MUCH ADO ABOUT NOTHING: AN ANALYSIS OF THE "ACCREDITED NATURAL PERSON" STANDARD

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I. INTRODUCTION

Hedge funds are private investment vehicles that avoid a large degree of securities regulation through exemptions in the major Congressional acts that created securities law.[1] Because hedge funds are largely unregulated, they are able to engage in trading strategies not available to other investment vehicles, such as mutual funds.[2] Due to the growth of the hedge fund industry and the collapse of some large hedge funds, the Securities and Exchange Commission ("SEC" or "Commission") is reexamining many of the securities law provisions that deal with hedge funds, including those that exempt hedge funds from regulation.[3]

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[1] Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style and Mission*, 2006 U. ILL. L. REV. 975, 976 (2006).

[2] For example, while both hedge funds and mutual funds are able to engage in short selling, mutual funds must cover their "short" positions with cash or other securities. *See* Dale A. Oesterle, *Foreword: Regulating Hedge Funds*, 1 ENTREPREN. BUS. L.J. 1, 15-17 (2006).

[3] *See* Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006); Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054-01, 72055-60 (explaining that the collapse of Long Term Capital Management has caused both the SEC and the President's Working Group to reexamine the laws that create the hedge fund industry).

Currently, hedge funds are able to avoid regulation under the Securities Act of 1933 by limiting the sale of their securities to "accredited investors."[4] For a natural person to qualify as an "accredited investor," he or she must either have a net worth of $1 million or a minimum annual income.[5] The SEC recently released Proposed Rules 509 and 216, which would reduce the number of natural persons able to invest directly in hedge funds by creating an "accredited natural person" test that would require an individual to own $2.5 million in investments before he or she can invest directly in a hedge fund.[6]

This Note evaluates the impact that the "accredited natural person" standard would have on both the market and individual investors, ultimately concluding that the SEC should not adopt the Proposed Rules. Part II describes the current regulations governing individual investment, some of the major hedge fund collapses that have motivated the SEC to act, and the "accredited natural person" standard that will be created by Proposed Rules 509 and 216. Part III analyzes whether the Commission should adopt the "accredited natural person" standard based on three criteria: (1) whether the standard will reduce systemic risk, (2) whether it is necessary to protect the investors who the Proposed Rules would exclude from direct investment, and (3) whether it will have a negative impact on capital formation, efficiency, and competition. The Proposed Rules will not reduce the probability of a systemic shock to the market because they do not address the causes of systemic risk.[7] While the SEC believes that the Proposed Rules provide necessary investor protection, they will actually harm the individuals who

[4] 17 C.F.R. § 230.506 (2008); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Accredited Investors in Certain Private Placement Vehicles, Securities Act Release No. 8766, Investment Advisers Act Release 2576, 72 Fed. Reg. 400, 404 (proposed Dec. 27, 2006) [hereinafter Proposed Rules].

[5] *See infra* Part II.A.1.

[6] Proposed Rules, *supra* note 4.

[7] *See infra* Part III.A.

would be excluded from investing directly in hedge funds.[8] Finally, the Proposed Rules will hinder capital formation and reduce hedge fund competition.[9]

II. CURRENT REGULATION AND PROPOSED RULES

A. Current restrictions on the eligibility of natural persons to invest in hedge funds

Hedge funds are private investment vehicles that escape many substantive SEC regulations through exemptions in the major securities acts.[10] Hedge funds avoid regulation by limiting the sale of their securities to investors who meet certain statutory requirements.[11] Three federal statutes[12] limit the class of natural persons who are able to invest in the hedge fund industry: the Securities Act of 1933 ("Securities Act"), the Investment Company Act of 1940 ("Company Act"), and the Investment Advisers Act of 1940 ("Advisers Act").[13]

1. Securities Act of 1933

One of the goals of the Securities Act, as well as securities regulation generally, is to protect the general public through disclosure; investment vehicles that only service clients who can "fend for themselves" are therefore outside of this purpose.[14] Based upon this principle, Section 4(2) of the

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[8] *See infra* Part III.B.

[9] *See infra* Part III.C.

[10] Paredes, *supra* note 1, at 976.

[11] *See infra* Part II.A

[12] *See* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 688-98 (2000) (explaining that there are four major Congressional Acts that regulate hedge funds but the Securities and Exchange Act of 1934 does not directly limit the class of natural persons able to invest in hedge funds).

[13] *See infra* Part II.A.1-3.

[14] *See* SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (holding that "[t]he design of the statute is to protect investors by promoting full

Securities Act exempts funds that make "private offerings."[15] Hedge funds qualify for the "private offering" exemption through Rule 506 of Regulation D, which allows funds to avoid registration under the Securities Act when they sell securities to an unlimited number of "accredited investors" and up to 35 non-"accredited investors."[16] A natural person can qualify as an "accredited investor" under Rule 501 if he or she has: 1) a net worth (or joint net worth) exceeding $1 million, 2) earned over $200,000 in income for each of the last two years, or 3) earned a joint income over $300,000 for each of the last two years.[17]

2. Investment Company Act of 1940

The Company Act requires that "investment companies" register with the SEC and subjects these companies to many substantive provisions, including debt limitations.[18] Hedge funds qualify as "investment companies" under the Company Act, but escape its reach through either Section 3(c)(1) or Section 3(c)(7) of the Act.[19]

Section 3(c)(1) exempts a fund comprised of no more than 100 "accredited investors" as defined by Regulation D,

disclosure of information thought necessary to informed investment decisions," but noting that registration is unnecessary when investors can "fend for themselves").

[15] 15 U.S.C. § 77d-(2) (2000).

[16] 17 C.F.R. § 230.506 (2008).

[17] *Id.* § 230.501.

[18] *See* 15 U.S.C. § 80a-3(1)(a) (2000) (providing that an investment company is any organization 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"); *see also* Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 331-32 (2007) ("Along with registration, the Investment Company Act limits transactions with affiliated persons, requires funds to maintain sufficient liquidity to redeem shares, regulates corporate governance of the funds and establishes rules for pricing of the funds' portfolios.") (citing Investment Company Act, 15 U.S.C. § 80a-9, -10, -12, -17, -22, -16, -1(b) (2004)).

[19] Justin A. Dillmore, *Leap Before You Look: The SEC's Approach to Hedge Fund Regulation*, 32 OHIO N.U.L. REV. 169, 176 (2006).

discussed in Part II.A.1, *supra*.[20] In contrast, Section 3(c)(7) exempts a fund that offers its securities to an unlimited number of "qualified purchasers,"[21] a condition an individual can satisfy if he or she currently owns $5 million in investments.[22] Because the Securities Act requires that all hedge fund investors meet the "accredited investor" threshold, a natural person must pass a two-step test to invest in a 3(c)(7) fund, satisfying both an investment requirement ("qualified purchaser") and a net worth requirement ("accredited investor").[23]

3. Investment Advisers Act of 1940

The Investment Advisers Act subjects investment advisers[24] to significant SEC scrutiny and prohibits the charging of performance fees.[25] Hedge fund managers satisfy the statutory definition of investment advisers,[26] but easily escape the Advisers Act because Section 3(c)(7) advisers are exempt and Section 3(c)(1) managers are able to avoid

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[20] "Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." 15 U.S.C. § 80a(3)(c)(1) (2000).

