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If You Only Knew the Power of the Dark Side: An Analysis of the One-Sided Long Position Hedge Fund Public Disclosure Regime and a Call for Short Position Inclusion

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If You Only Knew the Power of the Dark Side: An Analysis of the One-Sided Long Position Hedge Fund Public Disclosure Regime and a Call for Short Position Inclusion*

Christian Bonser

Abstract

Disclosure rules in the United States capital markets were designed to promote fairness among all participants by providing a transparent system for equal access to information. The interpretation of information is the foundation of all prudent investment decisions; thus, an efficient capital market depends on the proper disclosure of information. Hedge funds heavily influence and play an integral role in the proper functioning of capital markets. For the markets' benefit, hedge funds must publicly disclose their investing activity, which consists of long positions, like buying stock to sell later, and short positions, like short selling.

However, while hedge funds are obligated to disclose their long positions on Form 13F, there is no equivalent obligation to disclose short positions. Due to this "long-only" disclosure regime, the publicly available information is distorted and the marketplace lacks full and fair information. As a result, market participants and regulators are making important decisions based on misleading information, and the capital markets are left ripe for fraudulent and manipulative practices.

This Article advocates for an expanded disclosure regime that includes the disclosure of both long and short positions. A balanced disclosure mandate will optimize the functioning of capital markets by reducing informational asymmetry, fraud, manipulation, and systemic risk while promoting liquidity, efficiency, accurate pricing, and effective capital allocation.

KEYWORDS: Hedge Fund, Disclosure, Financial Markets

*J.D., Fordham University School of Law, 2016; M.B.A., Gabelli School of Business, Fordham University, 2016; B.S. Accounting & Finance, Florida State University, 2013. I would like to express my sincere gratitude to Professor Caroline Gentile for her tremendous guidance and support in writing this Article. I appreciate the helpful comments from the editors of the Fordham Journal of Corporate & Financial Law. This Article would not have been possible without the love and encouragement of my family and friends.

IF YOU ONLY KNEW THE POWER OF THE DARK SIDE: AN ANALYSIS OF THE ONE-SIDED LONG POSITION HEDGE FUND PUBLIC DISCLOSURE REGIME AND A CALL FOR SHORT POSITION INCLUSION

*Christian Bonser**

Disclosure rules in the United States capital markets were designed to promote fairness among all participants by providing a transparent system for equal access to information. The interpretation of information is the foundation of all prudent investment decisions; thus, an efficient capital market depends on the proper disclosure of information. Hedge funds heavily influence and play an integral role in the proper functioning of capital markets. For the markets' benefit, hedge funds must publicly disclose their investing activity, which consists of long positions, like buying stock to sell later, and short positions, like short selling. However, while hedge funds are obligated to disclose their long positions on Form 13F, there is no equivalent obligation to disclose short positions. Due to this "long-only" disclosure regime, the publicly available information is distorted and the marketplace lacks full and fair information. As a result, market participants and regulators are making important decisions based on misleading information, and the capital markets are left ripe for fraudulent and manipulative practices. This Article advocates for an expanded disclosure regime that includes the disclosure of both long and short positions. A balanced disclosure mandate will optimize the functioning of capital markets by reducing informational asymmetry, fraud, manipulation, and systemic risk while promoting liquidity, efficiency, accurate pricing, and effective capital allocation.

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INTRODUCTION

Capital markets have many working parts, all of which play an integral role in promoting the market's efficiency, fairness, and general ability to function. In a capital market, companies issue securities in the form of stocks and bonds to raise capital to fund their businesses. Investors buy and sell those stocks and bonds to generate profit. Long position investing, the most fundamental type of investment, occurs when an investor buys a security, holds it for a period of time, and then sells it. Another type of investment, called short selling, involves borrowing a security and subsequently selling it on the open market in the hopes that the security's value declines. If and when the security's value declines, the borrower buys the same security on the open market for the reduced price and returns it to the lender, resulting in the borrower profiting on the spread between the price at the time the security was borrowed and sold, and the price when the security was purchased on the market.¹ Short selling accounts for over 25% of all capital market trading.² In a market that promotes the free flow of security purchases and sales, both in the form of long positions and short positions, the prices of those securities will be accurate and capital allocation will be optimized.

However, markets do not always have accurate pricing and effective capital allocation, especially those markets that restrict the free flow of transactions. The symptoms of a poorly functioning financial market include ineffective price discovery and inadequate liquidity. In times of turmoil, like a recession or depression, those symptoms are exacerbated to a point where pricing is either inaccurate or nonexistent, and liquidity is similarly reduced or nonexistent. Moreover, systemic risk, the risk of one isolated negative event causing a chain reaction of negative events throughout the market, has the effect of magnifying those already exacerbated symptoms, and potentially spreading those symptoms to other markets.

Hedge funds are the most important market participants for promoting efficient price discovery and liquidity, as well as reducing

1. See Coal. of Private Inv. Cos., *Investment Strategies*, HEDGE FUND FACTS (2009), <http://www.hedgefundfacts.org/hedge/about-hedge-funds/investment-strategies/> [<https://perma.cc/8ZJU-79VF>]; Coal. of Private Inv. Cos., *Setting Policy*, HEDGE FUND FACTS (2009), <http://www.hedgefundfacts.org/hedge/setting-policy/> [<https://perma.cc/Z4FC-4TS4>].

2. See Jenny Anderson, *A New Wave of Vilifying Short Sellers*, N.Y. TIMES (Apr. 30, 2008), <http://www.nytimes.com/2008/04/30/business/30shorts.html> [<http://perma.cc/F4PM-HEHB>].

systemic risk. As this Article explains, hedge funds constantly trade massive amounts of capital with a multitude of counterparties from all industries. Hedge funds are notorious for trading in areas that are often avoided by other market participants. Short selling is an essential tool employed by hedge funds to carry out their strategies. By utilizing short selling, hedge funds not only play a key role in maintaining a functional market, but also help to revive and restore a market that is not functioning optimally. Moreover, a market that restricts hedge funds' ability to take short positions will almost surely suffer from the symptoms of a dysfunctional financial system.

From 2007 till 2009, a credit and liquidity crisis tore through the economy, both in the United States and around the globe, resulting in the worst economic downturn since the Great Depression.³ Financial institutions became insolvent and some even went bankrupt: JPMorgan Chase & Co. acquired Bear Stearns in March 2008 at a fraction of its peak market cap over the prior year; Lehman Brothers filed for Chapter 11 bankruptcy protection in September 2008; and Bank of America purchased Merrill Lynch & Co. in September 2008, also at a deep discount.⁴ As financial institutions rapidly collapsed, banks grew more and more hesitant to lend to one another, the London Interbank Offered Rate ("LIBOR") and Treasury security interest rates spread further apart, and risk premiums for debt increased markedly.⁵ Across the world, market liquidity deteriorated precipitously, and in many cases, froze altogether.⁶

On July 15, 2008, the Securities and Exchange Commission ("SEC"), in an attempt to slow the downward spiral of liquidity, issued an emergency order to halt a popular form of short selling—termed "naked shorting"—on the stocks of 799 independent financial institutions.⁷ Naked shorting is the practice of selling short a security that

3. *See id.*

4. *See The Financial Crisis: Full Timeline*, FEDERAL RESERVE BANK OF ST. LOUIS, <https://www.stlouisfed.org/financial-crisis/full-timeline> [<http://perma.cc/QW2M-GGRD>].

5. *See* Coal. of Private Inv. Cos., *Credit Crisis*, HEDGE FUND FACTS (2009), <http://www.hedgefundfacts.org/hedge/about-hedge-funds/credit-crisis-2/> [<http://perma.cc/XB36-5VL2>].

6. *See id.*

7. Press Release, Sec. & Exch. Comm'n, SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets (Sept. 19, 2008), <http://www.sec.gov/news/press>

the seller neither owns, borrows, nor even attempts to borrow.⁸ The SEC justified its order by claiming the ban would instill confidence in the financial markets⁹ and would “enhance investor protection.”¹⁰ However, it is largely undisputed that short selling provides many benefits to the markets, most of which are particularly important in times of financial distress.

It was therefore counterintuitive for the SEC to prohibit one of the only remaining tools that could mitigate the financial crisis. The SEC’s short selling ban was particularly perplexing, given that the SEC has historically recognized short selling as a practice that promotes the health and efficiency of financial markets.¹¹ In fact, the SEC’s penultimate attempt to protect the markets through short selling restrictions resulted in a decline in share prices.¹² New York hedge fund manager Whitney Tilson pronounced the ban a “desperation move” akin to “grasping at straws” in the hopes of saving the stocks of major United States financial institutions.¹³ Another hedge fund manager, Jim Chanos, commented that “[i]nvestors are best served when they can hear both the reasons to buy and the reasons to sell any given security,” and accordingly, “[t]hese emergency orders limit the free flow of information and ultimately will not work to help the United States maintain the freest, strongest and most liquid capital markets in the world.”¹⁴

In one well-regarded empirical study, the stock performances of a group of nineteen of the world’s most prominent financial institutions (“G19”) were analyzed to determine the efficacy of the SEC’s short

/2008/2008-211.htm [https://perma.cc/WYX3-WVXT]; ARTURO BRIS, *SHORT SELLING ACTIVITY IN FINANCIAL STOCKS AND THE SEC JULY 15TH EMERGENCY ORDER 2* (2008).

8. Kara Scannell & Jenny Strasburg, *SEC Moves to Curb Short-Selling*, WALL ST. J. (July 16, 2008, 12:01 AM), <http://www.wsj.com/articles/SB121614248005255151> [http://perma.cc/9XYC-YGJ3].

9. See Press Release, Sec. & Exch. Comm’n, *SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets* (Sept. 19, 2008), <http://www.sec.gov/news/press/2008/2008-211.htm> [https://perma.cc/WYX3-WVXT].

10. Bris, *supra* note 7, at 2; see Press Release, Sec. & Exch. Comm’n, *SEC Enhances Investor Protections Against Naked Short Selling* (July 15, 2008), <https://www.sec.gov/news/press/2008/2008-143.htm> [https://perma.cc/4DUX-YSMJ].

11. See Vikas Bajaj & Graham Bowley, *S.E.C. Temporarily Blocks Short Sales of Financial Stocks*, N.Y. TIMES (Sept. 19, 2008), <http://www.nytimes.com/2008/09/20/business/20sec.html> [https://perma.cc/TKZ2-P5UJ].

12. See *id.*

13. Scannell & Strasburg, *supra* note 8.

14. Bajaj & Bowley, *supra* note 11.

selling ban.¹⁵ The study found that, as a result of the ban, the G19 stocks performed significantly worse than comparable stocks in the ban period.¹⁶ The study concluded that the “lower market quality of the G19 stocks [was] not caused by short-selling activities”; that “the G19 stocks . . . suffered a significant reduction in intra-day return volatility and an increase in spreads, which suggests a deterioration of market quality”; and that “market efficiency . . . declined overall after the [short selling ban became] effective.”¹⁷

This Article argues that the current disclosure regime, particularly as it pertains to the disclosure of short positions, perpetuates widespread secrecy and misinformation, which ultimately leads to scenarios like the SEC’s imprudent short selling ban. Much about short selling, such as the volume of short sales, the size of the aggregate short selling exposure, and the identity of short sellers remains a mystery due to inadequate disclosure mandates. In fact, hedge funds, which are among the most frequent short sellers, are only required to publicly disclose their long positions despite short positions making up an essential part of their trading.¹⁸

This Article proposes that by expanding the current hedge fund public disclosure obligations to include both long positions and short positions, much of the opacity and misinformation that is prevalent in the market today will be eradicated. By eliminating this uncertainty, market participants and regulators will be able to make decisions and act on a balanced information set. Hopefully, such a symmetrical underlying information set will deter misinformed decision-making, like the SEC’s ban on short selling, and instead facilitate the free flow of securities, thereby rejuvenating and optimizing the functionality of the financial markets.

This Article proceeds in three parts. Part I discusses hedge funds and the ways in which they utilize short selling, and then describes the role of disclosure and its application to hedge funds. Part II presents the inadequacies of and resultant harms caused by the current disclosure regimes. Part III describes the author’s proposal to compel public disclosure of short positions in an effort to promote market efficiency, price discovery, liquidity, and reduce systemic risk.

15. See Bris, *supra* note 7, at 2.

16. See Bris, *supra* note 7, at 2, 5-6.

17. Bris, *supra* note 7, at 3, 5-6.

18. See SEC. & EXCH. COMM’N, FORM 13F.

I. HEDGE FUNDS AND THE ROLE OF DISCLOSURE

This part begins by introducing hedge funds through the exploration of their structures and the ways in which they implement short selling into their strategies. This part then examines how disclosure is integral to the protection of investors and the financial system, and presents the current disclosure mandates applicable to hedge funds in the United States and the European Union (“EU”). It concludes by analyzing the effects of the EU’s implementation of short position disclosure on the markets.

A. HEDGE FUNDS

1. *Hedge Fund Primer*

The term “hedge fund” generally refers to a pooled alternative investment vehicle that is professionally managed and whose investors are of the highest sophistication.¹⁹ A hedge fund’s ultimate goal is to generate positive returns, limit volatility, and protect its investors’ capital.²⁰ Compared to a mutual fund whose investment prospects are legally limited to mostly diversified long positions on equities, bonds, and cash, a hedge fund can trade derivatives, utilize leverage, invest in illiquid assets, concentrate its investment portfolio, and take on much more risk through both long and short positions.²¹ Historical hedge fund performance has shown that hedge funds are particularly stable during market downturns, as witnessed during the 2008 United States financial crisis when hedge fund losses were less than half of those suffered by the market as a whole.²² The size of the hedge fund industry is enormous, with over ten thousand active hedge funds collectively managing in excess of \$3 trillion in assets.²³

19. See COAL. OF PRIVATE INV. COS., *THE BASICS OF HEDGE FUNDS* (2009), http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/08/The_Basics.pdf [<http://perma.cc/UJ4J-UX2G>].

20. See *id.*

21. Coal. of Private Inv. Cos., *Benefits*, HEDGE FUND FACTS (2009), <http://www.hedgefundfacts.org/hedge/about-hedge-funds/benefits/> [<http://perma.cc/7CQ7-3247>].

22. See COAL. OF PRIVATE INV. COS., *FACTS ABOUT HEDGE FUNDS* (2009), <http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/08/Facts.pdf> [<https://perma.cc/7YC3-47A2>].

