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PRIVATE GOVERNANCE OF FINANCIAL MARKETS: THE US REGULATORY REGIME ON HEDGE FUNDS

Paola Robotti

Abstract: The article investigates the private governance of financial markets by looking at the evolution of the regulatory debate on hedge funds in the US market. It starts from the premise that the privatization of regulation is always the result of a political decision and analyzes how this decision came about and was implemented in the case of hedge funds. The starting point is the failure of two initiatives on hedge funds that US regulators launched between 1999 an 2004, which the analysis explains by elaborating the concept of *self-capture*. Facing a trade off between the need to tackle publicly demonized issues and the difficulty of monitoring increasingly sophisticated and powerful private markets, regulators purposefully designed initiatives that were not meant to succeed, that is, they "self-captured" their own activity. By formulating initiatives that were inherently flawed, regulators saved their public role and at the same time paved the way for the privatization of hedge fund regulation. This explanation identifies a link between the failure of public initiatives and the success of private ones. It illustrates a specific case of formation of private authority in financial markets that points to a more general practice emerging in the regulation of finance.

Key words: Hedge Funds, US Financial Markets, Financial Market Regulation, Financial Governance, Private Authority, Regulatory Capture.

1. Introduction

Financial market regulation is increasingly going private. Banking regulation and supervision, accounting standards, derivatives transactions are some of the domains where private authority thrives (Tsingou 2003; Strange 1996; Cutler et al 1999; Cerny 1996 and 2002; Haufler 2003). Whether it is the case of privatizing a former publicly-regulated domain or setting up industry guidelines for the first time, private authority is the result of a political decision. When and how is this decision taken?

The article answers this question with reference to the regulation of hedge funds in the US market. Home to the majority of hedge fund assets under management globally, the US authorities launched several initiatives between 1999 and 2008 to investigate the quantitative relevance of the industry as well as to provide evidence in favor of or against its regulation. Considering that US regulators hold significant ideational power vis-à-vis other regulatory authorities, the history of their domestic debate is crucial in understanding the trend towards the privatization of hedge fund regulation more generally.

Two initiatives - or rather phases of the US domestic debate on hedge funds – will be analyzed. The first initiative consisted of two bills introduced to the US Congress in 1999, which dealt with issues of systemic stability in the wake of the collapse of Long-Term Capital Management (LTCM). The second initiative (2003-2004) was launched at the administrative level by the Securities and Exchange Commission (SEC) and dealt with issues of investors' protection in the wake of the "market-timing" scandals involving hedge funds and mutual funds and following the investigations of New York Attorney General Eliot Spitzer.

The article shows that despite a lengthy and costly debate in both phases, none of the two initiatives in the end got implemented. It argues that investigating the reasons that made the two public initiatives fail can contribute to mapping the private turn in the regulatory regime of hedge funds and can also be important in evaluating other "private turns" in the regulation of finance. A first reason for the failure can be attributed to the belief among regulators and market players that hedge fund strategies are efficiency-enhancing and that, therefore, their regulation is undesirable. Moreover, the level of sophistication in the industry is such that private voluntary initiatives are considered more effective than mandatory ones. Within this perspective, US regulatory actions did not fail but simply achieved the objective of stimulating private markets' own self-regulatory actions. A second reason can be identified in regulatory capture: regulators promoted the interests of the regulated instead of enforcing rules to the benefit of the whole market community. The private turn, in other words, was imposed by hedge fund managers in an effort to elude any form of public intrusion.

This article supports a third explanation, which argues that the US actions failed because regulators *purposefully* designed initiatives that were not meant to succeed, that is, they "self-captured" their own work. Regulators pursued this strategy in the face of a trade off between the need to show their commitment to tackle publicly demonized issues and the awareness of their limitations vis-à-vis increasingly sophisticated and powerful private actors. By formulating initiatives that were inherently flawed, regulators saved their public role and at the same time paved the way for the privatization of hedge fund regulation. It can be said that regulators voluntarily surrendered to the power of financial markets. This explanation identifies a link between the failure of public initiatives and the success of private ones.

The article starts by summarizing the main features of the hedge fund industry, their role, impact, and the market events that triggered regulatory attention. It then analyzes the first and second phases of the US regulatory debate on hedge funds and the initiatives that were launched in each phase. By following the development of each initiative from its launch to its demise the article shows a particular strategy that regulators followed, that is, the use of the traditional *loci* of political legitimization to de-legitimize their action and indirectly transfer authority to private market players. It illustrates a specific case of the formation of private authority in financial markets that can point to a more general practice emerging in the regulation of finance.

2. Summary notes on the regulatory debate on hedge funds

Hedge funds are private investment partnerships that operate largely outside any regulatory control and as a consequence have maximum flexibility in their investment strategies. They have so far enjoyed special regulatory treatment because they are perceived as a form of investment for the very wealthy, who do not need any investor protection from public authorities. (In the US the laws that accord hedge funds exemptions are the *Securities Act of 1933*, the *Securities Exchange Act of 1934*, the *Investment Company Act of 1940*, the *Investment Advisers Act of 1940* and the *Commodity Exchange Act of 1974*.)[1]

The name 'hedge fund' can be misleading. Hedging means covering open positions, that is, covering or controlling risk. Hedge funds, however, do not always hedge and the reason why they became popular after the emerging market turmoil of 1998 is not their low-risk character. To understand the origin of the name, it is necessary to go back to

1. In order to avoid regulation, a fund must fulfill the following conditions: (1) it does not have more than 100 investors and 'is not making and does not presently propose to make a public offering of its securities' (§ 3(c)(1) 1940 Act); and (2) each investor in the fund invests at least $1 million. In 1996, the US Congress made a further exemption with regards to point (1). According to the new § 3 (c) (7), a fund is exempted from regulation if it does not make a public offering and *only has qualified purchasers*. Therefore, a fund can have more than 100 investors, but they all have to be qualified ones (in addition to qualified purchasers, the fund can have no more than 100 non-qualified investors, as previously established). A qualified purchaser is 'any natural person […] who owns not less than $5,000,000 in investments; […] any person acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments (§ 2 (a) (51) Investment Company Act, 1996 revision.

their beginnings and to what their inventor had in mind. Their invention is unanimously attributed to Alfred Winslow Jones, a sociologist and financial journalist who in 1949 in the US created the first such vehicle. His purpose was to take two investment strategies that are commonly understood to be speculative – short selling and leverage – and combine them to create a conservative investment system (Caldwell 1995: 7). Conservative, in this context, refers to a system that is better able to cope with risk.

