An Analysis of Recent Developments in Hedge Funds Regulations in the U.S., U.K., and Germany

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Abstract

This paper examines the regulatory framework for hedge funds in the U.S, Germany and the U.K. It covers the historical development and risk elements involved in the hedge funds industry. The main distinctions between hedge funds and conventional investment funds are highlighted throughout the paper. Further, the paper examines the inherited conflict of interest in the hedge funds industry and the lenient regulatory framework that allows the industry to engage in regulatory arbitrage. All covered jurisdictions opt not to define hedge funds due to the various structures adopted in the industry.

The German regulatory framework adopted a parental approach and highlighted the needed diversification strategies that need to be followed by the hedge funds industry. Conversely the U.S and the U.K regulators focused on disclosure elements and the need to bring the industry under the regulators umbrella.

This paper concludes that the existing relaxed regulatory environment for hedge funds are most likely to change in the near future for more parental regulations which can affect the latitude that the industry enjoyed throughout the years.

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Introduction

This article examines the recent developments in hedge fund regulations in the jurisdictions of the U.S., the U.K., and Germany. In the U.S.\(^{(2)}\) and Germany\(^{(3)}\) new rules have already been adopted, while in the U.K. the matter is under discussion by the Financial Services Authority (“FSA”).\(^{(4)}\) Also, the risks associated with hedge funds in general and the impact of investments by pension funds in hedge funds will be discussed.

The first hedge fund can be traced back to 1949.\(^{(5)}\) Alfred Winslow Jones was an Australian investor, and he is thought to be the first to run a “hedge fund” as that term is now understood in the financial marketplaces of the world. He incorporated a private investment partnership and implemented what were at the time comparatively innovative new investment strategies, such as, e.g., short selling, in order to hedge against market risks.\(^{(6)}\) Since its advent the hedge fund industry has flourished; it is estimated that the market capitalization of securities and other financial instruments held by the global hedge funds industry is presently around U.S. $500 billion, with a 20% growth rate annually.\(^{(7)}\)

Historically, hedge funds at first excluded and discouraged general public investors, and their marketing was formerly limited to institutional and high-net worth investors. This is due to the relatively sophisticated nature of hedge fund investments and the risks associated with them.

\(^{(2)}\) In the U.S the Final Rule has been issued by the SEC on the 10th of December 2004 and is expected to come into force by February 2006. See below for more details.

\(^{(3)}\) In Germany the enactment of the Investment Act (Investmentgesetze-InvestmentG) has introduced new regulatory requirements for the hedge funds industry. See below for more details.


These factors are typically reflected by minimum investment requirements that hedge funds usually require their investors to meet. In the past, a minimum investment requirement of U.S. $500,000 was not uncommon. But as time evolved standards began to change, and fund managers began to aim their marketing efforts at “less-net-worth investors” as minimum requirements dropped to around U.S. $50,000. Presently, minimum investment requirements are becoming even lower; for example, the Monetary Authority of Singapore (MAS) has lowered the requirement to U.S. $10,000.\(^{(8)}\)

**What is a Hedge Fund?**

According to Joseph Hellrun, “hedge funds are the mysterious rich uncle of the investment industry family; no one agrees on his age, occupation or history, but everyone knows that he is related.”\(^{(9)}\) There is no universally accepted or agreed definition of hedge funds. This could be due to the radically different investment strategies adopted by hedge funds managers.\(^{(10)}\)

In the U.K., the FSMA considers hedge funds as part of the “collective investment schemes,” however, the Act does not provide any definition. Nor do any English statutes, regulations, or common law define the term “hedge fund” specifically. The FSMA definition of Collective Investment Schemes, in which hedge funds are included, are “arrangements with respect to property of any description, the purpose or effect of which is to enable persons taking part in the arrangement...to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property sums paid out of the profits income.”\(^{(11)}\) But since most hedge funds are usually incorporated

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\(^{(10)}\) See Jarakko Syyrila at p. 96.

