

Hedge Funds-Impediments to Misconduct: An Alternative to the Proposed Hedge Fund Transparency Act

Jeffrey Gerber
University of Arizona

Neil Vance
University of Arizona

Nicole Pasteur
University of Arizona

Current hedge fund regulation fails to provide adequate impediments to corruption. Legislative proposals address this issue; yet previously proposed legislation has proven inadequate or failed to pass, leaving this \$2 trillion industry remains largely unregulated. Previously proposed legislation largely focused on registration requirements, and although these requirements demand attention, we propose a shift in the primary focus of hedge fund legislation to reporting requirements. The financial services industry carries significant impact on legislation getting passed in congress, thus for future legislation to successfully pass congress, it must encompass the perspectives of regulators as well as the financial services industry.

INTRODUCTION

Hedge funds compare to mutual funds in the way they pool together large funding amounts and make investments to meet investor objectives. However, since hedge funds evade many of the registration requirements imposed on mutual funds, they can be used to invest in alternative vehicles generally beyond the scope of mutual funds. While altering this investment ability would impact the most unique characteristic of hedge funds, changes in legislation are necessary in order to appropriately regulate a \$2 trillion industry (Devasabai, 2011).

The authors of this article propose making changes to hedge fund registration requirements, financial and performance reporting requirements, and the monitoring options to oversee hedge fund activities, with the ultimate goal of providing the foundation for a bill with the potential to successfully pass Congress. A primary focus when proposing such legislation is avoiding unnecessary regulatory measures; cumbersome regulations will not be followed.

The Hedge Fund Transparency Act of 2009 (HFTA) was proposed with a similar goal in mind: to create impediments for hedge fund misuse and misconduct. However, this bill stalled during committee stages of introduction. Whereas the HFTA primarily focused on registration requirements for hedge funds, the following proposed changes and additional measures for deterrents focus on hedge fund reporting requirements (*Hedge Fund Registration Bill Announced*, 2009). Simply increasing regulation by

means of registration requirements will not adequately circumvent the risks hedge funds create to the United States economy.

In this proposal, there are two focus areas for hedge fund reporting requirements:

- Designing a standard set of financial statement reporting guidelines, which the SEC then needs to be able to access
- Standardizing hedge fund performance metric reporting requirements to be made available for public

Implementing a standard set of reporting guidelines to combine with regular monitoring will create significant impediments to hedge fund misconduct while not being too cumbersome on hedge funds.

“Hedge fund is a general, non-legal term originally used to describe a type of private and unregistered investment pool employing sophisticated hedging and arbitrage techniques to trade in the corporate equity markets” (Ruiz-Carus, et.al., 2011). Today, a hedge fund is just one of many unique investment vehicles open to investors. Amidst the increasing incidences of hedge fund fraud however, there are arguments as to whether hedge funds have a place of in the financial services industry in the future.

As recent studies show, by the end of 2011, hedge funds are estimated to form a \$2.5 trillion worldwide industry and at about a 20% per year growth rate, with approximately 8,350 active hedge funds in the world (Devasabai, 2011). Illustrating this growth, Deutsche Bank’s 2011 Alternative Investment Survey reported more than 50% of surveyed investors increased hedge fund assets in 2010 and nearly 70% are predicting further inflows this year (Devasabai, 2011).

These statistics indicate large amounts of assets continuing to be placed within hedge funds in the midst of potential corruption, and understandably so. Aggregately, hedge funds’ earnings have outperformed indexes with less volatility and less risk than equities over sustained periods of time, making them attractive to investors. Therefore, focus has shifted from allowing hedge funds to exist, to how to properly regulate them.

With the hedge fund industry consisting of such large sums of assets, the potential for catastrophic damage to the overall financial market exists. Current Securities Exchange Commission regulations on hedge funds fail to provide adequate impediments to corruption. However, most proposed solutions create unnecessary obstacles for hedge funds and potentially minimize current benefits offered. Increased impediments are necessary while still enabling hedge funds to continue operating successfully.

This article proposes making changes to registration requirements of hedge funds and financial and performance reporting requirements, as well as monitoring options to oversee hedge fund activities. The ultimate goal of this proposal is to lay the foundation for a bill strong enough to pass Congress. As a benchmark, direct comparisons are made throughout the proposal to the Hedge Fund Transparency Act of 2009, which stalled in committee.

