HEDGE FUND REGISTRATION: YESTERDAY'S REGULATORY SCHEMES FOR TODAY'S INVESTMENT VEHICLES

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I. INTRODUCTION

Hedge funds have become some of the most influential players on Wall Street in the past decade. In 1990, there were approximately 300 hedge funds with $39 billion in assets under management; the most recent studies estimate that there are 8000 to 9000 hedge funds with nearly $1 trillion in assets under management.[1] The secretive nature of hedge funds, the general public's lack of knowledge about hedge funds, the potentially market-destroying collapse of Long-Term Capital Management, and the monumental growth in the industry have drawn strong media exposure and have piqued the interest of regulators across the nation. The 1992 Joint Report on the Government Securities Market dedicated seven pages of a nearly 200 page report to a cursory discussion of hedge funds.[2] A decade later, however, the government had commissioned two separate studies just

[1] David Skeel, *Behind the Hedge*, LEGAL AFF., Nov.–Dec. 2005, at 30.

[2] SEC. & EXCHANGE COMMISSION, JOINT REPORT ON THE GOVERNMENT SECURITIES MARKET (1992).

to deal with the growth of hedge funds. The culmination of the government studies resulted in changes to the hedge fund legal landscape. Under a new rule, hedge fund managers were required to register with the Securities & Exchange Commission ("SEC" or "Commission"), a move that required managers to report the financial statements of their funds to the SEC and to adopt more stringent compliance and regulatory controls.[3] The new rule, however, was deemed an arbitrary rule because there was "a disconnect between the [risky] factors the Commission cited and the rule it promulgated[.]"[4] The D.C. Circuit Court therefore vacated and remanded the rule.[5]

This note argues that a registration requirement by the SEC will not provide increased protection—over the fairly comprehensive, already existing body of securities law—to investors, particularly when comparing the effects of imposing new rules on hedge funds with the effects of imposing new rules on mutual funds. More specifically, the current state of the financial and legal regulatory environment, and the types of investment vehicles being scrutinized, are sufficiently different from the state of affairs preceding the first round of regulation. Thus, hedge fund investors will not realize the intended benefits of the regulation. Part II explores in greater detail the growth of the hedge fund industry and defines the term "hedge fund." The legal framework of hedge funds is defined, particularly by delineating how a hedge fund operates within the four major securities acts.[6] Part III presents the text and justifications for the hedge fund rule. The two opinions filed by the dissenting commissioners are analyzed to highlight the potential shortcomings of the new rule. Also, the court

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[3] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279) [hereinafter Final Rule].

[4] Goldstein v. S.E.C., 451 F.3d 873, 882 (D.C. Cir. 2006).

[5] *Id.* at 884.

[6] The four major acts are the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940.

opinion vacating the rule is examined in order to highlight the legal inadequacies of the rule. Part IV compares the current securities marketplace to the marketplace in existence when the major acts regulating mutual funds were established. The purpose and role of mutual funds in the securities markets at the time of the establishment of the acts are compared to the purpose and role of hedge funds today. The effects of the acts on the mutual fund industry are used to predict the effects of the rule on the hedge fund industry. This note argues that a hedge fund registration requirement is inadequate because it is geared towards a different type of investment company—public mutual funds—and is ill-fitting for a more fluid and dynamic contemporary marketplace. Finally, Part V offers proposed solutions to better address the concerns of the SEC in terms of providing more transparency to potential investors and, more importantly, better insulating the market and investors from the potentially crippling effects of hedge fund investment methods in volatile markets.

II. ON HEDGE FUNDS

The spectacular growth of the hedge fund industry has come about as the result of several different economic and legal factors working in fine unison. Understanding these factors provides background and understanding as to why the industry has taken a crucial and important position as a powerful portion of the nation's capital markets. First, the problem with and difficulty of defining hedge funds will be explored. The growth of the hedge fund industry will then be defined in terms of numbers: How did hedge funds start and exactly how much assets under management have shifted into the hands of hedge fund managers? This will be buttressed with an analysis of market factors that have also precipitated the amount of money flowing into hedge funds. Finally, the legal exceptions within securities law that allow hedge funds to remain unregistered and mostly unregulated will be explained.

A. The Problem with Defining Hedge Funds

Defining the hedge fund has been difficult for those who have studied the industry. There is no legal definition of hedge funds, as supported by Roger Lowenstein in his account of the famous meltdown of Long-Term Capital Management: "As far as securities law is concerned, there is no such thing as a hedge fund."[7] He further stated that "[u]nlike mutual funds . . . these partnerships operate in Wall Street's shadows; they are private and largely unregulated investment pools for the rich."[8] In its report, *Implications of the Growth of Hedge Funds*, the SEC even notes the following:

> The term [hedge fund] has no precise legal or universally accepted definition. The term generally identifies an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act.[9]

Additionally, in his comments at an SEC Roundtable on Hedge Funds, David A. Vaughn, a Dechert partner with a focus in hedge funds, submitted a sheet with no less than fourteen different definitions.[10]

Defining a hedge fund is more easily achieved by pointing out the general characteristics that seem to be most uniform across the industry: private nature, small investor base, measurement of returns in absolute figures, great investment flexibility, use of leverage, and use of performance fees

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[7] ROGER LOWENSTEIN, WHEN GENIUS FAILED 24 (2000).

[8] *Id.*

[9] SEC. AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS viii (2003) [hereinafter 2003 REPORT].

[10] David A. Vaughn, Selected Definitions of "Hedge Fund," Securities and Exchange Commission Roundtable on Hedge Funds (May 14-15, 2003), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm.

or allocations.[11] Each of these factors is particularly important in understanding both the huge growth of the industry in the last decade and the Commission's desire to have more control over their operations.

The private nature of a hedge fund generally means that the funds are not registered under the major securities acts; thus, they have greater freedom to pursue more aggressive investment strategies.[12] The greater investment flexibility comes from the fact that hedge funds are not limited by the restrictions on mutual funds, such as diversification requirements and the inability to short-sell.[13] The lack of these restrictions allows and almost incentivizes the hedge fund to leverage itself heavily because the hedge fund can "multipl[y] [its] strength . . . because [leverage] enables you to earn a return on the capital you have borrowed as well as on your own money."[14] Given their financial flexibility, hedge funds in part derive their names from the fact that they can utilize one of approximately thirteen investment strategies in pursuing their investment goals.[15] The final major difference from mutual funds is the performance fee structure used by the fund managers, which is meant to align the incentives of the managers with the objectives of the investors. The fee structure has also served as an impetus for many individuals to shift careers from other sectors of the securities market into hedge funds.[16]

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[11] GERALD T. LINS, THOMAS P. LEMKE, KATHRYN L. HOENIG & PATRICIA SCHOOR RUBE, HEDGE FUNDS & OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 1:1 (2004).

[12] 2003 REPORT, *supra* note 9, at viii.

[13] LINS ET AL., *supra* note 11, § 1:1.

[14] LOWENSTEIN, *supra* note 7, at 27. See also *infra* Part II.D.3.a for a discussion of the exact limitations on investment that registered companies are subject to and that hedge funds, accordingly, avoid.

[15] LINS ET AL., *supra* note 11, § 1:2. *See also* 2003 REPORT, *supra* note 9, at 34-36.

[16] *See* Steve Fishman, *Get Richest Quickest,* N.Y. MAG., Nov. 22, 2004, *available at* http://nymag.com/nymetro/news/bizfinance/finance/features/10426/index.html. Fishman's article, in fact, not only highlights the growth of hedge funds, but reflects the paramount shift in attitude regarding hedge funds on Wall Street.

B. The Growth of the Hedge Fund Industry

Alfred Winslow Jones is credited with establishing the first hedge fund in 1949.[17] Jones first "took two speculative tools, short sales and leverage, and merged them into a conservative investing system. His goal was to shift the burden of performance from market timing to stock picking, and he succeeded."[18] Mutual funds were the "darlings of the era" (1950s and early 1960s), yet Jones outperformed the best mutual fund of that era by 87% over ten years. The popularity of hedge funds took off after these investing results were highlighted in an article in *Fortune* magazine in 1966.[19] With the article serving as a catalyst for investors seeking out greater returns during a raging bull market, the Commission estimated that by 1968, nearly 140 hedge funds existed.[20] The number of hedge funds moved in direct correlation to the market, decreasing when the market contracted in the 1970s and increasing when the market grew in the 1980s.[21]

In 1990, there were about 300 hedge funds with $39 billion under management.[22] By 2003, the SEC Staff Report on Hedge Funds estimated that the number had grown to "6000 to 7000 [hedge funds] . . . managing approximately $600 to $650 billion in assets," a twenty-fold growth in the number of hedge funds and nearly a sixteen-fold growth in the amount of assets under management.[23] The report also estimated that "in the next five to ten years, hedge fund assets [are] predicted to exceed $1 trillion."[24] A year after

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[17] TED CALDWELL & TOM KIRKPATRICK, A PRIMER ON HEDGE FUNDS 5 (1995).

[18] *Id.* at 6. The investing strategies of hedge funds will be explored in greater detail in Part II.D, The Legal Definition of Hedge Funds.