23. Luther R. Ashworth II, *Is Hedge Fund Adviser Registration Necessary to Accomplish the Goals of the Dodd-Frank Act’s Title IV?*, 70 WASH. & LEE L. REV. 651,

The hedge fund adviser and the investors are the two main parties in the hedge fund structure.²⁴ The adviser is responsible for developing investment strategies, managing the fund's portfolio holdings, as well as making day-to-day decisions about the fund's operations.²⁵ Although compensation structures may vary from fund to fund, the adviser is typically compensated through two fees: the assets under management fee and the performance fee.²⁶ The most common fee structure is the "2 and 20," whereby an adviser is compensated with 2% of the dollar amount of assets that the fund is managing, as well as 20% of the overall profit in a given term.²⁷ Performance fees are well-regarded in the industry because the adviser only receives compensation if the fund makes a profit; accordingly, the interests of the adviser and the investor are aligned.²⁸

The type of person or entity that can invest in hedge funds is restricted primarily by the Investment Company Act of 1940 ("ICA"), which requires registration of investment companies unless the fund qualifies for an exemption.²⁹ Sections 3(c)(1) and 3(c)(7) of the ICA provide for exemptions from registration so long as the fund's investors are from the United States and are either "accredited investors" or "qualified purchasers," respectively.³⁰ To qualify for registration exemption under Section 3(c)(1), the fund can sell its shares only privately and to no more than 100 investors. Nevertheless, the fund may still qualify for the exemption if it sells its shares to more than 100 investors, so long as those investors are deemed accredited investors, which include institutional investors, such as banks, pension funds, and

657 (2013); Al Lewis, *The Systemic Risk of Hedge Funds*, WALL ST. J. (Apr. 19, 2014, 8:25 PM), <http://www.wsj.com/articles/SB10001424052702303626804579505673648422470> [<http://perma.cc/P476-TBGT>].

24. See Coal. of Private Inv. Cos., *Structure*, HEDGE FUND FACTS (2009), <http://www.hedgefundfacts.org/hedge/about-hedge-funds/structure/> [<http://perma.cc/D7N5-XBXC>] for an elaboration on the operational structure of a hedge fund.

25. See *id.*

26. See *Hedge Fund Advisor*, MANAGED FUNDS ASSOCIATION (2016), <https://www.managedfunds.org/hedge-fund-investors/faqs/hedge-fund-advisor/> [<http://perma.cc/D7N5-XBXC>].

27. See *id.*; *Two and Twenty*, INVESTOPEDIA, http://www.investopedia.com/terms/t/two_and_twenty.asp [<https://perma.cc/68YF-ZQ6H>] (last visited May 21, 2017).

28. See *id.*

29. See 15 U.S.C. §§ 80a-3(c)(1), (7); MANAGED FUNDS ASSOCIATION, *supra* note 26.

30. 15 U.S.C. § 80a-3(c)(1), (7).

endowments, as well as individual persons who have a net worth of at least \$1 million or individual income exceeding \$200,000 or joint income exceeding \$300,000 in each of the prior two years.³¹ Alternatively, to qualify for registration exemption under Section 3(c)(7), the fund can sell its shares only privately, and each investor in the fund, at the time the shares were acquired, must be a qualified purchaser, which includes certain family owned companies, qualifying trusts, institutional investors, as well as any natural person who owns, together with their spouse, at least \$5 million in investments.³²

Generally, hedge funds adhere strictly to the investor limitations because there are a multitude of additional burdens if registration under the ICA is triggered. This results in a significant reduction in the prospective overall investor pool. For example, only about 8.5% of households in the United States qualify to invest in hedge funds.³³ More than 70% of a hedge fund's investors are made up of funds of hedge funds,³⁴ private and public pension funds, endowment plans, and family offices.³⁵

Despite these investor limitations, hedge funds provide a multitude of benefits to the financial system and its participants, and "their importance has been acknowledged by the President's Working Group on Financial Markets, the Commodities Futures Trading Commission, the Securities and Exchange Commission, two chairs of the Federal Reserve Board, and Members of Congress."³⁶ Primarily, hedge funds improve liquidity and price efficiency in the markets, while reducing risk and facilitating global market integration.³⁷ Hedge funds enhance liquidity and efficiency through active trading in a wide variety of market sectors.³⁸ A hedge fund's presence is most influential in illiquid markets, i.e.,

31. 15 U.S.C. § 80a-3(c)(1); 17 C.F.R. §§ 230.500-230.508; MANAGED FUNDS ASSOCIATION, *supra* note 26.

32. See 15 U.S.C. § 80a-3(c)(7); MANAGED FUNDS ASSOCIATION, *supra* note 26.

33. Todd Zaun, *Goldstein v. Securities and Exchange Commission*, 1 PEPP. J. BUS. ENTREPRENEURSHIP & L. 111, 130 (2007).

34. Funds of hedge funds are investment funds that invest in a group of hedge funds.

35. See Coal. of Private Inv. Cos., *Institutional Investors*, HEDGE FUND FACTS (2009), <http://www.hedgefundfacts.org/hedge/statistics/institutional-investors/> [<http://perma.cc/ES6Y-XCNV>].

36. Coal. of Private Inv. Cos., *supra* note 21.

37. COAL. OF PRIVATE INV. COS., REFORMING HEDGE FUND REGULATIONS: THE WAY FORWARD 2 (2009), http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/08/The_Way_Forward.pdf [<https://perma.cc/56ZQ-RYUZ>].

38. See Coal. of Private Inv. Cos., *supra* note 21.

markets that are less actively traded in and where trading securities have high transaction costs and a wide bid-ask spread.³⁹ In an illiquid market, hedge funds are willing to make long and short trades where others would steer clear.⁴⁰ This increase in trading volume helps to provide liquidity and increase price accuracy for those nontraditional assets that would otherwise be impossible to value.⁴¹ A study by the Federal Reserve Bank of Cleveland concluded that hedge fund shorting strategies, in particular, significantly reduce price volatility because the strategies usurp traditional buy-and-hold market sentiments.⁴² The study also concluded that such shorting strategies help to prevent asset bubbles, rather than contribute to them.⁴³

2. Hedge Fund Strategies Involving Short Selling

This part of the Article aims to demonstrate the importance and prevalence of short selling in hedge fund trading, which reinforces this Article's position that the current "long-only" disclosure regime is incomplete and ineffective, and therefore, in need of reform. Accordingly, this part begins by defining the terms "hedging," "speculation," and "leverage," and follows with examples of some of the most common hedge fund investment strategies in order to shine light on the fundamental necessity of short selling for hedge funds. Then, select malevolent hedge fund strategies involving short selling will be discussed to show how the current disclosure regime can be exploited to the detriment of investors and the financial system as a whole.

39. See Campbell R. Harvey, *Illiquid Definition*, NASDAQ, <http://www.nasdaq.com/investing/glossary/i/illiquid> [<https://perma.cc/Z9EF-7RMU>] (last visited Oct. 29, 2016).

40. See Ashworth II, *supra* note 23, at 661; Coal. of Private Inv. Cos., *supra* note 21.

41. See Ashworth II, *supra* note 23, at 661.

42. See Coal. of Private Inv. Cos., *supra* note 21; WILLIAM P. OSTERBERG & JAMES B. THOMSON, *THE TRUTH ABOUT HEDGE FUNDS* (1999), <https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/economic-commentary-archives/1999-economic-commentaries/ec-19990501-the-truth-about-hedge-funds.aspx> [<http://perma.cc/72JU-YEP3>].

43. See Coal. of Private Inv. Cos., *supra* note 21; see also OSTERBERG & THOMSON, *supra* note 42.

a. Hedging, Speculation, Leverage, and the Widespread Use of Short Selling

Hedging, as it pertains to financial market investment, is the practice of trading a security while also placing a corresponding trade that helps to offset a potential loss.⁴⁴ Hedging can be thought of as an insurance policy whereby you forfeit some upside gain in return for protection from downside losses.⁴⁵ How much an investor wants to hedge will likely depend on its unique risk tolerance and investment objectives.⁴⁶ A perfect hedge would be one where the hedge is 100% inversely correlated to the position, and thus all risk in a position is eliminated.⁴⁷ A hedged trade would look like coupling a purchase of one share of Apple in the hopes that its market price increases with selling short one share of Microsoft as the hedge. This trade is hedged because Apple and Microsoft are in the same industry; if the entire industry loses value, you lose on the Apple purchase but gain on the Microsoft short sale. Conversely, if the entire industry experiences an uptick, you lose on the Microsoft short sale but gain on the Apple purchase. Depending on how much one wants to hedge, one could modify the investment by, say, purchasing two shares of Apple yet selling short only one share of Microsoft.

Speculation, as it pertains to financial market investment, is the practice of trading a security with the expectation of substantial gain, but without protection from substantial loss.⁴⁸ The key motivation for a speculative trade is that the value attributed to the potential gain is higher than the negative value attributed to the potential loss.⁴⁹ Speculation differs from gambling because the former is akin to a calculated risk, while the latter is dependent on pure chance.⁵⁰ A speculative trade would look like buying a share of Apple and hoping its market price increases or shorting a share of Apple and hoping its market price decreases, but without executing a corresponding hedge trade in either case.

44. See Coal. of Private Inv. Cos., *Investment Strategies*, *supra* note 1.

45. See *Hedge Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/h/hedge.asp> [<https://perma.cc/SQC7-CB2N>] (last visited Oct. 29, 2016).

46. See *id.*

47. See *id.*

48. See *Speculation Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/speculation.asp> [<http://perma.cc/8A2Q-YDRQ>] (last visited Oct. 29, 2016).

49. See *id.*

50. See *id.*

What separates hedging from speculation is leverage, which is the use of borrowed money or other financial instrument to increase the potential return on an investment.⁵¹ Leverage is used because it can magnify returns if the investment moves in the investor's favor; however, it can also magnify losses if the investment moves against the investor.⁵² For instance, let us assume that in case "X," Apple's stock price rises from \$100 to \$150, and in case "Y," Apple's stock price falls from \$100 to \$50. In case X without the use of leverage, the investor simply invests \$100 and receives \$150, resulting in a 50% return. In case X with the use of leverage, let us assume that the investor invests \$50 of its own money, and borrows the other \$50. Here, the investor invests \$50, receives \$150, pays back the \$50 borrowed, and is left with \$100, resulting in a 100% return. Conversely, in case Y without the use of leverage, the investor invests \$100 and receives \$50, resulting in a negative 50% return. In case Y with the use of leverage, let us assume again that the investor invests \$50 of its own money, and borrows the other \$50. Here, the investor invests \$50, receives \$50, pays back the \$50 borrowed, and is left with \$0, resulting in a negative 100% return. Accordingly, the use of leverage can drastically increase return on investment in the bull case, but can also greatly decrease the return on investment in the bear case.

Hedge funds use a combination of hedging, speculation, and leverage, although speculation is used much more sparingly.⁵³ In fact, around 72% of hedge funds utilize leverage, yet given the magnified risks, only about 20% of hedge funds have leverage ratios above 2:1.⁵⁴ It follows that it is vital for hedge funds to use short selling to protect their investments from downside losses, especially when leverage is employed.

The most fundamental trading strategy employed by hedge funds is the equity long/short. The first modern-day hedge fund, formed by Alfred Winslow Jones in 1949, employed the equity long/short strategy to hedge against market risks by offsetting depreciations in long (short) position

51. See Coal. of Private Inv. Cos., *Investment Strategies*, *supra* note 1; *Leverage Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/leverage.asp> [<http://perma.cc/UH4Z-UP4J>] (last visited Oct. 29, 2016).

52. See INVESTOPEDIA, *supra* note 51.

53. Coal. of Private Inv. Cos., *supra* note 21.

54. See Coal. of Private Inv. Cos., *Leverage*, HEDGE FUND FACTS (2009), <http://www.hedgefundfacts.org/hedge/statistics/leverage/> [<http://perma.cc/Y33C-BBD> B].

values with appreciations in short (long) position values.⁵⁵ The long position in Apple coupled with a short position in Microsoft as mentioned above is an example of an equity long/short strategy. The underlying principle of this strategy is to shift risk from the market to the adviser based on the assumption that the hedge fund adviser has the superior information and skill to select the best trades.⁵⁶ While the equity long/short strategy is fundamental and used almost exclusively by around 23% of hedge funds,⁵⁷ it is also the foundational principle in many other trading strategies, and is thus used in some form by virtually every hedge fund.

A derivative of the equity long/short strategy is employed by short bias hedge funds. Prior to the bull market of the 1990s, a significant number of hedge funds were dedicated short sellers, i.e., they almost exclusively sold short and had little upside protection.⁵⁸ However, with the growth of the market in the 1990s, most of the funds moved from dedicated short bias to a net short bias, employing a larger long hedge to protect from market upswings.⁵⁹

Another prevalent trading strategy employed by hedge funds is arbitrage. In its simplest sense, arbitrage involves simultaneously buying and selling identical securities to profit from differences between the prices of those securities across multiple markets.⁶⁰ The three most common forms of arbitrage include pairs trading, fixed-income arbitrage, and merger or risk arbitrage.

Pairs trading is a form of relative value arbitrage—which is the exploitation of pricing inefficiencies across asset classes—and seeks to exploit the correlation between two similar securities.⁶¹ To use this strategy, hedge funds will identify two securities that are competitors or are in the same industry and have a strong correlation in stock price movements.⁶² When the correlation deviates from its norm, resulting in a

55. See Ashworth II, *supra* note 23, at 656.

56. See DAVID STOWELL, *INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY* 245 (2nd ed. 2013).

57. See Coal. of Private Inv. Cos., *Strategy Focus*, HEDGE FUND FACTS (2009), <http://www.hedgefundfacts.org/hedge/statistics/strategy-focus/> [<http://perma.cc/R662-YRD7>].

58. See FRANCOIS-SERGE LHABITANT, *HANDBOOK OF HEDGE FUNDS* 187 (2006).

59. See *id.*

60. See Coal. of Private Inv. Cos., *Investment Strategies*, *supra* note 1.

61. See STOWELL, *supra* note 56, at 253.

62. See *id.*

spread between the two securities that is wider than usual, the hedge fund will buy the underperforming stock and short the overperforming stock in the hopes that the value of each security converges back in line with the historical correlation.⁶³ For example, assume shares of Apple and Microsoft historically move with 100% correlation, i.e., if Apple's stock goes up by \$1, Microsoft's stock will also go up by \$1. Assume further that Apple's shares are trading at \$100 and Microsoft's shares at \$50. Now, if a hedge fund sees Apple's stock price go up by \$1 while Microsoft's stock goes up by \$2, the hedge fund will employ a pairs trade, which is a bet that Microsoft is temporarily overvalued, and Apple is temporarily undervalued. To execute this strategy, the hedge fund will sell short a share of Microsoft at \$52 and buy a share of Apple at \$101. This trade becomes profitable if, for example, Microsoft shares drop by \$2 and return to \$50, and Apple shares drop by \$1 and return to \$100. Here, the hedge fund profits \$2 from the Microsoft short sale and loses \$1 from the Apple purchase, netting a \$1 profit. Similarly, this trade is also profitable if, for example, Microsoft shares increase by \$1 to \$53, and Apple shares increase by \$2 to \$103. Here, the investor loses \$1 on the Microsoft short sale but profits \$2 from the Apple purchase, again netting a \$1 profit. Sometimes these correlative divergences are only a fraction of a penny per share, yet hedge funds utilize their large pool of capital to simultaneously place millions of identical trades to turn fractions of pennies into millions of dollars.