[21] *Id.* § 80a-3(c)(7)(A) ("Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers.").

[22] *Id.* § 80a-2(a)(51)(A)(i).

[23] *See* Proposed Rules, *supra* note 4, at 404; 17 C.F.R. § 230.506; 15 U.S.C. § 80a-3(c)(7)(A) (2008) (recognizing that 3(c)(7) investors must meet both the "accredited investor" and "qualified purchaser" thresholds).

[24] 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, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." 15 U.S.C. § 80b-2(a)(11) (2000).

[25] 17 C.F.R. § 275.204 (2008).

[26] *See* SEC STAFF REPORT, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 20 (Sept. 2003) [hereinafter STAFF REPORT] (stating that "[v]irtually all hedge fund advisers meet the definition of 'investment adviser'"), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

regulation by either (1) limiting the number of clients in the fund to less than fifteen or (2) advising only "qualified clients."[27] A natural person can meet the "qualified client" threshold if he or she has either a net worth of $1.5 million or has invested $750,000 with the fund manager.[28] It is generally accepted that the true "qualified client" standard is a net worth requirement of $1.5 million because an individual who is able to invest over $750,000 almost always will have a net worth far in excess of $1.5 million.[29] Therefore, if a 3(c)(1) fund does not rely on the fewer-than-fifteen exemption under the Advisers Act, the de facto "floor" for investment in a 3(c)(1) fund is $1.5 million.[30]

B. Highly publicized hedge fund failures have prompted new regulations

Hedge funds can engage in risky investment strategies not available to other investment vehicles because they are

[27] *See* Ordower, *supra* note 18, at 350; 15 U.S.C. § 80b-5(b)(4) (2007) (exemption for 3(c)(7) funds); Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon Capital Appreciation of a Client's Account, 63 Fed. Reg. 39,022 (July 21, 1998) (exemption for 3(c)(1) funds that only sell to "qualified clients"); 15 U.S.C. § 80b-2(a)(3) (fewer than fifteen client exemption).

[28] "[T]he Commission is adopting rule amendments to eliminate the provisions of the rule that prescribe contractual terms and require specific disclosures. In addition, the amendments change the client eligibility criteria to permit the following clients to enter into performance fee arrangements with their investment advisers: (1) clients with at least $750,000 under management with the adviser or more than $1,500,000 of net worth." *See* Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon Capital Appreciation of a Client's Account, 63 Fed. Reg. 39,022, 39,022.

[29] Comments on Proposed Rule: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 17 CFR 230 and 275, Release No. 33-8766, File No. S7-25-06, PLI/Corp 13, 223 (2007) [hereinafter Comments] (Comment by New York State Bar Association) (claiming that the hedge fund industry generally accepts that investors who have $750,000 in investments will meet the $1.5 million net worth requirement), *available at* http://www.sec.gov/comments/s7-25-06/s72506.shtml.

[30] *Id.* at 223.

exempt from the regulations discussed *supra*.[31] The highly publicized collapses of several large hedge funds brought attention to the hedge fund industry and prompted the SEC to consider additional regulation.[32]

Prior to 1998, Long-Term Capital Management ("LTCM") was one of the most successful hedge funds, posting annual returns of forty percent.[33] In 1997, LTCM invested based on the belief that the price of risky debt would increase across the globe while the value of governmental bonds would decrease.[34] Their prediction was incorrect. The combination of the Asian financial crisis and the devaluation of the Russian Ruble caused investors to buy less risky debt, and the value of risky debt dropped.[35] At the time of its collapse, LTCM was leveraged 25 to 1 and had derivative positions in excess of $1.5 trillion.[36] A world financial crisis was avoided only because the Federal Reserve Bank of New York and other banks invested $3.6 billion into LTCM to bail out the fund.[37] As the D.C. Court of Appeals noted in *Goldstein v. SEC*, which invalidated another recent attempt by the SEC to further regulate hedge funds, the current push for hedge fund regulation is based largely upon LTCM's failure.[38]

The collapse of Amaranth Advisors, the largest hedge fund failure to date, also drew large media attention.[39] Amaranth's failed investment strategy, which focused on natural gas futures, resulted in a $5 billion loss over one

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[31] For a discussion of hedge fund investment strategies, see generally STAFF REPORT, *supra* note 26, at 34-42.

[32] Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006) (stating that the most recent push for regulation is due to the highly publicized collapses of major hedge funds).

[33] Melissa Antoszewski, *Las Vegas Style: In the Absence of Regulation, Risky Hedge Fund Bets Can Win Big and Lose Even More*, 8 TENN. J. BUS. L. 381, 407 (2007).

[34] Paredes, *supra* note 1, at 984.

[35] *Id.*

[36] *Id.*

[37] Antoszewski, *supra* note 33, at 407.

[38] Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006).

[39] Amaranth controlled over $9 billion in assets before its collapse. Antoszewski, *supra* note 33, at 408.

week and a sixty-five to seventy percent drop in the value of Amaranth.[40] While J.P. Morgan and Citadel purchased Amaranth's natural gas portfolio, which prevented a larger market failure, this event demonstrated the impact that one flawed aggressive investment strategy by a large fund could have on the market.[41]

C. The proposed "accredited natural person" standard

Regulation D, which created the "accredited investor" threshold,[42] was promulgated in 1982. Since its adoption, the percentage of households able to meet this standard has increased from 1.87% to 8.74%.[43] This increase is attributable to inflation and the increased value of personal residences.[44] If the SEC merely updated the "accredited investor" definition to correct for inflation, it would adopt a net worth standard of about $1.9 million.[45] But the Proposed Rules go much further.

Driven by the concern that the current standard does not adequately protect investors,[46] Proposed Rules 509 and 216

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[40] *Id.*

[41] Many major investors had invested in Amaranth, and it is unclear how much investment these institutions will be able to recover. Many experts argue that Amaranth's collapse could have sparked a chain reaction of other collapsing funds. *See id.* at 408-11.

[42] *See supra* Part II.A.1.

[43] These estimates are found in the 1983 and 2004 triennial Federal Reserve Surveys of Consumer Finance. While the percentage of households qualifying as "accredited investors" has most likely increased since 2004, the 2007 Survey has not yet been released. *See* Proposed Rules, *supra* note 4, at 405-06.

[44] *Id.* at 404.

[45] The Office of Economic Analysis has estimated that if the accredited investor definition were adjusted for inflation, it would require a net worth of $1.9 million, a joint income of $582,000, or an individual income of $388,000. *Id.* at 405-06.