During the most recent State of the Union address, President Barack Obama pledged to eliminate unneeded regulations. Coinciding with his pledge, the purpose of proposed hedge fund requirements is not to create regulatory busywork, rather to avoid unneeded regulation through implementing deterrents and transparency within hedge funds and potentially develop arguments against current regulations. In a late study, Diane Vaughan found, “if regulations are too numerous, too complex, or too old, it could actually lead organizations to ignore them and intentionally break the law” (Vaughn, 1983). Furthermore, “it is more important to regularly update laws and regulations, as laws get outdated as times change.” Many steps can be taken to improve transparency without hindering performance or creating unnecessary tasks through regulation.

What Are Hedge Funds?

Referenced in the name, hedge funds were initially designed and became known for their ability to hedge against downturns in the overall market. In recent years, the term ‘hedge fund’ has become more broadly used to cover funds engaging in complex investment strategies.

Hedge funds compare to mutual funds in the way they pool together large funding amounts and make investments to meet investor objectives. One of the main distinctions between hedge funds and other investments is that “hedge funds offer their securities as private placements, on an individual basis, rather

than through public advertising, and need not register as securities issuers or publicly disclose their financial performance and asset positions” (Eichengreen, et.al., 1999).

Offering securities as private placements allows hedge funds to be “extremely flexible in their investment options because they use financial instruments generally beyond the reach of mutual funds, which have SEC regulations and disclosure requirements largely preventing them from using short selling, leverage, concentrated investments and derivatives” (*Hedge vs Mutual Funds*, 2011).

One popular misconception is that all hedge funds are volatile—that they all rely on risky techniques and strategies and place large bets on stocks, currencies, bonds, commodities and gold, while using heavy leverage (Ruiz-Carus, et.al., 2011). While hedge funds can potentially carry high risk, it is not an entirely systematic risk inherent to the entire market or an undiversified risk, to which most investment vehicles are linked. Different from other investment vehicles, less transparency and less stringent regulation requirements combined with the ability to invest in alternative investments create a large portion of the risk associated with hedge funds. To illustrate, Adam Sindler, fund manager of Exis Capital Management Inc., often purchases the artwork of “undervalued” artist. In comparison to typical equity investments, artwork is one of the alternative investments available to fund managers. Therefore, although the nature of the individual investments is potentially riskier, the main purpose of these investments is to hedge downside risks, reducing the overall systematic risk in the fund.

ECONOMIC IMPACT

Regulators, economists, and industry professionals all tend to agree that hedge funds can benefit the overall economy by mitigating significant price downturns, while taking on risks does not yield the same; these benefits are attributed to the relaxed regulations requirements imposed on hedge funds (Shadab, 2007). However, less regulation also creates significant economic concerns. Over the years, regulators have professed a lack of necessity for more rigorous investor-protection regulations affecting hedge funds because of the entry requirements to invest in hedge funds. While once reserved for wealthy individual investors, current investors have expanded to large pension funds and university endowments (“Sophisticated Investor”, 2000). Still, there is a widespread belief that qualified “sophisticated investors” have the ability to fend for themselves.

Typically, a qualified “sophisticated investor” must have either a net worth of \$2.5 million or have earned more than \$250,000 in the past two years to qualify to invest directly in hedge funds (“Sophisticated Investor”, 2000). Certain assumptions are attached to sophisticated investors: that they can hold their investments indefinitely (the funds do not need to be liquidated for cash needs), and they can assume a total loss of investment principal without causing severe damage to their overall net worth (“Sophisticated Investor”, 2000). Being considered a sophisticated investor and investing in assets generally considered risky in nature based on personal finances contributes to those assumptions. Whether or not they hold any truth, little evidence suggests a direct correlation between one’s net-worth and one’s investment knowledge. A loss of full investment can often prove just as financially fatal for wealthier investors as it is for general investors.

Sophisticated investors notwithstanding, the reality is that hedge funds control enormously large amounts of assets. They impact more than just hedge fund investors. As previously mentioned, hedge fund assets are anticipated to reach \$2.5 trillion by the end of 2011. Moreover, the hedge fund industry is very compact. As of January 1, 2011 the largest 225 hedge fund managers in the United States held a total of \$1.297 trillion (Allen, 2011). Additionally, hedge funds are predominately operated within the largest financial institutions in the world: the largest manager being JP Morgan Chase (\$53.5 billion), followed by Bridgewater Associates (\$43.6 billion), Paulson & Co. (\$32 billion), Brevan Howard (\$27 billion), and Soros Fund Management (\$27 billion) (Tausche, 2011). With the majority of industry assets heavily condensed within some of the largest financial institutions, impeding corruption becomes all the more pressing; these institutions are large enough to subvert an entire financial system and impact more than just funds’ investors. Yet, they remain essentially unregulated.

