William & Mary Environmental Law and Policy Review

Volume *41*
Issue 3

Article 6

April 2017

A “Green” Approach to Hedge Fund Regulation and Reform

Matthew Keehn

Repository Citation
Matthew Keehn, *A “Green” Approach to Hedge Fund Regulation and Reform*, 41 Wm. & Mary Envtl. L. & Pol'y Rev. 653 (2017), https://scholarship.law.wm.edu/wmelpr/vol41/iss3/6

A "GREEN" APPROACH TO HEDGE FUND REGULATION AND REFORM

MATTHEW KEEHN*

INTRODUCTION

The green energy revolution has always lacked one thing: money. At its beginning, it was thought of as an idealist, hippie movement that would never be able to stand up to traditional forms of energy. A 2011 blog post for the Huffington Post sums up the general consensus succinctly, in a discussion on personal sustainability, saying "[T]he government won't do it for you. The banking industry has proven they don't want to do it for you."[1] The blog writer also offers up an American Indian proverb to his readers: "Only when the last tree has died, and the last river has been poisoned, and the last fish has been caught, will we realize that we cannot eat money."[2] However, not all hope is lost for sustainable energy solutions in the United States. Nor is the financial services sector quite the big bad wolf that this blog author makes it out to be. The government is pulling for green energy.[3] Financial markets are betting on green energy.[4] Despite this, traditional forms of energy are still the norm in the United States, and renewable energy has yet to capture significant market share from traditional forms. While the country has taken significant steps

---

* J.D. Candidate, William & Mary Law School, 2017; B.A. Engineering Studies, minor in Classics, Lafayette College, 2012, cum laude. The author would like to thank the staff of the *William & Mary Environmental Law and Policy Review* for their efforts on this Note, as well as his family and friends for their constant support and encouragement.

[1] Jerry Nelson, *We Can't Eat Money*, THE HUFFINGTON POST BLOG (Dec. 19, 2011, 6:01 PM), http://www.huffingtonpost.com/jerry-nelson/we-cant-eat-money_b_1156252.html [https://perma.cc/U37E-JC8K].

[2] *Id.*

[3] *See Budget Formulation and Execution*, U.S. DEP'T OF ENERGY, OFFICE OF ENERGY EFFICIENCY AND RENEWABLE ENERGY, http://energy.gov/eere/budget/budget-formulation-and-execution [https://perma.cc/W4VA-4XAQ] (last visited Nov. 15, 2016) (outlining the process of the EERE, a sub-office of the Department of Energy, submitting a planned budget to Congress for approval and subsequent evaluation of that budget).

[4] *See* Peter C. Fusaro, *The New Green Business Model For Investment*, FORBES CUSTOM (2008), http://www.forbescustom.com/EnvironmentPgs/NewGreenBusinessModelP1.html [https://perma.cc/37C2-ARZM] (last visited Nov. 15, 2016) (discussing the emerging market for hedge funds that invest in green energy, the status of such funds in 2008, and how the green hedge fund has become a new asset class for investors).

toward sustainability, traditional energy still has much more capital funding than sustainable forms of energy in the marketplace.

That leaves environmentalists with a question: where can we find the capital for sustainable energy? To answer this question, we must first take a step back, and ascertain how capital enters the marketplace. Firms in the marketplace generate capital by selling financial instruments to investors, who give the firms cash in return for some share in the future value of the firm.[5] This cash, or capital, that investors contribute to the market is instrumental in the growth of any firm.[6] Capturing a greater market share (the percentage of an industry's sales that go to a particular company) requires large amounts of capital.[7] This is particularly true in an established market, like the energy sector.[8] This explains why the sustainable energy sector, even though it is getting some funding, will not be able to capture significant market share from traditional energy without significant capital investment. One possible solution is to get hedge funds to invest more in the sustainable energy sector.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") recently reshaped hedge fund regulations,[9] and the new rules are unnecessarily stringent. Regulations increase the cost of running the business of a hedge fund, and therefore the capital provided by those funds becomes more expensive for the borrowers who receive large capital investments[10] (to make up for the increased expenses on the fund-side). The market as a whole—corporations and investors alike—would benefit from cheaper capital if the regulations were moved back to pre-Dodd-Frank standards. In order to prove this hypothesis, the SEC should allow a subset of hedge funds to operate on pre-Dodd-Frank regulatory standards, and evaluate those funds as compared to remaining hedge funds operating under Dodd-Frank regulations. The performance of pre-Dodd-Frank funds will surpass that of Dodd-Frank funds, and fraud will not be an issue. In response to this the SEC would be able

---

[5] *See Capital Markets*, INVESTOPEDIA, http://www.investopedia.com/terms/c/capitalmarkets.asp [https://perma.cc/LH6T-NSSB] (last visited Nov. 15, 2016) (defining capital markets basic structure and components).
[6] *Id.*
[7] *Market Share*, INVESTOPEDIA, http://www.investopedia.com/terms/m/marketshare.asp [https://perma.cc/3RMR-GQ8W] (last visited Nov. 15, 2016).
[8] *Id.*
[9] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[10] *See* PHILIP COGGAN, GUIDE TO HEDGE FUNDS 82–83 (John Wiley & Sons, Inc., 2d ed. 2011) (discussing the effect of hedge funds on the overall financial markets).

to remove the Dodd-Frank restrictions on hedge funds (for good cause) and cut a costly administration task from its budget. The question then remains: which subset of hedge funds should operate as this subset?

The answer is also the answer to the capital investment problem in the renewable energy sector. Allowing "green" hedge funds to operate on pre-Dodd-Frank regulations would bring some of the necessary capital into the sustainable sector of the energy market. This influx of cheap capital into the green energy firms will facilitate expansion and capture a greater portion of the overall energy space from traditional, fossil fuel based forms of energy.[11] An additional impact of this influx of capital is that the federal government can decrease the funding it is currently pouring into sustainable energy. Although the private sector currently funds a substantial portion of sustainable energy efforts, the government still distributes significant funds into this particular market.[12] The result of allowing funds to go pre-Dodd-Frank is a win-win scenario. Hedge fund regulation is amended to an optimal point for both protection and market operations. In addition, sustainable energy is a more viable product for a larger portion of the American population, thus reducing our national contribution to global climate change.

Hedge fund regulation ramped up after the 2008 Financial Crisis in the form of Dodd-Frank.[13] While there were concerns about the regulation of hedge funds after the credit crunch and economic woes of 2008, these funds were not as substantial contributors as once thought.[14] As our economy is in constant motion and contains enormous amounts of moving parts, it is difficult to evaluate the current status of markets and their regulations. There are always new factors that were not present in the past, which may or may not skew the analysis. Due to this fluctuation, it is difficult to test the effectiveness of new regulations as they happen. We can only look back into the past, and evaluate the regulations in hindsight.

---

[11] *See* Rich Anderson, *Ready, Set, Grow: Using Capital to Invest in Your Company's Growth*, MOSS ADAMS LLP INSIGHTS, http://www.mossadams.com/articles/2015/February/raising-capital-for-growth [https://perma.cc/VXA9-65EQ] (last visited Nov. 15, 2016).

[12] *See* Ron Flavin, *The US Department of Energy's 2014 Budget Request: Implications for Renewable Energy Funding*, RENEWABLEENERGYWORLD (Mar. 5, 2014), http://www.renewableenergyworld.com/articles/2014/03/the-us-department-of-energys-2014-budget-request-implications-for-renewable-energy-funding.html [https://perma.cc/RA3T-QZRY].

[13] BINGHAM MCCUTCHEN LLP, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: A SUMMARY 1 (Practising Law Inst., 2010) [hereinafter DODD-FRANK SUMMARY].

[14] Barbara C. George et al., *The Opaque And Under-Regulated Hedge Fund Industry: Victim Or Culprit In The Subprime Mortgage Crisis?*, 5 N.Y.U. J.L. & BUS. 359, 360 (2009) (discussing the role of hedge funds in the 2008 financial crisis).

In addition to introducing large amounts of capital into the green sector, evaluating the pre-Dodd-Frank funds will allow the SEC to evaluate its hedge fund regulations in real-time. Due to the fact that hedge funds create concerns for economists and regulators,[15] there was an increase in SEC regulation in the Dodd-Frank reform after the Financial Crisis of 2008.[16] However, there are camps of scholars who are not convinced of hedge funds' role in causing the economic setbacks of 2008.[17] If hedge funds are overregulated, the government is needlessly spending money to supervise an industry that does not need supervising. This is the equivalent of having a lifeguard watching a pool full of Olympic swimmers; it is redundant and wasteful. In addition, these regulations create additional tasks for funds, which raise their operational costs,[18] and in turn raise the costs of capital.[19] Proving the regulations are necessary with empirical evidence will quash any theorists pushing for less regulation. By monitoring a specific and controlled subset of hedge funds that are operating regulation free, and comparing the results to other hedge funds operating under Dodd-Frank regulation, the SEC will ascertain that these specific Dodd-Frank regulations are hindering the financial markets.