Fixed income arbitrage is a strategy employed by a large portion of hedge funds. Fixed income arbitrage is similar to the equity long/short and pairs trading strategies, except it focuses on fixed income or debt instead of equity. This strategy aims to capitalize on pricing inefficiencies in fixed income securities through a combination of long and short positions.⁶⁴ An example of a lucrative fixed income arbitrage trade involves exploiting liquidity discrepancies between newly issued thirty-year United States Treasury bonds (called on-the-run bonds) and older thirty-year Treasury bonds (called off-the-run bonds).⁶⁵ When new Treasury bonds are issued, the bonds that were previously on-the-run

63. *See id.* The same is true if the correlation is narrower than usual, in which case the hedge fund will trade in the hopes that the value of each security diverges back in line with the historical correlation.

64. *See id.* at 248.

65. *See id.*

bonds become off-the-run bonds and their price typically declines.⁶⁶ At the same time, the bonds that were already off-the-run bonds experience a price uptick, and their prices align with the bonds that were just relegated from on-the-run to off-the-run status.⁶⁷ Here, hedge funds will purchase the lower priced off-the-run bonds and sell short the higher priced on-the-run bonds to profit from the resulting price variance when new Treasury bonds are issued.⁶⁸ The same fixed income arbitrage strategy can be used with bonds of varying risk profiles, where the fund bets on yield spreads in the hopes of generating profits when those spreads widen or narrow.⁶⁹

Merger arbitrage, also called risk arbitrage, is another strategy employed by hedge funds. Upon an announcement of an acquisition involving two publicly traded companies, the fund bets on the completion of the acquisition.⁷⁰ In its simplest application, the merger arbitrage strategy profits if the deal is completed and loses if the deal falls apart. Historically, when a deal is announced, the buyer company's (the "acquirer") stock price experiences an immediate uptick, and the selling company's (the "target") stock price immediately increases to a point below the proposed merger price, which is the market price that reflects the per share value of the purchase price paid by the acquirer to the target shareholders.⁷¹ As the acquisition moves closer to its completion date, the acquirer's stock price steadily decreases while the target's stock price continues to steadily increase towards the proposed merger price.⁷² For instance, assume that before the announcement of an agreement by GiantCo to acquire TinyCo for \$100 per share, GiantCo is trading at \$30 per share and TinyCo is trading at \$75 per share. After the deal is announced, GiantCo's share price jumps to \$35 and TinyCo's share price jumps to \$95, which is \$5 less than the \$100 that GiantCo plans to pay for each share. Here, a hedge fund sells short shares of GiantCo and simultaneously buys shares of TinyCo. As the deal moves closer to completion, GiantCo's share price will steadily revert to its pre-announcement price of \$30, and TinyCo's share price will steadily align with the \$100 purchase price. If the deal is completed, the hedge fund making the merger arbitrage play will profit \$5 per share from the short

66. *See id.*

67. *See id.*

68. *Id.*

69. *See* Ashworth II, *supra* note 23, at 669.

70. *See* STOWELL, *supra* note 56, at 255.

71. *See id.* at 87, 255.

72. *See id.* at 87, 255.

sale of GiantCo's stock and another \$5 per share from the purchase of TinyCo's stock.

The equity long/short, pairs trading, fixed income arbitrage, and merger arbitrage strategies are just some examples of the ways in which hedge funds depend on short positions. Each strategy is founded upon market principles that have consistently delivered positive returns. Hedge funds are able to make investments that many other investors will not, or cannot, make largely because the funds have the asymmetrical advantage of superior capital, advisors, information, and technology that allows them to detect fractional mispricing in the market and execute protected investments in those areas. By investing in this manner, hedge funds enhance market liquidity, pricing efficiency, and risk allocation.

b. The Exploitation of the Long-only Disclosure Regime

Hedge funds, investors, companies, and the financial system are all harmed by the current long-only hedge fund disclosure regime. Without uniform reporting of short positions, hedge funds operate behind closed doors and can use short selling as a tool for fraudulent market manipulation. Hedge funds can act alone or in coordination with other hedge funds to exploit this regime by, for example, conducting a mirror of the "pump-and-dump" strategy called "short and distort," predatory trading, or secondary offering manipulation.

The "pump-and-dump" is a well-known and long-outlawed market manipulation tactic. To carry out this scheme, an investor buys a large percentage of a given security in order to artificially inflate the security's price. When the price of the security rises, the investor sells its entire holding in the security simultaneously, causing the security's price to expediently revert to, or fall below, its price before the pump-and-dump was executed. The perpetrators of this scheme profit from the artificial price inflation while the everyday investor is fooled into thinking it can share in the price upswing, only to find out that the uptick was artificial, resulting in a loss on the investment.

A mirror of the "pump-and-dump" strategy can be executed on the short side and is called "short and distort."⁷³ The "short and distort" is

73. See James Surowiecki, *Short and Distort*, NEW YORKER (Aug. 12, 2012), <http://www.newyorker.com/magazine/2002/08/12/short-and-distort> [<http://perma.cc/9BN7-PLD8>].

executed by shorting a mass quantity of one security to artificially depress the price and following it with a mass purchase of the security.⁷⁴ A “short and distort” trader profits on the short sale as the price drops and also profits on the purchase of the security as the price stabilizes and rises back to its true market value. One of the most baleful variations of this strategy, which provides the derivation of its name, involves coupling the mass short sale with widespread public dissemination of false negative information about the company being shorted to further drive down the share price.⁷⁵ Some studies by social scientists have shown that this variation of the “short and distort” scheme can be much more harmful than the traditional “pump-and-dump” scheme because investors tend to react more strongly to negative information than to positive information, causing the market to react faster and more dramatically to negative news.⁷⁶ Some commentators have opined that this strategy, in some form, exacerbated stock market volatility during the financial crisis.⁷⁷ Hedge funds, bereft of the obligation to report their short positions, are in a prime position to exploit this strategy to the detriment of the everyday investor.

Predatory trading (or “front running”) is a strategy whereby a trader seeks to profit from driving down the market price of a security or forcing a vulnerable financial institution to liquidate assets at prices well below fair market value.⁷⁸ For example, a hedge fund could continuously short an institution’s security thus driving its price lower and lower, all without the fear of being detected because the hedge fund currently does not have to publicly disclose those short positions. Hedge funds are in a particularly advantageous position to execute this strategy because the predatory trader must have a wealth of information about the vulnerable financial institution, including knowledge about its balance sheet and its current or impending insolvency.⁷⁹ It follows that individual investors bear the brunt of the misfortune resulting from this strategy because they do not have the resources to glean this, presumably nonpublic,

74. See CHARLES M. JONES ET AL., REVEALING SHORTS: AN EXAMINATION OF LARGE SHORT POSITION DISCLOSURES (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1910372 [<http://perma.cc/56YR-QTD2>].

75. See Surowiecki, *supra* note 73.

76. See *id.*

77. See JONES ET AL., *supra* note 74.

78. See *id.*; JENNIFER LA’O, PREDATORY TRADING AND CREDIT FREEZE 1 (2010), <http://economics.mit.edu/files/5529> [<https://perma.cc/CJ4P-387R>].

79. See LA’O, *supra* note 78, at 1.

information themselves; thus, they are left to sit idly by as the value of their portfolio dwindles.

The current inadequate disclosure regime allows hedge funds to exploit secondary offerings as well, all while being immune from detection. To exploit secondary offerings, a hedge fund can short an issuer's securities after the announcement of the secondary offering but before the pricing date.⁸⁰ In effect, the issuer must then price and sell its new shares at artificially depressed prices, which lowers the issuer's overall value while the hedge fund profits on the short sale.⁸¹ Despite regulatory attempts to limit shorting during a secondary offering, like Rule 105 of Regulation M, studies have shown that short sellers continue to create downward price pressure on secondary offerings.⁸² Once again, the individual investors are at a disadvantage, as they experience the decline in the value of their investments in these institutions. A disclosure regime requiring public reporting of short positions would go a long way to detect and deter this abusive activity.

B. DISCLOSURE

1. Purpose of Disclosure

Federal securities laws were created to protect investors and the financial system as a whole "by providing for the transparency of markets [and by] prohibiting fraud."⁸³ Disclosure, which is mandated by these securities laws, is paramount to ensuring that these laws' goals are accomplished. Disclosure regimes can be harmful to investors when they do not provide for the full and fair disclosure of information to all market participants, and thus, promote informational asymmetry. Inadequate disclosure regimes can harm the financial system by contributing to systemic risk.

A market that is plagued with widespread informational asymmetry experiences a decreased investor base, higher transaction costs, lower liquidity, decreased efficiency, inaccurate pricing, and decreased profits

80. See JONES ET AL., *supra* note 74.

81. See *id.*

82. See *id.*; see also 17 C.F.R. § 242.105 (2015).

83. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72054-01 (Dec. 10, 2004).

from trading.⁸⁴ The theoretical premise of this observation lies in the fact that unlike in a transaction involving a sale of an item on Craigslist, individual investors in financial markets do not have the luxury of inspecting and analyzing the companies in which they want to invest.⁸⁵ Moreover, even if the individual investor had the resources to hire its own accountants, bankers, and financial analysts, the upfront costs of doing so would far exceed any potential gain on the purchase of a security.⁸⁶ Accordingly, individual investors must rely on disclosures by these companies.⁸⁷

The concern for investors arises when market participants like hedge funds deploy their superior resources to accumulate asymmetrical market advantages.⁸⁸ These hedge funds can trade on information that is legally public, yet known only to them, until that information is fully incorporated into the price of the security, effectively excluding the possibility of an individual investor profiting from a market transaction.⁸⁹ Rational individual investors are then deterred from participating in the market.⁹⁰

An effective disclosure regime is one that helps to eliminate systemic risk. Systemic risk can be defined as:

[T]he risk that an economic shock, such as market or institutional failure, triggers (through a panic or otherwise) either the failure of a chain of markets or institutions or a chain of significant losses to financial institutions, resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.⁹¹

Disclosure plays a big part in limiting systemic risk because it aims to provide equal information to all market participants and regulators. This allows market participants to transact with knowledge of the risk exposure posed by their counterparties and the market. Similarly, regulators can regulate more effectively because they have a more complete picture of the interconnectedness and interdependencies of the market. In sum,

84. See Ryan M. Carpenter, *Providing Equal Investment Opportunity via Securities Exchange Act Section 13(F)*, 46 CONN. L. REV. 763, 788-89 (2013).

85. See *id.* at 791.

86. See *id.*

87. *Id.*

88. See *id.* at 772-73.

89. See *id.*

90. See *id.*

91. See Coal. of Private Inv. Cos., *Setting Policy*, *supra* note 1.

when all parties act upon this full information set, actions that contribute to systemic risk are avoidable, and those systemic risks that do exist can be discovered earlier.

2. *What is Disclosed Today*

For the purposes of this Article, the types of mandatory disclosure applicable to hedge funds can be divided into two groups: (1) long-only disclosure, which, as its name suggests, only requires hedge funds to publicly disclose their long positions; and (2) long-and-short disclosure, which requires hedge funds to publicly disclose both their long positions and their short positions.

a. Long-only Disclosure (Form 13F)

Currently, in the United States, hedge funds are required to publicly report only certain long positions in equity securities. In accordance with Section 13(f) of the Securities Exchange Act of 1934 (“Exchange Act”), the disclosure is to be made on Form 13F (“13F”) and filed with the SEC.⁹² Section 13(f) applies to “[e]very institutional investment manager which uses the mails, or any means or instrumentality of interstate commerce in the course of its business as an institutional investment manager and which exercises investment discretion with respect to accounts holding equity securities . . . having an aggregate fair market value . . . of at least \$100,000,000” or an amount, not less than \$10,000,000, that the SEC in its discretion deems necessary for reporting purposes.⁹³

The 13F filing shall include, with certain exemptions and extensions, “the name of the issuer and the title, class, CUSIP number, number of shares or principal amount, and aggregate fair market value . . . of each such [equity] security” that the investment manager holds as a long position.⁹⁴ 13F filings are to be made within forty-five days of the end of the most recent quarter.⁹⁵ The SEC collects these disclosures and makes available a list of these equity securities and presents it in a manner that

92. 15 U.S.C.A. § 78m(f) (West 2010).

93. *Id.* § 78m(f)(1).

94. *Id.*

95. SEC. & EXCH. COMM’N, FORM 13F.

will “maximize the usefulness of the information to other Federal and State authorities and the public.”⁹⁶

The purpose of 13F disclosure is to “create in the Commission a central repository of historical and current data about the investment activities of institutional investment managers.”⁹⁷ This therefore aims to achieve the aforementioned goals of federal securities laws⁹⁸ by establishing a uniform reporting standard and centralized database that serve to increase the amount of public market data, and thus, facilitate a general understanding of how hedge funds affect financial markets.⁹⁹

Specifically, 13F filings require hedge funds to disclose long positions in United States equity markets, American Depositary Receipts, purchased put and call options, and convertible notes.¹⁰⁰ Interestingly, despite short selling making up a significant amount of hedge funds’ trading activity,¹⁰¹ 13F filings do not require disclosure of short positions, borrowed securities, short derivative positions, cash positions, or positions in any asset class other than equity securities.¹⁰²

The cost and time required to complete a 13F filing are reasonably low compared to the \$100,000,000 threshold amount in long equity positions that triggers mandatory 13F filings. The SEC estimates that 13F filings cost about \$3000 per report, or \$12,000 per year.¹⁰³ The SEC further estimates that each hedge fund filer will spend an average of 24.7 hours preparing the report.¹⁰⁴ In addition, the SEC approximates that filers

96. 15 U.S.C.A. § 78m(f)(4) (West 2010).

97. Filing and Reporting Requirements Relating to Institutional Investment Managers, Exchange Act Release No. 14,852, 1978 WL 196605 (June 15, 1978); Carpenter, *supra* note 84, at 770.