\(^{(11)}\) See Simon Atiyah & Andrew Walters, at p. 173.
in an offshore jurisdiction, they are considered to be “unregulated schemes.”(12)

In Germany, a whole chapter on hedge funds was included in the new Investment Act. In the Act hedge funds are called “funds with additional risks” and the regulations are similar to the Swiss regulations on hedge funds. The Act does not define hedge funds; rather, it adopted a criteria for the identification of hedge funds. According to the Act any fund that invests or uses short selling, derivatives, or high leverage will be considered a “fund with additional risks.”(13)

Hedge funds are usually identified in the U.S. by considering three main elements. The first is the fact that they are associated with high leverage; the second is that they tend to be composed of “elite investors”; and the third is that they are currently subject only to limited SEC supervision, although this third area is changing as will be discussed below. Hedge funds usually include a comparatively small number of investors versus, for instance, pension and mutual funds; the numbers usually range from 100 to 499 investors. Limited partnerships and limited liability companies are usually the two main business forms used for hedge funds.(14)

**Hedge funds Structures**

The individual structures of hedge funds tend to vary depending on the jurisdiction in which they wish to operate and from which they desire to attract investors. The main reason behind such variation is the aim to achieve regulatory arbitrage.

Hedge funds in Germany have two basic formats.

First, a fund can be established by way of one or more contracts, in which case they are not allowed by law to act by themselves and are required to enter into a management agreement with an Investment

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(14) See Joseph Hellrung at p. 320.
Management Company. Investment Management Companies must have a minimum capital requirement of 730,000 Euros, and this requirement increases in proportion to the total value of the managed assets to a maximum of 10 million Euros. According to the Banking Act (Kreditwesengesetz), every investment management company must have “at least two experienced and competent directors,”(15) and the personnel that will manage a hedge fund must have “sufficient experience and practical knowledge in the field of hedge fund investments. It must be noted that funds of hedge funds are the only kind of hedge funds that are allowed for public offerings.”(16)

Second, a hedge fund in Germany may be formed as an Investment Stock Corporation. However, although the corporate form for investment funds was introduced in 1998, it was unpopular for a period of time due to certain disadvantageous tax applications. Nonetheless, with the introduction of the new Investment Tax Act, investment stock corporations were given the same treatment as investment funds.(17)

In the U.K. the majority of hedge funds are incorporated in off-shore jurisdictions such as the Cayman Islands, Guernsey, and the Isle of Man for tax purposes and to enjoy the locally available lenient regulatory environment. The tax aspect is essential as zero-tax jurisdictions ensure at least that the fund itself is not taxed. Nonetheless, even though the majority of hedge funds are located in the Cayman Islands, the real management is usually actually conducted in the U.K. via contracting with a U.K.-based fund manager. Further, the administrative issues of the fund are usually contracted to a “specialist hedge fund administrator” and thus ensuring that there is no time difference with the U.K. for practicality reasons. Dublin is especially popular as a location for hedge fund administrators.(18) Hedge funds usually take the form of either a corporate vehicle, limited partnership, or a unit trust. The decision as to what is more suitable depends on the regulatory framework

(16) Ibid.
of the jurisdiction within which the fund is going to be marketed. For instance, in the U.S. a limited partnership is more suitable as it can attract “U.S. tax paying investors.” In the case of the corporate vehicle, typically the investors will become shareholders and after a period of time these shares will be redeemed by the company; the end result will be that the company will become an “open-ended investment company” according to the FSMA (See Annex 1).

There are two main categories of hedge funds within the U.S. The first consists of domestic hedge funds, while the second is comprised of offshore hedge funds. Domestic hedge funds tend to take the form of a limited partnership or limited liability company for tax purposes. Both of these two business structures can utilize the “pass-through” tax treatment. This means that only investors will be subject to taxation. Domestic hedge funds usually have a sponsor that will be responsible for marketing and investors’ services. Off-shore hedge funds tend to attract U.S. tax exempt organizations as they will not be subject to taxation, whereas they might be taxed if they invest in domestic hedge funds.

**Hedge Funds’ Investment Strategies**

Hedge funds’ investment strategies tend to vary considerably. In this section the main investment strategies will be highlighted. The goal of every hedge funds manager is to formulate and implement an investment strategy within a single fund in order to achieve a positive return regardless of market conditions. As a result of this unique aspect and strategy of each hedge fund the level of risk varies considerably from one fund to the other. Hedge funds’ investment strategies varies and include, *inter alia*, “long/short equity, global macro, emerging markets, convertible arbitrage, fixed income arbitrage, merger arbitrage, distressed securities and event-driven.”

