

TAMING THE LOCUSTS?¹

EMBATTLED HEDGE FUNDS IN THE E.U.

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The recent financial crisis and the ongoing sovereign debt crisis have put the spotlight on the traditionally secretive and opaque hedge fund industry. Widespread financial losses have provoked popular suspicion against hedge funds, which are viewed as speculators that destabilize the financial system. Adhering to the pattern of crisis-driven financial regulation, the European Union has enacted legislation that is expected to radically transform the hedge fund industry in Europe. While it may seem at first glance that only the Alternative Investment Fund Managers Directive and its complex and burdensome requirements for hedge funds and their managers is expected to directly impact the hedge fund industry, the effect of the Short Selling Regulation and the Proposal for a Financial Transaction Tax will be equally devastating for hedge funds by curtailing their investment techniques and market operations. This article argues that the European Union has engaged in a crisis-driven regulatory spree and that this regulatory overhaul is founded on perceptions and popular beliefs rather than actual evidence. In regulating hedge funds, the E.U. has moved forward with regulating not only hedge funds and their managers, but also their investment techniques and market operations. The cumulative impact of the E.U.'s regulatory spree is expected to be a sharp increase in costs for hedge funds operating in Europe and a decline in investor returns with negative consequences for European investors and markets. Thus the term "embattled" hedge funds.

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1. Poul Nyrup Rasmussen, *Taming the Private Equity 'Locusts'*, THE GUARDIAN (UK), Apr. 10, 2008, available at <http://www.guardian.co.uk/commentisfree/2008/apr/10/tamingtheprivateequitylo>.

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I.

INTRODUCTION

Praised as the prototypical arbitrageurs correcting inefficiencies and providing liquidity in financial markets but criticized for driving short-term profit seeking, creating asset bubbles² and preying on companies like “swarms of locusts,”³ hedge funds remain the most controversial vehicles in the alternative investment funds universe. Twenty-one years after hedge funds gained mainstream attention when George Soros speculated against the British pound and won his bet that the U.K. would be forced to exit the Exchange Rate Mechanism

2. See Photis Lyssandrou, *The Real Role of Hedge Funds in the Crisis*, FIN. TIMES (U.K.), Apr. 1, 2013, available at <http://www.ft.com/intl/cms/s/0/e83f9c52-6910-11e1-9931-00144feabdc0.html#axzz2g8gHQO35>; Martin Lip-ton, *Important Questions about Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (MARCH 9, 2013, 10:10 AM), available at <http://blogs.law.harvard.edu/corpgov/2013/03/09/important-questions-about-activist-hedge-funds/>.

3. The description of hedge funds as “swarms of locusts” belongs to the former Chairman of the Social-Democratic Party of Germany Frank Muntefering following the outcry provoked by the shareholders’ rebellion against Deutsche Boerse’s bid for the London Stock Exchange (LSE) which resulted in the collapse of the bid and the resignation of Deutsche Boerse’s Chief Executive Officer and Chairman of the Board of Directors. The revolt was led by U.K.-based hedge fund The Children’s Investment Fund (TCI) and marked the advent of Anglo-Saxon aggressive shareholder activism in the traditionally closed and insider-dominated German corporate system. For an excellent overview of this landmark revolt and its effects on German corporate governance, see generally Sudi Sudarsanam & Tim Broadhurst, *Corporate Governance Convergence in Germany through Shareholder Activism: Impact of the Deutsche Boerse bid for London Stock Exchange*, 16 J. MGMT. & GOV. 235 (2012).

and devalue its currency,⁴ the hedge fund industry has managed to establish itself as a powerful force in modern financial markets.

The 2008 financial crisis put financial regulation at the top of regulators' and politicians' agendas worldwide. Hedge funds – criticized for operating largely outside regulatory reach⁵ and engaging in highly specialized and controversial investment techniques such as short-selling, credit default swaps (“CDS”)⁶ and high frequency trading – were one of the first targets of regulators and politicians in their efforts to create a

4. After massive selling of the pound with Soros's Quantum Fund at the forefront, the Bank of England abandoned its defense of the currency and the British government announced on the evening of the 16th of September 1992, a day which will remain in British history as “Black Wednesday,” that it was withdrawing from the Exchange Rate Mechanism. Apart from earning himself the nickname “The Man Who Broke the Bank of England,” Soros also made a profit of almost 1 billion dollars on his speculative bet. See David Litterick, *Billionaire Who Broke the Bank of England*, THE TELEGRAPH (UK) (Sept. 13, 2002), available at <http://www.telegraph.co.uk/finance/2773265/Billionaire-who-broke-the-Bank-of-England.html>.

5. In contrast to the perceived wisdom frequently expressed by politicians and the press that the hedge fund industry was completely unregulated, at least until the adoption of the Dodd-Frank Wall Street Reform Act (hereinafter “Dodd-Frank Act”) and the Alternative Investment Fund Managers Directive (hereinafter “AIFM Directive”), one should note that hedge funds were in fact regulated by various Member States in the E.U. For instance in the U.K., hedge fund managers were subject to registration with the Financial Services Authority. Regarding hedge fund regulation in the European Union prior to the adoption of the AIFM Directive, see generally PHOEBUS ATHANASSIOU, HEDGE FUND REGULATION IN THE EUROPEAN UNION: CURRENT TRENDS AND FUTURE PROSPECTS 125-64 (Joseph J. Norton et al. eds., 2009) (discussing hedge fund regulation in the European Union prior to the adoption of the AIFM Directive). Even in the U.S. where hedge funds were not subject to registration with the Securities and Exchange Commission (hereinafter “SEC”) and therefore had no obligation to disclose information to the SEC and the public, they were subject to the SEC's investigation and prosecution authority for insider dealing and fraud. See Luther R. Ashworth II, *Is Hedge Fund Adviser Registration Necessary to Accomplish the Goals of the Dodd-Frank Act's Title IV?*, 70 WASH. & LEE L. REV. 651, 654 (2013).

6. Credit default swaps are a form of insurance against an issuer's default. The protection seller will compensate the protection buyer in the event of a loan or bond default or any other “credit event.” In return, the protection buyer will pay a premium to the protection seller. See generally Frank Partnow & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007) (describing the benefits and perils of credit default swaps).

new financial architecture.⁷ The financial crisis presented a unique opportunity for the European Union and its largest Member States to bring the industry and its investment techniques under their regulatory grip. Germany and France were traditionally skeptical towards the hedge fund industry.⁸ The sovereign debt crisis and the belief that hedge funds, through short-selling and CDS trading, aggravated or even caused the crisis, only reinforced the determination of E.U. regulators to move forward with their ambitious plans.⁹ The result was the adoption of legislation that will radically transform the hedge fund industry in the E.U. Apart from the passage of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (“AIFM Directive”),¹⁰ which were the first efforts to directly regulate hedge funds, the European Union has also extended its regulatory reach to hedge funds’ investment techniques and market operations with the adoption of Regulation 236/2012, which regulates short-selling and certain aspects of sov-

7. *Gordon Brown’s Call for a New Bretton Woods Gains Traction*, THE TELEGRAPH (UK), Oct. 15, 2013, available at <http://www.telegraph.co.uk/finance/3201885/Gordon-Browns-call-for-a-new-Bretton-Woods-gains-traction.html>.

8. The former President of France Nicolas Sarkozy was one of the most vocal opponents of freewheeling Anglo-Saxon capitalism and an ardent supporter along with German Chancellor Angela Merkel of stricter pan-European hedge fund regulation. See Patience Wheatcroft, *City Should Not Rise to Sarkozy Rhetoric*, WALL ST. J., Dec. 3, 2009, available at <http://online.wsj.com/article/SB10001424052748704107104574571933458067204.html>; U.K. *Suffers Hedge Fund Blow*, FIN. TIMES (May 13, 2010), available at <http://www.ft.com/intl/cms/s/0/f583a770-5ed4-11df-af86-00144feab49a.html#axzz2G54zLj7t>.

9. See Stephen Fidler, *Merkel and Sarkozy’s Bid for Haste Risks Derivatives Strife*, WALL ST. J. (June 11, 2010), available at <http://online.wsj.com/article/SB10001424052748703627704575298690940763432.html>; Patrick Donahue, *Merkel Slams Euro Speculation “Warns of Resentment”*, BLOOMBERG (Feb. 23, 2010), available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aQ9wHnlOENSr>; *Out of Control: The Destructive Power of the Financial Markets*, DER SPIEGEL (Aug. 22, 2011), available at <http://www.spiegel.de/international/business/out-of-control-the-destructive-power-of-the-financial-markets-a-781590.html>.

10. Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 O.J. (L 174) 1 [hereinafter AIFM Directive].

ereign CDS (“Short Selling Regulation”)¹¹ and the proposal for a Financial Transaction Tax (“Proposal for a Financial Transaction Tax”).¹²

This article offers a critique of the recent efforts to regulate the hedge fund industry and argues that the European Union has engaged in a crisis-driven regulatory spree, which will severely impact the industry and cause hedge funds to withdraw from European markets. E.U. regulators and politicians have moved towards regulating not only hedge funds and their managers, but also their key investment techniques and market operations. The cumulative impact of E.U. legislation will lead to the diminution of the hedge fund industry in Europe by squeezing its profits and curtailing the competitive advantage of hedge funds, namely their ability to operate unrestrictedly in financial markets and engage in dynamic trading strategies by quickly entering or exiting positions in different markets.

Part I describes hedge funds and their investment techniques. Part II examines the main rationales for hedge fund regulation and investigates the role of hedge funds in the financial crisis of 2007 and the ongoing sovereign debt crisis. Part III critically assesses recent E.U. legislative attempts to regulate hedge funds, their investment techniques, and market operations. The AIFM Directive, the Short Selling Regulation, and the Proposal for a Financial Transaction Tax, if implemented, would radically transform the hedge fund industry in Europe. Part IV argues that the European Union’s regulatory response conforms to all the attributes of crisis-driven financial regulation and paints a rather bleak picture for the future of the hedge fund industry in Europe, which is embattled with regulations touching upon not only hedge fund managers and funds, but also their market operations and investment techniques. Part V concludes by arguing that the cumulative impact of the E.U.’s crisis-driven regulatory spree will be a severe increase in costs for hedge funds operating in Europe and a

11. Regulation No. 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps, 2012 O.J. (L 86) 1 [hereinafter Short Selling Regulation].

12. *Commission Proposal for a Council Directive Implementing Enhanced Cooperation in the Area of Financial Transaction Tax*, (COM) (2013) 71 final (Feb. 2, 2013).

decline in investor returns with negative consequences for European investors and markets.

II.

HEDGE FUNDS: AN INTRODUCTION

Hedge funds, the poster boys of modern financial capitalism, owe their existence to Alfred Winslow Jones, a former student of the Marxist Workers School in Berlin turned investment manager.¹³ By buying undervalued stocks and selling overvalued stocks using his superior stock picking abilities and utilizing leverage to amplify his returns, Jones was able to run his hedge fund profitably in all market conditions. In addition, Jones devised the modern hedge fund structure by charging his investors a performance-based fee and structuring his fund so that he could escape regulation under U.S. securities laws.

Although hedge funds lack a formal or universally accepted definition, a hedge fund can be described as including “any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.”¹⁴ The inclusion of the word “hedge” would lead one to assume that a defining characteristic of hedge funds is their use of hedging strategies. Although hedge funds do commonly engage in trading strategies seeking to insulate their investors from adverse market movements, this is not always the case.¹⁵

Hedge funds are commonly structured as limited partnerships,¹⁶ raising capital from a number of investors who be-

13. For an excellent introduction into Alfred Wilfred Jones' biography, investment style and philosophy, see generally SEBASTIAN MALLABY, *MORE MONEY THAN GOD: HEDGE FUNDS AND THE MAKING OF A NEW ELITE* 15-39 (2010).