98. *See supra* Section I.B.1.

99. *See* Filing and Reporting Requirements Relating to Institutional Investment Managers, Exchange Act Release No. 14,852, 1978 WL 196605 (June 15, 1978); Carpenter, *supra* note 84, at 770.

100. *See The Pros and Cons of Tracking Hedge Funds via 13F Filings*, MARKET FOLLY (Oct. 8, 2012), <http://www.marketfolly.com/2012/10/hedge-fund-13f-filing-pros-and-cons.html> [<http://perma.cc/BDQ7-YK3U>].

101. *See supra* Section I.A.2.

102. SEC. & EXCH. COMM’N, FORM 13F; SEC. & EXCH. COMM’N, DIVISION OF INVESTMENT MANAGEMENT: FREQUENTLY ASKED QUESTIONS ABOUT FORM 13F questions 41-43 (Mar. 9, 2015), <https://www.sec.gov/divisions/investment/13ffa.htm> [<http://perma.cc/SF3N-27GC>]; *see* MARKET FOLLY, *supra* note 100.

103. *See* Filing and Reporting Requirements Relating to Institutional Investment Managers, Exchange Act Release No. 15,461, 16 SEC Docket 687 (Jan. 5, 1979).

104. SEC. & EXCH. COMM’N, FORM 13F.

who must amend their filings or supplement their expired or denied confidential treatment requests will spend four additional hours on the resubmission.¹⁰⁵

To prevent or suspend the requisite public disclosure of certain long equity positions, hedge funds can apply to the SEC for confidential treatment.¹⁰⁶ In enacting this exemption, Congress recognized that some disclosures might not be in the public interest because they could have harmful effects for either hedge fund advisers or those investors whose assets are under the advisers' management.¹⁰⁷ Advisers could be harmed because certain information may reveal their proprietary investment strategies.¹⁰⁸ Without the ability to protect their proprietary practices, hedge funds would be disincentivized to expend their resources because outsiders could unfairly reap the benefits that the hedge funds derived. Furthermore, such a public revelation would minimize the hedge funds' profit margins because outsiders could mimic their strategies. Additionally, investors could be harmed when, say, public disclosure reveals which securities are held by an individual, estate, or trust.¹⁰⁹ Recently, the SEC added merger arbitrage to the list of categories eligible for confidential treatment.¹¹⁰

The procedures for requesting confidential treatment are set out under Rule 24b-2 of the Exchange Act¹¹¹ and principally require three things. First, the hedge fund must provide certain information, such as the grounds for objecting to public disclosure, the basis for the objection to be eligible under the SEC's framework adopted under the Freedom of Information Act,¹¹² as well as a description of the hedge fund's investment strategy and accompanying analysis supporting the request.¹¹³ Second, the hedge fund must "justify the time period for which confidential treatment

105. *Id.*

106. *See* SEC. & EXCH. COMM'N, STAFF GUIDANCE AND STUDIES, 1998 WL 35318911, at *2; Carpenter, *supra* note 84, at 774.

107. *See* SEC. & EXCH. COMM'N, *supra* note 106, at *2; Carpenter, *supra* note 84, at 774.

108. *See* Carpenter, *supra* note 84, at 774-75.

109. *See id.* at 775.

110. *See id.*

111. 17 C.F.R. 240.24b-2 (2016).

112. 5 U.S.C. § 552. (2012).

113. *See* SEC. & EXCH. COMM'N, *supra* note 106, at *2.

is sought,”¹¹⁴ which is limited to a period of three, six, nine, or twelve months from the date the confidential treatment request is filed.¹¹⁵ Third, the hedge fund must demonstrate how its proprietary strategy would be divulged if the particular securities were disclosed, how the particular securities relate to its overall investment strategy, and how the public would be able to detect the strategy as a result of the disclosure.¹¹⁶

In 2014, the SEC received a total of 172 confidential treatment requests and granted 143 of them.¹¹⁷ From 2011 to 2014, approximately 85% of all confidential treatment requests were granted.¹¹⁸ Among the filers, hedge funds are responsible for approximately 56% of all confidential requests.¹¹⁹ On average, about 33.8% of a hedge fund’s total portfolio value is kept confidential, which represents around \$1 trillion in total value.¹²⁰ The hedge funds that most often seek confidential treatment include those with large portfolio sizes, high portfolio turnover, and those who manage portfolios with high concentration in a given industry or sector.¹²¹ The types of stocks that make up the bulk of the requests generally include those associated with information-sensitive events like merger arbitrage, as well as stocks with high volatility, small market caps, and high historical returns.¹²² When compared to non-confidential holdings, hedge funds tend to conduct more trading in the confidential holdings during the confidential period, and it typically takes much longer to accumulate the full portfolio in the confidential holdings.¹²³ As for performance, the confidential holdings realize significantly higher returns compared to non-confidential holdings.¹²⁴ In fact, over a twelve-month investment horizon, confidential holdings outperform non-confidential

114. *See id.* at *3.

115. *See* Carpenter, *supra* note 84, at 775.

116. *See* SEC. & EXCH. COMM’N, *supra* note 106, at *4.

117. *See* Richard Teitelbaum, *SEC Grants Too Many Confidential Treatment Requests, Critics Say*, INSTITUTIONAL INVESTOR (Oct. 07, 2015), <http://www.institutionalinvestor.com/article/3495423/asset-management-regulation/sec-grants-too-many-confidential-treatment-requests-critics-say.html#.VzILghUrKR>s [<http://perma.cc/UR3Z-PZFU>].

118. *See id.*

119. *See* VIKAS AGARWAL ET AL., *Uncovering Hedge Fund Skill from the Portfolio Holdings They Hide*, 68 J. FIN. 739, 740 (2013).

120. *See id.* at 740, 749.

121. *See id.* at 741, 756-58.

122. *See id.* at 741-42.

123. *See id.* at 741.

124. *See id.* at 741, 768.

holdings by 5.2% to 7.5% on an annualized basis.¹²⁵ An analysis of short interest, which indicates the percentage of total outstanding shares of a particular stock that are sold short,¹²⁶ exhibits significant differentiation between disclosed short sales and short sales kept confidential.¹²⁷ The stocks in which short positions were disclosed experienced abnormally high short interest at the time of disclosure, and that level of abnormality continued for about two weeks before returning to normal levels.¹²⁸ Interestingly, the stocks in which short positions were kept confidential evinced no such abnormal increases.¹²⁹

b. Long-and-Short Disclosure

As pertains to this Article, there are currently two disclosure regimes that require disclosure of both long and short positions. In the United States, certain hedge funds are required to file Form PF, which discloses long and short positions to the SEC.¹³⁰ In the EU, certain hedge funds are required by the Alternative Investment Fund Managers Directive (“AIFMD”) to publicly disclose long and short positions.¹³¹

i. Form PF: Privately Disclosed Long-and-Short Positions

Form PF, required by Rule 204(b)-1 of the Investment Advisers Act of 1940,¹³² mandates disclosure by hedge fund advisers, among others. An adviser must file Form PF if it “(1) is registered or required to register

125. *See id.* (showing this difference as calculated by the value-weighted Four-Factor Alpha and DGTW-Adjusted Returns tests, two industry standard measures of performance).

126. *Short Interest Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/shortinterest.asp> [<http://perma.cc/9QQM-TGMH>] (last visited Oct. 29, 2016).

127. Note that the analysis was performed on European stocks because unlike in the United States, the European disclosure regime mandates disclosure of short positions in certain circumstances.

128. *See JONES ET AL.*, *supra* note 74.

129. *See id.*

130. *See infra* Section I.C.2.b.i.

131. *See* Directive 2011/61, of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 O.J. (L 174) 33 [hereinafter AIFMD].

132. 17 C.F.R. § 275.204(b)-1 (2015).

with the SEC; (2) advises one or more private funds; and (3) had at least \$150 million in regulatory assets under management attributable to private funds as of the end of its most recently completed fiscal year.”¹³³ An adviser designated as managing a “hedge fund” for the purposes of Form PF is subject to heightened disclosure obligations.¹³⁴ Form PF defines “hedge fund” to include a private fund that meets one of the following hedge fund characteristics: “(a) a performance fee that takes into account market value (instead of only realized gains); (b) high leverage; or (c) short selling.”¹³⁵ The form then categorizes three types of “Large Private Fund Advisers” based on different corresponding thresholds for assets under management:

- Any adviser having at least \$1.5 billion in regulatory assets under management attributable to hedge funds as of the end of any month in the prior fiscal quarter;
- Any adviser managing a liquidity fund and having at least \$1 billion in combined regulatory assets under management attributable to liquidity funds and registered money market funds as of the end of any month in the prior fiscal quarter; and
- Any adviser having at least \$2 billion in regulatory assets under management attributable to private equity funds as of the last day of the adviser’s most recently completed fiscal year.¹³⁶

Most advisers of smaller hedge funds are only required to file Form PF annually.¹³⁷ Large hedge fund advisers must update information related to their hedge funds on a quarterly basis.¹³⁸

133. 15 U.S.C. §80b-3 (2012); Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 102 SEC Docket 1266 (2011).

134. Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 102 SEC Docket 1266 (2011).

135. *Id.*

136. *Id.*; SEC. & EXCH. COMM’N, FORM PF.

137. See Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 102 SEC Docket 1266 (2011).

138. *See id.*

Form PF has four sections, the first two of which are required to be completed by the hedge fund adviser.¹³⁹ Section 1 requires disclosure of information regarding: (1) the adviser's identity and assets under management;¹⁴⁰ (2) the size, leverage, and performance of the adviser's fund;¹⁴¹ and (3) general information about the hedge fund, including investment strategies, percent of assets employed in high frequency trading, as well as any significant counterparty exposures.¹⁴² Section 2 requires disclosure of hedge fund-specific information, including: (1) the value and holding duration of assets (both long and short) in commodities and fixed income, the value of turnover in certain asset classes, and a geographical breakdown of investments held by the hedge fund;¹⁴³ and (2) portfolio liquidity, risk metrics, impact of certain market factors, holdings of unencumbered cash, concentration of positions, base currency, collateral practices with counterparties, trades cleared through a central clearing company, obligations to creditors, investment horizon breakdowns, and much more.¹⁴⁴

As is unequivocally evident from its substantive reporting requirements, Form PF is aimed at understanding the systemic risk implications of hedge fund activity.¹⁴⁵ For example, much of Section 1 serves to accomplish the following:

[A]llow FSOC to monitor certain systemic trends for the broader private fund industry,¹⁴⁶ . . . monitor systemic risk that could be transmitted through counterparty exposure, track how different strategies are affected by and correlated with different market stresses, and follow the extent of private fund activities conducted away from regulated exchanges and clearing systems.¹⁴⁷

139. *See id.*

140. SEC. & EXCH. COMM'N, FORM PF §1(a).

141. *Id.* §1(b).

142. *Id.* §1(c).

143. *Id.* §2(a).

144. *Id.* §2(b). This second part of Section 2 applies only to advisers of hedge funds having a net asset value of at least \$500 million. *Id.*

145. Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 102 SEC Docket 1266 (2011).

146. *Id.*

147. *Id.*

Likewise, much of Section 2 is “designed to assist FSOC in monitoring asset classes in which hedge funds may be significant investors and trends in hedge funds’ exposures,”¹⁴⁸ “identify[ing] concentrations in particular asset classes,”¹⁴⁹ “monitoring the composition of hedge fund exposures over time as well as the liquidity of those exposures,”¹⁵⁰ examining hedge fund’s leverage,¹⁵¹ and “monitor[ing] the hedge fund’s susceptibility to failure through investor redemptions in the event the fund experiences stress due to market or other factors.”¹⁵²

In contrast to Form 13F, the data disclosed in Form PF is not publicly released.¹⁵³ The SEC may share this information with the Commodity Futures Trading Commission, the FSOC, and other Federal departments, agencies, or self-regulatory organizations when it is within their jurisdictional scope.¹⁵⁴ The SEC justified the importance of keeping this information confidential based on the fact that Form PF extracts non-public information, and the disclosure of such information could adversely affect the fund and its investors.¹⁵⁵ In fact, the Dodd-Frank Wall Street Reform and Consumer Protection Act¹⁵⁶ was amended to shield Form PF disclosures from demands made under the Freedom of Information Act.¹⁵⁷ The SEC can, however, use the information disclosed on Form PF in an enforcement action.¹⁵⁸

148. *Id.*

149. *See id.*

150. *Id.*

151. *See id.*

152. *Id.*

153. *See id.*

154. *Id.*

155. *See id.*

156. The Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as Dodd-Frank, was enacted to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail,” to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S.C.).

157. *See* Emily Kehoe, Note, *Hedge Fund “Regulation” for Systemic Risk: Largely Impossible*, 14 J. BUS. & SEC. L. 35, 47 (2013).

158. *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 102 SEC Docket 1266 (2011).

The SEC estimated that Form PF, when compared to Form 13F, would impose a significantly heavier burden on advisers to compile, review, and electronically file. For smaller hedge fund advisers, the SEC estimated that a total of 40 burden hours and 15 burden hours would be necessary to complete initial and subsequent Form PF filings, respectively. Likewise for larger hedge fund advisers, the initial and subsequent Form PF filings would require 300 burden hours and 140 burden hours, respectively.¹⁵⁹

ii. European Union: Publicly Disclosed Long-and-Short

In response to the financial crisis, the EU created the AIFMD.¹⁶⁰ Effected on July 21, 2011, the AIFMD created “rules for the authorisation, ongoing operation and transparency of managers of alternative investment funds [(“AIFs”).”¹⁶¹ For the purposes of the AIFMD, AIFs include those “entities managing AIFs as a regular business . . . which raise capital from a number of investors with a view to investing that capital for the benefit of those investors in accordance with a defined investment policy.”¹⁶² A non-EU alternative investment fund manager (“AIFM”) is subject to the requirements of the AIFMD if it is “(a) managing or marketing one or more AIFs established in the European Union to investors in the European Union; or (b) marketing one or more AIFs established outside the European Union (a non-EU AIF) to investors in the European Union.”¹⁶³

As part of the AIFMD, on March 14, 2012, the EU adopted Regulation (EU) No 236/2012 (“EU 236”), mandating hedge fund disclosure of short positions, long positions, and credit default swaps.¹⁶⁴ The EU 236 mandate is wide in scope and covers

159. *See id.*

160. *See* AIFMD, *supra* note 131.

161. *See* NORTON ROSE LLP, AIFM DIRECTIVE: THE IMPACT ON NON-EU FUND MANAGERS OF NON-EU FUNDS 1 (2012), <http://www.nortonrosefulbright.com/files/aifm-directive-the-impact-on-non-eu-fund-managers-of-non-eu-funds-60540.pdf> [<http://perma.cc/KL4H-KGFH>].