(20) See Rory B. O’Halloran, at pp. 465-466.
Hedge Funds Risks

There a number of risks that are associated with the hedge funds industry, and they are the result of the special characteristics of the industry itself as discussed above. These risks vary from, *inter alia*, legal, credit, to systematic risk to the financial industry in general. (23)

The two primary legal risks associated with hedge funds are related to the nature of investments and positions acquired by the fund and the second is the relationship with the prime broker. The first legal risk deals with the type of investments that hedge funds usually get into, e.g., derivatives instruments, which includes repo, options, swaps and futures, and finally short selling. These investments have three main legal characteristics that distinguish them from traditional investment assets. The first is the fact that liability is an integral ingredient of derivatives and short-selling. Hence, the risk is not only limited to not realizing the anticipated return; rather, it includes the possibility of assuming a liability, e.g., “a put option in respect of assets not owned by the fund.” (24) The second main legal risk is the fact that derivatives are usually highly leveraged and as a result, any slight changes in the price could turn out to be a potential liability for the fund. Finally, derivatives are simply contractual rights and there is no actual ownership of the assets underlying the derivatives; as a result, credit risk is a potential risk that the fund will have to bear especially if the derivative are traded OTC. (25)

The potential outright insolvency of hedge funds is an additional risk. This is due to the special nature of hedge funds' investments. Hedge funds engage in very highly leveraged investments and in some cases the liability of the fund exceeds the existing assets, which is never the case in ordinary funds. A portion of this risk is borne by the service provider, if as actual manager of the fund the suffered losses were the result of his

(23) For a detailed discussion on hedge funds industry risks see *Hedge Funds Consultation Paper*, supra, at N. 3.
(24) See Simon Atiyah & Andrew Walters, at p175
direct negligence; the main problem in imposing liability in these situations comes in terms of both legal expenses a well as the time that litigation usually takes. As a result of this huge exposure fund managers tend to establish an off-shore corporation in order to limit their liability.\(^{(26)}\) Eventually, this will augment the credit risk of the third parties that engage in dealing with the insolvent fund.

In addition, risks in hedge funds’ trading strategies can be substantial. The D.E, Shaw fund losses in treasuries obligations is an example. The fund used very sophisticated computer software that predicted the actual future value of securities, and the fund manager invested based on the results generated by this mathematical model. The fund believed in 1997 that the differences between U.S. Treasuries and foreign corporate debt would narrow. However, in 1998 the Russian default caused the market to react the opposite way, as everyone rushed to acquire U.S. treasury obligations. As a result, the differences increased. The same can be found in the autopsy records of some hedge funds that miscalculated the crash of the dot.com market; some funds found themselves engaged in short-selling techniques while the share prices continued to rise; by the time the bubble burst and the market crashed, many funds had already been wiped out with no way to retroactively recoup their losses.\(^{(27)}\) The fact that OTC markets are not regulated increases the asymmetry of information which affects investors regardless of the level of sophistication these investors may possess. “For these investors, it really is a case of *caveat emptor.*”\(^{(28)}\)

The conflict of interest that exists in the hedge funds industry is also an additional risk. For instance, The SEC is worried that the advisers conflict of interest between hedge funds and other investment funds has not been dealt with in a proper way. Even though such conflict is allowed provided that the needed notification has been served on the interested

\(^{(26)}\) Ibid at p176.  
\(^{(28)}\) Ibid., at p. 257.
parties, the SEC believes that such notifications have not been served in a proper manner. For instance, the fact that hedge funds adopt short selling as a major investment strategy and other investment funds under the same management adopt a long positioning strategy is a clear example of such a conflict of interest. This situation is exacerbated by the fact that hedge funds advisers receive higher fees for hedge funds if compared with mutual funds, so it is only natural that they will be more likely to prefer to concentrate their attention and expertise on hedge funds over mutual funds.\(^{(29)}\)

Finally, systematic failure is an additional risk that the hedge funds industry poses to the financial community. This can be illustrated by examining the events that collectively comprised the Long-Term Capital Management, or LTCM, crises that took place in 1998.\(^{(30)}\)

### An Overview of Hedge Funds Regulation

Hedge funds and mutual funds regulations in general usually aim at addressing three main issues. The first aim is to offer sufficient protection to the investors of these funds. The second purpose is to ensure the integrity of the market. And finally, some regulations aim at preventing systematic risk.\(^{(31)}\) Investor protection becomes the focus of the regulator when the investors are usually conceived to be unsophisticated, and hence need to be protected. Usually the regulator will either enforce stringent disclosure requirements or even exclude some investors from participating, or both.\(^{(32)}\)

Finally, regulators tend to intervene in the market in order to prevent systematic risk and maintain the stability of the market. This is usually through the regulation of, among other things, margin and

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\(^{(29)}\) See Joseph Hellrung at p. 333.