[46] The SEC has stated that this new investment threshold is necessary because the current standard might not adequately protect investors. Specifically, the SEC fears that some individuals that currently qualify as "accredited investors" are not "capable of evaluating and bearing the risks of their investments." The SEC also notes that this

create a new requirement for natural persons to satisfy before investing in Section 3(c)(1) funds.[47] An "accredited natural person" would still be required to meet the current "accredited investor" standard but would also need to own investments of at least $2.5 million.[48] Unlike the other thresholds mentioned thus far, the "accredited natural person" standard would be adjusted for inflation every five years.[49]

It is also worth noting that under the Proposed Rules' definition of "investment," marital property is valued at 50% of its market value, which differs from the definition of "investment" in the "qualified purchaser" standard.[50] Further, the "accredited natural person" standard would only apply to "private investment vehicles."[51] The Proposed

additional test creates a two-step approach similar to the current "qualified purchaser" test that restricts entry in 3(c)(7) funds. *See* Proposed Rules, *supra* note 4, at 400-06.

[47] *Id.* at 405.

[48] *Id.*

[49] Including a provision to automatically adjust for inflation represents "a marked departure from comparable investor qualification provisions." Currently, the "accredit investor," "qualified client," and "qualified purchaser" standards do not adjust for inflation. Unless the SEC amends those definitions to adjust for inflation, eventually the investment threshold of the "accredited natural person" standard will surpass the "qualified purchaser" standard. As a result, it will be easier for a natural person to invest in a 3(c)(7) fund than a 3(c)(1) fund. This result goes against Congress's intent when they created 3(c)(7) funds. *See* Comments, *supra* note 29, at 161 (Comment by Davis Polk & Wardwell), 182-83 (Comment by Schulte Roth & Zabel LLP).

[50] *See* Proposed Rules, *supra* note 4, at 407. Commentators argue that there is no justification for treating marital property at 50% of its market value when marital property is valued at 100% when qualifying to invest in 3(c)(7) funds. *See, e.g.*, Comments, *supra* note 29, at 96 (Comment by Seward & Kissel), 218 (Comment by Debevoise & Plimpton).

[51] The definition of "venture capital fund" would be the same as the definition of "business development company" under Section 202(a)(22) of the Advisers Act. *See* Proposed Rules, *supra* note 4, at 405-07. For arguments against this distinction, see Nathan J. Greene, *The SEC's Latest Hedge Fund Rulemaking: More than 600 Comment Letters*, 26 No. 7 BANKING & FIN. SERVICES POL'Y REP. 4, 6 (2007); Comments, *supra* note 29,

Rules specifically exempt venture capital funds and Section 3(c)(7) funds would not be subject to this new rule because entry into those funds requires that natural persons meet the higher "qualified purchaser" standard of $5 million in investments.[52]

III. ANALYSIS OF "ACCREDITED NATURAL PERSON" STANDARD

The Commission's mission is to (1) reduce systemic risk, (2) protect individual investors, and (3) promote capital formation, efficiency, and competition.[53] The "accredited natural person" standard will serve none of these goals and, in fact, will actually harm individual investors and inhibit capital formation and competition.[54] Therefore, the Proposed Rules should not be adopted.

at 90 (Comment by Syracuse & Hirschtritt LLP), 122 (Managed Funds Association).

[52] Proposed Rules, *supra* note 4, at 405.

[53] *See* SEC, The Investor's Advocate, http://www.sec.gov/about/whatwedo.shtml (last visited Jan. 24, 2008) ("The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."); ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION 26-31 (3d ed. 2003) (claiming that the purpose of the SEC was to prevent another systemic failure by increasing investor information through adequate disclosure); Paredes, *supra* note 1, at 999 (arguing that the SEC's goal of promoting efficient markets has been held to include protecting investor confidence, which includes reducing systemic risk), 1005 ("The need to get accurate information into investors' hands and to protect them from hedge fund abuses could be argued to justify the hedge fund rule."); 15 U.S.C. § 77b(2) (2000) ("Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.").

[54] *See infra* Part III.A-C.

A. The impact on systemic risk

The Securities Act of 1933 and Securities and Exchange Act of 1934, passed during the Great Depression, were designed to prevent another financial catastrophe; the SEC achieves this goal by reducing systemic risk.[55] The collapses of LTCM and Amaranth demonstrated to the SEC that the downfall of a large hedge fund could have market-wide implications.[56] This is in part due to the hedge fund industry's reach. The growth of the industry, including the trend toward retailization, means that the collapse of a single fund could cause a systemic shock.[57] Such collapses are usually the result of risky trading strategies, such as LTCM's bet on risky debt value, or fraudulent activities.[58] The Proposed Rules will have no impact on the industry's size or the causes of hedge fund collapse.

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[55] *See* KHADEMIAN, *supra* note 53, at 26-31 (explaining that the purpose of the SEC was to prevent another systemic failure by increasing investor information through adequate disclosure); Paredes, *supra* note 1, at 983 (quoting Nicholas T. Chan et al., *Systemic Risk and Hedge Funds* (Working Paper, 2005) (defining systemic risk as the "possibility of a series of correlated defaults among financial institutions . . . that occurs over a short period of time, often caused by a single major event"), *available at* http://ssrn.com/abstract=671443).

[56] *See* Ben S. Bernanke, Chairman, Federal Reserve, Address at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference: Hedge Funds and Systemic Risk (May 16, 2006) (claiming that the collapse of a major hedge fund could lead to heavy losses to counterparties and could trigger further defaults), *available at* http://www.federal reserve.gov/newsevents/speech/Bernanke20060516a.htm.

[57] *See* Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006) (stating that the SEC was motivated to act by the growth of the industry, the trend towards retailization, and the increase in fraud actions brought against hedge funds).

[58] *See id.* (suggesting that the increase in fraud actions brought against hedge funds raises concern that such behavior is on the rise); Part II.B, *supra* (illustrating how the collapses of LTCM and Amaranth were caused by risky investment strategies).

1. The proposed rules will have a negligible impact on growth

The size of the hedge fund industry doubled from 1999 to 2004 and total investment in hedge funds worldwide is now over $1.5 trillion.[59] Because of the growth in size of individual hedge funds and the hedge fund industry, the SEC and the financial community are concerned about the chance of a systemic shock caused by the collapse of a large fund.[60] Increasing the requirements for natural persons to invest directly in the hedge fund market will have an insignificant impact on this rapid growth because 3(c)(1) funds account for a small part of the market and investors will likely shift to indirect investment.[61]

As investment activity by institutional investors increases, investment by individuals becomes a relatively smaller percentage of the industry's capital inflow.[62] Due to the relatively smaller size of 3(c)(1) funds, some commentators claim that even the complete removal of 3(c)(1) funds would not make our financial market less susceptible to systemic risk.[63] If completely eliminating 3(c)(1) funds will not reduce systemic risk, then reducing the size of those funds will also have no impact.[64]

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[59] HOUMAN B. SHADAB, MERCATUS CENTER AT GEORGE MASON UNIVERSITY, THE DEFINITION OF ACCREDITED INVESTORS IN CERTAIN PRIVATE INVESTMENT VEHICLES 5 (2007), *available at* http://ssrn.com/abstract=980751.

[60] One of the three justifications by the SEC for the look-through provision struck down in *Goldstein* was the growth of the hedge fund industry. *See Goldstein*, 451 F.3d at 877; *but see* Dillmore, *supra* note 19, at 173 (arguing that the concern in the financial community after the collapse of LTCM was over-exaggerated).