162. AIFMD, *supra* note 131, pmb1. para. 6.

163. NORTON ROSE LLP, *supra* note 161, at 1; *see also* AIFMD, *supra* note 131.

164. *See* Regulation (EU) No. 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps, 2011 O.J. (L 86).

not only short positions created by trading shares or sovereign debt on trading venues but also short positions created by trading outside trading venues and net short positions created by the use of derivatives, such as options, futures, index-related instruments, contracts for differences and spread bets relating to shares or sovereign debt.¹⁶⁵

Short positions include traditional short sales and any “transaction which creates or relates to a financial instrument . . . where the effect or one of the effects . . . is to confer a financial advantage on the [person or entity] entering into that transaction in the event of a decrease in the price or value of the share or debt instrument.”¹⁶⁶ Identically, long positions include traditional buy-and-hold transactions, as well as transactions that have the effect of conferring a financial advantage “in the event of an increase in the price or value of the share or debt instrument.”¹⁶⁷ In addition, any form of economic interest in credit default swaps relating to sovereign debt issuers should also be disclosed.¹⁶⁸ EU 236 includes credit default swaps because a purchase of credit default swaps without holding a corresponding long position in the underlying assets is essentially a short position on the underlying debt instrument.¹⁶⁹

EU 236 mandates two different forms of disclosure that are relevant to this Article’s discussion. First, hedge funds must disclose a change in net short position when it reaches a certain threshold.¹⁷⁰ Second, the relevant government entity of each EU Member State must submit a summary of net short positions to the European Securities and Markets Authority (“ESMA”) on a quarterly basis.¹⁷¹

The EU 236 establishes an event-driven framework wherein disclosure is necessary when a “change in a net short position results in an increase or decrease above or below certain thresholds.”¹⁷² Furthermore, a two-tier model was created so that lower threshold changes in net short positions are disclosed privately to regulators, and higher threshold changes in net short positions are disclosed publicly to

165. *Id.* pmb. para. 10.

166. *Id.* art. 3(1).

167. *Id.* art. 3(2).

168. *Id.* pmb. para. 12.

169. *Id.* pmb. para. 14.

170. *Id.* arts. 5(1), 6(1).

171. *Id.* art. 11(1).

172. *Id.* pmb. para. 15.

the market.¹⁷³ Mandatory disclosure to a government entity is triggered when such a change is a percentage that equals 0.2% of the outstanding shares of a company's stock, and at each 0.1% above that.¹⁷⁴ Mandatory public disclosure is triggered when such a change is a percentage that equals 0.5% of the outstanding shares of a company's stock, and at each 0.1% above that.¹⁷⁵

The event-driven disclosure must include the identity of the AIFM, the size of the relevant position, the company whose stock is the subject of the position, and the date the position was "created, changed or ceased to be held."¹⁷⁶ The disclosure must be made no later than the end of the day following the change that triggered the disclosure obligation.¹⁷⁷

On a quarterly basis, the relevant government entity of each EU Member State must provide a summary to ESMA that includes information about net short positions in public equity and sovereign debt, and, in certain circumstances, uncovered positions relating to sovereign credit default swaps.¹⁷⁸ Moreover, ESMA can at any time request additional information on net short positions in those securities, and the relevant government agency has seven days to comply.¹⁷⁹

EU 236 was prompted by the divergent regulatory frameworks of EU Member States prior to and during the financial crisis.¹⁸⁰ The European Parliament felt a uniform regulatory framework and reporting standard would facilitate "the proper functioning of the internal market, . . . ensure a high level of consumer and investor protection," and eliminate sources of systemic risk.¹⁸¹ This regime aims to increase transparency surrounding significant short positions so as to allow market participants to make better decisions, and to provide regulators with the opportunity to address "identified risks without unduly detracting from the benefits that short selling provides to the quality and efficiency of markets."¹⁸² In developing the two-tier disclosure model, the European Parliament reasoned that

173. Compare *id.* art. 5, with *id.* art. 6; see *id.* pmbl. para. 7.

174. *Id.* art. 5(2).

175. *Id.* art. 6(2).

176. *Id.* art. 9(1).

177. *Id.* art. 9(2).

178. *Id.* art. 11(1).

179. *Id.* art. 11(2).

180. *Id.* pmbl. para. 1.

181. See *id.* pmbl. paras. 1-3.

182. See *id.* pmbl. paras. 5, 7.

private disclosure to regulators will “enable them to monitor and, where necessary, investigate short selling that could create systemic risks, be abusive or create disorderly markets.”¹⁸³ The European Parliament recognized that public disclosure of some information “could have a detrimental effect on . . . markets where liquidity is already impaired,”¹⁸⁴ while acknowledging that such disclosure will nonetheless “provide useful information to other market participants about significant individual short positions in shares.”¹⁸⁵

In addition to disclosure mandates, EU 236 also grants EU Member State regulators and ESMA the authority to restrict certain market practices. Generally, both uncovered short sales and uncovered sovereign credit default swaps are restricted.¹⁸⁶ During times of market turmoil, EU Member State regulators are granted the authority to prohibit or impose conditions relating to short positions so long as the chosen measure does not have a disproportionately “detrimental effect on the efficiency of financial markets.”¹⁸⁷ ESMA itself may intervene to prohibit or impose conditions relating to short positions when there are cross-border implications or there is a threat to the stability or integrity of the financial system as a whole, and when EU Member State regulators either do not take measures to address the threat or when the measures taken are inadequate.¹⁸⁸

3. Effect of Disclosure on the Market

A key consideration in deciding what to include in a disclosure regime is the impact that the introduction of such public disclosure of short positions may have on the market. Luckily, the EU, having already implemented such a regime, furnishes the opportunity to measure that impact. This section will first parse out the effect of short disclosure on changes in share price. Next, this section will look to the changes in short interest, bid-ask spread, and follow-on shorting activity to determine the effect that short position disclosure has on liquidity, and identify the catalyst of shorting activity.

183. *See id.* pmb. para. 7.

184. *See id.* pmb. para. 8.

185. *Id.* pmb. para. 7.

186. *Id.* arts. 12-14.

187. *See id.* art. 20(1).

188. *See id.* art. 28(1)-(2).

Interestingly, immediately after a short position is disclosed there is no significant price reaction. More precisely, in the three days following a short position disclosure, the corresponding stock price experiences an abnormal return of just -0.41%.¹⁸⁹ This return remains at low levels until about the tenth day following the disclosure, when the stock exhibits an abnormal return of -1.24%.¹⁹⁰ On the ninetieth day following the disclosure, the abnormal returns grow to a significant -5.23%.¹⁹¹ In sum, a disclosure of a short position has no significant price effect immediately after disclosure, but there is a gradual depression of the share price over time.¹⁹² Short interest, on the other hand, exhibits a significant negative reaction after disclosure of a short position.¹⁹³ Generally, a reduction in short interest is a predictor of high future returns, and vice versa.¹⁹⁴ The bid-ask spread, which represents the difference between the prices that a buyer is willing to pay and a seller is willing to accept for a given security,¹⁹⁵ also experiences a significant reduction in the disclosed stocks.¹⁹⁶ A reduction in the bid-ask spread suggests that the market is less fearful of the informational asymmetry between buyers and sellers, leading to increased market liquidity.¹⁹⁷

An analysis of follow-on shorting activity, which is the increase in short position disclosures after the first short position disclosure, shows that there is a positive correlation between the size of the disclosed short position and the likelihood that a different short seller will disclose a short position in the same stock within a month.¹⁹⁸ In addition, the likelihood of follow-on disclosures increases in proportion to the amount of assets under management of the initial disclosing entity.¹⁹⁹ However, the amount

189. See JONES ET AL., *supra* note 74, at 3.

190. See *id.* at 20.

191. See *id.* at 20.

192. See *id.* at 20.

193. See JONES ET AL., *supra* note 74, at 3.

194. See *id.* at 8 (citing Hemang Desai et al., *An Investigation of the Informational Role of Short Interest in the NASDAQ Market*, 68 J. FIN. 2263 (2002); Ekkehart Boehmer et al., *The Good News in Short Interest*, 96 J. FIN. ECON. 80 (2010)).

195. *Bid-Ask Spread*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/bid-ask-spread.asp> <http://perma.cc/MV9Y-6EMW> (last visited Sept. 24, 2016).

196. See JONES ET AL., *supra* note 74.

197. See *id.* at 3.

198. See *id.* at 36.

199. See *id.* at 33.

of short activity does not change significantly after disclosure. Instead, most of the changes in short activity occur before the disclosure.²⁰⁰

In sum, short position disclosure results in an increase in expected future returns, as well as an increase in market liquidity.²⁰¹ The combination of a greater probability of follow-on shorting activity for larger disclosers and the fact that most short activity occurs before the disclosure seems to suggest that information is the catalyst behind short activity, not the disclosure itself.²⁰²

II. INADEQUACIES OF TODAY'S PUBLIC DISCLOSURE REGIMES

This part begins by establishing the objectives that Form 13F seeks to achieve through mandated disclosure of long positions, and then surveys evidence of market manipulation and hedge fund-imposed systemic risk in an effort to prove that 13F is failing to accomplish these objectives. The remainder of this part then demonstrates how long-only disclosure and the limited resources of the SEC result in a release of information to the public that is wholly inadequate.

A. 13F DISCLOSURE FAILS TO SERVE PURPOSE

As discussed in Part I,²⁰³ federal securities laws that mandate public disclosure are designed to serve a specific purpose. The SEC opined that the purpose of public reporting requirements is to “provide a level of transparency that will help to identify practices that may harm investors, will aid investors in conducting their own due diligence, and will deter advisers’ fraud and facilitate earlier discovery of potential misconduct.”²⁰⁴

Form 13F, a public reporting requirement created by the Exchange Act, also has a specific purpose. As discussed in Part I of this Article and stated on the form itself, “[t]he purpose of Form 13F is to provide a reporting and disclosure system to collect specific information and to disseminate such information to the public about the holdings of

200. *See id.*

201. *See id.* at 3, 33.

202. *See id.* at 4.

203. *See supra* Section I.B.1.

204. *See Ashworth II, supra* note 23, at 688; Mary Schapiro, Chairman, Sec. & Exch. Comm’n, Opening Statement at SEC Open Meeting: Dodd-Frank Act Amendments to the Investment Advisers Act (June 22, 2011), <https://www.sec.gov/news/speech/2011/spch062211mls-items-1-2.htm> [<http://perma.cc/Y3MH-DG7X>].

institutional investment managers.”²⁰⁵ In the 1978 adopting release of 13F, the SEC specified two main objectives. First, the public reporting requirement should provide more factual information to the market to facilitate the market’s understanding of the “influence and impact” of hedge funds.²⁰⁶ Second, the requirement should result in a “uniform centralized data base” that is managed, processed, and disseminated by the SEC.²⁰⁷ In addition, as noted in a no-action letter written by the SEC regarding 13F obligations, SEC representatives have testified that “the primary users and beneficiaries of information collected by Form 13F should be the public.”²⁰⁸

The change in reporting periods from annually to quarterly is also instructive of 13F’s purpose. As originally adopted on June 15, 1978, 13F only required annual disclosure.²⁰⁹ After a notice and comment period, the SEC amended 13F to require quarterly disclosure.²¹⁰ In the final rule, the SEC stated that quarterly reporting would “enhance the likelihood of an effectively functioning system.”²¹¹ The SEC did, however, acknowledge that the fourfold increase in the reporting obligation would impose more costs upon filers.²¹² Ultimately, it found that any resulting burdens of quarterly reporting would be outweighed by the significant benefits that the information would provide to investors.²¹³ The SEC was therefore willing to impose additional burdens upon filers for the sake of providing investors with more information, which would inevitably result in an improvement in market liquidity, price discovery, and overall capital allocation.

Despite the clear and noble purposes of 13F, the form falls terribly short of achieving them. There is clear evidence of hedge funds taking advantage of the lax reporting requirements of 13F to unfairly benefit themselves at the expense of investors. Furthermore, the systemic risks

205. SEC. & EXCH. COMM’N, FORM 13F.

206. See Filing and Reporting Requirements Relating to Institutional Investment Managers, Exchange Act Release No. 14,852, 1978 WL 196605 (June 15, 1978).

207. *Id.*

208. See Clinton C. Hotaling, SEC No-Action Letter, 1990 WL 304975, at *2 (Nov. 16, 1990).

209. See Filing and Reporting Requirements Relating to Institutional Investment Managers, Exchange Act Release No. 15,461, 16 SEC Docket 687 (Jan. 5, 1979).

210. See *id.*

211. *Id.*

212. See *id.*

213. See *id.*

that hedge funds contribute to the market are only exacerbated by the current 13F regime, which perpetuates a lack of transparency on the market, and thereby fails to facilitate the market's understanding of the influence and impact of hedge funds.

1. Widespread Market Manipulation Under the Current 13F Regime

Under the current 13F long-only public disclosure regime, there is evidence of widespread market manipulation that specifically takes advantage of 13F's lax mandates. The "short and distort" strategy, predatory trading strategy, and manipulative short selling strategy relating to secondary equity offerings all capitalize on the ability to be executed without detection. Even voluntary disclosure of short positions under this regime provides a manipulative avenue for generating profit. Interestingly, confidential treatment requests can also be used as a manipulative tool to disingenuously extend the time before a hedge fund adviser has to disclose a given equity position.

Clear examples exist as to the exploitation of the "short and distort strategy." The technological innovations of the twenty-first century have only rendered this strategy more effective, as the media can now provide up-to-the-second market coverage to the public.²¹⁴ For example, in 2002, false rumors swirled throughout the market that J.P. Morgan Chase was facing fines, criminal prosecution, and a large loss from commodities and derivatives trading, and was ultimately approaching inevitable insolvency.²¹⁵ In a span of less than ten days, these rumors drove down J.P. Morgan Chase's stock price by an astounding 39%,²¹⁶ or \$24 billion in terms of market capitalization,²¹⁷ which was its lowest price going back six years.²¹⁸ J.P. Morgan then explicitly denied the false rumors, and in

214. See Surowiecki, *supra* note 73.

215. See Surowiecki, *supra* note 73.

216. See *JPM Historical Prices*, YAHOO! FINANCE, <http://finance.yahoo.com/q/hp?s=JPM&a=05&b=1&c=2002&d=08&e=1&f=2002&g=d> [<https://perma.cc/MC6X-5UK5>] (last visited Oct. 29, 2016). The 39% drop was calculated using J.P. Morgan Chase's high price on July 15, 2002 of \$30.09 per share, and the low price on July 24, 2002 of \$18.22 per share. *Id.* Also notable was that the trading volume went from 11,558,500 on July 15, 2002, to 46,819,400 on July 24, 2002. *Id.*

217. Market cap was calculated by multiplying each share price by the fully diluted average share count for Q2 2002 of 2,016,000,000. See J.P. Morgan Chase & Co., Quarterly Report (Form 10-Q) 89 (Aug. 12, 2002).

