Symposium Articles

HEDGE FUND FORUM SHOPPING

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Hedge funds have been the subject of media attention in the United States (“U.S.”) and around the world given the pronounced growth of the hedge fund sector in recent years and the comparative dearth of regulations faced by hedge fund managers. The first part of this paper provides an overview of the potential agency problems associated with managing a hedge fund and the associated rationales for hedge fund regulation. While hedge funds are hardly regulated in the U.S., there are nevertheless jurisdictions outside the U.S. with different and sometimes more onerous sets of regulatory requirements. Examples of international differences in hedge fund regulation include minimum capitalization requirements, restrictions on the location of key service providers and different permissible distribution channels via private placements, banks, other regulated or non-regulated financial intermediaries, wrappers, investment managers and fund distribution companies.

The second part of this paper provides an analysis of hedge fund strategies in the context of international differences in hedge fund regulation. Certain fund strategies have been characterized in the law and finance literature, as well as in popular media and public policy debates, as being inherently more risky and associated with more pronounced agency problems. For instance, managed futures, long/short and event driven strategies might be associated with greater risk and agency problems than

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market neutral equity strategies and various arbitrage strategies. At issue, therefore, is whether funds engage in forum shopping to select jurisdictions that potentially offer greater scope for agency problems associated with hedge fund management.

The data examined offer little or no support for the view that hedge fund managers pursuing riskier strategies or strategies with potentially more pronounced agency problems systematically select jurisdictions with less stringent regulations. For the most part, fund strategies are not systematically and statistically related to different regulations observed in different jurisdictions. In fact, to the extent that there is evidence of forum shopping, it is such that funds pursuing riskier strategies or strategies with greater potential agency problems select jurisdictions with more stringent regulations. We may infer from the evidence that forum shopping by fund managers in relation to fund strategic focus is not consistent with a "race to the bottom." Rather, hedge fund managers appear to select jurisdictions that are in funds' investors' interests in order to facilitate capital raising by the hedge fund.

I. INTRODUCTION

Hedge funds have been the subject of media attention in the U.S. and around the world given the pronounced growth of the hedge fund sector in recent years and the comparative dearth of regulations faced by hedge fund managers. As of date, it is estimated that hedge fund managers manage more than \$2 trillion (in USD) in hedge fund capital worldwide.¹ This amount, while not trivial, is small compared to the size of worldwide mutual fund capital, which is estimated at \$24.32 trillion (in USD).²

Mutual fund investors are great in number and are comprised primarily of retail investors. Securities laws are thus designed to mitigate excessive risk-taking and other behavior of mutual fund managers that would be against the interests of retail investors. Hedge fund investors, by contrast, are usually much more limited in number and are deemed to be sophisticated investors (institutional and high net worth investors). This difference in the investor base creates a "gulf," so to speak, between the mutual fund and hedge fund industry. As a result of differing investor bases, hedge funds are able to take advantage of various exemptions in the

1. PRICEWATERHOUSECOOPERS, THE REGULATION, TAXATION AND DISTRIBUTION OF HEDGE FUNDS AROUND THE GLOBE, June 2007, [http://www.pwc.com/extweb/pwcpublications.nsf/docid/5D8AB75A01C274B9852572FA0073A6C0/\\$File/under_the_spotlite.pdf](http://www.pwc.com/extweb/pwcpublications.nsf/docid/5D8AB75A01C274B9852572FA0073A6C0/$File/under_the_spotlite.pdf).

2. See Worldwide Mutual Fund Assets and Flows, Second Quarter 2007, INVESTMENT COMPANY INSTITUTE, Nov. 14, 2007, http://www.ici.org/stats/latest/ww_06_07.html#TopOfPage (last visited Jan. 23, 2008).

laws and regulations, which were promulgated and implemented by some of the most sophisticated regulatory authorities in the world. By compromising on the extent to which their products or funds can be marketed to the public,³ hedge funds are not prohibited from employing a variety of investment instruments and strategies, many of which would not be permitted to other funds such as mutual funds and private equity funds. Hedge funds, for example, may utilize derivative instruments; they may also short sell and leverage rather highly to achieve their investment goals. Commonly observed hedge fund strategies (i.e., the primary mandate of a hedge fund) include investments in distressed companies, commodity trading advisors / managed futures, short biased and small / micro capitalization (“micro cap”) focused strategies, and many others that will be discussed herein. Although hedge funds are able to use a multitude of investment strategies, many use similar ones. This behavior is termed as “herding.”⁴

There are inevitably various agency problems associated with hedge fund management. While these agency problems will be described in more detail in Part III of this paper, we would like to briefly outline the extent to which potential agency problems may arise. First, in a more direct manner, hedge funds might pursue investment strategies and/or make financial reports that benefit the hedge fund manager at the expense of their investors. For example, hedge funds are much more likely to report marginally positive monthly returns than returns that are marginally negative, and this type of returns manipulation significantly aids capital raising efforts of hedge fund managers.⁵ Second, in a more oblique

3. In the U.S. and the U.K. for example, hedge funds can only be distributed by private placements. See PRICEWATERHOUSECOOPERS, *supra* note 1.

4. See Michael S. Haigh, Naomi E. Boyd & Bahattin Buyuksahin, *Herding Among Large Speculative Traders in Futures Markets* (Working Paper Series, 2007), available at <http://ssrn.com/abstract=981752> (concluding that herding does exist among hedge funds and is similar in magnitude to such behavior in the private equity market).

5. See Nicolas P.B. Bollen & Veronika Krepely Pool, *A Screen for Fraudulent Return Smoothing in the Hedge Fund Industry*, (Owen Graduate School of Management, Vanderbilt University, Working Paper, 2006), available at <http://ssrn.com/abstract=686137> (discussing managerial smoothing to deal with the risk of capital flight) [hereinafter *A Screen for Fraudulent Return Smoothing*]; Nicolas P.B. Bollen & Veronika Krepely Pool, *Conditional Return Smoothing in the Hedge Fund Industry*, J. Fin. & Quant. Analysis (forthcoming), available at <http://ssrn.com/abstract=937990> (finding that managers use conditional return smoothing—reporting gains but delaying reporting losses—as a response to the risk of capital flight) [hereinafter *Conditional Return Smoothing*]; Nicolas P.B. Bollen & Veronika Krepely Pool, *Do Hedge Fund Managers Misreport Returns? Evidence from the Pooled Distribution* (Working Paper, Vanderbilt University 2007) (positing that hedge fund managers do not report losses in order to attract and retain investors, which may explain why the number of small gains far exceeds the number of small losses in reported hedge fund returns); see also Douglas Cumming, *Hedge Fund Regulation and Misreported Returns* (Feb. 11, 2008) (York University, Working Paper), available at

manner, hedge funds' investment strategies might be contrary to the interests of other investors or shareholders in portfolio companies in which hedge funds invest.⁶ For example, hedge funds that acquire significant voting rights in a company may act in ways that bring about financial benefit solely for the fund (and therefore its investors), at the expense of the other company's shareholders and possibly more detrimentally at the expense of the fund investors' aim to promote industry.⁷ Such active participation in portfolio companies by hedge funds have been both labeled in a flattering manner, as hedge fund activism, and in the more critical manner, as vulture fund activity.⁸

One concern shared by many regulators around the world is that the size of the hedge fund industry coupled with potential agency problems, activist (vulture) investment practices, and herding behavior, exacerbates financial instability. The hedge fund industry comprises more than \$2 trillion (in USD) in capital under management in recent 2007 estimates.⁹ Thus, this industry has significant ability to move markets. For example, in the week of August 6, 2007, hedge funds following long/short equity strategies experienced massive losses.¹⁰ Empirical evidence on this event is suggestive of significant and growing systematic risk in the hedge fund industry.¹¹

<http://ssrn.com/abstract=1029195> (claiming that the likelihood of managers to misreport returns is affected by differences in hedge fund regulations in different jurisdictions).

6. See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007) (providing many illuminating examples of this category of agency problems).

7. Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61(3) BUSINESS LAWYER 1011 (2006) (suggesting the decoupling of economic interest from voting rights in order to deal with such possibly detrimental behavior by hedge funds).

8. See Kahan & Rock, *supra* note 6 (discussing hedge fund activism and its benefits and criticisms, concluding that such behavior does not warrant regulation).

9. PRICEWATERHOUSECOOPERS, *supra* note 1, at 2.

10. Amir E. Khandani & Andrew W. Lo, *What Happened to the Quants in August 2007?*, (Nov. 4, 2007) (Massachusetts Institute of Technology, Working Paper) (discussing the causes and effects of the losses experienced by the quantitative long/ short equity hedge funds); see also Mila Getmansky, Andrew W. Lo, & Shauna X. Mei, *Sifting through the Wreckage: Lessons from Recent Hedge Fund Liquidations* (Nov. 14, 2004) (Massachusetts Institute of Technology, Working Paper) (analyzing the attrition rates of hedge funds across different investment styles and making recommendations to stabilize the market). For related media discussions of this period, see The Hedge Fund Quants of August, Oct. 3, 2007, <http://www.salon.com/tech/htww/2007/10/03/quants/index.html> and What Happened to the Quants in August 2007?, Oct. 2, 2007, <http://www.nakedcapitalism.com/2007/10/what-happened-to-quants-in-august-2007.html>.

11. Evidence of hedge fund contagion is mixed. For example, little evidence of contagion is found in the work of Nicole M. Boyson, Christof W. Stahel & René M. Stulz, *Is There Hedge Fund Contagion?* (Nat'l Bureau of Econ. Research Working Paper No. 12090, 2007), available at <http://ssrn.com/abstract=884202>. However, Stephen Brown's

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One argument consistently put forth against more onerous regulation of hedge funds is the threat of hedge funds moving from one jurisdiction to a less regulated one to avoid such onerous regulatory oversight. Hedge funds are free to forum shop by registering in many different countries around the world, subject to meeting the requirements of the particular jurisdiction.¹² A central issue considered in this paper is therefore whether hedge funds that are pursuing riskier strategies are in fact selecting jurisdictions that have less onerous regulation. If hedge funds pursuing risky investment strategies select jurisdictions with more onerous regulation, then we may infer that hedge fund managers perceive regulation to be informative to investors. By registering in jurisdictions with greater regulatory oversight, managers proactively mitigate potential agency conflicts associated with fund management, thus enhancing investor confidence. By gaining the investors' confidence through regulation, the hedge funds in return aim to raise more capital. On the other hand, if hedge fund managers pursuing riskier strategies select jurisdictions that have less onerous regulatory oversight, then we may worry that those international differences in hedge fund regulation facilitate a race to the bottom where fund managers' interests are served at the expense of their investors. Last, if hedge fund strategies do not vary by international differences in regulation, then we may infer that regulatory differences provide little or no information to a fund's investors.

The latter part of this paper provides an empirical analysis of hedge fund strategies in the context of international differences in hedge fund regulation. The data examined encompass 1845 funds registered in twenty-

comments on this paper at the University of Pennsylvania Weiss Center Conference on Alternative Investments indicated there is an alternative way to interpret and understand hedge fund data that is more indicative of contagion. See Stephen Brown, *Hedge Fund Contagion and Liquidity*, Presentation at Wharton Impact Conference: A Global Perspective on Alternative Investments (Apr. 4, 2008) (presentation available at http://finance.wharton.upenn.edu/weiss/Conf_Presentations/Brown08.pdf).

12. For many countries these requirements are summarized in PRICEWATERHOUSECOOPERS, *supra* note 1, at 12-45.

four countries around the world. The data offer scant support for the view that hedge fund managers pursuing riskier strategies or strategies with potentially more pronounced agency problems systematically select jurisdictions with less stringent regulations. For the most part, fund strategies are not systematically and statistically related to different regulations observed in different jurisdictions.¹³ In fact, to the extent that there is evidence of forum shopping, it is for the most part suggestive that funds pursuing riskier strategies or strategies with greater potential agency problems select jurisdictions with more stringent regulations.¹⁴ We may infer from the evidence that forum shopping by fund managers in relation to fund strategic focus is not consistent with a race to the bottom, where funds select jurisdictions with scant regulation such that regulators have incentives to offer limited regulation. Rather, the data suggest that hedge funds select heavily regulated jurisdictions that are in the fund investors' interests in order to facilitate capital raising by the hedge fund. The data examined, however, only offer imperfect proxies for agency problems associated with hedge fund management, and it is possible that the coarseness in the empirical measures do not pick up certain factors. Given these limitations, we interpret the evidence in light of the broader law and finance literature on hedge fund regulation and governance.