[61] The Proposed Rules may, however, reduce the size of the entrepreneurial hedge fund market. *See infra* Part III.C.2.

[62] *See* SHADAB, *supra* note 59, at 5 (claiming that direct investment by individuals, not counting investment through a "fund of funds," is currently decreasing and this trend is projected to continue).

[63] *See, e.g.*, Comments, *supra* note 29, at 227 (Comment by New York State Bar).

[64] *But see* J. Bradford DeLong et al., *The Survival of Noise Traders in Financial Markets*, 98 J. POL. ECON. 703 (1990), *available at* http://econ

The growth of the hedge fund industry is largely a result of retailization.[65] Retailization can be defined as the increased exposure to hedge fund risk by average investors through either direct investment by charities, pension plans, universities, and endowments or indirect investment by natural persons through a "fund of funds."[66] The Proposed Rules fail to address concerns related to retailization. The Rules will not impact the first form of retailization because the proposed standard only applies to natural persons, not institutional investors.[67] As to the second form of retailization, the "accredited natural person" standard will only increase indirect investment through a "fund of funds."[68] "Accredited investors" who can no longer directly invest in hedge funds because they do not meet the new "accredited natural person" standard will still be able to meet the lower financial requirements of "funds of funds."[69] While it is true that investing in a "fund of funds" provides additional

161.berkeley.edu/pdf_files/Survival_Noise_Traders.pdf (systemic risk may be reduced in the industry by preventing irrational "noise traders" from entering the hedge fund market and investing in faddish hedge funds).

[65] SEC Chairman Christopher Cox has expressed his concern about the increase of "retailization" in the hedge fund industry. *See* Jean P. Hanna, *Hedge Funds and Funds of Fund: An Update on Regulations Governing Hedge Funds, and the Duties of Registered Representatives and Investment Advisers in Recommending Hedge Funds and Funds of Funds*, 615 PLI/CORP 451, 462-63 (2007).

[66] *See* STAFF REPORT, *supra* note 26, at 80-81; Hanna, *supra* note 65, at 457, 462 (defining a "fund of funds" as an investment company that invests in hedge funds; these funds often have a much lower investment threshold); Antoszewski, *supra* note 33, at 393 (noting that one "fund of funds," Oppenheimer Tremount, requires an investment of only $25,000); SHADAB, *supra* note 59, at 5 (estimating that pension plans will become the majority of investment flow into hedge funds through 2010).

[67] An institutional investor is a company, usually a pension fund, investment company, trust manager, or insurance company, that trades in large volumes of securities. BLACK'S LAW DICTIONARY 846 (8th ed. 2004).

[68] *See* Hanna, *supra* note 65, at 462 (a "fund of funds" is an investment vehicle that invests in hedge funds).

[69] *See* Antoszewski, *supra* note 33, at 393 and Greene, *supra* note 51, at 5 (some funds of funds have investment qualifications as low as $25,000 while many 3(c)(1) funds already demand investments of $500,000 or more).

investor protections,[70] the shift from direct investment to indirect investment will not reduce the total amount of capital entering the hedge fund industry or the number of investors impacted by the industry.[71]

2. The proposed rules will not impact the causes of hedge fund collapse

The proposed rules will have no impact on the risky investment strategies of hedge funds. The collapses of LTCM and Amaranth demonstrated that even large, prosperous hedge funds could collapse due to one "bad bet."[72] Because hedge funds are exempt from the Company Act,[73] they are able to engage in trading strategies specifically prohibited to mutual funds and other investment vehicles covered by that statute.[74] The Proposed Rules will only shift the way capital enters the hedge fund market.[75] The Rules will not have any impact on the investment strategies available to hedge funds.[76] Even if the Proposed Rules would impact the investment strategies of 3(c)(1) funds, the new standard does not apply to large hedge funds, usually organized as 3(c)(7) funds, which are the most likely candidates for causing a domino effect in the market.[77]

[70] *See* Proposed Rules, *supra* note 4, at 404, 411 (recognizing that a "fund of funds" is "generally administered by entities of plan fiduciaries and registered investment professionals"); Hanna, *supra* note 65, at 462 (a "funds of funds" register with the SEC and file quarterly reports).

[71] It is possible that some investors will choose not to shift to indirect investment through a "fund of funds." *See infra* Part III.C.2.

[72] *See supra* Part II.B.

[73] *See supra* Part II.A.2.

[74] *See* Paredes, *supra* note 1, at 982 (noting that hedge funds are able to engage in "short selling" without covering this position); Gibson, *supra* note 12, at 705 (suggesting that the excessive use of leverage by hedge funds in a volatile market makes them much more likely to fail than mutual funds).

[75] *See supra* Part III.A.1.

[76] Proposed Rules, *supra* note 4.

[77] *See* Greene, *supra* note 51, at 6 (arguing that larger hedge funds tend to be organized as 3(c)(7) funds which have a statutory investment requirement of $5 million).

Therefore, even if we assume that 3(c)(1) funds will adjust their trading strategies, the Proposed Rules would not influence the large funds that could trigger a systemic shock upon their collapse.

Further, the Proposed Rules will not reduce instances of fraud. If a large enough hedge fund collapsed due to fraud, it would create a systemic shock.[78] The SEC's concern over hedge fund fraud[79] is compounded by the reality that hedge fund fraud is usually undetectable until investors raise their concerns to the SEC[80] and that the number of SEC hedge fund fraud cases has increased over the past few years.[81] The Proposed Rules, however, do not claim to address concerns related to fraud and no commentators have posited any theory on how the "accredited natural person" standard would reduce the likelihood of a hedge fund collapse due to fraud.[82] Further, the SEC is currently considering other regulation to address concerns related to hedge fund fraud.[83]

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[78] Due to the secrecy of the hedge fund industry, it is possible for a fund the size of LTCM to commit fraud. In 2005, the SEC stepped in to prevent an $81 million fraud by the KL Group and then watched as Bayou Management collapsed after months of fraudulent conduct. *See* Paredes, *supra* note 1, at 980-86.

[79] *See* Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006) ("[T]he Commission was concerned about an increase in the number of fraud actions brought against hedge funds.").

[80] Dustin G. Hall, *Elephant in the Room: Dangers of Hedge Funds in Our Financial Markets*, 60 FLA. L. REV. 183, 199 (2008).

[81] Dillmore, *supra* note 19, at 180.

[82] No commentator has identified a way that Proposed Rules 209 and 516 will address fraud. *See generally* Comments, *supra* note 29.

[83] *See generally* Proposed Rules, *supra* note 4 (explaining that the SEC is considering adopting Proposed Rule 206(4)-8 that would amend certain anti-fraud provisions of the Advisers Act to better prevent hedge fund fraud).