218. See Surowiecki, *supra* note 73.

just three trading days its share price clawed back 59% of the losses, or \$14 billion in terms of market capitalization.²¹⁹

The “short and distort” scheme was also prevalent leading up to and during the financial crisis. In 2008, Bear Stearns, a global investment bank and securities trading and brokerage firm, saw its share price drop roughly 60% in a matter of days as a result of a sudden surge in short sales of its stock.²²⁰ Doubtfully a coincidence, the seemingly impromptu short selling occurred just as rumors were spreading that Bear Stearns was fast approaching a liquidity crisis.²²¹ Bear Stearns’ CEO, Alan D. Schwartz, later opined that the insidious rumors were spread intentionally and ultimately led to the short sales.²²² Also in 2008, Lehman Brothers, a global financial services firm, fell victim to the dissemination of a similar false rumor that ultimately led to its share price falling nearly 40% in just one day.²²³ A Lehman spokesperson implied that a “short and distort” scheme had been carried out to the firm’s detriment when she stated, “[Lehman is] suspicious that the rumors are being promulgated by short sellers of our stock that have an economic self-interest.”²²⁴

This strategy is so common that legislators and regulators in various financial markets have recognized it as a major problem. United States Senator Christopher J. Dodd has said that this strategy is more than just a spreading of rumors; rather, the strategy amounts to collusion.²²⁵ Across the pond, the United Kingdom Financial Services Authority stated that it would “cast a wide net” to identify and punish those who attempt to gain from spreading lies.²²⁶ The current short-only public disclosure regime in the United States facilitates this type of behavior, as perpetrators can carry out this strategy without the public ever knowing.

Investors have utilized the lax long-only disclosure regime to carry out predatory trading strategies. The best example is the 1998 collapse of Long Term Capital Management (“LTCM”), a relative value hedge fund

219. *See id.*; *see also JPM Historical Prices*, *supra* note 216. Losses recovered were calculated using the July 29, 2002 high of \$25.22. *See JPM Historical Prices*, *supra* note 216; *see also J.P. Morgan Chase & Co.*, *supra* note 217 (showing diluted share count).

220. *See Anderson*, *supra* note 2.

221. *See id.*

222. *See id.*

223. *See id.*

224. *See id.*

225. *See id.*

226. *See id.*

that fell victim to a front running predatory trading strategy.²²⁷ Due to some investments that went awry, LTCM sustained losses representing about 45% of its equity value, which prompted it to liquidate assets to delever its portfolio.²²⁸ As word of LTCM's distressed condition spread throughout the economy, predatory traders rushed to the market to front-run LTCM by short selling its assets before LTCM had the chance to liquidate them.²²⁹ The short sales caused the market price of these assets to plummet, making it near impossible for LTCM to recover its losses because the fund had no choice but to sell its assets at the now depressed market prices.²³⁰ Although the identities of LTCM's counterparties remain anonymous, an empirical study conducted in 2003 by Fang Cai, then a staff economist of the Division of International Finance of the Federal Reserve Board, concluded that the counterparties engaged in significant front running by executing the short sale trades merely one or two minutes before LTCM executed its own trades.²³¹ Cai's findings make sense. LTCM's counterparties were incentivized to short sell the assets because they had an economic self-interest in LTCM's collapse. The long-only disclosure regime allowed these counterparties to carry out this predatory trading strategy with both criminal and reputational immunity.

Evidence suggests that manipulative short selling pertaining to secondary equity offerings ("SEO") still exists on the market and contributes to a material downward price pressure on United States' SEOs.²³² For example, in 2012, J.P. Morgan sold short shares of American International Group ("AIG") four days before AIG sold shares in a secondary offering.²³³ Four days later, J.P. Morgan purchased shares from the AIG secondary offering, resulting in a profit of \$27,003.²³⁴ Because

227. See Alessandro Bruson, *LTCM: An Old but Not to Be Forgotten Story*, THE MKT. MOGUL (Apr. 28, 2016), <http://themarketmogul.com/lcm-old-not-forgotten-story/> [<http://perma.cc/3VW6-BFSQ>].

228. See *id.*

229. See *id.*

230. See *id.*

231. See Fang Cai, *Was There Front Running During the LTCM Crisis?*, INT'L FIN. DISCUSSION PAPERS, Feb. 2003, at 3.

232. See JONES ET AL., *supra* note 74, at 43-44.

233. See Matthew Heller, *Six Firms Fined \$2.5M for Illicit Short Sales*, CFO (Oct. 15, 2015), <http://ww2.cfo.com/credit-capital/2015/10/six-firms-fined-2-5m-illicit-short-sales/> [<https://perma.cc/9EM8-GHYH>].

234. See *id.*

of Rule 105 of Regulation M—which prohibits short selling a stock within five days of participating in a secondary offering for that same stock—J.P. Morgan was fined more than \$1 million by the SEC and was forced to disgorge over \$650,000 in profits from the prohibited activities.²³⁵ While Rule 105 has gone a long way to catch some short selling manipulators, the evidence suggests that undetected uses of this practice are still prevalent.²³⁶ The long-only public disclosure regime allows these manipulators to engage in this practice without having to publicly reveal the trades.

In a market with a disclosure regime that only requires reporting of long positions, the voluntary disclosure of short positions can have a magnified effect on market prices; and therefore, can be used as a manipulation device. For example, Kerrisdale Capital, a hedge fund, voluntarily disclosed that it had taken a short position in Zafgen Inc., a biotech company.²³⁷ After the disclosure, Zafgen's share price decreased by 10.6%.²³⁸ Kerrisdale was motivated to disclose its short position as there was a possibility that a Zafgen drug, called Beloranib, was not going to get approved by the Food and Drug Administration because of two deaths that may have resulted from its use.²³⁹ Sahm Adrangi, founder and chief investment officer of Kerrisdale, claimed that they disclosed their short position to stimulate a discussion as to the true worth of Zafgen's shares.²⁴⁰ In this regard, Adrangi considers Kerrisdale to be a "short activist," meaning the fund takes and discloses short positions to raise awareness and promote change.²⁴¹ Adrangi did not say, however, that there is a self-fulfilling profit motive in this strategy: by taking a short position and then disclosing that position publicly, the fund hopes to lower the share price, and thus make a profit. With or without an altruistic motive, using voluntary public disclosure to drive the price of a security

235. *See id.*

236. *See* JONES ET AL., *supra* note 74, at 43-44.

237. *See* Robert Weisman, *Zafgen Shares Drop as Hedge Fund Discloses Short Position*, BOSTON GLOBE (Jan. 25, 2016), <https://www.bostonglobe.com/business/2016/01/25/zafgen-shares-drop-hedge-fund-discloses-short-position/ebqslBcSAVxISLaPTLqKfL/story.html> [<https://perma.cc/4HBT-ZHVW>].

238. *See id.*

239. *See id.*

240. *See id.*

241. *See id.*

in a direction that is favorable to the discloser is a certainly a form of manipulation.

A hedge fund manager can use confidential treatment requests as a tool to improperly extend the time before an equity position needs to be disclosed. An audit revealed that for some confidential treatment requests, the time between when the request is filed with the SEC and when the SEC delivers a written response to the request exceeded twelve months.²⁴² In the period after being filed with the SEC and before the SEC's response, the equity position does not have to be publicly disclosed.²⁴³ This is significant given that if a confidential treatment request is approved, the maximum amount of time that the position can remain confidential is twelve months, after which the position must be disclosed or a new confidential request filed.²⁴⁴ Accordingly, a hedge fund manager could file a confidential treatment request that it knows will be denied by the SEC just so it can keep the position confidential in the time period before the SEC renders a decision. Effectively, any equity position could be granted de facto confidential treatment, at least for some amount of time, before the SEC delivers a written decision.

2. The Current 13F Regime Fails to Mitigate Systemic Risk

Deterring market manipulation is not the only goal of 13F; systemic risk mitigation is a key component to optimizing capital allocation, price discovery, and liquidity. If the current 13F long-only disclosure regime is to satisfy its purpose as it relates to systemic risk, there should be a level of transparency in the market that supports the mitigation of systemic risk by allowing market participants and regulators to rationally act and react to market trends and conditions. Undoubtedly, hedge funds contribute to systemic risk, in part, due to their size and operational opacity. The ability of hedge funds to instigate dramatic and unexpected market and asset price swings affects a lot more market participants than one may think. Indeed, government entities are aware of hedge funds' contributions to systemic risk, as evidenced by the Federal Reserve's bailout of LTCM in 1998. An analysis of the impact of hedge funds both before and during the financial crisis is indicative of their role in systemic risk creation.

242. See Carpenter, *supra* note 84, at 783.

243. See *id.* at 766.

244. See *id.* at 783-84.

Given that there are over 10,000 hedge funds currently operating and managing over \$3 trillion in assets, hedge funds play a tremendous role in the financial system and contribute to systemic risk.²⁴⁵ Despite short selling representing such a large and integral part of hedge funds' hedging practices, the public is largely blind to the nature of hedge funds' investments.²⁴⁶ As mentioned above, hedge funds operate under what is essentially an invisible cloak as they are able to execute short selling strategies to manipulate the market. The combination of this apparent operational anonymity, the proprietary nature of their strategies, and the astonishing amount of assets under their management results in a frightening uncertainty as to how deeply intertwined hedge funds are with the markets they operate in, as well as with markets and industries in which they have no direct involvement.

The tendency of hedge funds to sell assets suddenly and below market value is a source of systemic risk. Intuitively, investors of hedge funds can pull their money out of the fund; however, this may be difficult in practice as the investors' capital may be employed by the hedge fund on a type of investment that prohibits withdrawal. Yet, the hedge fund is obligated to return the funds to the investor, so it must liquidate assets to obtain the cash for distribution. Now assume that a large portion of the fund's investors want to withdraw at the same time. In this case, the hedge fund must sell off a large quantity of assets to obtain the necessary cash to distribute to the withdrawing investors. The laws of supply and demand dictate that an asset sale of this magnitude and in such a short time period will drive down the price of those assets. Assume further that the investors sought withdrawal because of some market event, and that market event caused investors of other hedge funds to seek withdrawal of their funds as well. In this case, there are many hedge funds, all selling assets at the same time, thus driving the prices lower and lower. This may seem great for the buyers of those assets as they are paying pennies on the dollar, but is troubling for the hedge funds' creditors who expect to recoup their investments. This becomes decreasingly possible in this scenario: the hedge fund borrowed and traded on the value of assets at their assigned market values, and now the fund has received less than that value, but its obligations to its counterparties and creditors remains unchanged. If this causes hedge funds to fold, those counterparties and creditors must absorb

245. See Ashworth II, *supra* note 23, at 657; Lewis, *supra* note 23.

246. See Lewis, *supra* note 23.

huge losses, which can ripple throughout the financial system.²⁴⁷ Also, other institutions will be indirectly impacted due to holding similar assets that the hedge fund sold at low prices, thus necessitating unexpected adjustments in asset price.²⁴⁸ Another problem could arise when, as happens daily, hedge funds enter into credit default swaps with investment banks and borrow money from those banks to enter into the swaps.²⁴⁹ Here, the bank has considerable exposure to the hedge fund, and a default could have severe negative consequences.²⁵⁰ Whatever the source, there exists a pervasive uncertainty regarding the boundlessness of hedge funds' impact on systemic risk.

Evidently, the Fed was well attuned to this uncertainty and its potential implications for systemic risk, as manifested by the Fed's orchestration of a \$3.65 billion bailout of LTCM in 1998. The Fed organized the LTCM bailout due to fears that the risk accumulated by LTCM's highly leveraged portfolio could quite possibly have triggered a systemic chain reaction that could have decimated the financial system.²⁵¹ LTCM, similar to hedge funds today, was so deeply interconnected with the financial system that its collapse could have had widespread consequences.²⁵² LTCM initially focused on bond arbitrage, a form of fixed income arbitrage, but as time went on it expanded its strategies to include pairs trading, merger arbitrage, currency, interest, and default swaps, volatility trading, and global markets.²⁵³ As a result, LTCM's assets under management ballooned to over \$128 billion, and the magnifying effects of its aggressive leverage strategy implicated over \$1 trillion of market exposure worldwide.²⁵⁴ The secrecy in which LTCM operated exacerbated fears surrounding its potentially rippling impact on the market. Partners in the fund would never reveal specifics about their

247. See Reint Gropp, *How Important Are Hedge Funds in a Crisis?*, FED. RESERVE BANK OF S.F.: ECONOMIC LETTERS (Apr. 14, 2014), <http://www.frbsf.org/economic-research/publications/economic-letter/2014/april/hedge-fund-risk-measurement-spillover-economic-crisis/> [<http://perma.cc/8LE7-TB48>].

248. See *id.*

249. See *id.*

250. See *id.*

251. See Lewis, *supra* note 23.

252. See Lewis, *supra* note 23.

253. See Stephanie Yang, *The Epic Story of How a 'Genius' Hedge Fund Almost Caused a Global Financial Meltdown*, BUSINESS INSIDER (July 10, 2014, 4:26 PM), <http://www.businessinsider.com/the-fall-of-long-term-capital-management-2014-7?op=1> [<http://perma.cc/4EDJ-WAH2>].

