ECONOMICS MAKES STRANGE BEDFELLOWS:
PENSIONS, TRUSTS, AND HEDGE FUNDS IN AN
ERA OF FINANCIAL RE-INTERMEDIATION

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In *Strong Managers, Weak Owners*, Professor Mark J. Roe articulates an expansive theory to explain the evolution of the fragmented market structure in the United States. He posits that political choices led to fragmentation in the American financial markets, thus guiding the evolution of the Berle-Means Corporation. His view is sometimes supplemental to, but often in contradiction with, conventional economic efficiency or functionalism arguments that are used to explain that evolution.

This Article examines Professor Roe’s theory. It will use the political influences that Roe credits with fragmentation to understand current changes in market structure, including the growth of hedge funds, in general, as well as the advent of activist hedge funds that are re-shaping corporate governance. It will end by exploring some unique problems facing pensions and trusts that invest in hedge funds. The result will be a deeper understanding of the Disintermediation Thesis within the model of recent market evolution. This Article will also offer a policy prescription for government regulators that oversee the fiduciary intermediaries who invest in these new vehicles.

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2. *Id.*
3. *Id.*

63
I. THE DISINTERMEDIATION OF CAPITAL IN THE UNITED STATES

A. Historical explanation

The traditional theory of capital market evolution is that firms initially need to specialize and manage economic activity on vast scales, which probably makes fragmentation a necessity. Firms need to perform complex tasks, which are beyond the ability of shareholders to oversee. But because managers suffer from an agency conflict, it sometimes becomes profitable for them to shirk their fiduciary duty toward shareholders. While such temptations might be constrained by product markets and access to financial markets, sometimes managers can get away with fraud, shirking, or short-term empire building.

In attempting to monitor managers, shareholders suffer from a collective action problem since it is not cost effective for any one shareholder to undertake monitoring on his or her own. Some governance scholars argue that institutional intermediary owners can help eliminate this collective action problem by aggregating share ownership. This would require, of course, that it become cost efficient for the intermediary to monitor the firm's managers. A market that allows for intermediary monitoring would be de-fragmented, which might allow for collegial and hierarchical monitoring were it to become the norm. So why is that not a feature of the American system?

The crux of this question is: Why are American corporations organized so as to accumulate capital from individual investors with no significant oversight or governance by intermediary financial groups such as banks or pensions? Roe's answer is that political forces, rather than economic ones, forced this evolution through legislation that makes

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intermediary involvement in corporate decision making both difficult and expensive.  

The political process Roe describes is as follows: The source of laws that restrict the power of intermediaries comes from both public opinion and interest group power. Where the broad public has even a weak preference, that preference cannot be outweighed by that of a smaller, more interested group. The American public has always been suspicious of consolidated economic power. The flow of funds, though, is essential to economic stability, thus a choice was inevitable: either intense regulation of one consolidated entity, or fragmentation with light regulation. The American government chose the latter. These two forces are magnified by federalism, which serves to enhance the effects of fragmentation and path dependency, which make institutions evolve in response to political choices. Institutions that might have served as powerful intermediaries, namely, mutual funds, pension funds, banks, and insurers, were all constrained by a series of political reactions and rulemaking that constrained their economic influence over firms through some version of the political model described in Roe’s thesis. The political interest group theory is that managers and labor join together to oppose the rise of institutional investor power. Management does not want an intermediary that can monitor its extraction of rents in the form of excessive compensation, and labor is convinced that intermediaries will squeeze the employment rolls to maximize investor returns.

Roe’s view that political influences effect financial dis-intermediation serves as a supplement to the more universally accepted collective action/economic explanation. But does it necessarily have to be this way? In Germany, institutional investors control large blocks of stock. In Japan, financial institutions and companies engage in significant cross-holding of stock through economic alliances (the keiretsu system).

8. Roe, supra note 1.
10. Roe, supra note 1, at 48.
11. Id. at 41.
12. Id.
14. See, e.g., David Langer, Protector Becomes the Threat to Pensions, PENSIONS & INVESTMENTS, Sept. 14, 1992, at 15 (describing how United Steelworkers and the United Auto Workers were key lobbyists for ERISA and especially the PGBC guarantees).
15. Roe, supra note 1, at 42-45.
17. See Ronald J. Gilson & Mark J. Roe, Understanding the Japanese Keiretsu:
The contrast between the American system and those of other countries is largely due to different public perceptions about institutional power and company hierarchy. Public mistrust of centralized power is not as prevalent in Germany where labor power is actually retained by the supervisory board of the firm. In addition, the German codetermination culture and rules make the banks long-term partners with labor and other potentially combative interest groups. In Japan, American influence over rebuilding the banking system caused fragmentation, but cross-holding developed, closely linking financial intermediaries with companies. According to Roe, countries with a feudal past were and are more likely to allow economic concentrations of power with heavy regulation. Conversely, American public sentiment leaned against concentration. Because of this cultural prejudice, Americans prefer a more individualized, small business financier over the Wall Street mogul. While Americans also distrust large industrial moguls, they are more willing to side with managerial arguments against financial intermediary power than with a Wall Street banker. The comparison of public sentiment between countries is used by Roe to further the thesis that fragmentation is not the only way to incentivize a shift of savings from households to firms; it is merely the result of political choices informed by public sentiment and interest group preferences.

America’s pension system is an interesting example of Roe’s theory in action. Though corporate activism is not uncommon, it has tended to come mostly from public pensions such as the California Public Employee Retirement System (“CalPERS”). Even though private pensions own a large portion of publicly traded securities, they have tended to abstain from corporate activism. Indeed, private pensions rarely hold enough interest


18. Roe, supra note 1, at 169-221.


20. Roe, supra note 1, at 169-221.

21. Roe, supra note 1, at 207, 221.


23. Roe, supra note 1, at 208.


26. Id. at 92 n.60 (citing H.B. Atwater, The Governance System Is Sound, DIRECTORS & BOARDS, Spring 1991, at 17, 19 (stating, "I have never been asked about poison pills by a private pension fund, but I am asked all the time by public pension funds.").
in a company to encourage management to even respond to their efforts to communicate.27