[19] *Id.* at 8.

[20] *Id.*

[21] *Id.* at 9.

[22] Skeel, *supra* note 1.

[23] 2003 REPORT, *supra* note 9, at vii.

[24] *Id.* In contrast, by the end of 2004, mutual funds had over $8 trillion of assets under management. THE INVESTMENT COMPANY INSTI-

the report, there was an estimated 8000 funds with over $850 billion of assets under management; most recent estimates reveal that the $1 trillion mark has been reached.[25]

The growth in hedge funds was not only funded by Wall Street. Starting in the late 1990s, articles dealing with the "pedestrianization" of the hedge fund industry began appearing almost daily in major periodicals.[26] In 2000, a LexisNexis search of major U.S. newspapers produced 2157 articles that used the term "hedge fund."[27] By 2006, the same search yielded 10,462 results, with 2740 of those results coming in the last quarter of the year alone.[28] The exponential increase in media exposure for hedge funds reflects the growing influence and popularity of the investment groups.

C. Market Factors Fueling Growth

Stocks have been the best performing asset class since significant recording was started.[29] In fact, from 1926-1999, small stocks (Russell 2000 members) returned an average of 18.81% and large stocks (S&P 500 members) returned 13.11%, while long-term treasury bonds returned 5.36% and treasury bills returned 3.82%.[30] As a result of the clearly superior historic results, the hedge fund's investment of

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TUTE, *Table 1: U.S. Mutual Fund Industry Total Net Assets,* INVESTMENT COMPANY FACT BOOK: 2005 59, *available at* http://www.ici.org/factbook/.

[25] *Testimony Concerning Investor Protection & the Regulation of Hedge Funds Advisers Before S. Comm. on Banking, Housing and Urban Affairs,* 108th Cong. (2004) (statement of William H. Donaldson, Chairman, Securities & Exchange Commission), *available at* http://www.sec.gov/news/testimony/ts071504whd.htm. *See also* Skeel, *supra* note 1, at 30.

[26] James R. Hedges, IV, *The Pedestrianization of the Hedge Fund Industry*, TR. & EST. 62 (1998).

[27] LexisNexis search "Hedge Fund" for "major newspapers" date from 1/1/2000 to 12/31/2000.

[28] LexisNexis search "Hedge Fund" for "major newspapers" date from 1/1/2006 to 12/31/2006; date from 10/1/2006 to 12/31/2006.

[29] ZVI BODIE, ALEX KANE & ALAN J. MARCUS, INVESTMENTS 139 (2002).

[30] *Id.*

choice has been stocks. The sustained returns that individuals earn have provided an impetus for individuals to continuously pour their assets into the stock market in order to seek excess returns.

In the late 1990s, the U.S. stock market began to rise spectacularly in what is dubbed the "millennium boom."[31] In approximately five years, the U.S. stock market in 2000 peaked at a level more than three times higher than 1995 levels.[32] Further, the average U.S. household net worth increased from $237,700 in 1995 to $380,100 in 2001, stemming mostly from stock market appreciation.[33] Average financial net worth increased during the same years from $182,400 to $298,500.[34] Put another way, from 1991 to 2001, total household wealth tripled from $13 trillion to more than $40 trillion.[35] Additionally, the number of millionaires in the United States grew from 3.6 million to 7.2 million during the same period.[36] These statistics indicate a number of important changes in the investor marketplace for high net-worth individuals. First, with a nearly 60% increase in net worth in just six years, the physical amount of money that needed to be invested increased significantly.[37] Further, with the increase in financial wealth, newly minted millionaires could

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[31] ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 6 (2d ed. 2005).

[32] *Id.* at 4.

[33] Edward N. Wolff, *Changes in Household Wealth in the 1980s and 1990s in the U.S.* (Levy Inst. of Econ. at Bard Coll., Working Paper No. 407, 2004), *available at* http://www.levy.org/pubs/wp/407.pdf.

[34] *Id.* at 29.

[35] Paul Z. Pilzer, *The Next Millionaires*, DIRECT SELLING NEWS, June 2005, at 42, *available at* http://www.paulzanepilzer.com/TNM-June2005-Article%5B1%5D.pdf.

[36] *Id.*

[37] It is important to note that the increase in *financial* wealth is relevant here. Although the increase in net worth also grew by approximately the same amount, financial net worth provides a more accurate indicator of money seeking investment since it is liquid and not necessarily tied to real estate appreciation and other types of net worth increases.

now afford the substantial initial investments typically required by hedge funds.[38]

Another equally important market development in the past few years has been the substantial increase in U.S. housing prices across the nation. From 1997 to 2004, real home prices increased 52% as a whole.[39] The United States has only witnessed such substantial price increases one other time in history, after World War II.[40] In hot markets like Boston, New York, and Los Angeles, housing prices have nearly doubled in the five years since 2000.[41] Housing turnover, or the percentage of existing homes being sold as part of the housing inventory, has increased substantially to nearly 8%; this is almost a 33% increase in just five years.[42] The housing "bubble" has received virtually the same amount of media attention as the hedge fund boom in the past few years and has substantially increased wealth across the nation. The amount of turnover and new home starts indicate that Americans have been using their real estate to pull additional capital into their pocketbooks.[43] Thus, while the nation was reeling from the effects of the millennium boom, the housing market again provided abnormally large average returns that provided even more financial wealth for individuals to invest.

The sustained growth of the late 1990s caused a psychological shift in the expectations of investors. Given the general human tendency towards overconfidence, the

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[38] Initial investment requirements tend to be at least $1 million. Julian Delasantellis, *Hedge Funds: Playing Dice with the Universe*, ASIA TIMES ONLINE, July 6, 2006, *available at* http://www.atimes.com/atimes/Global_Economy/HG06Dj02.html.

[39] SHILLER, *supra* note 31, at 12.

[40] *Id.* at 13.

[41] *Id.* at 18.

[42] PATRICK FRANKE, THE US HOUSING MARKET: CAVEAT EMPTOR? PART 1 4 (2005), *available at* https://www.commerzbank.com/research/economic_research/pool/researchnotes/resnote_0506II.pdf.

[43] Frederick H. Lowe, *Equity Loans Still Cutting into Profits; Home Equity Loans Continue to Reshape Consumers' Strategies for Paying off Debt. Is There Hope for Issuers Seeking More Interest Revenue?*, CARDS & PAYMENTS, Aug. 1, 2006.

stock market boom of the 1990s provided ample evidence to support this overconfidence and also pushed the reasonable psychological anchors of "good" market returns even higher.[44] In other words, expecting returns far above historic market averages was an expected norm for future investments. In a questionnaire that asked, "When you think of the good life . . . which of the things on this list, if any, are part of that good life, as far as you personally are concerned[?]," 63% of respondents picked "a lot of money" in 1994, versus 38% in 1975.[45] Shiller identifies a number of factors that have increased upward pressure on markets and produced unreasonable investor expectations: the capitalist explosion, supportive monetary policy, the baby boomer effect on markets, an expansion in media reporting of business news, and the expansion of the volume of trade.[46] In conclusion, an extraordinary run-up in both the stock market and real estate prices has minted many new millionaires and effected a psychological shift in the marketplace that has made hedge funds more in vogue.

D. The Legal Definition of Hedge Funds

The statutory framework for the securities industry is mostly defined by four major statutes: the Securities Act of 1933 ("Securities Act"),[47] the Securities Exchange Act of 1934 ("Exchange Act"),[48] the Investment Company Act of 1940 ("Investment Company Act"),[49] and the Investment Advisers Act of 1940 ("Advisers Act").[50] While each of these acts pulls

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[44] SHILLER, *supra* note 31, at 142 (Shiller devotes an entire section to overconfidence, noting that "it is important to bear in mind that there appears to be a pervasive human tendency toward *overconfidence* in one's beliefs.") (emphasis added).

[45] *Id.* at 22.

[46] *Id.* at 33-53.

[47] 15 U.S.C. §§ 77a–77aa (2005) [hereinafter Securities Act].

[48] 15 U.S.C. §§ 78a–78*lll* (2005) [hereinafter Exchange Act].

[49] 15 U.S.C. §§ 80a-1 to § 80a-64 (2005) [hereinafter Investment Company Act].

[50] 15 U.S.C. §§ 80b-1 to § 80b-21 (2005) [hereinafter Investment Advisers Act].

the majority of securities investors and advisers under the authority of the Commission, hedge funds generally operate in the nebulous area surrounding all of these acts, thus avoiding registration.[51]

1. The Securities Act of 1933

The Securities Act was created to protect investors, but also to "promote efficiency, competition, and capital formation."[52] Further, one of the Securities Act's "primary objectives is to provide full and fair disclosure in securities transactions."[53] Under the Securities Act, anyone that wishes to make a public offering of securities must file a statement with the SEC.[54] To avoid this registration, hedge funds use the private offering exemption in Section 4(2) or Rule 506 of Regulation D.[55] Section 4(2) simply states that a transaction by an issuer that does not involve a public offering is exempted from the provisions of Section 5.[56] The usage of this provision is restricted, however, because the Supreme Court ruled that a private offering is "limited to situations where the offerees have access to the kind of information afforded by registration under Section 5 of the Securities Act."[57]

Rule 506 of Regulation D relies on the private exemption afforded by Section 4(2), whereby satisfaction of the conditions of Rule 506 entitles the issuer to claim a Section 4(2) exemption.[58] Many hedge funds rely on Rule 506 because it affords greater certainty than relying solely on Section 4(2).[59] A private offering exemption is available to

[51] 2003 REPORT, *supra* note 9, at viii.

