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The Regulator Strikes Back: A Look at the SEC's Most Recent Attempt to Regulate Hedge Funds and What It Missed

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THE REGULATOR STRIKES BACK: A LOOK AT THE SEC'S MOST RECENT ATTEMPT TO REGULATE HEDGE FUNDS AND WHAT IT MISSED

Alexander R. Roche[*]

I. INTRODUCTION

In September 2006, Amaranth Advisors, LLC ("Amaranth"), a hedge fund, did exactly what it had done the previous year: It placed a heavy bet that natural gas prices would rise.[1] To finance this bet, Amaranth borrowed eight dollars for each dollar in its investment pool.[2] When natural gas futures prices dropped, $6 billion of Amaranth's $9.6 billion in assets evaporated,[3] leading to a liquidation.[4] This is just one of many hedge funds that have suffered significant losses in recent years.[5] Amaranth's loss was similar to the 1998 failure of the Long Term Capital Management hedge fund ("LTCM").[6] While LTCM lost less in terms of dollars,[7] its over-leveraged derivative holdings nearly brought down the world's financial markets, necessitating a bailout organized by the Federal Reserve.[8] Conversely, Amaranth's creditors were less over-extended to Amaranth than LTCM's creditors because Amaranth's creditors took out futures contracts

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[1] Mara Der Hovanesian, *Amaranth's Loss, Wall Street's Gain: The Hedge Fund's Collapse Was Foreseen by Other Players, Who Laid Their Plans Accordingly*, 4004 Bus. Week 78, 78 (Oct. 9, 2006) (available at 2006 WLNR 17243463).

[2] Phillip Delves Boughton, *Hedge Fund: A Gamble Too Far* 2, http://www.thefirstpost.co.uk/index.php?menuID=2&subID=931 (Sept. 20, 2006).

[3] Jenny Anderson, *Betting on the Weather and Taking an Ice-Cold Bath*, 156 N.Y. Times C8 (Sept. 29, 2006) (available at 2006 WLNR 16872190).

[4] Der Hovanesian, *supra* n. 1, at 78.

[5] *See e.g.* Jenny Anderson, *Hedge Fund Shrinks Staff and Faces S.E.C. Inquiry*, 156 N.Y. Times A1, C4 (Sept. 29, 2006) (available at 2006 WLNR 16872294) (stating Hedge Fund Pirate Capital, a $1.7 billion fund, lost half of its investments in one week); Jon Danielsson, Ashley Taylor & Jean-Pierre Zigrand, *Highwaymen or Heroes: Should Hedge Funds be Regulated?* 1 J. Fin. Stability 522, 539 n. 33 (Sept. 2005) (stating that there were 700 hedge fund failures in 2002 and 800 in 2003); Sebastian Mallaby, *Hands Off Hedge Funds*, 86 For. Affairs 91, 94 (Jan./Feb. 2007) (stating that 848 hedge funds failed in 2005).

[6] Der Hovanesian, *supra* n. 1, at 78.

[7] *Id.*

[8] Joseph Hellrung, *Hedge Fund Regulation: Investors Are Knocking at the Door, but Can the SEC Clean House Before Everyone Rushes In?* 9 N.C. Banking Inst. 317, 328 (Apr. 2005). The Federal Reserve Bank of New York gathered LTCM's creditor banks together and convinced them to invest $3.6 billion in LTCM, which prevented LTCM from having to liquidate its securities holdings. Roger Lowenstein, *When Genius Failed* 195-210 (Random H. 2000). For an explanation of the effects of a liquidation of this type, see *infra* § V(A).

contrary to Amaranth.[9] Although Amaranth lost $6 billion over a matter of weeks, the market had learned to adjust since the downfall of LTCM, preventing a crisis in the financial markets as well as a massive bailout.[10]

Despite the risks that hedge funds pose, their popularity has increased since the liquidation of LTCM, with assets tripling to $1.4 trillion.[11] This rise in popularity has caught the attention of the Securities and Exchange Commission ("SEC").[12] Due to the way that hedge funds are organized, they are generally exempt from SEC oversight.[13] To rectify this, in December 2004, the SEC enacted certain regulations under the Investment Advisers Act of 1940 ("Investment Advisers Act") that required hedge fund advisers to register as investment advisers with the SEC.[14] However, in June 2006, the D.C. Circuit Court found these regulations to be invalid,[15] leaving the SEC to regroup and develop a new scheme for regulating hedge funds.[16] On January 4, 2007, the SEC proposed two new rules that are designed to inhibit fraud and limit the pool of eligible investors in hedge funds.[17] Additionally, on February 22, 2007, the President's Working Group on Financial Markets issued a set of non-binding principles and guidelines outlining the practices it expects market participants to observe with respect to hedge funds,[18] though this will have no effect on the two rules proposed by the SEC.[19]

While the SEC is ramping up its efforts to bring hedge funds under its regulatory umbrella, many advocates believe that the hedge fund industry

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[9] Der Hovanesian, *supra* n. 1, at 78.

[10] *Id. See infra* § V(A) (comparing Amaranth to LTCM).

[11] Der Hovanesian, *supra* n. 1, at 78; Carter Dougherty, *Economic Powers to Study Growing Influence of Hedge Funds*, 156 N.Y. Times § 1, at 121 (Feb. 11, 2007) (available at 2007 WLNR 2695717).

[12] *See* 69 Fed. Reg. 72054 (Dec. 10, 2004) (discussing the rationale for changing the Investment Advisers Act of 1940 to include specific provisions that would require hedge fund advisers to register with the SEC).

[13] Willa E. Gibson, *Is Hedge Fund Regulation Necessary?* 73 Temp. L. Rev. 681, 688 (2000). *See infra* § III (describing current regulations and how hedge funds avoid many of the requirements).

[14] Daniel K. Liffmann, Student Author, *Registration of Hedge Fund Advisers Under the Investment Advisers Act*, 38 Loy. L.A. L. Rev. 2147, 2148 (2005).

[15] *Goldstein v. SEC*, 451 F.3d 873, 883-84 (D.C. Cir. 2006). *See infra* § III(E) (explaining the court's rationale in vacating the rule).

[16] Lynn Hume, *Cox to Push Emergency Hedge Fund Rules in Wake of Court Ruling*, 357 Bond Buyer 4 (July 26, 2006).

[17] *See* 72 Fed. Reg. 400 (Jan. 4, 2007); *infra* § IV (describing the proposed rules).

[18] President's Working Group on Fin. Mkts., *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, http://www.treasury.gov/press/releases/reports/hp272_principles.pdf (Feb. 22, 2007) [hereinafter *PWG Agreement*] (The President's Working Group on Financial Markets is composed of the Treasury Department, SEC, Commodities Futures Trading Commission, and Federal Reserve Board). *See infra* nn. 268, 280, 300 (discussing the specifics of the *PWG Agreement*).

[19] Stephen Labaton, *Officials Reject More Oversight of Hedge Funds*, 156 N.Y. Times A1, C4 (Feb. 23, 2007).

is stable[20] and that SEC regulation will have no impact on the perceived problems with hedge funds.[21] This Comment argues that although the SEC and other regulatory agencies should take minor steps to achieve some oversight of hedge funds, there is no need for a major overhaul of the current regulatory scheme. The SEC's proposal to reduce the number of individuals who can invest in hedge funds goes too far and should be revised. This Comment will also look at the justifications for increasing hedge fund regulation and will show that these justifications, although in some cases legitimate, are not substantial enough to warrant major regulatory reform. Furthermore, because hedge funds provide an investment option that fills a gap in the rest of the investing world, the SEC and other regulatory agencies must take particular care not to over-regulate an industry that is playing an ever-increasing and crucial role in the functioning of the financial markets. Finally, this Comment will propose two methods—allowing hedge funds to advertise and a cap on pension fund investment in hedge funds—that regulators should use to satisfy their concerns without over-burdening the efficient operations of hedge funds.

Section II of this Comment will provide an overview of the hedge fund industry. Section III will explore the current major regulations of hedge funds and show how hedge funds structure their operations to prevent registration. Section III will also examine the D.C. Circuit Court's rationale for invalidating the SEC's rule requiring hedge fund advisers to register with the SEC. Section IV will provide an overview of the newest rule proposals by the SEC and examine if the proposed rules are in line with the SEC's concerns about hedge funds. In addition, Section IV will argue that one of the proposed rules goes too far and that the SEC should revise it before issuing its final rule. Section V will take an in-depth look into other common justifications for increasing hedge fund regulation, and if such a need exists, will propose avenues that the SEC, Congress, and other regulatory agencies can potentially take to increase regulation in a manner that is aligned with the regulatory gaps, without disadvantaging the way in which hedge funds currently operate.

II. OVERVIEW OF THE HEDGE FUND INDUSTRY

The first hedge fund was formed in 1949 by Alfred Winslow Jones.[22] He employed a strategy of using leverage to purchase securities

[20] *See* Steven Rattner, *Don't Fence in Hedge Funds With a Wide Range of Investing Styles, They Need Room to Roam*, 3967 Bus. Week 104, 104 (Jan. 16, 2006) (available at 2006 WLNR 641303) (arguing against increasing regulation of hedge funds).

[21] 69 Fed. Reg. at 72090.

[22] SEC, *Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission* 3, http://www.sec.gov/news/studies/hedgefunds0903.pdf (2003) [hereinafter *Staff Report*]. Warren Buffet, CEO of Berkshire Hathaway and "the most revered investor of our day," argues that hedge funds have existed since the mid-1920s when Benjamin Graham utilized a limited partnership structure, performance fees, and long and short positions for his investing entity. Chet Currier, *Buffett*

long and sell securities short to hedge against risks in the market.[23] From this simple trading strategy came the term *hedge fund*. Since those days, hedge funds have significantly increased in size and scope, with the term *hedge fund* now describing funds that utilize numerous different trading strategies.[24] Because of this, there is neither a generally accepted definition of a hedge fund in the industry nor a statutory definition.[25] The term *hedge fund* is now a catch-all for "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act."[26]

At the end of 2003, hedge fund assets were estimated to be $870 billion in 7,000 funds.[27] Estimates indicate that hedge funds were a $1.3 trillion industry by the end of 2006.[28] It is predicted that by 2008, "11,700 hedge funds will be operating globally, with $1.7 trillion in assets."[29] Much of this growth is attributable to institutional investors investing more of their assets into hedge funds.[30] With this growth, hedge funds have begun to dominate the financial markets, accounting for 30% of trading activity[31] and a sizeable portion of the convertible bond market.[32] Hedge funds have "infiltrated every corner of every market,"[33] and there is no indication that hedge fund growth is going to diminish.[34]

Says Hedge Funds are Older Than You Think, http://www.canadianhedgewatch.com/content/news/general/?id=975 (Sept. 29, 2006).

[23] *Staff Report*, *supra* n. 22, at 3.

[24] *See infra* § II(A) (listing numerous strategies used by hedge funds).

[25] Gibson, *supra* n. 13, at 683. During the SEC's Roundtable on Hedge Funds, David Vaughn submitted a list of fourteen different definitions for the term "hedge fund." David A. Vaughn, *Comments for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds; Selected Definition of "Hedge Fund"* (D.C., May 14-15, 2003) (available at http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm).

[26] *Staff Report*, *supra* n. 22, at 3.

[27] 69 Fed. Reg. at 72055.

[28] Dougherty, *supra* n. 11, at § 1, at 21.

[29] Ted Gogoll, *What's Driving the Hedge Fund Boom?* http://www.businessweek.com/print/investor/content/oct2006/pi20061013_353103.htm (Oct. 13, 2006) (stating the prediction made by Van Hedge Fund Advisers, a hedge fund consultant).

[30] *Staff Report*, *supra* n. 22, at 43.

[31] This number reflects all financial market trading activity, such as trading on the New York Stock Exchange or the Chicago Board of Exchange. Jenny Anderson, *S.E.C. Chief Looks to Regain Power Over Hedge Funds*, 155 N.Y. Times C2 (July 26, 2006) (available at 2006 WLNR 12858312). Hedge funds represent 10-20% of equity trading in the United States. 69 Fed. Reg. at 72056.

[32] 69 Fed. Reg. at 72056.

[33] *Regulating Hedge Funds*, 156 N.Y. Times § 4, at 11 (Sept. 24, 2006) (available at 2006 WLNR 16557895). *Every market* is not an exaggeration. Because of the flexibility of investment decisions, hedge funds invest in numerous assets, including real estate, art, and anything else that may appreciate in value.