Dodd-Frank hedge fund regulation is overbearing and unnecessary. Allowing hedge funds that pledge a sustainable energy investment strategy to return to pre-Dodd-Frank regulation will generate an influx of capital into sustainable energy firms, thus allowing those firms to expand and gain market share from traditional fossil fuels, and allow the SEC to perform a real-time evaluation of the Dodd-Frank hedge fund regulations. Such real time evaluations are usually not possible given the nature of regulations, making the proposal even more beneficial. The first section of this Note will provide a brief background on hedge funds and Dodd-Frank reform. The second section will discuss the impact that hedge funds had in the Financial Crisis, and renew arguments for and against regulation of hedge funds. The third section will outline the history of funding for the green energy sector, what makes up a "green fund" and the current state of the traditional energy market. The Conclusion will outline how funds will apply for this regulatory relief, as well as map out the potential challenges to this scheme.

---

[15] *See* COGGAN, *supra* note 10, at 64–65 (discussing the four major areas of concern for hedge funds: systematic risk, fraud, tax evasion, and regulatory arbitrage).
[16] *See* DODD-FRANK SUMMARY, *supra* note 13, at 3.
[17] *See* George et al., *supra* note 14.
[18] *See* DODD-FRANK SUMMARY, *supra* note 13, at 3.
[19] *See* COGGAN, *supra* note 10, at 82–83.

I. BACKGROUND

A. What Is a Hedge Fund?

It is important to start from the beginning by addressing what a hedge fund is actually comprised of. "Hedge fund" is a term used very frequently when financial markets are concerned, but it is difficult to concretely define the elements of these entities. As Philip Coggan of the *Economist* described hedge funds, "It is a bit like describing a monster; no single characteristic is sufficient but you still know one when you see one."[20] The Securities and Exchange Commission ("SEC") itself does not have a concrete definition of a hedge fund;[21] the SEC did not even attempt to define one in Dodd-Frank,[22] except to say that a hedge fund is an issuer that would be an issuer under the Investment Company Act of 1940 ("1940 Act") but for the exceptions existing in sections 3(c)(1) and (7) of the Act.[23] This definition is intentionally vague, as the point of Dodd-Frank was to close this loophole in the 1940 Act.

Hedge funds can be outlined, however, by the following characteristics: (1) they are usually private pools of capital, i.e., not everyone can invest in them; (2) they are illiquid investments, i.e., investors cannot immediately access their investment; (3) until Dodd-Frank reform, they were largely unregulated in the United States; (4) they are typically registered in an offshore location like the Cayman Islands; (5) they invest using complex strategies; (6) they often borrow money from big banks in the course of investing to enhance returns, a process known as leveraging; and (7) the managers of the funds are rewarded according to the fund's performance.[24]

Hedge funds have evolved over time, along with the regulations on investment companies in the United States. They were essentially created to take advantage of the definition of investment companies in the 1940 Act.[25] In order to fully understand the Dodd-Frank hedge fund regulations, it is necessary to briefly review the entirety of securities regulation. The basis of securities regulation in the United States is comprised

---

[20] COGGAN, *supra* note 10, at 3.
[21] *Id.*
[22] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 402, 124 Stat. 1376 (2010).
[23] *See* DODD-FRANK SUMMARY, *supra* note 13, at 14.
[24] COGGAN, *supra* note 10, at 4.
[25] *Id.* at 64.

of the Securities Act of 1933 ("1933 Act"), the Securities Exchange Act of 1934 ("1934 Act"), and the 1940 Act. The 1940 Act defines an investment company as a company who:

> (a) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
> (b) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
> (c) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.[26]

At first glance this definition seems to encompass hedge funds, but the subsequent section of the act carves out specific exceptions. Those exceptions are numerous (there are two full sections of exceptions, totaling six pages of text in the Act).[27] The biggest of those exceptions are that companies owned by fewer than 100 people are not considered investment companies, as well as those comprised of only sophisticated investors.[28] The 1940 Act forces any funds that qualify as investment companies to register with the SEC and disclose their financial condition, investment objectives, structure, and operations on a regular basis.[29]

Hedge funds were created to exploit the gaps in the 1940 Act, which may give the reader the impression that these funds are the problem child of Wall Street.[30] But hedge funds' origins are not necessarily a bad

---

[26] Investment Company Act of 1940, Pub. L. 112-90 § 3(a)(1) (2012).
[27] Investment Company Act of 1940, § 3(b)–(c).
[28] *Id.*; *see also* COGGAN, *supra* note 10, at 64 (discussing institutional funds and high wealth individuals—the idea is that these investors have the knowledge and means to perform due diligence on their own, and the government is not as worried about fund managers taking advantage of them).
[29] COGGAN, *supra* note 10, at 3.
[30] DOUGLAS CUMMING ET AL., HEDGE FUND STRUCTURE, REGULATION & PERFORMANCE AROUND THE WORLD 160–61 (Oxford Univ. Press 2013).

thing. Absent the need to adhere to the SEC regulations, fund managers could use investment strategies that may present more risk, as well as investing in illiquid assets (vehicles of investment that cannot readily pay the fund back its investment).[31] This allowed managers to create a more diversified portfolio for the fund than an investor could achieve on their own.[32] The goal of this diversification is to generate a greater return than the average investment vehicle; hedge funds typically measure their success against a benchmark index that measures the performance of a general portion of the stock market.[33] Most managers consider their funds to perform well when they beat their specified index by three percentage points or more.[34] The evolution of hedge funds has left the U.S. marketplace with a large sector of the financial services market that exists today.[35]

Before the passing of Dodd-Frank in the United States, a hedge fund was formed as a limited liability partnership, with the investors as limited partners and hedge fund managers as general partners.[36] A fund's limited partners (the investors) are made up of wealthy individuals and institutional investors.[37] Funds are limited to 499 investors, to avoid registration under the 1940 Act, where each investor has at least $5 million in assets; due to the required sophistication of investors, funds cannot advertise or make public offerings.[38] General partners (the managers) are compensated with a mix of fixed fees and performance based fees, usually 1–2% in the form of a fixed fee and 15–20% in the form of performance fees.[39] These fees make sense: they align the interests of the managers with those of their investors, by only providing a limited fee unless the fund does well and creates corresponding incentives for those large returns that investors are promised when investing in a hedge fund.[40] While the basics of hedge funds have not changed in the wake of the 2008 financial crisis, Dodd-Frank did impose a new set of regulations on hedge funds.

---

[31] *See* COGGAN, *supra* note 10, at 64.
[32] *Id.* at 7–8.
[33] *Id.* at 8.
[34] *Id.*
[35] *Id.* at 7.
[36] CUMMING ET AL., *supra* note 30.
[37] *Id.* at 161.
[38] *Id.*
[39] *Id.*
[40] *Id.*

B. Dodd-Frank Wall Street Reform

On July 21, 2010, Congress signed into law a regulatory reform for the financial services industry that covers almost every aspect of capital markets and requires massive rulemaking: the Dodd-Frank Wall Street Reform and Consumer Protection Act.[41] The Bernie Madoff Ponzi scheme scandal that hit the fan amid the 2008 crisis set those regulators, who were already opposed to hedge funds, on a mission to reform.[42] Even though Madoff did not run a hedge fund, his operation did resemble something like a hedge fund (and as stated above, because hedge funds have no clear cut definition it is hard to separate certain investment vehicles out). But, as Philip Coggan notes in his analysis of hedge funds, "As one fund manager says: 'When a fight breaks out in a bar, you don't hit the bloke who started it. You hit the nearest bloke you don't like.'"[43] So, one of the foremost objectives of Dodd-Frank was to repeal the "private adviser" clause contained in the updated Section 203(b)(3) of the 1940 Act.[44] Dodd-Frank simply states that any fund previously utilizing the "private advisor exemption" must now register with the SEC and/or their state's principal office or place of business, leaving just a few exceptions remaining for very small or nuanced funds.[45] Now that registration is necessary, hedge funds have a myriad of new disclosure requirements, reporting requirements, and information sharing obligations to the SEC.[46] In addition, Dodd-Frank limits the ability of insured banks and thrifts from acquiring or gaining partial ownership in hedge funds and private equity funds, and changes two key definitions from the 1940 Act with significant implications.[47] The following paragraphs outline these new burdens in more detail.