[52] Securities Act § 77b(b).

[53] 2003 REPORT, *supra* note 9, at 13.

[54] Securities Act § 77e. The registration can include items such as a prospectus regarding the securities and the issuer. *See* Securities Act § 77j.

[55] 2003 REPORT, *supra* note 9, at 14.

[56] Securities Act § 77d(2).

[57] 2003 REPORT, *supra* note 9, at 14.

[58] *Id.*

[59] *Id.*

issuers that make an offering to "accredited investors" and do not participate in "general solicitation or advertising."[60] Accredited investors include:

> Individuals who have a net worth, or joint worth with their spouse, above $1,000,000, or have income above $200,000 in the last two years (or joint income with their spouse above $300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and
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> Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than $5,000,000 in assets; and many, if not most, employee benefit plans and trusts with more than $5,000,000 in assets.[61]

The thirty-five purchaser limitation delineated in Rule 506 does not apply to accredited investors.[62] Importantly, "if the offering is made only to accredited investors, no specific information is required to be provided to prospective investors."[63] Finally, there is a limitation on resale by investors in a private offering, but this ordinarily presents no problem for hedge funds since the managers do not encourage resale and require written consent prior to resale.[64]

The restrictions on "general solicitation or advertisement" limit the issuer from publishing advertisements or articles in any newspaper, magazine, or other similar media, and

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[60] *Id.* at 14-16. *See* 17 C.F.R. § 230.501 (2006) for "accredited investors." *See also* 17 C.F.R. § 230.502(c) (2006) for the limitation on "general solicitation."

[61] 2003 REPORT, *supra* note 9, at 15. *See* 17 C.F.R. § 230.501(a) (2006).

[62] 17 C.F.R. § 230.501(e)(1)(iv) (2006).

[63] 2003 REPORT, *supra* note 9, at 15.

[64] *Id.* at 17-18.

broadcasting advertisements over television or radio.[65] Seminars and other meetings open to the public are also forbidden.[66] More recently, the Commission has issued a release regarding the Internet to make sure that Internet usage by issuers is sufficiently limited and does not constitute solicitation.[67]

2. The Securities Exchange Act of 1934

The Exchange Act was enacted to "protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions."[68] Under the Exchange Act, some hedge funds may be required to register with the SEC as dealers.[69] A dealer is defined in the Exchange Act as "any person engaged in the business of buying and selling securities for such person's own account . . . ."[70] As noted in the SEC report, "[t]he Commission . . . has distinguished 'dealers' from 'traders' . . . . Entities that buy and sell securities for investment generally are considered traders, but not dealers . . . . [T]here is no registration requirement for traders."[71]

Section 12 may also require hedge fund managers to register the funds with the Commission. Section 12 requires registration for an issuer whose assets are held by more than 500 persons.[72] Therefore, to avoid registration under these provisions, hedge funds ordinarily limit the number of equity holders to a maximum of 499.[73]

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65 17 C.F.R. § 230.502(c)(1) (2006).

66 *Id.* § 230.502(c)(2).

67 *See* Use of Electronic Media, Securities Act Release No. 7856, 65 Fed. Reg. 25,843 (May 4, 2000). *See also* 2003 REPORT, *supra* note 9, at 17.

68 Exchange Act § 78b.

69 2003 REPORT, *supra* note 9, at 18.

70 Exchange Act § 78c(a)(5).

71 2003 REPORT, *supra* note 9, at 18.

72 Exchange Act § 78l(g)(1)(B) (internal quotation marks omitted).

73 2003 REPORT, *supra* note 9, at 19.

In addition, beneficial ownership may trigger SEC reporting requirements. Under Sections 13(d) and 13(g), an individual who acquires five or more percent of any class of registered securities must file a beneficial ownership statement with the Commission and the issuer of the security.[74] The statement under 13(d) requires more extensive detail than 13(g) by requiring items such as the identity of the owner,[75] the source and amount of funds used in making the purchases,[76] the purposes in acquiring the security, and any potential plans to liquidate the security purchased.[77] Similar reporting is required for beneficial owners of ten or more percent of any class of registered securities under Section 16.[78]

3. The Investment Company Act of 1940

The Investment Company Act was enacted seven years after the first major securities acts of the nation. The stated policy indicates that the Investment Company Act was as much an attempt to protect the national interest as it was a realization and affirmation by Congress that investment companies had become the "media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets."[79] In terms of policy alone, it would seem that hedge funds fall directly under the regulatory framework of the Investment Company Act. Indeed, the definition of an investment company under the Investment Company Act, which includes any issuer 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,"[80] quite clearly seems to include

[74] *See* Exchange Act §§ 78m(d), 78m(g).

[75] *Id.* § 78m(d)(1)(A).

[76] *Id.* § 78m(d)(1)(B).

[77] *Id.* § 78m(d)(1)(C).

[78] 2003 REPORT, *supra* note 9, at 20.

[79] Investment Company Act, 15 U.S.C. § 80a-1(a)(4) (2005).

[80] *Id.* § 80a-3(a)(1)(A).

hedge funds. Thus, hedge funds rely upon the Act's exceptions to escape registration.

Hedge funds primarily rely upon two different statutory exclusions within the Investment Company Act to avoid the regulatory provisions.[81] Under Section 3(c)(1), an issuer is exempted from the provisions of the Investment Company Act if its outstanding securities are beneficially owned by less than 100 persons and if the issuer does not plan to make a public offering of its securities.[82] If a beneficial owner owns less than 10% of the issuer's securities and is an investment company under Section 3(c)(1) or 3(c)(7), then the beneficial owner will be treated as a single owner of the shares in the fund.[83] Importantly, the exception in Section 3(c)(1) reflected Congress's view that private investment companies with limited investors do not require regulation.[84]

The other exclusion that most hedge funds rely upon is Section 3(c)(7). Under this section, investment companies that do not make a public offering and whose securities are owned exclusively by qualified purchasers are excluded from regulation.[85] Importantly, a qualified purchaser is defined as:

> [A]ny natural person . . . who owns not less than $5,000,000 in investments, as defined by the Commission; any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse . . . [; or] any person acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.[86]

[81] 2003 REPORT, *supra* note 9, at 11.

[82] Investment Company Act § 80a-3(c)(1).

[83] *Id.* § 80a-3(c)(1)(A). This was modified by the new rule.

[84] 2003 REPORT, *supra* note 9, at 11-12.

[85] Investment Company Act § 80a-3(c)(7)(A).

[86] *Id.* § 80a-2(a)(51)(A)(i)-(iv).

Thus, under Section 3(c)(7), a hedge fund is actually free to accept as many qualified purchasers as it desires.[87] For all intents and purposes, however, the size of the hedge fund is generally limited to less than 500 to avoid registration under the Exchange Act.[88] Another important caveat is that Section 3(c)(7) limits "look-through" requirements to situations where the investment company was "formed for the purpose" of investing in the Section 3(c)(7) fund, in which case the fund must determine whether that company's investors are qualified purchasers.[89]

The second prong of both Section 3(c)(1) and 3(c)(7) exceptions, which requires no public issuance, ties in succinctly with and is identical to the requirement under the Securities Act that the placement of securities be private and not public. In practice, the interpretation of "public offering" under Section 3(c)(1) is the same as the interpretation in Section 4(2) of the Securities Act; further, Congress has indicated that the meaning of public offering under Section 3(c)(7) should be interpreted in a similar manner.[90]

a. Investment Strategies Disallowed for Registered Investment Companies

Avoiding registration under the Investment Company Act permits hedge funds to avoid a number of restrictions on the types of investments permissible under the Act. For example, the very name "hedge" speaks to the fact that the fund hedges against the market and seeks absolute returns, regardless of market direction.[91] However, the Investment Company Act essentially prohibits any sort of investment

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[87] 2003 REPORT, *supra* note 9, at 13.

[88] *Id.*

[89] *Id.* (quoting Rule 2a51-3 of the Investment Company Act). In the case that the company was created for the purpose of specifically acquiring shares in a fund excluded under Section 3(c)(7), then each beneficial owner of the company must be a qualified purchaser. 17 C.F.R. § 270.2a51-3 (2005).

[90] *See* Privately Offered Investment Companies, 62 Fed. Reg. 17,512 (Apr. 9, 1997) (to be codified at 17 C.F.R. pt. 270).

[91] LINS ET AL., *supra* note 11, § 1:1.

strategies that would be considered "excessively risky." The limitations on types of strategies were intended to restrict the volatility of the investments and provide the average investor—who was not expected to possess expert financial acumen—with a smoother, albeit potentially lower, return.[92] Hedge funds were exempted because the sophisticated investor was presumed to be aware of the risks and chose to assume those risks. The major limitations on incurring risk are that registered open-ended investment companies that leverage themselves must have 300% asset coverage, cannot purchase on margin, and cannot effect short sales of any security unless they are underwriting the security.[93] In other words, registered investment companies are barred from using leverage for investment purposes in virtually any form.