254. See *id.*

strategies, and even went so far as to disseminate a single trade across multiple banks to avoid unveiling their secrets.²⁵⁵ As trades went south, LTCM started to take enormous losses, as much as \$500 million in one day and \$2 billion in one month.²⁵⁶ LTCM could no longer maintain its secrecy as such drastic price swings caught the attention of not just LTCM's counterparties, but also other market participants.²⁵⁷ LTCM's fate was sealed after Bear Stearns stopped clearing LTCM's trades, and LTCM's attempts to raise capital from other banks and individuals such as Warren Buffet and George Soros failed.²⁵⁸ The Fed, based on this information and the fear that what was not publicly revealed could be even more severe, was virtually certain that one hedge fund's failure could bring down the entire financial system.²⁵⁹ Ultimately, the Fed-orchestrated bailout pooled capital injections from fourteen major banks that were indifferent to LTCM's failure yet participated in trepidation of losing their own assets.²⁶⁰

Another source of hedge fund-imposed systemic risk arises from the inherent disconnect in the funds' un-governed relationships with the shareholders of the companies with whom hedge funds invest and transact.²⁶¹ The sheer size of the investments that hedge funds make affects the prices of companies' securities.²⁶² Here, the fate of these unsophisticated investors is partially and indirectly dependent on the actions of the hedge fund.²⁶³ To quantify this, consider an investor who, in July of 1998, invested \$100,000 in a portfolio consisting of Barclays, Morgan Stanley, J.P. Morgan, and Merrill Lynch: banks with solid performances but which would, unbeknownst to the investor, participate in the LTCM bailout in September of 1998. About one week after the announcement of the LTCM bailout, the value of that portfolio would have dropped, on average, by 56%. In other words, due to the reckless decisions that LTCM made, the unsophisticated investor, through its investment in companies that invested in and transacted with LTCM, saw the value of its portfolio drop precipitously over a span of about two

255. *See id.*

256. *See id.*

257. *See id.*

258. *See id.*

259. *See id.*

260. *See id.*

261. *See Kehoe, supra* note 157.

262. *See id.*

263. *See Ashworth II, supra* note 23, at 675.

months from \$100,000 to just \$44,000. To further exemplify the systemic implications, imagine that due to the losses that the unsophisticated investor sustained, it will soon be unable to meet its mortgage obligations or car payments. Obviously, one individual's inability to pay its debts would hardly make a dent in the stability of the financial system but when it is thousands, or even hundreds of thousands of insolvent debtors, the systemic impact cannot be ignored.

B. THE INFORMATION DISCLOSED TO THE MARKET IS INSUFFICIENT

1. Long-only Public Disclosure is Misleading

Among the many shortcomings of the current 13F long-only public disclosure regime is the inability to effectively use the information that is disclosed. This stems largely from the fact that the list of reportable securities under 13F is glaringly outdated. As it stands today, the long-only public disclosure distorts market perceptions when it is not accompanied by the disclosure of short positions. Form PF is more comprehensive in this regard, but the information disclosed there is kept confidential.

New investment vehicles and investment strategies are created all the time as financial market participants constantly seek out the next big profit-generating machine. Nevertheless, the list of reportable securities under 13F has not changed since its enactment in 1975.²⁶⁴ The amount of innovation and creativity with regard to investment vehicles has changed drastically. For example, the credit default swap was not invented until 1994,²⁶⁵ the first collateralized debt obligation was not issued until 1987,²⁶⁶ and merger arbitrage did not become a widely used strategy until the 1980s.²⁶⁷ Also excluded from the list of reportable securities are options contracts and mutual fund shares.²⁶⁸ Accordingly, the strategies and investment vehicles that hedge funds use are wholly unaccounted for in the public information set.

264. See Carpenter, *supra* note 84, at 782.

265. Matthew Philips, *How Credit Default Swaps Became a Timebomb*, NEWSWEEK (Sept. 26, 2008, 8:00 PM), <http://www.newsweek.com/how-credit-default-swaps-became-timebomb-89291> [<http://perma.cc/B262-B9EG>].

266. Gregory Cresci, *Merrill, Citigroup Record CDO Fees Earned in Top Growth Market*, BLOOMBERG, Aug. 30, 2005.

267. LISA ENDLICH, GOLDMAN SACHS: THE CULTURE OF SUCCESS 109 (1999).

268. See Carpenter, *supra* note 84, at 782.

The usefulness of the information regarding hedge fund investment strategies that is publicly disclosed is drastically diminished absent a complete picture of the corresponding short positions. Such limited disclosure is misleading in three scenarios: first, a hedge fund could be taking a speculative short position against a stock; second, a hedge fund could be hedging a long position with a corresponding short position; and third, a hedge fund could be hedging a short position with a corresponding long position.

The first scenario is rather simple: given that it is only a short position, it will never be publicly disclosed under the current 13F regime. Consider, for example, a scenario where a hedge fund or group of hedge funds have utilized their resources to discover that all Apple products have been manufactured with a toxic level of lead, but Apple is either unaware of this fact, or is aware but has yet to disclose this information publicly. In this case, the hedge fund will surely short a large portion of Apple's stock, as it anticipates that the release of the news will cause the stock price to plummet. However, the lowly individual investor is entirely unaware of this impending crash, and happily invests their life savings into Apple stock. Six months later when the information is released, Apple's stock crashes, the hedge fund profits, and the individual investor is left with nothing.

The second scenario is typical of the most widely used strategy by hedge funds—the equity long/short—as well as pairs trading. Take, for example, a hedge fund that buys shares in the NASDAQ-100 Technology Sector Index, which is a basket of 100 of the world's largest technology companies, and correspondingly sells short shares of Apple. Here, the hedge fund, through its sophisticated research, believes that the technology sector is on the rise, but wants to hedge against that bet by shorting Apple, the largest stock in the index. The 13F disclosure would send a signal to the market that hedge funds are extremely bullish on the technology sector. What those investors would not know, however, is that the hedge fund is not as confident as the disclosure suggests because it recognized a possible downside risk, and thus, hedged its position by shorting Apple's stock.

The third scenario is arguably the most distortive. Take, for example, a scenario where a hedge fund has reason to believe that Apple's stock is going to plummet, so it short sells a large amount of Apple's stock, and hedges that bet with a small long position in Microsoft's stock. This hedge fund position would be referred to as “net short.” The public disclosure in this case would merely send the signal that hedge funds are somewhat

bullish on Microsoft's stock. Here, the public would never know that the true trade was actually a pessimistic view on Apple. As one commentator put it, "You've kind of taken the hedge out of the hedge fund strategy if you don't know what these funds are shorting . . . [y]ou've got less than half the puzzle."²⁶⁹

2. *The Limited Resources of the Securities and Exchange Commission*

There is no question that the resources of the SEC are limited; it simply cannot police every transaction, analyze every data point, and catch every fraud related to securities. However, the SEC's resources are so limited that they diminish the utility of 13F filings. In 2010, the SEC's Office of Inspector General ("OIG") released a review of the significant shortcomings on the part of the SEC with regards to administering and supervising the filings.²⁷⁰

The report found that no division or office was individually or specifically responsible for reviewing the 13F filings.²⁷¹ As one could expect, this resulted in no division or office prioritizing the review of 13F filings, resulting in the data being "less useful and reliable than Congress had intended."²⁷² In fact, the report found numerous instances where members of the general public notified the SEC of noncompliance in some filers' forms.²⁷³ Some of the notifications involved glaringly obvious errors: for instance, a graduate student informed the SEC of a filer who continued to submit the filing in paper format, despite an online EDGAR form being available since 1999.²⁷⁴ In that case, the filer had never been informed of the error,²⁷⁵ which might suggest that those filings were never reviewed by the SEC at all. The fact that as of 2013, the SEC

269. Lewis Braham, *Attack of the Hedge Fund Clones*, BLOOMBERG (June 3, 2013), <http://www.bloomberg.com/news/print/2013-06-03/attack-of-the-hedge-fund-clones.html> [<https://perma.cc/T2HQ-SBNF>].

270. See OFFICE OF INSPECTOR GEN., SEC. & EXCH. COMM'N, REVIEW OF THE SEC'S SECTION 13(F) REPORTING REQUIREMENTS (2010) [hereinafter *OIG Report*]; Carpenter, *supra* note 84, at 780.

271. See *OIG Report*, *supra* note 270; Carpenter, *supra* note 84, at 781.

272. See *OIG Report*, *supra* note 270, at 8; Carpenter, *supra* note 84, at 781.

273. See *OIG Report*, *supra* note 270, at 11-12; Carpenter, *supra* note 84, at 781.

274. *OIG Report*, *supra* note 270, at 11.

275. See *id.* at 11.

has only brought one enforcement action against a 13F filer is yet another indication of the SEC's ineffectiveness.²⁷⁶

Confidential treatment requests have also been disregarded, lost or misplaced, and in some cases improperly revealed to the public. To conduct a review of the SEC's handling of confidential treatment requests, the OIG requested a random sample of twenty-five documents from the SEC's Investment Branch ("IM") and Records Management Branch ("RM"), two entities that retain, process, and share confidential treatment requests.²⁷⁷ Alarming, neither IM nor RM could locate or even account for twelve of the twenty-five requested documents.²⁷⁸ The OIG verified that for six of those missing documents, the corresponding confidential treatment requests were approved despite no existing record supporting the approval decision.²⁷⁹ The OIG concluded that the SEC's blatant failure to comply with its record retention procedures for confidential treatment filings raises serious concerns that those filings could be misplaced, lost, or even inadvertently disclosed.²⁸⁰

The SEC also lacks the technology to review the wealth of 13F filings. Due to budgeting constraints and superseding priorities, the SEC cannot compete with the private sector in terms of technological prowess.²⁸¹ Hedge funds certainly have better technology, part of which they expend on generating these reports, yet the SEC has proven to be unable to effectively handle such a large amount of information.²⁸² Confessedly, the SEC stated in 2011 that it "will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency."²⁸³ The SEC then suggested that more funding would be needed, and that funding would

276. See Quattro Global Capital, LLC, Exchange Act Release No. 56,252, Investment Advisers Act Release No. 2634, 91 SEC Docket 994 (Aug. 15, 2007); Carpenter, *supra* note 84, at 786.

277. See OIG Report, *supra* note 270, at 19.

278. See *id.* at 20.

279. See *id.*

280. See *id.* at 20-21.

281. See Kehoe, *supra* note 157, at 67-68.

282. See *id.*

283. SEC. & EXCH. COMM'N, STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS 3-4 (2011), <https://www.sec.gov/news/studies/2011/914studyfinal.pdf> [<https://perma.cc/N3KD-4YB7>].

have to grow as the number of registered investment advisers increases over time.²⁸⁴

III. A PROPOSAL FOR EXPANDING THE LIST OF REPORTABLE SECURITIES UNDER FORM 13F TO INCLUDE BOTH LONG POSITIONS AND SHORT POSITIONS

Despite hedge funds' widespread growth and popularity, and their recognition by market actors, regulators, and academics as systemically influential institutions, little has been done to learn more about the implications that their practices have on the financial system.²⁸⁵ The current disclosure regime does little to inform the public or the SEC about these implications. Short selling is at the core of virtually every hedge fund strategy, yet the current disclosure obligations only require long position disclosure.²⁸⁶ The omission of public short position disclosure has rendered investors, corporations, and the market as a whole vulnerable to manipulation and the resultant harms of systemic risk. Ultimately, the lack of transparency in the market has led to inefficient capital allocation and price discovery, and a suboptimal level of liquidity. Therefore, 13F has unquestionably failed to accomplish the purpose that it was designed to achieve. To remedy these issues, the list of reportable securities under Form 13F should be expanded to include both long positions and short positions.

Specifically, Form 13F should be expanded to include short positions as they are defined in EU 236: any transaction entered into by a hedge fund where the hedge fund receives a financial benefit from the decrease in price or value of the security. This would include traditional equity-based short selling, as well as derivatives positions that result in a net short position. To be clear, the short position should be viewed in isolation and not in conjunction with or netted against a corresponding or associated long position. The reporting periods should remain as within forty-five days of the end of the most recent quarter, and should apply to those advisers whose funds hold an aggregate fair market value of at least \$100,000,000. The value of each individual short position should be calculated by the greater of the value of the security on the date the short position was made (i.e., on the day an equity security was borrowed and

284. *See id.*

285. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72054-01 (Dec. 10, 2004).

286. *See* SEC. & EXCH. COMM'N, FORM 13F.

sold short) and the total value of short exposure on the short position on the last day of the most recent quarter. No event-driven threshold framework, such as the one in EU 236, should be adopted under 13F. Confidential treatment should still be available; however, there should be increased penalties for frivolous filings.

Such an expansion would be easy to implement and would single-handedly allow 13F to achieve its ultimate purpose. First, investors will benefit from a reduction in informational asymmetry and an elimination of the distorted picture painted by the current publicly available information set. Second, investors and corporations will no longer be susceptible to those manipulative short selling practices that exist purely because of the current one-sided 13F disclosure regime. Third, the systemic risks perpetuated by today's 13F disclosure will be drastically reduced by a more transparent and comprehensive disclosure mandate. Fourth, a disclosure expansion will act to curb and even work around the limitations of the SEC and its resources. Finally, to the extent that disclosure reveals trading strategies, the proposal put forth in this Article would ensure that hedge funds do not lose profit opportunities as a result of disclosure.

The burden on hedge fund advisers to file a 13F disclosure would increase only marginally, with the bulk of the burden coming from filing more confidential treatment requests. However, the compliance burden is outweighed by the benefits to investors, the public, and the market. After all, disclosure is a reasonable cost to pay to operate in an efficient market that is well-regulated and provides protections for its investors and issuers alike.²⁸⁷ Information regarding assets managed, leverage employed, fund performance, long positions, short positions, and much more is already filed in Form PF. Accordingly, merely adding short positions to 13F would be simple and inexpensive. This Article does not argue for the adoption of the EU's threshold reporting approach because, among other reasons, it would drastically increase the compliance burden on managers, as they would need to constantly keep track of their holdings and fickle changes in their net short positions due to market fluctuations. Likewise, the EU's threshold reporting framework is event-driven, which requires hedge funds to report short position changes as often as every day. A periodic, quarterly disclosure mandate will better serve to limit the compliance burden levied upon filers.

287. See Carpenter, *supra* note 84, at 774.

A. REDUCED INFORMATIONAL ASYMMETRY AND MANIPULATION

The SEC has opined that every investor and market participant “deserve[s] equal access to information.”²⁸⁸ Disclosure is an effective tool to ensure equal access and reduce informational asymmetry. With no disclosure, or inadequate disclosure, individual investors are simply incapable of bearing the costs of fully assessing the relevant risks in order to invest efficiently. It can be argued that it is somewhat unfair for institutions like hedge funds, which use their expensive and time consuming resources to gather the necessary information, to have to disclose their findings to the public for free. However, without such disclosure, those investors without the requisite resources would not invest in the market because it would be impossible to compete with hedge funds for those opportunities for positive returns. Therefore, it would be in the hedge funds’ best interest to be subject to mandatory disclosures so as to avoid market illiquidity and inefficiency, and thereby increase trading opportunities.