Under Dodd-Frank reporting and disclosure, hedge funds must do the following:

1. Keep any and all records that the SEC deems necessary in the public interest for the protection of investors.

---

[41] DODD-FRANK SUMMARY, *supra* note 13, at 1.
[42] COGGAN, *supra* note 10, at 72.
[43] *Id.* at 81.
[44] DODD-FRANK SUMMARY, *supra* note 13, at 3.
[45] *Id.* at 3–4.
[46] *Id.* at 5.
[47] *Id.* at 6–7 (describing the limited ability for institutions that act like banks, for example, a thrift, to own or sponsor hedge funds under the provisions of the Act).

2. Prepare and provide for the Financial Stability Oversight Council data in order for the FSOC to monitor systematic risk.
3. Record and retain the total assets under management, the fund's use of leverage, the fund's risk exposure to counterparty credit, all positions and assets held, valuation strategies, trading practices and any other information that the SEC would determine necessary for public interest and protecting investors.[48]

This seems like a significant amount of information to report because it is, in fact, a hefty requirement. Not only is this cumbersome for the funds to perform, but the mere fact of disclosing things like trading strategies and assets held could inhibit funds from using some of their more lucrative, but complex, strategies.[49] These reporting requirements have yet to be defined by the SEC, and are also subject to change by the SEC as they see fit.[50] This means that the requirements have the potential to become more cumbersome and costly in the future.

The changes of the definitions of "qualified client" and "accredited investor" under Dodd-Frank also have implications on fund functionality. Dodd-Frank outlines the following qualifications for a qualified client: "$750,000 assets under management and $1.5 million net worth thresholds for determining a client's status as a 'qualified client' to be adjusted for inflation by the SEC one year after enactment and every five years thereafter."[51] As for an accredited investor, Dodd-Frank requires the following: a net worth (or joint net worth with a spouse) of over $1 million, not including the value of their primary household.[52] This is a higher threshold than previously required, and the new qualifications limit the potential pool of investors who are capable of investing in hedge funds.

In addition to the new reporting requirements and limited investor pool, the Volcker Rule portion of the Act amends the Bank Holding Company Act ("BHCA") and limits the participation of banking entities

---

[48] *Id.* at 5.
[49] *See* CUMMING ET AL., *supra* note 30, at 162 (discussing the restrictions that increased regulation puts on hedge funds and the implications of such restrictions).
[50] DODD-FRANK SUMMARY, *supra* note 13, at 3.
[51] *Id.* at 7.
[52] *Id.* at 7–8.

in hedge fund management.[53] The Volcker Rule defines a banking entity as "any insured depository institution; any company that controls [such institutions] or that is treated as a bank holding company; and any affiliate or subsidiary of any such entity."[54] Essentially, what this rule does is limit the ability of a bank to make large bets in their investments in a hedge fund.[55] While it is still possible for banks to do so, the regulatory reporting requirements in the Volcker Rule make this a more burdensome process.[56] All in all, just as the other requirements within Dodd-Frank, this additional reporting will increase the costs to both banks and funds, which in turn will be passed along to the investor (and subsequently the market) in the form of more expensive capital.

It is important to remember that implementing a regulatory structure of this magnitude is no small feat. Title IX of Dodd-Frank sets out the budget needed to bring this piece of legislation from theory into reality.[57] To put in place a regulatory system of this magnitude takes serious capital investment by the U.S. government, enough capital to make the budget look like a hedge fund portfolio itself. Specifically, Title IX of Dodd-Frank set out the following budget proposals for 2011 through 2015:

1. $1,300,000,000 for fiscal year of 2011
2. $1,500,000,000 for fiscal year of 2012
3. $1,750,000,000 for fiscal year of 2013
4. $2,000,000,000 for fiscal year of 2014
5. $2,250,000,000 for fiscal year of 2015[58]

That is a grand total of $8.8 billion over five years, at a time when our national debt that has just risen to an astonishing value of over $19 trillion.[59] Any way to help minimize national spending is clearly in the best interest of the country, and removing the Dodd-Frank reporting regulations on hedge funds would certainly help toward that goal.

---

[53] *Id.* at 12.
[54] *Id.* at 14.
[55] *See Volcker Rule*, INVESTOPEDIA, http://www.investopedia.com/terms/v/volcker-rule.asp [https://perma.cc/RB5N-BG54] (last visited Nov. 15, 2016).
[56] *Id.* (noting that banks can still make investments into hedge funds, but must meet reporting and disclosure requirements, and that larger institutions must also implement programs to comply with these new rules).
[57] DODD-FRANK SUMMARY, *supra* note 13, at 19.
[58] *Id.*
[59] U.S. NATIONAL DEBT CLOCK, http://www.usdebtclock.org [https://perma.cc/Q2UG-4F3G] (last visited Nov. 15, 2016).

II. HAMLET ON HEDGE FUNDS: TO REGULATE OR NOT TO REGULATE, THAT IS THE QUESTION

A. Hedge Funds' Impact on the 2008 Financial Crisis

Despite what the restrictions on hedge funds in Dodd-Frank might suggest to the average American, hedge funds most likely deserve little to no blame in the Financial Crisis of 2008.[60] Two major arguments work in favor of alleviating hedge funds of culpability from the financial woes of our country.[61]

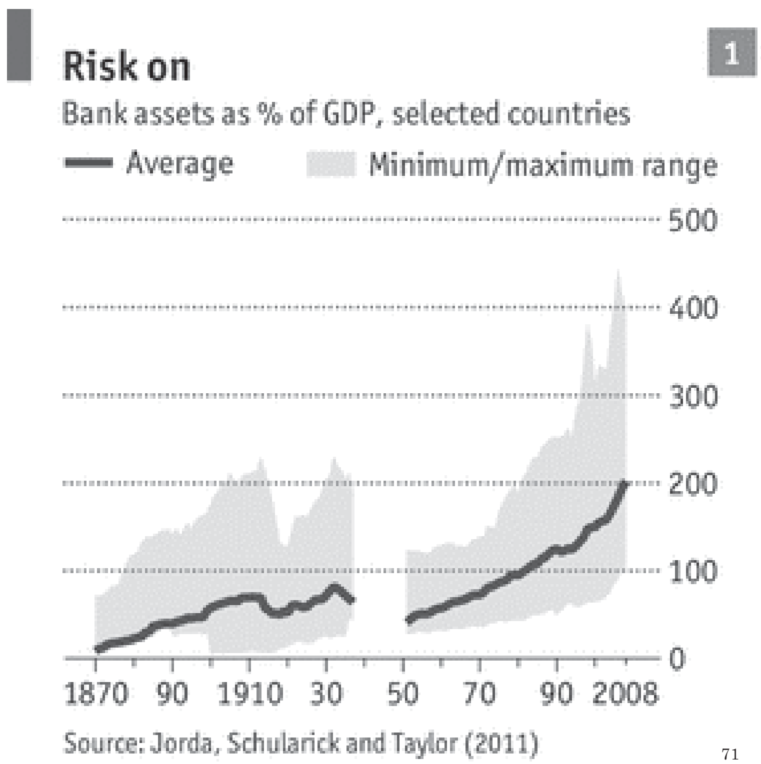
First, hedge funds did not create the mortgage-backed securities that were the epicenter of the financial break down.[62] It was the Lehman Brothers of the world, the large investment banks, that pooled these mortgages and issued them as securities.[63] Hedge funds played no role in the creation of these financial instruments. Funds may have purchased these faulty products, but they were not the only participants in this sham, as almost all large market players were trading in mortgage-backed securities.

Second, as stated above, hedge funds were not the only entities buying up these faulty products.[64] Mutual funds, pension funds, insurance companies, and many other institutions (such as foreign banks in the Euro-zone and China) were all culprits of buying these defective securities, along with hedge funds.[65] And as these suspect assets became more and more engrained into the investing institutions, it set up the dominos that were one tap from tumbling down and leaving only rubble in our

---

[60] Hossein Nabilou & Alessio M. Pacces, *The Hedge Fund Regulation Dilemma: Direct vs. Indirect Regulation*, 6 WM. & MARY BUS. L. REV. 183, 188 (2015), http://scholarship.law.wm.edu/wmblr/vol6/iss1/6 [https://perma.cc/AH98-5G5E] (discussing the general consensus that hedge funds were not contributors to the 2008 financial crisis).
[61] *See generally* Photis Lysandrou, *The Real Role of Hedge Funds in the Crisis*, FINANCIAL TIMES (Apr. 1, 2012), http://www.ft.com/cms/s/0/e83f9c52-6910-11e1-9931-00144feabdc0.html#axzz3rVFqAfD8 [https://perma.cc/FM4X-SDXQ].
[62] *Id.*; *see also The Origins of the Financial Crisis: Crash Course*, THE ECONOMIST (Sep. 7, 2013), http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article [https://perma.cc/TTB3-UME2] (defining mortgage backed securities as collateral for bundles of overpriced mortgages that failed when the housing bubble burst and the true value of the securities revealed itself as much lower than they were priced on the market).
[63] *See The Origins of the Financial Crisis*, *supra* note 62.
[64] Lysandrou, *supra* note 61.
[65] *Id.*; *see also The Origins of the Financial Crisis*, *supra* note 62.

nation's economy.[66] The first domino began rocking uneasily in 2007 as banks finally started to question viability of these mortgage backed securities.[67] And then, in 2008, the complex chains of debt completely fell apart.[68] The dominos rattled to the ground, as Lehman Brothers (an investment bank) filed for bankruptcy, and the crippling effect of credit default swaps hit insurance giant AIG very hard as well.[69] The following chart shows how these large institutions bloated their balance sheets leading up to the depression in 1933 and the crisis in 2008,[70] providing a good visual to grasp the severity of the situations:



[71]

---

[66] *See The Origins of the Financial Crisis*, *supra* note 62.
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *The Origins of the Financial Crisis*, *supra* note 62.