Short selling is the practice of 'selling a borrowed asset on the expectation that its price will decline by the time of repayment' (International Monetary Fund 1998: 27). For example, a trader borrows stocks to sell them in two months time (forward sale), betting that by that time their price would have dropped. At the end of the two months, the trader buys the stocks to return them to the lender and, if the price effectively dropped, he or she would gain all the difference between the selling and the buying price. Leverage instead refers to the use of debt to acquire assets and thus raising the expected return per unit of capital employed (Deutsche Bundesbank 1999: 30).

Going back to Jones's model, how was it possible to obtain a conservative system out of short selling and leverage? In order to answer this question, it is necessary to look at the idea of risk behind Jones's strategy. The case of equity investment will be considered. Risk in equity investment is commonly understood as the sum of two different risks: (1) general market risk and (2) risk linked to the particular stock selection. Market risk refers to the fact that an equity investment can lose value because of a general market drop. Stock-selection risk, instead, means that an equity portfolio can be affected by a drop in the price of the selected stocks. Jones thought that if it were possible to design a strategy to minimize market risk and at the same time maximize stock risk, this would place all the risk in the hands of the manager and his ability to pick the right stock, while the impact of overall market trends would be neutralized. He calculated his exposure to market risk using the following formula:

$$\text{Market exposure} = \frac{(\text{Long exposure} - \text{Short exposure})}{\text{Capital}}$$

According to this formula, market risk would be completely neutralized if the value of the shares Jones bought were equal to the value of the shares he sold short. In this extreme case, the above equation would be zero - hence market risk would be zero. Usually, the portfolio was not left completely hedged but partially exposed to market risk. In the formula shown above, long exposure would usually be higher than short exposure, following the reasoning that the market generally rises. In this case, the portfolio would be 'net long' (Caldwell 1995: 7).[2]

2. Of course, the portfolio can also be net short.

Having hedged market risk, return would mainly depend on the ability of the manager to pick the right stocks. Jones's strategy was to go long on (buy) shares that he considered 'undervalued' and go short on (sell) shares that he considered 'overvalued'. The better the choice of the stocks, the higher the returns and the lower the risk. This because in a rising market good long selections (undervalued stocks) would rise more than the market and good short selections (overvalued stocks) would rise less than the market, thus amplifying the return to the fund. The reverse would happen in a falling market, where undervalued stocks would fall less and overvalued stocks would fall more, again amplifying the exposure and return to the fund (ibid: 8). In other words, return and risk were made dependent on the capacity of the manager to pick the most undervalued stocks and sell the most overvalued ones.

Hedge funds are portrayed as carrying out a large variety of investment strategies. As they enjoy a high degree of freedom in their prospectus, in theory there is no limit to the types of strategies they can undertake (International Monetary Fund 1998: 42). Each data provider has its own classification and sometimes differences are a question of splitting the same strategy into distinct categories according to the geographical focus or the situation in which the strategy is used. The one feature that all these strategies have in common is that very few of them consist of a traditional buy-and-hold approach. In one way or another they all try to actively play the market and to be significantly uncorrelated with market results (Calwell 1995: 89). Many of these strategies can be reduced to two main categories (International Monetary Fund 1998: 42-54): arbitrage/market neutral funds and macro funds.

The *arbitrage-type hedge funds* are the closest ones to Jones's original model. They aim at profiting from current price discrepancies in two instruments that will have at maturity the same value, and more generally from mis-pricing or mis-valuation between instruments that are supposed to have the same characteristics or be driven by the same underlying factors. In order to profit from these discrepancies, an arbitrage fund always enters into two transactions: it buys instruments that it considers 'undervalued' and sells those it considers 'overvalued'. The fund will use some analytical model to apply to various instruments in order to detect possible discrepancies. LTCM is the most famous example in this category. Its analytical model was formulated by two Nobel prize-winners and gained immediate credibility.

Strategies that can be included in this category are: convertible arbitrage, equity hedge, equity market neutral, equity statistical arbitrage, fixed income arbitrage, merger arbitrage, relative value arbitrage, and short selling. In the case of convertible arbitrage, for instance, the manager buys convertible securities (in general convertible bonds, e.g. bonds that can be converted to equity) and sells short the underlying equity, in order to profit from the supposed mispricing of the equity component of the convertible bond relative to traded equity (International Monetary Fund 1998: 43). Equity hedge or long/short strategy, instead combines a long position in stocks that are expected to outperform the market and a short position in stocks that are expected to underperform the market – or, alternatively, a short position in the equity index futures. The reason why these funds are also called 'market neutral' is because they claim that their trades have low or no correlation to market direction and that by holding long and short positions in similar assets they neutralize market risk (as in Jones's model).

Macro funds differ from arbitrage funds in one main respect: they usually do not take offsetting positions, but make directional bets over expected changes in overall economic conditions (e.g. of a country or group of countries). While arbitrage funds attempt to detect and profit from price discrepancies, macro funds attempt to determine whether the price is in tune with the macroeconomic situation to start with (International Monetary Fund 1998: 47-49). Macro funds are said to take an opportunistic or 'top-down' approach: they attempt to profit from macro-economic imbalances or changes in economic policy that are likely to affect interest rates, exchange rates, bond/equity markets or commodity prices. Strategies that can be included in this category are principally macro funds, global macro funds and emerging market funds.

Starting from the late 1990s, various episodes of fraud as well as concerns with the systemic stability consequences that the collapse of such a fund could produce made regulators grow increasingly wary of hedge fund strategies. In addition, the fast growth in their capital and share of trade has made them some of the most influential market players. According to the US Treasury, the number of hedge funds more than doubled between 2002 and 2007 and their assets grew by more than 400 percent since 1999. Now they are estimated to be a 1,5 trillion industry with over 9,000 funds. They are also said to be very active traders and to be responsible for up to 50 percent of the equity trading volume in the US (Department of the Treasury 2007).

Hedge funds have been a topic of regulatory discussion since the Asian Financial crisis of 1997, which triggered concerns over the impact of hedge funds in initiating or exacerbating currency crises (i.e. issues of market dynamics and integrity), and the near-collapse of LTCM in 1998, which triggered concerns due to the sudden liquidation of a highly leveraged fund and the domino effect that this can have on the financial system (i.e. issues of systemic stability) (Robotti 2006). In 1999 an international forum – the Financial Stability Forum (FSF) – was created in Basel to deal with these two sets of problems (Ibid). Its conclusions were published in a report (FSF 2000) that contained a series of recommendations especially targeted at hedge funds' counterparties and their supervisors. The report gave substantially more weight to the problem of systemic stability than to the problem of market integrity, which gradually disappeared from regulators' agenda. This is explained by the fact that systemic stability is the main preoccupation for advanced markets, which are the main constituency of the Financial Stability Forum, and that the likelihood of hedge funds precipitating a currency or equity crisis in their markets is very low (Robotti 2003; Robotti 2006). On the whole, none of the FSF recommendations implied major changes to the regulatory regime of hedge funds, apart from a call for private-driven regulatory initiatives.