II. WHAT ARE HEDGE FUNDS?

For the purposes of this paper, we will refer to George Soros's statement to help us describe a hedge fund: "Hedge funds engage in a variety of investment activities. They cater to sophisticated investors and are not subject to the regulations that apply to mutual funds geared toward the general public. Fund managers are compensated on the basis of performance rather than as a fixed percentage of assets."¹⁵ Note that in the

13. This finding is consistent with the evidence on U.S. hedge fund registration presented in Stephen Brown, William Goetzmann, Bing Liang & Christopher Schwarz, *Mandatory Disclosure and Operational Risk: Evidence from Hedge Fund Registration*, J. FIN. (forthcoming 2007).

14. Consistent empirical evidence has been found in other unrelated contexts, such as in the seminal work on forum shopping in U.S. corporate law by Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985). Forum shopping has also been considered in the international context, and the evidence tends to be consistent in that there is not much evidence in support of a race to the bottom. For instance, an analysis of forum shopping in Canadian corporate law is provided in Douglas Cumming and Jeffrey MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 INT'L REV. L. & ECON. 141 (2000). Forum shopping for Canadian securities laws is discussed in Cécile Carpentier and Jean-Marc Suret, *The Canadian and American Financial Systems: Competition and Regulation*, 29 CANADIAN PUBLIC POLICY 431 (2003).

15. GEORGE SOROS, OPEN SOCIETY: REFORMING GLOBAL CAPITALISM 32 (PublicAffairs

U.S. and the United Kingdom (“U.K.”), the regulatory authorities have yet to promulgate a legal definition of “hedge fund.”¹⁶ Other jurisdictions have decided to take into account the rapidly evolving structure of so-called hedge funds and their rather innovative investment strategies, thereby specifying such funds as “Sophisticated Alternative Investment Vehicles,”¹⁷ “Highly Leveraged Institutions,”¹⁸ and “Leveraged Investment Funds.”¹⁹ As various highly competent regulatory bodies have been unable to define the term “hedge fund,” we will not attempt to do so in this paper. Therefore, for the purposes of this paper, when reference is made to the term “hedge fund,” we believe the description provided by Mr. Soros will suffice.

The implementation of hedge fund investment strategies is facilitated by various external (and increasingly internal) service providers, as depicted in Figure 1. The hedge fund managers, rather obviously, manage the fund and determine its investment strategies. They may have other investment and professional advisors assisting them, such as lawyers, accountants, consultants, and tax and audit specialists. If the manager is a large enough organization, such assistance may be obtained internally. If such an organization is successful, they may be able to manage a few funds. Administrators also assist the fund managers in providing fund administrative and accounting services, including record keeping, independent valuation of investments, and meeting disclosure requirements. Similarly, the registrar or transfer agent may assist the manager in processing subscriptions and redemptions and in maintaining the register of shareholders. Sometimes, depending on the structure of the fund and the manager, these duties may be carried out internally by the fund manager. The actual financing arrangements and execution of investments are carried out by prime brokers which can be either securities firms or banks. Occasionally, the prime brokers decide to set up their own fund, and they therefore also become hedge fund managers. There is, of course, another service provider—the custodian that has custody over the fund assets. Again, this duty may sometimes be carried out internally by the prime broker.

2000). For a list of definitions of hedge funds, see David A. Vaughan, *Selected Definitions of “Hedge Fund,”* Comments for the U.S. SEC Roundtable on Hedge Funds (May 14-15, 2003), available at <http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm>.

16. See Tomas Garbaravicius & Frank Dierick, *Hedge Funds and Their Implications for Financial Stability* 6 (Eur. Cent. Bank Occasional Paper Series, Paper No. 34, 2005) (noting that there is “no legal or even generally accepted definition of a hedge fund”).

17. As specified by the European Parliament. *Id.* at 8.

18. As specified by The Basel Committee on Banking Supervision. *Id.*

19. As specified by The Multidisciplinary Working Group on Enhanced Disclosure. *Id.*

Figure 1. Typical Parties Appointed to Operate a Hedge Fund²⁰

The hedge fund industry is rather similar to other forms of financial intermediation, such as that carried out by mutual fund managers or private equity managers. Of course, we are not discounting the rather significant differences among these three types of financial intermediaries, and in fact we will very briefly set out the most obvious differences. Mutual funds, hedge funds, and private equity funds differ in many ways, including, but not limited to, their investor base, regulatory oversight, transparency, liquidity, pricing strategies, leverage, and fees.

A. Investor Base

Generally speaking, mutual funds, hedge funds, and private equity funds can be categorized as public investment companies or pooled investment vehicles.²¹ What inevitably exempts hedge funds and private equity funds from the legal and regulatory requirements and ensuing oversight of public investment companies or pooled investment vehicles are the characteristics of their typical investors. Unlike mutual funds,

20. Administrator: record and bookkeeping and independently verify asset value of the fund. Registrar / Transfer Agent: process subscriptions and redemptions and maintain registrar of shareholders. Custodian: safe-keeping of assets. Prime Broker: provides access to stock and loan financing, as well as a host of value-added services.

21. See PRICEWATERHOUSECOOPERS, *supra* note 1.

hedge funds and private equity funds limit the number of investors as required by the relevant regulatory authorities. For example, in the U.S., hedge funds utilize the exemptions provided pursuant to Section 3(c)(1) of the Investment Company Act of 1940 and do not exceed ninety nine investors in order to avoid regulatory oversight.²² Hedge fund investors are also mainly comprised of institutional investors and high net worth or wealthy individuals. Taking the U.S. example again, to take advantage of the exemption under the same Act, hedge funds likely would not allow those with assets below five million U.S. dollars access to their services.²³

B. Regulatory oversight

Due to their accessibility to the general public or retail investors, mutual funds are subject to rather strict legal and regulatory oversight. In the U.S., for example, the Securities and Exchange Commission requires mutual fund managers to be registered.²⁴ Additionally, they are also subject to various regulations under the Investment Advisers Act of 1940, the Securities Act of 1933, the Investment Company Act of 1934, and the Securities Exchange Act of 1933. Hedge funds and private equity funds are not as strictly regulated since they are enabled by their structure and investment strategies to meet the relevant exemption requirements of the laws and regulations that could otherwise limit their operational freedom. They essentially avoid regulation by following the letter of the law.

C. Transparency, liquidity, valuation and pricing

Mutual funds, as a result of their investor base and ensuing regulatory oversight, have to meet stringent disclosure requirements, are obliged to implement established valuation principles, and have to price their portfolios on a daily basis. Mutual funds are also the most liquid of the three funds. In contrast, hedge funds and private equity funds are extremely opaque with regards to the reporting of their operations and the

22. See Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(1) (2000 & Supp. IV 2004).

23. See 15 U.S.C. § 80a-3(c)(7). For a discussion of hedge fund investor protection in the U.S., refer to William H. Donaldson, Testimony Concerning Investor Protection Implications of Hedge Funds by Chairman, U.S. Securities and Exchange Commission Before the Senate Committee on Banking, Housing, and Urban Affairs (Apr. 10, 2003), available at <http://www.sec.gov/news/testimony/041003tswhd.htm> [hereinafter Hearings].

24. See Securities Act of 1933, 15 U.S.C. § 77(f) and (g) (2000 & Supp. IV 2004) (outlining registration requirements); 15 U.S.C. § 80a-2(a)(51)(A) (listing the Investment Company Act of 1940 registration requirements); 15 U.S.C. § 80a-3(c)(7) (listing the Securities Exchange Act of 1934 reporting obligations); 15 U.S.C. § 80b-3(b) (listing the Investment Advisers Act of 1940 registration requirements).

valuation of their portfolios. Such is the case for private equity funds that, as a result of mandatory disclosure of private equity fund performance data such as internal rates of return ("IRR") by public institutional investors investing in public equity funds, led to the decision by some funds to exclude public institutional investors.²⁵ With regard to liquidity, hedge funds are more liquid than private equity funds since private equity funds require their investors to commit their capital for up to ten years while hedge funds at most have lock-up periods of up to twenty five months.

D. Strategies and Leverage

Of the three types of funds, the hedge fund is the most autonomous in its ability to implement its rather innovative investment strategies. Usually mutual funds are to a certain extent constrained legally in their asset choices and have to disclose the anticipated allocations in such asset classes to their investors. Private equity funds are equally constrained by contract, since they are required at the outset to specify the maximum amount of capital to be invested in any one company and also to specify the industry and stages of development of investee companies. Conversely, hedge funds are able to use a variety of investment strategies that ironically have far less to do with hedging. These strategies include the use of facilities not normally accessible to mutual funds and private equity funds such as short-selling and derivatives. We will elaborate on the strategies utilized by hedge funds in Part V.

Another rather significant difference is that both mutual funds and private equity funds are constrained in their ability to leverage. These constraints are usually legal and regulatory in form for mutual funds and are contractual for private equity funds. In contrast, hedge funds are "leveraging" creatures in that they sell securities short and buy securities on leverage.²⁶ They are, however, not leveraged in the more traditional sense of taking on more debt capital. They leverage themselves by the innovative use of derivative instruments, the use of margin financing, and short selling.

25. See Nat'l Venture Capital Association, Latest FOIA Developments—San Jose Mercury News vs. CALPERS (Nov. 22, 2002), http://www.nvca.org/nvca11_22_02b.html (discussing San Jose Mercury News v. California Public Employees' Retirement Systems decided by California Supreme Court on Nov. 6, 2002); see also Susan Chaplinsky & Susan E. Perry, *CALPERS vs. Mercury News: Disclosure Comes to Private Equity* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=567525 (discussing the effect of *CALPERS v. Mercury News* on the private equity market).

26. See *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Report of the President's Working Group on Financial Markets, Report 3097, 2, (Apr. 15, 1999), where it is also stated that "While this activity is not unique to hedge funds, hedge funds often use leverage aggressively."

E. Fees and proprietary investment

Mutual funds are usually constrained in their ability to arbitrarily impose fees or sales charges, and they are more often than not required to disclose their fees to their potential investors. In contrast, hedge fund and private equity fund managers impose a management fee based on the size of the fund managed (usually 2.5% for private equity funds and 1.5% for hedge funds) and a performance fee, which is usually 20% of the profits.²⁷ Private equity fund managers and hedge fund managers are both usually required to put their money where their mouths are, or pay to play. This is not the case for mutual fund managers. Private equity fund managers however only really invest a minimal amount in the fund partnership to meet the requirements of general partnership, and they are for the most part restricted from co-investing in investee companies. Hedge fund managers in contrast are not restricted in the amount of proprietary capital that they may invest in the hedge funds they manage.

While there are very significant differences among the three funds, what is significantly similar among them are that all three types of fund managers owe their funds and fund investors a fiduciary duty to act in the best interest of the fund and fund investors. The duties of good faith, fair dealing, loyalty, and care have to be upheld by all hedge fund managers as well as their counterparts. They are also prohibited from engaging in fraudulent activities as are other financial intermediaries. As with any form of financial intermediation, however, there will inevitably be conflicts of interest or agency problems. Such agency problems are exacerbated by the characteristics of the hedge fund which we listed earlier in this part. In the next part we will list the potential agency problems encountered in hedge fund management, how they are connected to the characteristics of hedge funds, and how regulatory measures have sought to mitigate such problems.

