's nature and contributions to current financial conditions need not prevent the project of fashioning policy responses to the current financial crises. However, developing an appropriate framework within which to formulate policies should improve the likelihood that those policies will have positive outcomes or at least reduce the likelihood that they will impose substantial costs to parts of the financial system that are not evidently broken.

Toward that end, it is worth separating types of regulation that may achieve systemic risk mitigation from those that likely will not. An initial step toward that end should be to countenance the possibility that not all activities that private funds pursue are likely to contribute to systemic risk. That is, to the extent that systemic risk arises from certain types of transactions and activities, it should be possible to categorize funds based on the activities they pursue and then focus regulatory analysis on the relevant subset. Toward *that* end, the primary criterion for categorizing funds should be whether *their activities*, in circumstances of distress, could potentially affect parties beyond the funds themselves and their investors.

More specifically, as discussed above, certain types of portfolio activities make funds *obligated* to third parties that have no beneficial interest in the funds' performance — but not all types of portfolio activities do. Accordingly, legislation and regulation aimed at systemic risk mitigation should be directed only at those funds that engage in activities in the former category, *i.e.*, activities that obligate the funds engaging in them.

But can the field be narrowed further? Whether risks arising from “obligating” activities are potentially “systemic” depends on a mixture of the size and nature of the obligations and their connections to particular industries or markets, as well as the identities of the counterparties to the transactions — the firms or funds to whom the obligations are owed. From a regulatory perspective, because of the indeterminate nature of that “mixture,” *size* is probably a workable bright line. That is, even among the funds that pursue activities that obligate them, unless a fund or fund group is of appreciable size, in terms of assets, its activities arguably will not be important from a systemic perspective. Therefore, only the subset of funds above a certain size should be the focus of regulation intended to address systemic risk.

The evident corollary to this analysis is that funds that do not assume obligations should not be the focus of measures to mitigate systemic risk, even if those activities may potentially affect market prices. To be sure, if fund of this type were to suddenly sell all of its securities, those sales could dramatically adversely affect the prices of the securities sold, particularly if the fund were relatively large in terms of its asset size. That would presumably impact shareholders market wide, including other hedge funds and financial institutions. Without more, however, that result should not give rise to systemic risk concerns.

Even funds whose (non-obligating) activities indirectly increase leverage in the broader economy, without more, may not cause systemic risk concerns necessitating regulation *directed at funds' activities* (as opposed to regulation governing the investment instruments themselves, that, therefore applies to all investors). As an example, funds that invest in debt instruments that, in turn, finance the activities of municipalities or corporations or homeowners, though possibly engaging in risky investment activities, are not thereby creating obligations to third parties that they may be unable to satisfy. The same holds for funds engaging in direct lending activities,

such as making commercial loans. The borrower may or may not be repay the loan, and, if it does not, the fund stands to lose, possibly considerably. However, those lending activities, in and of themselves, presumably will not have significant systemic implications.

IV. *Ensuring the confidentiality of information about private funds' portfolios.*

Tailoring disclosure requirements to the types of funds whose information is actually necessary for systemic risk mitigation is not merely a matter of economy. It also is a step that furthers, and reflects a recognition of, a second goal that should be prominent in efforts directed at systemic risk mitigation insofar as they involve private funds and their investment advisers.

That second goal derives from the circumstance that private funds have the flexibility to pursue most any investment strategy, and investment advisers develop those strategies based on their assessments of debt and equity and other markets worldwide. That flexibility and innovation has value in the financial and capital markets, contributing to capital formation and market efficiency in myriad ways. Included in the well-worn litany: private funds promote market liquidity through their willingness to engage in all sorts of transactions with banks, brokerage firms, and other counterparties, from lending capital, to entering into contracts for derivative instruments, to buying relatively illiquid securities and other instruments, to providing capital to companies needing additional financing. Because of their diverse strategies, private funds also serve as tools of portfolio diversification for investors.