\(^{(31)}\) See Barry Eichengreen & Donald Mathieson, at pp. 9-10.

collateral requirements. In the case of hedge funds, creditor banks and brokers tend to evaluate their positions in regard to their relationship with the hedge funds by assessing the credit-worthiness and the financial status of the hedge fund. Nonetheless, such measures are inadequate, and the LTCM is just an example of how creditor can fail to preserve and protect its interest. One of the main obstacles of eliminating or minimizing such risks is the fact that many hedge funds use derivatives and financial instruments and this makes it difficult for the banks and regulators to evaluate and gather information about the hedge fund. Coordination among regulators and the sharing of information is crucial to maintain the stability of the international financial system.\(^{(33)}\)

**Hedge Funds Regulations in the U.S.**

In the U.S., the SEC has introduced new rules that aims at bringing hedge funds under its supervision. On 10 December 2004 the SEC issued its final rules, and cited three main reasons behind their adoption. These include the increased number of fraud cases involving hedge funds, the growth in the industry, and finally the “retailization” of hedge funds via funds of hedge funds (i.e., the marketing of fund shares to less sophisticated investors).\(^{(34)}\)

Five main goals have been cited by the SEC that it wishes to achieve as a result of incorporating the final rules. The first is to gather precise and accurate information regarding the hedge funds industry. The second goal is to spot and detect fraudulent actions at an early stage. The third goal is that once the registration requirements have been complied with, advisers must thereafter adopt measures to prevent conflicts of interest. The fourth goal is to prevent prospective fraud, as it is hoped that the registration process will act as a deterrent to incompetent individuals that would like to exploit the absence of a proper regulatory framework. Finally, the final objective aims at restricting “retailization,” as the Advisers Act requires that investors must have at least U.S. $1.5 million


\(^{(34)}\) See Joseph Hellrung, at p. 334.
or U.S. $750,000, depending on a particular fund’s strategies and circumstances, in order for the adviser to charge performance fees.\(^{(35)}\)

The direct and indirect regulatory framework of hedge funds in the U.S. can be traced to four main items of legislation. The Securities Act of 1933, the Securities Exchange Act 1934, the Investment Advisers Act of 1940, and Investment Company Act of 1940. Hedge funds usually structure themselves in a way to avoid registration with the SEC. This is done via exploiting the exceptions in each act.\(^{(36)}\)

**The Securities Act of 1933**

The Securities Act of 1933 provides that as a general rule, all public offerings must file a registration statement with the SEC, and the issuer must prepare a prospectus. Hedge funds are exempted from this requirement as they rely on the private placement exemption in section (4)(2) of the Securities Act.\(^{(37)}\)

The private placement exemption is based on rule 506 of Regulation D, which states that private offerings to accredited investors are exempted from registration. An accredited investor is any individual that has an income of more than $200,000 in the last two years or any individuals that have a net worth either individually or along with a spouse of more than $1,000,000. No advertising or solicitation is allowed if the hedge fund wants to benefit from this exemption. Finally, Rule 506 prohibits the resale of the investment to the public by the buyer(s).\(^{(38)}\)

**Securities Exchange Act of 1934**

According to the Securities Exchange Act of 1934, both brokers and dealers must register with the SEC. Nonetheless, hedge funds fall under the “trader exception” and as a result are exempted from the registration requirement. Moreover, Section 12(g) and Rule 12g-1 obliges all issuers


\(^{(37)}\) *Ibid*.

that have more than 500 holders to register with the SEC. In order to avoid this requirement, hedge funds tend to limit their equity holders to 499.\(^{39}\)