III. AGENCY PROBLEMS IN HEDGE FUND MANAGEMENT

The debate with regard to the regulation of hedge funds probably started as a result of the Long Term Capital Management debacle in 1998,

27. For data on venture capital and private equity funds, see Douglas J. Cumming & Sofia A. Johan, *Is it the Law or the Lawyers? Investment Covenants around the World*, 12 *EUROPEAN FINANCIAL MANAGEMENT* 535 (2006). See also Douglas J. Cumming & Sofia A. Johan, *Legality and Fund Manager Compensation* (York University Schulich School of Business, Working Paper, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=765004. For hedge fund manager compensation data, see Douglas Cumming, *A Law and Finance Analysis of Hedge Funds* (York University Schulich School of Business, Working Paper, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=946298.

and will continue as capital increasingly floods into the industry. The risks such funds pose to the stability of the financial industry as a whole are becoming more apparent. While being demonized in the popular media, it would however be incorrect to say that hedge funds are wholly unregulated rogue entities.²⁸ Across the globe, the activities of hedge funds are constrained to a certain extent by various laws and regulations which aim to protect investors and the stability of the financial market or economy within a given jurisdiction. However, even in the U.S. and the U.K., which are deemed to be the strictest regulatory regimes, such laws and regulations have been found to be insufficient in view of the potential systemic damage as a result of the growth and evolution of the industry, and there is a call by policy makers for this “regulatory-light” environment to be reviewed.²⁹

The agency problems that may arise in a hedge fund manager and client relationship comprise conflicts of interest between any of the parties involved in the management of the hedge fund. As we mentioned earlier in Part I, depending on the structure, size, and jurisdictional base of the hedge fund, the duties carried out by the manager, its advisors, administrator, registrar or transfer agent, prime broker and custodian may either be carried out partly or wholly internally, or partly or wholly outsourced. There will, therefore, be a rather endless list of potential conflicts of interest that may arise between the parties depending on the nature and extent of their relationship. We will for the purposes of this paper limit our discussion of conflicts to those that more common and readily recognizable among the parties and regulatory bodies, and how they relate to the characteristics unique to hedge funds. We will also provide a brief description of the nature of the conflict, whether they are business oriented in nature, related to the marketing process, or a legal conflict. These types of conflicts may also overlap. For example, the business conflict of the manager using his proprietary assets to allocate securities to his own account before implementing his investment strategy may be a business conflict as well as a legal conflict of insider trading and a breach of fiduciary duty.

A. Potential conflicts arising from investor base

Hedge funds comprise institutional investors, endowments, and high net worth individuals. While the argument against the regulation of hedge

28. This perception of hedge funds being unregulated entities may have been exacerbated by the ruling of the U.S. Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC*, on June 23, 2006. The court overturned SEC Rule 203(b)(3)-2 of the Investment Advisers Act of 1940, commonly known as the Hedge Fund Rule, that required hedge fund managers to register with the SEC no later than February 1, 2006 based on the number of investors in their funds, not the number of funds they manage. See *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

29. See Hearings, *supra* note 23.

funds may center around the fact that its investors are sophisticated investors, it can be argued that, of the different types of investors, the least sophisticated may be the high net worth individual. The threshold to be deemed as a high net worth individual and therefore a sophisticated investor, may range from the holding of assets of \$1 million to \$5 million (in USD) and above.³⁰ However, does it make sense that if a person was to win \$5 million (in USD) in a lottery tomorrow, that person would immediately become as sophisticated an investor as an insurance company? We would not think so and neither would a hedge fund manager. The hedge fund manager is aware that the level of due diligence carried out prior to investment by a high net worth investor will differ from that of an insurance company. The high net worth individual may neither have the technical capabilities nor want to incur the added expense of hiring experts to carry out the due diligence.³¹ The institutional investor, however, has a fiduciary duty to its own clients and will therefore exercise a thorough due diligence. The hedge fund manager may therefore be incentivized to provide more information during the marketing exercise to different types of investors. The hedge fund manager also aims to not only attract new investors to a fund, but also retain existing investors as potential investors in other hedge funds he will inevitably establish. The potential for conflicts to arise as a result of his preference to retain specific investors over others may result in preferential disclosure in different marketing efforts, preferential investment, and preferential redemption terms among others. Such agency problems may give rise to a legal conflict with regard to allocation issues, breach of fiduciary duty, and disclosure issues.³² A potential business conflict is the high net worth individual being given less

30. Beat D. Speck & Joseph Tanega, *Private equity placements: Comparing the laws in Switzerland, the European Union, the United Kingdom and the United States: Part II*, 21 J. INT'L BANKING L. AND REG. 252, 255 (2006).

31. The SEC recommends that potential hedge fund investors carry out the necessary due diligence to verify the qualifications and track record (such as disciplinary record) of the prospective financial intermediary. Such due diligence may be carried out by reviewing the prospective agent's Form ADV (if he is registered) through a search at the Investment Adviser Public Disclosure Website. SEC, Investment Advisor Public Disclosure, http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_OrgSearch.aspx (last visited March 7, 2008). Alternatives include the SEC's Public Reference Room or the state securities regulator, where the adviser's principal place of business is located (for advisers with less than \$25 million (in USD) in assets under management). Investors are also advised to check the NASD's FinRaBrokerCheck database. FINRA, Investor Protection, <http://www.finra.org/InvestorInformation/InvestorProtection/index.htm> (last visited March 7, 2008). A final source may be checking the listings of any other relevant state securities regulator for any information they may have.

32. See *A Screen for Fraudulent Return Smoothing*, *supra* note 5, at 36 (finding that among fifty-three SEC litigation cases, fraudulent offerings where the fund is advertised to new investors comprises five of the fifty-three cases (or ten of eighty offenses allowing for more than one offense per case)).

favorable investment terms in the fund than other more sophisticated investors.

B. Potential conflicts arising from fees and proprietary investment by hedge fund managers

The fee structure for hedge fund managers may also bring about potential agency problems as the hedge fund manager may be incentivized to take unnecessary risks. The manager essentially has a 20% share of unlimited upside potential, but will not similarly share in any losses.³³ Unlike the investor, unless he invests his own proprietary capital, the manager in essence has an option-like compensation structure. That said, as he has total control over the investment strategies, he may be able to protect his share of the fund from the additional risks that he is placing on the rest of the fund. This total control over the investment of the fund also follows through to the fees to be paid to support service providers.

As mentioned above, some successful hedge fund managers manage a few funds, sometimes concurrently. There are also instances where prime broker banks that already manage a few mutual funds establish their own hedge funds. What is increasingly the case is that other financial intermediaries, such as mutual fund managers and private equity fund managers, are joining the fray, so to speak, and establishing hedge funds alongside other types of funds. This is also the case for the support service providers such as prime brokers that may not have their own hedge funds to manage, but provide services to both hedge funds and mutual funds. In these situations where one institution wears two hats or where one party has to act in the interests of various side-by-side clients, there is the potential for agency problems to arise. This is especially the case where the level of fees acquired from different clients, or different types of clients, differs in that some funds or managers are willing to pay higher transaction fees for "special" services. Some managers and prime brokers therefore may provide additional information regarding an investment, carry out preferential allocations, confer liquidity preferences, or other preferential treatments in favor of a specific hedge fund over others either due to higher fees paid or the level of proprietary investment made in that specific fund. Specific hedge funds may also be favored over other mutual funds again due to the higher fees or the institution's dependency on the execution business of the hedge fund. It has been indicated that prime brokers are increasingly becoming dependent on the income stream garnered from hedge funds to the point of such income comprising an

33. Cumming, *supra* note 27.

eighth of total revenue in one case.³⁴ Such agency problems may give rise to a legal conflict with regard to allocation issues, breach of fiduciary duty, disclosure issues and insider trading. A potential business conflict is the competition of allocations and investment opportunities between an institution (or manager) on a proprietary basis and the hedge fund.

C. Potential conflicts arising from lack of regulatory oversight

As mentioned above, in many jurisdictions, if not all, hedge funds are not as strictly regulated as they are enabled by their structure and investment strategies to meet the relevant requirements to be exempt from the laws and regulations that could limit their operational freedom. This ability to operate freely may give rise to a gamut of potential agency problems. It is said that “Power tends to corrupt, and absolute power corrupts absolutely.”³⁵

Agency problems in hedge fund management often take a more basic form of simple fraud. In a recent study of hedge fund litigation cases, it is noteworthy that Professors Bollen and Pool found that the most common type of offense involved misappropriation, whereby a fund manager diverts investor capital for personal expenses.³⁶

While it is true that regulatory oversight may not totally remove agency problems, proper regulation may still mitigate the potential for them to arise as proper rules of behavior by all parties involved and procedures to be adhered to are to be abided at the threat of civil or criminal penalties. What is interesting to note is that just as hedge funds have utilized the letter of the law to be exempted from regulatory oversight, they are also using the law to protect themselves in the event they themselves or any of their support service providers become “corrupted absolutely.” In some private placement memoranda, the instrument with which they market their fund to sophisticated investors, they include a section specifically addressing a range of potential conflicts of interest or activities that could be construed as such. These include, but are not limited to, proprietary trading, managing side-by-side funds, and managing competing funds. With this disclosure, investors are given notice and will have to agree that the

34. See Garbaravicius & Dierick, *supra* note 16, at 36.

35. See E.D. HIRSCH, JR., JOSEPH F. KETT, & JAMES TREFIL, *THE NEW DICTIONARY OF CULTURAL LITERACY* 324 (3d ed., 2002) (quoting Lord Acton in a letter to Bishop Mandell Creighton in 1887).

36. Professor Bollen and Pool investigated fifty SEC hedge fund litigation cases, and found that misappropriation was an offense in twenty-one of the fifty three cases. See *A Screen for Fraudulent Return Smoothing*, *supra* note 5. Similarly, Ponzi schemes—where abnormally high short-term returns are offered in order to entice new investors, which can only be sustained by a continued increase in the flow of capital from new investors—comprised six of the fifty-three cases. See *id.*

disclosed potential activities will not be actionable, thereby protecting the fund and the manager from potential lawsuits or disciplinary measures. The lack of regulatory oversight may provide the hedge fund manager and other support service providers with the necessary latitude to undertake behavior that may be improper, if not illegal, because of the lack of regulation. On the other hand, this perception of the hedge funds as wholly unregulated rogue financial intermediaries may be detrimental to the participants and therefore the lack of formal regulation may be ameliorated by self-regulating actions.³⁷

D. Potential conflicts arising from lack of transparency, liquidity, independent valuation and pricing

Hedge funds are known for their opaqueness, illiquidity, highly subjective valuation methods, and inability (or rather unwillingness) to price themselves. If the investors in hedge funds find it difficult to obtain a full picture of the investment, they will find it almost impossible to determine the full extent of the related party transactions among the external support service providers and the fund itself. It is not difficult to see how agency problems may arise in this case. Also, note that even if most of the support services are provided internally, they will be provided by different departments or agents and therefore there is still the potential for conflicts of interest to arise. Take for example the simple valuation of investments carried out by the hedge fund. This is not usually carried out independently by an external agent, and this subjective valuation process gives rise to the potential for managers to over-value certain investments, under-value losses, and generally sugarcoat fund performance.³⁸ Even

37. The Hedge Fund Working Group, led by Sir Andrew Large, former Bank of England deputy governor, released best practice standards that encourage full disclosure of investment risk, independent valuation of investment portfolios and transparency over fees, investment risks and relationships with lenders and prime brokers. Fourteen large hedge fund managers including Lansdowne Partners, RAB Capital, Brevan Howard, Man Group, Och Ziff and Cheyne Capital have voluntarily agreed to introduce the standards. See David Litterick, *Hedge Fund Managers Outline Transparency Code*, THE TELEGRAPH, Jan. 23, 2008, available at <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/01/23/cnhedge123.xml>. Jean-Claude Trichet, President of the European Central Bank and the German authorities have been pushing for some time for the introduction of a voluntary code of conduct for hedge funds. See Ralph Atkins & Lionel Barber, *Trichet Sees More Support for Hedge Fund Code*, FINANCIAL TIMES, May 18, 2007, available at <http://www.ft.com/cms/s/0/f1858e0a-04db-11dc-80ed-000b5df10621.html>.

38. In fifty-three hedge fund fraud cases litigated by the U.S. SEC, twenty-one involved misappropriation where a fund manager diverted investor capital for personal expenses and fifteen involved misrepresentation of returns where a fund manager overstated or otherwise distorted fund asset values. See *A Screen for Fraudulent Return Smoothing*, *supra* note 5; see also Susan Ferris Wyderko, *Testimony Concerning Hedge Funds by the Director, Office of Investor Education and Assistance, U.S. SEC Before the Subcommittee on Securities and*

where such valuation is carried out independently, the valuer is essentially carrying out the instructions of its client and the hedge fund manager. Valuations and disclosures are made on the basis of information, which is in turn disclosed to him by the hedge fund manager. Conflicts may also arise when all support services are provided internally as different business units within an institution do not act in alignment and against the interest of the fund the institution is managing. For example, some banks have units which carry out mergers and acquisitions advisory, underwriting activities and distressed companies advisory. These activities may have an effect on the companies in which a hedge fund unit of the bank is investing.³⁹ Conversely, where all business units do act in concert, conflicts may also arise. For example, where a custodian acts in concert with the manager and against the interest of the fund, there is a potential for the manager to misuse the fund capital at the expense of fund investors. Such agency problems may give rise to a legal conflict with regard to disclosure issues, breach of fiduciary duty, insider trading or improper related party transactions, and allocation issues. A potential business conflict is the provision of such fee generating services such as M&A advisory, underwriting activities and advising distressed companies by a unit of the bank at the expense of the investments made in such companies by the hedge fund unit of the same bank.