Concerns with investor protection arose only a few years later and in response to two major developments in the industry. First, hedge funds started marketing their products to smaller investors, who were not deemed to have the skills and sophistication to understand the risks involved in this business. Second, mass investors like mutual and pension funds started investing in hedge funds, once again exposing unsophisticated investors to risks that might be beyond their reach. In some countries hedge funds were involved in episodes of fraud at the expense of mutual fund investors (see Section 7 below), raising further concerns over the protection of small market players.

Systemic stability concerns dominated the first phase of the US debate and will be analyzed in Section 6, while investor protection concerns dominated the second phase of the debate and will be analyzed in Section 7. The concept of self-capture is the explanatory model that this article offers to account for the failure of public initiatives (Section 5). Other explanations were invoked, however, as Sections 3 and 4 will now examine.

3. Regulation is unnecessary

In the February 2007 issue of *Foreign Affairs*, Washington Post Columnist Sebastian Mallaby clearly states the reasons why hedge funds should not be regulated in any mandatory way. Mallaby along with the majority of financial economists (see for instance Danıelsson and Zigrand 2003; Danielsson et al. 2005; International Monetary Fund 1998; Brown et al. 1998; Stonham 1999) say that by investing as market contrarians –that is, by taking opposite positions to those of the mass of less sophisticated investors –hedge funds reduce rather than increase risk. If for instance the value of a financial asset rises well above what would be justified by the underlying fundamentals, hedge funds are well suited to sell the asset short and by so doing bring prices back to their equilibrium level. The key word here is 'short selling', a practice that implies the forward sale of borrowed assets in the expectation that their price will fall by the time of repayment. It is seen as a mechanism that adds efficiency and liquidity to the market, and hedge funds are the players with the highest capacity (by law and expertise) to sell short – especially for the few restrictions placed upon their operation. The idea of the efficiency role of contrarian investing finds its origin in the very formulation of mainstream financial theory (theory of arbitrage, Friedman 1953; Fama 1965; 1970), which postulates a relationship between the rationality of sophisticated investors and the efficiency of the market (Robotti 2006):

[I]f there are many sophisticated traders […] they will be able to recognise situations where the price of a common stock is beginning to run up above its intrinsic value. Since they expect the price to move eventually back toward its intrinsic value, they have an incentive to sell this security or sell it short (Fama 1965: 38)

Hedge funds' almost unlimited ability to use short selling – which is instead forbidden for most institutional investors – makes them the perfect example of the arbitrageurs described in Fama's theory. This justifies the appreciation hedge funds have enjoyed throughout the market community. All those speaking against the regulation of hedge funds – including regulators and politicians (see for instance Greenspan –Committee on Banking and Financial Services 1998, and Greenspan 2005; The President's Working Group on Financial Markets 1999) – have drawn upon this argument. The impact of this idea on the work of regulators was evident both in the international debate on hedge funds, which was carried out at the Financial Stability Forum in Basel between 1999 and 2002, and in the two phases of the domestic debate in the US (1999-2000 and 2004-2006) (Robotti 2006).

4. Regulators are captured

Another reason to justify the collapse of the publicly-driven initiatives on hedge funds is that regulators were captured by the hedge fund industry. Regulators are said to be 'captured' when they become dominated by the industries that they are in charge of regulating. Public choice theory has extensively discussed this phenomenon starting with the work of George Stigler (1971) and Richard Posner (1974), both members of the Chicago School. Within this perspective, capture is said to be inevitable, as it will be explained below. Deregulation and the retreat of state intervention are offered as solutions to avoid control of public policy by vested interests.

The Economics literature provides several explanations for regulatory capture. First, regulators might have an interest in getting employment opportunities in the industry (the so-called 'revolving door' phenomenon), usually as a second career following retirement. In this case, they might want to show their appreciation for industry's particular concerns. Second, the revolving door phenomenon plus the proximity of the two communities of regulators and regulated create personal bonds and relationships that can make the former reluctant to take decisions against the latter. Third, regulators might want to prevent excessive criticism from the industry by avoiding the use of a strong hand in their supervisory role. Finally, the industry might channel monetary contributions to the regulators, for instance in the forms of contributions to political campaigns (Laffont, J.J. and Tirole, J. 1991).

In the International Political Economy literature, regulatory capture is specially seen as the consequence of the proximity between regulators and regulated and of the increased sophistication of the latter, which places them in a position of power *vis-à-vis* their supervisors. According to Underhill, 'relationships among regulators and their constituencies of market participants remain close […]' (Underhill 1997: 5), so that these two sets of actors might be seen as a *closed policy community* (ibid: 24). Similarly, Gill talks of a 'banking complex' encompassing private and central banks, other regulatory agencies and financial institutions, prestigious universities, and influential members of the financial media (Gill 1990: 117). Moreover, these authors point out that the co-operation between agencies and regulated is increasingly turning into a dependency. Referring to the Basel process, Underhill argues that '[banks'] many possibilities for innovative avoidance of regulatory provisions or prudential standards enhance the dependence of official agencies on the industry' (Underhill 1997: 25). This highlights how easily the regulated can promote their interest through regulators. (For an analysis of the capture and recapture of the state and regulatory processes by powerful domestic groups see also Moravcsik 1997.)

5. Self-capture: regulators purposefully fail their own initiatives

This article offers a third explanation regarding the lack of assertiveness of official regulatory actions on hedge funds. The efficiency considerations that prevail across the financial community are certainly a crucial factor in explaining regulators' behavior. The capturing of regulators by the industries that they are supposed to regulate/supervise is also a concrete possibility.

Yet the collection of evidence from the U.S. debate on hedge funds reveals that these two factors combined with a particular strategy of regulators, namely the use of the traditional sites of political legitimization (Congress, public administrative agencies), to shape initiatives that were bound to fail since their very inception. The article argues that regulators acted in this way to protect their role in the face of mounting pressure from capital markets (increasingly more sophisticated and more powerful than their watchdogs) and as a new strategy to privatize financial regulation. It can still be seen as an explanation within the argument of regulatory capture. Yet it differs in the importance it gives to the changing structure of financial governance and to the trend towards the privatization of regulatory and supervisory functions (For an analysis of this trend, see Tsingou 2004).