**Investment Companies Act 1940**

According to the Investment Company Act of 1940, all investment companies must register with the SEC. Hedge funds exploit an exception in the Act that states that if an investment company sells to “qualified investors,” which usually must have a personal net worth of U.S. $5 million or more, will not be subject to the registration requirements. This exception is based on Section 3(c)(7).\(^{40}\)

**The Investment Advisors Act of 1940**

The Investment Advisors Act of 1940 obliges any investment adviser that has more than 15 clients and assets under management that exceed U.S. $30 million to register with the SEC and file an ADV form. The main obligations that emerge from such registration include the obligation to disclose any disciplinary history of their clients to the SEC, and they must also provide a statement describing their investors’ business practices. Furthermore, registered advisers must maintain certain accounting standards and will become under periodical inspections by the SEC. In addition, registered advisers must ensure that they incorporate fraud preventive safeguards.\(^{41}\)

Hedge funds must also register with the Commodity Futures Trading Commission (CFTC). However, it is possible to structure the fund activities in a way that will allow it to avoid registration with the CFTC.\(^{42}\)


\(^{40}\) *Ibid.*, at pp. 693-694.


\(^{42}\) For more details see *Ibid.* at pp. 608-609.
The New SEC Rules

The new final rules amended the regulatory framework for hedge funds in the U.S. The new rules oblige hedge funds managers that manage funds that have more than 14 investors and have U.S. $30 million or more under management to register with the SEC. Furthermore, when it comes to smaller advisors, it is more likely that they would be subject to one or more state registration requirements. The scope of these rules has been extended to include non-U.S. hedge funds advisers. The only condition when it comes to non-U.S. hedge funds is that they must have at least 14 US investors.\(^{(43)}\)

One of the main positive outcomes that will be realized as a result of this registration requirement is that hedge fund advisers will be subject to the compliance program. As a result, these advisers will be obliged to adopt policies and procedures that aim at the avoidance of the violation of the Investment Advisers Act. In addition, the appointment of a “chief compliance officer” becomes as necessity, and this officer will become, in effect, the private enforcer of federal securities laws.\(^{(44)}\)

All investment advisers according to r.203(b)(3)-2 have to count each investor as a client when it comes to private funds. This includes both Americans and foreign investors. This definitely will affect the scope of s.203(b)(3) that deals with advisers’ exemptions. Further, if a fund of funds invests in a hedge fund then the adviser must look at the “top tier” in that fund and count the investors in this “top tier” as separate clients. Moreover, if an U.S.-registered investment company invests in a private fund, then the adviser shall consider each shareholder of that company as an independent client.\(^{(45)}\)


Further, the SEC has stated that the adviser shall not include itself as a client if it invested in a particular private fund. In addition, if a member of “knowledgeable personnel” invests in the private fund, then it shall be seen as a “qualified client” and as a result will not be counted as a client. This new rule that has limited and minimized the scope of advisers’ exemptions goes further by stating that it will also apply to advisers even though they are acting as sub-advisers or participating in the so called “manager of managers structure.”

Insofar as non-U.S. advisers are concerned, the final rule states that they should apply the same requirements only to U.S. resident investors and not to overseas investors. If the non-U.S. adviser becomes subject to registration, then the Adviser Act rules will become applicable to him.

The final rule defines private funds as “a fund that (i) would be an investment company under s.3(a) of the Investment Company Act, but for the fact that it is sold in the United States based on an exception provided in either s.3(c)(1) or s.3(c)(7) of the Investment Company Act, (ii) that permits owners to redeem any portion of their interests within two years of the investment, and (iii) which offers interests based on investment advisory skills, ability or expertise of the investment adviser.”

It should be noted that hedge funds are usually structured in a way that they can be considered qualified for “the “private” investment company exceptions from the definition of investment company found in s.3(c)(1) and s.3(c)(7).”

Some commentators have questioned the SEC’s ability to cope with this new requirement; they argue that the SEC is an under-funded agency with full hands dealing with its current responsibilities. Furthermore, some opponents to the new final rules state that it is an unnecessary burden as two-thirds of the largest 100 hedge funds are already registered with the CFTC, and hedge funds that “hold large amounts of

(47) Ibid., at p. 219.
government securities are obliged to report to the Treasury Department.’” In addition, hedge funds are monitored via their creditors and counterparties. Alan Greenspan is one of the opponents of the new regulatory framework of hedge funds. He has stated that “I grant you that registering advisers in and of itself is not a problem. The question is, what purpose does it serve unless it’s going to go further? Therefore, I feel uncomfortable with that issue.”