[34] Major brokerage houses are adding hedge funds to their product offerings as a way to attract new investors as well as recruit new managers. Emily Thornton, *Morgan Stanley: A Big Bet on Hedge Funds*, http://www.businessweek.com/investor/content/nov2006/pi20061101_517314.htm?chan=search (Nov. 1, 2006) (reporting that Morgan Stanley recently purchased the hedge fund FrontPoint). Also, one hedge fund adviser group has sold its securities in an initial public offering and will be traded on an exchange. Eleanor Laise, *Hedge Funds Beckon Small Investors*, 249 Wall St. J. D1 (Feb. 14, 2007) (stating that Fortress Investment Group, a private equity and hedge fund manager, completed a successful initial

A. Characteristics of Hedge Funds

Former managers from investment banks, investment management firms, and other financial institutions generally form hedge funds.[35] Hedge fund advisers are drawn by the ability to employ numerous investment strategies and gain potential compensation from performance fees in forming their own hedge funds.[36] The performance fee is usually 20% of realized and unrealized capital gains.[37] The performance fee is the main draw for advisers to organize a hedge fund, and the most successful hedge fund advisers can "take home several hundred million dollars annually, much more than top Wall Street executives."[38]

Domestic hedge funds are most often organized as limited partnerships, though some are organized as limited liability companies.[39] A limited partnership provides two benefits: limited liability and pass-through taxation.[40] The investors share in the hedge fund's income, gains, and losses but are not liable for any losses in excess of their investment, though the general partner is personally liable.[41] Pass-through taxation prevents double taxation, so the hedge fund itself is not directly taxed, only the gains for the partners are taxed.[42] A limited liability company provides the same benefits, but instead of a general partner, the adviser is the managing member and

public offering). *See also* Jonathan Bevilacqua, Student Author, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 Buff. L. Rev. 251 (2006) (arguing that hedge funds are beginning to behave more like private equity firms, leaving little distinction between the two types of investment companies). Additionally, there has been a large increase in the number of funds of hedge funds, which are hedge funds that invest in 15-20 different hedge funds and may or may not be registered with the SEC. *Staff Report*, *supra* n. 22, at 67. Even though the emergence of registered hedge funds is an interesting trend, the focus of this Comment is on unregistered hedge funds. *See* Erik J. Greupner, Student Author, *Hedge Funds are Headed Down-Market: A Call for Increased Regulation?* 40 S.D. L. Rev. 1555, 1580-84 (2003) (discussing the increase and implications of hedge funds registering with the SEC).

[35] *Staff Report*, *supra* n. 22, at 52.

[36] *Id.* Some hedge funds are entities that manage billions of dollars; have a large staff, including analysts, brokers, and portfolio managers; and have extensive procedures to comply with advisers' fiduciary duties, as contrasted with less sophisticated entities or persons that manage smaller sums of money, have fewer formal procedures, and may have "one individual serv[ing] as marketer, portfolio manager, trader, operations officer and risk manager." *Id.* at 53.

[37] *Id.* at 61. An unrealized gain is a paper profit. The security that has been invested in has appreciated in value, but the investor has not yet sold his interest in it. Conversely, a realized gain is one where the investor has closed out his position and has made an actual, tangible profit. The fee can be higher or lower depending on the adviser's reputation within the investing community. Hedge funds may also have a high-water mark whereby the fund must recoup its losses before the fund will charge a performance fee. Gibson, *supra* n. 13, at 684. A hedge fund may also have a hurdle rate, which is a certain rate of return that the fund must achieve before charging a performance fee. *Staff Report*, *supra* n. 22, at 63.

[38] Mallaby, *supra* n. 5, at 94 (noting that six hedge fund managers in Connecticut made $2.15 billion collectively in 2005).

[39] Gerald T. Lins, *Hedge Fund Organization*, in *Hedge Fund Strategies: A Global Outlook* 98, 98 (Brian R. Bruce ed., Institutional Investor, Inc. 2002).

[40] *Id.*

[41] *Id.* The hedge fund's adviser generally serves as the general partner. *Staff Report*, *supra* n. 22, at 9. The investors are the limited partners. Lins, *supra* n. 39, at 98.

[42] Lins, *supra* n. 39, at 98.

also has limited liability.[43]

One common characteristic of hedge funds is the use of leverage. Leverage is usually employed by borrowing money to purchase securities.[44] However, leverage can also be obtained by "taking short positions in securities, employing collateralized borrowing through repurchase agreements . . . , executing derivatives transactions,"[45] and purchasing securities on margin. The use of leverage can result in larger gains or larger losses than would otherwise result.[46] Hedge funds typically engage in highly active short-term trading,[47] and the use of leverage allows larger gains for hedge funds that seek to exploit small inefficiencies in market price.[48] Additionally, there are numerous overall investment strategies that hedge funds may employ, such as convertible arbitrage,[49] short-bias,[50] emerging markets,[51] equity/market neutral,[52] event-driven,[53] fixed-income

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[43] *Id.* at 99. However, not all hedge funds are formed under domestic laws. Offshore hedge funds are usually established in the corporate form under the laws of the particular jurisdiction. *Id.* at 100. Offshore hedge funds are able to gain access to non-U.S. investors and have some tax advantages. *Id.* at 99. Additionally, offshore hedge funds are more attractive to U.S. tax-exempt entities such as pension funds. *Staff Report*, *supra* n. 22, at 10. Tax-exempt entities that engage in an investment strategy that involves borrowing money can be taxed for unrelated business income regardless of its tax-exempt status. This tax can be avoided by investing in offshore hedge funds. *Id.* at 10 n. 29. *See also* Jay Crenshaw, *Hedge Funds: Regulatory, Tax, and Organizational Considerations*, 18 Fla. J. Intl. L. 359, 403-11 (2006) (discussing tax implications of offshore hedge funds and organization of offshore hedge funds).

[44] *Staff Report*, *supra* n. 22, at 37.

[45] Gibson, *supra* n. 13, at 686-87 (footnotes omitted). Short selling is a form of leverage because when the security is sold short, the seller receives the proceeds from that sale, even though it did not own the underlying security at the time. The short seller will then purchase the security at an indefinite time in the future, presumably for less than it was sold.

[46] *Id.* at 687.

[47] *See* Marcia Vickers, *The Most Powerful Trader on Wall Street You've Never Heard Of*, 3842 Bus. Week 66, 66 (July 21, 2003) (available at 2003 WLNR 9519339) (noting that one hedge fund manager was found to have conducted 3% of the New York Stock Exchange's market activity).

[48] *Staff Report*, *supra* n. 22, at 4.

[49] The convertible arbitrage strategy

> is identified by hedge investing in the convertible securities of a company. A typical investment is to be long in the convertible bond and short in the common stock of the same company. Positions are designed to generate profits from the fixed income security as well as the short sale of stock, while protecting principal from market moves.

Mila Getmansky, Andrew W. Lo & Shauna X. Mei, *Sifting Through the Wreckage: Lessons From Recent Hedge-Fund Liquidations*, in *The World of Hedge Funds: Characteristics and Analysis* 7, 41 (H. Gifford Fong ed., World Sci. Publg. Co. Pte. Ltd. 2005).

[50] The short-biased strategy is designed to maintain a net short position, as opposed to all short positions. Positions are taken in equities and derivatives. *Id.*

[51] The emerging markets strategy "involves equity or fixed income investing in emerging markets around the world. Because many emerging markets do not allow shortselling, nor offer viable futures or other derivative products with which to hedge, emerging market investing often employs a long-only strategy." *Id.*

[52] The equity/market neutral strategy

> is designed to exploit equity market inefficiencies and usually involves being simultaneously long and short matched equity portfolios of the same size within a country. Market neutral portfolios are designed to be either beta or currency neutral, or both. Well-designed portfolios typically control for industry, sector,

arbitrage,[54] global macro,[55] long/short equity,[56] managed futures,[57] or a strategy that encompasses two or more investment strategies.[58]

> market capitalization, and other exposures. Leverage is often applied to enhance returns.

Id. Beta is a measure of risk that compares the risk of an investment with the S&P 500. The S&P 500 has a beta coefficient of 1, and thus if an investment "has a beta of less than 1, it will rise and fall more slowly than the S&P 500 and have less volatility. The inverse relationship to the S&P 500 is also true as an investment's beta increases above 1." Greupner, *supra* n. 34, at 1565 n. 50.

[53] The event-driven strategy captures price movements generated by a significant pending corporate event such as a merger, corporate restructuring, liquidation, bankruptcy, or reorganization. Getmansky et al., *supra* n. 49, at 41.

[54] The fixed income arbitrage strategy

> aims to profit from price anomalies between related interest rate securities. Most managers trade globally with a goal of generating steady returns with low volatility. This category includes interest rate swap arbitrage, US and non-US government bond arbitrage, forward yield curve arbitrage, and mortgage-backed securities arbitrage. The mortgage-backed market is primarily US-based, over-the-counter and particularly complex.

Id. An interest rate swap is an agreement between parties to exchange interest rate receipts or obligations, generally exchanging a fixed rate for a variable rate. A mortgage-backed security is an asset-backed security, backed by mortgages, which can be traded on an exchange. Over-the-counter derivatives are contracts between parties that are not traded on a regulated exchange but are similar to exchange-traded derivatives in nature.

[55] The global macro strategy involves

> [g]lobal macro managers carry[ing] long and short positions in any of the world's major capital or derivative markets. These positions reflect their views on overall market direction as influenced by major economic trends and/or events. The portfolios of these funds can include stocks, bonds, currencies, and commodities in the form of cash or derivatives instruments. Most funds invest globally in both developed and emerging markets.

Id. at 42.

[56] The long/short equity strategy

> involves equity-oriented investing on both the long and short sides of the market. The objective is not to be market neutral. Managers have the ability to shift from value to growth, from small to medium to large capitalization stocks, and from a net long position to a net short position. Managers may use futures and options to hedge. The focus may be regional, such as long/short US or European equity, or sector specific, such as long and short technology or healthcare stocks. Long/short equity funds tend to build and hold portfolios that are substantially more concentrated than those of traditional stock funds.

Id.

[57] The managed futures strategy

> invests in listed financial and commodity futures markets and currency markets around the world. The managers are usually referred to as Commodity Trading Advisers, or CTAs. Trading disciplines are generally systematic or discretionary. Systematic traders tend to use price and market specific information (often technical) to make trading decisions, while discretionary mangers use a judgmental approach.

Id.

[58] This is not an exhaustive list. For instance, Hedge Fund Research, Inc. has identified thirty-two different investment strategy categories for hedge funds. Hedge Fund Research, Inc., *Strategy*

B. Market Benefits Provided By Hedge Funds

Hedge funds provide numerous benefits to the financial markets, the economy, and investors. Hedge funds play an important role in maintaining and enhancing market liquidity.[59] One way hedge funds enhance liquidity is by assuming risks for others in the market.[60] For example, regulated entities may have to divest an investment because it exceeds the allotment of risk various regulations allow them to manage.[61] Hedge funds do not have to be concerned with regulatory oversight of their risk, and therefore enhance liquidity by providing a market for these investments. Furthermore, because hedge funds are active short sellers of securities, the supply for those securities is increased, which also results in enhanced market liquidity.[62] Short selling is also a method that contributes to price efficiency. Hedge funds that use an arbitrage strategy are constantly seeking out securities that are mispriced in order to exploit the mispricing.[63] By actively seeking to exploit the mispricings that occur in the financial markets, hedge funds play an integral role in keeping assets at their true value.[64]

Additionally, hedge funds provide diversification for investors.[65] Hedge funds seek out absolute returns and are only successful if they profit in rising and falling markets, while registered investment companies seek relative returns and base success on performance measured against an index or the market as a whole.[66] Hedge fund advisers have the flexibility in their management of assets to pursue different strategies in differing market conditions, which helps protect investors from bear market conditions.[67]

C. Justifications for Increased Hedge Fund Regulation

The SEC and other regulatory agencies have cited several reasons for increasing regulation of hedge funds. These stated justifications include: the increase in the number of hedge funds engaging in fraudulent behavior,

Definitions, https://www.hedgefundresearch.com/pdf/HFR_Strategy_Definitions.pdf (last accessed Oct. 10, 2007).

[59] *Staff Report*, *supra* n. 22, at viii.

[60] *Id.* at 4.

[61] Danielsson et al., *supra* n. 5, at 523.

[62] *Staff Report*, *supra* n. 22, at 40. The practice of short selling can be abused; for instance, a bear raid can be used to drive the price of a particular security down. This practice can eliminate buyers from the market. However, Rule 10a-1 established the "tick test" to prevent such abusive practices. *Id.* at 40-41. The tick test states that a short sale is priced at a price above the price at which the immediately preceding sale was effected or at the last sale price if it is higher than the last different price. 17 C.F.R. § 240.10a-1 (2007) (The SEC has proposed eliminating this test. *See Amendments to Regulation SHO and Rule 10a-1*, 71 Fed. Reg. 75068 (Dec. 13, 2006)).

[63] Danielsson et al., *supra* n. 5, at 533 ("By acting upon their research . . . hedge funds affect prices and volumes and reveal some of their private information to the market at large, helping assets move back to fundamental values more quickly.").

[64] *Id.* ("[V]ery few mispricings are quite so obvious, perhaps exactly because hedge funds by their trading push prices towards and inside the no-arbitrage set.").

[65] *Staff Report*, *supra* n. 22, at 5.

[66] *Id.* at 5, 36.

[67] Danielsson et al., *supra* n. 5, at 534.

retailization, systemic risk, and a lack of accurate information concerning hedge funds. This section will only provide a brief overview of the perceived problems. Sections IV and V of this Comment will take a more in-depth look at each stated justification and, where the problem does exist, provide a better regulatory solution.