Short sale reporting would eliminate the skewed and misleading nature of the long-only disclosure regime. Short selling is an essential part of hedge fund trading. Hedge funds utilize short selling as a hedging mechanism to reduce risk, and a leverage mechanism to magnify returns.²⁸⁹ Nevertheless, a 13F disclosure today would only provide information regarding long positions. An unhedged speculative short position would not appear in the disclosure at all, a net long position would convey an inaccurate level of optimism, and a net short position would appear as merely a small bullish investment on a particular stock. At worst, this distortion ultimately discourages investors from participating in the markets, and at best, decreases the usefulness of the long-only Form 13F; thus, the justifications regarding imposing costs on hedge funds to file it are severely undermined.

A mandatory short-and-long disclosure regime could allow the market to better assess the short selling impetus by revealing the identity of short sellers who may have ulterior motives other than an apparent desire to optimize price discovery. With disclosure of short positions, the market can better assess the intentions of the short sellers. With no short disclosures, investors are left to blindly assume that because a stock’s short interest increases, its price must be overvalued. However, in a short-disclosure regime, market participants can see who is shorting a

288. See Kehoe, *supra* note 157, at 60.

289. See *supra* Section I.A.2.a.

company's stock, which will allow them to make their own assumptions as to the motivations behind the short sales. Rather than a signal of overvaluation, perhaps those hedge funds that sold a stock short had an economic self-interest in the share price dropping. A comprehensive disclosure would provide investors with the facts to assess these misaligned interests and act accordingly.

By adding short positions to 13F disclosures, some of the manipulative practices that exploit the current long-only disclosure regime would be severely disincentivized. Today, schemes like the "short and distort" strategy, predatory trading, and manipulative short selling leading up to an SEO unfairly ravage the coffers of targeted corporations. The most egregious part of these schemes is that hedge funds are able to carry them out with impunity by using short positions that never have to be disclosed. A more comprehensive 13F regime could provide a tool both for those targeted corporations and for market watchdogs to identify such manipulations. For example, the enhanced disclosure would expose a collusive scheme by a group of hedge funds to short one stock at the same time. Interestingly, in the Lehman Brothers example from Part II,²⁹⁰ Lehman suspected that the false rumors were promulgated by short sellers who had an economic interest in the stock. It stands to reason that a long-and-short disclosure regime would have pierced the veil protecting the anonymity of those short sellers, and could have revealed intentions incongruent with traditional market practices or even served as evidence of collusion.

One study sought to explore the possibility of mandatory short disclosure being used as a coordination mechanism for manipulative short sellers.²⁹¹ The study looked at the effects of companies in the EU's new long-and-short disclosure regime and found that disclosure of a short position in a certain stock significantly increased the possibility of another short disclosure.²⁹² The risk of short disclosures being used as a coordination mechanism would be significantly reduced under this Article's proposal for two reasons. First, reporting would be quarterly and not event-driven like under the EU 236. With quarterly disclosure, a disclosed short position could be months or even more than a year old if it was granted confidential treatment. Accordingly, the reasons for the adoption of the short position are likely to be outdated, thereby reducing

290. See *supra* Section II.A.1.

291. See JONES ET AL., *supra* note 74, at 5.

292. See *id.*

the likelihood of a short seller mimicking a prior disclosure. Second, the identity of the short sellers would be revealed to the public. Surely, a short seller would be foolish to try to carry out any form of coordinated manipulation if their identity and exact positions are in the public domain.

Potential harm to corporations and hedge funds from the disclosure of short positions could result from the corporations retaliating against the hedge fund that disclosed its short positions in their stock.²⁹³ In this case, those corporations may cease communicating with those who short their stock, or even use the media to launch attacks against the hedge fund.²⁹⁴ This could potentially limit a hedge fund's motivation to take a given short position, leading to market inefficiencies. However, the disclosure of short positions could also facilitate a conversation between the corporation and the hedge fund that shorted its stock.²⁹⁵ Without public disclosure of short positions, corporations' market values are depressed by short positions, and they have little recourse to speak with the short sellers to identify their concerns.²⁹⁶ Corporations would be in a situation to analyze the perceptions, whether true or false, about their securities, and act to eliminate their perceived shortcomings.²⁹⁷ Conversely, hedge funds would be less hesitant to take short positions and overall market efficiency would be improved, not hindered.

An expanded 13F regime would also significantly reduce the harm to companies and investors caused by voluntary disclosure manipulation. In a disclosure regime where short positions are not required to be reported, the voluntary disclosure of a short position through, say, the media will have an abnormal impact on the performance of a stock. If short disclosure were mandatory, this window for manipulation would be minimized because the revelation of a short position would be the status quo. For example, if Kerrisdale Capital's short position of Zafgen Inc. had been disclosed in a mandatory short position regime, 13F filings would have shown a vast number of other hedge funds that had the same short position, or alternatively, the filings would have shown that no other hedge funds had shorted Zafgen. Either way, the short position disclosure by one hedge fund would be much less impactful in a mandatory short position public disclosure regime.

293. See Coal. of Private Inv. Cos., *Setting Policy*, *supra* note 1.

294. See *id.*

295. See Email from Elizabeth King, Gen. Counsel & Corp. Sec'y, New York Stock Exchange, to Brent J. Fields, Sec'y, Sec. & Exch. Comm'n (Oct. 7, 2015), <https://www.sec.gov/rules/petitions/2015/petn4-689.pdf> [<https://perma.cc/6X2U-P859>].

296. See *id.*

297. See *id.*

B. MITIGATION OF SYSTEMIC RISK

Hedge funds and their strategies contribute to systemic risk, and that risk is only amplified by the current disclosure regime that fails to fully gather information on the short position exposure on the market. While commentators quarrel as to the degree to which hedge funds contribute to systemic risk, few, if any, argue that hedge funds are not systemically important at all.²⁹⁸ The difficulty in measuring hedge funds' contribution to systemic risk can largely be attributed to having too little information about hedge funds, their strategies, and the identity of their counterparties. The information that is disclosed publicly is too incomplete to be of value. The information that is disclosed only to the SEC would help measure hedge fund-generated systemic risk, but its utility is diminished since it remains hidden from the public eye. Such uncertainty perpetuates systemic risk. Simply put, to understand and thus reduce hedge funds' contribution to systemic risk, more information must be publicly disclosed, and that information must be tailored to hedge funds and their unique strategies.

Researchers can trace some of hedge funds' actions and the effects of those actions, but their findings are limited by what is publicly disclosed. One research initiative sought to estimate the spillover effects—when an event or action in one market spills over and affects another market—of various hedge fund strategies and practices.²⁹⁹ The initiative employed a model that was able to calculate the statistical relationships between markets, but it was unable to explain the economic relationships underlying the statistical relationships.³⁰⁰ According to the researchers, the economic drivers of the statistical relationships could only be determined if there was more information on the hedge funds' counterparty exposure, assets, and liabilities.³⁰¹ While statistical analysis is useful in many respects, it falls short in the measurement of hedge fund generated systemic risk.

298. See Ashworth II, *supra* note 23, at 670-71; Kehoe, *supra* note 157; Lewis, *supra* note 23; Coal. of Private Inv. Cos., *Credit Crisis*, *supra* note 5; COAL. OF PRIVATE INV. COS., *Facts About Hedge Funds*, *supra* note 22; Coal. of Private Inv. Cos., *Setting Policy*, *supra* note 1, at 3; Gropp, *supra* note 247.

299. See Gropp, *supra* note 247.

300. See *id.*

301. See *id.*

The proposed 13F regime will result in more information being publicly disclosed to the market by increasing the amount of 13F filers. Intuitively, with more 13F filers comes more information. To accomplish this, the proposal does not adopt the EU 236 net short threshold. As a result, all short positions must be disclosed, irrespective of the size or percentage change in value of the position. One could argue, however, that the disclosure of miniscule short positions could trigger a market reaction that is disproportionately large in relation to the value of the short position.³⁰² Moreover, one could argue that it would be unduly burdensome to require hedge funds to calculate and report the values of these small short positions. Nevertheless, this Article takes the position that any additional burden or disproportionate market reaction is outweighed by the benefits of more public information in the market.

With more information publicly available, the proposed 13F regime will result in increased market transparency. More transparency will enhance the beneficial effects while at the same time debasing the detrimental effects of 13F disclosures. As the beneficial effects pertain to systemic risk, the market and its investors, issuers, and regulators will all have a wealth of balanced information to tackle systemic risk. Those systemic risks that already exist will be more easily identified, and potential sources of new systemic risk can be avoided. Indeed, the imposition of 13F filing burdens on hedge funds is more justifiable when the disclosure results in the mitigation of, not contribution to, systemic risk.

C. IMPLICATIONS OF THE SECURITIES AND EXCHANGE COMMISSION'S LIMITED RESOURCES

It would be physically impossible and an inefficient use of resources for the SEC to examine and analyze each long and short position for the well over 10,000 13Fs filed each quarter. The SEC has demonstrated an inability to police each and every filer and filing.³⁰³ However, that is how the United States government has approached essentially every policing function. The Internal Revenue Service does not audit every tax filing, the Food and Drug Administration does not inspect every single label for compliance, and the police departments do not arrest everyone who

302. See *supra* note 193 and accompanying text.

303. See Kehoe, *supra* note 157, at 67; see also OIG Report, *supra* note 270, at 11, 12, 19-21.

commits a crime. The reason for this, primarily, is that a sufficient deterrence effect can be generated with randomized monitoring.³⁰⁴ Accordingly, the SEC need not expend its limited resources to achieve 100% noncompliance detection.

Moreover, while the SEC can surely fortify its administration and handling of 13F filings, it should not be stripped of the responsibility altogether. If nothing else, the SEC plays an integral role in the public disclosure process by serving as a centralized body for filing and reviewing 13F filings. Without a uniform public disclosure standard, 13F would be rendered utterly useless.

With that being said, calls for hedge funds to provide more information to the SEC on a confidential basis³⁰⁵ are misplaced. Any attempt to receive even an incremental benefit from feeding more information into an entity that is already overburdened would be futile. The information provided by Form PF is comprehensive and sufficient to analyze and understand hedge funds' contribution to systemic risk. However, the SEC cannot be held responsible for managing that risk themselves. While it is very important for regulators to have access to that information, it is merely half the formula for achieving a fully functioning, liquid, and efficient market. Such information, in one form or another, needs to be disclosed to the public.

Members of the public can, as they have before, report to the SEC when they find instances of noncompliant filings. This crowdsourcing approach is certainly more efficient than the SEC bearing all the responsibility. Members of the public will continue to report these instances because they stand to gain when a counterparty or entity in which they have an economic interest does not disclose their positions properly. The SEC can, as it has been doing, decide whether or not to pursue those noncompliant filers. With the advent of twenty-first century instantaneous media coverage, filers themselves are already incentivized to file properly as reputational risk can be very damaging.

If short positions are included in 13F filings, there will be more reasons for hedge fund advisers to seek confidential treatment. The fact

304. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72054-01 (Dec. 10, 2004) (citing Jennifer F. Reinganum and Louis L. Wilde, *Income Tax Compliance in a Principal-Agent Framework*, 26 J. PUB. ECON. 1 (Feb. 1985); Jennifer F. Reinganum and Louis L. Wilde, *A Note on Enforcement Uncertainty and Taxpayer Compliance*, 103(4) Q. J. ECON. 793 (Nov. 1988)).

305. See Gropp, *supra* note 247.

that the SEC's resources are already extended beyond its capacity begs the question of how it will deal with more confidential treatment requests. This ripens the opportunity for confidential treatment manipulation. To remedy this, the penalties for frivolous confidential treatment filings must be harsh. In effect, heightened penalties will deter those attempts to exploit de facto confidential treatment during the time it takes the SEC to review the request.

D. THE IMPORTANCE OF PROTECTING HEDGE FUNDS' PROPRIETARY INFORMATION

Hedge funds go to great lengths to protect the secrecy of their investment strategies, and rightly so. Hedge funds employ enormous amounts of capital to develop these strategies, and thus, the opacity in which hedge funds operate is justifiable. However, hedge funds do avail themselves of the benefits and protections of the regulated markets in which they participate. Accordingly, it is not unreasonable to mandate hedge fund disclosure to ensure and increase the liquidity, efficiency, price discovery, and capital allocation in the markets.³⁰⁶ Nevertheless, a balance must be struck between disclosure for the good of the market and the protection of proprietary trading strategies.

To reach this equilibrium, this Article utilizes three tools: a periodic reporting framework, a forty-five day "buffer" period, and confidential treatment requests. The periodic reporting periods provide a better solution than the EU 236 event-driven framework. With EU 236, changes in short positions could occur multiple times a day as prices fluctuate. This could trigger a reporting obligation every day, which makes hedge funds more vulnerable to copycat investors who mimic their strategies and thus diminish their potential returns. Conversely, quarterly reporting with a forty-five day buffer period results in fewer obligations per year, and renders hedge funds' potential profits less susceptible to being usurped by copycat investors. Such a delay in reporting allows hedge funds more time to generate information regarding their trades and adjust their positions before public revelation. More likely than not, the trade would already have been entered into and exited from before it must be disclosed; thus, all profit opportunities would have already been realized by the hedge fund.³⁰⁷

306. See Carpenter, *supra* note 84, at 774.

307. See Carpenter, *supra* note 84, at 774; see also AGARWAL ET AL., *supra* note 119, at 6; Email from Elizabeth King, *supra* note 295.

Despite the poor handling and the delayed response time caused by the SEC's limited resources, confidential treatment requests remain an important part of protecting hedge funds from losing profits as a result of disclosing their various positions. For those strategies that involve an implementation or investment period that exceeds the buffer period, which could be as little as forty-five days and as much as 135 days, the confidential treatment request will provide protection from lost profits.³⁰⁸ And as mentioned above, an increase in penalties for those confidential treatment requests deemed frivolous will deter abuse of the de facto confidential treatment during the period between filing and approval or denial of the request.³⁰⁹

CONCLUSION

As evidenced, the current 13F mandated long-only public disclosure regime is severely ineffective and the benefits reaped from the information disclosure hardly justify the compliance costs imposed on hedge fund filers. The regime can be likened to reporting the score of a football game by disclosing only one team's score. While some information and associated benefits can be gleaned from one-sided reporting, a more balanced two-sided disclosure mandate would benefit all market participants exponentially. The increased transparency resulting from a 13F expansion would eliminate informational asymmetry, minimize opportunities for manipulation, and reduce systemic risk, all while taking into account the limited resources of the SEC and the possibility of lost profits from the disclosure of trading positions. Irrefutably, the realization of such benefits will result in a market and financial system that is more liquid and efficient, with more accurate pricing and effective capital allocation.

308. *But see* Carpenter, *supra* note 84, at 785 (arguing that after the forty-five day delay period, any lost excess return as a result of disclosure is a cost of operating in efficient markets).

309. *See supra* Section III.C.