E. Potential conflicts arising from strategies and leverage

Hedge funds, in contrast to mutual funds or private equity funds, are able to use a variety of investment strategies that ironically have far less to do with hedging. These strategies include the use of facilities not normally accessible to mutual funds and private equity funds, which are short-selling and derivatives. We will elaborate on the strategies utilized by hedge funds in Part V. Contrary to popular belief, hedge funds no longer primarily hedge, nor do they utilize uniform investment strategies or investment instruments. It is therefore said that, "The complexity of the strategies employed by hedge funds as they aim for absolute returns adds to the barrier of understanding regarding the specific risk posed by the

Investment of the U.S. Senate Committee on Banking, Housing, & Urban Affairs (May 16, 2006) ("Unlike a mutual fund, hedge fund valuation practices are not overseen by an independent board of directors. A number of the Commission's enforcement cases against hedge fund advisers involve the adviser's valuation of fund assets in order to hide losses or to artificially boost performance.").

39. In mid-2005, the U.K. Financial Services Authority (FSA) expressed concern over institutionalization of insider trading affecting almost a third of mergers and acquisitions where hedge funds are involved not only as part of their strategies of risk/merger arbitrage but also simply as traders.

investments.”⁴⁰ Fund managers may even pursue offsetting strategies that are disguised in marketing materials. For example, a fund manager might invest long in one index and short the same index within the same fund or with two different funds.⁴¹ Such a fund manager would collect management fees on both funds and performance fees on one of the two funds, at the expense of the investors. Further, hedge fund managers might “style drift” and invest in a strategy that is different from their strategy that was stated to their investors.⁴²

Different hedge fund strategies may pose conflicts of interest with the other shareholders or debtholders in the companies in which the fund invests.⁴³ For example, for micro cap investments, while the hedge fund investors are very large, the investee companies themselves are very small and illiquid, and it is relatively easy to manipulate trading activity and returns among such investments. As another example, hedge funds can innovatively take advantage of derivatives instruments, margin financing, and short selling to make both debt and equity investments in financially distressed companies, and thereby profit by investing in ways that are counter to the interests of the company’s other shareholders and/or debt holders. Further, hedge funds may engage in “empty voting” when they acquire voting rights that are divergent from their ownership interests, and thereby vote in a way that is counter to the interests of the other shareholders and solely at a financial gain to the fund.⁴⁴ More generally, it is possible that hedge fund interests are much more short term than that of the other shareholders thereby leading to investment strategies and voting decisions by the hedge fund that are to the detriment of their investee companies and such companies’ other shareholders.⁴⁵ Such practices, however, have not been prevalent or severe enough for legal analysts to conclude that a case for legal intervention has been made.⁴⁶

Hedge fund investment horizons also tend to be more short term than banks. For instance, hedge funds may pursue strategies in which they trigger bankruptcy in a financially distressed company and then buy the

40. Remarks before the SIA Hedge Funds & Alternative Investments Conference by Commissioner Roel C. Campos, U.S. SEC (June 14, 2006).

41. This example was discussed by Larry Harris in 2006 at the DeGroote Market Microstructure Conference in Toronto (Nov. 2006).

42. Professor Bollen and Pool found that misrepresenting strategy accounted for one of 53 SEC hedge fund litigation cases (and allowing for more than one offence per case, misrepresenting strategy involved 4 of 80 offences). See *A Screen for Fraudulent Return Smoothing*, *supra* note 5. This suggests style drift is not that pronounced or alternatively, it suggests that it is not so serious as to lead to litigation.

43. Kahan & Rock, *supra* note 6.

44. Hu & Black, *supra* note 7.

45. Kahan & Rock, *supra* note 6.

46. *Id.*

debt of the company in the secondary loan market. Banks, for instance, face regulations that impose a “Chinese Wall” to separate commercial and investment banking activities within the institution, and these restrictions were strengthened by the Sarbanes-Oxley Act of 2002.⁴⁷ Hedge funds face a comparative dearth of oversight and are nevertheless able to lend and hold equity in the same company.

Below, in Part V of this paper we consider alternative fund strategies in more detail. Specifically, we address the question of whether differences in hedge fund strategies are associated with hedge fund forum shopping. That is, because hedge funds may register in different jurisdictions, it is possible that funds pursuing strategies with more pronounced agency costs select jurisdictions with comparatively less regulatory oversight. Before we turn to that question, we first explain international differences in hedge fund regulation in Part IV.

IV. INTERNATIONAL DIFFERENCES IN HEDGE FUND REGULATION

Given the significant scope of potential agency problems, regulators in many countries around the world are calling for additional hedge fund regulation. For example, it is noteworthy that on January 22, 2008, fourteen of the largest hedge funds in the U.K. agreed to greater voluntary disclosure standards.⁴⁸ The disclosure standards are designed to give rise to more information about investment strategies, risks and asset valuation. It has been conjectured by media commentators that the hedge fund industry agreed to the voluntary standards in order to mitigate the possibility of more onerous regulatory standards being imposed in the future.⁴⁹ This possibility for more onerous regulation may still be rather far off in the horizon as even in the U.S., hedge funds still enjoy comparatively minimal regulation. U.S. hedge funds organize themselves as limited partnerships, market themselves by private placements to sophisticated institutional investors and high net worth individuals, and limit their investor number to meet exemption requirements, such as those enabling them to avoid disclosure laws of the U.S. Securities Act of 1933.⁵⁰ In 2006, the U.S. Securities and Exchange Commission Chairman, Christopher Cox, expressly indicated that hedge funds should not remain unregulated.⁵¹

47. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002).

48. James Mackintosh, *Hedge Funds Agree Greater Disclosure*, FINANCIAL TIMES, Jan. 22, 2008, at 18.

49. *Id.*

50. In a private placement there must not be more than thirty-five “non-accredited” investors, where a non-accredited investor is someone with more than \$1 million (in USD) in wealth or earned more than \$200,000 (in USD) in the previous two years. See 17 C.F.R. § 230.501(a) (defining “non-accredited” investor).

51. Hearings, *supra* note 23 (testimony of Chairman Cox). See also Harvey J.

Most hedge funds, however, remain largely unregulated irrespective of SEC initiatives.⁵²

In view of the growing call towards increasing hedge fund regulation in certain countries, it is worthwhile to examine the international experience with hedge fund regulation. It was argued in *Goldstein v. SEC* and elsewhere that hedge funds should not face greater regulations in the U.S. since many fund managers would simply relocate abroad or “forum shop to the bottom.”⁵³

International differences in hedge fund regulation are outlined in Table 1. For the purposes of this paper, we will concentrate on differences in hedge fund regulation across countries that fall within three primary categories: (1) minimum capital to operate as a hedge fund, (2) permissible marketing channels, and (3) restrictions on the location of key service providers.⁵⁴ Specific details on these differences across countries are reviewed in detail in the PriceWaterhouseCoopers report⁵⁵ (“PWC”) and are briefly summarized below.

Goldschmid, Speech by SEC Commissioner: Should Hedge Funds be Regulated? (Nov. 17, 2004) available at <http://www.sec.gov/news/speech/spch111704hjg.htm>. For industry perspectives on hedge fund regulation, see, e.g., HedgeCo.net, Hedge Funds Regulation: Demand for Increase in Hedge Fund Regulations due to Increasing Fraud Cases, <http://www.hedgeco.net/hedge-fund-regulations.htm> (last visited May 10, 2008) and Hedge Fund Regulation.com, Hedge Fund Regulation, <http://www.hedgefundregulation.com/> (last visited May 10, 2008).

52. *Goldstein*, 451 F.3d at 875. Regardless, empirical evidence is consistent with the view that the information produced by the registration of hedge funds did not significantly increase information available to investors. See Brown et al., *supra* note 13 (explaining the effect disclosure requirements had on hedge funds).

53. 451 F.3d at 883.

54. See *supra* Part II (Figure 1) for a discussion of key services providers.

55. See PRICEWATERHOUSECOOPERS, *supra* note 1 (illustrating differences in hedge fund regulation and taxation among countries). The majority of countries and years are available in PWC report. For countries/years not available, we obtained information about regulation from the hedge funds in a survey sent to selected funds. It is noteworthy that the broad regulatory categories we use have been stable over time (distribution channels, size and restrictions on location are rarely modified restrictions), but there have been changes to other areas, particularly taxation.

Table 1. Regulation of and Channels for Distribution of Hedge Funds by Country

This table summarizes by country the regulation of hedge funds across twenty-four countries, including the minimum capital requirements, permissible marketing channels and whether there exists restrictions on the location of key service providers (Figure 1). Sources: PriceWaterhouseCoopers, *The Regulation, Taxation and Distribution of Hedge Funds in Europe: Changes and Challenges* (June 2006), PriceWaterhouseCoopers *Under the spotlight: The Regulation, Taxation and Distribution of Hedge Funds around the Globe*. London: PriceWaterhouseCoopers (June 2007), and authors' surveys of hedge funds.

Country	# Funds in Combined CISDM HFN Dataset	# Funds in CISDM Dataset	Proxy for minimum capital requirement to operate as hedge fund manager (2005 \$ USD)	Restrictions on location of key service providers?
Australia	2	1	\$0	0
Austria	2	1	\$6,750,000	0
Bahamas	19	18	\$25,000	1
Bermuda	76	70	\$0	1
Brazil	6	4	\$362,000	1
British Virgin Islands	97	97	\$500,000	1
Canada	20	13	\$0	0
Cayman Islands	372	371	\$500,000	1
Channel Islands	4	0	\$44,077	0
China	1	0	\$0	1
France	8	7	\$168,750	0
Hong Kong	1	0	\$2,275,000	0
Ireland	24	20	\$67,500	1
Isle of Man	1	1	\$142,500	1
Japan	2	0	\$0	0
Luxembourg	9	9	\$168,750	0
Mauritius	2	2	\$0	1
Netherlands	1	0	\$303,750	1
Netherland Antilles	6	6	\$0	1
New Zealand	1	1	\$0	0
Switzer-land	2	0	\$4,300,000	1
U.K.	20	0	\$67,500	0
U.S.	1455	503	\$0	0
U.S. Virgin Islands	6	0	\$500,000	1

Table 1 (Continued). Regulation of and Channels for Distribution of Hedge Funds by Country								
Country	Main Marketing Channels							Total # of marketing channels
	Banks	Fund distrib. co.'s	Wrappers	Private placements	Investment managers	Other regul. fin. services instit.'s	Non-regul. fin. inter-med.'s	
Australia	1	1	1	1	1	1	0	6
Austria	1	1	1	0	0	0	0	3
Bahamas	0	0	0	1	1	0	0	2
Bermuda	1	0	0	1	1	0	0	3
Brazil	1	1	0	1	1	1	0	5
British Virgin Islands	1	0	0	1	1	0	0	3
Canada	1	1	1	1	1	1	0	6
Cayman Islands	1	0	0	1	0	0	0	2
Channel Islands	1	1	1	1	1	1	1	7
China	1	1	1	1	1	1	0	6
France	0	1	1	1	1	0	0	4
Hong Kong	1	1	0	1	1	1	0	5
Ireland	1	0	0	1	0	1	0	3
Isle of Man	0	1	1	1	1	0	0	4
Japan	1	1	1	1	1	1	0	6
Luxembourg	1	0	0	0	0	1	0	2
Mauritius	0	0	0	1	0	0	0	1
Netherlands	0	0	1	0	1	1	0	3
Netherlands	0	0	0	1	0	0	0	1
Antilles New	1	1	1	1	1	1	0	6
Zealand	1	1	1	0	1	1	0	5
Switzerland	1	0	1	1	1	0	0	4
U.K.	0	0	0	1	0	0	0	1
U.S.	1	0	0	1	1	0	0	3
U.S. Virgin Islands	1	0	0	1	1	0	0	3

Some jurisdictions require hedge funds to maintain minimum capitalization in order to continue operating. One rationale is that greater minimum capitalization facilitates financial stability by mitigating the risk of fund failure. An additional rationale for minimum capitalization requirements is that lower quality and less reputable fund managers will have difficulty establishing funds in jurisdictions with higher minimum capitalization requirements. In view of the sophisticated investor base, it is perceived that the funds that are able to attract enough investors and pass their due diligence exercises to raise the minimum amount of capital required should be allowed to operate. Also, as the fees charged by the hedge fund managers are dependent on the capital raised, there needs to be sufficient capital to meet overhead costs of managing a fund and meeting relevant administrative, disclosure and regulatory requirements. Minimum capitalization also indirectly ensures that hedge funds limit their investors to high net worth individuals and institutional investors. They are restricted in the number of investors they may have, therefore each investor has to invest a rather substantial sum. The larger the amount an investor invests, the better his bargaining power with regards to seeking more transparency from the hedge fund, obtaining better liquidity terms and ensuring that proper valuation and pricing methods are used. Minimum capitalization amounts indicated in Table 1 are however comparatively small relative to potential losses.⁵⁶ Austria has the greatest minimum capitalization requirement at \$6.75 million (in USD) among the twenty-four countries enumerated in Table 1. Many jurisdictions such as Bermuda, Canada, New Zealand and the U.S. currently have no minimum capitalization requirements.