1. Fraud

Hedge fund fraud has long been a concern for the SEC. The SEC has stated:

> [G]rowth in the number of hedge fund fraud cases is likely attributable to a number of factors, including: the popularity of hedge fund investments and the large amounts of money they involve (and thus their attractiveness to perpetrators of fraud); the entrance to the industry of inexperienced, untested and, in some cases, unqualified individuals; and lack of adequate controls on the operations of some hedge fund advisers.[68]

The SEC brought 51 fraud actions against hedge fund advisers from 1999-2004.[69] These actions involved a wide variety of misconduct, including: "misappropriation of assets; misrepresentation of portfolio performance; falsification of experience, credentials and past returns; misleading disclosure regarding claimed trading strategies; and improper valuation of assets."[70] These incidents, some of which have been highly publicized, have created the impression among the public and regulators that hedge funds are engaged in a disproportionate amount of fraudulent behavior.[71]

2. Retailization

Retailization of hedge funds has two prongs: direct and indirect exposure to retail investors. The primary concern with direct investment by retail investors is not that those who are ineligible to invest are investing, but that there are too many individuals who qualify to invest who lack the necessary sophistication to make informed investments in hedge funds.[72] Additionally, the SEC stated that retail investors were indirectly exposed to, or had the potential to be exposed to, hedge funds by the increase in hedge fund investment by pension funds, universities, endowments, and charities.[73] This indirect exposure through pension funds is the primary concern of

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68 *Staff Report*, *supra* n. 22, at 73.
69 69 Fed. Reg. at 72056.
70 *Staff Report*, *supra* n. 22, at 73-74.
71 *See infra* § IV(A) (discussing the proposed rule concerning hedge fund fraud).
72 69 Fed. Reg. at 72057, 72093; *Staff Report*, *supra* n. 22, at 80. *See infra* § IV(B) (discussing the proposed rule to reduce the number of investors eligible to invest in hedge funds).
73 69 Fed. Reg. at 72057.

regulators, because a hedge fund failure may prevent a pension fund from meeting its current obligations and may injure those who would not otherwise be eligible to invest in hedge funds.[74]

3. Systemic Risk

Systemic risk is also a very serious concern associated with hedge fund practices. In general, systemic risk is the risk of a disruption within the financial system, which causes market players to have difficulties transacting normal business.[75] The disruption can be limited to the losses suffered by one market participant.[76] Losses at one firm can create a domino effect, spreading to other market participants, possibly resulting in a worse-case scenario—a market comprised solely of sellers. The efficient operation of the financial markets is created by liquidity, and a complete void of liquidity, i.e., all sellers and no buyers, results in a collapse of the financial markets. A hedge fund can create a systemic crisis because its use of leverage will exacerbate its losses, which in turn can extend throughout the financial markets.[77]

4. Lack of Information

As noted above, all the numbers concerning the size of the hedge fund industry are estimates. Regulatory agencies are concerned that there is no reliable or accurate information as to how many hedge funds are in operation, what their assets are, or even who controls them.[78] The lack of information not only makes it difficult for agencies to develop an effective regulatory policy, but also prevents regulators from ensuring that investors are receiving material information about the hedge funds in which they are investing.[79] Hedge funds are generally secretive, and will disclose as little information as possible to their investors.[80]

III. CURRENT REGULATIONS

An investor's interest in a hedge fund is classified as a security.[81]

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[74] *See infra* § V(B) (discussing the specifics of hedge fund investments made by pension funds).

[75] U.S. Gen. Acctg. Off., *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk* 2 n. 2, http://www.gao.gov/archive/2000/gg00003.pdf (Oct. 1999) [hereinafter *GAO Report*].

[76] Gibson, *supra* n. 13, at 705.

[77] *See infra* § V(A) (discussing hedge fund involvement in a potential systemic crisis).

[78] *Staff Report*, *supra* n. 22, at 77.

[79] *Id.* at x.

[80] *See infra* § V(B) (discussing the void of information at the investor and regulatory levels).

[81] In a limited partnership, the limited partners' interests are always securities. The Howey test also designates interests in hedge funds as securities. Joseph C. Long, *A Hedge Fund Primer*, in Practising Law Institute, *Securities Arbitration 2005: A Rapidly Evolving Process* vol. 2, 233, 239-240 (P.L.I. 2005) (available at WL, 1503 PLI/Corp 233) (citing *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (requiring that for an interest to qualify as a security there must be an investment of money in a common enterprise with the expectation of a profit, coming solely or substantially from the efforts of others)).

Therefore, hedge funds are subject to securities regulations passed by Congress or developed by the SEC. However, hedge funds are generally formed in a way that allows for exemption or exclusion from federal securities law.[82]

A. Securities Act of 1933

The Securities Act of 1933 ("Securities Act") was promulgated for the registration of public offerings of securities. In order to protect investors, the Securities Act requires disclosure of certain information and approval by the SEC before the public sale of securities can take place.[83] Section 5 of the Securities Act prohibits the offer and sale of a security prior to filing a registration statement with the SEC.[84] Hedge funds are able to avoid the public disclosure requirement by utilizing the § 4(2) exemption and Regulation D.

Section 4(2) exempts non-public offerings from complying with the § 5 requirements.[85] In determining if the offering is non-public, the courts will generally examine four factors: "the number of offerees and their relationship to each other and the issuer, the number of units offered, the size of the offering, and the manner of the offering."[86] The larger the number of offerees and the larger the size of the offering the more likely that courts will draw the inference that the securities will end up in the hands of those investors that the Securities Act was passed to protect.[87] However, Rule 506 of Regulation D[88] provides a safe harbor for offerings made under the § 4(2) exemption. If an issuer complies with the requirements of Rule 506, then the offering is deemed to be private.[89] Rule 506 requires a hedge fund to deliver certain information to prospective investors,[90] to refrain from engaging in general advertising or solicitation,[91] and to sell shares to no more than 35 non-accredited investors.[92]

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[82] Gibson, *supra* n. 13, at 688.

[83] Adam R. Bolter, Student Author, *Regulation of Hedge Fund Advisers: A Valid Exercise of Rulemaking Authority or the Promulgation of New Law?* 57 Admin. L. Rev. 595, 610 (2005).

[84] 15 U.S.C. § 77e(c) (2000).

[85] *Id.* at § 77d(2).

[86] *Doran v. Petroleum Mgt. Corp.*, 545 F.2d 893, 900 (5th Cir. 1977). *See also SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) ("An offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering.").

[87] Gibson, *supra* n. 13, at 690.

[88] 17 C.F.R. § 230.506 (2007).

[89] *Id.*

[90] *Id.* at § 230.502(b). This includes information that is required for a registered company. Certain disclosures do not have to be made to accredited investors, however, although it is prudent to do so due to the anti-fraud rules of the Securities Act. Douglas L. Hammer et al., *U.S. Regulation of Hedge Funds* 127 (ABA 2005).

[91] 17 C.F.R. at § 230.502(c). "[T]he offer must be directed to the offeree personally to satisfy the ban on general solicitation." Gibson, *supra* n. 13, at 691 (footnote omitted).

[92] 17 C.F.R. at § 230.506(b)(2). Hedge funds use this limitation as a means of compensating their employees, not as a way to seek outside investors, but because many of their employees are not accredited investors. 72 Fed. Reg. at 406-07. Rule 506 also requires the hedge fund to use reasonable

The most important of these limitations is the requirement that investors be *accredited investors*.[93] Accredited investors include: banks; insurance companies; natural persons with at least $1 million net worth; and natural persons reporting at least $200,000 in individual income (or $300,000 joint income in the case of a married couple) and having a reasonable expectation of reaching the same income level in the current year.[94] A hedge fund adviser must reasonably believe that each investor is accredited and therefore should take reasonable steps to ascertain an investor's status by "requiring each investor to represent in writing that the investor is an accredited investor and to complete an offering questionnaire that requires the investor to identify which of the categories applies."[95] By offering securities through the safe harbor provision of Regulation D, hedge funds have a great deal of control over what information is disclosed to accredited investors.

B. Investment Company Act of 1940

The enactment of the Investment Company Act of 1940 ("Investment Company Act") protects investors from abusive practices by those managing investment companies.[96] The Investment Company Act defines an investment company as a company that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."[97] Although this definition encompasses hedge funds, they structure themselves around one of two exclusions to avoid falling within the Act's provisions.

Section 3(c)(1) of the Investment Company Act[98] "excludes any pooled investment vehicle from the definition of an investment company if it does not have more than 100 beneficial owners of its outstanding securities . . . and does not make or propose to make a public offering of its securities."[99] Therefore, as long as the hedge fund has fewer than 100 investors, the first exclusion applies. However, if one investor, or beneficial owner, owns more than 10% of the outstanding voting securities, the hedge fund must look-through the investing entity and count as a beneficial owner each investor in the investing entity.[100] Additionally, if the hedge fund meets the requirements of the Securities Act, then the second requirement of

care to prevent the reselling of shares by investors and to file Form D with the SEC within fifteen days of the first sale indicating that securities are being sold pursuant to Regulation D. 17 C.F.R. at §§ 230.502(c), 230.503(a).

93 17 C.F.R. at §§ 230.501(a), 230.215.

94 *Id.*

95 Hammer et al., *supra* n. 90, at 123.

96 Gibson, *supra* n. 13, at 693; Bolter, *supra* n. 83, at 612.

97 15 U.S.C. § 80a-3(a)(1)(A) (2000).

98 *Id.* at § 80a-3(c)(1).

99 Hammer et. al., *supra* n. 90, at 62 (footnote omitted).

100 15 U.S.C. § 80a-3(c)(1)(A). To look-through an entity is to disregard the way the business has been organized. *Black's Law Dictionary* 962 (Bryan A. Garner ed., 8th ed., West 2004).

§ 3(c)(1) is met.[101] Therefore, the hedge fund utilizing § 3(c)(1) is limited to 100 accredited investors, unless one of the investors owns more than 10% of the outstanding shares, which would require the hedge fund to look-through the investing entity.

Section 3(c)(7) of the Investment Company Act[102] excludes hedge funds "if all of the beneficial owners of its outstanding securities are 'qualified purchasers,' . . . and it does not make or propose to make a public offering of its securities."[103] A *qualified purchaser* is a natural person who owns at least $5 million in investments, a family-owned company which owns at least $5 million in investments, certain trusts, or any person who owns and invests on a discretionary basis at least $25 million in investments.[104] The term *investments* includes securities;[105] cash and cash equivalents;[106] and other assets held for investment purposes such as real estate,[107] commodity interests,[108] and physical commodities.[109] The use of the § 3(c)(7) exclusion does not limit the number of investors in the fund, though in practicality, it is limited to 499 qualified purchasers.[110] Additionally, avoidance of the registration requirements of the Securities Act satisfies the second requirement of the exclusion.[111] However, because of the requirements of the Securities Act, an investor in a § 3(c)(7) fund must also meet the requirements of an accredited investor.[112]

C. Investment Advisers Act of 1940

The Investment Advisers Act of 1940 ("Investment Advisers Act") was enacted to curb abusive practices of investment advisers by requiring them to register with the SEC.[113] An investment adviser is "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[114] Hedge fund advisers fall within this definition, though they typically structure their fund to fall within the small-adviser exemption.[115] To qualify as a small-adviser,

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[101] *See supra* § III(A) (explaining how a hedge fund makes a non-public offering).
[102] 15 U.S.C. § 80a-3(c)(7).
[103] Hammer et al., *supra* n. 90, at 74-75 (footnotes omitted).
[104] 15 U.S.C. § 80a-2(a)(51)(A).
[105] 17 C.F.R. § 270.2a51-1(b)(1) (2007).
[106] *Id.* at § 270.2a51-1(b)(7).
[107] *Id.* at § 270.2a51-1(b)(2). Real estate that is used for personal purposes or in connection with a business is excluded. *Id.* at § 270.2a51-1(c)(1).
[108] *Id.* at § 270.2a51-1(b)(3).
[109] *Id.* at § 270.2a51-1(b)(4).
[110] Gibson, *supra* n. 13, at 696. *See infra* § III(D) (showing that the Exchange Act effectively limits the number of investors to 499).
[111] *See supra* § III(A) (explaining how a hedge fund makes a non-public offering).
[112] 72 Fed. Reg. at 404.
[113] Liffmann, *supra* n. 14, at 2155-56.
[114] 15 U.S.C. § 80b-2(a)(11).
[115] Gibson, *supra* n. 13, at 696.

a hedge fund adviser must have had fewer than 15 clients during the previous 12 months, must not hold himself out generally to the public as an investment adviser, and must not act as an investment adviser to a registered investment company.[116]

Under Rule 203(b)(3), a limited partnership is considered one client of the investment adviser.[117] Therefore, the number of investors in a hedge fund is of little use in determining the number of clients a hedge fund adviser has. To qualify for the small-adviser exemption, a hedge fund manager must act as the adviser for 14 or fewer limited partnerships.[118] Additionally, the SEC has stated that it will narrowly construe the provision that prevents a party from holding itself out as an investment adviser.[119] This means that

> [t]he maintenance of a listing as an investment advisor in a telephone or business directory, the expression of willingness to existing clients or others to accept new clients, or the use of a letterhead indicating any activity as an Investment Advisor, would be included among acts that would constitute a holding out to the public as an investment advisor.[120]

Furthermore, the Investment Advisers Act prohibits the use of performance fees by registered investment advisers[121] unless the hedge fund complies with Rule 205-3 of the Act.[122] This rule requires that the investors in the hedge fund be qualified clients.[123] Hedge fund advisers that use the small-adviser exemption, or have less than $25 million under management, are not subject to the prohibition against performance fees.[124]

D. Other Regulatory Requirements

A hedge fund may also have to register with the SEC under the Securities Exchange Act of 1934 ("Exchange Act"). Broker-dealers are

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[116] 15 U.S.C. § 80b-3(b)(3).