14. THE PRESIDENT'S WORKING GRP. ON FIN. MKTS., *HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT I* (Apr. 1999).

15. Examining a large sample of hedge funds, Chen finds that the majority of hedge funds trade derivatives. The use of derivatives is associated with lower fund risks such as return volatility, downside risk, and extreme event risk, as well as lower risk of fund failure in severe market conditions. These characteristics indicate that hedge funds trade derivatives for hedging purposes. See Yong Chen, *Derivatives Use and Risk Taking: Evidence from the Hedge Fund Industry*, 46 J. FIN. & QUANTITATIVE ANALYSIS 1073 (2011).

16. Limited partnerships offer the advantage of pass-through tax treatment of partnership profits. Tax liability on partnership profits is not incurred on the entity level, but is rather passed on to the investors. See Alan L.

come limited partners.¹⁷ Investors are usually subject to subscription and redemption limits and an initial lock-up period, commonly set at one year, before they can redeem their interests.¹⁸ The investment adviser/manager is responsible for running the fund and serves as a general partner.¹⁹ In contrast, limited partners are generally prohibited from participating in the management of the fund and making investment decisions.²⁰

Hedge funds share unique characteristics that distinguish them from other investment vehicles, most notably mutual funds. First and foremost, hedge funds are able to operate relatively unconstrained in liquid public markets by following a wide variety of short-term investment strategies²¹ and employing sophisticated investment techniques such as short-selling, derivatives trading, and leveraged investing – techniques that are severely curtailed for mutual fund managers.²² Furthermore, unlike mutual funds whose performance is measured by

Kennard, *The Hedge Fund Versus the Mutual Fund*, 57 TAX LAW. 133, 136 (2003).

17. FRANÇOIS-SERGE LHABITANT, HANDBOOK OF HEDGE FUNDS 86 (2006).

18. *Id.* at 29. This stands in sharp contrast to private equity funds which lock up investor capital for the whole life of the fund, typically set at ten years. See George W. Fenn et al., *The Economics of the Private Equity Market* 28 (Bd. of Governors of the Fed. Reserve Sys., Staff Studies No. 168, 1995).

19. SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 2:2.1, 2-3 (2007).

20. LHABITANT, *supra* note 17, at 86.

21. While hedge funds invest in public markets seeking profitable opportunities, private equity funds concentrate their investments in illiquid securities. Unlike hedge funds, which pursue an investment strategy of finding value, private equity is focused on creating value. Leveraged buyout funds, the most famous category of private equity, invest in securities of private issuers with the aim of increasing their long-term value. However, recent years have seen hedge funds directly competing with private equity funds for buyouts of companies. See generally Jonathan Bevilacqua, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 BUFF. L. REV. 251 (2006); Houman B. Shadab, *Coming Together After the Crisis: Global Convergence of Private Equity and Hedge Funds*, 29 NW. J. INT'L. L. & BUS. 603 (2009).

22. The Investment Company Act of 1940 in the U.S. severely limits the use of leverage, derivatives and short selling by mutual funds. See Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. LEGIS. & PUB. POL'Y 251, 283 (2008). The UCITS framework in Europe governing mutual funds in essence prohibits short selling and curtails the ability of funds to use derivatives and leverage. See ATHANASSIOU, *supra* note 5, at 104-07.

reference to a market index, hedge funds seek absolute returns.²³ This pursuit is enhanced by the high-powered performance-based compensation of hedge fund managers. Apart from the management fee, typically set at 1-2% of assets under management, hedge fund managers charge investors an incentive fee, usually set at 20% of the fund's profits, which is widely known as "carried interest."²⁴ Finally, due to regulatory constraints, hedge funds are open only to qualified investors,²⁵ although recent years have seen the spread of products seeking to offer the benefits of hedge fund investing to retail investors.²⁶

23. See FRANCOIS SERGE L'HABITANT, HEDGE FUNDS: MYTHS AND LIMITS 18 (2002).

24. A common contractual provision is the "high-water mark" which allows the hedge fund manager to claim the carried interest only after previous losses of the fund have been recouped. See Ludwig Chincarini, *Hedge Funds – An Introduction*, in RESEARCH HANDBOOK ON HEDGE FUNDS, PRIVATE EQUITY AND ALTERNATIVE INVESTMENTS 13, 24 (Phoebus Athanassiou ed., 2012). While "high-water marks" are common, "claw back" provisions requiring the return of any incentive fee paid after the fund experiences subsequent losses are rarely used. See Alex Barker & Sam Jones, *EU Hedge Funds Face Pay Threat*, FIN. TIMES (London), Aug. 13, 2012, at 13, available at <http://www.ft.com/intl/cms/s/0/a766a03e-e47d-11e1-affe-00144feab49a.html>.

25. In order to evade various onerous regulatory requirements, hedge funds are closed to retail investors and impose a high minimum investment threshold. For a review of the U.S. regulations which hedge funds seek to evade, see generally Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 252-60 (2009). Similar requirements can be found in individual European countries. For instance, Section 112(2) of the German Investment Act prohibits hedge funds from being marketed publicly, thus allowing hedge fund marketing only through private placement. Investmentgesetz [InvG] [Investment Act], Dec. 15, 2003, BUNDESGESETZBLATT [BGBL.] I at 2676, § 112(2) (Ger.). In fact, as it will be explained below, the AIFM Directive, which will replace the existing national private placement regimes, primarily regulates the marketing of hedge funds to professional investors.

26. The most widespread products are funds of hedge funds, namely funds which invest in multiple individual hedge funds. Recent developments include: the initial public offerings of hedge fund managers, the proliferation of exchange-traded funds and indexes seeking to track the performance of hedge funds, and the offering of mutual funds which use hedge-fund-like strategies. See generally L'HABITANT, *supra* note 23, at 579-90; Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172.

The beneficial role of hedge funds in financial markets is firmly acknowledged.²⁷ By constantly trading in and out of markets, hedge funds provide much needed liquidity to the financial system.²⁸ Operating unconstrained by burdensome regulation and with high-powered performance incentives, hedge funds are induced to exploit profitable albeit risky opportunities, thereby adding to risk diversification in the financial system and providing liquidity when other participants are unwilling to do so.²⁹ Furthermore, acting as the prototypical arbitrageurs betting against mispriced securities, hedge funds help bring prices in financial markets closer to their fundamental value, thus contributing to market efficiency.³⁰ Moreover, hedge funds play a unique role in the promotion of good corporate governance. Referred to as “financial detectives,” hedge funds have exposed some of the biggest corporate frauds³¹ through their diligent research while the new breed of activist hedge funds are further shaking up the cozy atmos-

27. Timothy F. Geithner, President & CEO, Fed. Reserve Bank of N.Y., Keynote Address at the National Conference on the Securities Industry: Hedge Funds and Their Implications for the Financial System (Nov. 17, 2004); Ben S. Bernanke, Chairman Fed. Reserve Board of Governors, Speech at the New York University School of Law: Financial Regulation and the Invisible Hand (Apr. 11, 2007).

28. Geithner, *supra* note 27.

29. *Id.*

30. *Id.* Although, one should note that arbitrageurs do face limits when operating in markets and, therefore, their role in contributing to the efficiency of markets is more limited than usually acknowledged. See generally Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, J. ECON. PERSP., Spring 1990, at 19.

31. James Chanos, President, Kynikos Assocs., Prepared Statement for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds (May 15, 2003) (transcript available at http://www.sec.gov/spotlight/hedge_funds/hedge-chanos.htm) (offering a first-hand account of how hedge fund Kynikos Associates uncovered Enron's accounting irregularities, leading to the exposure of a spectacular corporate scandal). Another notorious case was Bill Ackman's, then owner of hedge fund firm Gotham Partners LP, bet against MBIA, an overleveraged AAA-rated bond insurer that was engaging in accounting manipulation. MBIA suffered huge losses during the financial crisis, and its rating was lowered to junk status. As a result, Ackman was able to profit handsomely from MBIA's near-demise. For an excellent description of Bill Ackman's crusade against MBIA see CHRISTINE S. RICHARDS, CONFIDENCE GAME: HOW HEDGE FUND MANAGER BILL ACKMAN CALLED WALL STREET'S BLUFF (2011).

phere that pervades boardrooms.³² Activist hedge funds buy substantial blocks in undervalued companies and use this influence to advocate for changes in management and business strategy.³³ A novel phenomenon is the move of activism out of

32. See Ben Fox Rubin, *Einhorn Sues Apple Over Preferred Stock Plan*, WALL ST. J. (Feb. 7, 2013, 1:47 PM), available at <http://online.wsj.com/article/SB10001424127887323452204578289811591849522.html> (detailing the pressure exerted by activist David Einhorn over Apple to return its huge cash pile to shareholders); Chris Burritt & Katherine Burton, *Bill Ackman Sells McDonald's Stake After Stock Surges*, BLOOMBERG (Dec. 5, 2007), available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=AZ6kcn5qqUo> (reporting activist investor's Bill Ackman successful pressure on McDonald's to sell assets and increasing distributions to shareholders).

33. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1029 (2007). The present article predominantly deals with hedge funds' impact on financial stability. Therefore, hedge fund activism, which falls under the rubric of corporate governance, is beyond the scope of our article. However, one should note that hedge fund activism is increasingly gaining traction with activists targeting ever-bigger companies. The most prominent example is the recent fight between hedge fund firm Greenlight Capital Inc. and Apple over the return to shareholders of Apple's enormous cash hoard. See Ben Fox Rubin, *Einhorn Sues Apple over Preferred Stock Plan*, WALL ST. J. (Feb. 7, 2013, 1:47 PM), <http://online.wsj.com/article/SB10001424127887323452204578289811591849522.html>. The recent surge in activism has provoked an unfolding debate among academics, practitioners and the judiciary regarding the promise and perils of hedge fund activism. On the one hand, proponents of hedge fund activism praise hedge funds' contributions to improving share price and operational performance at target companies. See generally Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39 (2012); Alon Brav et al., *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS FIN. 185 (2009); Alon Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, 63 J. FIN. 1729 (2008); Alon Brav et al., *The Real Effects of Hedge Fund Activism: Productivity, Risk, and Product Market Competition* (Nat'l Bureau of Econ. Research, Working Paper No. 17,517, 2011), available at http://www.nber.org/papers/w17517.pdf?new_window=1; Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. (forthcoming Oct. 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2248111. On the other hand, opponents of hedge fund activism—most notably Martin Lipton, the founder of prominent U.S. law firm Wachtell, Lipton, Rosen & Katz, and Leo Strine, the current Chancellor of the Delaware Court of Chancery—criticize their role in provoking short-term focus by companies they invest in at the expense of long-term value creation and the obscure tactics that activists employ in order to amass their stake in the targets., such as the use of derivatives. See generally Adam. O. Emmerich et al., *Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power*, 3 HARV. BUS. L. REV. 135 (2013); Leo E. Strine, Jr.,

the public spotlight and into the “shadow” of the bankruptcy process.³⁴

III.