On top of this, European countries had racked up huge debt disparities during the same period.[72] This only exacerbated the financial problems in the United States once trouble hit.[73] One entity missing from all of these causes leading to the financial crisis: hedge funds. They may have been there, but as players in the market they could not simply abstain. They were not, however, cited as either cause or creation of the faulty securities that brought about 2008.

B. *Why Hedge Funds Worry Regulators*

There are certain aspects of hedge funds that made them an easy target for blame after the Financial Crisis of 2008. The answer is that hedge funds have always caused regulators and politicians to worry for the following fundamental reasons:

1. The potential for systematic risk of hedge funds, because of their complex, derivative investments can have impacts on many other institutions.
2. The use of leverage within hedge fund investing that ties hedge funds to investment banks.
3. The lack of transparency into hedge fund activities and the potential for fraud.
4. The placement of hedge funds outside the United States creates a potential for their use as tax havens.
5. The incentives for other institutions (like banks) to commit "regulatory arbitrage" and classify as hedge funds to evade their regulations.[74]

Specifically, the concerns over leveraging and lack of transparency are the driving force behind the increased regulation arguments.[75] However, those characteristics that bring about the condemnation of hedge funds also potentially generate the benefits derived from such alternative investments.[76]

---

[72] *Id.*
[73] *Id.*
[74] *See* COGGAN, *supra* note 10, at 64–65.
[75] Laszlo Ladi, *Hedge Funds: The Case Against Increased Global Regulation in Light of the Subprime Mortgage Crisis*, 5 BYU INT'L L. & MGMT. R. 99, 100 (2008), http://digitalcommons.law.byu.edu/cgi/viewcontent.cgi?article=1055&context=ilmr [https://perma.cc/4XP5-BMHQ].
[76] *Id.* at 104.

Complex derivative investments are very risky, but they can also generate extremely high returns on investment.[77] That is simply the nature of high risk investing—the point of hedge funds—for the high net worth individuals and institutional investors to seek a greater return on investment ("ROI") than they would in other, more traditional investment vehicles. These are sophisticated and intelligent investors who understand this risk. Leveraged investments, the additional concern, facilitate liquidity in the global market.[78] This liquidity creates the ability of capital to flow in our markets, enabling innovation in the marketplace.[79] A decrease in liquidity will limit the capital available to those emerging businesses, and for sustainable energy, means that less capital will be available for innovation in products and development for green energy firms.[80]

Another argument that cuts against both of these worries is that hedge fund managers want to run a successful business. Managers generate most of their profits from a performance based fee structure,[81] which means that if the funds do not generate a positive return, their managers take significant pay cuts. A sophisticated hedge fund that generates true value in the marketplace takes this risk very seriously,[82] and its managers are hardly the "cowboys" that run fast and loose with other people's money that the media sometimes makes them out to be.[83] Some of managers' risks line up with those of the regulators, and the entire developed world that want to see stable financial markets: general market risk, liquidity and leverage risk and ensuring the correct amount of each in a portfolio, risks of counterparties not paying the hedge fund, and valuation risks of ensuring positions in the fund are valued accurately.[84]

In response to these risks, prudent managers have developed methods to test each risk and ensure that their funds will generate the returns that they and their investors are looking for, called stress tests.[85] These managers' livelihoods are on the line, so there is no reason to question their motives in performing these tests. Because they are the

---

[77] *Id.*
[78] *Id.*
[79] *See generally Liquidity*, INVESTOPEDIA, http://www.investopedia.com/terms/l/liquidity.asp [https://perma.cc/7U7F-X2R6] (last visited Nov. 15, 2016).
[80] *Id.*
[81] *See* CUMMING ET AL., *supra* note 30, at 161.
[82] *See* COGGAN, *supra* note 10, at 78.
[83] *Id.* at 67.
[84] *Id.* at 78–79.
[85] *Id.* at 79–80 (discussing the chief risk officer of a hedge fund developing what he called the "seven pillars of risk assessment" to stress test his hedge fund).

individuals who have the greatest knowledge of the funds and their risks, they are best poised to design and perform these stress tests. Forcing them to conform to an additional, potentially less effective reporting scheme drives up the costs of running the fund, costs that are then passed on through the market to the companies that those hedge funds invest in. For these reasons, regulators do not need to worry about the unknown factors of hedge funds that have scared them since the 1970s. They should trust that the managers are the intelligent businessmen and women and the prudent investors that they were hired to be, and know that their sophisticated investors will be watching their every move.

C. *Economic Analysis of Hedge Fund Regulation*

Law can use either direct or indirect methods to effect behavioral change in the industries that our government regulates.[86] Direct regulations specify the target industry and put in place immediate measures to force behavior modification, while indirect regulations put in place measures that impact the target industry through an intermediary entity.[87] In other words, direct regulations force action under threat of repercussions, whereas indirect regulations rely on economic theory to bring about the desired directives.[88] Prior to Dodd-Frank, the United States used a system of limited, indirect regulations for their hedge funds, these being limits on the number of investors as well as who may invest, described in Section I.[89] Dodd-Frank's imposition of reporting requirements and limitations on how hedge funds can invest their capital (also described in Section I) are the type of direct regulations that have been shown to negate the benefits that hedge funds bring to financial markets.[90]

Not only do direct regulations of hedge funds limit their benefit to the financial markets, they do little to eliminate the negative externalities that hedge funds can cause.[91] Reporting and disclosure requirements do not necessarily or automatically make hedge funds less risky. Only changes in investing strategies can remedy the risk and uncertainty of hedge funds, and simply requiring disclosure does not guarantee that end result.[92] These requirements also cut against the very core of hedge

[86] Nabilou & Pacces, *supra* note 60, at 190.
[87] *Id.*
[88] *Id.* at 190–91.
[89] Ladi, *supra* note 75, at 105.
[90] Nabilou & Pacces, *supra* note 60, at 192.
[91] *Id.*
[92] *Id.*

fund ideals: that their manager's use unique and complex strategy to create the high return on investment ("ROI") expected from investors. Disclosure, however, could lead to herding and strategy replication by other hedge fund managers, and even further to pirated strategies used in more traditional investment vehicles.[93] Professor of Law and Finance Alessio M. Pacces, along with graduate researcher Hossein Nabilou, identify three overarching, specific reasons that direct regulations are ineffective for hedge funds, "(1) direct regulation encourages regulatory arbitrage; (2) it creates legal placebo effects in hedge funds' counterparties and investors; and (3) the one-size-fits-all measures typical of direct regulation cannot adequately address the wide diversity and heterogeneity of hedge funds and their strategies."[94]

First, regulatory arbitrage is the practice of exploiting the gaps between the "economic substance of a transaction and its legal or regulatory treatment, taking advantage of the legal system's intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision."[95] Essentially, it is finding the legal loopholes to save the fund money or generate higher returns. This argument cuts both ways, as one criticism of hedge funds is that they are a form of arbitrage themselves. However, if the funds will continue to arbitrage, then it is simply the nature of the beast. Implementing costly regulations that do not fix the problem is not the answer; it merely shifts the problem.