[117] 17 C.F.R. § 275.203(b)(3)-1(a) (2007).

[118] Gibson, *supra* n. 13, at 698.

[119] *Frank T. Hines*, SEC No-Action Ltr., 1972 WL 8250 (Aug. 21, 1972).

[120] *Id. See Zinn v. Parrish*, 644 F.2d 360 (7th Cir. 1981) (holding that a football player's agent is not required to register as an investment adviser, even though he provided the client with nominal investment advice); *Weiss, Barton Asset Management*, SEC No-Action Ltr., 1981 WL 26285 (Mar. 12, 1981) (stating that an individual wishing to contact utilities to indicate that he could manage investments for the utilities' pension plans was required to register under the Investment Advisers Act).

[121] 15 U.S.C. § 80b-5(a)(1) (No *registered* investment adviser shall enter into an agreement that "provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client.").

[122] 17 C.F.R. at § 275.205-3.

[123] *Id.* at § 275.205-3(a). A qualified client is a natural person who has $750,000 under management of the investment adviser, has $1.5 million net worth, or is a qualified purchaser. *Id.* at § 275.205-3(d)(1). *See supra* § III(B) (describing the qualifications of a qualified purchaser).

[124] Hammer et al., *supra* n. 90, at 333.

required to register under the Exchange Act,[125] but hedge funds typically make use of the trader exception which excludes "a person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business."[126] Hedge funds and hedge fund managers trade for their own accounts, rather than as a regular securities business.[127] Furthermore, a company that has 500 or more investors is required to register under the Exchange Act.[128] Additionally, hedge funds that trade futures contracts may be required to register with the Commodities Futures Trading Commission ("CFTC"). However, the CFTC focuses primarily on consumer protection and prevention of market manipulation, and it does not impose capital requirements or limits on risk-taking, which limits its effectiveness in regulating the broader concerns of hedge funds.[129]

Furthermore, the National Securities Markets Improvements Act of 1996[130] has limited the states' ability to regulate the offer and sale of hedge fund securities.[131] However, many states require hedge fund advisers who do not register with the SEC under the Investment Advisers Act to register with the applicable state agencies, which require advisers to make certain disclosures to investors, as well as be subject to periodic examinations by state officials.[132] Additionally, hedge funds are always subject to state anti-fraud statutes,[133] and the state of Connecticut, where many hedge funds operate, has set up a special hedge fund task force to prosecute hedge fund abuses.[134]

E. SEC Attempt at Regulation and Goldstein v. SEC

On December 10, 2004, the SEC adopted a new rule ("2004 Rule"),

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[125] 15 U.S.C. § 78c(a)(4) ("The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others" but does not include banks.); *id.* at § 78c(a)(5)(A) ("The term 'dealer' means any person engaged in the business of buying and selling securities for such person's own account, through a broker or otherwise.").

[126] *Id.* at § 78c(a)(5)(B).

[127] Gibson, *supra* n. 13, at 692.

[128] 15 U.S.C. § 78l(g). *See also* President's Working Group on Fin. Mkts., *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* B-3, http://www.ustreas.gov/press/releases/reports/hedgfund.pdf (Apr. 15, 1999) [hereinafter *PWG Report*]; Gibson, *supra* n. 13, at 692.

[129] *See* Jane Kang Thorpe, Speech, *SEC Roundtable on Hedge Funds* (D.C., May 15, 2003) (available at http://www.sec.gov/spotlight/hedgefunds/hedge-thorpe.htm) ("CFTC regulation of commodity pools centers on issues of customer protection, the prohibiting of misleading means of solicitation, and requirements for the keeping of books and records - and it does not address issues of financial stability and impose such things as capital requirements or limitations on risk-taking. . . . [To create a regime for hedge funds] would require substantive statutory amendment."); Crenshaw, *supra* n. 43, at 398-403 (discussing the registration requirements and exemptions hedge funds use under the Commodity Exchange Act).

[130] Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.).

[131] *Staff Report*, *supra* n. 22, at 31.

[132] *Id.* at 32.

[133] *Id.* at 32 n. 117.

[134] Mallaby, *supra* n. 5, at 92.

revising its interpretation of the Investment Advisers Act.[135] Specifically, the 2004 Rule amended Rule 203(b), creating a look-through provision for determining the number of clients of a private fund.[136] The look-through provision was designed to change the old rule from one under which one fund would be considered a client for purposes of the Investment Advisers Act, to a new rule that counts each investor in the fund as a client.[137] Therefore, under the 2004 Rule, if the fund had more than 14 investors, the hedge fund adviser would be required to register with the SEC under the Investment Advisers Act.[138] Additionally, the definition of a private fund was construed in a manner that made the look-through provision only applicable to hedge funds.[139] The stated purposes of the 2004 Rule were to gather information about the hedge fund industry and its advisers, to oversee hedge fund advisers, and to deter and detect fraud.[140] The proposed 2004 Rule caused a great deal of controversy and passed by a 3-2 vote of the Commissioners. Shortly after the approval of the 2004 Rule, a hedge fund adviser challenged the SEC's equation of " 'client' with 'investor.' "[141]

In *Goldstein v. SEC*, the D.C. Circuit Court vacated the 2004 Rule *in toto*.[142] The court reviewed the 2004 Rule based on the SEC's construction of the Investment Advisers Act. An agency's construction of an Act cannot exceed the authority the Act gives the agency.[143] This will occur if the action defies the plain language of the statute or is "utterly unreasonable and thus impermissible."[144] The court stated that "[t]he reasonableness of an agency's construction" of a statute will be based "on the construction's 'fit' with" the language of the statute as well as the construction's "conformity to statutory purposes."[145] The court began its analysis by examining how the term *client* had been interpreted in the past. It acknowledged that *client* could mean different things in different situations but did not accept the SEC's argument that *client* was ambiguous.[146] The court noted that although the Investment Advisers Act does not define *client*, it does define an *investment adviser* as "any person who, for compensation, engages in the business of advising others, either

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[135] 69 Fed. Reg. at 72054. For discussions of this rule, see Bolter, *supra* note 83; Liffmann, *supra* note. 14; and Hellrung, *supra* note 8.
[136] 69 Fed. Reg. at 72069-71.
[137] *Id.* at 72070.
[138] This is a generalized statement. Other provisions of the Investment Advisers Act excluding registration still applied, such as a minimum threshold for assets under management of $25 million. *Id.*; *see also* 15 U.S.C. § 80b-3a(a)(1)(A).
[139] The SEC "proposed to define a 'private fund' by reference to three characteristics shared by virtually all hedge funds, and that differentiate hedge funds from other pooled investment vehicles such as private equity funds or venture capital funds." 69 Fed. Reg. at 72073 (footnotes omitted).
[140] *Id.* at 72059.
[141] *Goldstein*, 451 F.3d at 874.
[142] *Id.* at 884.
[143] *Id.* at 881.
[144] *Id.* (quoting *Aid Assn. for Lutherans v. U.S. Postal Serv.*, 321 F.3d 1166, 1174 (D.C. Cir. 2003)).
[145] *Id.* (quoting *Abbott Laboratories v. Young*, 920 F.2d 984, 988 (D.C. Cir. 1990)).
[146] *Id.* at 878.

directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[147] An investor in a hedge fund does not receive advice directly from the hedge fund manager because "[t]he adviser does not tell the *investor* how to spend his money; the investor made that decision when he invested in the fund."[148] Therefore, if the investor is not receiving investment advice from the adviser, the investor cannot be a client of the adviser.[149] The court found that the SEC endorsed this interpretation in 1985 when the SEC adopted the safe harbor provision for the Investment Advisers Act: A client is the limited partnership, not the individual partners.[150] The SEC reiterated this interpretation in 1997.[151] In these regulations, the SEC made clear that the adviser of an investment pool manages that pool based on the objectives of the pool, not on the objectives of the individual investors.[152]

Against this historical backdrop, the court analyzed the SEC's new interpretation of the term *client*. By extending the definition of *client* to individual investors, the investment adviser owes fiduciary duties to the fund as well as to each investor.[153] The court viewed this as a clear conflict of interest that came close to defying the plain language of the statute.[154] The court analogized this conflict to a corporation's lawyer who serves the interests of the corporation, not the individual shareholders, just as the investment adviser must act in the best interests of the fund, not the individual investors.[155] For instance, if a fund were nearing bankruptcy, the adviser's fiduciary duty to the fund would be to do everything possible to keep it solvent, while his fiduciary duty to the investor would be to recommend liquidation of the investor's shares.[156] The SEC argued that the 2004 Rule only changed the method of counting clients, not the adviser's fiduciary duties, but the court stated that when the same words are used in different parts of the statute, the same meaning is given to them because "form matters in this area of the law because it dictates to whom fiduciary duties are owed."[157]

The court then turned to the relationship between the rule and the

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[147] *Id.* at 879 (quoting 15 U.S.C. § 80b-2(a)(11)) (emphasis added by court).
[148] *Id.* at 880.
[149] *Id.*
[150] *Id.* (citing 17 C.F.R. at § 275.203(b)(3)-1(a)(2)). *See supra* § III(C) (explaining what constitutes a client).
[151] *Goldstein*, 451 F.3d at 880 (citing 62 Fed. Reg. 15098, 15102 (Mar. 31, 1997)).
[152] *Id.*
[153] *Id.* at 881.
[154] *Id.*
[155] *Id.*
[156] *Id.*
[157] *Id.* at 882. Furthermore, "[t]he [Supreme] Court thought it 'significant' that the [Investment] Advisers Act 'repeatedly' referred to 'clients,' which signified to the Court 'the kind of fiduciary relationship the Act was designed to regulate.'" *Id.* at 880 (quoting *Lowe v. SEC*, 472 U.S. 181, 208 n. 54, 201 n. 45 (1985)).

factors justifying the rule. The SEC's reasons for regulation—fraud, growth, and retailization—were not sufficiently related to the relationship between advisers and investors.[158] Although registration of investment advisers may achieve those objectives, the method of relying on the interaction between advisers and investors is too disconnected.[159] The possibility that hedge fund advisers may treat some investors differently does not justify treating all investors as clients.[160] Furthermore, because the SEC did not cite any changes in the relationship between investors and clients, the rule was completely arbitrary.[161] Therefore, because the 2004 Rule contradicted the language of the statute, and did not have a sufficient connection to the justifications for regulation, the court concluded that the SEC's interpretation of client fell "outside the bounds of reasonableness,"[162] was "arbitrary," and therefore the 2004 Rule exceeded the SEC's authority.[163]

IV. THE PROPOSED RULES

Since the D.C. Circuit Court's decision to vacate the 2004 Rule, the hedge fund industry has been in a state of limbo. It is almost certain that some regulation affecting the hedge fund industry will be promulgated—but will it be by the SEC, Congress, or another regulatory agency? In the wake of the court's decision, SEC Chairman Christopher Cox stated, "Hedge funds are not, should not be and will not be unregulated."[164] Additionally, Representative Barney Frank said that figuring out "what to do about hedge funds followed by doing it" is a high priority for the 110th Congress.[165] However, the Bush administration is in strong opposition to an increase in hedge fund regulation.[166]

On January 4, 2007, the SEC proposed two new rules that would affect hedge funds.[167] The first rule would prohibit hedge fund advisers from defrauding investors ("Fraud Rule") and the second rule would change the definition of accredited investor ("Accredited Natural Person Rule").

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[158] *Id.*

[159] *Id.* at 882 ("That the [SEC] wanted a hook on which to hang more comprehensive regulation of hedge funds may be understandable. But the [SEC] may not accomplish its objective by a manipulation of meaning.").

[160] *Id.*

[161] *Id.*

[162] *Id.* at 881.

[163] *Id.* at 883.

[164] Alistair Barr, *SEC Won't Appeal Hedge-Fund Ruling, Works on New Rules*, MarketWatch (Aug. 7, 2006) (available at WL, 8/7/06 THOMSONFIN 22:22:35).

[165] Rep. Frank is Chairman of the House Financial Services Committee. Robert Schroeder, *Rep. Barney Frank Would Have New Priorities for Key Panel*, MarketWatch (Oct. 9, 2006) (available at WL, 10/9/06 THOMSONFIN 17:03:00).

[166] Labaton, *supra* n. 19, at A1 ("[T]he [Bush] administration, in an agreement it reached with the independent regulatory agencies, announced that investors, hedge fund companies and their lenders could adequately take care of themselves by adhering to a set of nonbinding principles.").

[167] 72 Fed. Reg. at 400.

A. Fraud Rule

The Fraud Rule was promulgated in the wake of *Goldstein v. SEC*,[168] not to give the SEC any new authority over policing hedge funds, but to clarify the SEC's ability to bring enforcement actions against investment advisers that are not registered under the Investment Advisers Act. [169]

The SEC is relying on § 206(4) of the Investment Advisers Act[170] to prohibit advisers of any pooled investment vehicle from "(i) making false or misleading statements to investors in pooled investment vehicles, or (ii) otherwise defrauding these investors."[171] The Fraud Rule defines a "pooled investment vehicle" as an investment company that utilizes either the § 3(c)(1) or § 3(c)(7) exclusion under the Investment Company Act.[172] Furthermore, § 206(4) applies to all investment advisers, including those advisers exempt from registration and those who cannot register under the Investment Advisers Act.[173] Thus, § 206(4) will allow the SEC to apply the Fraud Rule to all advisers of all hedge funds.