It might not be sufficient to prove that regulators were willing to favor the industry in order to get a series of material benefits, e.g. a second career, political contributions. The complexity of financial markets and the fact that the balance of expertise (and resources) is tipped in favor of the regulated, constrain regulators' choice even when there is no willingness to back the industry. Capture, in other words, is not only due to the fact that the industry is able to put direct pressure upon regulators, but also to the complexity of financial market operations, which substantially limit regulators' ability to effectively monitor their industries. Faced with the prospect of criticism for inaction, regulators might want to show their engagement and ability to tackle publicly-demonized strategies and actors, even if they know that their actions will not translate into substantive political and administrative changes. In other words, regulators 'self-capture' their own initiatives in an attempt to show dedication to their public role.

The article identifies two processes justifying the theory of self-capture in the case of the US debate on hedge funds: the first will be defined as *legislation without enactment* and the second as *rule-making without implementation*. The first process refers to the introduction of legislative actions that are not eventually translated into law. The second process refers to the launch of initiatives at the administrative level that fail to get implemented. These two processes were preceded by a phase in which the technical concerns regarding hedge funds were politicized: (1) the issues were presented as deserving political attention; (2) new initiatives, groupings or institutions were created; (3) public resources were devoted to these initiatives. Politicization is intended as the inclusion of the hedge fund problem in the regulators' agenda. Once included in the political agenda, this issue was addressed using either the legislative or the administrative channel. In the end, however, both channels did not produce any concrete change in the regulatory regime of hedge funds.

More to the point, by politicizing the issue of hedge funds, decision-makers achieved the opposite result of de-politicizing it and sending it back to private market forces. This happened in two different ways. First, the failure of the planned initiatives was justified as a way to trigger a response from the private sector. Initiatives – it was argued – were not meant to be implemented but to motivate market actors to reform things in a self-regulatory way. By so doing, however, the traditional venues for political legitimization (Congress, administrative process through public agencies, etc.) were used to de-legitimize regulators' and legislators' own actions. Second, de-politicization happened because the public perceived that the problem was taken care of, that resources were devoted to it and that therefore it could go out of the spotlight.

The following sections analyze the two phases of the US regulatory debate on hedge funds as evidence for the theory exposed in this section. The first phase dealt with issues of financial stability following the near-collapse of LTCM. It evidences a case of legislation without enactment. The second phase dealt with issues of investor protection and started with the investigation that New York State Attorney General Eliot Spitzer launched to tackle some illegal practices in the hedge funds and mutual fund industries. It evidences a case of rule-making without implementation.

6. First phase: 1998-2000

The US started debating hedge funds in 1999. The first regulatory move was a study carried out by the President's Working Group on Financial Markets (PWG)[3] and titled *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (1999). It contained a series of policy recommendations targeted at the systemic-stability concerns triggered by hedge funds. The PWG report was meant to respond to the near-failure of LTCM in 1998. LTCM was the Connecticut-based hedge fund that almost collapsed in the wake of the emerging market turmoil of 1998 and that was rescued with a private bailout orchestrated by the Federal Reserve. The awareness of the potential damages that such episodes could create to the *system* triggered a prompt and joint response from the US regulatory authorities, which materialized in the PWG report. The main thread of the report was to increase public disclosure both in the hedge fund industry and among hedge funds' counterparties and credit providers (Eichengreen 2003).

In order to achieve this objective, the PWG urged initiatives to improve the quality and quantity of information on both hedge funds and public companies' exposures to hedge funds. For the disclosure of hedge fund activities, the PWG distinguished the situation of those few hedge funds that were already required to file with a US regulatory agency (i.e. Commodity Pool Operators, CPOs, and Commodity Trading Advisers, CTAs, which are required to file with the Commodity Futures Trading Commission, CFTC) and those that were not. For the first category, the PWG urged the CFTC to implement changes that could be carried out at the administrative level, without Congress action. For instance, it was suggested that CPOs file with the CFTC quarterly rather than annually and that information include 'more meaningful and comprehensive measures of market risk' (PWG 1999: 33). For the second category, Congress 'would need to enact legislation that authorises mechanisms for disclosure. […] Such legislation should be solely for the purpose of promoting public disclosure' (ibid). For the disclosure of public companies' exposures to hedge funds, the PWG called upon the Securities and Exchange Commission (SEC) to take steps to ensure that public companies (banks, etc.) disclose their material exposures to significantly leveraged financial institutions. The PWG suggested including these disclosures in the periodic reports (e.g. form 10-K, form 10-Q) that public companies file with the SEC. To sum up, the PWG report triggered two debates: a Congressional one at the House of Representatives, where two bills on hedge funds were introduced in September and November 1999 respectively; and an administrative one at the SEC ad CFTC, where a few proposals to change the regulatory regime of hedge funds were launched during the same period of time.

3. The PWG is comprised of the Secretary of the U.S. Treasury and the respective chairs of the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

What happened to these calls in terms of implementation? As for the call upon the CFTC, this agency issued a *concept release* asking for comments on the PWG proposed changes to the regulation of CTAs and CPOs (CFTC interview 2002; CFTC 1998; see also FSF 2000: 31). The proposed rule change (proposed rule 4.27), however, died in 2000. "The industry was so adamantly against it, a CFTC official said, that we no longer implemented the proposed rule change" (CFTC interview 2002).

As for the call upon Congress to enact legislation on hedge fund disclosure, two bills were introduced to the House of Representatives. On 23 September 1999, Congressman Richard Baker introduced to the House Banking Committee a bill that

Require[s] unregulated hedge funds to submit regular reports to the Board of Governors of the Federal Reserve System, to make such reports available to the public to the extent required by regulations prescribed by the Board, and for other purposes (H.R. 2924, 1999).

This Act was referred to as the 'Hedge Fund Disclosure Act'. According to an anonymous interviewee, 'the general concern of the Act and the people introducing it was the unavailability of knowledge about hedge funds' value at risk (VAR). Even counterparties could not figure out the overall risk of hedge funds' (Anonymous interview 2002). The act required hedge funds with a capital of $3 billion or more to make a quarterly report to the Board with the following information: (1) total assets, total notional amount of their derivatives position and leverage level; (2) 'meaningful and comprehensive measures of market risk' (HR 2924, 1999); (3) any other information that regulators may require. Reports were supposed to be made available to the public with a notable exclusion: "proprietary information concerning investment strategies and positions" had to be kept confidential (H.R. 2924, 1999: 6).