Additionally, avoiding registration gives a hedge fund flexibility. A registered investment company is required to obtain a majority vote of its shareholders to effect any change in investment policy, including changing the classification of the fund,[94] borrowing money, issuing or underwriting securities,[95] and changing its concentration of investments.[96] Thus, a registered company is strongly limited to operating within the sphere of investments that it originally established at its creation and is less able to modify its investments quickly in response to market conditions. Hedge funds successfully avoid all of these restrictions.

[92] BODIE ET AL., *supra* note 29, at 189 (describing how leverage is employed to boost returns beyond the expected return of an unleveraged position).

[93] Investment Company Act §§ 80a-12(a)(1), 80a-18(a)(1)(A), 80a-12(a)(3). Underwriting abilities are also limited for registered companies. *See id.* § 80a-12(c).

[94] *Id.* § 80a-13(a)(1).

[95] *Id.* § 80a-13(a)(2).

[96] *Id.* § 80a-13(a)(3).

4. The Investment Advisers Act of 1940

Almost all hedge fund managers fall under the heading "investment adviser," as defined in the Advisers Act. An investment adviser is defined as a person:

> [W]ho, 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.[97]

An investment adviser must register with the SEC if he has greater than fifteen clients[98] or more than $25 million in assets under management.[99] Registered advisers are required to maintain a Form ADV—the mandatory disclosure form filed by investment advisers with the SEC—with the Commission that discloses current information regarding business practices and disciplinary action.[100] Also, registered advisers must maintain required books and records and submit to periodic examinations by the Commission.[101]

Hedge fund advisers avoid registration by relying on the Advisers Act's *de minimis* exemption.[102] Before the rule modification, an adviser was permitted to count a legal organization as a single client and could, accordingly, manage fourteen unique hedge funds without concern for the number of investors that constituted each hedge fund.[103] The

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[97] Investment Advisers Act, 15 U.S.C. § 80b-2(a)(11) (2005).

[98] *Id.* § 80b-3(b)(3).

[99] *Id.* § 80b-3a(a)(1)(a).

[100] 2003 REPORT, *supra* note 9, at 20-21. See 17 C.F.R. 275.203-1 (2005), for Form ADV requirements. *See also* 17 C.F.R. 275.204-1 (2005).

[101] 2003 REPORT, *supra* note 9, at 21. See Investment Advisers Act § 80b-4, for reporting requirements.

[102] 2003 REPORT, *supra* note 9, at 21. Under § 80b-3(b)(3), as previously mentioned, any adviser with less than fifteen clients does not have to register with the SEC.

[103] *Id.* See also Rules Implementing Amendments to the Investment Advisers Act of 1940, 62 Fed. Reg. 28112, 28124 n.132 (May 22, 1997) (to

other major portion of the Advisers Act allows advisers in private investment companies to charge a performance fee.[104]

III. THE HEDGE FUND RULE

The enactment of the hedge fund rule, which required the registration of hedge fund advisers, was a highly debated and controversial issue that sparked a significant response from the financial and legal communities.[105] The rule went through an expedited process of approval: the initial proposal was published on July 28, 2004, the comment period ended on September 15, 2004, and the final rule was passed and published on December 10, 2004.[106] The rule was vacated and remanded to the SEC for revision by the D.C. Circuit Court on June 23, 2006.[107] The SEC has chosen not to seek review of the decision.[108]

A. Reasons for Commission Action

Hedge funds became more prominent in the investment community in the 1990s with the Titanic-like collapse of Long-Term Capital Management ("LTCM").[109] LTCM was a

be codified at 17 C.F.R. pts. 275, 279), for the exact amendment that reflects the fact that legal organizations prior to the recent modification were treated as a single entity with no look-through. The new rule modified this definition and required a "look-through" of each fund to the investors constituting the fund.

[104] Investment Advisers Act § 80b-5(a).

[105] Final Rule, *supra* note 3, at 72,058. During the comment period, the SEC received 161 comment letters from investors, hedge fund advisers, other investment advisers, trade associations, and law firms. Of those letters, forty-two commenters expressed no view on the registration requirement and thirty-six endorsed the registration requirement. *Id.* By implication, the remainder of the letters (eighty-three) indicated that the commenters were opposed to the registration requirement.

[106] Final Rule, *supra* note 3, at 72,090 n.5.

[107] Goldstein v. S.E.C., 451 F.3d 873 (D.C. Cir. 2006).

[108] SEC, Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in Phillip Goldstein, et al. v. SEC, (Aug. 7, 2006), *available at* http://www.sec.gov/news/press/2006/2006-135.htm.

[109] *See* THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL

hedge fund built on the strong reputations of its principals and the amazing complexity of its strategies.[110] At the beginning of its downfall, LTCM had nearly $4.1 billion in capital that was almost completely owned by the principals.[111] During August and September of 1998, LTCM saw its fund melt down to virtual default before being bailed out by the major Wall Street banks and the U.S. government.[112] The real danger of LTCM was that its total over-the-counter derivatives positions at the end of 1998 (even after the meltdown) added up to $1.5 *trillion*.[113] LTCM had taken large positions using complicated derivatives products in Russian debt. When Russia defaulted on its debt, the positions—all legally taken and supported by major financial institutions—came due with LTCM being liable for that $1.5 trillion. LTCM lacked those funds or anything marginally near that amount.[114] Since the default of LTCM on such large contracts could have derailed the entire world's financial markets, the U.S. government launched an investigation into the matter.[115] It is important to note that LTCM was not entirely to blame because banks were willing to extend substantial credit to the fund without adequate due diligence and capital adequacy checks.[116] The implication of the LTCM debacle is that hedge funds employing unchecked leverage have the potential to stall and disrupt world financial markets.

In its 2003 report, the SEC cited a number of concerns that arose in connection with the growth of hedge funds,

MANAGEMENT 10 (1999) [hereinafter 1999 REPORT], *available at* http://www.ustreas.gov/press/releases/report3097.htm.

[110] *Id.* at 10. Indeed, one of the board members, Myron Scholes, won the Nobel Prize in Economics in 1997 for his Black-Scholes model of options pricing.

[111] *Id.* at 12; *see also* LOWENSTEIN, *supra* note 7, at 219.

[112] 1999 REPORT, *supra* note 109, at 13-14.

[113] *Id.* at 29.

[114] *Id.* at 12-13.

[115] *Id.* at ii.

[116] *Id.* at 14.

including a lack of Commission regulatory oversight,[117] the retailization of hedge funds,[118] inadequate disclosure,[119] and the advisers' conflict of interests.[120] In essence, the concerns were split into two camps: (i) the Commission's lack of knowledge and inability to regulate or investigate the funds and (ii) the Commission's inability to protect less sophisticated investors who buy into the funds not fully aware of the danger of default from the risks of hedge funds (both market and fraud). In the final rule, the SEC cited these reasons for adopting the registration requirement.

There is one important distinction that the SEC never truly addressed in any of its releases about protecting investors. Namely, which investors did the SEC seek to protect? If it sought to protect *all* investors, then its position seemed to contradict its stance prior to the amendment, where it clearly exempted sophisticated investors. The hedge fund rule did not maintain the carveout; all hedge funds with all types of investors were susceptible to the rule's requirements. Although the Commission never actually acknowledged the distinction, the assumption, at least from its concerns about "retailization," would seem to indicate that it was worried about the less sophisticated investors that may now be investing in hedge funds. This was further evidenced by the Commission's continued exemption for high net worth, sophisticated investors.

More specifically, the SEC first cited the need for "census information" regarding the hedge fund industry. The Commission intended to use the required Form ADV to gather data about the operation of hedge fund managers in order to

[117] 2003 REPORT, *supra* note 9, at 76. This lack of oversight was manifested both in the "[i]nability to [d]etect [f]raud and [o]ther [m]isconduct at [e]arly [s]tages" and in the "lack of information available about hedge funds and [hedge fund advisers]." *Id.* at 76-77.

[118] *Id.* at 80. Retailization occurs when "as a result of the growth of hedge funds, or otherwise, significant numbers of less sophisticated investors [begin] investing in hedge funds." *Id.*

[119] *Id.* at 83. Disclosure in this instance refers specifically to the mandatory disclosures that the investment advisers must make to their investors.