The Fraud Rule was designed to be similar to other anti-fraud statutes and rules under the various securities law acts.[174] Similar to the other laws and rules, the Fraud Rule would prevent a hedge fund adviser from making untrue statements or omissions of material facts to investors or prospective investors.[175] The Fraud Rule would affect statements and omissions relating to investment strategies of hedge funds (including those that may be pursued in the future), experience and credentials of the adviser, risks associated with an investment in the hedge fund, and valuations of the investors' interest in funds as well as deceptive conduct that does not involve statements.[176] However, the Fraud Rule differs from the other anti-fraud laws in a few respects. First, fraud by an investment adviser would not have to be in connection with an offer, purchase, or sale of securities.[177]

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[168] *See supra* § III(E) (explaining why the D.C. Circuit Court vacated the 2004 Rule).

[169] 72 Fed. Reg. at 401. As this Comment was going to press, the SEC released its final version of the Fraud Rule. *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, 72 Fed. Reg. 44756 (Aug. 9, 2007). The SEC chose to adopt the rule as it was proposed. *Id.* at 44757.

[170] This provision gives the SEC the authority to "prescribe means reasonably designed to prevent, such acts, practices and courses of business as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 80b-6(4). Additionally, the decision in *Goldstein* did not affect the authority of the SEC to enact provisions regarding unregistered investment advisers. 72 Fed. Reg. at 401.

[171] 72 Fed. Reg. at 401.

[172] *Id.* at 402. *See supra* § III(B) (explaining the exclusions from the Investment Company Act).

[173] 72 Fed. Reg. at 401-02. The other anti-fraud rules under the Investment Advisers Act only apply to advisers who are registered or are required to be registered. 17 C.F.R. at § 275.206(4)-1 to 7.

[174] 72 Fed. Reg. at 402. *See e.g.* 15 U.S.C. § 77q (Securities Act § 17); 15 U.S.C. § 78n (Exchange Act § 14); 17 C.F.R. at §§ 230.156, 230.159, 230.610 (Securities Act Rules 156, 159, and 610); 17 C.F.R. at §§ 240.10b-5, 240.13e-3, 240.13e-4, 240.15c1-2 (Exchange Act Rules 10b-5, 13e-3, 13e-4, and 15c1-2).

[175] 72 Fed. Reg. at 402.

[176] *Id.* at 403.

[177] *Id.*

The SEC would be able to bring an enforcement action against a hedge fund adviser for any false or misleading statements made to investors in the fund. Second, the SEC would not have to show that an adviser acted with scienter.[178] Under § 206(4), advisers can be found liable if they act negligently.[179] Finally, there is no private right of action under the Fraud Rule.[180]

All in all, this is a relatively benign rule for hedge fund advisers. Prior to the decision in *Goldstein*, the anti-fraud rules under the Investment Advisers Act were believed to apply to unregistered investment advisers.[181] Additionally, because federal and state regulators, as well as investors, already have the means of redress for fraud by hedge fund advisers, the Fraud Rule likely will not impose any new burdens on hedge fund advisers because they should have already been taking precautions to prevent untrue statements and omissions of material facts.[182] It is unlikely that there will be any strong resistance to this rule.

Proponents of increased hedge fund regulation may argue that the Fraud Rule does not go far enough. There is nothing in the Fraud Rule that gives the SEC enhanced authority to police hedge fund abuses such as insider trading,[183] conflicts of interest,[184] scams,[185] improper valuation,[186] or

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[178] *Id.*

[179] *SEC v. Steadman*, 967 F.2d 636, 643 n. 5, 647 (D.C. Cir. 1992).

[180] 72 Fed. Reg. at 403.

[181] *Id.* at 410. This rule is a return to the status quo before the decision in *Goldstein*. However, one of the main purposes of the 2004 Rule requiring registration was to allow the SEC to have periodic examination privileges of hedge funds, which would allow the SEC to be proactive in detecting fraud. *Staff Report*, *supra* n. 22, at 74. However, the dissenters to the 2004 Rule argued that the SEC not only lacked the resources to create a sufficient deterrence to fraud, but that the fraud engaged in by hedge funds is not the type that the SEC would have been able to detect with the proposed regulatory measures. 69 Fed. Reg. at 72092.

[182] 72 Fed. Reg. at 410.

[183] For an overview of recent insider trading cases involving hedge funds, *see* Jenny Anderson, *SEC is Looking at Stock Trading*, 156 N.Y. Times A1 (Feb. 6, 2007) (available at 2007 WLNR 2244224) (stating that the SEC has begun to look into banks leaking inside information to hedge funds).

[184] Conflicts of interest can occur when the same adviser runs a hedge fund and a mutual fund. Because of the performance fee of a hedge fund, the adviser may be more likely to give a more favorable trade to the hedge fund. *See* Rory B. O'Halloran, Student Author, *An Overview and Analysis of Recent Interest in Increased Hedge Fund Regulation*, 79 Tul. L. Rev. 461, 482-87 (2004) (describing how funds engaged in market-timing and late trading in order for the hedge fund to profit at the expense of the mutual fund).

[185] *See e.g.* Pl.'s Compl., *SEC v. Viper Capital Mgt.*, No. 06 CV 6966SI, 2006 WL 3616995 (N.D. Cal. Nov. 8, 2006) (available at http://www.sec.gov/litigation/complaints/2006/comp19905.pdf) (complaining that the adviser to a $5 million hedge fund used the fund's assets for his personal expenses, continued to accept funds from new investors after the fund was defunct, and forged audit letters and financial statements in soliciting new investors).

[186] There can be virtually no independent checks on how a hedge fund adviser values his portfolio. This freedom of valuation, combined with the compensation structure, creates the opportunity for the hedge fund adviser to overstate the fund's gains in order to receive a higher fee. *See Staff Report*, *supra* n. 22, at 79-80; Danforth Townley, *Recent SEC Enforcement Actions Relating to the Valuation of Hedge Fund Portfolios*, in Practising Law Institute, *Hedge Funds 2006: The Changing Regulatory Landscape* vol. 1, 93 (P.L.I. 2006) (available at WL, 1563 PLI/Corp 93) (describing six recent SEC enforcement actions against hedge funds that misvalued their portfolios).

side letters.[187] However, these concerns are overblown because the SEC will continue to prosecute hedge fund abuses. As one commentator noted, the number of SEC enforcement actions against hedge funds "suggests that regulators are not shy about using these powers, and hedge funds regularly experience inquiries from the SEC when they happen to trade heavily in a stock ahead of a price-moving announcement."[188] Though the SEC may have to rely on whistle-blowers and investors to detect hedge fund fraud, the same is true with the other companies that the SEC oversees. Therefore, with the addition of the Fraud Rule, the SEC has the regulatory authority it needs to prosecute hedge fund fraud.

B. Accredited Natural Person Rule

The second rule proposed by the SEC is a redefinition of accredited investor, specifically with respect to natural persons.[189] The accredited investor standard was developed under the Securities Act to limit to whom a security could be offered and sold when the issuer utilized an exemption to avoid the registration requirements under the Act.[190] The purpose of the standard is to be a proxy for investor sophistication, in that securities issued without regulation should only be issued to those who are sophisticated and knowledgeable enough to understand, not only the business in which they are investing, but also the risks that the investment entails. The current accredited investor standard, which was enacted in 1982, and has not been adjusted since then includes:

> [A] natural person whose individual net worth, or joint net worth with the person's spouse, exceeds $1,000,000 at the time of the purchase, or whose individual income exceeds $200,000 (or joint income with the person's spouse exceeds $300,000) in each of the two most recent years and who has a reasonable expectation of reaching the same income level

[187] Side letters grant different terms to certain investors in the fund than those established by the fund's offering documents, including liquidity preferences and preferential access to portfolio information. Dechert's Fin. Servs. Group, *SEC Guidance on Side Letters*, 5 Dechert On Point 1, 1 (June 2006) (available at www.dechert.com/library/FS_Update5_6-06.pdf). A liquidity preference grants one investor the ability to withdraw some or all of his investment in the hedge fund and has the potential to reduce the total liquidity of the hedge fund, possibly resulting in other investors being unable to withdraw their investments. *Id.* However, the main concern of the SEC is not the provisions that the side letters grant, but rather whether or not these provisions are being properly disclosed to other investors. *Id. See* Mara Der Hovanesian, *The SEC Isn't Finished with Hedge Funds*, 3993 Bus. Week 34, 34 (July 17, 2006) ("[L]egal experts say the SEC or Britain's Financial Services Authority will soon wipe out the practice" of issuing side letters.); *see also* Susan Ferris Wyderko, Dir. Office of Investor Edu. and Assistance for U.S. Sec. & Exch. Commn., Testimony, *Before The Subcommittee on Securities and Investment of the United States Senate Committee on Banking, Housing, and Urban Affairs* (D.C. May 16, 2006) (copy of transcript available at http://www.sec.gov/news/testimony/ts051606sfw.htm).

[188] Mallaby, *supra* n. 5, at 95.

[189] *See supra* § III(A) (explaining the current requirements for an accredited investor).

[190] 72 Fed. Reg. at 403-04. For a discussion on what the Securities Act requires with respect to public and private offerings, and how hedge funds exempt themselves from registration, see *supra* § III(A).

in the year of investment.[191]

The SEC is proposing the creation of a new category of accredited investor, the "accredited natural person," that would limit who could invest in what the SEC is calling a "private investment vehicle."[192] The SEC has clearly stated that the Accredited Natural Person Rule is only applicable to the offers and sales of securities by investment vehicles that use the § 3(c)(1) exclusion of the Investment Company Act.[193] By defining a private investment vehicle in that way, the SEC is clearly targeting hedge funds that make use of the exclusion to limit who can and cannot invest in hedge funds.[194]

Hedge funds utilizing the § 3(c)(1) exclusion of the Investment Company Act are the focus of the proposed rules because that section requires only that investors be accredited, whereas § 3(c)(7) requires accreditation and a minimum total investment for investors. The qualified purchaser standard goes above and beyond the accredited investor standard, because it not only requires investors to be accredited investors but also to own $5 million in investments.[195] The two-step approach for determining who can invest in a § 3(c)(7) hedge fund is the approach that the SEC wants to mimic for determining who can invest in a § 3(c)(1) hedge fund.[196] Therefore, for an investor who is a natural person to be eligible to invest in a § 3(c)(1) hedge fund, the SEC is proposing that the investor be required to comply with the current accredited investor standard and own, individually or jointly with the investor's spouse, at least $2.5 million in investments.[197] Therefore, to be eligible to invest in a hedge fund, an accredited natural person would be an investor who is either worth $1 million or has an income over $200,000 (or $300,000 with spouse), *and* has at least $2.5 million in investments.

The SEC has included the investments requirement to serve as a bright-line test to determine the eligibility of accredited natural investors.[198] The SEC defines investments with respect to accredited natural investors similarly to how it defines investments with respect to qualified purchasers. For example, the definitions include securities, cash and cash equivalents,

[191] 72 Fed. Reg. at 404. *See also* 17 C.F.R. at § 230.501.

[192] 72 Fed. Reg. at 405.

[193] *Id. See supra* § III(B) (explaining the § 3(c)(1) exclusion under the Investment Company Act).

[194] Further, the SEC specifically states that the Accredited Natural Person Rule will not apply to venture capital firms because a venture capital firm is defined as a "business development company." Venture capital firms will be defined by § 202(a)(22) of the Investment Advisers Act. 72 Fed. Reg. at 407-08. A business development company is a company that provides significant managerial assistance and owns at least 60% of the companies in which it invests. 15 U.S.C. § 80b-2(22). *See also* 15 U.S.C. §§ 80a-54(a), 80a-2(48).

[195] 15 U.S.C. § 80a-2(a)(51)(A)(i). *See supra* § III(C) (explaining the qualifications for a qualified purchaser).

[196] 72 Fed. Reg. at 405.

[197] *Id.*

[198] *Id.* at 407.

and physical commodities, commodity interests, and real estate that are held for investment purposes.[199] The SEC has proposed adjusting the investment threshold every five years based on inflation, to begin on April 12, 2012.[200] The major exclusion from investments is "the value of a person's personal residence or place of business, or real estate held in connection with a trade or business."[201]

The SEC cites numerous reasons in support of the proposed rule and for why its approach is justified. The major reason is that the current definition of "accredited investor" has not been updated since 1982, and that has caused an enlargement of the class of citizens eligible to purchase securities issued by hedge funds that do not have to register with the SEC when offering securities for purchase.[202] When the original standard was adopted, 1.87% of United States households were eligible to invest in these types of investment vehicles.[203] By 2003, the number of eligible investors increased 350% to 8.47% of households.[204] With the $2.5 million investment threshold, only 1.3% of households would be eligible.[205] The SEC finds that this is an appropriate level because of "the increasing complexity of financial products, in general, and hedge funds, in particular, over the last decade."[206]

Furthermore, the proposal does not include a grandfather clause that would allow the investors who are currently eligible to invest in hedge funds to continue to make investments in hedge funds if they fail to meet the new standards.[207] Additionally, the new investment standard increases the threshold of net worth or income of an investor based on inflation from 1982 to 2003. Adjusted for inflation, the accredited investor standard would be $1.9 million in net worth or income of $388,000 (individual) or $582,000 (joint).[208] The Accredited Natural Person Rule would effectively limit the number of individuals who are eligible to invest in hedge funds, addressing the SEC's concerns of retailization at the investor level.