Hedge Funds under the New German Legal Framework

The enactment of the Investment Act 2004 (InvestmentgesetzInvesmG) has introduced new regulations for hedge funds. The previous Capital Investment Companies Act (Gesetzuber Kapitalanlagegesellschaften-KAGG) used to effectively prohibit the formation of hedge funds as it did not allow the use of short selling and had limited the use of derivatives. It also provided that only a maximum of up to 10% of a fund’s assets could be borrowed.

Nonetheless, hedge funds established outside Germany were allowed to solicit investors within Germany, but at the price of losing all otherwise-available tax incentives. The Foreign Investment Act also effectively restricted any hedge fund desiring to sell its units to German investors via private placement, as the law did not offer attractive tax schemes for such investments. However, German investors started to invest in the so-called “hedge funds certificates” as a way of circumventing the above-mentioned legal constraints. The main problem with this solution was the fact that transactional and structuring costs tended to be comparatively high.

The new Investment Act also deals with the issue of outsourcing asset management. It allows for such arrangements provided that the third party in charge of the asset management is licensed and under proper supervision. However, the fact that the asset management has

(49) See Rory B. O’Halloran, at pp. 475-477.
(50) See Achim Putz & Christian Schmies, at p. 177.
(51) Ibid.
been outsourced does not mean that the company that outsourced it is no longer liable. It will continue to be liable for any fault committed by this third party and it should state the “investment guidelines for the investment activities on a regular basis.”

The Federal Supervisory Agency for Financial Services (BaFin) must issue a license for any Investment Management Company or a German Investment Stock Corporation before it starts its business. In addition, each hedge fund that is administrated by an Investment Management Company must be granted a separate license.

The new Investment Act distinguishes between single hedge funds and funds of hedge funds. Single hedge funds must comply with risk diversification principles that can be found in the Act. As a general rule, a single hedge fund can invest in any investment asset with the exception of real estate and commodities, but precious metals and futures contracts traded on organised exchanges are excluded from the prohibition.

Further, unlisted equities investments must not exceed 30% of the fund net asset value. Finally, it should be noted that the new Act allows the Ministry of Finance to issue further restrictions on single hedge funds when it comes to the use of leverage and short selling. The main aim of such delegation to the MoF is to ensure that it will be able to react effectively if the integrity of financial markets is threatened.

Due to the fact that funds of hedge funds are the only funds that are allowed to be offered to the public, the new Act imposed further restrictions on such funds that are not applicable for the case of single hedge funds. For a start, the fund can only invest in the so called “target funds” and up to 49% of their assets can be held in liquid investments, e.g. money market instruments. Further, the fund cannot engage in short selling or any leverage by itself, but it can invest in funds that engage in such activities. Short-term credit is also prohibited for funds of hedge funds, which should ensure that a sufficient amount of liquidity is

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(52) See Dr. Thomas Paul, at p. [FAHAD: THERE IS A MISSING PAGE REFERENCE HERE.]144.
(53) Ibid.
(54) See Achim Putz & Christian Schmies, at p. 179.
available for investors’ redemptions. Any single hedge fund in Germany that is regulated by the Investment Act can be seen as an eligible “target fund,” and the same applies to foreign hedge funds provided they have similar characteristics, particularly in the use of short selling and leverage. In this way an indirect extraterritorial application of the new German rules is achieved. Finally, if a fund invests in other single hedge funds then it will not be eligible to become a target fund.(55)

The Act also obliges a fund of hedge funds not to invest more than 20% in a single target fund. This rule aims at maintaining a proper risk management tool to protect the interests of the investors. The fund must invest in at least three target funds. This is to prohibit the so called “master feeder funds” practices. In addition, the new law states that at most the fund may invest in two target funds that are managed by the same fund manager. According to the new regulations, a fund of hedge funds must engage in a due diligence process when it comes to investing in target funds, and the law states the minimum amount of information that the fund of hedge funds must possess prior to its investment decision. These include, “the last annual and half yearly report; terms of the investment contract, prospectus or similar documents; information on the organization, management, investment policy, risk management, depositary bank or comparable institution of the target fund; information on investment restrictions, liquidity, the use of leverage and the use of short sales by the target fund.”(56)