REGULATING HEDGE FUNDS: A PRAGMATIC APPROACH

A. *The Case for Regulating Hedge Funds*

Proponents of stricter hedge fund regulation build their case in favor of regulatory intervention on three distinct grounds: (1) investor protection; (2) market integrity; and (3) systemic stability. Pursuant to the investor protection rationale, regulation is warranted by the high informational asymmetries, potential conflicts of interests, and agency costs that exist between investors in hedge funds and their managers.³⁵ However, investors in hedge funds are sophisticated, wealthy, and able to “fend for themselves” by demanding adequate protections from fund managers before and during the life of their investment.³⁶ One should not forget that the hedge fund in-

One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?, 66 *Bus. Law.* 1 (2010); Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 26, 2013, 9:22 AM), <http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/>. The debate has heated up since Wachtell’s petition to the SEC urging it to tighten the disclosure rules applying to outside blockholders. Under current SEC rules, any shareholder acquiring beneficial ownership of more than five percent of any class of publicly traded securities in a public company must within ten days notify the SEC by filing a Schedule 13D. 17 C.F.R. § 240.13d-1(a), (i) (2013). The petition advocates in favor of shortening the ten-day period in which shareholders must publicly disclose their acquisition of stock after they have reached five percent ownership and including derivative positions in the calculation of the five percent threshold. Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n (Mar. 7, 2011), available at <http://www.sec.gov/rules/petitions/2011/petn4-624.pdf>.

34. Activist distressed-debt investors purchase debt in a troubled company and use their rights as debtholders to control the restructuring process and acquire the company by converting their debt into equity. See Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 *FORDHAM L. REV.* 703 (2008).

35. Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style, and Mission*, 2006 *U. ILL. L. REV.* 975 (2006).

36. FIN. ECONOMISTS ROUNDTABLE, STATEMENT ON LONG-TERM CAPITAL MANAGEMENT AND THE REPORT OF THE PRESIDENT’S WORKING GRP. ON FIN.

dustry is a highly competitive market. An incident commonly used to justify hedge fund regulation is the Madoff scandal. What is not usually mentioned, however, is that Madoff's firm was not an unregulated and opaque hedge fund, but rather an entity registered with the SEC and under its direct supervision.³⁷

Another common criticism leveled against the industry concerns the growing incidences of insider trading and the propensity of hedge funds to engage in market manipulation.³⁸ While recent incidences of insider trading touching upon star fund managers and the empirical data seem to suggest that these concerns are not unfounded,³⁹ the European Union already has a comprehensive legislative framework in place to combat insider trading and market manipulation.⁴⁰

MKTS. (Oct. 6, 1999), *available at* <http://fic.wharton.upenn.edu/fic/Policy%20page/fer1999.pdf>.

37. Bernard Madoff was able to run, under the SEC's radar, the largest "Ponzi Scheme" in U.S. financial history with losses suffered by investors estimated at over fifty billion dollars. Both Madoff's brokerage business and separate investment company were actually registered and regulated by the SEC. *See* Editorial, *Review & Outlook: Madoff & Markets*, WALL ST. J., Dec. 15, 2008, at A.18.

38. *See, e.g.*, Lynn Stout, *How Hedge Funds Create Criminals*, HBR BLOG NETWORK (Dec. 13, 2010, 9:58 AM), http://blogs.hbr.org/cs/2010/12/how_hedge_funds_create_crimina.html.

39. The latest incidence is the implication of a growing number of employees of SAC Capital, one of the most successful hedge funds, in insider trading. *See* Michael Rothfield et al., *Trading Charges Reach SAC*, WALL ST. J. Nov. 21, 2012, at A.1, *available at* <http://online.wsj.com/article/SB10001424127887323713104578130930796204500.html>. Regarding market manipulation, recent research suggests that hedge funds engage in market manipulation by bidding up prices on critical reporting dates in order to reap higher fees. *See* Itzhak Ben-David et al., *Do Hedge Funds Manipulate Stock Prices?*, J. FIN. (forthcoming Aug. 31, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1763225.

40. Insider dealing and market manipulation in the E.U. are regulated by the Market Abuse Directive, which governs dealings in instruments admitted to listing in regulated markets. *See* Directive 2003/6/EC, of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 96) 16. The European Commission has recently adopted proposals for: a regulation which will update the Market Abuse Directive and expand its application to instruments traded on new trading platforms and over-the-counter markets, *Proposal for a Regulation of the European Parliament and of the Council on Insider Dealing and Market Manipulation (Market Abuse)*, COM (2011) 651 final (Oct. 20, 2011); and, a directive imposing criminal sanctions for market abuse and

The issue here is one of enforcement rather than regulation. Indeed, regulators, most prominently the SEC, have, in the aftermath of the financial crisis and the Madoff scandal, stepped up their enforcement efforts against insider trading and market manipulation by hedge funds.⁴¹ It follows, therefore, that European regulators would emulate the example of the SEC and increase their enforcement against hedge funds.

The sole rationale justifying regulatory intervention is the repercussions that the failure of a large hedge fund or multiple smaller hedge funds acting in correlated markets could have on the stability of the financial system.⁴² Hedge funds contribute to systemic risk via two channels, the credit channel and the market channel. The credit channel refers to the impact that the failure of a large leveraged fund (or multiple smaller funds) could have on its creditors and other financial institutions that act as counterparties.⁴³ Systemic risk through the market channel can arise when adverse market movements lead to the withdrawal of credit, tightening of collateral requirements, collateral calls, and investor redemptions, forcing leveraged hedge funds to liquidate their positions.⁴⁴ The re-

insider trading, *Commission Proposal for a Directive of the European Parliament and of the Council on Criminal Sanctions for Insider Dealing and Market Manipulation*, COM (2011) 654 final (Oct. 20, 2011).

41. For instance, the SEC reached a \$600M settlement with hedge fund firm SAC Capital, which was the target of an insider trading investigation by the agency. See Jonathan Stempel & Katya Wachtel, *Cohen's SAC to Pay \$616 Million in SEC Insider Trade Settlement*, REUTERS (Mar. 15, 2013, 6:08 PM), <http://www.reuters.com/article/2013/03/15/us-sec-insidertrading-idUSBR E92E0V720130315>. See also *SEC Charges Billionaire Hedge Fund Manager with Insider Trading*, WALL ST. J., (Oct. 16, 2009, 2:23 PM), available at <http://blogs.wsj.com/dispatch/2009/10/16/sec-charges-billionaire-hedge-fund-manager-with-insider-trading/> (reporting the arrest of billionaire hedge fund manager Raj Rajaratnam for illegal insider trading); Juliet Chung, *Falcone Admits Wrongdoing, Agrees to Five-Year Ban*, WALL ST. J., (Aug. 19, 2013), available at <http://online.wsj.com/article/SB10001424127887323608504579023123351192450.html> (detailing the SEC's action against Philip Falcone a billionaire hedge fund manager accused of illegal market manipulation).

42. LLYOD DIXON ET AL., RAND CORP., HEDGE FUNDS AND SYSTEMATIC RISK 1, 4 (2012), available at http://www.rand.org/content/dam/rand/pubs/monographs/2012/RAND_MG1236.pdf.

43. Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risk*, 5 J. FIN. STABILITY 283, 290 (2009).

44. Andrei Shleifer & Robert Vishny, *Fire Sales in Finance and Macroeconomics*, J. ECON. PERSP., Winter 2011, at 29, 35.

sulting decline in security prices leads to a further freezing of credit and investor withdrawals prompting a new round of forced sales. If this “death spiral” continues and spreads to other investors as well, a financial crisis can develop quickly.⁴⁵

However, one should note that in contrast to popular beliefs, hedge funds utilize leverage in a prudent manner,⁴⁶ with prime brokers imposing strict leverage limits and adopting adequate collateral and margin requirements,⁴⁷ thus making it unlikely that the failure of a hedge fund would have an impact on its counterparties. In fact, the severe losses suffered by hedge funds during the crisis leading to widespread failures did not significantly impair their counterparties.⁴⁸ Nonetheless, the widespread forced liquidations by financial institutions including hedge funds which occurred during the crisis and especially after the collapse of Lehman Brothers in September 2008 when short-term financing, such as commercial paper and repurchase agreements, evaporated and the quant

45. *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Hearing on Hedge Funds Before the H. Comm. On Oversight & Gov't Reform*, 110th Cong. 5 (2008) (written testimony of Andrew W. Lo, Harris & Harris Group Professor, MIT Sloan School of Management, and Chief Scientific Officer, AlphaSimplex Group, LLC).

46. Ang, Gorovyy and van Inwegen, investigating actual leverage ratios obtained by a fund of hedge funds, find that average gross leverage including derivatives exposures from December 2004 until October 2009 was at a modest 2.1 times Net Asset Value. What is most interesting is that, comparing hedge fund and finance sector leverage, the authors show that before the outbreak of the financial crisis in mid-2007, but also during the heights of the crisis in 2008 and 2009, hedge funds were actually reducing their leverage while bank leverage was shooting up. See Andrew Ang et al., *Hedge Fund Leverage*, 102 J. FIN. ECON. 102 (2011); see also FIN. SERVS. AUTH., *ASSESSING THE POSSIBLE SOURCES OF SYSTEMIC RISK: A REPORT ON THE FINDINGS OF THE FSA'S HEDGE FUND SURVEY AND HEDGE FUND AS COUNTERPARTY SURVEY 9* (Aug. 2012) (U.K.) (finding that aggregate gross hedge fund leverage including derivatives exposures remained modest at 3.8 times NAV from April 2010 until March 2012).

47. See Stephen Brown et al., *Hedge Funds, Mutual Funds, and ETFs, in REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE* 351, 353 (Viral V. Acharya et al. eds., 2011).

48. See LLYOD DIXON ET AL., *supra* note 42, at 41-42.

meltdown of 2007⁴⁹ indicate that hedge funds can potentially destabilize markets through the market channel.⁵⁰

B. *Hedge Funds and Financial Crises*

Proponents of hedge fund regulation usually point to the role that hedge funds played in various crises in order to justify a regulatory intervention. Criticism against hedge funds started mounting after Soros's bet against the sterling showed that the hedge fund industry was not a marginal player, but rather a powerful force in financial markets. The Asian Financial Crisis of 1997 resulted in a populist outrage against hedge funds that were vilified for speculating against the currencies of Asian countries, especially Thailand and Malaysia.⁵¹ The near failure of Long-Term Capital Management⁵² and the collapse of Amaranth Advisors⁵³ were the next worrying incidents. While all of the abovementioned incidents were followed by calls for regulating the hedge fund industry, the E.U.'s regulatory spree was not the product of any thoughtful analysis of the lessons learned from the previous crises, but rather a hasty response to the recent double crises, the financial crisis of 2007 and the sovereign debt crisis still plaguing Europe. Hedge funds were once again vilified for the failures of regulators, politicians, and the banking system.

49. The quant meltdown refers to the widespread losses that a large number of quantitative long-short equity funds, which are supposed to be market neutral, faced during the week of August 6, 2007. The losses were the result of forced liquidations of similarly constructed portfolios triggering stop-loss orders and leverage limits, thereby leading to further fire sales. See Amir E. Khandani & Andrew W. Lo, *What Happened to the Quants in August 2007?*, J. INVESTMENT MGMT., Fourth Quarter 2007, at 5.

50. Shleifer & Vishny, *supra* note 44, at 40.

51. These allegations, however, were unsubstantiated. See Stephen J. Brown et al., *Hedge Funds and the Asian Currency Crisis of 1997* 13 (Nat'l Bureau of Econ. Research, Working Paper No. 6427, 1998), available at http://www.nber.org/papers/w6427.pdf?new_window=1.

52. See Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, J. ECON. PERSP., Spring 1999, at 189.

53. The largest hedge fund failure was the collapse of Amaranth, a Connecticut-based hedge fund that experienced spectacular losses as a result of its natural gas trades. Its portfolio was bought by JPMorgan Chase and another hedge fund, Citadel Investments, and thus Amaranth was allowed to fail without jeopardizing financial stability. See MALLABY, *supra* note 13, at 318-22.