Legislation

Hedge funds are currently exempt from the registration and disclosure requirements of the SEC including the Securities Act of 1933, the Securities and Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 (Stoutenburg, et.al., 2009). By limiting the number of their beneficial owners and accepting funds only from investors of means, hedge funds qualify for the exclusions provided in Sections 80a-3(c)(1) and (7) of the Investment Company Act, and thus have not been subject to the Act and the SEC's statutory and regulatory requirements ("Hedge Fund Registration Bill Announced", 2009). Similar circumstances in other acts allow hedge funds to avoid additional regulatory requirements.

Despite these exemptions, hedge funds are subject to some government regulations. They must provide investors with information regarding their securities and activities through an offering memorandum and regularly audited financial statements; they are also subject to statutes governing fraud and other criminal activities including insider trading. However, these regulations alone are insufficient. Increased regulations are necessary to provide additional transparency into hedge funds and to deter deviance.

Previous bills have been passed in attempts to address this regulatory issue. In 2005, the SEC passed the "Hedge Fund Rule," requiring previously exempt fund advisors to register with the SEC under the Investment Advisor Act of 1940 (Securities and Exchange Commission, 2005). According to the SEC, mandatory registration was expected to have a number of benefits including serving as a deterrent to fraud (Ruiz-Carus, et.al., 2011). However, after a DC Circuit Court case ruled on the SEC's interpretation of the word "client", this group of fund managers was once again exempt (*Goldstein v. SEC*, 2007).

More recently, the Hedge Fund Transparency Act of 2009 was drafted to clarify the SEC's ability to require hedge fund registration, enabling the government to monitor their actions. It also aimed to remove ambiguities regarding the role and interpretation of an investment company.

Hedge Fund Transparency Act of 2009

In January 2009, Senator Chuck Grassley (R) of Iowa and cosponsoring Senator Carl Levin (D) of Michigan introduced the Hedge Fund Transparency Act (HFTA) which focused on clarifying current laws while removing, reiterating, and further reinforcing the Securities and Exchange Commission's authority to require hedge funds to register. Senator Grassley Stated

a major cause of the current crisis is a lack of transparency. The wizards on Wall Street figured out a million clever ways to avoid the transparency sought by the securities regulations adopted during the 1930s. Instead of the free flow of reliable information that markets need to function properly, today we have confusion and uncertainty fueling an economic crisis.

Senator Levin further noted, "hedge funds control massive sums of money, and although they can cause serious damage to investors, other financial firms and to the entire U.S. financial market, they are largely unregulated," said Levin.

If the events of the last year (2009) have taught us anything, it's that we need to regulate firms that are big enough to destabilize our economy if they fail. It's time to subject financial heavyweights like hedge funds to federal regulation and oversight to protect our investors, markets, and financial system.

The HFTA's purpose for introduction, among others, was to require hedge funds to register with the SEC ("S. 344--111th Congress: Hedge Fund Transparency Act", 2009). Included in the Act are amendments to the Investment Company Act of 1940 (ICA), alterations of language to include hedge funds under the definition of an investment company, as well as registration and reporting requirements resulting from the qualification.

The HFTA, like many other proposed bills aimed at deterring hedge funds from unscrupulous behavior, centered on the principle of registering hedge funds under the ICA. Uniquely, the HFTA proposed that many current exceptions within the ICA be removed and transformed to exemptions

(Sidley, 2009). Additionally, the bill proposed the following requirements to be met in order to maintain exemption:

1. Registering with the SEC.
2. Maintaining books and records that the SEC may require.
3. Cooperating with any request by the SEC for information or examination.
4. Filing an information form with the SEC electronically, at least once a year. This form must be made freely available to the public in an electronic, searchable format. The form must include:
 - a. The name and current address of each individual who is beneficial owner of the investment company.
 - b. The name and current address of any company with an ownership interest in the investment company.
 - c. An explanation of the structure of ownership interests in the investment company.
 - d. Information on any affiliation with another financial institution.
 - e. The name and current address of the investment company's primary accountant and primary broker.
 - f. A statement of any minimum investment commitment required of a limited partner, member, or investor.
 - g. The total number of any limited partners, members, or other investors.
 - h. The current value of the assets of the company and the assets under management by the company.