[120] *Id.*

plan its policies and create a database of relevant information.[121] The Commission stated that no government agency had any reliable data regarding the industry and that using current statutory filings (such as transaction reports and broker-dealer reports) would have been too time-consuming for the staff to analyze.[122]

The Commission also believed that by requiring registration, which made advisers susceptible to examinations, more advisers would be deterred from committing fraud.[123] The Commission justified its position by relying on an economic principle which states that a sufficient amount of random examinations could create a net economic benefit through an increase in the magnitude of deterrence.[124] By requiring registration, the Commission intended to deter all types of fraud committed in the hedge fund realm, including misrepresentation, misappropriation of assets, and misleading disclosures.[125]

Finally, one of the Commission's ultimate concerns was to limit the retailization effect. The retailization of hedge funds was established by the increased investment by pension funds, endowments, universities, and other major institutional investors.[126] The assets of these larger investors may potentially be at risk, putting their ability to deliver the benefits promised to their constituencies in jeopardy. Another manifestation of retailization that occurred was through the establishment of "funds of funds."[127] These funds can be registered companies that pool assets together and then invest those assets into a hedge fund. With much lower buy-ins, the fund of funds extends the opportunity to invest in hedge funds to those who may not meet the statutory requirements for outright investment into the hedge fund and who are not deemed sophisticated by the

[121] Final Rule, *supra* note 3, at 72,061.

[122] *Id.*

[123] *Id.*

[124] *Id.* at 72,062.

[125] *Id.* at 72,062-63.

[126] *Id.* at 72,057-58.

[127] *Id.* at 72,057.

Commission. The limit on funds of funds occurs indirectly through Rule 205-3.[128] Rule 205-3 requires that the investors in a registered private investment company have a net worth of $1.5 million or else have at least $750,000 under management of the adviser in order for the adviser to receive a performance fee.[129]

B. Amendments

Two main amendments to the Investment Advisers Act effectively forced hedge fund advisers to register with the SEC. The first major amendment dealt with the definition of the term "client" and modified Rule 203(b)(3)-2. The rule required that advisers look through each investing fund and count each owner or shareholder of a private fund as an investor in the hedge fund.[130] This effectively rid the hedge fund adviser of the ability to rely on the private adviser exemption previously available when the fund was considered a single entity.[131] Equally important is the fact that if one of the investors was a registered investment company, then that entity could not be counted as a single entity. Rather, if the owner was a registered investment company, then the hedge fund was required to count each owner of the investment company as a client.[132] Rule 203(b)(3)-2 did not modify, however, the "minimum assets under management" requirement.[133] Also, advisers of publicly offered offshore funds would not have been required to register in the United States if they were registered in their country of origin.[134]

The other major amendment was to the definition of "private fund." To prevent every fund from having to look

[128] *Id.* at 72,064.

[129] 17 C.F.R. §§ 275.205-3(d)(1)(i), 275.205-3(d)(1)(ii)(A) (2006).

[130] 17 C.F.R. § 275.203(b)(3)-2(a) (2006) (invalidated by Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006)).

[131] Final Rule, *supra* note 3, at 72,070.

[132] 17 C.F.R. § 275.203(b)(3)-2(b) (2006).

[133] 17 C.F.R. § 275.203(b)(3)-2 (2006).

[134] Final Rule, *supra* note 3, at 72,072.

through "every business or other legal organization," the Commission only required that "private funds," defined by three common elements of hedge funds, look through their investors.[135] First, a private fund must have been classified as such by either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.[136] Second, a private fund must have permitted its owners to redeem any portion of their interests within two years of purchase.[137] Finally, the interests in the fund must have been offered based on the investment advisory skills or expertise of the investment adviser.[138] The Commission believed that these three characteristics fundamentally defined a hedge fund and "differentiat[ed] [them] from other pooled investment vehicles such as private equity funds or venture capital funds."[139] The rest of the amendments to the rules were meant to deal with compliance in recordkeeping and administrative tasks.[140]

In its cost-benefit analysis, the SEC clearly found that the value of implementing these rules outweighed the potential costs of implementation and compliance.[141] The Commission focused strongly on the fact that it had brought fifty-one fraud cases against hedge funds in the five years preceding the adoption of the final rule, representing aggregate losses of nearly $1.1 billion.[142] It valued the costs of implementation to be approximately $50,000 per hedge fund for professional fees and internal costs.[143] It also valued the

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[135] *Id.* at 72,073.

[136] 17 C.F.R. § 275.203(b)(3)-1(d)(1)(i) (2006).

[137] 17 C.F.R. § 275.203(b)(3)-1(d)(1)(ii) (2006).

[138] 17 C.F.R. § 275.203(b)(3)-1(d)(1)(iii) (2006).

[139] Final Rule, *supra* note 3, at 72,073 (footnotes omitted).

[140] See 17 C.F.R. § 275.204-2 (2006) for recordkeeping modifications. See 17 C.F.R. § 275.205-3 (2006) for grandfather provision allowing hedge funds to reconcile their accounts. See also 17 C.F.R. § 275.206(4)-2 (2006) for amendment allowing time to complete audit work for advisers of funds of funds that deliver audited material to investors.

[141] Final Rule, *supra* note 3, at 72,078-82.

[142] *Id.*

[143] *Id.* at 72,081.

annual ongoing cost of compliance to be between $25,000 and $50,000.[144]

C. Dissent of Commissioners Cynthia Glassman and Paul Atkins

Commissioners Glassman and Atkins, in a rare move, filed a dissent to the rule and protested both the reasoning and the workings of the rule as unjustified and overly burdensome, given the outcomes the Commission hoped to reach. The dissent took issue with all parts of the majority's reasons for adopting the rule.

First, the dissent observed that the information that the Commission sought to gather could be obtained from other sources. The chosen method of collection, Form ADV, would not provide the information necessary for the Commission to make meaningful policy determinations regarding asset allocations, investment strategies, and other in-depth financial decisions. Additionally, the dissenters argued that the information collection should have been coordinated with other regulators, such as the Department of Treasury, for efficiency and to prevent duplicity.[145] Further, the commenters to the rule displayed a willingness to assist with information gathering, rather than to require registration. As a starting point, the dissent wanted the Commission to increase its oversight of existing registrants.[146]

The dissent also believed that the rule did not genuinely address the concerns that inspired its adoption. The dissent argued that mere growth of an industry did not necessarily imply the need for greater regulation.[147] The dissent essentially noted that while substantial growth has occurred, retailization was much less dramatic than the majority claimed. To substantiate that claim, the dissent observed that only 1% of the pension funds' $6.4 trillion in assets was

[144] *Id.* at 72,082.

[145] *Id.*

[146] *Id.* at 72,091.

[147] *Id.*

invested in hedge funds.[148] Moreover, the retailization had itself inspired greater self-regulation because competitiveness in the marketplace had already placed a premium on advisers that offer extensive due diligence and high quality monitoring.[149] Conversely, the rule's effect may have been to catalyze retailization because it would have created an air of safety with the SEC's stamp of approval.[150]

The dissent also argued that this sort of regulation would not have prevented the fraud that did occur and particularly took issue with the fact that the bulk of the cases cited by the majority were market timing cases.[151] Even if the examinations would have proven effective in deterrence, the deterrence effect was muted by the public fact that the SEC lacked the resources to conduct the quality and quantity of examinations necessary to sufficiently deter. The dissent took a broad view of the SEC's enforcement resources and noted that with the passage of the rule there would be approximately 200,000 high net worth investors of hedge funds that would have consumed a substantial portion of the SEC's limited regulatory resources.[152] Finally, the dissent claimed that the majority's rule strayed from statutory precedent.[153]

D. The D.C. Circuit's Rejection of the Hedge Fund Rule

In late June 2006, the D.C. Circuit issued its opinion in *Goldstein v. SEC*, a case that a hedge fund adviser brought against the Commission.[154] The petitioners challenged the Commission's equation of the term "client" with "investor." Relying on a number of cases, the Commission argued that

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[148] *Id.* at 72,093.

[149] *Id.* at 72,094.

[150] *Id.* at 72,096.

[151] *Id.* at 72,092. Market timing cases are controversial in and of themselves because the action of the hedge funds was legally permissible.

[152] *Id.* at 72,093-94. In contrast, there are ninety million mutual fund investors. *Id.*

[153] *Id.*

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

since "client" has never been defined, the Commission had the power to define "client" as it deemed necessary.[155] The court, however, rejected both the Commission's authority to define the term "client" as such in light of precedent, and also highlighted some of the possible legal confusion that had been caused by the redefinition. Specifically, the court noted that clients are owed a fiduciary duty by advisers and that the SEC's rule created the assumption that the adviser would now, in a strong break from precedent, owe a fiduciary duty to each individual investor.[156] The court highlighted the Commission's aforementioned inconsistency and rejected the Commission's attempt to overcome the fiduciary duty conflict by limiting the new client definition to counting investors.[157] As the court succinctly summarized, "[i]f there are certain characteristics present in some investor-adviser relationships that mark a 'client' relationship, then the Commission should have identified those characteristics and tailored its rule accordingly."[158] Finally, the court also acknowledged that the Commission's attempt to regulate hedge funds by relying on the number of investors in the fund was a faulty measure of the fund's activities:

> The number of investors in a hedge fund—the "clients" according to the Commission's rule—reveals nothing about the scale or scope of the fund's activities. It is the volume of assets under management or the extent of indebtedness of a hedge fund or other such financial metrics that determines a fund's importance to national markets.[159]

IV. COMPARING HEDGE FUND REGULATION TO MUTUAL FUND REGULATION

By enacting the hedge fund registration rule, the Commission sought to subject hedge funds to the same sort

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[155] *Id.* at 878.