One supposition is that the Employee Retirement Income Security Act ( "ERISA") encourages fragmentation.28 Passed in order to secure the retirement pensions of the baby-boomer generation, ERISA has the effect of limiting pension participation in corporate governance. This is because, by placing corporate managers in charge of private pensions,29 pension managers are put in a position of conflict. Further, corporate managers simply have no interest in taking on other managers.30 In effect, institutions controlled by corporate managers are unlikely to control corporate managers because they risk the same thing happening to them. This can be combined with the fact that they get little advantage from being the first player to change the rules of the game.31 This version of the golden rule seems to be: "Do unto other companies as you would have their pension funds do unto your company."32

A second reason why ERISA has been so successful in limiting private pension activism is that it encourages over-diversification and discourages holding enough shares to make any meaningful change through voting. In order to justify the cost of activism—paying for lawyers, court costs, proxy campaigns, and time spent analyzing the target financials—a fund needs to hold a large block of the target's stock. ERISA's prudent investor rule discourages pensions from holding such portions of another company's stock because of its insistence on maintaining the status quo of other institutional investors who are similarly regulated out of activist activity.33 In order to avoid lawsuits claiming they have breached their fiduciary duty of trust, pension managers end up over-diversifying their investments.34

Finally, securities laws prevent intermediaries from coordinating corporate oversight without satisfying proxy notification rules, which the intermediaries seek to avoid.35 This begs the question of how an increased

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30. Roe, supra note 25, at 84, 96.
31. See id. at 78.
33. Roe, supra note 25, at 97-98.
34. See, e.g., Jones v. O'Higgins, No. 87-CV-1002, 1989 WL 103035, at *8 (N.D.N.Y. Sept. 5, 1989) (finding that defendant corporation acted prudently in diversifying pension assets to minimize the risk of loss).
number of intermediaries, especially hedge funds, fit into Roe’s theory at all. It seems that the power of national banks has found a way to overcome the power of other interest groups. Perhaps labor is not as well organized in an informational economy as it was in a manufacturing economy, contributing to the downfall of that interest as a political force. Perhaps, as well, farmers are no longer as concerned about banking power. Also, stabilization of interest rates through sound Federal Reserve policymaking might be one factor assuaging the national mood toward banks. Where interest rates are generally low, customers might prefer the ability of large enterprises to decrease fees through economies of scale more than they fear the influence of consolidation. But it might also be that adding another player to the game could change the dynamic completely.

B. Activist Hedge Funds and the New Economic Order

One might argue that intermediaries are beginning to exert more influence. The Roe Thesis can deepen our understanding of the current wave of activist hedge fund investing in the United States. Why is it that political forces are willing to allow these intermediaries to hold such sway over firms? Doesn’t the same dynamic explained in Roe’s political theory still apply, with managers and labor banding together to oppose intermediary power? But something is different now, because demographics have shifted. CalPERS and the pensions of the AFL-CIO are now political allies of the intermediaries, because they need the efficiency that these intermediaries bring more than ever. These retirement coffers are in a dramatic shortfall, and the political interest groups served by this demographic are incredibly powerful. So, in light of this demographic change, the nation’s present lax attitude to de-fragmentation is precisely in line with the Roe Thesis.

Further supporting the Roe Thesis is the fact that the hedge firms are the intermediaries being chosen, rather than the other intermediaries being de-regulated. In effect, path dependency has forced institutional investors to become non-intermediary firms; they are built to accommodate the regulation. Thus, they actually have to invest in other entities that are able to actively oversee management. The intermediaries themselves invest in intermediary funds; those intermediaries then get economic power, and the interest groups do not protest because they need the returns more than they fear the power of the intermediary.

36. Though not all hedge funds engage in activism—indeed, they are not even the most popular hedge fund strategy—this Article will focus on hedge funds because they form the vital link between institutional investors and publicly traded companies. This link could potentially shatter the conventional wisdom about financial dis-intermediation.
And are the interest groups involved static? Demographics change the interests of the groups that affect regulation. The average age of a labor force changes. The market makeup of heavy manufacturing versus service sector or knowledge-based industry changes. Heavy manufacturing jobs are more unionized; thus, union presence partially remedies the collective action problem in heavily industrialized states, and the state would rationally focus more on stakeholders because they have more political power.

Unlike heavy industry's unionized labor force, knowledge-based workers are likely more heavily compensated with stock options. Thus, they will be more interested in shareholder wealth maximization and may be less inclined to fight intermediary power. In addition, the employment of service sector workers is often more fluid and more flexible in terms of job transfers. This flexibility, however, weakens their ability to organize as workers, creating a collective action problem. Thus, service sector employees are not able to exercise as much control over management through negotiation or through the political process as their unionized counterparts.37

The rate at which households save also changes over time, which either increases or decreases the economic power centered in the hands of investment intermediaries. Efficiency gains that increase the ability of a market to make outputs using fewer inputs would also necessarily alter the dynamic between the interest groups in some unique way. All these variables affect the way interest groups will respond to a market structure, and will impact the outcomes informed by the Roe thesis. They also deserve some examination and exploration to deepen our understanding of this dynamic. But perhaps there is an even simpler explanation.

Demographics are always in the background of social change. In the instance of hedge-fund intermediaries, the baby boom generation is retiring. A great many pensions face severe funding shortfalls.38 Hedge funds promise to generate returns to remedy those funding shortfalls, thus providing justification for pension investment. Therefore, the interest group politics that classically constrained intermediation are conflicted; some interest groups might still be suspicious of intermediary power, but they cannot resist the added returns that activist hedge funds might offer.

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37. However, their ability to access hedge funds, if they handle their own retirement accounts, would be severely limited by the proposed minimum wealth requirement of $2.5 million. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 405 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230, 275).

Activist hedge funds might also help to remedy the conflict that corporate managers of private pensions face in overseeing fellow corporate managers. With corporate governance activity one step removed, corporate pension managers can wash their hands of the dirty work. Indeed, with a bundle of dozens, or perhaps even hundreds, of corporate pension investors, it would be difficult for the target corporation to contact all of the pension managers that invest in the hedge fund to warn them against continuing their investments with the fund.

As a secondary intermediary, activist hedge fund managers can bundle the interests of small investments in order that the diversification problem is not nearly as cogent for the pension investor. Indeed, the pension investor will still be able to diversify his interests into different activist hedge funds, while the activist fund amasses enough stake in one individual company to make it cost effective for it to engage actively in overseeing the company’s affairs. Thus far, private pension exposure to hedge funds has been limited to funds of funds, thereby putting a tertiary intermediary between the corporate manager and the target, further eliminating the diversification and conflict problems.