Different countries also have different permissible distribution channels. In the hedge fund industry, capital is most often sought through private placements. Jurisdictions limit the hedge funds' distribution channels to mainly private placements as that channel precludes the hedge funds from direct access to retail investors and thereby limits potential conflicts of interests that might arise with unsophisticated retail based investors.⁵⁷ In view of their aim to limit their investor base to sophisticated institutional and high net worth individuals, this limitation on hedge funds' distribution channels cannot however be said to be overly detrimental. In

56. For some countries, minimum capitalization depends on fund operating costs and other things specific to the fund, and as such the values indicated in Table 1 are proxies. For details, see PRICEWATERHOUSECOOPERS, *supra* note 1, at 46-48 (illustrating minimum investment amounts among countries).

57. See *supra* Part IV. Private placements have nevertheless been associated with exacerbated agency problems associated with managerial entrenchment in different contexts. See, e.g., Michael Barclay, Clifford G. Holderness & Dennis P. Sheehan, *Private Placements and Managerial Entrenchment*, 13 J. CORP. FIN. 461 (2006) (providing evidence on the effect of private placements of large percentage blocks of stock).

fact, this limitation may enable hedge funds to be less transparent with their initial disclosures, such as their fee structure and liquidity terms. Their private placement memoranda (and ensuing negotiations) may be tailored to meet the requirements of different types of investors, and therefore the investors may not be playing on a level playing field. Private placements are permitted in most jurisdictions, except Austria, Luxembourg and Switzerland (Table 1).

In many countries outside the U.S., there are additional distribution channels through which funds may gain greater access to a wider range of investors. For example, twelve of the twenty-four countries in the sample permit distributions via wrappers. Wrapper products are typically insurance policies or structured products,⁵⁸ and some jurisdictions such as the Isle of Man and South Africa permit wrappers distributions via insurance companies only.⁵⁹ Legal practitioners have noted potential conflicts of interest with respect to disclosures in the wrapper,⁶⁰ and generally wrappers are used to overcome regulatory barriers in distributions to high net worth individuals.⁶¹ While it is possible that retail investors may take advantage of this potential access to hedge fund via wrapper products, these products are most probably characterized as higher risk products within the institutions that create them. As these institutions themselves are highly regulated and will have more stringent risk disclosure requirements, it is unlikely that the products would be marketed to, and included in, an unsophisticated retail investor's portfolio.

Distributions via banks are permitted in every country enumerated in Table 1 except the Bahamas, France, Isle of Man, Mauritius, Netherlands, Netherland Antilles, and the U.S. Many (albeit not all) of these jurisdictions that permit distributions via banks also permit distributions via other regulated financial services institutions. Sixteen of the twenty-four jurisdictions permit distributions via investment managers and twelve of the jurisdictions permit distributions via fund distribution companies. These additional channels of distribution may be deemed by regulators to be appropriate in view of the strict regulatory oversight over these institutions themselves. Also, it is in the interests of the hedge funds themselves to avoid the inclusion of potentially unsophisticated investors to ensure the continuity of their ability to operate rather free of regulation.

58. See Stanley Fink, *The Distribution of Hedge Funds to Mass Affluent Investors*, ALTERNATIVE INV. MGMT. ASS'N J. (Sep. 2005), available at <http://www.aima.org/uploads/Fink68.pdf> (explaining that the two main types of wrapper products are insurance policies and structured products).

59. PRICEWATERHOUSECOOPERS, *supra* note 1, at 50-51.

60. See Gerstein, K.S., *Hedge Fund Distribution: Regulatory Hot Buttons*, Schulte Roth & Zabel, LLP (2006) (illustrating conflicts of interest with wrappers).

61. See Fink, *supra* note 58 (explaining the advantages of wrappers to individuals with a high net worth).

Therefore, the hedge fund managers will themselves ensure that investment managers market the product appropriately.

The final type of regulation we address in this paper is the restriction on the use of key service providers based outside the jurisdiction. Of the jurisdictions, twelve impose restrictions on the location of key service providers. For example, the Isle of Man requires local residency for day-to-day operators for Professional Investor Funds and Experienced Investor Funds. For Germany, the investment manager and custodian bank are required to be based in, and regulated by, Germany (Additional details on the nature of the restrictions of location are provided by PricewaterhouseCoopers⁶²). Regulatory authorities most likely view as sufficient the existing regulatory oversight of key service providers providing support services to the hedge fund. Even if these services are carried out internally within an institution, the provision of such services by the specific department will be regulated by the relevant regulatory body or authority. Unlike the two previous types of restrictions mentioned earlier, which are somewhat related to limiting access to hedge funds by unsophisticated retail investors, this restriction is more in line with ensuring that the hedge fund utilizes only recognized (thus potentially regulated) service providers. For example, the higher fees the hedge funds pay may not be that much of an incentive for service providers to act in concert with hedge fund managers contrary to the interest of hedge fund investors if there is a threat of disciplinary action or reputational harm. The reputational concerns among service providers have led them to ensure that the hedge funds meet certain transparency, disclosure, liquidity and valuation method benchmarks. Also, as hedge funds seek to build up their own reputations for professionalism to seek further capital, they will align themselves to the more reputable and professional service providers.

Suffice it to say that the international differences in hedge fund regulation broadly depicted in Table 1 do not capture all of the nuances of the differences across countries. They do, however, enable broad levels of comparison that can be used in our empirical analyses of forum shopping, which is carried out in the next part below.

Based on the data used in the empirical analyses in this paper, the prevalence of funds registered in each jurisdiction is summarized in Table 1. The data sources are described in Part V.B provided immediately below.

V. HEDGE FUND FORUM SHOPPING

This part considers the issue of whether hedge funds pursuing riskier strategies select jurisdictions that have less onerous regulation. We look at

62. PRICEWATERHOUSECOOPERS, *supra* note 1.

the average monthly return and standard deviation of returns to determine the riskiness of each strategy. In Part V.A. we describe hedge fund strategies and relate different strategies to the extent to which risk and agency problems are more pronounced. In turn, we also conjecture hypotheses regarding fund strategies and forum shopping for different regulation. In Part V.B., we describe the dataset used to test the hypotheses. Multivariate empirical tests are provided in Part V.C. Limitations and extensions regarding the tests are acknowledged in Part V.D. Thereafter concluding remarks follow in Part VI.

A. Hedge Fund Strategies and Forum Shopping

Hedge fund strategies are classified into different investment strategies. Funds report their primary strategies or investment focus to hedge fund data vendors such as the Center for International Securities and Derivatives Markets ("CISDM"), HedgeFund.Net, and TASS. The range of strategies recorded differs slightly across different data vendors. The strategies indicated in the HedgeFund.Net and CISDM datasets (which are described further below in Part V.B) are indicated in Table 2. The range of strategies recorded in the HedgeFund.Net dataset is slightly broader than that which is found in CISDM.⁶³

63. The Center for International Securities and Derivatives Markets ("CISDM") records styles for Merger Arbitrage, Equity Long/Short, Relative Value Multi-Strategy, Emerging Markets, Equity Market Neutral, Multi-Strategy, Convertible Arbitrage, Global Macro, Fixed Income, Fixed Income Arbitrage, Technology Sector, Event Driven Multi Strategy, Distressed Securities, Option Arbitrage, Capital Structure Arbitrage, Market Timing, Short Bias, Equity Long Only, Regulation D, Other Relative Value and Other Strategy. HedgeFund.Net records these styles, as well as the additional ones indicated in Table 2.

Table 2. Hedge Fund Strategies

This table defines the fund strategies. Sources: <http://www.hedgefund.net/def.php3>, <http://www.investopedia.com>, and <http://www.wikipedia.com>. The number of funds in each strategy and the average monthly return and standard deviation for the period 2003-2005 are also presented.

Fund Strategy	# of Funds	Average Monthly Return (%)	Average Standard Deviation of Returns (%)	Definition
Market Neutral Equity	512	1.17	2.90	An investment strategy that seeks to mitigate or avoid market risk in equity investments, such that there is minimal or zero correlation with fluctuations in the relevant set (as defined by the hedge fund) of equity investments.
Long/Short Equity	227	0.89	3.20	An investment strategy involving purchases of equity expected to increase in value and short sales of securities expected to decrease in value.
Multi-Strategy	169	0.94	2.11	A multi-faceted investment strategy (i.e., there is no specifically identified fund style).
CTA/Managed Futures	131	0.81	5.17	Commodity Trading Advisors (CTAs) operate managed futures, which is an investment fund that takes long and short positions in futures, options on futures, and government securities.
Emerging Markets	109	2.21	4.12	An investment strategy where the fund invests in emerging or developing regions of the world, and often characterized by significant political risk and economic risk.
Technology Sector	104	1.35	3.74	A fund focused in technology sector specific investments, such as Internet, semiconductors, hardware, software, etc.
Convertible Arbitrage	95	0.58	1.61	A market neutral investment strategy which simultaneously involves the purchase of convertible securities and the short sale of the same issuer's common stock.
Fixed Income Arbitrage	94	0.72	1.28	An investment strategy which exploits inefficiencies in bond pricing.
Macro	73	0.91	4.64	A macro hedge is used to eliminate the risk of a portfolio of assets, which implies taking a position in a single asset or multiple assets that offsets the whole portfolio.

Table 2 (Continued). Hedge Fund Strategies				
Fund Strategy	# Funds	Average Monthly Return (%)	Average Standard Deviation of Returns (%)	Definition
Distressed	67	1.47	2.04	Funds that invest in financially distressed companies.
Merger/Risk Arbitrage	45	0.47	0.97	A minimal risk investment strategy where the stocks of two merging companies are simultaneously bought and sold at a profit. Risk relates to likelihood and timing of deal approval.
Event Driven	31	0.97	2.20	A fund strategy to invest in companies with special situations, including financial distress, mergers and takeovers.
Value	22	1.04	3.30	An investment strategy focused on companies that are trading on values less than their intrinsic value.
Short Bias	19	-0.49	3.86	An investment strategy in which the fund manager takes more short positions than long positions.
Fixed Income (non-arbitrage)	18	0.80	1.45	Investments in fixed income securities beyond the realm of fixed income arbitrage strategies (defined above).
Options Strategies	17	0.55	2.44	Funds that focus investments in options.
Long Only	12	0.66	3.61	Funds that do not make short sale investments.
Finance Sector	11	1.06	1.97	Funds that focus investments in finance sector companies.
Small/Micro Cap	10	1.92	4.28	Small investee focus fund investments.
Regulation D	10	1.58	4.03	The U.S. Securities and Exchange Commission (SEC) Regulation D governs private placement exemptions for smaller companies raising debt or equity capital without registering their securities with the SEC.
Healthcare Sector	10	0.46	3.80	Funds focused in the health care sector.
Capital Structure Arbitrage	9	0.97	1.27	Funds that exploit inefficiency in pricing from the capital structure of the company, such as by different long and short positions of debt and equity of the same company.