1. *The Financial Crisis of 2007*

The financial crisis of 2007 presented the perfect opportunity for E.U. regulators to bring the hedge fund industry under their control. Long before the dust had settled and a consensus about the causes of the crisis had been formed, politicians of Member States attacked the industry, accusing it of being one of the architects of the crisis.⁵⁴ Hedge fund regulation thus became a major pillar of the E.U.'s envisioned post-crisis regulatory regime.

In 2008, at the height of the crisis, hedge funds were fiercely criticized for aggravating market declines by spreading false rumors about the health of financial institutions and short selling their stocks, thus engaging in so-called "bear raids."⁵⁵ After intense lobbying by the banking industry, governments around the world imposed bans on short selling. On September 18, 2008, the SEC and the U.K. Financial Services Authority ("FSA") introduced bans on short sales of financial stocks.⁵⁶ The majority of governments around the world adopted similar actions.⁵⁷ The bans severely impacted hedge

54. See Ambrose Evans-Pritchard, *Sarkozy Turns on 'Predator' Hedge Funds*, DAILY TELEGRAPH (London), May 1, 2007, at 7, available at <http://www.telegraph.co.uk/finance/economics/2808197/Sarkozy-turns-on-predator-hedge-funds.html>. For instance, Guilio Tremonti, the Italian Minister of Finance, described hedge funds as "hellish" and pushed for their complete ban. See Tracy Corrigan, *Hedge Funds Don't Need Punishing – They Are Suffering Enough*, DAILY TELEGRAPH (London), Oct. 17, 2008, at 5, available at <http://www.telegraph.co.uk/finance/comment/tracycorrigan/3212102/Hedge-funds-dont-need-punishing-they-are-suffering-enough.html>.

55. These attacks were most famously led by Dick Fuld, last CEO of Lehman Brothers, whose failure sparked a widespread panic in financial markets. See Stephanie Kirchgaessner, *Fuld Says Lehman Victim of Short Sellers*, FT.COM (Oct. 6, 2008), <http://www.ft.com/intl/cms/s/0/f59fdd00-93b0-11dd-9a63-0000779fd18c.html#axzz2J75k8wAN>; Bill Saporito, *Are Short Sellers to Blame for the Financial Crisis?*, TIME (Sept. 18, 2008), <http://www.time.com/time/business/article/0,8599,1842499,00.html>.

56. Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,592, 73 Fed. Reg. 55,169 (Sept. 18, 2008); FIN. SERVS. AUTH., SHORT SELLING (NO. 2) INSTRUMENT 2008, FSA 2008/50 (Sept. 18, 2008) (relating to U.K. financial sector companies).

57. For an overview of the regulations restricting short selling after the demise of Lehman Brothers in September 2008 from various governments around the world, see JANE A. KANTER ET AL., DECHERT LLP, INTERNATIONAL SHORT SELLING REGULATION: RECENT DEVELOPMENTS (2008), available at

funds since many of their trading strategies, such as market neutral strategies, rely on short selling.⁵⁸ Moreover, numerous studies have concluded that the short selling bans slowed price discovery and dampened liquidity without successfully supporting the prices of financial stocks.⁵⁹ Even the SEC has acknowledged that it was mostly long sellers that drove the severe price declines during September 2008.⁶⁰

Hedge funds have also been accused of fueling the credit and real estate boom by purchasing collateralized debt obligations (“CDOs”), the instruments at the heart of the subprime crisis.⁶¹ Nonetheless, the total size of hedge funds devoted to CDO trading was calculated to be around \$7 billion as of July 2007, which represented only a small percentage of the overall CDO market.⁶² Indeed, banks continue to be the main holders

http://www.dechert.com/files/Publication/c998f66d-7cae-4738-9dc9-00cf9a86fe22/Presentation/PublicationAttachment/00b16ff9-c57f-42fd-a8cd-00fab4e5349/FS_25_09-08_International_Short_Selling_Regulation.pdf.

58. Market neutral strategies, in essence, seek to neutralize market risk. An example is a convertible arbitrage strategy where the investor seeks to exploit the mispricing between the undervalued convertible bond and the overvalued underlying stock by taking a long position in the bond and shorting the stock. See generally L'HABITANT, *supra* note 17, at 269-95; Louise Story, *A Debate as a Ban on Short-Selling Ends: Did It Make Any Difference?*, N.Y. TIMES (Oct. 7, 2008), at B8, available at http://www.nytimes.com/2008/10/08/business/08short.html?_r=0.

59. See Robert Battalio et al., *Market Declines: What is Accomplished by Banning Short-Selling?*, 18 CURRENT ISSUES ECON. & FIN. (Fed. Reserve Bank of N.Y., New York, N.Y.), no. 5, 2012, at 1; Alessandro Beber & Marco Pagano, *Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis*, 68 J. FIN. 343 (2013); Ekkehart Boehmer et al., *Shackling Short Sellers: The 2008 Shorting Ban 3* (Sept. 2009) (unpublished manuscript) (on file with EDHEC-Risk Institute).

60. Memorandum from Office of Economic Analysis, U.S. Sec. & Exch. Comm'n, to Distribution List on Analysis of the July Emergency Order Requiring a Pre-Borrow on Short Sales (Jan. 14, 2009), available at <http://www.sec.gov/spotlight/shortsales/oeamemo011409.pdf>.

61. See Photis Lysandrou, *The Primacy of Hedge Funds in the Subprime Crisis*, 34 J. POST KEYNESIAN ECON. 225 (2011). A collateralized debt obligation—commonly referred to as a CDO—is a debt security issued by a special purpose vehicle and backed by a portfolio of assets such as mortgage-backed securities. The debt securities are usually divided into several tranches with different seniorities and different ratings.

62. *Hedge Funds and the Financial Market: Hearing on Hedge Funds Before the H. Comm. On Oversight & Gov't Reform*, 110th Cong. 9 (2008) [hereinafter “Hearings”] (written testimony of Houman B. Shadab, Senior Research Fellow, The Mercatus Center at George Mason University). The size of the CDO

of CDO securities.⁶³ Furthermore, one has to take into account the reasons behind the growth of the CDO market. The CDO market was in essence created in response to the growing demand of institutional investors for highly rated securities offering attractive returns. Unlike institutional investors who were the main investors in the highly rated tranches of CDO deals, hedge funds concentrated their investments in the more speculative lower rated tranches and equity tranches.⁶⁴

As one can easily discern, the foundations of the European Union's response were rather unstable. Hedge funds were not the villains, but rather the victims of the crisis that paralyzed the global financial system. Faced with a drying up of funding liquidity due to withdrawals from panicked investors, margin calls, and the freezing of credit markets, hedge funds were forced to deleverage massively and exit their positions in the stock market at a loss. These exits led to more investor withdrawals and margin calls, thus creating a vicious cycle.⁶⁵

2. *Hedge Funds and the Sovereign Debt Crisis*

The current sovereign debt crisis in Europe started in 2010 when fears regarding the solvency of Greece led investors to massively flee Greek sovereign bonds, shutting the country out of financial markets, and forcing it to resort to a joint E.U.-

market in the U.S., the main market for CDOs, was estimated at around \$900 billion in 2007. INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: FINANCIAL MARKET TURBULENCE: CAUSES, CONSEQUENCES AND POLICIES 16 (2007), available at www.imf.org/External/Pubs/FT/GFSR/2007/02/pdf/text.pdf.

63. ALT. INV. MGMT. ASS'N, THE ROLE OF CREDIT HEDGE FUNDS IN THE FINANCIAL SYSTEM: ASSET MANAGERS, NOT SHADOW BANKS 11 (2012), available at <http://www.aima.org/en/media/press-releases.cfm/id/446286DC-FB7C-4AF6-96C83E65E2A6BDF5>.

64. *Hearings, supra* note 62, at 9 (written testimony of Houman B. Shadab). In a CDO deal, the equity tranche represents the most speculative tranche, which stands to be wiped out first in case of default or losses in the underlying mortgage backed securities backing the debt securities issued by the special purpose vehicle. See GUNTER MEISSNER, CREDIT DERIVATIVES: APPLICATION, PRICING, AND RISK MANAGEMENT 45 (2005).

65. See Itzhak Ben-David et al., *Hedge Fund Stock Trading in the Financial Crisis of 2007-2009*, 25 REV. FIN. STUD. 1 (2012) (documenting that in each of the third and fourth quarters of 2007 and 2008 hedge funds reduced their equity holding in U.S. stocks by about 5% and 15%, respectively).

International Monetary Fund (hereinafter "IMF") bailout.⁶⁶ Markets soon turned their attention to Ireland and Portugal, who in turn had to resort to a bailout package.⁶⁷ The crisis spread to the core of the Eurozone with Spain and Italy facing increased borrowing costs and the Eurozone showing real signs of financial disintegration.⁶⁸ The threat of a disorderly Greek exit from the Eurozone, as well as questions about the ability and/or willingness of Europe's richest countries to bail out Spain and Italy, put the very existence of the euro and the Eurozone in doubt.⁶⁹ The last few years following the onset of the crisis have seen the adoption of hastily conceived and unrealistic bailout packages,⁷⁰ a never-ending saga of Greek

66. Charles Forelle & Alkman Granitsas, *Greece Asks for \$60 Billion Bailout*, WALL ST. J. (Apr. 24, 2010), at A1, available at <http://online.wsj.com/article/SB10001424052748703709804575201330937572258.html>.

67. See Patricia Kowsmann, *Portugal Bailout Plan Detailed*, WALL ST. J. (May 5, 2011), at A13, available at <http://online.wsj.com/article/SB10001424052748703937104576302883922114642.html>; Marcus Walker et al., *Ailing Ireland Accepts Bailout*, WALL ST. J. (Nov. 22, 2010), at A1, available at <http://online.wsj.com/article/SB10001424052748703567304575628362883493310.html>.

68. Liz Alderman & Matthew Saltmarsh, *Worries Rise over Spain and Italy Debt*, N.Y. TIMES (Aug. 2, 2011), http://www.nytimes.com/2011/08/03/business/global/pressure-builds-on-italy-and-spain-over-finances.html?page-wanted=all&_r=0. At the height of the crisis, depositors in Southern European countries, who were worried about the solvency of national banks exposed to sovereign debt, were massively transferring funds to the stronger Northern countries. See David Enrich et al., *Europe Banks Fear a Flight*, WALL ST. J. (May 21, 2012), at C8, available at <http://online.wsj.com/article/SB10001424052702304019404577416200222787714.html>. Indeed, regulators of Northern countries started ring-fencing their national banking systems, protecting them against infection by the sovereign debt crisis. An example was Unicredit's transfer of funds from its healthy German subsidiary to its Italian parent company at a time when the bank was facing a liquidity squeeze. The move provoked the intervention of the German banking regulator, BaFin., with Italian regulators pushing back, thus sparking a clash. See David Enrich & Alessandra Galloni, *Turmoil Frays Ties Across Continent*, WALL ST. J. (May 31, 2012), at A1, available at <http://online.wsj.com/article/SB10001424052702304065704577426560281463958.html>.

69. David Gauthier-Villars & Charles Forelle, *Downgrades Fan Fresh Euro Fears*, WALL ST. J. (Jan. 16, 2012), <http://online.wsj.com/article/SB10001424052970203735304577162832015883536.html>.