Roe posits that self-interested economics might make corporate managers of private pensions engage in oversight if it was worth their while. He notes, however, that the absence of other financial institutions to lead the charge, due to dis-intermediation of mutual funds and banks, means managers simply suffer from a collective action problem. Perhaps activist hedge funds are the lead actor needed in order to make managers

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39. Cf. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* 34-35 (European Corporate Governance Inst., Law Working Paper No. 76/2006, 2006), available at http://ssrn.com/abstract=919881 (arguing that the slowdown in private pension investments due to the resurgence of defined contribution plans, means that pension investments are not expected to grow beyond their current level of 10% of hedge fund investors). “The Hennessee Group recently estimated that public and private pension funds combined account for 9% of the sources of capital to hedge funds.” *Id.* at 35 n.200. “In 1995, private pension funds held corporate equities of $1.3 trillion, amounting to 15% of the total market value of corporate equities. By 2005, private pension funds held corporate equities of $1.7 trillion, amounting to 9% of the total market value of corporate equities.” *Id.* n.201.

These figures, however, fail to account for 1) the percentage of total investors comprised of pension funds in activist hedge funds; 2) increases in hedge fund investments for those defined benefit plans that need to increase returns to meet demographic demands; 3) the likelihood of future congressional lawmaking to incentivize defined benefit plans owing to expected strains on the retirement system; or 4) defined contribution plans investing in funds of hedge funds. Pension fund links to activist hedge funds are significant, and will only grow from here.

40. *Id.* n.202 (“Much of the new pension money enters the market through funds of hedge funds.” (quoting Jane B. Kenney et al., *The Hedge Fund*, INSTITUTIONAL INVESTOR, June 2003, at 40)).

interested. This is especially likely since the pensions and activist hedge funds would be working together; the activist fund would be willing to do all the work for fees as a percentage of the investment’s performance. Additionally, activist hedge funds can help alleviate any collective action problems that public pensions face in instituting activist activity. In addition to its own corporate governance initiatives, CalPERS, for example, also invests in activist hedge funds.

Though banks, even after the Gramm Leach Bliley reforms, are still constrained in their ability to act as financial intermediary overseers, the trust money they invest on behalf of others can be placed in hedge funds that can serve that function on their behalf. One reason for the rise of trust money is development of the tax code that makes trusts more tax efficient. Estate tax rates are in a severe state of temporal flux. Evolution in this area is so uncertain that protection through trusts is now becoming more and more popular. Another reason is, again, demographic shifts; as those baby boomers that had saved near retirement begin to plan for the next generation. And though trusts do not specifically fit into our dis-intermediation story previously, it is apparent they are becoming a part of it, and present the conflicts that will be most in need of oversight going forward.

II. THE FEASIBILITY OF THE ACTIVIST HEDGE FUND AS A SERVICE PROVIDER FOR INSTITUTIONAL INVESTORS

Activist hedge funds are creatures of the 21st century of corporate governance, only recently entering the scene to shake up the equilibrium that had evolved in the 1990’s. Hedge fund activism can take the form of

42. Public pensions have always engaged in activism, but of a different sort. See Kahan & Rock, supra note 39, at 15 (arguing that public pensions were involved in activism by making shareholder proposals and engaging in private negotiations with the board of directors). See also Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 STAN. L. REV. 857, 866 (1993) (indicating that even these limited actions can be meaningful and influence the corporate governance process when “used simply, but credibly, as a threat”).

43. This may in part help to remedy the political conflicts of interest that these investors face. See Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 COLUM. L. REV. 795, 796-822 (1993). See also Kahan & Rock, supra note 39, at 27 (“Given the potential pitfalls from high pay packages, a politically safer course for pension fund boards that are willing to pay steep performance fees would be to entrust funds to an outside entity rather than to pay such fees to in-house managers.”).


45. See Kahan & Rock, supra note 39, at 1-2 (“Over the last few months, hedge funds have pressured McDonalds to spin-off major assets in an IPO; asked Time-Warner to
legal battles to inspect the corporate books\textsuperscript{46} as a prelude to further litigation or as an aid in proxy fights, blocking takeovers,\textsuperscript{47} suits alleging fiduciary duty violations in Delaware, or suits alleging securities fraud liability under the PLSRA.\textsuperscript{48} It could also involve waging proxy contests for corporate control or for board seats, or withholding vote campaigns to oust directors using new majority voting by-laws.\textsuperscript{49} Until now, only a minority of hedge funds have utilized the activist strategy. One estimate is that roughly five percent of the one trillion dollar hedge fund world, or a mere fifty billion dollars, is available for activism.\textsuperscript{50} However, this strategy is still very new, and as returns in this space grow we can expect the amount of capital diverted there to grow, as well.

The present value of benefits from the good public press in a proxy fight will be quantifiably valuable to the hedge fund in a way that pensions and trusts will not experience.\textsuperscript{51} This dynamic speaks to active investment management generally. People rarely make pension decisions based on which pension manager recently made the front page of Business Week for taking on the CEO of a company in a proxy fight or a withhold vote campaign. The same cannot be said of institutional investments in hedge funds. Thus, the activist hedge fund internalizes the positive externality of the future reputation benefits of making a name for oneself as a strong force in corporate activism.

If the overall cost of proxy fights declines, hedge funds will also benefit to the extent their activism involves proxy wars. But even with

change its business strategy; threatened or commenced proxy contests over H.J. Heinz, Massey Energy, KT&G, infoUSA, Sitel, and GenCorp; made a bid to acquire Houston Exploration; pushed for a merger between Euronext and Deutsche Boerse; pushed for changes in management and strategy at Nabi Biopharmaceuticals; opposed acquisitions by Novartis of the remaining 58% stake in Chiron, by Sears Holdings of the 46% minority interest in Sears Canada, by Micron of Lexar Media, and by a group of private equity firms of VNU; threatened litigation against Delphi; and pushed for litigation against Calpine that lead to the ouster of its top two executives." (citations omitted)).