[156] *Id.* at 880.

[157] *Id.* at 882.

[158] *Id.* at 883.

[159] *Id.*

of regulations as mutual funds. Admittedly, while the investing limitations of mutual funds do not apply to hedge funds, the registration, compliance, bookkeeping, and auditing requirements are identical. Therefore, to evaluate the effectiveness of the hedge fund rule, it is best to compare the regulatory and economic environments of hedge funds and mutual funds before, during, and after the passage of the regulation.[160] Since the hedge fund rule has now been enacted and subsequently vacated, the predicted effects of the rule, derived from an analysis of the mutual fund industry, will be compared to the actual initial response of the hedge fund industry. The industry's reaction after the rule was vacated will also be presented. Finally, some solutions will be suggested that may address the Commission's concerns more effectively without placing such a burden on the entire hedge fund industry.

A. The Conditions Preceding Regulatory Action for Mutual Funds

The conditions preceding the stock market crash of 1929 were the result of the barren regulatory and legal landscape, which provided no safeguards against deceit and instilled no fairness into the market. The "booming twenties" was a time when the nation's prosperity was taking off, as new financial instruments were being introduced to the public for the first time.[161] Unbridled speculation in the stock market was reaching its crest in the 1920s as a result of the post-war influx of wealth.[162] Wall Street still focused virtually all of its efforts on institutional investors, but, for the first time, began to simultaneously target the retail public for

[160] In this case, the mutual fund regulation dealt with will be both the Investment Company Act and the Investment Advisers Act. The two Acts were simultaneously pursued and even the Senate Subcommittee Hearings prior to enactment deliberated about the two Acts together because of their interconnectedness. *See* Silver *infra* note 180.

[161] CHARLES R. GEISST, WALL STREET: A HISTORY 157-59 (1997) (describing how Wall Street shifted its focus primarily from institutional investors to the average public investor).

[162] *Id.* at 158.

investment products.[163] From the late 1920s and right up to the beginning of the Great Depression, certain reporters began to note that the market had taken on a hysteria of sorts and that the economy was being supported by the substantial rise in prices.[164] The events of the Depression were exacerbated in part by the high margin (without collateral and sufficient credit checks) provided by the investment banks.[165] The investment banks, however, did not suffer nearly as much as their customers during the days of the crash because they were front-running all of their customers' orders with their own orders.[166] The stock market crash of 1929 came off the heels of a strong decade of growth where the market had been sustained strictly on speculation and margin, without any safeguards in place.

The marketplace of the 1930s was undoubtedly one of the most tumultuous in American history. The country suffered its greatest economic recession, the Great Depression, starting at the end of 1929 through approximately 1933. As Milton Friedman observed, "[t]he contraction from 1929 to 1933 . . . may well have been the most severe in the whole of U.S. history."[167] In a matter of three days, the 1929 stock market crash erased over $14 billion of stock capitalization; the total market capitalization eventually dropped from $90 billion to $16 billion.[168] To put this into perspective, between 1929 and 1933, *national* personal income went from just

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[163] *Id.* at 162.

[164] *Id.* at 179.

[165] *Id.* at 188, 192 (particularly noting how the huge number of short positions created a problem when those positions were to be covered, and how liquidation and margin calls depressed prices even further).

[166] *Id.* at 195.

[167] MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES (1867-1960) 299 (1963).

[168] BARRIE A. WIGMORE, THE CRASH AND ITS AFTERMATH 13 (1985). The $14 billion drop would be the equivalent of wiping out over $160 billion dollars over three trading days in 2005. Numbers taken from the U.S. Department of Labor. *See* BUREAU OF LABOR STATISTICS, CONSUMER PRICE INDEX (2006), *available at* ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt.

under $90 billion to just over $40 billion.[169] Thus, the initial stock market slide alone wiped out virtually 15% of the nation's income in one fell swoop. A number of reasons were cited for the crash of 1929, but a few key factors contributed to the fall: vast speculation, outstanding trading volume, short-selling, and inadequate margin requirements that produced credit shortfalls.[170]

While the nation suffered through the Great Depression, the U.S. government recognized the need for sweeping legislation. Wall Street did not respond proactively to the effects of the Depression, thereby angering the government and the vast majority of the U.S. population.[171] The government responded with the Securities Act of 1933 and the Securities Exchange Act of 1934; both were unappreciated by Wall Street.[172] Nevertheless, President Roosevelt's administration realized that "the growth of American business had created a 'bigness' that had to be regulated."[173] During the next five years (1933-37), the economy grew at "extraordinary rates" with the fastest rise in income in constant prices since the mid-1800s.[174] Nevertheless, the period ending the 1930s was marked with another economic slowdown that lasted until World War II.[175]

Thus, the nation was reeling from its greatest economic recession of all time, the result of a rampant free market that had no safeguards whatsoever. Geisst summarizes the reasons for and national response to the crash of 1929:

> The events of 1929 made an indelible imprint on the United States. Much of the faith that had been shown in markets, institutions, and politicians would

[169] FRIEDMAN & SCHWARTZ, *supra* note 167, at 303.

[170] WIGMORE, *supra* note 168, at 26.

[171] GEISST, *supra* note 161, at 199-200.

[172] *Id.* at 229.

[173] *Id.*

[174] FRIEDMAN & SCHWARTZ, *supra* note 167, at 493.

[175] GEISST, *supra* note 161, at 251. As evidence of the slide on Wall Street, brokerage commissions from securities underwriting and other market activities totaled $43 million in 1938; commissions in 1929 were $227 million.

> quickly give way to skepticism and a longing for effective leadership. Bankers quickly moved from the pinnacle of public esteem to the bottom. Wall street legends became symbols of avarice and greed, despised in all quarters . . . . [Eventually] a public inquiry into their affairs revealed corruption and a total lack of interest in public accountability.[176]

Admittedly, when Roosevelt ran for office, he took the first domestic point of view on the American crash, that the crash and bank failures were a result of problems that started at home, not abroad.[177] Accordingly, banking and securities litigation—not well received at all by Wall Street—were the first things on the agenda for the new administration.[178] In response to a crippling failure of the market mechanism perpetuated by speculation and a virtual monopoly on the financial industry, major securities regulations were passed. The legislation was designed to be a *first* response to an area that had never before been regulated and had now failed miserably. Comfortable with its established ways, Wall Street responded coldly to the initial legislation.[179]

Eventually, the Commission's continued investigations and forced financial regulation convinced Wall Street of the need for a new legal defense in upcoming regulation. As such, by the time the Investment Company Act and the Investment Advisers Act (the "Investment Acts") were being deliberated in Congress, Wall Street voiced its opinion on the formulation of the regulations. The two Investment Acts

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[176] *Id.* at 196.

[177] *Id.* at 217.

[178] *Id.* at 227.

[179] To say Wall Street responded coldly is virtually an understatement. Rather, Wall Street effectively waged war against the New Deal administration and its attempts to regulate the financial industry. As Geisst stated, "Wall Street and the New Deal would now become more opposed than ever." GEISST, *supra* note 161, at 232. Wall Street barons started "The American Liberty League" which hosted dinners, testimonials, and massive pamphlet-writing campaigns that continuously attacked the New Deal. *Id.* at 238-39. In terms of business, financiers started issuing nearly half of all their new securities privately with institutional investors in order to circumvent SEC registration. *Id.* at 263.

were the result of negotiations *with* the financial industry, and the final text was completed in approximately six weeks.[180] As Roe observed in his history of the mutual fund industry, "[t]he mutual fund industry didn't strongly oppose all of the restrictions, in fact it preferred some elements. It wanted to sell its product and needed a code of conduct to certify the industry to the public."[181] Moreover, Roe identified the three main public interest perspectives of enacting the legislation: fighting cartelization,[182] promoting political stability,[183] and protecting *unsophisticated* investors.[184] More specifically, "Congress wanted to protect investors, fearing that unsophisticated investors would invest in mutual funds expecting diversification but be unable to evaluate the portfolio."[185] Congress's condemning opinion of investment companies was solidified by the in-depth SEC study, *The Investment Trust Study*, which thoroughly analyzed the industry and highlighted the fraud and abuses that had occurred both before and after the Great Depression.[186] The

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[180] David Silver, Remarks at The Roundtable on Investment Company Regulation (Dec. 4, 2002), *available at* http://sechistorical.org/collection/oralHistories/roundtables/investmentCoRegulation/INV1204Transcript.pdf. The most definitive source of information on the background of the Investment Acts is the Subcommittee Hearings regarding Investment Trusts and Investment Companies, which indicates the clear cooperation and contributions of the financial industry to Congress in developing the laws. Indeed, over thirty heads of different, major investment trusts testified before the Senate during the final amendments of the Acts.

[181] Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1489 (1991).

[182] *Id.* at 1492.

[183] *Id.* at 1490.

[184] *Id.* at 1488 (emphasis added).

[185] *Id.* In fact, the SEC believed that a mutual fund's only function was to provide diversification. *See Investment Trusts and Investment Companies: Hearings Before a Subcommittee of the Committee on Banking and Currency on S. 3580*, U.S. Senate, 76th Cong., 3d Sess. 132, 807 (1940) [hereinafter 1940 Hearings].