Table 2 (Continued). Hedge Fund Strategies				
Fund Strategy	# Funds	Average Monthly Return (%)	Average Standard Deviation of Returns (%)	Definition
Special Situations	9	1.44	3.55	Funds that base their investment strategies on special situations, such as lawsuits, spinouts, bankruptcy, mergers and tender offers.
Short-term Trading	8	0.50	1.74	Strategic trading for short term capital gains.
Statistical Arbitrage	8	0.51	1.32	A trading strategy focused on inefficient pricing of securities identified from statistical models.
Other Arbitrage	8	0.74	1.53	Funds that find inefficiency in the pricing of securities based on a variety of (non-specified) arbitrage techniques.
Market Timer	5	0.48	1.99	Funds that purchase or sell assets based on predicted future price movements.
Mortgages	5	0.92	0.79	Funds that focus their investments in the mortgage sector.
Energy Sector	4	2.18	4.32	Funds that focus investments in energy sector companies.
Country Specific	3	0.94	4.61	Funds that focus their investments within a certain country(ies).

Hedge fund strategies in Table 2 are listed according to the frequency in which they are observed in the combined CISDM and HedgeFund.Net dataset. Additionally, each fund strategy presented shows the average monthly return and standard deviation of monthly returns over the period 2003 to 2005. These performance statistics provide a rough guide to risk and returns associated with different fund strategies.⁶⁴

While it is not possible to perfectly classify different hedge fund strategies into different degrees of risk, it is possible to carry out a rather rough grouping of strategies into different risk profiles and potential agency problems with an analysis of average monthly returns and average standard deviation of returns. For example, strategies that involve risk-free arbitrage would, of course, be of minimal concern for either risk and/or agency problems.⁶⁵ The arbitrage strategies indicated in Table 2 include convertible arbitrage, fixed income arbitrage, merger/risk arbitrage, capital

64. See Burton G. Malkiel & Atanu Saha, *Hedge Funds: Risk and Return*, 61 FIN. ANALYSTS J. 80, 81 (2005) (providing similar information over the period from 1995 to 2003).

65. In practice, arbitrage will involve an element of risk.

structure arbitrage, statistical arbitrage and other arbitrage. Generally, the standard deviation of returns is lower for these arbitrage strategies relative to other non-arbitrage strategies. We may therefore infer that potential agency problems are less pronounced for these arbitrage strategies. For example, fixed-income arbitrage strategies have been described as analogous to steam rollers that pick up loose change on the street.⁶⁶

For reasons identified in Part III.E. above, strategies for which agency problems may be more pronounced might include long/short equity, multi-strategy, CTA/Managed futures, emerging markets, technology sector, macro, event driven (in some classifications, event driven strategies encompass distressed securities, Regulation D and high yield low grade fixed income securities),⁶⁷ short bias, small/micro cap, special situations,⁶⁸ energy sector and country specific. For example, long/short strategies have been associated with potential agency problems where the fund manager acts against the interests of its investors,⁶⁹ and such strategies have been associated with massive volatility swings.⁷⁰ Funds pursuing small/micro cap strategies and distressed investments also are significantly relevant for exacerbated agency problems.⁷¹

While we do not seek to precisely identify the severity and scope of agency problems within each fund or class of funds for the purposes of this paper, we can nevertheless determine whether fund managers pursuing different strategies, irrelevant of risk, tend to register their funds in different countries with different sets of regulations identified in Table 1 and discussed in Part IV above. As such, we may pose three alternative hypotheses about forum shopping:

Hypothesis 1—Race to the Bottom: Hedge fund managers pursuing riskier strategies and strategies for which potential agency problems are more pronounced select jurisdictions that have less onerous regulatory oversight.

Hypothesis 2—Neutrality: The relation between hedge fund strategies and hedge fund regulation is random.

Hypothesis 3—Alignment of Interests: Hedge funds pursuing risky

66. See, e.g., Fixed-Income Arbitrage, <http://www.investopedia.com/terms/f/fixedincomearbitrage.asp> (indicating that large losses are nevertheless possible with fixed income arbitrage strategies).

67. See Hedge Fund Styles, Lipper HedgeWorld's Education Center, http://www.hedgeworld.com/education/index.cgi?page=hedge_fund_styles (last visited Apr. 21, 2008) (defining the categories of investment styles used by hedge fund managers).

68. "Event driven" and "special situations" are arguably quite similar but are nevertheless two separate categories used by HedgeFund.Net and as such are maintained as separate categories herein.

69. *Supra* note 40 and accompanying text.

70. *Supra* note 10 and accompanying text.

71. See *supra* Part III.E.

investment strategies select jurisdictions with more onerous regulation.

Below, we assess the empirical validity of these competing hypotheses. To the extent that we find evidence in support of Hypothesis 1, we may be concerned that international differences in hedge fund regulation facilitate a race to the bottom where fund managers' interests are served at the expense of their investors. In the alternative, if the data are consistent with Hypothesis 2 such that hedge fund strategies are invariant to international differences in regulation, then we may infer that regulatory differences provide little, if any, information regarding a fund manager's intentions with regards to potential agency problems. Finally, if we find evidence in support of Hypothesis 3, then we may infer that hedge fund managers perceive regulation to be informative to the funds' investors because fund managers signal their interest in mitigating potential agency conflicts associated with fund management by registering in a jurisdiction with greater regulatory oversight and thereby facilitating fundraising efforts.

B. Data

The data used in this study comprise 1845 funds. Data were used from two sources: (1) CISDM,⁷² and (2) HedgeFund.Net ("HFN") DataExport collected by Channel Capital Group Inc.⁷³ Similar data have been used in prior work.⁷⁴

The number of fund strategies in each country of fund registration is indicated in Table 3. There are some patterns that are notable in Table 3. For example, a greater proportion of the funds pursuing emerging market strategies are registered in offshore centers such as the Bahamas, Channel Islands and Cayman Islands.

72. The Center for International Securities and Derivatives Markets, <http://cisdm.som.umass.edu/> (last visited May 10, 2008).

73. Hedgefund.net, <http://www.hedgefund.net/> (last visited May 10, 2008).

74. See Cumming, *supra* note 27 (using the data to examine the impact of hedge fund regulation on fund structure and performance); see also Douglas Cumming, *Capital Flows and Hedge Fund Regulation* (Feb. 11, 2008) (York University Schulich School of Business, Working Paper) (using similar data to analyze the flow-performance relationship of hedge funds). We do not include fund-of-fund strategies in the dataset used in this paper as such funds do not have an identifiable strategic focus. Of the fund-of-funds that were excluded from the data, we observe a majority registered in the U.S.

Table 3. Number of Hedge Funds Using Different Strategies, by Country of Registration						
This table presents the number of hedge fund using different strategies according to the country of registration. Fund strategies are as defined in Table 2.						
	Market Neutral Equity	Long/Short Equity	Multi- Strategy	CTA/Managed Futures	Emerging Markets	Technology Sector
Australia	0	0	0	1	0	0
Austria	0	0	0	1	0	0
Bermuda	33	1	7	0	6	5
Brazil	0	1	0	0	4	0
Bahamas	3	0	1	0	7	0
British Virgin Islands	43	0	19	0	8	11
Canada	14	0	0	1	0	0
Switzerland	0	0	2	0	0	0
China	0	1	0	0	0	0
France	2	0	1	0	0	0
Channel Islands	0	0	0	0	3	0
Hong Kong	0	1	0	0	0	0
Ireland	12	0	0	4	0	0
Isle of Man	0	0	1	0	0	0
Japan	0	2	0	0	0	0
Cayman Islands	135	0	44	0	58	12
Luxembourg	4	0	2	0	0	0
Mauritius	1	0	0	0	1	0
Netherlands	0	0	0	0	0	0
Netherland Antilles	1	0	3	0	1	0
New Zealand	0	0	0	0	0	0
U.K.	2	11	1	1	0	0
U.S.	262	210	88	118	21	76
U.S. Virgin Islands	0	0	0	5	0	0

Table 3 (Continued). Number of Hedge Funds Using Different Strategies, by Country of Registration							
	Convertible Arbitrage	Fixed Income Arbitrage	Macro	Distressed	Merger/Risk Arbitrage	Event Driven	Other Less Common Fund Strategies
Australia	0	0	1	0	0	0	0
Austria	0	0	0	0	1	0	0
Bermuda	11	2	2	4	1	2	2
Brazil	0	0	1	0	0	0	0
Bahamas	0	3	2	0	2	0	1
British Virgin Islands	2	1	5	3	2	0	2
Canada	0	0	0	0	0	0	5
Switzerland	0	0	0	0	0	0	0
China	0	0	0	0	0	0	0
France	0	2	0	0	1	0	1
Channel Islands	0	0	0	0	0	0	1
Hong Kong	0	0	0	0	0	0	0
Ireland	3	0	2	0	3	0	0
Isle of Man	0	0	0	0	0	0	0
Japan	0	0	0	0	0	0	0
Cayman Islands	24	39	20	13	14	0	13
Luxembourg	1	2	0	0	0	0	0
Mauritius	0	0	0	0	0	0	0
Netherlands	0	0	0	1	0	0	0
Netherland Antilles	0	0	0	0	0	0	1
New Zealand	0	0	1	0	0	0	0
U.K.	0	0	1	0	0	0	0
U.S.	54	44	38	46	21	29	162
U.S. Virgin Islands	0	1	0	0	0	0	0

While some patterns may already become apparent in Table 3, for the most part it is necessary and worthwhile to consider multivariate tests to ascertain patterns in fund registration relative to fund strategies. This exercise is provided immediately below.

C. Multivariate Empirical Tests

Table 4, Panels A and B provide empirical tests of the propensity of funds pursuing different strategies to select jurisdictions of registration

based on their fund strategy. Panel A provides analyses with the use of the combined CISDM and HFN dataset, while Panel B provides analyses with the use of the HFN dataset alone.⁷⁵ We provide eight different regression models to assess the extent of jurisdiction shopping for minimum capitalization (Model 1), restrictions on location (Model 2), and different distribution channels (Models 3 to 8). In the regressions we include as control variables fund size and age, as well as dummy variables for their primary location of assets.⁷⁶

75. A limitation with the HedgeFund.Net dataset is that country of fund registration is not observable for many of the funds in the source data. The different data vendors also do not track all of the same fund types. As such, we show regression results below with and without the HedgeFund.Net dataset in Table 4, Panels A and B to show robustness.

76. Fund size is measured as of 2003, which is an imperfect control variable. We might measure fund size at the time of first registration, but size at that time would technically be at or close to zero. We control for fund size considering the possibility that funds expecting to raise more capital will tend to register in jurisdictions that have larger minimum capitalization. We do acknowledge that fund size will be in part endogenous to regulations in different countries; however, we do not have suitable instrumental variables to account for endogeneity. Excluding the fund size variable in any of the regressions does not materially impact the variables of interest pertaining to fund strategy and jurisdiction shopping.

TABLE 4. REGRESSION ANALYSES OF HEDGE FUND FORUM SHOPPING

PANEL A. COMBINED CISDM AND HFN DATA

Table 4 Panel A presents logit regression analyses of the determinants of forum shopping for different rules for minimum capitalization, restrictions on location and distribution channels in the HFN and CISDM datasets. Fund strategy variables are dummy variables equal to one where the fund's primary strategy is indicated, as per the fund strategies as defined in Table 2. All regression models in Panel A use dummy variables equal to one for the location of fund assets and a dummy variable equal to one for the HFN Dataset. Model (1a) includes but does not report (for reasons of space) the coefficient estimates for dummy variables equal to one for statistical arbitrage, value, Regulation D, fixed income (non-arbitrage), finance sector, long only, energy sector, country specific, options strategies and other arbitrage (all of these strategy variable estimates were statistically insignificant in Model 1a); Models (2a)-(8a) do not include any strategy variables not indicated; more parsimonious specifications were necessary in the logit models (2a)-(8a) due to collinearity and invariance with respect to the binary dependent variable. Fund size is excluded in Model (3a) to avoid collinearity problems. Marginal effects are reported and not the standard logit coefficients in order to highlight economic significance alongside statistical significance. Notations "*", "**", "***", "****" indicate that the results are statistically significant at the 10%, 5% and 1% levels, respectively.