The Hedge Fund Disclosure Act suffered the same fate as the CFTC rule 4.27: it died in 2000 with the end of the 106th Congress. As a matter of fact, it should be referred to as a 'bill' rather than an 'act', as it has never become an act under US Law. In the US legal system, all bills that have not been enacted before the end of Congress automatically die and cannot be resumed without starting the process all over again.

The end of Congress, however, might not be the reason for the non-implementation of the H.R. 2924. According to an anonymous interviewee, the bill was never intended to become law. Congressman Baker did not want to see hedge funds regulated, but to send a warning message to hedge funds and banks. In other words, Baker implicitly called on the industry to do something before public regulators decided to implement more mandatory rules (Anonymous, interview 2002).

Even if the bill had been enacted, however, its implementation would have been highly unlikely or ineffective. First of all, the bill targeted those hedge funds with a capital of $3 billion or higher. As regulators themselves recognize, $3 billion is too high a threshold to be of any significance. Very few hedge funds have such capital and, even if they did, it would be easy to keep their size just below the threshold so as to avoid disclosure requirements. Second, the bill adamantly excluded proprietary information from the reporting requirements: 'no […] regulation may require an unregulated hedge fund to reveal proprietary information' (H.R. 2924, 2000: 6). Market observers also point out the limitations that this provision entails. Peter Temple, for instance, argues that proprietary information should be reported, as otherwise it is difficult for supervisors to assess the risky character of hedge fund activities (Temple 2001: 187). Third, and the most important limitation, the bill set out that hedge funds had to report quarterly to the Federal Reserve Board of Governors. This assumes that the Board had the power to receive and process this information, that is, that requesting information from hedge funds was within the Board's jurisdiction. A brief digression on the principles of market regulation in the US explains why this is not the case.

Authorities in the US can only enforce public disclosure if there is an issue of investor protection. Hedge funds, however, are unregulated precisely because they benefit from an exception in the Investment Company Act, which was designed for funds that do not trigger any investor protection concern. The inclusion in the Bill of this recommendation is against the exceptions to the Investment Company Act. The Fed Board, therefore, would have had no authority over it and would have 'felt very uncomfortable to receive information it did not know what to do with: this would have increased the moral hazard assumption that the Fed had knowledge of hedge fund activities and could intervene accordingly' (Anonymous, interview 2003). This is why the Fed strongly opposed this provision. This issue alone would have been enough to block the effectiveness of the Hedge Fund Disclosure Act.

Another bill introduced to the House of Representatives two months after the introduction of the Hedge Fund Disclosure Act addressed the regulation of hedge funds in similar terms. Named 'Derivatives Market Reform Act of 1999' (H.R. 3483, 1999), the bill was introduced to the House Committee on Energy and Commerce by Congressman Edward Markey. Title III of the HR 3483 lists a series of disclosure requirements hedge funds should be subjected to. The focus is once again on the reporting or disclosure requirements by 'unregistered hedge funds' (i.e. not registered with the SEC). This time, however, the threshold is 1 and not 3 billion dollars. In addition, and more wisely than the Baker Bill, the Markey Bill addresses regulators' lack of authority to enforce public disclosure by proposing an amendment to the Investment Company Act:

Sec 301 Public Reporting by Unregistered Hedge Funds […] would amend Section 30 of the Investment Company Act of 1940 by adding a new subsection (k). Paragraph (k) (1) would require unregistered hedge funds to file reports with the Commission no later than 15 days after the end of each calendar or fiscal quarter. Such reports […] shall including the following information for each pooled investment vehicle that is part of the unregistered hedge fund: A statement of the financial condition as of the end of the quarter; B statement of income (loss) for the quarter ended; C statement of cash flows; D statement of changes in equity; E description of the models and methodologies that the pooled investment vehicle *uses to calculate, assess, and evaluate market risk; F such other information as the Commission, in consultation with the other financial regulators, may require by rule or regulation (H.R. 3483, 1999).*

According to staffers at the office of Congressman Markey, this Bill went far beyond the Baker Bill in terms of comprehensiveness and forcefulness. It affected hedge funds not only by placing public disclosure requirements upon them, but also by urging the SEC to issue a final large-trader reporting rule (Anonymous interview 2002). Congress gave the SEC this authority in the Market Reform Act of 1990, in order to assure that the SEC could track the trading activities of hedge funds and other large traders for market surveillance and other purposes. As Markey writes, however, 'nearly 10 years later the SEC has failed to issue a final rule, and the draft rules it issued years ago are gathering dust. Our bill would change that' (Markey 1999).

The Markey Bill had the same fate as the Baker Bill: it was not enacted, for it died with the end of the 106th Congress. As far as the SEC large trader reporting rule is concerned, the SEC does not seem to have implemented any new rule that goes in the direction proposed by the Markey Bill.

The last PWG recommendation on disclosure targeted the SEC and concerned the initiatives that the SEC could implement administratively without the need of legislative actions. The PWG urged the SEC to implement new rules to assure disclosure of public companies' direct material exposures to significantly leveraged institutions.[4] This was intended as a means to strengthen private market discipline upon these companies, as, in this way, difficulties originating in one firm or excessive exposures to leveraged funds would be visible to all market participants. This visibility was deemed capable of preventing a domino effect or bank-run. This information should have been included in the periodic reports that public companies file with the SEC. (The same provision was also included in H.R. 2924, 2000: 9.) No rule, however, was formulated and enforced.

At first glance, most of these regulatory initiatives did not succeed because of the strenuous opposition of the industry – which may point to a case of regulatory capture. This was particularly clear in the interviews at the CFTC, which literally withdrew its initiatives under pressure from the industry. Yet these events, and especially the ones in Congress, can also be read in a different light. Both bills introduced to the House of Congress epitomized a case of 'legislation without enactment'. Congress did not want to tackle hedge funds but give them a chance to

4. Public companies include both financial and non-financial public companies that have direct exposures to significantly leveraged financial institutions.

take the self-regulatory route before public regulators could clamp down on them. Congress felt compelled to address the issue of hedge funds following the public concerns that LTCM triggered, but it was clear since the beginning that it wanted to de-politicize rather than politicize the problem. Reaching out to the world of hedge funds is considered so difficult that regulators are willing to delegate this task to private actors (Fed interview 2005). This is indeed what happened in the US debate. Regulators preferred to delegate responsibilities to private governance arrangements and even pushed for the creation of such arrangements where they did not exist. An example is the Counterparties Risk Management Policy Group (CRMPG), a group of banks that issued guidelines for banks dealing with hedge funds and that received ample support from the President's Working Group.