The SEC is seeking to limit the number of investors because the burgeoning economy of the 1990s, as well as the lack of updates to the current accredited investor standard, allowed investors without sufficient sophistication or knowledge to invest in hedge funds. The influx of eligible investors is also the justification for excluding real estate that is not held for

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[199] *Id.* at 406, 414-15.
[200] *Id.* at 406.
[201] *Id.* at 407.
[202] *Id.* at 406.
[203] *Id.*
[204] *Id.*
[205] *Id.*
[206] *Id.*
[207] *Id.*
[208] *Id.*

investment purposes. The SEC has determined that such real estate "bears little or no relationship to [a] person's knowledge and financial sophistication."[209] Property values have increased dramatically during this past decade, and a buyer's decision to purchase property that subsequently increases in value may not reflect any particular sophistication. Additionally, the SEC cites the complicated nature of hedge funds, including complex trading strategies, performance fees, lack of information, and undisclosed conflicts of interest as reasons to increase the wealth requirements for prospective hedge fund investors.[210]

Furthermore, the SEC states that the costs for compliance with the Accredited Natural Person Rule by hedge funds will be minimal.[211] Under § 3(c)(1), hedge funds would be required to prepare new documents and to implement new procedures to ensure that prospective investors meet the new requirements, but because funds are already required to investigate an investor's net worth, the new screening process will be similar to the previous screening process.[212] Additionally, the SEC notes that many hedge fund advisers operate § 3(c)(7) as well as § 3(c)(1) hedge funds, so they will already have procedures for ascertaining investors' investments.[213] Furthermore, with a reduction of the investor base, competition for eligible investors would increase, possibly lowering profits, and preventing new hedge funds from entering the market.[214]

For investors, the SEC predicts some additional costs as well as some additional benefits. The most obvious cost is that 88% of currently eligible households will lose their eligibility if the Accredited Natural Person Rule is approved as is.[215] Investors who have been investing in hedge funds for years may be shut out because they do not meet the new definition of "sophisticated." However, with the decrease in available investors, competition for those remaining will be increased, resulting in benefits for those investors.[216] The increase in competition may result in lower fees charged for investors.[217]

The purpose of the Accredited Natural Person Rule is to increase investor protection. By limiting the number of investors eligible to invest in hedge funds, the SEC is attempting to protect investors by restricting where they can invest. The rationale is that only sufficiently sophisticated and knowledgeable investors are able to deal with and understand unregistered

209 *Id.* at 407.
210 *Id.* at 404.
211 *Id.* at 411.
212 *Id.*
213 *Id.*
214 *Id.* at 411-12.
215 *Id.* at 412.
216 *Id.*
217 *Id.*

investment vehicles. This argument has long-standing precedent, though what the SEC is attempting to do is to redefine who is sophisticated by creating an investments standard for § 3(c)(1) hedge funds that is more restrictive than that which inflation would dictate. When the accredited investor standard was first promulgated in 1982, hedge funds were hardly within the public consciousness. Since then, hedge funds have become notorious within the mainstream investing public as well as within regulatory agencies, not only for earning potential but also for abuse. However, with the Accredited Natural Person Rule, the SEC is attempting to deprive the investing public of an investment vehicle run by professional managers that historically has outperformed indices such as the Dow Jones Industrial Average and the S&P 500, as well as yielded gains in down markets. Since 1982, there has been a major shift in the amount of information available to consumers. The Internet gives any would-be investor access to a plethora of information, which for instance could help the most unsophisticated investor learn about the hedge fund industry or a hedge fund adviser. Additionally, the advent of cable, satellite television, and satellite radio has provided unprecedented access to business news throughout the 24-hour day. Of course, "increased information does not always result in increased sophistication."[218]

Therefore, the argument centers on what the proper standard should be. SEC Commissioner Roel Campos wondered, "[S]houldn't all investors have access to potential high returns of hedge funds?"[219] This raises the question of whether there should even be a monetary standard. However, there must be some sort of standard to determine who is eligible to invest in unregulated hedge funds.[220] Using objective criteria (e.g., wealth) is far from the fairest method of determining investor sophistication, but a subjective test hardly seems feasible.[221] While surely there are many people who do not meet current accreditation standards yet have an excellent understanding of the costs and benefits of hedge fund investing, an objective bright-line test is the most economically feasible method of defining eligibility. Because of the complexities and potential volatility of a single hedge fund, not having some sort of eligible investor standard would be illogical. An objective test reduces costs to hedge fund managers in finding

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[218] Greupner, *supra* n. 34, at 1594.

[219] Roel C. Campos, Speech, *Speech by SEC Commissioner: Rule to Prohibit Fraud by Investment Advisors to Certain Pooled Investment Vehicles; Rule to Revise Criteria for Accredited Investors in Certain Private Investment Vehicles* (SEC Open Meeting, D.C., Dec. 13, 2006) (transcript available at http://www.sec.gov/news/speech/2006/spch121306rcc5.htm).

[220] It should be noted that a hedge fund can avoid the accreditation standards by simply complying with the extensive disclosure requirements of the § 4(2) exemption. *See supra* § III(A).

[221] It is difficult to envision a subjective test that could be administered and policed by the SEC. For instance, if the hedge fund was required to "test" prospective investors, its costs would be increased, and it would be difficult for the SEC to oversee that such tests were being administered fairly. Another option would be for the SEC to certify individuals who wish to invest in hedge funds, but that would require more resources than the SEC has.

eligible investors and allows investors to know their eligibility.

Nevertheless, is the investment standard chosen by the SEC for an Accredited Natural Person the proper threshold? The SEC has determined that the proper standard is $2.5 million in investments, even though $1.5 million in net worth is sufficient for a hedge fund to charge a performance fee.[222] Based on inflation, the accreditation standard would be $1.9 million in net worth or income of $388,000. There is no magic level of net worth, income, or investments that can demarcate between sophisticated and unsophisticated investors. Therefore, it helps to evaluate the SEC's limitation on the basis of the wrong it is attempting to cure. By creating an investment standard for natural persons investing in § 3(c)(1), the SEC is trying to protect investors by discouraging retailization. The SEC justifies the Accredited Natural Person Rule by citing both the growth of the economy during the 1990s as increasing the number of accredited investors and the complexity of hedge funds as reasons for eliminating 88% of currently eligible households.[223] However, the SEC does so without explaining any changes that have occurred in the industry since it released its comprehensive report on the hedge fund industry in 2003, *Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission* ("Staff Report"), which stated that direct retail investment was not occurring.[224] The Accredited Natural Person Rule is intended to prevent direct investment by unsophisticated investors, but the SEC fails to explain exactly why $2.5 million in investments is the proper threshold.

Therefore, it seems highly unnecessary for the SEC to promulgate an entirely new method for determining accreditation. The SEC should merely update the current accredited investor standard to conform to increases in inflation and update the threshold every five years. The SEC is well within its authority to update the definition of accredited investor under

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[222] 17 C.F.R. at § 275.205-3(d)(1) (defining a qualified client, or one who can be charged a performance fee under the Investment Advisers Act, as being a natural person with $1.5 million in net worth, having $750,000 under management by the investment adviser, or being a qualified purchaser).

[223] 72 Fed. Reg. at 404.

[224] *Staff Report*, *supra* n. 22, at 80. *But see* Thomas Kostigen, *Hedge Funds Charm Main Street, Though Few Understand Them*, MarketWatch (Oct. 24, 2006) (available at WL, 10/24/06 THOMSONFIN 19:50:00) (stating that financial advisers are placing clients in hedge funds even though advisers are unaware if the investors are qualified to invest in them). One-third of financial advisers believe that the qualifications for accredited or qualified investors are not relevant today and that investors have found ways to circumvent the qualifications, or more simply, are lying to advisers who will not question investors because the advisers want investors' business. *Id.* The SEC cites no study of its own confirming or denying investment by retail investors into hedge funds. One would think that if investors can get around the requirements of showing a specific net worth or income level, they would also be able to get around the investments requirement. If the advisers are assisting investors to circumvent the requirements, they should be prosecuted for fraud. A hedge fund adviser only has to reasonably believe that the investor is accredited, so if investors are lying to get into hedge funds, it speaks more to the SEC's method of regulation than to the deviousness of hedge fund advisers.

the standard it set in 1982—Rule 506 of Regulation D.[225] Further, the SEC should revise the language of Regulation D to reflect the inflationary changes, rather than add a new hurdle.[226] By putting the minimum requirement for accredited investors at $1.9 million in net worth or income of $388,000, the SEC will not be turning the accredited investor requirement into a nearly irrelevant provision of securities regulation, but rather maintaining its purpose. This standard, based on inflation, will not effectively eliminate the majority of the current accredited investors and will maintain a distinction between investors eligible for § 3(c)(1) funds and those eligible for § 3(c)(7) funds.[227] The SEC should stay in line with its historical precedent for determining the standard for an accredited investor.

V. OTHER CONCERNS AND REGULATORY SOLUTIONS

If the proposed rules are passed, two of the SEC's concerns would be alleviated: fraud and direct retailization. The Accredited Natural Person Rule does not affect indirect retailization, or hedge fund investment by pension funds, charities, and endowments.[228] Additionally, the SEC's other concerns would not be remedied by the proposed rules. This section will take an in-depth look at systemic risk, the lack of meaningful information about hedge funds, and investment by pension funds in hedge funds to determine if there is a regulatory gap that needs to be filled. This section will show that there is no regulatory gap concerning systemic risk, and that the deficiencies in regulation concerning investment by pension funds and the lack of information can be remedied with minimal intrusion upon the benefits provided by hedge funds.

A. Systemic Risk

Systemic risk, or the failure of the financial markets, seems ominous and foreboding in the abstract, but it takes certain circumstances to create a potential systemic loss situation. Currently, the primary mechanism for controlling systemic risk is through "market discipline." Market discipline is the term used to describe creditors'[229] use of sound practices to evaluate to whom and how much they lend and "is the primary mechanism to control risk-taking."[230] There are several facets to utilizing market discipline. First,

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[225] 17 C.F.R. at §§ 230.501(a), 230.215.
[226] Specifically, the SEC should revise 17 C.F.R. § 230.215(e)-(f) and § 230.501(a)(5)-(6).
[227] It does seem likely that there is a large difference between investors with $2.5 million in investments and those with $5 million in investments. Therefore, the few individuals between those two figures would be the only investors eligible for a § 3(c)(1) fund but not a § 3(c)(7) fund.
[228] The SEC has called indirect retailization the most significant portion of the retailization of hedge funds and was a major reason why the SEC passed the 2004 Rule. 69 Fed. Reg. at 72057.
[229] This Comment uses the terms "creditor" and "counterparty" interchangeably. Generally, a creditor is one who lends money and a counterparty is one who enters into a contract with a hedge fund. If a hedge fund defaults, a counterparty becomes a creditor.
[230] *GAO Report*, *supra* n. 75, at 10.

creditors are expected to exercise due diligence in assessing "the financial soundness and managerial ability of the counterparty, including its risk profile."[231] Due diligence is an ongoing process over the term of the credit extension, and creditors are expected to keep up on financial reports, volatility of positions, and financial condition of the counterparty.[232] Market discipline also includes setting credit limits and requiring collateral for some transactions.[233]

However, the very nature of hedge funds can cause difficulties for lenders in exercising prudent due diligence because "[t]he variability of a hedge fund's financial position and risk profile . . . makes traditional tools of financial statement analysis less effective in assessing the credit exposure to a hedge fund."[234] To counter this, creditors evaluate a hedge fund's risk management system and trading strategies, but only qualitatively.[235] Additionally, many hedge funds prefer to keep much of their proprietary information out of the hands of creditors, making it more difficult for creditors to gain access to the information they need to exercise proper market discipline.

The collapse of the Long Term Capital Management hedge fund illustrates how a complete breakdown of market discipline can lead to a systemic crisis.[236] LTCM was formed in 1993, and raised $1.25 billion in initial capital.[237] From the start, LTCM intended to use large amounts of leverage—20-30 times its capital—in order to exploit its arbitrage strategy.[238] LTCM was highly successful and highly leveraged.[239] Its

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231 *Id.* at 11.

> Due diligence reviews by extenders of credit to hedge fund customers typically include assessments of: offering circulars or private placement memorandums; partnership agreements; performance history; investment authority; management ability and reputation; capital, including size, growth, investor concentration, and management share of the capital base; risk profile implications of the fund's investment and trading styles; liquidity, including types of positions and investor withdrawal rules; leverage, including on-and off-balance-sheet leverage, and fit with liquidity of positions; risk management; and front and back office operations.

PWG Report, *supra* n. 128, at 7.

232 *GAO Report*, *supra* n. 75, at 11.

233 *Id.*

234 *PWG Report*, *supra* n. 128, at 8.

235 *Id.*

236 For a more complete description of the rise and fall of LTCM, see Lowenstein, *supra* note 8. *See also GAO Report*, *supra* n. 75; *PWG Report*, *supra* n. 128; Liffmann, *supra* n. 14; Jonathan H. Gatsik, Student Author, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 Suffolk U. L. Rev. 591 (2001).