	(1a) Minimum Capitalization Requirements	(2a) Restrictions on the Location of Key Service Providers	(3a) Marketing via Private Placements	(4a) Marketing via Wrappers
Constant	380210.296***	0.296***	0.016	-0.057***
Hedge Fund Strategy				
Fixed Income Arbitrage	70454.269*	0.113	-0.038**	0.010
Merger/Risk Arbitrage	47740.678	0.150		0.050
Convertible Arbitrage	-3312.301	0.078		
Multi-Strategy	75605.281	0.041	-0.036***	0.024
Event Driven	-12643.066	0.241		
Short-term Trading	-11039.529			
Market Neutral Equity	-18918.861	0.008	-0.003	0.010
Small/Micro Cap	-1872.101			
Short Bias	44861.133	0.039		
Long/Short Equity	-2457.890	-0.102		0.029*

TABLE 4. REGRESSION ANALYSES OF HEDGE FUND FORUM SHOPPING				
PANEL A (CONTINUED). COMBINED CISDM AND HFN DATA				
	(1a) Minimum Capitalization Requirements	(2a) Restrictions on the Location of Key Service Providers	(3a) Marketing via Private Placements	(4a) Marketing via Wrappers
Technology Sector	-60895.931	-0.082*		
Emerging Markets	60490.056	0.232**		-0.001
Macro	145446.365	0.160		0.009
Capital Structure Arbitrage	43149.933			
CTA/Managed Futures	70527.075	0.239*		-0.001
Market Timer	-139038.931***			
Distressed Securities	-23136.145	-0.040		
Fund Characteristics				
Fund Size	0.00001*	1.06E-10***		-5.63E-12
Fund Age	-488.661***	-0.0009***	0.00001	-0.0001
<i>Model Diagnostics</i>				
Number of Observations	1845	1845	1845	1845
Number of Observations with Dependent Variable =1	Not Applicable	612	1833	59
Loglikelihood Function	-25992.874	-749.307	-64.099	-233.041
Adjusted R ² (Pseudo R ² for Models 2-8)	0.110	0.361	0.117	0.108
F-Statistic (Chi-squared Statistic for Models 2-8)	25.38***	845.942***	16.572**	56.166***

TABLE 4. REGRESSION ANALYSES OF HEDGE FUND FORUM SHOPPING

PANEL A (CONTINUED). COMBINED CISDM AND HFN DATA				
	(5a) Marketing via Banks	(6a) Marketing via Other Regulated Financial Institution	(7a) Marketing via Investment Managers	(8a) Marketing via Fund Distribution Companies
Constant	0.494***	-0.067***	0.466***	-0.069***
Hedge Fund Strategy				
Fixed Income Arbitrage	0.051	0.0003	0.071	0.011
Merger/Risk Arbitrage	0.110	0.108	0.068	0.051
Convertible Arbitrage	0.063	0.036	-0.010	
Multi-Strategy	-0.015	0.002	-0.022	0.016
Event Driven	0.054		0.018	
Short-term Trading				
Market Neutral Equity	-0.015	0.024	-0.063	0.006
Small/Micro Cap				
Short Bias	0.040		-0.011	
Long/Short Equity	0.052	0.001	0.025	0.005
Technology Sector	-0.129**		-0.144***	
Emerging Markets	0.082	0.008	0.188*	0.046
Macro	0.117	0.039	0.071	0.032
Capital Structure Arbitrage			0.001	
CTA/Managed Futures	0.172	0.040		0.007
Market Timer				
Distressed Securities	-0.120**	-0.010	-0.105*	

TABLE 4. REGRESSION ANALYSES OF HEDGE FUND FORUM SHOPPING				
PANEL A (CONTINUED). COMBINED CISDM AND HFN DATA				
	(5a) Marketing via Banks	(6a) Marketing via Other Regulated Financial Institution	(7a) Marketing via Investment Managers	(8a) Marketing via Fund Distribution Companies
Fund Characteristics				
Fund Size	2.74E-10***	1.10E-12	1.37E-10***	-5.71E-12
Fund Age	-0.002***	-0.0002**	-0.0014***	-0.00009
Model Diagnostics				
Number of Observations	1845	1845	1845	1845
Number of Observations with Dependent Variable=1	640	73	633	49
Loglikelihood Function	-804.086	-286.646	-813.738	-215.631
Adjusted R ² (Pseudo R ² for Models 2-8)	0.325	0.067	0.314	0.046
F-Statistic (Chi- squared Statistic for Models 2-8)	773.709***	41.328***	745.427***	21.139

TABLE 4. REGRESSION ANALYSES OF HEDGE FUND FORUM SHOPPING

PANEL B. CISDM DATA ONLY

Table 4 Panel B presents logit regression analyses of the determinants of forum shopping for different rules for minimum capitalization, restrictions on location and distribution channels in the CISDM dataset (excluding the HFN Dataset). Fund strategy variables are dummy variables equal to one where the fund's primary strategy is indicated, as per the fund strategies as defined in Table 2. All regression models in Panel B use dummy variables equal to one for the location of fund assets; there are no other non-reported variables in Table 4 Panel B. Fund size is excluded in Model (3a) to avoid collinearity problems. Marginal effects are reported and not the standard logit coefficients in order to highlight economic significance alongside statistical significance. Notations "*", "**", "****" indicate that the results are statistically significant at the 10%, 5% and 1% levels, respectively.

	(1b) Minimum Capitalization Requirements	(2b) Restrictions on the Location of Key Service Providers	(3b) Marketing via Private Placements	(4b) Marketing via Wrappers
Constant	410359.853***	0.540***	0.027	-0.096***
Hedge Fund Strategy				
Fixed Income Arbitrage	71212.581	0.091	-0.049**	0.043
Merger/Risk Arbitrage	25597.807	0.112		0.107
Convertible Arbitrage	-16830.136	0.061		
Multi-Strategy	15931.457	-0.007	-0.020	0.015
Market Neutral Equity	-27607.358	-0.038	-0.004	0.029
Short Bias	41785.728	0.009		
Technology Sector	-78828.207	-0.205		
Emerging Markets	54200.932	0.211*		0.052
Macro	225534.869	0.143		0.080
Capital Structure Arbitrage	74264.175	0.248		
Market Timer	-180318.466***	-0.207		
Distressed Securities	-48694.995	-0.163		

TABLE 4. REGRESSION ANALYSES OF HEDGE FUND FORUM SHOPPING				
PANEL B (CONTINUED). CISDM DATA ONLY				
Fund Characteristics				
Fund Size	0.00001**	1.75E-10***		-2.59E-12
Fund Age	-515.783***	-0.001***	-2.17E-06	-1.86E-05
Model Diagnostics				
Number of Observations	1127	1127	1127	1127
Number of Observations with Dependent Variable=1	Not Applicable	588	1118	28
Loglikelihood Function	-15787.576	-652.245	-48.276	-125.919
Adjusted R ² (Pseudo R ² for Models 2-8)	0.098	0.164	0.079	0.040
F-Statistic (Chi-squared Statistic for Models 2-8)	7.08***	255.732***	8.318	10.388

TABLE 4. REGRESSION ANALYSES OF HEDGE FUND FORUM SHOPPING

PANEL B (CONTINUED). CISDM DATA ONLY				
	(5b)	(6b)	(7b)	(8b)
	Marketing via Banks	Marketing via Other Regulated Financial Institution	Marketing via Investment Managers	Marketing via Fund Distribution Companies
Constant	0.635	-0.123***	0.632***	-0.103***
Hedge Fund Strategy				
Fixed Income Arbitrage	0.061	0.093	0.049	0.045
Merger/Risk Arbitrage	0.108	0.392	0.028	0.115
Convertible Arbitrage	0.083	0.198	-0.046	
Multi-Strategy	-0.037	0.041	-0.085	0.017
Market Neutral Equity	-0.016	0.103*	-0.118	0.032
Short Bias	0.071		-0.034	
Technology Sector	-0.192*		-0.263***	
Emerging Markets	0.115	0.162	0.190*	0.140
Macro	0.139	0.247	0.059	0.085
Capital Structure Arbitrage				
Market Timer				
Distressed Securities	-0.197*		-0.226**	
Fund Characteristics				
Fund Size	3.89E-10***	2.12E-12	1.98E-10***	-4.03E-12
Fund Age	-0.002***	-1.86E-04	-0.002***	-3.44E-05

TABLE 4. REGRESSION ANALYSES OF HEDGE FUND FORUM SHOPPING				
PANEL B (CONTINUED). CISDM DATA ONLY				
	(5b)	(6b)	(7b)	(8b)
	Marketing via Banks	Marketing via Other Regulated Financial Institution	Marketing via Investment Managers	Marketing via Fund Distribution Companies
Model Diagnostics				
Number of Observations	1127	1127	1127	1127
Number of Observations with Dependent Variable=1	590	52	586	32
Loglikelihood Function	-645.732	-194.927	-661.944	-137.649
Adjusted R ² (Pseudo R ² for Models 2-8)	0.172	0.075	0.152	0.054
F-Statistic (Chi- squared Statistic for Models 2-8)	268.397***	31.619***	236.668***	15.724

Model (1a) and (1b) (for Panels A and B, respectively) provide an ordinary least squares regression of funds registering in jurisdictions with different minimum capitalization requirements. The data indicate very weak evidence of any jurisdiction shopping for fund strategies in relation to minimum capitalization in Models (1a) and (1b).⁷⁷ Model (1a) shows that Fixed Income Arbitrage funds are more likely to select jurisdictions with larger capital requirements. This is not surprising, as fixed income arbitrage strategies involve small gains on extremely large transactions.⁷⁸

Models (1a) and (1b) show Market Timer funds tend to be registered in jurisdictions with lower minimum capitalization requirements. Some commentators have noted market timing strategies may involve taking advantage of differences in market prices for funds that own assets in different parts of the world and differences in information after markets

77. We also considered Tobit regressions to account for the fact that minimum capitalization cannot be bounded below by zero. Those regressions showed no significant relation between fund strategy and minimum capitalization.

78. *Supra* note 66 and accompanying text.

close at different points in time around the world, and possibly trading strategies that are associated with manipulating closing prices.⁷⁹ While the evidence in Table 1 shows Market Timer funds tend to select jurisdictions with lower capital requirements, we do note that our data comprise five funds with a primary market strategy of market timing, and of these four are registered in the U.S. (where there are no minimum capitalization requirements for hedge funds) and one in Bermuda. Also, when we employ alternative estimation methods, we do not find evidence of a significant relation between market timing and minimum capitalization.⁸⁰ It would thus be difficult to conclude from the evidence on a negative relation between market timing strategies and minimum capitalization in Table 4 that there is a “race to the bottom” along the lines of Hypothesis 1 outlined above.

Models (2a) and (2b) show some evidence that fund strategies are related to choice of jurisdiction in terms of restrictions on the location of key service providers. In particular, the data indicate at the 5% level of statistical significance that Emerging Markets funds are 23.2% more likely to register in countries with restrictions on the location of key service providers (Model (1a)). Model (1b) with the subset of CISDM data similarly only shows at the 10% level of significance that funds pursuing emerging market strategies are 21.1% more likely to register in countries with restrictions on the location of key service providers. If we may infer that emerging market strategies involve potentially more pronounced agency problems than other strategies, then the fact that these funds select jurisdictions that restrict location is consistent with Hypothesis 3 described above in Part V.A.

Consistent with the evidence on emerging markets and restrictions on location in support of Hypothesis 3, Table 4 Panel A Model (2a) also shows at the 10% level of statistical significance that funds pursuing CTA/Managed Futures strategies are 23.9% more likely to register in countries with restrictions on the location of key service providers. We had suggested above that CTA/Managed Futures fund strategies involved potentially greater agency problems, and certainly this strategy is riskier than other strategies in terms of variance in returns (Table 2). As such, we would again infer that the data are consistent with Hypothesis 3 insofar as funds pursuing riskier strategies register in countries with more onerous regulations. We do note, however, that the positive association between CTA/Managed Futures strategies is not statistically significant in Model (2a) with the subset of CISDM data only.

79. See CNNMoney.com, Market Timing: A Weed that Won't Die, Aug. 26, 2005, http://money.cnn.com/2005/08/26/markets/hedge_timing/index.htm (reporting on a study that found that market timing strategies are still being used by some funds outside the U.S.).

80. *Supra* note 77 and accompanying text.