70. A prominent example is the first Greek bailout package. In return for obtaining funds from the EU and the IMF, Greece committed to adopt painful austerity measures and structural reforms aimed at cutting its budget deficit from an astronomical 13.6% to 3% in just three years. See Lefteris

bailouts, debt restructurings and buybacks,⁷¹ profound changes to the Eurozone's institutional arrangements,⁷² and the slowing of the Eurozone economy.⁷³

The new crisis again provoked a search for scapegoats. Hedge funds soon became a populist target blamed for causing and/or aggravating the sovereign debt crisis by using wolf pack tactics⁷⁴ to attack the euro and individual countries' bonds. Soon after Greece started seeing its refinancing costs

Papadimas & Jan Strupczewski, *EU, IMF Agree \$147 Billion Bailout for Greece*, REUTERS (May 2, 2010, 6:13 PM), <http://www.reuters.com/article/2010/05/02/us-eurozone-idUSTRE6400PJ20100502>. Various commentators immediately criticized the plan as unworkable arguing that front-loaded austerity would depress demand and increase unemployment thereby diminishing any gains from spending cuts and tax increases. See, e.g., Martin Feldstein, *Why Greece Will Default*, PROJECT SYNDICATE (Apr. 28, 2010), <http://www.project-syndicate.org/commentary/why-greece-will-default>.

71. See Steven Castle, *Europe Agrees on New Bailout to Help Greece Avoid Default*, N.Y. TIMES (Feb. 21, 2012), at A1, available at http://www.nytimes.com/2012/02/21/world/europe/agreement-close-on-a-bailout-for-greece-european-finance-ministers-say.html?pagewanted=all&_r=0; Charles Forelle, *Greece Defaults, and Tries to Move on*, WALL ST. J. (Mar. 10, 2012), at A6, available at <http://online.wsj.com/article/SB10001424052970204603004577270542625035960.html>; Stelios Bouras et al., *Greece's Buyback Effort Advances*, WALL ST. J. (Dec. 11, 2012, 8:28 PM), <http://online.wsj.com/article/SB10001424127887324024004578173080175399670.html>; Rachel Donadio, *Growing Air of Concern in Greece over New Bailout*, N.Y. TIMES (Feb. 21, 2012), <http://www.nytimes.com/2012/02/22/world/europe/euro-zone-leaders-agree-on-new-greek-bailout.html>.

72. In response to the financial and sovereign debt crises, the European Union has moved towards greater political and economic integration by putting forth proposals for the creation of a single bank supervisor, a common framework for the resolution of banks and the guarantee of deposits, and fiscal oversight rules, among other bailout mechanisms. See William Boston et al., *German Lawmakers Approve Broadened EFSF*, WALL ST. J. (Oct. 27, 2011), <http://online.wsj.com/article/SB10001424052970203687504576654531439758862.html>; Laurence Norman, *Europeans Reach Deal on Fiscal Oversight Rules*, WALL ST. J. (Feb. 20, 2013, 1:36 PM), <http://online.wsj.com/article/SB10001424127887323864304578316191467424574.html>; John O'Donnell & Robin Emmott, *Europe Deepens Union with ECB as Chief Bank Watchdog*, REUTERS (Dec. 13, 2012, 7:50 AM), <http://www.reuters.com/article/2012/12/13/us-eu-banking-idUSBRE8BB00820121213>.

73. James Fontanella-Khan, *Eurozone Slides Back into Recession*, FIN. TIMES (Nov. 16, 2012), at 8, available at <http://www.ft.com/intl/cms/s/0/9a505532-2efd-11e2-b88b-00144feabdc0.html>.

74. In this context, a wolf-pack tactic can be defined as hedge funds acting together to make coordinated bets against securities in order to drive down their prices. See Nick Dunbar, *An Imaginary Wolf-Pack*, NICK DUNBAR

rise, Greek Prime Minister George Papandreou, joined by other EU politicians – most notably Nicolas Sarkozy, then President of France – led a campaign against hedge fund speculators and the use of naked credit default swaps on sovereign debt, accusing them of driving up the funding costs of European governments.⁷⁵ During the crisis, European regulators adopted uncoordinated measures banning naked credit default swaps of Eurozone government bonds and short selling of financial stocks.⁷⁶

Nonetheless, the allegations that speculative trading of CDS on sovereign debt was driving the drop in the underlying bond prices (thereby increasing borrowing costs for Eurozone governments, especially Greece) had little to do with reality. The overwhelming majority of studies, including, most importantly, the report of the European Commission's intra-service task force (a group set up to examine the effects of CDS trading on the sovereign debt crisis) have concluded either that the changes in spreads in sovereign CDS and bond markets were either mainly contemporaneous, or in the case that price changes in the CDS markets did actually lead changes in the underlying bond markets, the changes in CDS spreads were linked to fundamentals responding to country-specific events.⁷⁷

(Dec. 1, 2010), <http://www.nickdunbar.net/articles-and-reviews/an-imaginary-wolf-pack/>.

75. See Tracy Corrigan, *Attacking Speculators Is a Good Bet for Troubled Politicians*, DAILY TELEGRAPH (London), Mar. 12, 2010, at 5, available at <http://www.telegraph.co.uk/finance/financialcrisis/7423145/Attacking-speculators-is-a-good-bet-for-troubled-politicians.html>. A naked credit default swap is a credit default swap in which the buyer does not own the underlying debt against which protection is sought. See René M. Stulz, *Financial Derivatives: Lessons from the Subprime Crisis*, MILKEN INST. REV., First Quarter 2009, at 58, 70.

76. Alan Crawford, *Germany to Temporarily Ban Naked Short Selling, Some Swaps of Euro Bonds*, BLOOMBERG (May 18, 2010, 3:51 PM), <http://www.bloomberg.com/news/2010-05-18/germany-to-start-temporary-ban-on-naked-short-selling-of-euro-bonds-banks.html>; Brooke Masters, *European Short-Selling Ban Comes Under Attack*, FIN. TIMES (Aug. 12, 2011, 8:14 PM), <http://www.ft.com/intl/cms/s/0/763a185e-c4e1-11e0-9c4d-00144feabdc0.html>.

77. See SARAI CRIADO ET AL., REPORT ON SOVEREIGN CDS (2011), available at <http://online.wsj.com/public/resources/documents/ReportonsovereignCDS12072010.pdf> (finding no evidence of mispricing in either the bond or CDS markets and that spread changes in these two markets were mainly con-

IV.

THE E.U.'S REGULATORY RESPONSE

A. *The Alternative Investment Fund Managers Directive*

As previously discussed, immediately after the eruption of the financial crisis, E.U. politicians started attacking the hedge fund industry, voicing their determination to bring it under the regulatory radar. On April 29, 2009, regulators put their proposal on the table. The hedge fund industry, whose lobbying power at that time was rather weak, was taken by surprise.⁷⁸ The initial Commission proposal has been described as protectionist and ill-thought, at best.⁷⁹ The most controversial elements of the proposal were its “one size fits all” approach, the authorization granted to the Commission to regulate the use of leverage and short-selling and provisions, which essentially created a fortress around Europe by severely restricting the marketing of non-E.U.-based funds in Europe.⁸⁰ After long and heated negotiations and a politicized clash between, on one side, the U.K. and the hedge fund industry and, on the

temporaneous); *see also* DEUTSCHE BUNDESBANK, MONTHLY REPORT (Dec. 2010) (concluding that although the CDS markets of peripheral countries were leading their bond markets in price discovery, the changes in CDS prices were the result of country-specific events). Similarly, Gary Gorton claims that CDS trading has actually made bond prices more information-sensitive. CDS markets allow traders to trade on information where it would otherwise not be profitable to do so in the underlying bond markets due to the relative difficulty of trading bonds. Therefore, CDS contribute to market efficiency by revealing information which then gets impounded in bond prices. *See* Gary Gorton, *Are Naked CDS Too Revealing?*, INV. DEALERS' DIG. (June 4, 2010), at 22. *But see* Anne-Laure Delatte et al., *Has the CDS Market Influenced the Borrowing Cost of European Countries During the Sovereign Crisis?*, 31 J. INT'L MONEY & FIN. 481 (2012) (finding that during market stress the CDS market leads the price discovery process and suggesting that, in the case of Greece, CDS were used in order to speculate against the onerous condition of the Greek economy).

78. Cornelia Woll, *Beyond Ideological Battles: A Strategic Analysis of Hedge Fund Regulation in Europe* 12-13 (Les Cahiers européens de Sciences Po. No. 2, 2011), available at http://www.cee.sciences-po.fr/erpa/docs/wp_2011_2.pdf.

79. Elis Ferran, *After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU*, 12 EUR. BUS. ORG. L. REV. 379 (2011).

80. For an overview of the relevant provisions and the concerns raised, *see* Phoebus Athanassiou & Thomas Bullman, *The EU's AIFM Directive and Its Impact – An Overview*, in RESEARCH HANDBOOK ON HEDGE FUNDS, PRIVATE EQUITY AND ALTERNATIVE INVESTMENTS, *supra* note 24, at 442, 444-51.

other, Germany and especially France,⁸¹ the final text of the Directive was adopted on November 16, 2011.

The Directive's goals were the creation of a harmonized Pan-European regulatory framework for alternative investment fund managers ("AIFMs") and a genuine internal market for their activities. The rationales behind the adoption of the Directive were a perceived lack of adequate investor protection and the role of hedge funds in aggravating and/or amplifying systemic risk. The Directive adopted a "one size fits all approach" encompassing E.U. domiciled AIFMs managing alternative investment funds ("AIFs") irrespective of whether they are E.U. based or not and non-E.U. AIFMs managing and/or marketing AIFs in the E.U.⁸² The definition of an AIFM covered any "legal person whose regular business is managing one or more AIFs."⁸³ Therefore, the application of the Directive extended to a broad array of AIFMs including hedge fund, private equity fund, real estate fund, and commodity capital fund managers. As Jennifer Payne has noted though, the target of EU regulators was primarily hedge funds, but other industries, such as private equity, were swept along.⁸⁴

The Directive provides for the mandatory authorization of AIFMs by the competent authorities subject to compliance with its provisions. A *de minimis* exemption is granted to managers managing AIFs with assets of less than EUR 100 million or less than EUR 500 million if the funds are unleveraged and offer no redemption rights for the first five years. This exemption was premised on the insignificance of small funds to over-

81. Angela Monaghan, *U.K. Coalition Faces First Test as Germany, France Push for Tough EU Hedge Fund Rules*, TELEGRAPH (May 14, 2010, 5 :30 AM), <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7721923/UK-coalition-faces-first-test-as-Germany-France-push-for-tough-EU-hedge-fund-rules.html>.

82. AIFM Directive, *supra* note 10, art. 2, at 14.

83. *Id.* art. 8, at 21. AIFs are defined as "collective investment undertakings . . . which raise capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and [which] do not require authorization pursuant to Article 5 of Directive 2009/65/EC" (alternatively referred to as UCITS Directive). *Id.* art. 4(1)(a), at 16.

84. Jennifer Payne, *Private Equity and Its Regulation in Europe*, 12 EUR. BUS. ORG. L. REV. 559, 582 (2011).

all financial stability.⁸⁵ In order to obtain authorization, hedge fund managers must furnish to the competent authorities detailed information concerning among other things, their investment strategies, their risk profiles, the use of leverage, and the identity of their owners.⁸⁶ Furthermore, AIFMs must comply with minimum initial and ongoing capital requirements.⁸⁷

Moreover, the AIFM Directive imposes a wide range of requirements regarding risk management, conduct of business, and corporate governance. Managers of hedge funds must implement robust risk and liquidity management systems⁸⁸ and devise arrangements for identifying and managing any conflicts of interest that would jeopardize the interests of the AIFs it manages or their investors.⁸⁹ Limits on leverage must be set by AIFMs themselves while national authorities may impose limits in order to protect financial stability.⁹⁰ Additionally, the Directive requires AIFMs to adopt sound remuneration policies and introduces remuneration restrictions for "identified staff" whose professional activities may adversely affect the risk profile of the fund(s) managed.⁹¹

The AIFM Directive also imposes stringent depositary and valuation requirements. Most importantly, a fund manager will

85. AIFM Directive, *supra* note 10, art. 3, at 15. The threshold of EUR 500 million has in essence been created for private equity funds which do not utilize leverage on a fund level and offer no redemption rights to investors until the liquidation of the fund typically after 10 years. In the hedge fund context, the relevant threshold will be usually inapplicable since the overwhelming majority of hedge funds utilize leverage and offer short lock-up periods.