B. Impact on natural persons to be excluded from investment

The Proposed Rules also fail to achieve the goal of providing additional investor protection.[84] The SEC argues that many natural persons who currently qualify as "accredited investors" should not be allowed to invest in hedge funds because (1) hedge funds are not transparent and these investors lack the knowledge or sophistication necessary to understand these investments, (2) hedge funds are too "risky" for some investors, and (3) hedge funds are more complex than other securities.[85] However, these assumptions about hedge funds are incorrect. First, hedge funds are becoming more transparent and investor knowledge is increasing.[86] Second, investment in hedge funds actually reduces portfolio risk.[87] Third, hedge funds are no more complex than other securities and complexity may actually reduce risk.[88] Additionally, the SEC's concern for these investors should be further alleviated because investors who cannot bear the risks of investment are already excluded in practice and investors are already protected by other sections of the securities laws.[89] When the Proposed Rules are analyzed under the current reality of the hedge fund market, it is clear that the "accredited natural person" standard will have an unnecessarily harsh impact on excluded investors.

[84] *See* SEC, The Investor's Advocate, http://www.sec.gov/about/whatwedo.shtml (last visited Jan. 24, 2008) ("The mission of the U.S. Securities and Exchange Commission is to protect investors.").

[85] The SEC has expressed concern that hedge funds "have become increasingly complex and involve risks not generally associated with many other issuers of securities" and that "there is minimal information available about them in the public domain." Proposed Rules, *supra* note 4, at 404.

[86] *See infra* Part III.B.1.

[87] *See infra* Part III.B.2.

[88] *See infra* Part III.B.3.

[89] *See infra* Part III.B.4-5.

1. Changes in investor knowledge and industry transparency

The SEC has expressed concern that those who are not "accredited natural persons" should be excluded from investment in hedge funds due to a lack of information on hedge fund risks.[90] Hedge funds have long been thought of as secretive organizations that avoid the disclosure requirements central to securities regulation.[91] However, this characterization no longer reflects reality.

First, the hedge fund industry is becoming more transparent. While hedge funds have always been required to make certain disclosures,[92] hedge funds are now voluntarily disclosing more information to all investors to meet the demands of institutional investors who have become more active in the industry.[93] For example, hedge funds often disclose their risk-management policies, the potential risks of investing, and their investment strategies.[94]

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[90] *See* Proposed Rules, *supra* note 4, at 404 ("[I]nvestors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools").

[91] *See* Paredes, *supra* note 1, at 979 ("Hedge fund critics have characterized hedge funds as 'shadowy' investment vehicles that 'escape' regulation by 'exploiting loopholes' in the federal securities laws in order to freewheel in the equivalent of a 'wild west' financial frontier.").

[92] Most 3(c)(1) advisers already make certain disclosures to the SEC. For a hedge fund manager to charge a performance fee, he or she must become a registered adviser. Registered advisers are held to certain disclosure standards under the Advisers Act and their books are subject to periodic review by the SEC Office of Compliance Inspections and Examinations (OCIE). *See* Comments, *supra* note 29, at 183 (Comment by Schulte Roth & Zabel). Larger hedge funds that own a significant amount of publicly traded stock must also make additional quarterly disclosures. *See* SHADAB, *supra* note 59, at 3, 17.

[93] *See* Bernanke, *supra* note 56 (stating that since the collapse of LTCM, institutional investors are requiring additional information from the funds that they invest in).

[94] *See* Letter from Jeffrey Cobb to Securities and Exchange Commission 5 (Mar. 9, 20007) [hereinafter Cobb Comment] ("Market forces have compelled more detailed, as well as more comprehensible,

Second, individual investors are becoming more knowledgeable about hedge funds.[95] Though natural persons who invest in hedge funds will probably have less information about a fund's positions than an institutional investor, who can afford to conduct due diligence by hiring skilled investment advisors,[96] individuals are able to gain in-depth knowledge about the industry, including hedge fund risks, through detailed articles and studies available at no cost in libraries or on the internet.[97] The trend toward increased disclosure to institutional investors has also increased investor knowledge of individual funds.[98] In addition, the rise of internet trading and the availability of professional quality trading tools have increased individual sophistication by allowing investors to develop more complicated investment strategies.[99]

Further, the $2.5 million investment test advanced in the Proposed Rules would have a disproportionate impact on

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disclosure of strategies, policies and risks."), *available at* http://www.sec.gov/comments/s7-25-06/s72506-581.pdf.

[95] For a discussion of increasing investor knowledge, see generally AUSTRALIAN SECURITIES EXCHANGE, MEDIA RELEASE: GROWING RETAIL INVESTOR SOPHISTICATION – RESULTS OF ASX SHARE OWNERSHIP SURVEY, May 17, 2006, *available at* http://www.asx.com.au/about/pdf/mr2007 0517_share_ownership_study.pdf.

[96] Institutional investors typically retain the services of advisory firms to conduct due diligence before investing in a hedge fund. *See* Paredes, *supra* note 1, at 992; Bernanke, *supra* note 56.

[97] *See* SHADAB, *supra* note 59, at 3, 16; Cobb Comment, *supra* note 94, at 2 (claiming that the amount of information available to investors is increased through both disclosures by individual funds and general commentary on the hedge fund industry).

[98] *See* Cobb Comment, *supra* note 94, at 5 (arguing that information has trickled-down to natural persons through the internet and the birth of third-party databases).

[99] The gap between the tools available to professional trades and retail investors is narrowing rapidly. As a result, individuals with only $100,000 in investment may be developing complex trading techniques, thereby increasing their overall level of sophistication. *See* Comments, *supra* note 29, at 87 (Comment by Syracuse & Hirschtritt), 225 (Comment by New York State Bar).

younger sophisticated investors.[100] Under the current statutory framework, young, educated, and successful investors who are sophisticated enough to understand the risks and bear the burdens of investment are often able to satisfy the "accredited investor" standard based upon their income.[101] However, it may take years for these sophisticated "accredited investors" to amass $2.5 million in investments.[102] The arbitrary exclusion of these sophisticated investors clearly demonstrates the over-exclusivity of the Proposed Rules.

2. Investment in hedge funds reduces risk

Generally, hedge funds are considered a risky investment due to their lack of disclosure, high degree of leverage, and ability to engage in trading strategies not available to mutual funds.[103] The SEC believes that it is inappropriate for certain investors to be exposed to these risks.[104] However, the assumption that hedge funds are too risky for these investors is erroneous.

First, hedge fund risk is no greater than the risk an investor could assume through other forms of investments.

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[100] While the Proposed Rules will have the largest impact on young professionals who would meet any objective sophistication test but simply have not worked long enough to amass $2.5 million in investment, the Proposed Rules will also exclude older sophisticated investors who meet the current income or net worth qualifications. *Id.* at 183 (Comment by Schulte Roth & Zabel).

[101] *See supra* Part II.A.1 (natural persons can currently qualify as "accredited investors" by earning over $200,000 individually or $300,000 jointly for each of the previous two years).

[102] *See* Comments, *supra* note 29, at 183 (Comment by Schulte Roth & Zabel) ("[W]e are concerned with the inequitable impact that the $2.5 million investment threshold would have on young, educated people who possess sufficient financial knowledge to understand the risks of investing . . . but lack the quantity of qualifying investments.").