Second, the placebo effect described above will make the real policing body of hedge funds fall complacent in oversight of the funds. The counterparties of funds, the true "hedge fund police," will get lethargic in checking on hedge funds because they believe that the SEC is now performing this action through the new reporting guidelines.[96] Third, the fact that hedge funds have no easy definition means that there are a wide variety of structures among different funds, making a one-size-fits-all reporting requirement near impossible.[97] At minimum, a reporting structure that is both economic and effective is near impossible.[98] These two factors combined foreshadow a frightening situation: a marketplace of investors who no longer scrutinize their hedge funds, in the belief that

[93] *Id.*
[94] *Id.* at 194.
[95] *See* Victor Fleischer, *Regulatory Arbitrage*, UNIVERSITY OF MINNESOTA LAW UPLOADS 3 (Mar. 4, 2010), http://www1.law.umn.edu/uploads/3d/sF/3dsFF3ucy5Dc04r-tWv-Xw/Fleischer-RegulatoryArbitrage-03-08-10.pdf [https://perma.cc/JB3V-5NGS].
[96] Nabilou & Pacces, *supra* note 60, at 201.
[97] *Id.* at 205.
[98] *Id.*

government regulations are working, while those very government regulations are not effectively controlling the funds.

All of this analysis points to indirect regulations as the most effective regulation for hedge funds. The most indirect of those regulations are the original, albeit almost nonexistent, regulations in place pre-Dodd-Frank. That is the driving force behind this proposed experiment: it will give real-time, empirical evidence as to whether or not the above analysis proves true in today's complex financial markets. As the Conclusion will describe, it does so in a fairly controlled way, so as to limit any negative externalities. Therefore, this proposition can end the argument once and for all as to the proper forms of regulation for hedge funds. At the same time, it will provide the possibility for an influx of capital into the sustainable energy market that sorely needs it. It will allow for these green firms to capture market share from traditional fossil fuels. This will, in turn, reduce the nation's carbon footprint and combat Global Climate Change.

III. WHERE DO GREEN FUNDS COME FROM?

A. A Brief History of Funding Energy

Green energy firms have been getting increased amounts of funding in recent years.[99] However, the funding still pales in comparison to the capital available in the traditional energy sector. New investments are all well and good, but the green energy industry is facing a behemoth of an opponent.

The oil and gas industry, as odd as it sounds, is a traditional staple of the American way of life, and thus the industry has major impacts on the United States' economy. The first oil well in the world was struck in 1859 in Pennsylvania.[100] Since that time, the American economy has relied heavily on oil and gas, a history marred with volatile swings in the industry due to massive discrepancies between the supply and demand of oil.[101] Due to the nature of the process, an observer can see these boom-bust cycles occur consistently from the late nineteenth century up until

---

[99] *See* Eoghan Macguire, *Who's Funding the Green Energy Revolution?*, CNN (June 12, 2012, 5:15AM), http://www.cnn.com/2012/06/12/world/renewables-finance-unep/ [https://perma.cc/M3D5-3LE4] (last visited Nov. 15, 2016).

[100] *See* Matt Phillips, *Let us now give thanks for oil busts, a great American tradition*, QUARTZ (Dec. 11, 2014), http://qz.com/309410/were-about-to-experience-a-great-american-tradition-the-energy-bust/ [https://perma.cc/6LHL-GTB3] (last visited Nov. 15, 2016).

[101] *Id.*

present day.[102] Economists and investors continue to believe that a boom will soon follow the next bust, and oil and gas companies continue to receive large investments.

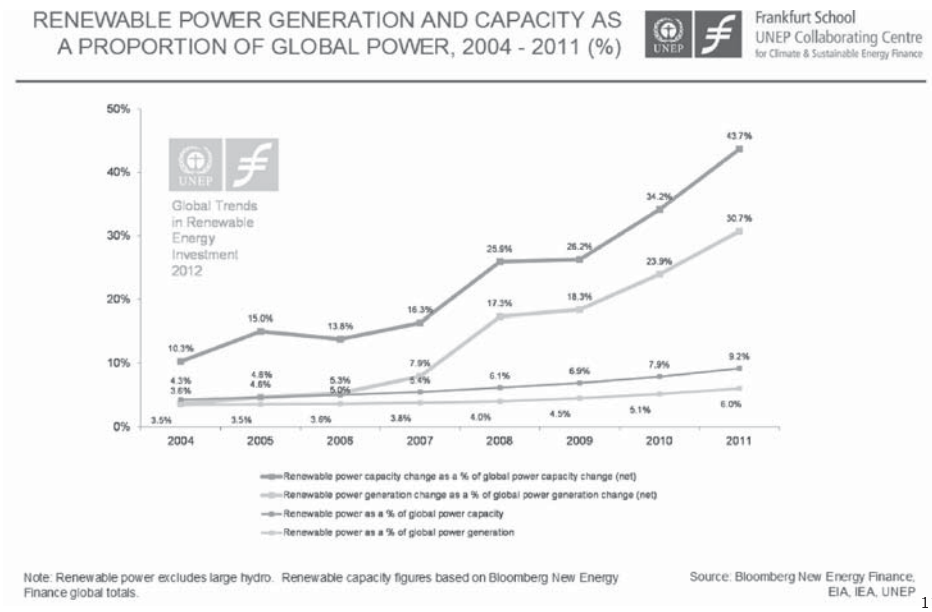
The inertia of oil and gas in the United States has led to massive corporations in the industry: a recent Statista study reported that there are seven companies globally with market capitalizations of over $100 billion.[103] Industry top dog, Exxon Mobil, has a market valuation of an astonishing $356.5 billion.[104] A Bloomberg New Energy Finance White Paper from 2014 called fossil fuel divestment a $5 trillion challenge, as that was the value of outstanding stocks in oil and gas firms at the time.[105] The same paper estimated a capacity for renewable energy investment at $257 million for 2015 (not a projection at the actual investment, but rather the total that could possibly be invested).[106] In addition, the WilderHill New Energy Global Innovation Index, an index that trades clean energy company stocks, supports a total of 106 green energy firms with a market capitalization of $220 billion.[107] A quick calculation comparing these market capitalizations shows that the sustainable energy firms are operating with about 4% of the capital that oil and gas firms have.

As far as new investment, Dr. Karlheinz Knickel, the head of the Frankfurt School for Climate and Sustainable Energy Finance, estimates that $400 billion of new money is poured into fossil fuel technology while renewables only have $66 billion at their disposal.[108] This is due, for the most part, to the fact that the Green Energy movement only came into being in the late 1960s,[109] and with such a significant head start, it is not difficult to understand why such a huge discrepancy in the market capitalization of the two industries exists.

---

[102] *Id.*
[103] *Top 10 oil and gas companies worldwide based on market value in 2015 (in billion U.S. dollars)*, STATISTA, http://www.statista.com/statistics/272709/top-10-oil-and-gas-companies-worldwide-based-on-market-value/ [https://perma.cc/66PA-C4FT] (last visited Nov. 15, 2016).
[104] *Id.*
[105] Nathaniel Bullard, *Fossil fuel divestment: a $5 trillion challenge*, BLOOMBERG NEW ENERGY FINANCE (Aug. 26, 2014), http://about.bnef.com/content/uploads/sites/4/2014/08/BNEF_DOC_2014-08-25-Fossil-Fuel-Divestment.pdf [https://perma.cc/PJ7G-C9R4] (last visited Nov. 15, 2016).
[106] *Id.*
[107] *Id.*
[108] *See* Macguire, *supra* note 99.
[109] *See* Sara, *A Brief History of the Modern Green Movement in America*, WEB ECOIST, http://webecoist.momtastic.com/2008/08/17/a-brief-history-of-the-modern-green-movement/ [https://perma.cc/M5TK-VGHR] (last visited Nov. 15, 2016).

This discrepancy in funding is directly correlated to the actual amount of power generated from sustainable forms of energy. Clearly, without the adequate capital to innovate and expand, green energy firms are unable to compete with traditional forms of energy on a large scale. The following chart shows just how small a percentage of power is generated from green energy as opposed to traditional forms across the globe from 2004 to 2011:



[110]

As the graph shows, renewable percentage change was moving at a good rate in 2011, increasing in capacity by 43.7% and actual generation by 30.7% as a percentage of global capacity and generation change.[111] Change is the key word in that statistic—that only compares renewables today to renewables yesterday. The values above for renewable power as a percent of total global power generation in 2011 were valued at a minuscule 6.0%, and the total capacity only at 9.2%.[112] This means that even if the U.S. fully committed to moving from traditional to green

---

[110] Angus McCrone et al., *Global Trends in Renewable Energy Investment 2012*, FS-UNEP COLLABORATING CENTRE FOR CLIMATE & SUSTAINABLE ENERGY FINANCE (June, 2012), http://fs-unep-centre.org/sites/default/files/attachments/unepglobaltrendschartpack2012.pdf [https://perma.cc/3XS2-K78G].
[111] *Id.*
[112] *Id.*

energy, that it would not even be possible to supply 10% of the nations power through renewable sources.