This 'legislation without enactment' raises concerns both for the effectiveness and the legitimacy of the process. According to participants, this legislation without enactment should have a role in sparking private sector initiatives. Yet the Multidisciplinary Working Group on Enhanced Disclosure was rather pessimistic on the achievements in terms of disclosure 'both on the part of regulated and unregulated firms' (MWGED 2001, The MWGED specifically referred to the effectiveness of the initiatives carried out by the CRMPG and a group of hedge funds. With specific reference to hedge funds' counterparties, they seem to be incurring the same problem that the Fed Board had in the case of the Baker Bill: they are unwilling and unable to take on supervisory responsibilities in relation to hedge funds.

As for the legitimacy concerns, the very bypassing of the traditional sites of political legitimization constrains governments' choices to the preferences of the financial community. The result is to ensure that 'the commanding heights of economic strategy are insulated from popular sovereignty and accountability' (Gill 1990: 8). While bypassing the traditional sites of political legitimization, decisions in financial markets are increasingly taken and implemented through non-accountable mechanisms such as due diligence and self-regulation. Due diligence, which was the specific outcome Congressman Baker was aiming at, means letting private actors sort things out by themselves in a non-binding way. This means relying upon a coincidence of interests between regulators and regulated and between these two categories and broader sectors of society. This coincidence, based on the assumption that by performing due diligence credit providers enhance both their own interest and the interest of the community, might not be there. First, there are incentives to take on risky activities even when this is against the firm's financial safety. Second, private actors will relax their self-imposed rules and good practices once the storm is over and competitive pressures are mounting again. The emphasis on due-diligence, therefore, translates into a 'blessing' to the hedge fund industry and a furthering of the legitimacy deficit.

7. Second phase: 2003 to present

Since 2003 a new concern for investor protection arose after several cases of fraud involving the hedge fund industry. The US debate formally restarted with the investigation that New York Attorney General (NYAG) Eliot Spitzer announced into the trading practices of mutual funds (NYSAG 2003, Sep 3). This investigation led to the discovery that specific mutual funds had colluded with hedge funds to facilitate the late trading and/or market timing of their funds (Zitzewitz 2003). The practice of late trading – illegal – and the practice of market timing – legal – both resulted in a transfer of wealth from ordinary mutual fund shareholders to hedge funds and arbitrageurs in general. Late trading is prohibited by New York law and SEC regulations because it allows a favored investor to take advantage of post-market-closing events not reflected in the share price set at the close of the market (Spitzer's case 11/25/2003). 'Timing' involves short-term 'in and out' trading of mutual fund shares to exploit market inefficiencies when the 'net asset value' (NAV) price of the mutual fund shares – which is set at 4:00 p.m. market close – does not reflect the current market value of the stocks held by the mutual fund. When a 'market timer' buys mutual fund shares at the stale NAV, it realizes a profit when it sells those shares the next trading day or thereafter. That profit dilutes the value of the shares held by long-term investors, for whom mutual funds are designed, such as retirees and other 'buy and hold' investors. (For a thorough understanding of the practice of market timing and late trading see also Zitzewitz 2003.) In all of these cases the consequences for mutual fund investors consisted in loss of market value of their funds. Unlike the previous phase of the debate, this time hedge funds triggered issues of investor protection, which were politically more delicate and more likely to win broader support for reform. This does not mean that the stability of the system does not have an impact on ordinary citizens, but the losses for mutual funds' shareholders, especially in a system that entrusts financial markets with the management of social security, have different political leverage.

The NYAG investigation, together with other episodes of fraud in the hedge-fund industry, convinced the Securities and Exchange Commission to introduce registration for certain categories of hedge fund advisers. Most of the NYAG cases involved parallel charges, i.e. both SEC (civil) and NYAG (criminal) charges. Given the increased number of these charges (the SEC reported 51 cases) and the publicity that gathered around them, the SEC decided to initiate a preventive action by subjecting hedge fund advisers to the same form of registration that other advisers are liable to.

The NYAG investigation, however, was not the only reason for enforcing registration. Changes in the hedge fund industry – or at least changes in the way SEC regulators perceived the industry – contributed to a shift in regulatory stance. By 2004, when the SEC was preparing the new rule on hedge fund advisers, hedge funds' number, capital and share of equity trading could no longer be overlooked. While in 1999 many commentators pointed to the negligible size of the hedge fund industry, especially compared to banks and mutual funds, and drew on it as a justification against any regulatory change (see for instance Eichengreen 1999), in 2004 the size of the industry became a reason to enforce registration of hedge-fund advisers. As Director of the SEC Division of Investment Management Paul Roy wrote:

One concern is the tremendous growth in the industry. While no one knows for sure, it is estimated that in the last five years, hedge funds have grown by 260 percent [and in] the last year alone, hedge fund assets have grown over 30 percent. Hedge funds are one fifth the size of equity mutual funds, but are growing at a much faster rate. Moreover, hedge funds tend to be very active traders. One study estimates hedge funds are responsible for up to 20 percent of equity trading volume in the United States. […] This growth and potential impact on our markets simply cannot be ignored (Roy, SEC 2004)

Last but not least, the SEC justified its regulatory action by pointing to the growing accessibility of hedge funds to retail investors ('retailization'). Once the domain of wealthy and sophisticated individuals, hedge funds were said to directly (via individual contributions) or indirectly (via shares in mutual and pension funds investing in hedge funds) attract investors who might not be fit to assume risky investments.

With these concerns in mind, the SEC started investigating the activities of hedge funds and hedge fund advisers in 2002. In 2003 it started a process of consultation with industry participants that began with a roundtable held on May 23 and 24, 2003. The roundtable exposed SEC's and market actors' concerns with any type of regulation of hedge fund activities. In July 2004 the SEC posted for comments a new rule requiring hedge fund advisers to register with the SEC. One hundred and sixty one letters were received as part of this deliberative process. In December 2004 the new rule was finalized, but with a split within the SEC Board. Two commissioners, Cynthia Glassman and Paul Atkins, publicly stated and motivated their dissent to the new rule. The contested nature of the process makes it an excellent laboratory to test the assumptions of regulatory self-capture as herein defined.