[186] HUGH BULLOCK, THE STORY OF INVESTMENT COMPANIES 75-76 (1959). The report thoroughly analyzes the problems associated with lack of disclosure, wild speculation, and inadequate—overly leveraged—capital structures. Perhaps the most important section of the report, however, is

Investment Acts were the necessary and logical development of an overzealous industry that sought to regain public support with a governmental stamp of approval. The mutual fund industry, dependent upon the average, unsophisticated investor, recognized the need to win back its clients' hearts in earnest and used the regulation to do so. Moreover, the government recognized the importance and pervasiveness of mutual funds to the investing community and sought to make them more available to the public.

B. Hedge Fund Conditions Differ Significantly from Conditions Preceding Mutual Fund Regulation

The conditions preceding the adoption of the hedge fund rule severely differ from the conditions preceding the adoption of the Investment Acts, both economically and psychologically. The late 1990s were marked with an equally impressive increase in national and personal wealth and a massive run-up in the national markets, as in the roaring twenties.[187] Similarly, after the millennium boom came a relatively minor recession that affected the national markets. While the national stock markets remained relatively stable, the national economy moved out of the recession within two quarters, after a slight contraction.[188]

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the section comparing public sentiment before 1929 and after 1929. In a chronicle of the major news and magazine articles that appeared after the crash, the report concludes that "a much broader section of the population, particularly the small investor, had become familiar with the investment trust industry." SECURITIES AND EXCHANGE COMMISSION, REPORT ON STUDY OF INVESTMENT TRUSTS PART III: CH. 1 55-57 (1938). "As the depression continued . . . investors became more receptive to critical discussion of investment companies." *Id.* at 55.

[187] *See* discussion *supra* Part II.C, Market Factors Fueling Growth. In terms of the market, the NASDAQ composite hit an all-time high of 5048.62 on March 10, 2000, and had fallen to just 30% of that figure (1491.45) eighteen months later. *See* Historical Prices for Nasdaq Composite, http://finance.yahoo.com/q/hp?s=%5EIXIC. In the following years the markets remained relatively stagnant.

[188] The contraction occurred in the third quarter of 2001, when GDP growth was -1.4% on an annualized rate. BUREAU OF ECON. ANALYSIS, *Table 1.1.2: Contributions to Percent Change in Real Gross Domestic*

Although the nation technically suffered a recession, the effects of the recession pale in comparison to the Great Depression. Unemployment, for example, averaged 5.2% from 2000 to 2004, the period most reflective of the downturn in the economy.[189]

The millennium boom, much like the roaring twenties, had its fair share of scandals that also came to light after the market bubble burst. Rife with accounting frauds, famously large companies, including Enron, MCI Worldcom, Adelphia, Arthur Andersen, and Global Crossing, all suffered amazing downfalls, with the "lucky" companies emerging from bankruptcy and the less fortunate ones permanently closing their doors.[190] While the market may have grossly mispriced the value of many companies that came into existence during the millennium boom, charges of fraud among twenty or thirty companies did not in any way constitute the chief reason for the market correction. Rather, as Alan Greenspan first remarked in his famous 1996 speech, the main driver and reasoning for the market movement was that the market had been overcome with an "irrational exuberance" and had merely corrected itself.[191]

Even if one compares the late 1990s tech bubble directly to the 1920s economy, the resulting impact on the nation's

Product (Jan. 27, 2006), *available at* http://www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=Y. The NASDAQ composite has had a -10.73% return in the past five years, while the Dow Jones Industrial has had a -1% return in the same period. Index Returns, http://screen.morningstar.com/index/indexReturns3YearDesc.html (the five year return was calculated as five years prior to the close of the market on Friday, January 20, 2006).

[189] BUREAU OF LABOR STATISTICS, TABLE 1: EMPLOYMENT STATUS OF THE CIVILIAN NONINSTITUTIONAL POPULATION, 1940 TO DATE (2005), *available at* http://www.bls.gov/cps/cpsa2004.pdf.

[190] *See* Penelope Patsuris, *The Corporate Scandal Sheet,* FORBES, Aug. 26, 2006, *available at* http://www.forbes.com/home/2002/07/25/accountingtracker.html.

[191] *See* Alan Greenspan, Chairman, The Fed. Reserve Bd., Remarks at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research: The Challenge of Central Banking in a Democratic Society (Dec. 5, 1996), http://www.federalreserve.gov/BOARDDOCS/SPEECHES/19961205.htm.

economy speaks clearly to the effectiveness of current regulation. The massive gains in the 1920s were built on unchecked loans and speculation that eventually (and inevitably) became due. While there was, and always will be, speculation in the markets, the financial industry's exponential advances in managing risk, credit, and volatility were obvious when one of the most substantial bubbles, the millennium bubble, resulted only in a mild recession for less than a year. The current regulatory and financial environment for protecting against runs on the bank, ensuring sufficient margin, and ensuring the efficient functioning of the banking sector of the economy have been phenomenally improved since the Great Depression. Wall Street's major players have taken an important role in advancing the Street's management of risk.[192] In conclusion, the market conditions in the decade prior to the Great Depression were so unique that they still motivate the market to continuously evolve its practices to avoid causing another remarkable depression.

The hedge fund industry, meanwhile, had impressive non-stop growth starting in the late 1990s.[193] With huge influxes in capital and amazing flexibility, the hedging aspect of hedge funds actually proved to be a boon to the industry during the general market recession. In fact, in its 2003 report, the SEC staff acknowledged that the investment flexibility that hedge funds utilize helped mitigate investor losses during the 2000-2002 bear market.[194] As such, the hedge fund industry suffered no economic or financial downturn. Moreover, the investor psychological tide was swinging in favor of hedge funds, as evidenced by the massive amount of capital flowing into the funds regularly.[195]

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[192] *See* Part V.A, *infra*, for an in-depth discussion of Wall Street's move towards managing risk.

[193] *See* discussion *supra* Part II.B, The Growth of the Hedge Fund Industry.

[194] 2003 REPORT, *supra* note 9, at 87.

[195] *See, e.g.*, James R. Hedges, IV, *The Pedestrianization of the Hedge Fund Industry*, TR. & EST. 62 (1998); Dave Kansas, *Making Sense of Wall Street*, WALL ST. J., Jan. 14, 2006; Burton G. Malkiel & Atanu Saha, *Hedge*

Finally, the number and amounts of scandals associated with hedge funds were not clearly disproportionate from the normal scandal figures released by the Commission.[196] Hedge funds, in fact, have been disproportionately compliant in comparison to the rest of the equities industry.[197]

The hedge fund industry, for the most part, was averse to the Commission's desired imposition of new regulation. As previously mentioned, of the 161 comment letters received, only thirty-six of those letters were actual endorsements of the regulation, while more than double that amount were opposed to the regulation.[198] Perhaps the most important observation is the clear lack of consensus on the efficacy of the regulation. While opposition in the legal arena is to be expected, the patent lack of certainty regarding efficacy has been manifested by a number of hedge funds' sluggish responses to register with the Commission.[199] Still others have simply rejected registration by exploiting the loopholes

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Funds Today: Caveat Emptor, WALL ST. J., July 26, 2005 ("Hedge funds have become the asset class of choice of the early 21st century.").

196 See *supra* Parts III.A and III.C for a discussion of the cases recently brought against hedge funds by the SEC.

197 Final Rule, *supra* note 3, at 72,062. Admittedly, one could speculate that the reason hedge funds are not prosecuted more often is that the instances of fraud are not uncovered. First, this same argument is equally effective for all other types of fraud committed in other equity investment companies and vehicles. Moreover, the numbers presented represent a fairly constant number of cases being brought annually, a contradiction to the fact that the hedge fund industry is significantly growing annually.

198 *See* discussion *supra* note 105.

199 *See* Christine Williamson, *Hedge Fund Managers Slow in Meeting SEC Registration Rule*, PENSIONS & INVESTMENTS, Sept. 5, 2005 (finding that between 40% and 50% of hedge fund managers have filed); Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, WALL ST. J., Nov. 10, 2005 ("[A] large number of major hedge-fund firms won't be registering with the [SEC] despite new rules . . . . An estimated 5000 or so of the approximately 8000 existing hedge funds aren't yet registered. So far this year, however, new registrations average about 100 a month.").

in the new rules.[200] Further, the hedge fund industry is not seeking public approval like the mutual fund industry was after the Great Depression.

The differences in the legal and economic markets between hedge funds and mutual funds show that there was neither an economic nor psychological need for hedge fund regulation. Economically, there was no market slowdown that severely hit the pocketbooks of investors; rather, the economy basically continued a mature, sustained level of growth during the entire decade preceding regulation. Moreover, the vast majority of the nation's retail—and even institutional—investors had not lost money at the hands of hedge funds; hedge funds had been providing above market returns for those that chose to diversify their portfolios into those types of assets. In addition, strong market performance has avoided creating the despondent attitude evidenced after the Great Depression. Perhaps most importantly, the Commission is not treading into "new space" by regulating hedge funds; hedge funds have *always* been subject to the anti-fraud provisions of the Securities Acts, all the trade limitations of the major exchanges, and all the transaction filing requirements of the securities acts. The rule, then, seems mostly superfluous because it is significantly raising administrative costs while not providing any new, added protections over those that already exist.