It is easy to see, through this statistical analysis, that the lack of funding leaves green energy firms at an extreme disadvantage in the marketplace. Without a substantial investment into the green sector, it will not have a chance to compete with traditional oil and gas energy. When it comes to financial markets, David cannot take down Goliath without a significant capital investment. As Renewable Energy Finance Project expert Kristy Hamilton stated, "Private financiers aren't going to go into renewables unless there is a commercial benefit, particularly now."[113] One potential solution to this problem is to create incentives for institutional investors to finance renewable energy firms. Green Energy Hedge Funds can help close this gap in capital. Allowing regulatory relief for these types of funds will not only allow green funds to achieve higher returns, but also incentivize more funds to adopt a strategy of investing in renewable energy firms.

B. What Makes a Green Fund?

In their book, *Energy and Environmental Hedge Funds: The New Investment Paradigm*, Peter Fusaro and Gary Vasey describe green funds as funds investing in "renewable forms of energy, alternative sources of energy, and energy efficient technologies."[114] Hedge funds can take many forms, but the specific strategy of interest for this proposal is the traditional equity investment in the above detailed Green Funds.[115] These are the types of funds that the SEC should allow to move back to pre-Dodd-Frank regulations. As hedge funds can have many complex strategies, not all of these strategies will have a positive impact on the industries that they invest in (the managers could essentially bet against the industry).[116] That result would run counter to this proposal, and therefore only funds

---

[113] *See* Macguire, *supra* note 99.

[114] *See* PETER C. FUSARO & GARY M. VASEY, ENERGY AND ENVIRONMENTAL HEDGE FUNDS: THE NEW INVESTMENT PARADIGM 84 (John Wiley & Sons, Inc., 2011) (discussing the "green" area of the energy hedge funds).

[115] *Id.* at 121.

[116] *See generally Hedge Fund: Strategies*, INVESTOPEDIA, http://www.investopedia.com/university/hedge-fund/strategies.asp [https://perma.cc/3CC2-5BF3] (last visited Nov. 15, 2016); *see also Short Selling*, INVESTOPEDIA, http://www.investopedia.com/terms/s/shortselling.asp [https://perma.cc/GQ9E-AZVP] (last visited Nov. 15, 2016) (outlining hedge fund strategies, including Short and Relative Arbitrage strategies: selling stocks that managers believe will decline in value with the intent to buy them back at a discount for profit, which results in a general depreciation of the shares in that corporation).

whose strategies are defined as investing in equities of renewable forms of energy, alternative sources of energy, and energy efficient technologies would be eligible.

Perhaps the best way to describe a green fund is to give the descriptions found on some current funds' websites that hold themselves out as green funds. Earth Capital Partners describes itself as "[a] company specializing in advising on investments that deliver a commercial risk adjusted return and addressing the challenges of Sustainable Development such as climate change, food, energy and water security."[117] The fund breaks down its focus areas of investment in the sustainable asset management as renewable energy, sustainable agriculture and clean technology.[118] This fund is a perfect model for green funds.

TerraVerde Capital Partners is another bastion of green fund management. TerraVerde's team describes their philosophy as: "[T]o achieve positive absolute returns and reduce portfolio volatility regardless of market direction through investments in the infrastructure and green hedge fund sector including clean tech, renewable energy, and water and power generation, transmission, and transportation."[119] To generate this type of return in a volatile market, TerraVerde employs skilled portfolio managers with a global focus who focus on the "paradigm shift of energy and power changes in. . . renewable energy markets."[120] So why would intelligent portfolio managers at hedge funds continue to invest in oil and gas? It is due to the deep integration of traditional energy into our society, as well as the "oil cycles" discussed above.[121] Experts will estimate that the oil cycle has bottomed out, even when the market outlook is not good, which will lead to massive investments back into oil and gas companies.[122] The section below will go further into the current market outlook, however, it is important to note this here because managers like those at TerraVerde are more forward thinking than most. TerraVerde

---

[117] *Our Business*, EARTH CAPITAL PARTNERS LLP, http://www.earthcp.com/our-business [https://perma.cc/CVC3-SVFU] (last visited Nov. 15, 2016).
[118] *Investment Focus*, EARTH CAPITAL PARTNERS LLP, http://www.earthcp.com/investment-focus [https://perma.cc/NYQ5-FQNY] (last visited Nov. 15, 2016).
[119] *Our Portfolio Objective With Infrastructure & Green Investments*, TERRAVERDE CAPITAL PARTNERS, http://terraverdecap.com/about-us/our-portfolio-objective [https://perma.cc/K6B5-7ZPY] (last visited Nov. 15, 2016).
[120] *Id.*
[121] *See* Phillips, *supra* note 100.
[122] Ky Trang Ho, *Why Two Wall Street Giants Recommend Investors Buy Oil and Gas Now*, FORBES (Apr. 24, 2015, 10:01 AM), http://www.forbes.com/sites/trangho/2015/04/24/why-two-wall-street-giants-recommend-investors-buy-oil-and-gas-now/#23562b912917 [https://perma.cc/VHA5-H6U7].

believes the best opportunity to achieve long-term growth is to invest ahead of the curve on the sustainable energy market.[123] Management takes their strategy into account when selecting new managers, and oversees them constantly to ensure they maintain their integrity to their mission statement.[124]

Earth Capital and TerraVerde provide the template for what a green fund should look like. The SEC should set out qualifying standards for green funds based on these two firms. Long-strategy equity investment portfolios that invest in renewable energy, sustainable agriculture, clean technology, climate change mitigation, and food and water sustainability should qualify. Firms would apply for an exemptive application,[125] and the SEC would review the application against this criteria. The SEC would then allow all firms that pass their judgment as green firms to operate in the pre-Dodd-Frank standards of reporting for hedge funds. This operation would take place at the time of filing for new funds, or upon an exemptive application by an existing fund (like Earth Capital or TerraVerde).

C. *The Current Energy Market and Future Green Potential*

It is no secret that the U.S. financial markets are in a state of disarray.[126] The current slide has been attributed to the economic woes in China,[127] in addition to the glut of oil supply that is hurting the energy sector.[128] Due to this massive oil supply, demand has slowed and driven

---

[123] *Sustainability*, TERRAVERDE CAPITAL PARTNERS, http://terraverdecap.com/sustainability [https://perma.cc/29ZX-5ALV] (last visited Nov. 15, 2016).

[124] *Infrastructure and Green Investments*, TERRAVERDE CAPITAL PARTNERS, http://terraverdecap.com/about-us/our-company [https://perma.cc/X3GM-C3ZL] (last visited Nov. 15, 2016).

[125] *See 40 Act Exemptive Applications*, SEC. & EXCH. COMM'N (Mar. 29, 1996), https://www.sec.gov/about/oig/audit/230fin.htm [https://perma.cc/3AFA-3P92] (outlining an application to exempt a person, security, or transaction from a rule under the Securities Acts or SEC rules).

[126] *See generally Stock Market and Financial Markets Overview*, BLOOMBERG BUSINESS, http://www.bloomberg.com/markets/world [https://perma.cc/9D7V-MGYP] (last visited Nov. 15, 2016) (stating statistical data for financial markets, with the Dow Jones, S&P 500, and NASDAQ indices down 7.60%, 6.18%, and 6.08% respectively over the past 12 months as of March 2, 2016).

[127] *See* Simon Denyer & Renae Merle, *U.S., world stock markets slide as panic in China spreads,* WASH. POST (Jan. 7, 2016), https://www.washingtonpost.com/world/china-stocks-plunge-7-percent-triggering-another-market-closure/2016/01/07/d6a83bf5-10b2-4289-8aab-98e485a3fe6e_story.html [https://perma.cc/J4U3-SCEG] (describing the weak economy, overvalued currency, and lack of investor confidence that has caused Chinese markets to plummet in 2016).

[128] *See* Patti Domm, *This is why oil glut not going away soon*, CNBC (Jan. 27, 2016), http://www.cnbc.com/2016/01/27/this-is-why-oil-glut-not-going-away-soon.html [https://

the price down to levels that have not been seen since 2003.[129] To give some context, that was the same time when 50 Cent's 'In Da Club' was topping the music charts and the statue of Saddam Hussein was falling in Iraq.[130] In fact, the price of a barrel of oil and the U.S. stock markets have been moving in almost identical trends during the turbulent start to 2016.[131] Over the first twenty days of January 2016, the correlation between price moves in the Brent (crude futures, a global benchmark for oil prices) and the S&P 500 Index (U.S. Stock Exchange) were at a staggering 0.95 (a value of one would mean that the two benchmarks were moving in exactly the same trend).[132] This value is astounding, and the correlation is higher than any calendar month that it has been calculated for, except for two months in 1990.[133] In fact, the correlation is around 0.15 higher than the value when it spiked to above 0.8 during the Financial Crisis of 2008.[134] Clearly there is something amiss with the U.S. economy, and the traditional energy sector is a major factor in the nation's fiscal distress.