47. See In re Tyson Foods, Inc., Sec. Litig., Civil Action No. 01-425-SLR, 2003 U.S. Dist. LEXIS 17904 (D. Del. Oct. 6, 2003) (permitting a hedge fund to serve as lead plaintiff in a securities fraud class action). However, appointing hedge funds as lead plaintiffs is not without its complications. See Kahan & Rock, supra note 39, at 8 ("Because hedge funds often engage in short selling, they face issues of reliance that may render them 'inadequate' class representatives.").

48. For more on the use of majority vote campaigns by activist hedge funds, see J. W. Verret, Pandora's Ballot Box, or a Proxy with Moxie?: Majority Voting, Corporate Ballot Access and the Legend of Martin Lipton Re-Examined 63 BUS. LAW. (forthcoming 2007).


50. See Verret, supra note 49, at Part III.B.
prohibitive costs to activism, hedge funds that specialize in activist investing can develop economies of scale in the field. By doing this sort of activity full time, they could find cost efficiencies. A hedge fund would be able to use, for instance, ongoing relationships with a law firm that could help negotiate down the price. A hedge fund might even have inside counsel devoted only to activism, which a larger institution could not afford as it operates in an environment that encourages competition on operational expenses. The lack of fee competition in the hedge fund industry would allow them to absorb more costs in this area.

Developing an internal corporate governance rating capability in identifying problem firms can also be useful for the non-activist trading on the side. This would not be the case for a more passive investor. In other words, the information garnered through the corporate governance rating function could also be useful to non-activist trading by the firm or could just be sold to another hedge fund that would be able to use it. An exception would be where the fund has representatives on a firm’s board, which will mean the fund cannot trade on information of that individual firm because it would make the fund liable for insider trading.

Hedge funds may also serve as a leader for activism that mutual funds can follow. The exemption from investment company registration means that hedge funds are not subject to the same securities law constraints as other institutional investors. Further, as a single actor, they are not constrained by the requirement that they file communication disclosures. 52 Also, hedge funds are free to engage in activism without violating the Regulation M tax rules that require over-diversification in mutual fund portfolios. 53

Hedge funds will also benefit from the ability to use the “220,” a new and cheap method for getting information to embarrass directors and officers and convince them to relinquish control. 54 Requests by hedge funds to inspect corporations’ books and records are already common in Delaware. 55 Some hedge funds make use of activist strategies to institute

53. If a mutual fund holds greater than a ten percent stake in any one of the companies in its portfolio, then it forfeits its diversified status and, therefore, loses its preferential tax treatment. See Investment Company Act of 1940, 15 U.S.C. § 80a-5(b) (1988). Subchapter M of the Internal Revenue Code levies substantial tax penalties on mutual funds which are not diversified. I.R.C. § 851(b)(4) (1988).
54. For more on section 220 litigation generally, see Radin, supra note 46 (arguing that Section 220 has ushered in a new stage of litigation and activism by granting shareholders a right to inspect corporate books and records).
“220” records inspections against the companies in which they invest, or they may make use of shareholder rights through appraisals and injunctions against mergers to negotiate for share repurchase or seats on a corporate board.56 Sure, board minutes, for instance, are often benign; however, the Disney57 case demonstrates how board minutes can include discussions that a board never believed would become an issue, yet ultimately do. Hedge funds also have the ability to bring a nuisance suit to stop a takeover, and the ability to use information garnered in their merger/governance analysis function to trade in merger arbitrage operations, or to sell that information to other hedge funds.

Other institutions will sometimes free ride on activism—especially if they are themselves investors in the activist hedge fund. The problem previously was that there was no one with a profitable reason to lead the charge. In other words, hedge funds benefit even if they lose the first couple of fights, where other institutions with more passive investors did not have an incentive to participate unless everyone else did. This is a prisoner’s dilemma where everyone ended up in a worse position than if they all had participated.

Also consider the implications of having more captive money, which allows hedge funds to take more illiquid positions.58 There is another effect flowing from lockups that permit activism as well—activist hedge funds will have more time to develop their earnings record. Much of the investment is on faith for a newly formed fund; if it loses the first few fights then its investors cannot get out and will have to stay the length of the lockup. Big firms, knowing that, will understand that the activists are less rational and more willing to fight, even if the expected value of the outcome is negative. Negotiation is partly about who has the most to lose especially where there is open information about the relative positions of the parties. Therefore, hedge funds are aided in negotiations with firms because they can afford to lose the first couple of fights and still come out ahead.

Additionally, once a hedge fund has developed a reputation for aggressive activism, it can obtain advantages with less expensive threats. Once it has a few victories under its belt, merely taking a one or two percent stake in a company could be an effective signal that the fund is willing to fight, and some firms might back down. The case of Cadbury is instructive. Nelson Peltz purchased three percent of its outstanding shares and advocated for a breakup of the company’s beverages and candy divisions to make the company a more attractive target for a private equity

56. For more on this, see Kahan & Rock, supra note 39, at 6.
buyout.\textsuperscript{59} Coming on the heels of his successful proxy fights with Heinz and Wendy's,\textsuperscript{60} Peltz's reputation as an activist was sound.\textsuperscript{61} Further, his ability to convince other investors to go along was also sound, as his track record was good for maximization of shareholder value at the other companies he had targeted. Thus, the odds of a victory, if he committed his full resources, were measurably threatening. His willingness to dedicate resources to purchasing three percent of the shares was an effective signal of his willingness to dedicate considerably more to waging a full proxy fight. But he didn't need to. Cadbury quickly got the message and acquiesced.\textsuperscript{62} The share price immediately responded positively to the company's announcement that it would split the divisions.\textsuperscript{63} This cost-effective activism requires specialization, something institutional investors are constrained from achieving, but which they can take advantage of through investments in these types of funds.

III. CHALLENGES POSED BY THE NEW MARKET STRUCTURE AND REGULATION OF INSTITUTIONS INVESTING IN HEDGE FUNDS

A. Regulatory Environment for Institutions Investing in Hedge Funds

When hedge funds were first created, only wealthy individuals and families could invest in them. Yet now, banks and pensions are increasingly becoming involved.\textsuperscript{64} Banks present the most difficult problem, and will therefore form the bulk of this Article's policy prescriptions. This is due to the recent Graham-Leach-Bliley reforms; the opportunities for conflict are omnipresent for banks because of the wide variety of business in which they can now engage in the wake of the de-
It is important to recognize that there are conflicts for pension fund investors as well; however, ERISA, with the federal Department of Labor administrative guidance, should form a sufficient framework to police the conflicts that will face private pensions.