86. *Id.* art. 7, at 20.

87. *Id.* art. 9, at 22.

88. *Id.* arts. 15-16, at 24-25.

89. *Id.* art. 14, at 24.

90. *Id.* art. 25(3), at 35.

91. *See id.* art. 13, at 24 & Annex II (1), at 70-71. In order to ensure prudent risk-taking, remuneration to identified staff including carried interest must be paid in both fixed and variable components with a minimum of 40%-60% of variable remuneration deferred and at least 50% of it paid in equity or in equity-linked instruments of the AIF(s) managed. *See id.* Annex II(1)(m)-(n), at 70-71. In addition, ex post risk adjustment of performance-related remuneration should be achieved through malus and clawback arrangements. *See id.* Annex II(1)(o), at 71. Remuneration committees staffed by non-executives must also be set up depending on the sophistication of the manager. *Id.* Annex II (3), at 71.

have to appoint a single depository for each AIF managed.⁹² Pursuant to article 21(12), a depository will be liable for any loss of financial instrument held by it or by any third party to whom custody has been delegated, except for any external event beyond its reasonable control and only if all possible precautions had been taken.⁹³ This provision introducing a near strict liability regime is expected to significantly raise fees charged by depositaries thus lowering investor returns.⁹⁴ Fund managers must also ensure that AIF assets are valued at least once per year either externally or, subject to certain requirements, internally.⁹⁵

Disclosure requirements towards investors and supervisors are aimed at enhancing the transparency of the industry and alleviating investor protection and systemic stability concerns. AIFMs must make specific information available to investors prior to their investment in a fund and periodically thereafter.⁹⁶ In addition, an annual report for each fund managed or marketed in the E.U. must be provided to the AIFM's competent authority and to investors on request.⁹⁷ Disclosures must also be made to the regulatory authorities regarding the main markets in which the AIFM trades, the principal exposures, and most importantly concentrations of each fund managed.⁹⁸

One positive development is the creation of a genuine internal market for hedge funds, which was made possible by regulations that grant AIFMs a Pan-European passport with respect to their management and marketing activities. E.U.-based managers will be allowed to manage E.U.-funds across the E.U. and market them to E.U. professional investors immediately after the Directive's entry into force.⁹⁹ E.U.-AIFMs may also manage non-E.U. AIFs if authorized pursuant to the Directive.¹⁰⁰ Nonetheless, E.U.-AIFMs managing non-E.U. AIFs

92. *Id.* art. 21, at 28-32.

93. *Id.* art. 21(12), at 31.

94. Phil Davis, *Custodian Banks Balk at AIFM Rules*, FIN. TIMES (London) (Jan. 7, 2013), at 12, available at <http://www.ft.com/intl/cms/s/0/12bdc778-37c5-11e2-a97e-00144feabdc0.html#axzz2N02WyaAD>.

95. AIFM Directive, *supra* note 10, art. 19, at 26-27.

96. *Id.* art. 23, at 33-34.

97. *Id.* art. 22, at 32-33.

98. *Id.* art. 24(1), at 34.

99. *Id.* art. 32, at 40-41.

100. *Id.* art. 34, at 42.

and non-E.U. AIFMs managing AIFs (both E.U. and non-E.U.-domiciled) will not be able to benefit from this regime until 2015, when the passport is expected to take effect.¹⁰¹ Until then, marketing to professional investors in the E.U. will be subject to national private placement regimes.

Overall, one could argue that the Directive is based on dubious foundations. Despite being adopted on the premise that the hedge fund industry contributed to the financial crisis of 2007, there is an absence of evidence that hedge funds caused or aggravated the crisis.¹⁰² Furthermore, regulating hedge funds from an investor protection perspective makes little sense. Investors in hedge funds are sophisticated and have the necessary expertise and bargaining power to “fend for themselves.”¹⁰³ As a result, various onerous provisions, such as disclosure and conduct of business requirements, impose costly and unnecessary standardization in an environment where investors are able to negotiate and obtain their preferred arrangements.¹⁰⁴ One major shortcoming of this approach is the creation of a false sense of security to investors, disincentivizing them from conducting careful due diligence and monitoring.

Judged against its stated goals, namely reducing exposure to systemic risk and protecting investors, the Directive does not fare much better. For instance, the power granted to national authorities to impose limits on leverage for protecting financial stability can have the exact opposite effect. Imposing limits during market stress will lead to deleveraging and forced

101. *Id.* arts. 35-42, at 42-56, art. 67(6), at 65.

102. Indeed, hedge funds do not feature at all in leading analyses of the causes of the crisis. See, e.g., RICHARD POSNER, *A FAILURE OF CAPITALISM* 75 (2009) (suggesting that the immediate causes of the crisis were “the confluence of risky lending with inadequate personal savings,” along with the collapse of the housing bubble and low interest rates); ANDREW ROSS SORKIN, *TOO BIG TO FAIL* 534 (2009) (noting that the “seeds of disaster” included bank deregulation, low interest rates, and a system of Wall Street compensation that rewarded short-term risk-taking).

103. FIN. ECONOMISTS ROUNDTABLE, *supra* note 36.

104. Franklin R. Edwards, *The Regulation of Hedge Funds: Financial Stability and Investor Protection*, in *HEDGE FUNDS: RISKS AND REGULATION* 30, 42-44. (Theodor Baums & Andreas Cahn eds., 2004) (for example, requiring disclosure of a hedge fund’s trading activity may be impractical and uninformative since hedge funds may have tens of thousands of positions that even financially sophisticated investors may not be able to decipher).

asset liquidations which will aggravate market declines.¹⁰⁵ Furthermore, the *de minimis* exemption for small funds does not sit very well from an investor protection perspective. One would expect that the potential for fraud would be greater in smaller funds employing unsophisticated systems and controls. In addition, the remuneration restrictions are particularly inappropriate for owner-managed funds, which comprise the majority of hedge funds.¹⁰⁶

Two positive aspects of the Directive are the disclosure of information to supervisors, which allows them to monitor systemic risk and the introduction of a passport regime, which will positively affect both investors and the hedge fund industry by lowering the costs of cross-border marketing. Overall, the Directive is expected to significantly raise costs for hedge funds operating in Europe. Indeed a study commissioned by the FSA regarding the original Commission Proposal concluded that one-off compliance costs could amount up to EUR 3.2 billion whereas ongoing costs could exceed EUR 1.4 billion per year.¹⁰⁷

B. *Batting with the Shorts: The Short Selling Regulation*

Momentum for the regulation of short selling began to build during the 2007 financial crisis as the demise of banks was attributed in part to short selling and especially “bear raids.” The Greek crisis created the requisite sense of urgency. Criticism against short selling and outcries against hedge funds were intertwined as hedge funds were seen as the main perpetrators of manipulative and destabilizing short selling. As a result, shortly after the outbreak of the sovereign debt crisis, the European Commission moved forward with a proposal for

105. Dan Awrey, *The Limits of EU Hedge Fund Regulation*, 5 L. & FIN. MARKETS REV. 119 (forthcoming 2011).

106. See Comment Letter from Richard H. Baker, President & CEO, Managed Funds Ass'n, to European Sec. & Mkts. Auth. 4, 9 (Sept. 27, 2012), available at <https://www.managedfunds.org/wp-content/uploads/2012/09/MFA-comment-letter-on-ESMA-remuneration-guidelines.pdf> (responding to European Securities and Markets Authority's request for public consultation on its guidelines on sound remuneration policies under the AIFMD).

107. KYLA MALCOLM ET AL., CHARLES RIVER ASSOCS., IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE 112-13 (2009).

the regulation of short selling.¹⁰⁸ The final Short Selling Regulation came into force on March 14, 2012. The Regulation seeks to regulate E.U. government bonds as well as covered and naked short selling of shares admitted to trading on an E.U. regulated market or multilateral trading facility.¹⁰⁹ Its main aims are to enhance transparency by forcing market players to disclose their positions, address settlement failure risk,¹¹⁰ and prevent negative price spirals.

Under the Short Selling Regulation, significant net short positions in shares must be disclosed both to supervisory authorities and the market. Net short positions in shares, obtained after deducting any long positions from any short positions, must be disclosed to regulators once they reach 0.2% of the issued share capital and for any 0.1% increase thereafter.¹¹¹ Disclosures to the public must be made at a higher 0.5% threshold and for each 0.1% above that.¹¹² Short and long positions also include derivative positions.¹¹³

108. *Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps*, COM (2010) 482 final (Sept. 15, 2010).

109. Short selling refers to the practice of selling a security without the seller actually owning it at the time of the sale. In a short sale, the seller will sell a security borrowed by a third-party lender and purchase an identical security at a later date to be returned to the lender. The short seller stands to profit from any decline in the price of the security between the sale and the repurchase. In a covered short sale, the seller will already have borrowed the security or entered into arrangements to borrow the security at the time of the sale. In a naked short sale, on the other hand, the seller will not have borrowed the security or entered into any arrangements to do so at the time of the sale. The seller hopes that he will be able to borrow and deliver the security to the buyer by the settlement date, which is usually three business days after the date of the sale. Abusive naked short selling occurs when the seller does not intend to borrow and deliver the securities to the buyer but instead seeks to create artificial supply in order to drive its price. See Jennifer Payne, *The Regulation of Short Selling and its Reform in Europe*, 13 EUR. BUS. ORG. L. REV. 413, 414-15 (2012).

110. One should note that settlement failure risk can also occur, apart from abusive naked short selling, in instances where the lending market has become illiquid, leaving the naked short seller unable to borrow the shares.

111. Short Selling Regulation, *supra* note 11, art. 5(2), at 10.

112. *Id.* art. 6(2), at 11.

113. See *id.* art. 3(1)-(2), at 9 (defining a short and long sale as a transaction which confers a financial advantage in the event of a decrease or an increase, respectively, in the value of a share or debt instrument).

Regarding net short positions in sovereign debt, the Regulation creates two different categories of issuers and mandates disclosure solely to regulators. For sovereign issuers with less than EUR 500 billion of outstanding debt, the initial threshold is set at 0.1% with additional disclosure for any 0.05% increase thereafter.¹¹⁴ Disclosure is triggered at 0.5% with ongoing disclosure obligations for any 0.25% increase for issuers with more than EUR 500 billion of debt or where a liquid futures market for the debt exists.¹¹⁵ The reporting thresholds are monetary amounts published on the website of the European Securities Market Authority calculated after applying the above thresholds to the debt of each individual sovereign issuer. Short and long positions also encompass derivatives and CDS on sovereign debt.¹¹⁶ Notifications both in relation to net short positions in shares and sovereign debt must be made no later than 3:30 PM the following trading day.¹¹⁷ An exemption from the disclosure requirements is granted for primary market operations by dealers to assist sovereign issuers and market-making activities.¹¹⁸

Seeking to address settlement failure risk and abusive naked short selling, the Regulation introduces a “super locate” rule making naked short sales considerably more difficult to execute.¹¹⁹ Short selling is allowed only when the seller has borrowed or entered into an agreement to borrow the share or sovereign debt instrument or has an arrangement with a third party confirming that the share or sovereign debt instrument has been located and settlement can reasonably be expected to be effected.¹²⁰ Furthermore, a mandatory buy-in procedure is introduced for settlement failures. If the seller

114. Commission Delegated Regulation 918/2012, art. 21(7)(a), (8)(a), 2012 O.J. (L 274) 1, 10 (EU).

115. *Id.*, art. 21(7)(b), (8)(b).