Oil and gas companies are suffering financially from this supply predicament.[135] A *Wall Street Journal* article on the subject, citing a Wolfe Research study, stated, "As many as a third of American oil-and-gas producers could tip toward bankruptcy and restructuring by mid-2017. . . ."[136] This third of oil companies will encompass the smaller firms in the market, who took on large amounts of debt to finance drilling operations in the U.S. during the drilling boom, and now owe in excess of $13 billion.[137] It is not just the small player oil companies that are taking a hit, though. Chevron posted a fourth quarter 2015 loss of over $500 million, its first quarterly loss since 2002.[138] The U.S.'s second largest

perma.cc/G6E2-MGSA] (describing the continued stockpiling of oil in the U.S. that is keeping oil around $30 a barrel and limiting the U.S. economy).

[129] Nicole Friedman, *Oil Skids to 12-Year Low*, WALL ST. J., Jan. 12, 2016, at C1.

[130] *Id.*

[131] Tommy Stubbington & Georgi Kantchev, *Oil, Stocks at Tightest Correlation in 26 Years*, WALL ST. J., Jan. 27, 2016, at C1.

[132] *Id.*

[133] *Id.* at C1, C2.

[134] *Id.* at C1, C2.

[135] *Another Steep Drop in Oil and Natural Gas Prices Is Pulling the Stock Market Lower in Early Trading*, U.S. NEWS (Feb. 1, 2016), http://www.usnews.com/news/business/articles/2016-02-01/asian-stocks-uneven-as-china-data-japan-policy-weighed [https://perma.cc/4LUG-MHZ8] (explaining a steep drop in oil and natural gas company stock prices).

[136] Bradley Olson & Erin Ailworth, *Oil Drop Sparks Bankruptcy Fears*, WALL ST. J., Jan. 12, 2016, at A1.

[137] *Id.* at A1, A2.

[138] Bradley Olson & Erin Ailworth, *Chevron Posts Loss, Readies More Layoffs*, WALL ST. J., Jan. 30–31, 2016, at B3.

energy company by revenue (Chevron) is also setting up a second wave of layoffs of around 4,000 employees in 2016 (after letting go 3,200 workers in 2015) and cutting its capital spending by $9 billion.[139] Big and small energy firms alike are suffering heavily, that much we know, but the question that remains is how will investors respond to the current market setting?

Above, Section III.A discussed the history of the energy sector in the U.S., and in particular the oil cycle that has been entrenched in our country's energy history.[140] The basic idea behind this cycle is that the processes by which companies extract oil from the ground cause large swings in the supply, and thus the demand, of oil and gas.[141] This idea can tempt investors to replenish their bets on traditional energy, even when the market is suffering such large losses. There are certainly experts who are making the case for such a bet, saying that investors can re-enter the traditional energy market while oil prices and oil company stock prices are bottomed out, and ride the upswing to large profits.[142] Ironically, this particular expert made this suggestion in August of 2015, when prices had just fallen below $50 per barrel.[143] Through January 2016 the price of a barrel of oil fell all the way through to the $27 range,[144] and analysts at the major investment banks like Morgan Stanley and Goldman Sachs estimate that the Chinese economic downturn could keep prices in the $20 range.[145] Betting on traditional energy last August, then, would have resulted in massive losses. The point here is that, while oil has always had a cycle, we also now know that oil is a finite resource.[146] Estimates as to the ultimate supply of oil on earth are always rough, but the U.S. Energy Information Administration ("EIA," a relatively unbiased party) estimated in 2014 that the global supply of oil would be adequate to satisfy human demand until 2039.[147] Investors might need a bit

---

139 *Id.*
140 *See* Phillips, *supra* note 100.
141 *Id.*
142 *See* Claire Poole, *22 Oil and Gas Stocks to Buy as Oil Prices Bottom Out*, THESTREET (Aug. 6, 2015), http://www.thestreet.com/story/13246592/1/22-oil-and-gas-stocks-to-buy-as-oil-prices-bottom.html [https://perma.cc/8YER-PJNU].
143 *Id.*
144 Matthew West, *Just how low can oil prices go and who is hardest hit?*, BBC (Jan. 18, 2016), http://www.bbc.com/news/business-35245133 [https://perma.cc/S3J8-6QE5].
145 *See* Olson & Ailworth, *supra* note 136.
146 *Nonrenewable Energy Explained*, U.S. ENERGY INFO. ADMIN. (Oct. 27, 2015), http://www.eia.gov/Energyexplained/?page=nonrenewable_home [https://perma.cc/2K4H-KUNE] (last visited Nov. 15, 2016).
147 *Frequently Asked Questions: Do we have enough oil worldwide to meet future needs?*,

of a push in order to break the oil cycle, but doing so could save them huge dollar amounts in the long run.

The regulatory break from Dodd-Frank for green funds is the perfect push. Private equity investors are already apportioning $100 billion to pick apart the remains of the failing small-oil-producing firms mentioned above.[148] But oil has a limited time span; for arguments sake let us assume that the supply ends in 23 years as suggested in the EIA study.[149] At that point in time, renewable and clean energy sources will not only have potential to capture market share in the energy market, they may provide the only viable source of energy for our society. Private equity managers are poised to start investing heavily into broader and newer investments at the start of 2016,[150] and private equity and hedge funds typically have similar investing strategies.[151] Twenty-three years may seem like a long time to the lay investor, but to private equity investors, or long positioned equity hedge fund managers, the time frame is not quite as prolonged. The current market structure and opportunity in the sustainable energy sector is a great selling point to hedge fund managers. It would promote participation by hedge funds in this regulatory scheme, pouring more money into the renewable energy sector.

CONCLUSION: GREEN FUND REGULATION EXEMPTIVE RELIEF

A. *Proposed Regulatory System*

The proposed regulatory system is a rather simple fix, in theory. Any new hedge fund, when registering under the Securities Act of 1933 and the 1940 Act, would have the opportunity to apply for exemptive relief to take advantage of the "Green Fund Reporting Structure." As stated above in Section III, exemptive applications allow 1940 Act registered companies to apply for "exemptive relief," or an authorization from the SEC to permit a person or company to operate outside of the scope of

---

U.S. ENERGY INFO. ADMIN. (Dec. 9, 2014), https://www.eia.gov/tools/faqs/faq.cfm?id=38&t=6 [https://perma.cc/CT6J-SJEV] (last visited Nov. 15, 2016).

148 *See* Olson & Ailworth, *supra* note 136.

149 U.S. ENERGY INFO. ADMIN., *supra* note 147.

150 Matt Jarzemsky, *Blackstone Thinks It's Time to Buy*, WALL ST. J., Jan. 29, 2016, at C1.

151 *Hedge funds, venture capital and private equity*, KHAN ACADEMY, https://www.khanacademy.org/economics-finance-domain/core-finance/investment-vehicles-tutorial/hedge-funds/v/hedge-funds-venture-capital-and-private-equity [https://perma.cc/6STG-FJD9] (last visited Nov. 15, 2016) (describing the difference between private equity ("PE") and hedge funds ("HF") being the investment in liquid (HF) or illiquid (PE) assets).

the Act.[152] Exemptive relief is not an underhanded move on the part of investment companies, for example exemptive relief is used in practice today to create novel investment vehicles like money market funds.[153] These actions are done through the SEC, undergo careful scrutiny, and are in the best interest of investment companies and their investors. Grants of exemptive relief are simply a way to update a very old legal structure without cumbersome political restructuring. In an industry that is almost constantly growing and changing, exemptive relief is a far superior option to completely overhauling the system.[154]

The application would contain a basis for the relief requested, identify the benefits to investors and any conditions that protect investors.[155] This is a standard procedure for all exemptive relief,[156] and the SEC can standardize the application to make the process easier for green funds to apply (using, among other things, the information contained in this article). The same body that reviews all exemptive relief applications (the Office of Investment Company Regulation or OICR) would then review the information provided, with the opportunity to ask the applying party for clarifications or modifications.[157] Once that review is complete and to the satisfaction of the OICR, exemptive relief is granted.[158] When relief is granted, a filing is made with the SEC; in the case of green funds, the SEC would need to add a new filing category.[159] If the petition is denied, a post is generated in the Federal Register and the applying party has a chance for a hearing to appeal the decision.[160] This is a process that the SEC has outlined and practiced for many years, making it relatively easy for the SEC to integrate new exemptive relief for green funds.[161]

Pre-existing funds that identify their strategies as a green fund would apply for exemptive relief in the same process.[162] As these funds are already in operation, the only substantive difference is that they will have the rest of their necessary forms already on file with the SEC. In