Banks typically act as fiduciaries for a number of account classes for which they are trustees. In 2002, trustees in the United States controlled over 1.1 trillion dollars in trust accounts, with a portion of that total run by chartered banks. As such, they have discretion over which asset classes these accounts will be invested in. Different institutions regulate banks depending on the source of its charter and its ownership structure. They may be chartered by the Office of the Comptroller of the Currency (OCC) or by the Federal Reserve, or they may be state chartered and regulated by the FDIC. States typically allow non-banks to act as trustees for funds. In addition, if they are owned by a financial holding company, the Federal Reserve will pre-empt other federal regulators.

Every state has a body of fiduciary duty and trust law that will apply to these activities. Whether the bank in question is a federally chartered bank or not, it will still be subject to state law. This is because OCC regulations proscribe that national banks chartered by the Comptroller of the Currency will be permitted to invest common trust assets in mutual funds and other equity classes, provided that such investment is permitted for state banks organized under the laws of the state in which the national bank maintains its headquarters.

Trustee powers are first construed based on the documents controlling the contract relationship, with an eye toward upholding freedom of contract so long as the "prudent" investor rule is met. Though there is a common law rule against delegation of trustee responsibilities, that delegation does not include investment in investment companies. This is justified under the assumption that the trustee has control over whether to invest in the investment company and whether to liquidate such investment when appropriate. Though it was originally illegal for trustees to pay a

67. Id. at 753.
69. See Ali, supra note 64, at 80.
71. Id.
management fee to investment companies out of trustee assets, state laws have since been amended to allow the practice.\textsuperscript{72}

Though supplemented by statute and narrowed by contractual limitations, fiduciary duty common laws are the overriding principle around which a fiduciary’s activities are judged. They require that investment of trust money be done in accordance with the prudent interest of the trust beneficiaries, with that prudent interest being defined by statutory constructs and case law.\textsuperscript{73} The seminal state case in this area is \textit{Harvard College v. Amory}:

\begin{quote}
All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probably outcome, as well as the probably safety of the capital to be invested.\textsuperscript{74}
\end{quote}

Self-dealing, or investing trust assets in a way that benefits the trustee to the detriment of the trust beneficiary, is one recognized violation of the prudent investor rule. For instance: investing trust money in a publicly traded stock where the trustee also has a large holding in the stock—when there is some evidence that the stock is overpriced and the investment is large enough to have a detrimental effect on prudent diversification of the trust portfolio—is a clear case of fiduciary duty violation.\textsuperscript{75} Though not binding precedent, the Third Restatement of Trusts is an informative source of law used by both state legislators and judges in interpreting trust duties. It was amended in 1994 to address the issue of fiduciaries investing in other entities, and its approach essentially embraces modern portfolio theory.\textsuperscript{76}

\begin{itemize}
\item \textsuperscript{72} \textsc{Broome} \& \textsc{Markham}, supra note 66, at 769.
\item \textsuperscript{73} This was also noted in an agreement between the President’s Working Group on Financial Markets and United States agency principals. See Press Release, Agreement Among PWG and U.S. Agency Principles and Guidelines Regarding Private Pools of Capital (2007), http://www.treasury.gov/press/releases/reports/hp272_principles.pdf, at 2-3 (hereinafter “President’s Working Group”) (“Concerns that less sophisticated investors are exposed indirectly to private pools through holdings of pension funds, fund-of-funds, or other similar pooled investment vehicles can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles. These fiduciaries have a duty under applicable law to act in the best interest of the beneficiaries. They have an ongoing responsibility to perform due diligence to ensure that their investment decisions are prudent and conform to sound practices for fiduciaries. Such pooled investment vehicles should address any special issues relating to investment in private pools of capital, including the availability of relevant, accurate, and timely historical and ongoing material information”).
\item \textsuperscript{75} \textit{Cent. Nat’l Bank of Mattoon v. U.S. Dep’t of Treasury}, 912 F.2d 897 (7th Cir. 1990).
\item \textsuperscript{76} Uniform Prudent Investor Act, National Conference of Commissioners on Uniform
Pensions are another pooled investment entity that places money in hedge funds. They are similar to trusts in that they utilize a trust manager who has broad discretion in placing pooled assets. Under the Employee Retirement Income Security Act of 1974 (ERISA), fiduciaries of employee retirement plans are regulated to protect pension holders from abuse; the fiduciary law of trusts was invoked by Congress within the ERISA framework to define the general scope of authority and responsibility for pension officers. ERISA guidelines supplement the general fiduciary duty law of trusts and further define the law of private pensions as including the duties of prudence and loyalty. As a general matter, there is nothing wrong with fiduciaries, pension or otherwise, investing in a hedge fund if the investment comports with the prudent investor rule. To meet these duties, an ERISA plan fiduciary must, at the time of the transaction: utilize proper methods to investigate, evaluate, and structure the investment; act in a manner as would others familiar with such matters; and exercise independent judgment when making investment decisions. As with most trusts, when the governing contract restricts an ERISA plan officer’s investment discretion further than ERISA guidelines, such restriction will govern. To increase the web of complexity in this area, ERISA plan administrators will frequently place the assets of the plan with a bank to serve as a trustee for the ERISA plan beneficiaries. In those cases, fiduciary obligations will apply to the trustee through both common law and common law as adopted by federal statute.

The Comptroller of the Currency has discretion to issue a notice of intent to revoke a bank’s authority to provide trust services; and can do so upon providing a hearing before an OCC administrative law judge, if it has evidence that the bank has exercised its trust powers “unlawfully or

State Laws, 1994. “(1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term ‘portfolio’ embraces all the trust’s assets. UPIA § 2(b). (2) The tradeoff in all investing between risk and return is identified as the fiduciary’s central consideration. UPIA § 2(b). (3) All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. UPIA § 2(e). (4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3. (5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. UPIA § 9.” Id. at Objective of the Act.

77. See Ali, supra note 64, at 89.
80. See Ali, supra note 64, at 86.
81. Id. at 87.
ECONOMICS MAKES STRANGE BEDFELLOWS

unsoundly. Currently, the OCC provides some guidance on fiduciary standards in the form of circulars issued under authority granted in 12 CFR § 9. State regulators and private litigants further supplement the enforcement of fiduciary standards.