[103] For a general discussion of hedge fund risks, see Oesterle, *supra* note 2, at 12-19; Ordower, *supra* note 18, at 324, 366-70.

[104] *See* Proposed Rules, *supra* note 4, at 404 (noting that (3(c)(1) funds "involve risks not generally associated with many other issuers of securities").

Because most 3(c)(1) funds invest primarily in liquid securities and offer periodic investment rights, they are often less risky than other types of funds that invest in illiquid assets.[105] Hedge funds are also less risky than venture capital funds.[106] Because the Proposed Rules only target one form of investment vehicle among a variety of equally risky investments, the Proposed Rules are either arbitrarily over- or under-inclusive (depending on whether all or none of these investment vehicles should be further regulated). In addition, even if hedge funds were once riskier than these other investments, the increased role of financial institutions in the hedge fund industry has reduced risk. [107] Also, the increased role of investment banks as managers and prime brokers has increased the ability of investors to monitor hedge fund activities.[108]

Further, when analyzed under modern portfolio theory, the inclusion of hedge funds in an investor's portfolio actually reduces that portfolio's risk.[109] According to modern portfolio theory, investors can minimize risk by holding a diversified portfolio, which occurs when returns from the various securities in an investor's portfolio are unrelated to

[105] *See* Comments, *supra* note 29, at 95 (Comment by Seward & Kissel) (arguing the SEC's belief that hedge funds are riskier investments than firms that invest in "real estate, windmills, technology, etc. . . . appears to be unfounded" because these illiquid assets do not allow investors periodic redemption rights).

[106] *See id.* at 90 (Comment by Seward & Kissel) ("[V]enture capital funds may provide equal if not greater risk than even the most sophisticated hedge fund."); *id.* at 122-24 (Comment by Managed Funds Association) (arguing that it is hard to distinguish between the risks of hedge funds and venture capital funds and these that two vehicles often invest in each other).

[107] *See* Bernanke, *supra* note 56 (suggesting that since the collapse of LTCM, institutional investors, creditors, and counterparties have taken an active role in identifying and reducing hedge fund risk).

[108] *See* SHADAB, *supra* note 59, at 14 (explaining that investment banks typically have the most sophisticated management systems and therefore are best qualified to manage hedge fund risk).

[109] *See id.* at 7 ("[T]he Commission fails to recognize that hedge funds' risk must be evaluated in terms of modern portfolio theory" and that hedge funds "reduce portfolio risk through diversification.").

each other.[110] An investor increases diversification by investing in securities that are not influenced by the same market factors.[111] The Mercatus Center at George Mason University studied hedge fund returns against market returns from January 1990 to 2004 and found that hedge funds tended to have either no losses or gains during months of general market loss.[112] Because hedge fund returns have less correlation to general market movements than mutual funds, a portfolio that contains hedge funds will be more diversified than a portfolio that contains only mutual funds.[113] Therefore, the Proposed Rules will increase investor risk by withholding the ability to diversify by investing in hedge funds.[114]

Next, assumptions underlying the concern that less wealthy investors will be forced to invest in riskier hedge funds are misguided. Less-wealthy investors are usually excluded from investing in large, popular hedge funds that are better capitalized and less prone to failure than the smaller hedge funds.[115] Smaller investors instead invest in small, new 3(c)(1) funds that some assume will be run by recent college graduates or average traders with little training or experience.[116] It is further assumed that these new hedge funds will suffer from entering an already crowded market and will likely find it difficult to produce returns without taking on additional risk, and may have a greater chance of failing as a result.[117] However, this

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[110] *Id.*

[111] *Id.* at 8.

[112] *Id.* at 9.

[113] *See id.* at 10 ("[H]edge fund returns substantially are less correlated to general market movements than traditional buy-and-hold mutual funds.").

[114] *See id.* at 21 ("The addition of hedge funds to a portfolio generally reduces the overall risk of loss.").

[115] *Id.* at 5-6 (claiming that smaller investors are typically rejected by larger hedge funds due to high investment requirements).

[116] Antoszewski, *supra* note 33, at 390 (claiming that less experienced managers are entering the market due to the current low entry barriers).

[117] SHADAB, *supra* note 59, at 16 (arguing that market crowding forces new funds to take on additional risk).

characterization of hedge funds is likely exaggerated. While some funds might be created by recent college graduates, hedge funds are typically created by "former traders, analysts, and portfolio managers"[118] because the ability to charge a performance fee[119] attracts skilled investment managers.[120] The assumption that new funds are undercapitalized is also untrue. Studies have shown that only a small percentage of hedge funds are undercapitalized.[121] Thus, investing in smaller funds does not necessarily mean taking on additional risk.

Finally, the Proposed Rules will expose excluded investors to the same risk at an increased cost if these investors shift to indirect investment. The demand by investors who are ineligible to receive hedge fund returns has led to the birth of "fund of funds"[122] and various forms of hedge fund doppelgangers.[123] As discussed in Part III.A.1, *supra*, accredited investors who are now excluded from direct investment in hedge funds can turn instead to these funds.[124] While these investment vehicles must make additional disclosures,[125] these funds typically have lower returns while exposing investors to the same risk and complexity.[126]

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[118] Antoszewski, *supra* note 33, at 383.

[119] *See supra* Part II.A.3.

[120] *See* Ordower, *supra* note 18, at 349 (claiming that performance fees "help to attract high quality and creative investment managers to the hedge fund industry").

[121] *See* SHADAB, *supra* note 59, at 15 (suggesting that only four percent of hedge funds are undercapitalized).

[122] A "fund of funds" is an investment vehicle that invests in a group of hedge funds. *See* Hanna, *supra* note 65, at 462.

[123] *See* SHADAB, *supra* note 59, at 18-19 (claiming that non-"accredited investors" currently invest in exchange traded funds, hedged mutual funds, and synthetic mutual funds which all attempt to mimic hedge fund returns though similar trading strategies).

[124] *See supra* Part III.A.1.

[125] A "fund of funds" must file prospectuses and quarterly reports with the SEC. *See* Hanna, *supra* note 65, at 462.

[126] *See* SHADAB, *supra* note 59, at 19 (arguing that while these funds "expose investors to the same types of risks and complexity" they have not "matched the performance of the best hedge funds").

Investing in a "fund of funds" is also more costly because investors are subject to two different performance fees.[127] Because the Proposed Rules can only lead to increased portfolio risk, the Commission should not adopt the "accredited natural person" standard.

3. Investors would be subject to the same degree of complexity investing in other securities and increased complexity does not necessarily correlate with increased risk

One justification for excluding non-sophisticated investors from investing in hedge funds is that these funds are too complicated for average investors.[128] However, there are many other securities that have the same level of complexity as hedge funds.[129] Even assuming that the hedge fund industry as a whole has become more complex, those that will be excluded by the Proposed Rules are not the investors who participate in funds that employ complex trading strategies. Instead, these non-"accredited natural persons" invest in funds that practice only "basic" long-short trading strategies, while only larger hedge funds, which have high investment thresholds, are integrating more complicated investment strategies.[130] Further, even assuming that hedge funds are more complex than other securities, this increased complexity does not necessarily translate into increased risk. Indeed, some scholars have argued that complexity actually

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[127] Hanna, *supra* note 65, at 462.