Investment advisers are defined as those advising others about securities. They are regulated under the Investment Advisers Act of 1940. This Act exempted from registration those advisers (1) having fewer than 15 clients; (2) not holding themselves out generally to the public as investment advisers; and (3) not advising any registered investment company. This was called the 'private adviser exemption' or safe harbor and reflected the view that there was no rational to regulate advisers with a small number of clients and whose activities were unlikely to affect national securities markets. In 1985 the SEC adopted a rule that permitted advisers to count each partnership, trust or corporation as a single client. As a consequence, the private adviser exemption was stretched so as to allow advisers to have a large number of clients without having to register. In 2004, however, the SEC argued that this exemption granted advisers the possibility of having a much larger number of clients than the spirit of the rule allowed. In other words, the SEC felt that the 1985 exemption was no longer consistent with the Adviser Act of 1940. One of the prescriptions – perhaps the main one – of the new SEC rule is that advisers need to 'look through' the funds they advise, that is, that they can no longer count each fund as a client, but have to count each of the funds' clients as the adviser's client.

In addition, SEC registration consists of the following steps. First, hedge fund *advisers must file* Form ADV with the SEC. This form collects census information about the advisers and the funds: the number of hedge funds managed by the adviser, the amount of assets in hedge funds, the number of employees, other business activities the adviser conduct and the identity of those affiliated with or controlling the firm. Advisers also have to disclose conflicts of interest – which, however, have also to be disclosed by non-registered advisers as part of their fiduciary duty. The ADV filing was deemed necessary since currently there is no reliable source of information on hedge funds. Second, registration will enable the SEC to make *examinations* of hedge fund advisers. Examination consists of SEC visits to the hedge fund adviser to inspect how she manages and tries to reduce risk, how she deals with conflict of interest, how she keeps her clients informed about any such conflict and more generally how she conducts her business. Most of these requirements are part of the fiduciary duty, which pertains to both registered and non-registered funds. The examination, however, would allow the SEC to verify compliance with this duty. Third, registration requires advisers to adopt compliance procedures and appoints a chief compliance officer. This is meant to ensure compliance with the Advisers Act and more generally to provide a frontline watch to complement SEC limited resources. As part of this task there is the need for advisers to adopt codes of ethics addressing issues such as personal securities trading by their personnel.

Compared to the situation of non-registration, hedge fund advisers have to invest resources in record keeping, in training or hiring a compliance officer, and in managing data to be presented to the SEC officers, if and when they carry out an examination. Yet registration is far from increasing SEC supervisory power over hedge funds. Registration does not interfere with funds' investment strategies, trading tools and philosophy.[5] It does not impose any detailed regulatory regime and is not regulation or supervision in the way it can be talked about in the cases of banks, for instance. Some participants in a 2006 conference on hedge fund compliance (Hedge Fund Regulation and Compliance Forum, May 22-23 2006, New York) argued that nothing in the new disclosure rules gives clues as to hedge funds' investment strategies, leverage, liquidity of portfolio, the terms under which investors invest, and, very importantly for investors, how the funds perform. It does not add much to what is already in a fund's memorandum: it just gives a picture of the advisers: who they are and if they have criminal charges. In addition, the rule left plenty of room to escape it, such as the provision that funds do not have to register if they impose a lock-up period of 25 months (e.g. investors cannot withdraw their money for two years). Many funds (some participants said up to 90% of funds) were expected to make use of these exemptions.

5. They have though to ensure best trade execution, that is, prove that they traded at the best price available.

Yet, the new registration rule triggered enormous opposition from both the financial industry and regulators. Let's start with the industry's concerns. More than half of the comment letters sent during the consultation process (83 out of 161 total letters) 'argued strongly against the [SEC] proposal' (SEC 2004: 131). They pointed to several alternatives to registration, stressing that equally useful information could have been collected through other regulators and regulated counterparties, thus proposing the idea of *indirect regulation*. The main concerns of those opposing registration were the costs of compliance and the effectiveness of the new rule in preventing fraud. But there were also concerns for the economic impact of the rule on liquidity, for instance. Many funds are managed through "funds of funds".[6] Some of them might opt for longer lock-up periods to avoid registration. Since a fund of funds is usually bound to have shorter lock-up periods, a liquidity mismatch might be created, with the fund of funds having better liquidity than the underlying funds and this could cause systemic risk in the market (Neil Sherman, Lehman Brothers, Hedge Fund Regulation and Compliance Forum, May 22-23 2006, New York).

Off record, managers were also concerned that this SEC proposal was only the first step within a broader project to regulate hedge funds. Participants in the above-mentioned conference stressed that 'regulation will not stop here' (New York, 22-23 May). Two of the five SEC Commissioners voiced similar criticisms. Their dissent was published together with the release of the final rule. In addition to listing the potential alternatives to registration, Commissioners Glassman and Atkins pointed out that registration will not prevent fraud in the industry. First, they pointed out that many of the enforcement cases were brought against small funds, which would have benefited from an exemption from registration (if they have less than $25 million under management). Second, they pointed out that the SEC does not have the resources to carry out thorough examinations across the industry and that form ADV is unlikely to provide the information that the SEC needs. In order to do so, resources would have to be diverted from other – perhaps more urgent – tasks. Finally, the two dissenting commissioners pointed out that fraud in the industry was not more rampant than in other sectors of US financial markets.

In addition to these remarks, the two dissenting commissioners pointed to some procedural issues affecting the legitimacy of rulemaking in this specific case. First, they criticized the SEC for not coordinating with other regulators in a data-sharing effort and for not consulting with other government institutions. In particular, they blamed the SEC for not coordinating with the other members of the President's Working Group on Financial Markets, many of whom – notably FED Chairman Alan Greenspan – were against any regulation of hedge funds. They

6. A fund of funds is a fund that holds a portfolio of several investments funds rather than investing directly in financial assets.

also blamed the SEC for not having consulted the Department of Labor, which has responsibility for private pension plan advisers. This lack of coordination and consultation was not only seen as illegitimate – the SEC is not the only regulator in charge of overseeing the US securities markets – but also ineffective. 'Because the regulation of hedge funds has broad market implications, any regulatory requirement would be more appropriately addressed as part of a collaborative effort […]' (SEC 2004:105).

The case of the proposed new rule for hedge fund advisers is an interesting one from the point of view of regulatory capture. In principle, the fact that the SEC implemented a new rule against the preferences of the industry implies that neither capture nor self-capture took place. Yet, as the analysis in this section reveals, the effectiveness of the new rule was not straightforward since its introduction and this might point to another type of 'self-capture'.

First, it was not clear what the new rule was adding in terms of SEC authority to monitor hedge funds. For many commentators, including the dissenting commissioners, the SEC could already draw on anti-fraud laws to tackle the abuses in the industry. In addition, it was not clear whether the new rule would be able to track the activities of smaller funds, which were the ones more likely to exhibit episodes of fraud. Second, plenty of loopholes were left in the provisions of the rule, let alone in the procedural issues, which did not follow a thorough consultation with all interested governmental bodies (e.g. the Department of Labor). Finally, the SEC did not consider whether the initiative was legitimate and within the limits of its mandate. This negligence became evident in June 2006, when a three-judge panel of the US Court of Appeals for the District of Columbia Circuit unanimously ruled against the SEC hedge fund adviser registration initiative.