The Proposal contemplates that investment advisers' disclosure about the portfolios they manage would not be publicly available, providing that "the regulatory reporting requirements for such funds should require reporting on a confidential basis." If, consistent with the Proposal, Congress were to direct the SEC to provide confidential treatment to the information that the SEC would require from private fund investment advisers, presumably the SEC would do so through one or two exemptions from disclosure under the Freedom of Information Act ("FOIA"). Exemption 4 under FOIA permits nondisclosure of information constituting "trade secrets and commercial or financial information obtained from a person and privileged or confidential," and FOIA Exemption 8 permits nondisclosure of information relating to "examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." The SEC relied on both of those exemptions in declaring in 2008 that reports of short selling activities on Forms SH required of "institutional investment managers" (investment managers managing at least \$100 million in US publicly-traded equity securities) would be treated confidentially.

Investment advisers need to be comfortable that the any information they provide to regulators under regulations adopted pursuant to regulatory reform will, in fact, remain confidential. Indeed, it is critically important: As noted above, investment advisers could lose incentives to innovate and pursue their strategies and operations if the composition of the portfolios of the funds they manage — which constitute trade secrets — were to be made publicly accessible.

One concern arising from disclosure of certain types of information would be that the those interested in doing so could effectively "reverse engineer" the advisers' proprietary investment

strategies, potentially ultimately harming the portfolios they manage.⁹ In addition, the issuers of securities comprising advisers' portfolios could, depending on the nature of the disclosure, use information obtained through disclosure to act adversely to advisers that may have pessimistic outlooks on those issuers' securities or otherwise seek to discourage those advisers' activities, ultimately impeding independent research and harming market efficiency and price transparency.¹⁰

Conversely, from the perspective of these concerns, it does not seem terribly problematic to require disclosure to regulators and no one else, so long as regulators do not — *and will not be legally required to* — make that information publicly available. However, that the SEC or other relevant regulator may specify that reports are to be treated confidentially does not, without more, ensure confidentiality. That is, without policymaking more thoroughgoing than directing regulators to grant confidential treatment, it will be difficult to ensure to investment advisers' satisfaction that disclosure to requesters from the public is not, in fact, a realistic prospect.

At the least, the public will undoubtedly seek the information that advisers are required to disclose, notwithstanding the FOIA exemptions on which the SEC has generally relied. Case in point: notwithstanding the SEC's intent that Forms SH would be exempt from disclosure under FOIA, various parties promptly submitted FOIA requests seeking disclosure of all or select Forms SH filed with the SEC. And beyond the likelihood that FOIA requesters will seek confidential information solidly within the categories of information intended (by Congress and the SEC) to be confidential, FOIA requesters could challenge whether certain information that regulators require under the new regime and deem confidential is actually covered by the Congressional directive, however phrased, regarding confidentiality. Courts have, in some instances, disagreed with the SEC's determinations on the applicability of FOIA exemptions.¹¹

As part of its legislation relating to private funds, then, Congress should take steps to ensure that confidential treatment will mean just that. Without that assurance, the SEC's (or other regulator's) proclamation that certain information that investment advisers must report will be subject to FOIA exemptions will likely not provide advisers with the necessary comfort that their trade secrets and other proprietary information will not ultimately be made publicly available.

⁹ See Akin Gump Strauss Hauer & Feld, LLP, Comment Letter to the SEC, available at <http://www.sec.gov/comments/s7-31-08/s73108-49.pdf>, at 8 (Dec. 16, 2008).

¹⁰ *Cf. id.* (noting that “by collecting the information required on Form SHs, the SEC risks becoming a resource for companies that would attempt to ‘freeze out,’ intimidate and ‘short squeeze’ short sellers to improperly prop up their stock price” and that, by requiring Form SH disclosures, “the SEC is greatly increasing the opportunity for issuers to target and retaliate against short sellers”).

¹¹ *See id.* at 6 & n.19.