237 Gatsik, *supra* n. 236, at 598.

238 Lowenstein, *supra* n. 8, at 26. While an in-depth discussion of a bond arbitrage strategy is beyond the scope of this Comment, one trade LTCM utilized was designed to exploit the difference between off-the-run 30-year Treasury bonds, meaning the bonds issued six months prior, and on-the-run 30-year Treasury bonds, or those just issued. The off-the-run bonds traded at a slight discount relative to the on-the-run bonds for no practical reason other than the on-the-run bonds were slightly more liquid. The yields of the two bonds were expected to converge after only a couple months, so LTCM would have bought the off-the-run bonds, sold the on-the-run bonds, and made a small profit for each bond pair. To

success caused creditors to become very interested in doing business with LTCM, but LTCM's use of leverage left many creditors exposed to risk and created the potential for systemic loss.[240] Those extending credit to LTCM failed to exercise market discipline in doing so for several reasons. First, LTCM was exceptionally profitable.[241] The competition for LTCM's business was fierce, and the creditors offered LTCM attractive credit standards in order to get LTCM's business.[242] By compromising their risk management systems, the creditors failed to consider charging higher rates for riskier activities. Additionally, the economy had been growing rapidly for several years, leading the creditors to liberalize their credit standards.[243] Finally, LTCM's principals were well known in the industry and creditors made credit decisions based on the reputations of LTCM's principals, rather than on traditional credit analysis.[244]

Those factors also enabled LTCM to remain secretive about its financial position. LTCM shared as little information as possible with its creditors.[245] Regardless, the creditors would not have been able to make a meaningful risk assessment of the information that LTCM did provide, because it failed to "reveal meaningful details about [LTCM's] risk profile and concentration of exposures in certain markets."[246] With a less robust economy and a lower profile hedge fund, it would seem unlikely that a hedge fund would be able to obtain the amount of leverage that LTCM did, if it were to provide as little information to its creditors as it did. However, with the circumstances what they were, LTCM was able to obtain large, highly leveraged positions that led to the threat of systemic loss, in part because of its creditors' lack of market discipline.[247]

When Russia devalued the ruble and declared a moratorium on its debt on August 17, 1998, investors began a "flight to quality," seeking out only the most liquid and least risky investments.[248] This resulted in a reduction of liquidity in numerous markets as prices LTCM had foreseen as

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magnify the gains, LTCM would have leveraged this trade and thus have had the ability to purchase more bonds by selling more bonds. *See id.* at 43-45.

[239] By 1997, LTCM had increased its capital base to over $7.5 billion. Gatsik, *supra* n. 236, at 599. LTCM returned $2.7 billion back to investors at the end of 1997, reducing its capital base to $4.8 billion without reducing the size of its investment positions, effectively increasing its amount of leverage. *PWG Report*, *supra* n. 128, at 11 ("[T]he managers of [LTCM] decided to increase its balance-sheet leverage by reducing its capital base rather than by increasing its positions.").

[240] *GAO Report*, *supra* n. 75, at 10.

[241] *Id.* at 11.

[242] *Id.*

[243] *Id.*

[244] *Id.* Among the principals of LTCM were Nobel Laureates Myron S. Scholes and Robert C. Merton. They received the award for their work on the Black-Scholes model, which is used to value options. The other principals of LTCM were well known and highly respected within the industry for their previous work at investment banks.

[245] *PWG Report*, *supra* n. 128, at 15.

[246] *Id.*

[247] *GAO Report*, *supra* n. 75, at 11.

[248] *PWG Report*, *supra* n. 128, at 12.

converging began to widen, causing LTCM's creditors to make margin and collateral calls,[249] which eventually drove LTCM's total capital base down to $400 million.[250] The Federal Reserve Bank of New York gathered LTCM's creditors together and fourteen of the creditor banks agreed to recapitalize LTCM by infusing it with $3.6 billion, preventing LTCM from defaulting.[251]

This recapitalization saved LTCM from defaulting on its obligations to its creditor banks and counterparties. Had LTCM defaulted, there would have been a significant market disruption that could have led to systemic loss.[252] A default would have forced LTCM and its counterparties to liquidate their holdings.[253] Some of LTCM's counterparties would have been forced to readjust their overall risk balance, which would have resulted in further liquidation of their holdings or repurchasing replacement derivatives, both at prices that would have resulted in large losses and would have driven market prices farther down.[254] In short, "a 'fire sale' of financial instruments by LTCM's creditors and counterparties might have set off a cycle of price declines, losses, and further liquidation of positions, with the effects spreading to a wider group of uninvolved investors."[255] With the market already suffering from the aftershocks of Russia's actions, the massive default of LTCM would have forced its counterparties and creditors to unwind the transactions they had had with LTCM at the prevailing market price. Given the size of the transactions that needed unwinding, prices would have been pushed farther down, which could have resulted in an inability to find buyers, hence jeopardizing the functioning of the financial markets.[256]

Amaranth, a multi-strategy hedge fund, had $9.2 billion in capital when natural gas prices fell dramatically in September 2006, causing Amaranth to lose $6 billion in less than a month.[257] However, this incident did not result in a bailout organized by the Federal Reserve Bank, and several federal regulatory agencies will not investigate to determine what went wrong. LTCM's losses were triggered by a global event that spread throughout the entire financial system, while Amaranth's losses were caused by a single market segment. A severe disruption in one market segment can cause systemic loss because the aftershocks of the loss can spread to other

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[249] *Id.* at 12-13.
[250] Lowenstein, *supra* n. 8, at 210.
[251] *GAO Report*, *supra* n. 75, at 5 n. 7, 40-41.
[252] *PWG Report*, *supra*, n. 128, at 17.
[253] Gibson, *supra* n. 13, at 705.
[254] *GAO Report*, *supra* n. 75, at 13.
[255] *Id.*
[256] *PWG Report*, *supra* n. 128, at 6.
[257] *Flare-Up*, 950 The Economist 83, 83 (Sept. 23-29, 2006) (available at 2006 WLNR 16409154); Der Hovanesian, *supra* n. 1, at 78. Amaranth marketed itself as a multi-strategy firm but made most of its profits on energy trades. Boughton, *supra* n. 2.

segments when investors must liquidate their assets. However, Amaranth's losses were well-contained for one simple reason: market discipline. Amaranth's creditors and other market participants were aware of what Amaranth was doing and were prepared when natural gas prices fell.[258] Since the days of LTCM, hedge fund creditors have become more adept at hedging their exposure in hedge funds.[259] Furthermore, the growth of the hedge fund industry has allowed hedge fund creditors to better hedge their credit risks by diversifying their investments in many hedge funds, leaving themselves less exposed to the failure of one.[260]

Market discipline prevented Amaranth from becoming dangerously over-leveraged. While LTCM was leveraged 28:1,[261] Amaranth was only leveraged 8:1.[262] While Amaranth still had a significant amount of leverage, its lower leverage ratio allowed it to absorb the losses that it incurred. Amaranth's creditors prevented it from becoming too leveraged to sustain the severe losses that it did.[263] Furthermore, the wider dissemination of information within the industry seems to have helped the market contain losses to Amaranth and its investors only. Unlike with LTCM, it seems that Amaranth's creditors were much more aware of the actions that Amaranth was taking and were not as exposed to risks as large as those to which LTCM's creditors were exposed. While Amaranth did not come as close to a default as LTCM, Amaranth's creditors prevented it from reaching that level by exercising market discipline and not allowing Amaranth to over-extend itself anymore than it already had. Such lenders are the ones in the best position to prevent systemic risk, and if they exercise prudent market discipline, systemic risk will not be a major concern of federal regulators. Even though "conditions can arise in which self-imposed standards are ignored,"[264] market discipline is the most effective way to control systemic risk.

One misguided proposal for containing systemic risk is to limit the amount of leverage a hedge fund can employ. Although limiting leverage seems to be a simple solution to the prevention of systemic risk, setting a limit on the leverage ratio could actually cause systemic loss. When a leveraged hedge fund begins to suffer losses, its capital base begins to decrease, though its positions remain constant, creating an increase in the fund's leverage ratio.[265] In most cases, this is how leverage gets to be so

[258] Der Hovanesian, *supra* n. 1, at 78.
[259] *Id.*
[260] *Id.*
[261] This figure is taken from January 1, 1998, after it returned a significant amount of its capital to its investors in order to become more leveraged. Lowenstein, *supra* n. 8, at 120.
[262] Boughton, *supra* n. 2, at 2.
[263] *Flare-Up*, *supra* n. 257, at 80 (quoting Peter Fusaro of the Energy Hedge Fund Centre, "I've never seen a hedge fund so highly leveraged in energy.")
[264] *GAO Report*, *supra* n. 75, at 30.
[265] Danielsson et al., *supra* n. 5, at 538.

large—not through a strategic decision on the part of the hedge fund.[266] By limiting a hedge fund to a maximum leverage ratio, losses would force the hedge fund to sell some of its riskier assets; this may exhaust market liquidity, which in turn would cause other prices to fall, resulting in the very situation the limitation was designed to prevent.[267] Therefore, enforcing a limit on how leveraged a hedge fund can be is not an effective means of preventing systemic loss.

The most effective means of preventing systemic loss is through the exercise of market discipline on the part of hedge funds and their creditors. Market discipline was essential in the containment of Amaranth's losses. With creditors and counterparties demanding more transparency from hedge funds, they are more likely to be able to protect themselves and hedge the risks to which they are exposed by hedge funds. As the hedge fund industry has grown and creditors have become more adept at dealing with hedge funds, the need for regulation to prevent systemic risk has vanished. The industry has evolved greatly since LTCM, and Amaranth's rapid collapse shows that market discipline is the only mechanism necessary for controlling systemic risk.[268]

B. Lack of Information

The void of information about hedge funds is double-faceted. Regulators are concerned that investors do not get enough information to make an informed investment decision and that regulators lack sufficient information concerning the industry to make effective policy.[269] The lack of information concerning hedge funds was one of the major reasons why the SEC passed the 2004 Rule.[270] However, the dissenting commissioners felt that requiring registration of all hedge fund advisers was not a justifiable reason for gaining this information. The dissenters pointed out that the SEC, as well as other regulatory agencies, should analyze all the information

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266 *Id.*
267 *Id.*
268 Reliance on market discipline to prevent systemic risk is the approach endorsed by the President's Working Group on Financial Markets. *PWG Agreement*, *supra* n. 18, at 3-6. It states that "[m]arket discipline by creditors, counterparties, and investors is the most effective mechanism for limiting systemic risk from." hedge funds. *Id.* at 3. Creditors have the expertise, resources, and ability to dictate financial terms to limit leverage employed by hedge funds. *Id.* The Group also states:

> Key creditors and counterparties must commit resources and maintain appropriate policies, procedures, and protocols to define, implement, and continually enhance best risk management practices. Those policies, procedures, and protocols should address how the quality of information from a private pool of capital should affect margin, collateral, and other credit terms and other aspects of counterparty risk management.

Id. at 3-4. The Group indicates that there is a high burden on hedge fund creditors to perform proper due diligence and ensure the integrity of the financial markets to prevent systemic loss. *Id.* at 4.
269 *Staff Report*, *supra* n. 22, at 78, 83.
270 69 Fed. Reg. at 72055-56.

that is available to them and use that information to determine what types of information the SEC actually needs to obtain.[271] While that recommendation should be utilized, this section will provide an additional solution with which Congress, through statutory amendments, can increase the amount of relevant information available to the public and regulators.

When a new hedge fund is formed or is seeking new capital, prospective investors generally receive some type of written information about the hedge fund in the form of a private placement memorandum.[272] In this document, a hedge fund will provide investors information that only generally discusses the fund's strategies and practices.[273] Additionally, once investors make an investment into the hedge fund, the investors are unlikely to get any meaningful information regarding their investments.[274] This can lead to problems in the valuations of hedge fund shares given to investors.[275]

Although these issues are potentially harmful to investors in hedge funds, the investors are the ones who choose whether or not to invest. Investors will typically hire a consultant or a private investigation firm to learn as much as they can about a hedge fund adviser.[276] Nearly all wealthy and institutional investors will perform due diligence in learning as much about an adviser as they can before committing a substantial sum of money to the adviser. Many investors spend a great deal of time performing due diligence.[277] Pension plans generally meet with forty hedge fund managers, though they only invest in 1-3.[278] However, the Staff Report noted that large investors are unable to dictate terms of their investments or bargain for

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[271] *Id.* at 72090.

[272] *Staff Report*, *supra* n. 22, at 46-47.

[273] *Id.* at 47.

[274] Most hedge funds will not disclose specific positions to investors because they consider that information confidential and do not want to allow hedge funds or investors to herd their investments. *Id.* at 49-50. Herding (i.e., when numerous investors follow the same strategy) is a serious concern within the hedge fund industry and was found to have contributed to the devaluation of the British pound in 1992. Danielsson et al., *supra* n. 5, at 531-32. One hedge fund adviser, Phillip Goldstein, the challenger to the 2004 Rule in *Goldstein v. SEC*, is considering having his positions classified as a trade secret by a court. Karyn McCormack, *Do Hedge Funds Hold 'Trade Secrets'?* http://www.businessweek.com/print/investor/content/sep2006/pi20060913_356291.htm (Sept. 12, 2006).