The case was brought to court by a hedge fund manager, Philip Goldestein, who appealed against the SEC's interpretation of the concept of 'client' (case *Phillip Goldstein, et al. v. Securities and Exchange Commission*). As described earlier in this text, with the new rule the SEC wanted to change the definition of client under the Adviser Act of 1940 so as to bring it closer to the original spirit of the law, which is to count each investor in each adviser's fund as a client. The Court held that the SEC rule was arbitrary because it resulted in a different definition of "client" for purposes of determining whether an adviser is required to register with the SEC than in all other contexts, thus violating the normal presumption that "the same words used in different parts of a statute have the same meaning." Moreover, the Court cited a long list of examples in which the SEC and even the courts agreed that a pooled investment vehicle, rather than its individual partners, members or shareholders, should be treated as the client of an investment adviser. Finally, the Court found that the premises underlying the SEC adoption of the Rule were misplaced. The Court noted that there was no evidence that the advisory relationship between hedge fund advisers and clients had changed, and further rejected the notion that the Rule was justified due to the enormous increase in importance that hedge funds have on US national markets.

Given the number of lawyers working at the Securities and Exchange Commission, it is surprising that this possibility was not explored during the lengthy process conducting to the approval of the Rule. Even more surprising is the SEC's response to the Court ruling. The SEC decided not to appeal to the United States Supreme Court. SEC Chairman Cox said that the SEC accepted the Court's decision and might consider alternative ways to regulate hedge funds. These alternative ways mainly referred to the belief that hedge funds would abide by the Rule as a voluntary effort, even without any obligation from the authorities, or that they would come up with better self-imposed guidelines that would be more effectively followed by industry participants.

There are similarities with the first phase of the debate, which favor an interpretation of the events according to the perspective of 'self-capture'. First of all, there is once again a fault in the interpretation of one of the most important Acts governing the functioning of US capital markets, notably the Investment Adviser Act of 1940. As in the case of the Baker Bill, which overlooked the fact that the Fed did not have supervisory responsibilities over hedge funds, the SEC overlooked the fact that the re-interpretation of the concept of 'client' could be illegitimate and outside its authority. The second similarity lies in the delegation of supervisory responsibilities to private actors. The SEC claimed that hedge fund advisers would nevertheless register with the SEC and follow its recommendations, despite the Rule no longer being biding. In other words, they claim that the Rule, even if it not implemented, will have a role in sparking private sector initiatives.

The case, which substantiates an example of "rule-making without implementation", also triggers concerns for the legitimacy and effectiveness of the rule-making process. Beginning with the effectiveness concerns, the motivation for private actors to comply even if the rule is no longer binding is not straightforward. After all, hedge fund managers and advisers strongly opposed the SEC registration rule (80% of the comment letters were against it) and it would be surprising if they would now register without being forced to do so. The only reason to register would be to use registration as a 'seal of approval' or proof of appropriateness of their business in the eyes of the public and potential investors: this would, perhaps, be even more dangerous than the avoidance of registration, given the little information that the new rule would provide. As for legitimacy concerns, the credibility of the SEC rule-making process has been seriously compromised. Time and resources – of both public and private actors – were spent to create a rule that was quickly vacated by a State Court. This is likely to influence the view that interested parties have of the legitimacy of the SEC rule-making process. They are going to be reassured that due diligence is the only plausible solution to any regulatory problem that financial markets create and might be less willing to participate in any future deliberative exercise.

8. Conclusions

Following the failure of the SEC initiative, US authorities promoted the self-regulating route. The US President's Working Group on Financial Markets set up two private committees, namely the Asset Manager's Committee and the Investors' Committee,[7] which on 15 April 2008 released two sets of standards for the hedge fund industry (Investors' Committee 2008; Asset Managers' Committee 2008). The PWG have often supported the creation of private initiatives, such as the Counterparties Risk Management Policy Group, since its first published study in 1999. Yet the creation of the two above-mentioned committees further institutionalizes self-regulatory practices in the hedge fund industry and rules out the possibility of a more mandatory regulation to be proposed in the future.

A similar path was followed in the UK. In January 2008 the Hedge Fund Working Group (HFWG), a UK-based industry group created in 2007, released a series of best practices for hedge fund managers, entitled "Hedge Fund Standards: Final Report" (HFWG 2008). A Hedge Fund Standards Board (HFSB) was set up to monitor conformity to the standards and to ensure that they would be updated and revised as appropriate. The HFWG and the HFSB refer to the UK jurisdiction and the principles of its regulator, the Financial Services Authority (FSA). Yet they explicitly invite managers in other countries to adopt their standards and explicitly call for collaboration with the two US committees. Given that the US and the UK jurisdictions together are home to about 85% of hedge fund assets under management globally (HFWG 2008: 4), these events point to a clear regulatory result: the regulation of hedge funds will be in private hands.

There is nothing new in private authority. As Pauly maintains, "there is no reason why [the authority to stabilize financial markets] cannot be delegated for a time to the private sector" (Pauly 2002: 87). Yet this type of delegation triggers concerns from an effectiveness and legitimacy points of view, especially if carried out according to the modality used in the case of hedge funds. This article argued that US regulators chose to self-capture their initiatives in order to transfer authority from the public sector to the private one without assuming full responsibility for it.

From an effectiveness point of view, private actors might be unwilling to self-impose restrictions on their modus operandi; counterparties (first phase) might be unwilling or unable to provide a form of indirect supervision; self-compiled guidelines (second phase) might have a very narrow sense of "public interest". From a legitimacy point of view, the failing of public regulation leads to the bypassing of the traditional sites of political legitimization and insulates financial decisions from popular sovereignty and accountability.

7. More information available at their webpage http://www.amaicmte.org/

More evidence on similar debates is warranted to understand whether self-capture is indeed a purposeful strategy that regulators use to retain some power in the allocation of supervisory responsibility or rather the passive performance of a role that sophisticated markets assign to them. Either way, the concept of self-capture can be of interest to understand changes in public policy in the domain of finance and to advance our theoretical elaboration of the migration of supervisory responsibility from the public to the private sphere.

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Most interviews carried out for this project were confidential.

I also used insights from participation in industry meetings such as the Hedge Fund Regulation and Compliance Forum, May 22-23 2006, New York.