The Federal Reserve has broad discretion as a regulator. It can define unsafe banking practices that are harmful to deposit holders and require banks to cease such activities. To provide guidance to banks in making decisions, the Federal Reserve issues advisory letters that help banks predict how the Federal Reserve will react to particular activities and provide guidance on the standard of review it will use in evaluating those activities. Although the Federal Reserve issued supervisory guidance letter SR 99-7 to help banks navigate the web of fiduciary conflicts that may arise when placing trust assets in mutual funds, it has issued no such letter regarding placement of trust assets within hedge funds. Though its prescriptions may be helpful by analogy, more guidance is needed due to the particular nature of hedge fund fees and their attendant conflict risks.

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84. Office of the Comptroller of the Currency, supra note 68.
86. See Bank Lending To and Other Transactions with Hedge Funds: Hearing Before the Subcomm. on Fin. Instns. and Consumer Credit of the H. Comm. on Banking and Fin. Servs., 106th Cong. 106, 121 (1999) (statement of Laurence H. Meyer, Member, Bd. Of Governors, Fed. Reserve Sys.) (explaining that supervisory opinion letters are intended to "enhance and support market discipline by strengthening the risk management processes of major creditors and counterparties").
87. SR 99-7 requires the following:

Reasoned Legal Opinion - The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, trust instrument, or court order, as well as any applicable disclosure requirements or "reasonableness" standard for fees set forth in the law.

Establishment of Policies and Procedures - The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations and sound fiduciary principles,
Hedge funds that meet the high net worth test for their investors are still largely unregulated. The fact that their activities are highly secretive, combined with the presence of some large hedge funds at the center of late trading mutual fund scandals, is cause for much concern among federal regulators and all investors in these funds. The Securities Exchange Commission (SEC) has tried to address some of the issues facing regulators of hedge fund investors, such as requiring registration, which would have given the SEC insight into the trading activities of these funds through compliance audits. Further, anyone who engages in securities trading is subject to the general anti-fraud provisions of the Securities Act of 1934. Proper coordination between the SEC and other regulators will determine whether a future SEC regulatory regime for hedge funds helps to cure some of the problems faced by institutions that invest in hedge funds. In addition, many hedge fund advisers are still voluntarily registered as advisers, so the Goldstein decision will not affect the SEC’s intelligence capability in that regard.

B. Problems Facing Institutions Investing in Hedge Funds

The ethical dilemma faced by banks engaged in trust activities is that they may have a vested financial interest contrary to the interest of their trust beneficiary. A hedge fund may provide a trustee with a fee rebate in return for investing in the fund. Hedge funds typically borrow more than what they invest. For example, if investing ten million dollars, a hedge

including any disclosure requirements or "reasonableness" standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.

Analysis and Documentation of Investment Decisions - Where fees or other compensation are received in connection with fiduciary account investments over which the institution has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with the provisions of the Prudent Investor or Prudent Man Rules, as appropriate.

Board of Governors of the Federal Reserve System, supra note 85.


90. See generally Ali, supra note 64.
The fund may well borrow an additional fifty or sixty million dollars to invest. So what if in exchange for placing a bank’s trust assets in the hedge fund, the hedge fund takes out loans from the same bank? The risk is that the trustee will not make decisions on where to place trust assets based on the proper risk/return provided by the asset, but rather by the hope for interest fees from the hedge fund as a quid pro quo.

If the trust documents describe the kinds of fees that a trustee will accept from a hedge fund, is that enough to cure the dilemma, or must the trustees further disclose particular arrangements with hedge funds? Alternatively, is it a better idea to ban the practice altogether and prevent possible trouble? Should regulators require that trust divisions submit to random compliance audits or would audits by independent accounting firms be enough?

The bank that acts as trustee may also run its own hedge fund. In that case, it will have a clear vested interest in placing trust assets with its fund because of the high performance fee. A common device used to cure institutional conflicts is to build operation walls around potential conflicts, requiring that trust officers and hedge fund managers be supervised and compensated by different parts of the institution. Is this enough to cure the conflict? Could an employee still have a vested interest in the general economic well-being of the institutional employer despite the operational wall?

C. Political Challenges

The U.S. banking system is subject to both horizontal and vertical regulatory competition, and banking regulators have a vested interest in the outcome of these regulations. If the OCC and the FDIC take positions different from the Federal Reserve, or state regulators take fundamentally different positions, it may mean banks that wish to invest in hedge funds will prefer the lighter regulator.

Other institutions that regulate hedge funds may also conflict with the Federal Reserve. The Commodities Futures Trading Commission (CFTC) and the SEC issue rules that define the activities that investors in hedge funds can engage in. If the Federal Reserve issues rules in its capacity as a regulator of fiduciaries that incentivize investors in hedge funds in ways that is adverse to the goals of the SEC and the CFTC, then the potential for further political turf wars, as well as Congressional involvement, increases.

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91. See Ali, supra note 64, at 86.
92. This is overly simplistic, as the “bank” will consist of numerous holding companies, such as fiduciary operations at Goldman Sachs Asset Management and hedge fund trading at Goldman Sachs Capital Partners, but with ultimately one umbrella organization in control.
Public pension funds present a unique political and administrative challenge in this area as well.\textsuperscript{93} Public pensions are governed by public bodies consisting of elected officials and individuals appointed by elected officials. Although this makes public pensions uniquely accountable to the electorate, it many times invokes severe conflicts of interest. For example, investment groups could give to the campaigns of elected officials, or pay lobbying fees to former members of pension oversight bodies, in order to garner investments and reap the management and carry fees from them. These conflicts are furthered by the fact that public pensions are not regulated by the federal government, unlike private pensions that are regulated under ERISA. As this area will require a state-level political solution, rather than a federal policy-oriented solution, I will leave that challenge open to future exploration.

In addition, the banking and financial services lobbies will be particularly interested in the outcome of these rules and may seek to overturn Federal Reserve pronouncements with Congressional lawmaking. If they can convince Congress to pass a statute granting a safe harbor for certain activities, for instance, then they might preempt the Federal Reserve's regulation. Another group with a vested interest will be mutual funds, which compete with hedge funds for fiduciary money, and trust beneficiaries themselves.