[275] While market-traded securities can be valued at their fair market value, hedge funds invest in numerous exotic instruments and other difficult-to-value assets, such as those traded over-the-counter. *Staff Report*, *supra* n. 22, at 64. The opaqueness of hedge funds inhibits investors from knowing if an adviser is assigning fair values to the assets held by the hedge fund. A hedge fund adviser is given absolute discretion in ascertaining the fair value of the fund, though the adviser will typically use prime brokers or other third parties to assist in valuation. *Id.* Additionally, hedge funds are not obligated to have independent audits. *Id.* at 65. This is one of the concerns regarding the lack of information, but investors and the SEC can achieve redress for this type of abuse through anti-fraud regulations.

[276] *Staff Report*, *supra* n. 22, at 47.

[277] Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. Ill. L. Rev. 975, 992-93 (2006) ("A 2004 study by Deutsche Bank found that nearly 40% of the hedge fund investors surveyed spend an average of three to six months doing diligence before investing, with 20% of those surveyed spending an average of six months or more on diligence. Merely 3% of investors surveyed said they spend less than one month doing diligence.") (footnote omitted).

[278] *Id.* at 993.

access to information about a fund's ongoing activities.[279] On the other hand, if the lack of transparency of a hedge fund is troublesome for an investor, the investor can simply choose not to invest. Investors who choose to invest in a hedge fund will perform a risk analysis to determine if the benefits of investing (e.g., earning returns that are larger than mutual funds and remaining steady even in down markets) are worth the detriments of giving a great deal of trust to the hedge fund adviser.[280]

While investors have a great deal of control regarding where to invest, regulators do not have such freedom. Regulators need to have access to information concerning the strategies that hedge funds employ in order to ensure the integrity of the financial markets. Such information in the aggregate, even if general, will allow regulators to better anticipate potential abuses and better understand the industry. However, required disclosures to the SEC by hedge funds would limit the effectiveness of hedge fund operations.[281]

The way to increase the amount of information available to investors and regulators about hedge funds is to eliminate the ban on advertising and general solicitation in the Investment Company Act.[282] This idea originated with the Staff Report for § 3(c)(7) hedge funds, or funds that may only have qualified purchasers as investors.[283] General solicitation to these wealthy investors would "facilitate capital formation without raising significant investor protection concerns."[284] If the Accredited Natural Investor Rule is passed as is, it would seem that the policy concerns for preventing general solicitation to less sophisticated investors would be inapplicable. Therefore, if the proposed rule is passed, the lifting of the ban on advertising should also extend to hedge funds utilizing the § 3(c)(1) exclusion.

Advertising directed to these wealthy investors would seem to be reasonable because these are the very investors that the SEC has determined

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[279] *Staff Report*, *supra* n. 22, at 47.

[280] The President's Working Group on Financial Markets asserts that the risk of investing in hedge funds is borne by the individual investor. *PWG Agreement*, *supra* n. 18, at 1-2. The Group states that investors should only invest if they understand the risk levels inherent in a particular hedge fund. *Id.* at 2. Additionally, investors are responsible for performing due diligence and evaluating all aspects of the hedge fund including its strategies, fees, valuation methodology, and the background and experience of the hedge fund's advisers and employees. *Id.* The hedge fund is expected to provide accurate information regularly regarding the fund to investors so they can perform on-going due diligence. *Id.* at 5.

[281] In order to take advantage of mispricings, hedge funds have to analyze a great deal of information within a short amount of time. Disclosing trades to the SEC would be time-consuming. Additionally, public disclosure would reveal the strategies of a hedge fund and allow others to emulate what a particular hedge fund does.

[282] 15 U.S.C. §§ 80a-3(c)(1), 80a-3(c)(7). *See supra* § III(B) (describing the requirements of the Investment Company Act).

[283] *Staff Report*, *supra* n. 22, at 100-01.

[284] *Id.* at 101.

to be able to fend for themselves in making investment decisions.[285] Because the general public would be exposed to the advertising, though unable to invest, it would be able to gain a better understanding of the nature of hedge funds through the advertising. Additionally, the SEC and other regulatory agencies would gain the same access as the investors to the identities of those running hedge funds, what type of strategies they are pursuing, and any other information that the SEC is interested in collecting.[286]

Furthermore, advertising would increase competition among hedge funds.[287] Investors would be exposed to more funds than they are currently exposed to, and would be in a better position to make wise investing choices based on the goals that they have. Additionally, the increase in competition could decrease performance fees—another benefit to investors.[288] By sanctioning "the free flow and exchange of information" about and from hedge funds, the SEC could easily gain the information it needs, while educating the general public about hedge funds without burdening the operations of hedge funds.[289]

In order to lift the ban on general solicitation, Congress will have to amend the Investment Company Act. The two exemptions that hedge funds generally use—§ 3(c)(1) and § 3(c)(7)—each state that the exclusions apply only if the hedge fund "does not . . . propose to make a public offering of its securities."[290] By eliminating this language, a hedge fund will be able to engage in general advertising, though only accredited investors or qualified purchasers will be allowed to invest.[291]

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[285] O'Halloran, *supra* n. 184, at 489.

[286] In 2006, the House of Representatives passed the Hedge Fund Study Act, which would have authorized the President's Working Group on Financial Markets to conduct an in-depth examination of hedge funds, including their growth, use of leverage, and risks, but the bill did not pass the Senate before the new session of Congress. H.R. 6079, 109th Cong. (Sept. 14, 2006).

[287] O'Halloran, *supra* n. 184, at 489.

[288] *Id.*

[289] *Id.* Lifting the ban on advertising and general solicitation would also benefit hedge funds by eliminating the confusion about what advertising or general solicitation actually is. Allison Bisbey Colter, *SEC Considers Lifting Ad Ban on Hedge Funds*, 242 Wall St. J. B4H (Nov. 12, 2003) (available at 2003 WLNR 3109861) ("Some hedge funds—and their lawyers—interpret the ban on general solicitation so narrowly that they avoid listing their names in the directory of their office buildings.").

[290] 15 U.S.C. §§ 80a-3(c)(1); *see also* 15 U.S.C § 80a-3(c)(7)(A).

[291] Eliminating the ban on advertising under the Investment Company Act creates some confusion with respect to other laws enforced by the SEC. Rule 502(c) of Regulation D prevents general advertising with respect to offers and sales of securities using Rule 506's safe harbor provision. 17 C.F.R. at § 230.502(c). The SEC has stated that under Rule 502(c), "because the primary purpose of the advertisement is to sell securities and to condition the market for future sales, the advertisement would constitute an offer even at a time when securities are not being sold if the syndicator expects in the near future to offer and sell securities." *Gerald F. Gerstenfeld*, SEC No-Action Ltr., 1985 WL 55681 (Dec. 3, 1985). Additionally, the SEC has stated, "The mere fact that a solicitation is directed only to accredited investors will not mean that the solicitation is in compliance with Rule 502(c). Rule 502(c) relates to the nature of the offering and not the nature of the offerees." 48 Fed. Reg. 10045, 10052 (Mar. 10, 1983). Therefore, there may be some issues under the Securities Act, such as forcing hedge funds to make the disclosure requirements necessary under § 5. Additionally, allowing advertising may result in hedge

C. Pension Fund Investment in Hedge Funds

While the Accredited Natural Person Rule purports to protect less sophisticated investors, the SEC has not taken action regarding indirect hedge fund exposure to these investors, namely through pension fund investment in hedge funds. The SEC's main concern with pension funds investing in hedge funds is that if a hedge fund suffers a loss, the pension fund may be unable to meet its current obligations.[292] However, the dissenters to the 2004 Rule point out many reasons why this argument is unavailing. Pension funds invest in hedge funds as a diversification strategy, and they usually only have 1% of their assets in hedge funds.[293] Additionally, pension fund managers are highly skilled individuals and their fiduciary obligations to the fund's beneficiaries prevent them from taking needless risks with the fund's assets.[294]

Several pension funds invested in Amaranth and suffered losses because of Amaranth's failure.[295] Out of its total assets of $7 billion, the San Diego County Employees Retirement Association had $175 million invested in the fund.[296] Although it had a substantial investment in the fund in terms of dollars, the investment was trivial when compared to its total assets, and the losses sustained did not inhibit its ability to meet its current obligations to its beneficiaries. Additionally, the Caisse, Quebec's public pension fund manager, had $77 million Canadian dollars out of $122 billion Canadian dollars in assets invested in Amaranth.[297] The manager of the pension fund took the loss in stride, stating that the Caisse would not reduce its exposure to hedge funds because hedge funds, and other alternative investment strategies, provide better returns than traditional investing methods.[298] These examples show that pension funds' exposure can result in losses, but the losses are unlikely to prevent them from meeting their

fund advisers having to register under the Investment Advisers Act. The advertising ban is construed narrowly under the Act, and by advertising a hedge fund, the adviser may need to register. *See supra* § III(C) (explaining the advertising ban under the Investment Advisers Act). However, the ability to advertise may result in more hedge fund advisers registering with the SEC. This recommendation is a starting point. By eliminating the ban under the Investment Company Act, hedge funds will at least have the ability to begin to disseminate more information about the industry to the public, whether it is being allowed to speak to a reporter about the hedge fund industry or to place an advertisement in *The New York Times*.

[292] *Staff Report*, *supra* n. 22, at 82; 69 Fed. Reg. at 72058.

[293] 69 Fed. Reg. at 72093.

[294] *Id. See supra* § V(B) (discussing the diligence performed by pension funds before investing in hedge funds).

[295] *Flare-Up*, *supra* n. 257, at 80.

[296] Chuck Jaffe, *A Flurry of Regulations Won't Fix Problems at Hedge Funds*, S.F. Chron. E5 (Sept. 24, 2006).

[297] Don MacDonald, *Don't Change Funds: Caisse CEO*, The Gazette (Montreal, Que.) (Sept. 23, 2006) (available at http://www.canada.com/montrealgazette/news/business/story.html?id=6eeb85c7-06a0-4356-a3d5-a0f75cbb45a9).

[298] *Id.* The Caisse CEO, Henri-Raul Rosseau, also stated that the fund had a total of $3.7 billion Canadian dollars invested in hedge funds. *Id.* Though he plans to continue to invest in hedge funds, he noted that the Caisse will improve its internal expertise of them. *Id.*

obligations.[299]

There are numerous reasons why a pension fund would choose to invest in hedge funds, and given the fact that pension funds are managed by professionals who are bound by fiduciary duties and who invest only a minimal portion of pension funds' assets in hedge funds, there does not seem to be too much of an indirect risk to retail investors.[300] However, with retail investors' livelihoods at stake, it may be prudent to err on the side of caution. In the case of pension funds, it may not even be the SEC's domain to enact regulations. The Employee Retirement Income Security Act of 1974 ("ERISA")[301] regulates private employer pension plans, which are overseen by the U.S. Department of Labor ("DOL").[302] Therefore, rather than the SEC trying to protect retail investors in pension funds, the DOL should enact regulations limiting how much an ERISA pension plan can invest in hedge funds using the exemptions under the Investment Company Act.[303] This Comment recommends that the DOL and the SEC evaluate hedge fund investing by pension funds and enact regulations determining an appropriate amount of plan assets that can be invested in unregulated hedge funds.

VI. CONCLUSION

Hedge funds play a vital role in society by adding efficiency and liquidity to the financial markets as well as providing diversification for wealthy and institutional investors. Therefore, any measure to regulate their activities must be entered into cautiously to ensure that the regulation will provide the desired benefits without inhibiting the ability of hedge funds to play their role in the marketplace. The SEC has taken a step in the right direction by proposing the Fraud Rule. However, the proposed Accredited

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[299] As of January 16, 2007, the San Diego County Employees Retirement Association had received $48.2 million back of its $175 million investment in Amaranth. Jenny Strasburg, *Amaranth Says Half of Remaining Fund Capital Returned*, http://www.bloomberg.com/apps/news?pid=20670001&refer=home&sid=a6WtNvAAuYfY (last updated Jan. 26, 2007).

[300] On this issue, the President's Working Group on Financial Markets states:

> Concerns that less sophisticated investors are exposed indirectly to private pools through holdings of pension funds . . . can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles. These fiduciaries have a duty under applicable law to act in the best interest of the beneficiaries. They have an ongoing responsibility to perform due diligence to ensure that their investment decisions are prudent and conform to sound practices for fiduciaries. [Pension funds] should address any special issues relating to investment in [hedge funds], including the availability of relevant, accurate, and timely historical and ongoing material information.

PWG Agreement, *supra* n. 18, at 2-3.

[301] Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of U.S.C.).

[302] Hammer et al., *supra* n. 90, at 249.

[303] Current DOL regulations effectively limit a hedge fund from allowing a single pension fund to own more than 25% of the hedge fund's securities. Hammer et al., *supra* n. 90, at 250-51.

Natural Person Rule goes too far in limiting the number of individuals eligible to invest in a hedge fund, and the SEC should revise its proposal to update the accredited investor standard based on inflation. Regulators should note that systemic risk can be contained by market discipline, and minor steps can be taken to increase the amount of information concerning hedge funds to the public and to protect pension fund assets. Going forward, the SEC and other regulatory agencies should use only non-intrusive methods of hedge fund regulation in order to allow funds to function properly and to provide numerous benefits to the financial markets and investors.