[128] *See* Proposed Rules, *supra* note 4, at 404. ("Moreover, private pools have become increasing complex . . . .").

[129] *See* Comments, *supra* note 29, at 161 (Comment by Davis Polk & Wardwell) claiming that many other securities available to investors are as complex as hedge funds); SHADAB, *supra* note 59, at 18 (positing that investing in information technology, financial services, and healthcare providers provides similar levels of complexity).

[130] *See* Cobb Comment, *supra* note 94, at 4-5 (suggesting that increased complexity is only seen in larger funds that typically offer their securities to institutional investors).

increases stability.[131] Thus, the increasing complexity of the hedge fund industry may justify lowering, not raising, the barriers to investment.

4. "Accredited Investors" who cannot bear loss already excluded from investment

The class of "accredited investors" has grown 350% since 1982 (largely due to inflation and the increase in the value of personal residences), and some natural persons in this class are not capable of bearing the risk of their investment.[132] However, in practice, investors who are "house rich" but "investment poor" are already excluded from investing in hedge funds due to a combination of SEC regulations and hedge fund business practices.[133]

Because the Advisers Act prohibits hedge funds from charging performance fees to investors who do not meet the "qualified client" standard,[134] hedge fund managers will usually only admit natural persons who meet the higher "qualified client" threshold.[135] In addition, Section 3(c)(1) managers are limited to advising only 100 investors[136] so

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[131] *See* SHADAB, *supra* note 59, at 14 (claiming that just as increased complexity in financial markets has reduced risk, increased complexity in the hedge fund industry has decreased risk in the industry); COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE, Appendix B-9 (July 25, 2005), *available at* http://www.crmpolicygroup.org/docs/CRMPG-II-App-B.pdf (arguing that increased complexity and innovation has diffused risk to the wider financial system).

[132] *See* Proposed Rules, *supra* note 4, at 406.

[133] *See* Comments, *supra* note 29, at 223-34 (Comment by New York State Bar) (claiming that investors who only meet the net worth requirement due to the value of their homes are, in practice barred from investment in hedge funds).

[134] *See supra* Part II.A.3.

[135] A natural person must have a net worth of $1.5 million to be considered a "qualified client." *See* Ordower, *supra* note 18, at 335.

[136] "Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." 15 U.S.C. § 80a(3)(c)(1) (2004).

many hedge funds managers must demand large minimum investments to generate enough capital to implement their investment strategies.[137]

5. Investors in hedge funds are protected through other regulations

Hedge fund investors are also protected from undue risk and extreme loss by both statute and private regulation. Hedge fund investors are currently able to bring claims against hedge fund advisors who commit fraud because the anti-fraud provisions of securities and commodities law apply to hedge funds.[138] Additionally, brokers who recommend hedge funds are subject to various federal and state regulations.[139] The National Association of Securities Dealers has also pressured broker-dealers to conduct proper diligence before recommending a hedge fund to a client.[140] Hedge fund investors have two potential sources of redress against broker-dealers. First, investors often can bring judicial claims against investment advisers when the fund they recommend commits fraud.[141] Alternatively, the National Association of Securities Dealers and New York Stock Exchange allow investors to file arbitration claims based upon improper recommendation of a hedge fund; in

[137] *See* Greene, *supra* note 51, at 5 (claiming that many hedge funds demand a minimum investment of over $500,000).

[138] Gibson, *supra* note 12, at 713-14.

[139] *See* Barbara A. Stettner & Darren Vierira, *The Distribution of Private Fund Securities: Regulatory Considerations and Potential Liabilities When Using Unlicensed Finders*, SL047 ALI-ABA 37, 40 (2006) (The sale of hedge funds may "(1) trigger federal and state broker-dealer registration requirements . . ., (2) implicate potential conflicts of interest issues under federal and state investment adviser regulations . . ., and (4) create certain civil liabilities for the private fund.").

[140] The National Association of Securities Dealers, in light of SEC concerns, has advised members to investigate each client to determine whether investing in hedge funds is appropriate. *See* Ross B. Intelisano, *Hedge Fund Fraud – The Future of Securities Arbitration?*, 1615 PLI/CORP 489, 495 (2007).

[141] Individuals who invested in Bayou Management are currently considering legal action. *See id.* at 497-98.

some cases, arbitration has resulted in significant awards to investors.[142]

C. Effect on capital formation, efficiency, and competition

Section 2(b) of the Securities Act requires the SEC to consider the impact each proposed rule would have on capital formation, efficiency, and competition.[143] The Proposed Rules have an unclear impact on economic efficiency because they will improve average investor knowledge, but prevent individuals from engaging in mutually beneficial transactions.[144] While the Proposed Rules may promote competition in the short term, competition will eventually be reduced as the number of funds decreases.[145] Finally, the "accredited natural person" threshold may undermine capital formation as investors choose to not invest instead of investing indirectly through a "fund of funds."[146]

1. It is unclear how efficiency will be affected

It is unclear whether the "accredited natural person" standard will improve or harm "economic efficiency."[147] If we

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[142] *Id.* at 495-96.

[143] "Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. §77b(2) (2000).

[144] *See infra* Part III.C.1.

[145] *See infra* Part III.C.3.

[146] *See infra* Part III.C.2.

[147] Scholars are divided on how to best define economic efficiency. *See generally* RICHARD O. ZERBE, JR., ECONOMIC EFFICIENCY IN LAW AND ECONOMICS (2001). As a result, there is also widespread debate on how to improve economic efficiency. *Compare* K. FRED SKOUSEN, AN INTRODUCTION TO THE SEC 8 (5th ed. 1991) (arguing that "economic efficiency" is increased when investors are more informed about their decisions) *with* SHADAB, *supra* note 59, at 22 (arguing that efficiency can be

assume that efficiency increases when investors are able to satisfy their highest level wants, then all hedge fund regulation, including the Proposed Rules, undermine efficiency because investment minimums prevent some investors from engaging in transactions that they believe are beneficial. [148] On the other hand, if efficiency is promoted when investor knowledge increases, then the Commission should either prevent investors who lack the knowledge to understand the industry from investing in hedge funds or simply increase hedge fund disclosure requirements.[149] The Proposed Rules might therefore increase efficiency by excluding unsophisticated investors from direct investment. However, the SEC should then consider the increase in investor knowledge and hedge fund disclosure, discussed *supra*, before regulating on that ground.[150] Due to these competing considerations, it is unclear whether the Proposed Rules will undermine or promote efficiency.

2. The proposed rules will eventually undermine capital formation

The Proposed Rules also have the potential to negatively impact capital formation in both the hedge fund industry and the market as a whole. At first glance, because "accredited investors" who would be excluded from direct investment in hedge funds will still be able to invest in hedge funds through a "fund of funds,"[151] total capital formation appears not to be affected. However, because a "fund of funds" is often a less favorable investment,[152] some investors

defined as "the allocation of resources in which value is maximized" (quoting RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 13 (5th 1998)).