Finally, a fund that is investing in a target fund must maintain constant supervision especially in terms of risk management and compliance with the target fund’s announced investment strategy.(57)

U.K. Regulatory Approach to Hedge Funds

In the U.K., offshore hedge funds are categorized as “Unregulated Collective Schemes.” It should be noted that neither the term hedge fund

(55) Ibid.
(56) Ibid., at pp. 179-180.
(57) Ibid.
nor hedge fund manager is defined under the U.K. regulatory framework.\(^{58}\) The main consequence of such classification is the marketing restriction imposed by the regulator.\(^{59}\) Nonetheless, all the parties involved in this scheme, such as the prime broker, fund manager, and promoter are supervised and regulated by the FSA as if they were U.K. entities. Furthermore, it is not allowed to market hedge funds to retail investors; marketing efforts must be directed to sophisticated investors only. According to the FSA the reason of such prohibition is due to the lack of a proper investor protection regulatory regime, at least the status quo will be maintained. Retail investor exclusion has led the FSA to continue to accept the current unregulated environment for hedge funds.\(^{60}\)

**The Future of Hedge Funds Regulation in the U.K**

In the U.K. the main obstacle behind the failure to introduce a proper regulatory framework is the fact that hedge funds structures make it extremely difficult to regulate their activities. The multi-jurisdictions structure adopted by the industry to achieve regulatory arbitrage limits the FSA’s ability to regulate the industry efficiently. Moreover, in the U.K. self-regulation has been historically the preferred method of regulating the financial industry, e.g., the Takeover and Merger Panel. This approach is an option according to the latest FSA discussion paper, in which it states that it is possible for the industry to offer an alternative approach other than the one mentioned by the FSA Discussion Paper. For example, the paper explicitly states that the industry may wish to incorporate a Code of Practice that will result in a reduction to the risk associated with the industry.\(^{61}\) Also, the FSA follows a risk methodology that categorizes hedge funds, as part of money managers, into two main types. The first is the so called “high-impact” money manager, which includes funds that if they were to suffer insolvency

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\(^{58}\) See Hedge funds Consultation Paper, at p. 10.

\(^{59}\) See Iain Cullen & Helen Parry Eds, Hedge Funds: Law and Regulation, at pp. 137-139.

\(^{60}\) [FAHAD: WE SEEM TO HAVE A MISSING FOOTNOTE HERE.] Ibid.

\(^{61}\) See Hedge Funds Consultation Paper, at p. 64.
would potentially affect the financial community; once again, LTCM can be seen as an example. The second category is the “low-impact” money managers which include small to medium size funds that will not shake the financial community if it the investment strategy goes badly and will harm itself only.\(^{(62)}\)

It is expected that the year 2006 will witness the introduction of a new regulatory\(^{(63)}\) framework for hedge funds in the U.K., however, taking into consideration the discussion papers trend such regulations will not be cumbersome and most likely will include a self-regulation framework introduced by the Alternative Investment Management Association (AIMA). The scope of the potential problems that any new regulatory scheme will seek to address will be exacerbated by the increasing pension funds investments in hedge funds. After the introduction of FRS17, there was an historical expansion of pension funds’ investments in the hedge funds industry from a low of about 5% in 1996 to a three-fold increase up to 15% in 2004.\(^{(64)}\)

**Conclusion**

According to one lawyer, “Either by law or by their own investment philosophies, insurance companies and pension funds gravitate toward registered rather than non-registered advisors.”\(^{(65)}\) Hedge funds regulations, provided that they are efficient, will promote the industry and will not act as an obstacle.

A number of reasons led to the emergence of new regulatory frameworks for hedge funds around the globe. These include the collapse of the LTCM in 1998, the increased number of frauds in the hedge funds industry (in the year 2004 the industry in the U.S. witnessed more than 20

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\(^{(64)}\) See *Hedge Funds Consultation Paper*, at p. 13.

\(^{(65)}\) See Rory B. O’Halloran, at p. 475.
fraud cases\textsuperscript{(66)}, and finally the expansion of the industry and the retailization phenomenon have all led the regulators to expand their authorities and at least attempt to supervise the industry with more scrutiny.

\textsuperscript{(66)} See Steve Zwick at p. 61.