Since its introduction as a bill in 2009 and referral to the committee of Senate, Banking, Housing and Urban Affairs, no further advancement occurred. Consequently, because the bill was introduced in a previous session of congress, no further action can be taken. Potential factors including the shift in congressional political party power, the War on Terrorism, financial and economic instability, and a other highly disputed bills, may have overshadowed the HFTA bill. It is also possible that the HFTA was not voted out of committee due to vigorous lobbying by the financial services industry.

Recently, bills related to HFTA have been proposed to Congress including the Hedge Fund Study Act, the Private Fund Transparency Act of 2009, and the Private Fund Investment Advisors Registration Act of 2009. Similarly, none of these bills were successful in obtaining a House vote.

PROPOSAL

The purpose for this proposal is to amend the HFTA and provide additional measures for deterrents, in order to increasing the likelihood of a similar bill passing in Congress.

Many of the proposed HFTA impediments will increase hedge fund transparency. However, some of the HFTA measures have the potential to negatively impact the investment nature and value of hedge funds. Additionally, rather than solely focusing on registration requirements, emphasis needs to be placed on reporting requirements.

Simply increasing regulation or increasing the number of regulators will not successfully circumvent hedge funds risks to the United States economy. Rather, a more suitable option is found in updating and changing regulations in an effort to increase levels of transparency within hedge funds and create deterrents for corruption.

The Securities Acts of 1933 and 1934 emphasized transparency when creating regulations for the stock market (The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, 2011). Many variables have changed since these Acts were originally implemented. Certain aspects of current legislation have become outdated and ambiguities now exist. This results in firms having the ability to dodge and circumvent current legislation, leading to a lack of transparency. Updating legislation will return transparency standards to acceptable levels.

Registration Requirements

The HFTA proposes requiring hedge funds to register with the SEC. Enforcing this requirement, in addition to changing some exceptions to exemptions within the ICA, has merit; however, conflict arises with some of the proposed terms of registration.

In the HFTA, one requirement to qualify for the proposed ICA exemptions includes filing a publically searchable form with the SEC. Of the proposed requirements, making public all the names of beneficial owners as well as the names of companies with an ownership interests in the fund is unnecessary. Rather, value lies in disclosing only the names of the largest beneficial owners, similar to publically traded companies.

In agreement with HFTA, necessary reporting requirements under the ICA include a high level structure of ownership interests in the fund, the number of owners, and the amount of assets the fund manages as well as the current market value of the assets. This enables potential investors to identify how the company is constructed and their position within the fund.

Reporting Requirements

The HFTA appropriately proposes that hedge funds maintain accessible financial books and records while cooperating with any request from the SEC for information or examination. However, there are two aspects to further address regarding accessibility: first, hedge funds need to have a standard set of financial statement reporting guidelines, to which the SEC needs access; second, hedge funds need to have a standard set of performance metric reporting requirements made available to the public.

Financial Statement Reporting Guidelines

The Generally Accepted Accounting Principles (GAAP) are in place, providing publically traded companies standards for reporting financials. In a likeness to the GAAP, a smaller set of guidelines needs to be created, providing a framework for hedge fund reporting. The standards need to address what type of information and the guidelines for which it must be presented. These principles will help to harmonize how hedge funds report their financial statements, creating industry-wide consistency. This will help deter funds from misstating financials.

This adjustment will take minimal additional efforts and will entail a shallow learning curve with insignificant implementation costs. While a standard set of financial statement principles will create little inconvenience for hedge funds, it will enhance the SEC's ability to monitor performances and behaviors and in turn, benefit investors.

Reporting to Investors

A standard set of metrics will enable investors to gain further insight into their investment performance. Additionally, a standard metric system provides investors an increased level of transparency, creating higher confidence levels when investing.

Currently, hedge funds choose what to report to investors. Typically a hedge fund will report returns, NAV, incentive and management fees, as well as the inception date. A study was done on two major databases containing hedge fund data noting that 465 common funds had significant differences in reported information (e.g. returns, inception date, net assets value, incentive fee, management fee, investment styles, etc.), and that 5% of return numbers and 5% of NAV numbers were dramatically different (Liang, 2000). Depicting the truth about fund performance with conflicting reporting data presents an obvious complication. A standardized set of reporting metrics combined with standard financial statement reporting will remove these discrepancies.

Position Reporting

While the HFTA offers some hedge funds exemptions to avoid registration with the ICA, many alternative proposals lack such exemptions. Additionally, if a hedge fund does not qualify for such exemptions under the HFTA, they are subject to ICA registration. Such registration would expose hedge funds to the position reporting requirements of the ICA.