[148] *See* SHADAB, *supra* note 59, at 22 ("Efficiency increases when consumers are able to engage in mutually beneficial transactions.").

[149] *See* SKOUSEN, *supra* note 147, at 8 (claiming that economic efficiency is increased when investors are more informed about their decisions).

[150] *See supra* Part III.B.1.

[151] *See supra* Part III.A.1.

[152] *See* SHADAB, *supra* note 59, at 19 (arguing that studies of hedge funds and investment vehicles that attempt to mimic hedge funds show

may decide to not invest in this industry at all instead of investing in a less desirable "fund of funds." As a result of reduced investment in hedge funds, capital formation in other areas of the economy may be reduced since investors are more willing to invest in stocks and bonds when they can reduce their portfolio risk by investing in hedge funds.[153]

Even if capital formation is not reduced in the industry as a whole, the Proposed Rules will clearly reduce capital formation in the entrepreneurial hedge fund market because many of the investors that new funds rely on for investment will be excluded from direct investment under the "accredited natural person" standard.[154] In a survey of small 3(c)(1) funds, many of the firms stated that approximately 50% of their client pool would be excluded from investment if the Proposed Rules were adopted.[155] Because institutional investors typically avoid this section of the market,[156] it is not clear if this loss of capital will be replaced by indirect investment through "funds of funds" or pension plans.

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that hedge funds are a better investment, largely because hedge funds rely more on individual human skill).

[153] *See id.* at 21 ("Just as fire insurance makes people more willing to invest in houses, hedge funds and other forms of portfolio diversification make people more willing to invest in stocks, bonds, and other productive assets.").

[154] The small 3(c)(1) funds that comprise the "entrepreneurial hedge fund market" typically rely on friends and family for initial investment and reduction in the number of friends and family able to contribute to initial capital formation will harm this section of the industry. *See* Comments, *supra* note 29, at 227-28 (Comment by New York State Bar). The Proposed Rules "would substantially inhibit new fund formation, as well as impair subsequent capital raising by smaller firms, with little or no offsetting benefit to investors." *See* Cobb Comment, *supra* note 94, at 2.

[155] *See* Cobb Comment, *supra* note 94, at 6.

[156] *See* Comments, *supra* note 29, at 107 (Comment by New York City Bar) (claiming that institutional investors usually concentrate their investment in larger, more established hedge funds).

3. The "accredited natural person" standard will stifle competition

The Proposed Rules may, over time, have a negative impact on competition, despite the SEC's assertion that the Proposed Rules will promote hedge fund competition by reducing the number of investors able to invest in 3(c)(1) funds.[157] While larger hedge funds can rely on institutional investors for capital, smaller funds typically rely on natural persons for investment.[158] As the number of potential investors decreases, competition amongst 3(c)(1) funds for these investors will increase; this will result in many funds going out of business[159] and potential managers not being able to break through this artificial barrier of entry.[160] As the number of 3(c)(1) funds declines, "accredited natural persons" would begin to compete with each other for admittance to this artificially reduced supply of 3(c)(1) funds.[161] As a result, smaller investors may be forced to agree to less favorable contractual terms.[162]

[157] The SEC claims that the Proposed Rules "may promote competition by shrinking the pool of investors eligible to invest in 3(c)(1) Pools." Proposed Rules, *supra* note 4, at 414; *see also* Cobb Comment, *supra* note 94, at 6 (claiming that some firms will lose up to 50% of their clients under the Proposed Rules).

[158] Smaller hedge funds typically rely on friends and family for initial capital and many of these natural persons will be excluded from investment due to Proposed Rules. This reliance is due in part to institutional investors adopting a "wait and see" approach to new funds; as a result, managers without very wealthy family and friends may be barred from entering the hedge fund arena. *See* Comments, *supra* note 29, at 107 (Comment by New York City Bar).

[159] *Id.* at 227 (Comment by New York State Bar) (arguing that the reduction in available investors will lead to many funds going out of business); Cobb Comment, *supra* note 94, at 5-6.

[160] Even if larger funds raise their prices above the competitive level, the inability of small managers to raise adequate capital will prohibit them from entering the market. *See* ROBERT PITOFSKY ET AL., TRADE REGULATION 199-203 (5th ed. 2003).

[161] *See* Comments, *supra* note 29, at 227 (Comment by New York State Bar).

[162] *Id.* at 227.

In addition to adversely affecting competition, the Proposed Rules may also stifle innovation. Many large hedge funds began as small start-ups that relied primarily on friends and family for initial investment.[163] Over time, the successful start-ups were able to grow to the point where they were able to attract large institutional investors.[164] Because of the Proposed Rules, many "innovative" funds will never acquire the initial capital necessary to engage in their unique strategies.[165] Further, in the face of decreased competition to retain institutional investors, larger hedge funds will be less pressured to improve their own investment strategies.[166]

IV. CONCLUSION

The SEC should not adopt the "accredited natural person" standard advanced in the Proposed Rules. The Proposed Rules will not address the industry's growth, risky investment strategies, or ability to commit fraud, all of which contribute to the possibility of a systemic shock.[167] While the SEC posits that the Proposed Rules will provide necessary investor protections, its arguments are based on false assumptions and the Rules will actually increase excluded investor's portfolio risk. First, investors' knowledge of the industry is increasing, in part due to increasing

[163] *Id.* at 128 (Comment by Managed Funds Association).

[164] *Id.* at 228 (Comment by New York State Bar) (noting that many of the large hedge funds that market to institutional investors began as entrepreneurial hedge funds).

[165] *See* PITOFSKY ET AL., *supra* note 160, at 201 (arguing that a lack of access to a scare resource can prevent competitors from entering the market); Cobb Comment, *supra* note 94, at 5 (claiming that new funds typically provide new investment strategies).

[166] While institutional investors currently concentrate investment in the largest hedge funds, the reduction in the number of 3(c)(1) funds reduces institutional investors' ability to invest in those funds. This market dynamic will only increase as the number of new 3(c)(1) funds decreases. As a result, competition to attract institutional investors may also decrease, resulting in less favorable terms for those investors. *See* Comments, *supra* note 29, at 228 (Comment by New York State Bar).

[167] *See supra* Part III.A.

industry disclosure.[168] Second, hedge funds are not riskier than other potential investments and actually reduce the overall risk of each investor's portfolio.[169] Third, hedge fund complexity does not translate to increased risk.[170] Fourth, investors not capable of bearing the risk of investment are already excluded from direct investment,[171] and other areas of securities law provide sufficient investor protection.[172] Finally, while it is unclear what impact the Proposed Rules will have on economic efficiency, the Proposed Rules will undermine capital formation and inhibit competition.[173] Based on this analysis, the SEC should not adopt the "accredited natural person" standard.

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[168] *See supra* Part III.B.1.

[169] *See supra* Part III.B.2.

[170] *See supra* Part III.B.3.

[171] *See supra* Part III.B.4.

[172] *See supra* Part III.B.5.

[173] *See supra* Part III.C.