116. Short Selling Regulation, *supra* note 11, art. 3(3), at 9.

117. *Id.* art. 9(2), at 11.

118. *Id.* art. 17, at 15-16.

119. However, exemptions are granted for market-making activities and primary market operations in sovereign debt conducted by dealers. *See id.*

120. *See id.* art. 12(1), at 12-13, art. 13(1), at 13. In order to safeguard the liquidity of underlying bond markets, the Regulation permits national regulators to suspend these restrictions on naked short selling when the liquidity of their debt market falls below a certain threshold. *See id.* art. 13(3), at 13. Additionally, the “super locate” restrictions are not applicable if the short sale hedges a long position in a sovereign debt instrument, the pricing of

fails to deliver the shares within four days of settlement being due, the central counterparty must buy-in the shares in order to ensure smooth settlement.¹²¹ Where a buy-in is not possible, cash compensation is paid to the buyer.¹²² The seller must reimburse the central counterparty for the costs of the buy-in or cash compensation.¹²³

In response to the perceived role of short selling in aggravating market declines, national regulators are granted additional powers in exceptional circumstances. In case of adverse market developments threatening financial stability, national regulators may impose additional disclosure obligations for net short positions in specific financial instruments or classes of instruments, request any party lending a specific financial instrument or classes of instruments to send notice of any change in the fees requested for such lending, or impose temporary bans on short selling and sovereign credit default transactions.¹²⁴ Irrespective of whether there are general adverse market developments, national regulators are granted the power to ban or restrict short selling in a financial instrument if there is a significant decline in the price of the relevant instrument.¹²⁵ The ban is temporary and shall last until the next trading day following the day on which the price decline occurs.¹²⁶ National regulators also have the power to extend the ban for an additional two days if the price continues to significantly drop in value at the end of second trading day.¹²⁷ Significantly, naked CDS on sovereign debt are prohibited. A CDS on sovereign debt can only be used in order to hedge a long position in the sovereign debt of the issuer or a position in assets or liabilities whose value is correlated to the value of the sovereign debt.¹²⁸

which is highly correlated with the pricing of a given sovereign debt. *See id.* art. 13(2), at 13.

121. *Id.* art. 15(1)(a), at 14.

122. *Id.* art. 15(1)(b), at 14.

123. *Id.* art. 15(1)(c), at 14.

124. *Id.* arts. 19-21, at 16-17.

125. *Id.* art. 23(1), at 17.

126. *Id.* art. 23(2), at 17.

127. *Id.*

128. *Id.* art. 14, at 14. The ban on uncovered CDS may be lifted by a competent authority if the authority concludes that the ban might negatively impact the sovereign CDS market by increasing the issuer's cost of borrowing or affecting the issuer's ability to issue sovereign debt. *Id.* art. 14(2), at 14.

The adoption of the Regulation was heavily influenced by popular beliefs regarding the causes of the financial and sovereign debt crises and can be considered to be an effort by E.U. regulators to indirectly curb hedge fund activity by regulating one of their main investment techniques. The problematic aspects of the Regulation are the very low disclosure thresholds, the “super locate” requirement, and the temporary bans it authorizes. While disclosure of short positions enhances market efficiency, the threshold has been set at unacceptably low levels. Considering that long positions have additional disclosure requirements,¹²⁹ the E.U. in essence treats two market participants—long buyers and short sellers—in different ways, thus distorting markets and the efficient allocation of capital.

A lower disclosure threshold is likely to chill short selling activity in Europe, which is where hedge funds dominate short sales.¹³⁰ On one hand, a low disclosure threshold will quickly alert company executives and market competitors of the short seller’s activities, allowing them to retaliate in a variety of ways including legal actions and short squeezes.¹³¹ On the other

129. Member States of the E.U. must ensure that a shareholder acquiring more than 5% of the voting rights of an issuer whose shares are admitted to trading on a regulated market notifies the issuer of the acquisition. *See* Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities Are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, art. 9(1), 2004 O.J. (L 390) 38, 47.

130. *See* OLIVER WYMAN, *THE EFFECTS OF SHORT-SELLING PUBLIC DISCLOSURE REGIMES ON EQUITY MARKETS: A COMPARATIVE ANALYSIS OF U.S. AND EUROPEAN MARKETS* 5 (2010), *available at* http://www.managedfunds.org/downloads/Oliver_Wyman_Financial_Services_Report.pdf (elaborating on these points and finding that short selling disclosure hampers liquidity by lowering trading volumes and increasing bid-ask spreads). Indeed, disclosure is associated with a large drop in short selling activity. Although the study seems to suggest that any public disclosure would be detrimental, our article advocates for a disclosure regime for short selling activity comparable to the regime for long positions. Such a disclosure regime will promote market efficiency while allowing short sellers to profit from their activity. In addition, a disclosure regime will also chill manipulative activity by short sellers.

131. A short-squeeze refers to the situation where the price of a stock rises sharply, forcing investors who have sold the stock to rush to buy it in order to close their positions, thus driving the prices even higher and amplifying their losses. *See* Sarah Marsh, *Short-Sellers Make VW the World’s Priciest Company*, REUTERS (Oct. 28, 2008), *available at* <http://www.reuters.com/article/2008/10/28/us-volkswagen-idUSTRE49R3I920081028> (reporting how short-

hand, the short seller's profits depend on the short position he is able to build until his activity becomes public, at which point other market participants will capitalize on the short seller's research and prices will adjust to reflect the new information. By setting a low disclosure threshold, short sellers may not be able to gain substantial profits in order to recoup the considerable costs of their activities, including the costs of amassing their stake and conducting research. Furthermore, the "super locate" requirement will unnecessarily hamper liquidity without any accompanying benefits since settlement failures are adequately addressed by the mandatory buy-in procedures.¹³² Finally, as illustrated above,¹³³ bans on short selling or CDS are a misconceived response to a nonexistent problem.

C. *An Old Idea: The Financial Transactions Tax*

Most famously advocated by James Tobin, a Nobel Prize Laureate in economics, the financial transaction tax rests on a simple rationale: to "throw some sand in the wheels" of markets.¹³⁴ Increasing transaction costs will reduce much of modern pure speculative trading activity and will lower market volatility while simultaneously raising tax revenue.¹³⁵ In the aftermath of the two crises, the idea of a financial transactions tax has been increasingly gaining traction on both sides of the Atlantic with negative implications for a wide array of market participants, including hedge funds whose ability to quickly exit and enter positions and markets will be severely curtailed. The E.U. was the first to move, with the European Commission adopting a first proposal for a Directive implementing an E.U.-wide financial tax.¹³⁶ Following objections from several Mem-

sellers suffered a short-squeeze after Porsche announced a majority stake in Volkswagen).

132. See Rodolphe B. Elineau, *Regulating Short Selling in Europe After the Crisis 16* (May 2011) (unpublished manuscript), http://works.bepress.com/rodolphe_elineau/1/.

133. See *supra* Part II.B and notes 61 & 79.

134. James Tobin, *A Proposal for International Monetary Reform*, 4 E. ECON. J. 153, 154, 158 (1978). See also Payne, *supra* note 109, at 436.

135. *Commission Proposal for a Financial Transaction Tax*, *supra* note 12, art. 2.

136. *Commission Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC*, COM (2011) 594 final (Sept. 28, 2011).

ber States¹³⁷ who decided not to participate in the adoption of the Directive implementing a tax on financial transactions, eleven Member States have decided to move forward alone by proposing a Directive.¹³⁸ A revised draft Directive was published on February 14, 2013 and is expected to come into force by January 2014 if all eleven Member States agree.

Pursuant to the draft Directive, the tax is applicable to a financial transaction where one party is a financial institution established in one of the eleven participating Member States.¹³⁹ The scope of application of the tax is broad, covering a wide array of financial institutions, including among others, banks, hedge funds, and private equity funds acting for their own account or on account of their customers.¹⁴⁰ The tax captures the purchase and sale of a financial instrument whether on an exchange or over-the-counter, intra-group transactions transferring the risk in a financial instrument, repurchase agreements, stock lending arrangements, and the conclusion of derivatives contracts.¹⁴¹ A financial institution will be considered to be established in a participating Member State if it is authorized by financial regulators of that Member State and has its registered seat or usual residence in that Member State.¹⁴² Additionally, a financial institution will be deemed to be established in a participating Member State if one of the parties to the transaction, natural or legal person, financial or non-financial institution, is established in a participating Member State.¹⁴³ The same applies if the financial instrument traded was issued within the territory of a participating Mem-

137. Most notably, the U.K. and Luxembourg, two major European financial centers, have resisted the imposition of a financial tax fearing the adverse effects on the competitiveness of their national financial sector. See Vanessa Mock & Gabrielle Steinhauser, *Eleven European Countries Support Tax on Transactions*, WALL ST. J. (Oct. 9, 2012, 1:50 PM), <http://online.wsj.com/article/SB10000872396390443982904578046532220799200.html>.

138. *Commission Proposal for a Financial Transaction Tax*, *supra* note 12.

139. *Id.* art. 3(1), at 23.

140. *Id.* art. 2(1)(8), at 20-21.

141. *Id.* art. 2(1)(2), at 20.

142. *Id.* art. 4(1)(a), (c), (d), at 24.

143. *Id.* art. 4(1)(f), at 24. As a result, a financial institution established in a non-participating Member State can become subject to the tax if its counterparty or the customer on behalf of which it is trading is established in a participating Member State.

ber State.¹⁴⁴ The tax imposed is left for the individual Member States to decide but cannot be less than 0.1% of the notional amount for derivative contracts and 0.1% of the consideration or market value for other financial transactions.¹⁴⁵ The relevant financial institution established in a participating Member State pays the tax and both parties to a transaction will be jointly and severally liable for the tax.¹⁴⁶

The rationales underpinning the E.U.'s financial transaction tax, namely the raising of revenue from the financial sector and the creation of disincentives for short-term speculative trading, especially high-frequency trading, indicate that the tax is just another child of the response to the financial and sovereign debt crises. A financial transaction tax will reduce liquidity in the market, make trading more expensive for investors, especially small ones, as financial institutions will pass the costs of the tax onto their customers. Moreover, it will lead to the relocation of financial activities and financial institutions offshore.¹⁴⁷ Indeed, a study by Anna Pomeranets and Daniel Weaver concerning the impact of the financial transaction tax that New York State imposed on transactions from 1932 until 1981 found that it resulted in a decrease in trading volume, an increase in the cost of capital, and most importantly increased volatility.¹⁴⁸

144. *Id.* art. 4(2)(c), at 24-25. The so-called "issuance principle" captures transactions even if none of the counterparties or their customers are established in the participating Member States.

145. *Id.* art. 9, at 26.

146. *Id.* art. 10, at 26-27.