Currently, position-reporting requirements are one of the most significant differences between hedge funds and mutual funds. Mutual funds are directly regulated by the ICA while hedge funds have been able narrowly escape the definition of an investment company, thus avoiding consequential regulations. Therefore, many believe if the ICA governs hedge funds, fund managers will be deterred from corruption by increased transparency into their holdings.

In terms of reporting, mutual funds are required to publically report holdings on a quarterly basis, to allow investors to make informed decisions on future investments within the fund. While this assists investors of mutual funds in making informed decisions, the nature of investments within hedge funds prevents this type of reporting requirement from being an acceptable solution. Current ICA reporting requirements would potentially have a negative impact on a hedge funds' ability to perform. Although this information should arguably be accessible by the SEC, thereby increasing transparency into the hedge fund, the information need not be made publically available. Limited information can be made public before there are direct impacts on the fund itself, a stock, or the market entirely.

Furthermore, the nature of investments within hedge funds is not suitable for quarterly reporting requirements. For instance, hedge fund investments may consist of both very drastic short-term movements, which level out over time, as well as investments that lack short-term volatility. Within mutual funds, there are consistencies across their classes of investments; therefore, quarterly results give accurate depictions. In the case of hedge funds, too frequent reporting can cause investor confusion.

Lastly, requiring hedge funds to report their holdings is not feasible. If a hedge fund were to report a largely concentrated short position in a company, it will immediately impact the movement of the company's stock. The market will react to the news and directly impact the fund's returns. For example, the European Union has a proposed regulation on short-selling that would require fund managers to publicly disclose net short positions above 0.5% of the share capital of companies trading on a European investment venue (Canada's Regulation Plans Repeal of Short Selling Restrictions, 2009). Such regulations create additional uncertainty and result in widened bid-ask spreads. It also increases the likelihood of short squeezes, creating artificial run-ups in prices to cover losses. In the United Kingdom, a similar rule was implemented. The direct result was a 13% drop in volume and bid-ask spreads widening by 45% (Block, 2010). This evidence shows the implementation of such reporting requirements is not the answer.

Regarding positions reporting, the United States can learn from others' mistakes and abstain from this type of unnecessary regulation. Increasing transparency by requiring reporting of individual positions is not a suitable option for hedge funds.

Monitoring

The HFTA did not directly focus on the monitoring of hedge funds, a facet that was either omitted or simply overlooked. However, including a provision regarding increased monitoring will significantly deter potential corruption.

The Sarbanes-Oxley Act of 2002 (SOX) was passed to increase reporting and auditing practices for publically traded companies. The main focus of the act is to protect investors by creating elements of situational prevention. Although a few methods have been previously addressed, additional auditing practices need to be installed to monitor hedge funds. This is the most imposing step of the proposed recommendations on hedge fund regulations.

The proposed guidelines for reporting financial statements simplify the auditing process of hedge funds and requiring an SEC auditor to perform auditing tasks. Currently, an independent auditor monitors hedge funds, similar to other companies. The case of Arthur Anderson with Enron as their client highlights an unfavorable outcome. Over time, Arthur Anderson became so reliant on Enron that the firm took all steps necessary to retain their client. In this case, misconduct was rewarded. Comparably, small hedge fund auditors likely become so heavily reliant on a fund, scenarios for situational misconduct are created. Requiring the SEC to perform auditing will add an additional level of scrutiny on funds and prevent an overreliance by auditors.

CONCLUSION

Within the United States, it has been difficult to reach an agreement on the estimates in value to deterrence in the case of weapons of mass destruction. It is simply easier to justify expenditures in reaction to an event, rather than to find the political will to prevent future occurrences. The same holds true regarding financial regulation. However, since the recent collapse of the financial system, an opportunity has arisen to make significant changes and return financial transparency to its intended levels, while increasing additional deterrents to prevent financial corruption.

Little has changed as a result of the recent financial crisis, in neither banking nor its regulations. As the financial crisis nears end and with the U.S. economy on the slow steps to recovery, the federal government stands to miss out an opportunity to employ needed reforms to current hedge fund legislation and regulation. As the stock market continues its climb to prior crisis levels, a lesser need for change will be seen.

An updated version of the HFTA bill needs to be enacted during the current session of congress. Recognizing the constructive measures proposed in the HFTA of 2009, changes to the current legislation make it less intrusive and add measures regarding monitoring and reporting, in an effort to provide both the necessary level of transparency and increased deterrents for corruption. Applying these measures will help ensure the next major financial crisis is not caused by the \$2.5 trillion hedge fund industry. Rather, hedge funds will aid in stabilizing the economy in the event of a future downturn, as they were originally intended.

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