---

[152] *See* SEC. & EXCH. COMM'N, *supra* note 125.
[153] *Id.*
[154] *Id.*
[155] *Id.*
[156] *Id.*
[157] *Id.*
[158] SEC. & EXCH. COMM'N, *supra* note 125.
[159] *Investment Company Act Notices and Orders Category Listing*, SEC, https://www.sec.gov/rules/icreleases.shtml [https://perma.cc/EH7N-ASQW] (last visited Nov. 15, 2016).
[160] *See* SEC. & EXCH. COMM'N, *supra* note 125.
[161] *Id.*
[162] *Id.*

practice, these funds will have an easier application process, as the SEC can view past investments and performance of the fund for a quick cursory check on whether or not they fall into the definition of a green fund. In addition, to check on the system as a whole and reevaluate the Dodd-Frank regulations for hedge funds, the SEC would have to perform an evaluation on the funds that have been operating under the exemptive relief at the one year and five year marks from the time when the system is first put into place.[163] All funds would have to submit any additional financial statements that the SEC requested at that time to ensure the exemptive relief was not abused, as well as give the SEC insight into whether or not to allow more or all hedge funds to operate under the same regulatory structure.[164]

B. Addressing Potential Concerns

Despite their many benefits, hedge funds are investment vehicles that come along with a certain amount of risk involved.[165] The general market risk, risk of leveraging and the risks of improper valuation of the funds are not exclusive to hedge funds, but are apparent in some way in any financial investment vehicle.[166] Admittedly, these risks are amplified due to the nature of hedge funds. Consequentially, one potential concern is if some maverick hedge fund managers are allowed to skirt the new rules, they will run afoul with their funds to the detriment of their investors and the market as a whole.[167] One response to this worry is that, as discussed above, hedge fund investors are sophisticated and capable of performing some due diligence on their own to safeguard their investments.[168] The securities laws (the 1933 Act, 1934 Act, and 1940 Act) were enacted to protect the general investing public.[169] The government is worried about the average investor not having access to enough information to make an informed decision about which securities to buy.[170] But

---

[163] *See* DODD-FRANK SUMMARY, *supra* note 13, at 7.
[164] *Id.* at 63.
[165] *See* COGGAN, *supra* note 10, at 67, 78–79.
[166] *What are some examples of risks associated with financial markets?*, INVESTOPEDIA, http://www.investopedia.com/ask/answers/050515/what-are-some-examples-risks-associated-financial-markets.asp [https://perma.cc/B94A-RQRJ] (last visited Nov. 15, 2016) (explaining some general risks of financial markets, such as volatility and uncertainty).
[167] *See* COGGAN, *supra* note 10, at 67, 81–82.
[168] *See id.* at 67.
[169] *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION CASES AND ANALYSIS 2 (Robert C. Clark et al. eds., 4th ed. 2015).
[170] *Id.* at 28–29.

with the limitations on hedge funds restricting their membership to only high net worth and entities well-versed in investing, the worries that prompted this entire framework of law are no longer present. The need is not there, and therefore any extra costs are superfluous and hurt the nation's economy.

As for the markets as a whole, the one and five-year audits of the system as a whole would safeguard against abuse. In these audits, which would be necessary to evaluate the effectiveness of the Dodd-Frank regulations on hedge funds, the SEC would also be able to ascertain if any fraud or other malfeasance took place under the exemptive relief. With both the concerns about investors and the overall economy mitigated by these two factors, the regulatory structure as a whole should not worry the general investing public.

Another worry could be that the hedge fund managers will not bite, and this entire scheme will be a waste of time and money. However, the current stressed state of the financial markets in the United States warrants a change in any investment strategy. Our current economic woes are due to the dependency of the U.S. on the traditional energy sector.[171] At a certain point the supply of traditional forms of energy will expire, and hedge fund managers (and all other investors) will need to move their money in another direction.[172] Moving forward now will allow hedge fund managers to ride investment returns ahead of the curve and win big on green energy. In addition, the simple fact that the new regulatory and reporting structure for hedge funds under Dodd-Frank is very costly to hedge funds[173] should at least attract some funds with ambitious managers who are confident in their investing abilities and looking to cut costs in a competitive market.

Recall that hedge funds are complex investment vehicles, which give them the reputation as the "bad boys" of Wall Street.[174] This caused the Dodd-Frank reform to target hedge funds in their new regulations and increase reporting and disclosure requirements for funds.[175] However, hedge funds were not a significant cause of the Financial Crisis of 2008 that prompted the Dodd-Frank reform in the first place.[176] Even though the configuration of hedge funds worry regulators, indirect regulations

---

[171] *See supra* Section III.C.
[172] *Id.*
[173] *See* CUMMING ET AL., *supra* note 30, at 162 (discussing the restrictions that increased regulation puts on hedge funds and the implications of such restrictions).
[174] *See supra* Section I.A.
[175] *See supra* Section II.B.
[176] *See supra* Section II.A.

are actually more effective at controlling these entities than direct regulations.[177] For these reasons, the SEC should not worry about imposing direct requirements on hedge funds. This calls for a reform of the hedge fund regulations imposed in Dodd-Frank. Combined with the sagging traditional energy sector of the market,[178] there is no worry that a plan for exemptive relief for green funds will garner participation from hedge fund managers.

C. The Outcomes: Win-Win or No-Lose

Hedge fund regulations under Dodd-Frank are unnecessarily stringent. The market as a whole, hedge funds, corporations, and investors, would benefit from cheaper capital if the regulations were moved back to pre-Dodd-Frank standards. In order to test this theory, the SEC should allow a subset of hedge funds to operate on pre-Dodd-Frank standards while forcing the remaining funds to operate under the current reporting regime. To support the need for greater capital influx into the renewable energy sector of the U.S. economy, the SEC should only allow those funds that apply for exemptive relief as "green funds" to make up the subset that operates under pre-Dodd-Frank standards. The SEC would then evaluate both sets of funds at one-year and five-year intervals out from the inception of the program, and determine whether or not the Dodd-Frank hedge fund regulations are necessary and working correctly.

The proposed scheme has two possible outcomes. For simplicities sake, we will label them the "Win-Win" outcome and the "No-Lose" outcome. If this theory is correct, the result is the Win-Win outcome. The logic of this outcome is as follows: if the regulations are, in fact, overly stringent and simply adding extra costs to hedge fund operations, then allowing green funds to operate at pre-Dodd-Frank standards will allow an influx of cheap capital into the sustainable energy market. This will allow sustainable energy firms to capture much needed market share from traditional oil and gas firms, which have always dominated the U.S. market. This will allow for innovation in research and development in sustainable energy firms, making it much more likely that clean energy alternatives will become viable choices for the American public. In turn, as citizens have more and more options for clean fuel, the U.S. will be able to use less and less fossil fuels that contribute to Global Climate Change,

---

177 *See supra* Sections II.B, II.C.
178 *See supra* Conclusion.B.

reducing the individual and national carbon footprint.[179] In the process of this movement toward a "green" America, the SEC will be able to evaluate its Dodd-Frank hedge fund regulations, and be able to modify the regulatory structure to optimize regulation and investing goals. This will reduce costs for the SEC and increase capital flow in the marketplace. A more sustainable country and a reduced cost to the SEC would be a win-win.

There is, of course, the possibility that the theory in this Note will not play out as described. Even if that happens, the proposal is still a worthwhile exercise for the SEC. If the Dodd-Frank hedge fund regulations are, in fact, necessary and working to actively protect the markets and the investing public, this experiment will prove that. Green funds could run into some foul play—which would be caught quickly by the SEC in their yearly review or by hedge fund investors doing their due diligence—and the SEC would know that the new regulations are necessary. Or, in the alternative, green funds could act perfectly lawfully but still perform on par with all other hedge funds. If either of these scenarios plays out, the SEC will be able to point to a tangible study that affirms their new regulatory structure. This is something that is rarely attainable for a new regulatory structure, and would put to rest any arguments from Wall Street activists who continue to fight the new regulations. No harm, no foul, the "No-Lose" scenario still gives the SEC valuable information. Either way, this is a worthy regulatory experiment that could result in massive development in sustainable energy in the United States. The need for a reduction in our national carbon footprint to combat climate change is so poignant that the nation should consider any possible solution, even obscure hedge fund reform, if it will help push toward a more sustainable world.

[179] *See What's My Carbon Footprint?*, NATURE CONSERVANCY, http://www.nature.org/greenliving/carboncalculator/ [https://perma.cc/4W69-9YTN] (last visited Nov. 15, 2016) (describing the greenhouse gas emissions that individuals use on a daily basis that contribute to climate change).