Another political challenge facing regulators in this area are the state Attorney Generals that may want to override federal regulation to catch some of the glamour that comes along with prosecuting a large financial institution on behalf of voters. While this may reap political capital, it wreaks havoc with private markets and federal regulators. Attorney Generals may be unwilling to coordinate with other regulatory bodies, thus leaving banks without any ability to plan their activities to maintain compliance. Also, state Attorney Generals may lack the sophisticated financial expertise to properly regulate financial markets, relying instead on broad fraud statutes and showy trials before unsophisticated juries.

\textbf{D. Is Increased Regulation the Answer?}

It seems that there is a marked difference between willingness, on the part of regulators, to allow investors to undertake some risks, such as systematic risk and interest rate risk, while at the same time expending significant government resources and requiring expenditure of investment company resources to minimize operational risk such as risk of fraud. What is the reason for the difference?\textsuperscript{94} Is it that operational risk is easier

\textsuperscript{93} See President's Working Group, \textit{supra} note 73, at 2.
\textsuperscript{94} For some unique ideas to explain the difference, see Stephen J. Choi & A.C. Pritchard, \textit{Behavioral Economics and the SEC}, 56 \textit{Stan. L. Rev.} 1 (2003) (discussing the
to quantify, measure, or prevent?\textsuperscript{95} If interest rate risk was something political actors legitimately felt they could shield investors from, then would they set up a state-run organization to help assess and minimize exposure to interest rate risk?

One question that becomes readily apparent is whether it is a good idea to set up multiple avenues for the same preventative effect. For instance, many of the abuses in hedge fund trading scandals and fiduciary duty violations cases are already textbook fraud, vulnerable to prosecution by the Department of Justice and civil action by the OCC or private litigants. Is it that these punitive responses are not enough to properly prevent abuse? And if so, would bolstering enforcement of these existing avenues of regulatory oversight be a less costly way to achieve the same result?

Investing in hedge funds is a relatively new phenomenon for banks. To the extent that fiduciary duty violations are unique when these entities invest in hedge funds rather than other investment vehicles, banking regulators should provide guidance in the form of administrative opinions. As bank compliance officers face unique challenges in response to trust office inquiries, they will seek guidance from the banking regulators. But guidance should come at the inquiry of the trust industry to address issues they face individually, not the other way around. Banks should be interested in enhancing information flow requirements to enhance public perception of the trust industry.

Many of the ethical conflicts facing actors in the hedge fund industry can be addressed using tools presently available in the regulatory environment. For instance, if a less onerous hedge fund registration requirement were to be instituted in the future, it would be advisable that the SEC provide banking regulators with the power to establish formal information sharing by fund investors. If registering entities used their compliance powers with registered hedge funds to collect information on trust officers that invested with those funds, banking regulators could cross reference that information with their own compliance audits to look for abuse of fiduciary status. In addition, if the information were made available to private litigants and other enforcement agencies upon issuance of a subpoena, then other enforcement mechanisms already in place would be enhanced. Rather than incur the increased cost of creating new enforcement initiatives, it would be advisable to utilize current avenues more effectively if doing so can achieve the same desired result.

\textsuperscript{95} Another take on this phenomenon posits that regulators merely regulate whether it is necessary or not, as it serves their own interests. See Milton Friedman, \textit{Why Government is the Problem}, in \textit{39 Essays on Public Policy}, 7-12 (1993).
Furthermore, global banking institutions will face unique challenges if the Federal Reserve’s rules are fundamentally different from those of financial regulators in other countries. For example, if the United Kingdom’s Financial Services Authority (FSA) or the Bank of Japan (BOJ) were to take dramatically different positions, then the complexity facing global institutions like Citigroup may be prohibitive. One difficulty Citigroup—a bank with a United States charter—might face is what it should do with funds it holds as a fiduciary for a sophisticated and wealthy investor who is a citizen of a country in the European Union, but invests in its London branch. The difficulty arises where the best available investments are hedge funds located in the United States and abroad that invest around the world. In short, a lack of global harmony in banking fiduciary regulations could potentially run counter to investor protection objectives. If the approach used by the Federal Reserve and the Office of the Comptroller of the Currency incorporates self-regulatory organizations (SROs) and enhanced regulatory regimes, then while federal rules will not engage in cross border conflicts, SROs will already be attuned to cross border challenges since they are made up of many banks that are global themselves.

E. Policy Recommendations

1. Recommendation #1

The ERISA rules should be amended so that hedge funds where public pensions hold 25% of the equity will not be subjected to ERISA regulations. A more nuanced guideline—such as an exemption for hedge funds that accept money from institutions already regulated by ERISA, combined with more regulatory guidance for institutions that invest in hedge funds—would allow pensions to utilize the advantages hedge funds offer while still monitoring conflicts. After all, there is nothing magical that happens at 25% holdings that does not occur at 10%. The evolution of this market structure calls for a second look at ERISA guidelines designed to serve an outdated dynamic.

2. Recommendation #2

In the event that some new form of registration becomes required, the information gathered during compliance audits could be used by both private and governmental actors for oversight of institutions that invest in hedge funds. Therefore, information gleaned during these audits should be

96. This would amend 29 C.F.R. § 2510.3-101(f) (1974).
made available to those authorities and individuals to enhance their ability to prevent mismanagement and fraud. In addition, if a proposal for regulation of a hedge fund is accepted, that fund should have access to the same information.

Accordingly, financial regulators should establish a “Financial Regulatory Coordination Board” with a full staff and a board comprised of banking and securities regulators, as well as private SROs. This board would establish guidelines for releasing the results of compliance audits to each other in addition to private investors. Such guidelines would set a standard requiring that information be sent to private actors when a case or controversy is established in some forum of dispute or when the agencies have a reasonable belief that the interests of investors are materially threatened. Understandably, the standard would need to be lower for information sent to coordinating agencies and self-regulating organizations. Further, guidelines would be issued by the board to ensure that the proprietary character of trading operations is protected and that firms do not lose money from their trading operations once their information is revealed on the exchange markets.

3. Recommendation #3

The Federal Reserve and the Comptroller of the Currency should issue supervisory releases and circulars encouraging regulated fiduciaries who invest in hedge funds to disclose to all fiduciaries the precise nature and amount of fee relationships that the bank has with the fund. The release would not mandate disclosure but merely describe it as a safe harbor that would permit the fiduciary to rely on disclosure as one practice that will presumptively protect it from liability for breach of fiduciary duty. For the disclosure to provide protection, it should require that the bank reveal any other relationships in which the bank, or any affiliate thereof, and the fiduciary, or any affiliate thereof, has with the hedge fund or any of its affiliates. The Federal Reserve and the Comptroller of the Currency, in the same administrative releases, should include an encouragement that the banks get proxy approval from fiduciaries for the fees charged with withdrawal of funds as a permitted alternative to approval.