Model (2a) shows Technology Sector funds pursuing Technology Sector strategies are 8.2% less likely to register in jurisdictions that restrict the location of key service providers, and this evidence is significant at the 10% level in Model (2a) (although statistically insignificant in Model (2b)). There are potentially a variety of reasons why Technology Sector funds seek fewer location restrictions. One explanation is that these funds exhibit greater agency problems since information asymmetries are more pronounced with high-tech investments and, as such, there is greater scope for fund managers to pursue excessive risk taking strategies. Another explanation is that these investments require greater geographical proximity to mitigate information asymmetries faced by the investee companies and its hedge fund manager and key service providers, and any restrictions on location may in turn have a negative effect on the hedge fund value since better performing funds are more geographically proximate to their investee companies.⁸¹ Overall, therefore, this is not conclusive evidence in support of Hypothesis 1 outlined above.

It is noteworthy that there are very few significant strategy variable coefficients in Models (1a), (1b), (2a) and (2b). Hence, in terms of minimum capitalization and restrictions on location, the data tend to offer greatest support for Hypothesis 2 that fund strategies are largely invariant to fund regulation. Where coefficients are statistically significant, they tend to be more consistent with Hypothesis 3 and do not support the race to the bottom view of Hypothesis 1.

Models (3a) to (8b) analyze forum shopping for different marketing channels in relation to fund strategies. Funds pursuing fixed income arbitrage strategies are approximately 3.8% to 4.9% less likely to be registered in countries that offer distributions via private placements (Models (3a) and (3b)), and this evidence is statistically significant at the 5% level of significance. Distribution via private placements offers the potential of risk reduction to the investor since there is more room for negotiation. For example, ratchet clauses may be used alongside various covenants to protect the investors, and if necessary, prices may be discounted in cases of riskier strategies.⁸² Since fixed income arbitrage is a comparatively risk free strategy—analogueous to steam rollers picking up loose change on the street—it is not surprising that fixed income arbitrage is less commonly associated with private placement distribution

81. See, e.g., Joshua D. Coval & Tobias J. Moskowitz, *Home Bias at Home: Local Equity Preference in Domestic Portfolios*, 54 J. FIN. 2045 (1999) (discussing the bias in favor of investing close to home); Joshua D. Coval & Tobias J. Moskowitz, *The Geography of Investment: Informed Trading and Asset Prices*, 109 J. POL. ECON. 811 (2001) (positing that investors trade local securities at an information advantage resulting in fund managers earning substantial returns in local investments).

82. We owe thanks to Professors Cécile Carpentier and Jean-Marc Suret (both of Laval University) for this comment.

jurisdictions. Model (3a) also indicates that multi-strategy funds are 3.6% less likely to be registered in jurisdictions that offer private placements; however, that evidence is not robust in the subsample of CISDM data in Table 4 Panel B for Model (3b).

Model (4a) indicates that funds pursuing long/short equity strategies are 2.9% more likely to be registered in jurisdictions that allow marketing via wrapper products. This might be suggestive of an exacerbated potential agency problem insofar as wrappers might facilitate distorted information distributed to investors with the combination of multiple products.⁸³ However, we note that this evidence is only statistically significant at the 10% level and not statistically significant in Model (4b) with the subsample of CISDM data only.

Models (5a) and (5b) show funds pursuing Technology Sector strategies and Distressed Securities funds are less likely to be distributed via banks. This evidence is statistically significant at the 5% level in Model (5a) and at the 10% level in Model (5b). In terms of the economic significance, Technology Sector funds are 12.9% and 19.2% less likely to be registered in bank distribution jurisdictions in Model (5a) and (5b), respectively. Distressed Securities funds are 12.0% and 19.7% less likely to be registered in jurisdictions involving bank distributions in Models (5a) and (5b), respectively. As agency problems with technology sectors and distressed securities are more pronounced and as bank distributions tend to facilitate greater access to retail customers (albeit of typically more inflated wealth), this evidence supports Hypothesis 3 in that funds are less prone to register in countries if their strategies are in conflict with their potential investors' interests.

Similarly, there are no significant coefficients in Model (6a) for other regulated financial institutions, and Model (6b) shows that the market neutral equity strategy is the only significant coefficient for other regulated financial institutions. Market Neutral Equity funds are 10.3% more likely to register in countries that permit distributions via other regulated financial institutions. Overall, this is suggestive of the absence of forum shopping for other regulated financial institution distributions (in support of Hypothesis 2), and, in the alternative, to the extent there is forum shopping, it is not in conflict with the interests with potential investors (in support of Hypothesis 3 and not Hypothesis 1).

Models (7a) and (7b) show funds pursuing emerging markets strategies are 18.8% Model (7a)-19.0% Model (7b) more likely to register in jurisdictions that offer marketing via investment managers. Investment

83. See *supra* notes 57-61 and accompanying text; see also *A Screen for Fraudulent Return Smoothing*, *supra* note 5, at 6 (finding that misrepresenting strategy accounted for one of fifty-three SEC hedge fund litigation cases and allowing for more than one offense per case, misrepresenting strategy involved four of eighty offenses).

managers are of interest to hedge funds that seek assistance for facilitating easier access to potential investors that have an interest in the particular strategy employed by the fund. The investment manager provides services for regular assessment of strategy and execution, as well as provides services for risk management reduction and reporting of the hedge fund. This makes the fund more attractive to its investors.⁸⁴ In view of the idiosyncrasies of emerging market hedge fund strategies, it is not surprising that it is more attractive for Emerging Market funds to seek jurisdictions that offer investment manager distribution channels so that the investment manager can help particular fund strategies match with suitable investors. In net, therefore, we may view this evidence of a positive association between Emerging Markets funds and distributions via investment managers as supportive of Hypothesis 3.

Models (7a) and (7b), however, also show that Technology Sector funds are 14.4% Model (7a) to 26.3% Model (7b) less likely to register in jurisdictions permitting distributions via investment managers. As well, Distressed Securities funds are 10.5% Model (7a) to 22.6% Model (7b) less likely to register in jurisdictions that permit distributions via investment managers. Fund managers typically require a performance fee of 20% of fund profits and an exclusivity arrangement.⁸⁵ It is possible that those terms are less suitable for hedge funds in the technology sectors and in distressed securities. As well, it is also possible that the client base of investment managers is less interested in technology focused funds and funds focused on distressed securities.

Finally, we note that there are no statistically significant relations between hedge fund strategies and registrations in jurisdictions that permit distributions via fund distribution companies. This is supportive of Hypothesis 2 outlined above.

More generally, we may view that comparative dearth of statistically significant coefficients in the eight models in Panels A and B of Table 4 as supportive of Hypothesis 2. In other words, there is not much evidence of forum shopping in relation to fund strategies. Where we do observe forum shopping, the evidence is less consistent with the "race to the bottom" view expressed in Hypothesis 1 and more consistent with the alignment of interests view in Hypothesis 3.

84. Victor Zimmermann, *Hedge Fund Marketing: Pros, Cons and Structuring Agreements with Third-party Marketers*, ALTERNATIVE INVESTMENT QUARTERLY, Third Quarter 2002, 11, available at http://www.cm-p.com/pdf/hedge_fund_marketing.pdf (discussing the increase in services offered by third party investment managers to attract investors).

85. *Id.* at 13-14.

D. Limitations and Extensions to Empirical Tests

The empirical evidence on forum shopping indicated above is limited in a few dimensions which are important to acknowledge. First, the measures used are coarse. We focus on broadly defined fund strategies as proxies for potential agency problems. More refined data that investigates the actual activities of the hedge fund manager might provide further insight into the issue of forum shopping.⁸⁶

Second, the data in this paper do not cover the universe of all hedge funds. Estimates suggest there are up to 10,000 funds worldwide and the data examined in this paper cover 1845 funds. We did show that the results are robust with the use of a sample that combines two datasets as well as with the use of only one of the two datasets. Additional data with more details on each fund could shed further light on this topic.

Third, the legal dimensions over which we measure forum shopping are coarse, but broadly defined to enable comparisons across all of the countries represented in the data. More specific legal differences exist across the countries in the data, and further legal analyses could seek to identify factors that lead funds to select particular jurisdictions. For example, there are tax differences across countries which lead to differences in jurisdiction selection, particularly for comparing onshore funds and offshore funds. We note, however, that we do not believe that these differences distort the measures we study in our empirical tests since our focus is on legal dimensions that are available to select in both tax friendly and tax unfriendly jurisdictions. For example, restrictions on location exist in some offshore centers such as the Cayman Islands but not in others such as the Channel Islands (Table 1). Hence, while we do not believe these extraneous legal and tax factors influence our results and analyses discussed above, we do believe these issues offer avenues for investigation in future studies.

VI. CONCLUDING REMARKS

The debate around hedge fund regulation in part involves the use of

86. To this end, further empirical work might consider differences in forum shopping among activist hedge funds. For work on hedge fund activism, see Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Governance and Firm Performance*, J. FIN. (forthcoming). See also April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors* (NYU Law and Economics Research Paper No. 06-41, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913362; FRANK S. PARTNOY & RANDALL S. THOMAS, *Gap Filling, Hedge Funds, and Financial Innovation*, NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES (Yasuyuki Fuchita & Robert E. Litan eds., Brookings Institution Press 2007).

innovative investment strategies by hedge funds. On the one hand, these innovative hedge fund strategies provide various benefits to the financial systems involved, including providing crucial liquidity to markets, limiting price distortions and anomalies via arbitrage trading, and taking on risk across instruments and markets as they are able to change portfolio composition rather quickly. On the other hand, as active risk takers across instruments and markets, hedge funds may also exacerbate the risk of systemic failure, as their strategies involve multiple markets with as yet untested instrument links.⁸⁷

Opponents of more stringent regulation believe that such beneficial hedge fund activities are facilitated within a “friendly” environment which allows freedom and discretion.⁸⁸ To curtail such freedom may just cause the players to leave for a friendlier playing field. To allow the players complete freedom, however, may enable them to run amok. Regulation and oversight may be too heavy-handed, forcing hedge funds and their managers to move their operations to more accommodating, less regulated jurisdictions. Also, as more regulatory oversight would involve taking self-regulating functions away from hedge fund participants, this may encourage laxity with regard to investment decisions and risk management. The question now is not how to regulate the industry, but where to draw the boundaries for such regulation. If we assume that all hedge fund managers want complete freedom to do what they do best, then it follows that any extra regulatory oversight will cause them to forum shop. It also follows that they might forum shop in a “race to the bottom.” We sought to determine in this paper whether this is the case. We considered whether forum shopping exists across different hedge funds, applying different strategies. In view of this argument that hedge funds will forum shop at the threat of added regulation, we sought to determine how tolerant different hedge funds are to existing regulation.

We analyzed data from 1845 funds registered in twenty-four countries. We concentrated on differences in hedge fund regulation across the twenty-four countries that fall within three primary categories: (1) minimum capital to operate as a hedge fund, (2) permissible marketing channels, and (3) restrictions on the location of key service providers. We considered the different strategies identified and characterized by the dataset providers, CISDM and HedgeFund.Net, to differentiate types of hedge funds. We also looked at the average monthly return and standard deviation of returns to determine the risk of each strategy. The data indicated scant evidence of hedge fund strategies that are systematically related to forum shopping towards lower minimum capitalization

87. See *supra* note 10 for work showing exacerbated systemic risks.

88. See, e.g., Cumming, *supra* note 27 (showing that hedge fund performance is hampered by more stringent regulation).

requirements. We did find some evidence that fund strategies are related to choice of jurisdiction in terms of restrictions on the location of key service providers. However, the data showed that forum shopping was in line with the view that funds pursuing riskier strategies selected jurisdictions that restricted the location of key service providers. Similarly, with regard to availing themselves of different marketing channels, the data mostly indicated that where forum shopping exists, funds are less prone to register in countries whose strategies are in conflict with the interests of their potential investors. We may interpret this evidence as supporting the view that fund regulations are selected relative to a fund strategy in order to facilitate capital raising.

Overall, we did not find evidence of forum shopping in a “race to the bottom” due to international differences in hedge fund regulation and fund strategies. The data for the most part show scant evidence of forum shopping in relation to fund strategies. Where forum shopping exists, the evidence shows little support for the race to the bottom view. Instead, it supports the view that hedge funds select jurisdictions where strategies and regulations are aligned to suit investor’s interests. We note that there have been no other studies of hedge fund forum shopping to date, and hence Part V.D. of this paper discussed possible caveats and extensions to the analysis provided in this paper.