147. See MARK P. KEIGHTLEY, CONG. RESEARCH SERV., A SECURITIES TRANSACTION TAX: BRIEF ANALYTIC OVERVIEW WITH REVENUE ESTIMATES, (2012); Anna Pomeranets, *Financial Transaction Taxes: International Experiences, Issues and Feasibility*, BANK OF CAN. REV. (Autumn 2012). Mark Keightley offers an example illustrating the potential costs that a tax may impose on small investors, especially non-financial ones. According to Keightley, an airline purchasing jet fuel futures contracts in January to protect against the risk of rising summer fuel prices from a counterparty, which speculates that the prices will move in the other direction, may face increased transaction costs as the counterparty subject to the tax on financial transactions may raise its price to transact with the airline.

148. See Anna Pomeranets & Daniel G. Weaver, *Securities Transaction Taxes and Market Quality* 18 (Bank of Can., Working Paper No. 2011-26), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1980185 (finding that a financial transaction tax reduces the number of positive net present value projects).

Taking into account the abovementioned costs, the European Union has less drastic means at its disposal to achieve its stated objectives. Forcing banks to cover the costs of the financial crisis and the implicit guarantees that they enjoy could be achieved by an imposition of a simple bank levy chargeable solely to banks or other financial institutions.¹⁴⁹ With respect to high-frequency traders, the Flash Crash of May 6, 2010 when the Dow-Jones Industrial Average suddenly lost about 9% only to recoup its losses a few minutes later and the implosion of Knight Capital, which suffered \$440 billion losses due to computer trading errors, have revealed the destabilizing effect of high-frequency traders on markets.¹⁵⁰ Trading on a rapid basis using complex computer systems and algorithms in order to exploit short-term price inefficiencies without any regard to the fundamentals of the companies being traded, high frequency traders have come to dominate modern financial markets.¹⁵¹ The potential costs of this activity seem to far outweigh its benefits, namely the provision of liquidity in markets.¹⁵² Indeed, the latest study on short-termism in U.K. equity markets commissioned by the U.K. government revealed the skepticism of institutional investors towards high fre-

149. See John Vella et al., *The EU Commission's Proposal for a Financial Transaction Tax*, 2011 BRIT. TAX REV. 607, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2026158.

150. The Flash-Crash has been attributed to the sudden selling of futures contracts by a mutual fund firm, sparking a massive sell-off led by high frequency traders. See U.S. COMMODITY FUTURES TRADING COMM'N & U.S. SEC. & EXCH. COMM'N, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010: REPORT OF THE STAFFS OF THE CFTC AND SEC TO THE JOINT ADVISORY COMMITTEE ON EMERGING REGULATORY ISSUES (2010), available at <http://www.sec.gov/news/studies/2010/marketevents-report.pdf>; Jacob Bunge & Jenny Strasburg, *Loss Swamps Trading Firm*, WALL ST. J. (Aug. 2, 2012), available at <http://online.wsj.com/article/SB10000872396390443866404577564772083961412.html>.

151. In contrast to popular beliefs, the majority of high frequency trading volume comes from dedicated high frequency trading firms and investment banks, with a small percentage of six percent coming from hedge funds. Stuart Baden Powell, *High Frequency Trading*, HEDGE FUND J. (Sept. 29, 2011), <http://www.thehedgefundjournal.com/node/6402>.

152. Although, high frequency traders are praised for providing liquidity in markets, one should note that the liquidity provided can evaporate quickly during market stress. Furthermore, the majority of orders submitted by such traders are rapidly cancelled. See Seth Merrin, *Economist Debates: High-Frequency Trading*, THE ECONOMIST (Mar. 7, 2012), <http://www.economist.com/debate/days/view/816>.

quency trading and its perceived benefits.¹⁵³ As a result, putting some sand in the wheels of high frequency traders is warranted. The safeguards that have already been proposed in the context of the revision of the Markets in Financial Instruments Directive, including increased regulation and organizational requirements for high frequency trading firms, are sufficient to deal with their potential destabilizing effects.¹⁵⁴

V.

CRISIS-DRIVEN REGULATION AND THE FUTURE OF HEDGE FUNDS

Roberta Romano contends that significant financial regulations are adopted in response to major financial crises when an informed understanding of the roots of the crisis has not yet been reached.¹⁵⁵ This pattern of crisis-driven regulation can even be traced back to the nineteenth century.¹⁵⁶ Popular outrage against speculators increases during a crisis as the gen-

153. JOHN KAY, *THE KAY REVIEW OF U.K. EQUITY MARKETS AND LONG-TERM DECISION MAKING: FINAL REPORT* 38 (2012).

154. The proposed revision to the Markets in Financial Instruments Directive would, among others, bring algorithmic traders under direct regulation by mandating the implementation of resilient risk systems and controls and the disclosure of the algorithmic trading strategies used. *See Commission Proposal for a Directive of the European Parliament and of the Council on Markets in Financial Instruments Repealing Directive 2004/39/EC of the European Parliament and of the Council*, art. 17, at 69-70, COM (2011) 656 final (Sept. 20, 2011). Furthermore, the European Parliament has voted to approve amendments to the Commission's proposal that would require all orders placed by high frequency traders to remain open for at least 500 milliseconds until they are cancelled or modified. *See Report on the Proposal for a Directive of the European Parliament and of the Council on Markets in Financial Instruments Repealing Directive 2004/39/EC of the European Parliament and of the Council*, EUR. PARL. DOC. A7-0306/2012, at 103 (Oct. 5, 2012) (proposing insertion of article 51(1)(b)). *See Amendments by the European Parliament to the Commission Proposal for a Directive of the European Parliament and of the Council on Markets in Financial Instruments repealing Directive 2004/39/EC of the European Parliament and of the Council*, art. 51(1)(b), COD (2011/0298).

155. Roberta Romano, *Regulating in the Dark* 4 (Yale Law Sch. John M. Olin Ctr. for Law, Econ. & Pub. Policy, Research Paper No. 442, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1974148.

156. *See* STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690-1860*, at 1, 3 (1998) (examining securities regulation in the US and the UK during the period 1690-1860).

eral public suffers financial losses.¹⁵⁷ Thus, shifts in public opinion accompanied by media calls for government intervention and an increase in the political salience of financial market regulation result in a regulatory response.¹⁵⁸ Legislators seeking reelection and the votes of their constituents will want to be seen as “doing something” in response to the crisis and will therefore obey the demands for more regulation.¹⁵⁹ Unfortunately, regulatory response in the midst or in the aftermath of financial crises is bound to be misguided since it is impossible to form an understanding of the roots of the crisis in such a short time frame.¹⁶⁰

The AIFM Directive, the Short-Selling Regulation, as well as the Proposal for a Financial Transactions Tax, fit perfectly within the abovementioned pattern. They were all adopted in response to the 2007 financial crisis and the ongoing sovereign debt crisis, which had provoked a backlash against hedge funds, which were criticized as speculators destabilizing the financial system and sovereign debt markets. European Union legislators rapidly adopted regulations targeting hedge fund speculators and their investment techniques, responding to the public demand for action in the face of the devastating crises that led to widespread market declines and economic contraction. However, the premises on which the E.U.’s regulatory response was built were unfounded. In contrast to popular perceptions, hedge funds played no role either in the 2008 financial crisis or in the ongoing sovereign debt crisis.¹⁶¹ On the one hand, the demise of financial institutions should not be attributed to short sellers, but to failures in their governance model, including the perverse incentives created by the structure of executive pay and regulatory capture.¹⁶² On the

157. See Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L. Q. 849, 851 (1997) (detailing attitudes towards speculators).

158. Romano, *supra* note 155, at 5.

159. *Id.*

160. *Id.*

161. See *infra* Part II.B.

162. For an in-depth analysis of the causes of the financial crisis and the demise of banking institutions, see FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

other hand, the European sovereign debt crisis is the result of the Eurozone's institutional weaknesses and individual countries' profligate behavior.¹⁶³

The misguided European regulatory response to the twin crises will negatively affect hedge funds, potentially leading to their withdrawal from European markets. While it seems at first glance that only the AIFM Directive and its onerous and costly organizational requirements will directly impact the hedge fund industry, the effect of the Short Selling Regulation and the Proposal for a Financial Transactions Tax, by curtailing their investment techniques and market operations will be equally devastating for hedge funds. Short selling is one of the most widely used investment techniques of hedge funds seeking to generate profits.¹⁶⁴ The Short Selling Regulation and particularly the low disclosure requirements will chill short selling activity by hedge funds, thus lowering their returns.¹⁶⁵ Additionally, the short selling bans will have adverse consequences during market stress, leading panicked investors to massively withdraw their funds from hedge funds as witnessed in the 2007 financial crisis.¹⁶⁶ Furthermore, the finan-

163. Greece for instance allowed the rise of an inefficient public sector exploited by various rent-seeking groups such as trade unions and business magnates while in Ireland, the government was forced to backstop with taxpayer funds an overleveraged banking system on the brink of collapse. See MICHAEL LEWIS, *BOOMERANG: TRAVELS IN THE NEW THIRD WORLD* (2012). Despite the apparent success of the common currency, the euro, it suffers from profound institutional weakness, most notably weak labor mobility, a lack of fiscal transfer mechanisms and the lack of individualized monetary policy for countries that have joined the monetary union. See Martin Feldstein, *Optimal Currency Areas*, Speech at the ECB Fifth Central Bank Conference: Optimal Currency Areas (Nov. 14, 2008), available at <http://www.nber.org/feldstein/Optimal%20Currency%20Areas.pdf>. Moreover, the option of currency devaluation is not available for a country sharing the common currency. As a result, the boosting of exports and the decrease in imports has to be accomplished by the method of internal devaluation, namely the lowering of labor costs primarily through nominal wage reductions. See INT'L MONETARY FUND, *GREECE: REQUEST FOR EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY - STAFF REPORT; STAFF SUPPLEMENT; PRESS RELEASE ON THE EXECUTIVE BOARD DISCUSSION; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR GREECE*, 13 (2012), available at <http://www.imf.org/external/pubs/ft/scr/2012/cr1257.pdf>.

164. See L'HABITANT, *supra* note 17, at 127

165. See WYMAN, *supra* note 130, at 5.

166. HEDGE FUND STANDARDS BD., *THE ROLE OF SHORT SELLING IN MARKETS AND THE IMPLICATIONS OF A SHORT SELLING BAN: RESPONSE TO THE CESR*

cial transactions tax, if implemented, will suppress one of the main competitive advantages of hedge funds, namely their ability to rapidly enter and exit positions in different markets and countries. Raising transaction costs will result in a diminution of hedge fund trading. As a result, hedge funds will be restrained from generating returns by exploiting short-term price inefficiencies and from fulfilling their roles as liquidity providers and arbitrageurs correcting mispricing in financial markets and thereby contributing to market efficiency.

VI. CONCLUSION

This article has attempted to shed light on E.U. legislation impacting hedge funds and reveal its rather defective foundations. The adoption of the AIFM Directive, the Short Selling Regulation, and the Proposal for a Financial Transactions Tax were based more on perceptions than actual evidence, a prominent characteristic of crisis-driven regulation. In regulating hedge funds, the European Union has moved forward with regulating not only hedge funds and their managers, but also their investment techniques and market operations. The cumulative impact of the E.U.'s crisis-driven regulatory spree will be a severe increase in costs for hedge funds operating in Europe and a decline in investor returns with negative consequences for European investors and markets.

CALL FOR EVIDENCE ON REGULATION ON SHORT SELLING 8 (2009), *available at* http://www.esma.europa.eu/system/files/HFSB_CESR_Short_Selling_submission.pdf; Louise Armitstead, *Hedge Funds Plan to Sue FSA over Short-Selling Ban*, SUNDAY TELEGRAPH (London) (Sept. 21, 2008), at 3, *available at* <http://www.telegraph.co.uk/finance/3046948/Hedge-funds-plan-to-sue-FSA-over-short-selling-ban.html>.