97. Recommendations of this sort have been made previously. See President’s Working Group, supra note 73, at 6 (“Supervisors should take full advantage of both formal and informal channels of coordination and cooperation across financial industry sectors and international borders when carrying out their responsibilities related to internationally active financial institutions’ management of exposures to private pools and leveraged counterparties.”). Though the report is a good start, the organization’s recommendations are not enough.

98. This recommendation is also in line with the recent President’s Working Group principles. See id. at 5 (“Supervisors should clearly communicate their expectations
4. Recommendation #4

The banking regulators should encourage existing banking associations to promulgate the best practices in trust creation relating to fee compensation, with model trust documents that best protect the trust beneficiary from fee exploitation. Compliance with such a document would be another factor that the Federal Reserve and the OCC would include as being among the presumptive best practices that afford safe harbor protection in their administrative releases.99

regarding prudent management of counterparty credit exposures, including those to private pools of capital and other leveraged counterparties, who are increasingly utilizing complex instruments, including certain over-the-counter derivatives and structured securities, such as collateralized debt obligations.” Supervisors’ expectations with respect to prudent risk management practices should take into account developments in financial markets and advances in best practices for counterparty credit risk management. Supervisors should actively monitor such developments and revise their policies and associated guidance as appropriate in a timely manner. In turn, supervisors should actively monitor and assess whether policies and procedures measure up to regulatory guidance and industry efforts to identify best practices.”).

99. Ali, supra note 64, at 87-88, provides a fiduciary investor’s best practices guide that might serve as a useful start:

(a) Understand the legal structure of the hedge fund; (b) Understand the hedge fund’s investment strategy, including the risks inherent in that strategy, whether there are any limits on the ability of the hedge fund manager to take concentrated positions..., the degree to which leverage is used by the hedge fund manager to implement that strategy, and the scalability of the hedge fund’s investment strategy; (c) Understand the market or “systematic” risk of the bond, share and derivatives markets in which the hedge fund invests; (d) Understand the composition of the hedge fund’s portfolio, the “unsystematic” or unique risks, in particular the credit risk or risk of default and insolvency, associated with the individual instruments in which the hedge fund has invested, and the price volatility (that is, the extent to which the price of an instrument fluctuates) and the liquidity (that is, the ability to buy or sell instruments expeditiously at a reasonable price) of those instruments; (e) Understand the liquidity of the hedge fund....This is dependent upon the hedge fund’s lock-up and redemption policies, the liquidity of the instruments invested in by the hedge fund and whether there is a secondary market for interests in the hedge fund (hedge funds are not usually listed on an official exchange such as the London Stock Exchange); (f) Monitor the returns generated by the hedge fund, in particular declines (or “draw downs”, as they are euphemistically referred to) in the net asset value of the hedge fund and the extent to which the fiduciary’s own portfolio is exposed to the hedge fund; (g) Monitor changes to the composition of the hedge fund’s portfolio....(h) Monitor redemptions of hedge fund interests...; and (i) Where possible, demand more detailed and regular disclosure about the matters listed in items (f) to (h). (citations omitted).
5. Recommendation #5

The ERISA rules should be amended to include specific rules alleviating potential conflicts between private pension managers and hedge fund advisers. For instance, it should not be permissible for a financial services company to invest its pension with a hedge fund that has lending arrangements with the company, engages the company for prime brokerage, or otherwise has a financial arrangement with the company other than the pension investment.

6. Recommendation #6

The Federal Reserve and the OCC should encourage Congress to establish a federal preemption in regulation of fiduciaries. Any action taken in compliance with the Federal Reserve or the OCC guidelines for fiduciaries should be considered as presumptively fulfilling state fiduciary duty requirements. This will prevent state and federal authorities from pursuing inconsistent goals. Though regulatory competition can be particularly useful, as explored in the first section of this paper, it is unlikely that state banking regulators can achieve the kind of sophistication and expertise necessary to police the industry in the current environment. Therefore, though horizontal-regulatory competition between the OCC and the Federal Reserve may be useful for the reasons explored in previous sections, it is not advisable on the vertical level.

IV. CONCLUSION

The danger faced in the hedge funds field is that, caught up in regulatory zeal, banking and pension regulators will limit access for institutional investors, such as trusts and pension funds, to this useful asset class. Additionally, the growing presence of hedge funds in political lobbying, calls for a measured and final rule on this issue before Congress becomes subject to regulatory capture.

100. Indeed, it is difficult for financial regulators to achieve the international coordination recommended in the President’s Working Group’s “Statement of Principles” if they must contend with fifty additional sets of patchwork fiduciary duty principles. See President's Working Group, supra note 73, at 6.

101. For example, similar goals were accomplished with federal preemption of state blue sky laws. See 15 U.S.C. § 77r (1988).


103. The Managed Funds Association (MFA) intends to double the size of its political action committee in 2007 to further its lobbying efforts. See Carrie Johnson & Jeffrey H. Birnbaum, Hedge Funds Begin to Show Up on Regulators’ Radar, WASH. POST, Feb. 9,
Oversight of trust officers and fiduciaries in the banking sector has occupied banking regulators since before the founding of this country. Though hedge funds are a relatively new phenomenon, the Federal Reserve and other banking regulators should be able to mend the fiduciary regulatory regime to account for the unique challenges of hedge fund investing by properly accounting for economic and political considerations for rulemaking in both the domestic and international spheres. In particular, proper integration with international banking regulators and securities regulators is essential and should be tempered by balancing the interests of the various constituencies involved.

Further, a more nuanced view of ERISA guidelines will permit policing conflicts without overly constraining the dis-intermediation of capital in the United States. The market wants to evolve, and its natural processes are leading it to limit information asymmetries and agency conflicts that constrain its efficiency. With a careful, intelligent regulatory touch, it is possible that the operational risk represented by the agency conflict of the separation of ownership and capital can be significantly reduced by the growing institutional interest in activist hedge funds, thereby flouting conventional wisdom in the story of market development.