The cost of compliance is particularly important to hedge funds because of the fact that many operating hedge funds are much smaller than the average mutual fund. The Investment Adviser Association's survey of asset managers found that the estimated cost of compliance per fund was $231,026 in 2005, with an expected 8% increase for 2006.[201]

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[200] *See* discussion *infra* Part IV.C, The Mutual Fund Industry's Reaction to Regulation, its Implications for Hedge Funds, and the Actual Hedge Fund Industry Response.

[201] Colleen M. O'Connor, *Compliance Costs Jump Ahead of New Regime*, INVESTMENT DEALERS' DIGEST, Nov. 14, 2005. Notice the drastic difference in the estimated costs in this study and the costs given by the SEC. Most importantly, the survey found that in 2004, managers spent an average of $144,394 on compliance. This number was based on actual

The survey also revealed that 50% of funds in 2005 spent between 1001 and 4000 hours on compliance related functions.[202] As one attorney remarked, "[t]he big question is what will happen when SEC examination staff begin to look at the filings and follow up with company visits, especially because hedge funds are so much more complex . . . ."[203] Given the almost $1 trillion in assets under management of the 8000 hedge funds, average hedge fund size is computed at $125,000,000, with more than three-fourths of the funds holding less than $50 million in assets.[204] Thus, compliance costs would represent a costly 5% reduction in earnings if a hedge fund of that size returns 10% per year.[205]

One of the key observations in comparing the two industries is the number and type of investors that the SEC is seeking to protect. When the Investment Acts were passed in 1940, there were nearly 296,000 mutual fund accounts in the United States.[206] Meanwhile, it has been estimated in the SEC's final rule adoption that there are less than 200,000 individual and institutional investors today that are

experience and is already almost three times the maximum total compliance estimate ($50,000) given by the SEC.

[202] *Id.*

[203] Williamson, *supra* note 199.

[204] Conrad De Aenlle, *So Many Hedge Funds, So Few Strategies*, N.Y. TIMES, Aug. 1, 2004. *See also* Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, WALL ST. J., Nov. 10, 2005 ("Still others are wary of the cost of complying with the SEC's registration requirement, which could cost more than *$500,000* for many funds.") (emphasis added).

[205] Assuming a $50 million fund returns 10% on assets ($5,000,000), then the cost of compliance at $250,000 would reduce earnings by 5%, a crucial difference in a highly competitive market. Mutual funds, on the other hand, have the same number of funds but have about eight times as many assets under management, making the relative cost imposition of regulation much less burdensome. Moreover, since regulation has been in place for over sixty years, the costs of regulation are not considered a new added burden. *See* INVESTMENT COMPANY INSTITUTE, *supra* note 24, at 59.

[206] *Id.* The U.S. population in 1940 was 131,409,881, meaning .2% of the nation had a mutual fund account. *See* U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 1940 2 (1941), *available at* http://www2.census.gov/prod2/statcomp/documents/1940-01.pdf.

invested in hedge funds, representing .07% of the nation's population.[207] Mutual funds, however, had approximately 267 *million* shareholder accounts in 2004, representing nearly 90 million investors, or 31% of the population.[208] Also, it is important to note that from the very establishment of the Investment Acts, the government did not want to regulate private companies and was aware of the fact that private investment companies could acquire significant assets.[209] Thus, in terms of sheer numbers, the case for hedge fund regulation looks much weaker when the SEC decides to apportion such a large portion of its valuable oversight resources to such a small group of investors.

Beyond the raw number of investors in each industry when first regulated, the type of investors for the two funds is markedly different. Mutual funds and their predecessors, investment trusts, were seen as the common way for the average American to invest in major corporations.[210] As such, it was the average, common investor that the

[207] Final Rule, *supra* note 3, at 72,094. The nation's population in 2004 was 293,907,000. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES 2006 8, http://www.census.gov/prod/2005pubs/06statab/pop.pdf.

[208] INVESTMENT COMPANY INSTITUTE, *supra* note 24, at 59; Mark Hendrickson, *Commissioner Atkins says Hedge Fund Rules Stretch SEC Too Thin*, SECURITIES WEEK, Oct. 10, 2005.

[209] *See* 1940 Hearings, *supra* note 185, at 179. David Schenker specifically noted:

> We do not want any part of it; and so we have said that even though you engage in the same type of activity as an investment company, which is within the purview of this section, if you have less than 100 security holders you are not a public investment company and not within the purview of this legislation . . . . Irrespective of the amount of the total asset they may have . . . [t]he total assets play no part in the determination as to whether a company is a public investment company or a private investment company.

Id.

[210] GEISST, *supra* note 161, at 184 ("One of the main appeals of the trusts was their ability to offer stocks to the public that were fast becoming unreachable by any other means.").

government sought to protect in enacting the Investment Acts. As previously stated, Congress wanted to protect *unsophisticated* investors because it feared that they would be incapable of valuing the fund's portfolio.[211] Investors in hedge funds, however, are considered sophisticated investors because they either have high net worth or represent institutional investors. The government protects unsophisticated investors from misunderstood risk by setting the definition of qualified purchasers and accredited investors sufficiently high to pertain only to those with advanced investment skill.[212] In terms of institutional investors, "over the past three years, there has been a flood of institutional assets, and those investors are much more sophisticated and have more resources to do their own due diligence."[213] More importantly, given the government's limited resources for enforcement and regulation, the government should not be spending its time and funds on a group of investors that has already been noted as capable of protecting itself in the marketplace.

A key difference between instilling this sort of legislation today versus sixty years ago is the amazing liquidity and fluidity that now exists in the market, which provide

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[211] *See* Roe, *supra* note 181.

[212] *See* discussion *supra* II.D, Legal Definition of Hedge Funds. The accredited investor definition, which seems to equate investment skill with wealth, seems much less restrictive given the substantial growth in wealth, inflation, and income since 1933. Based on historic figures, a net worth of $1,000,000 in 1933 is equivalent to a net worth of approximately $15,000,000 in 2005. U.S. DEPARTMENT OF LABOR, CONSUMER PRICE INDEX (2006), *available at* ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt. Based on today's statistics, to be considered in the top 1% of American households, a minimum net worth of approximately $10 million is necessary. Michael Milken, *The Boom Generation: Seventh Decade*, WALL ST. J., Sept. 19, 2006. Thus, if the definition of accredited investor would have tracked the CPI Index, presumably the definition would still be limited to those that either are savvy with investments or can afford advisers that will protect their financial interests.

[213] Emma Trincal, *Hedge Fund Registration Deadline Arrives*, THESTREET.COM, Jan. 9, 2006, http://www.thestreet.com/markets/hedgefunds/10260877.html (quoting Mr. Nir Narden, lawyer at Greenberg Traurig).

methods for investors to rapidly disseminate information, conduct due diligence, and therefore make investment decisions. Communication mediums in the 1930s were limited to print, with perhaps daily updates of major market stories. Idiosyncratic data was scarce and only available to those that could afford to obtain it. Meanwhile, the 21st century has twenty-four news television stations devoted to investing and the financial markets alone.[214] Furthermore, with the Internet and wired technology, average investors have access to the same amount of information as sophisticated investors at the same time.[215] The monumental increase in information access means that the ability of investors to conduct cost-effective, thorough due diligence has increased exponentially. This obviously does not give advisers freedom to relax their duties, but it does mean that committing fraud should be much more difficult.

While telephones were the state of the art communications medium in the 1930s, the Internet and fiber optic connectivity allow any individual to trade virtually instantly from anywhere on the globe. This phenomenon has been further solidified by the fact that the "capital of hedge funds" is not considered New York City, but actually Greenwich, Connecticut.[216] In the five years preceding the enactment of the Investment Company Act and Investment Advisers Act (1935-1939), the average volume of shares traded on the New York Stock Exchange (NYSE) was 1,226,660.[217] Conversely, in 2004, the average daily volume

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[214] SHILLER, *supra* note 31, at 43-44.

[215] See *id.* at 52, indicating that the expansion of the volume of trade has come as a result of greater connectivity and access to the markets stemming from both technological advances and government regulations encouraging access.

[216] Gregory Zuckerman, *In Connecticut, A New Cop Walks Hedge-Fund Beat*, WALL ST. J., Nov. 5, 2005 ("Connecticut, within commuting distance of Wall Street, is home to perhaps more than a third of the nation's 8,000 hedge funds.").

[217] *See* NYSE STATISTICS ARCHIVE, NYSE Daily Share Volume, 1930 through 1939, http://www.nyse.com/marketinfo/stats/vol30-39.dat.

of shares traded was over 1.4 *billion* shares.[218] Another telling change is the execution speed of trades, which averaged .47 seconds for a completed trade execution in July of 2004.[219] The increased liquidity in the markets means that investors can react much more quickly and move their funds when they spot trouble.[220] The 21st century marketplace provides sufficient information and a speedy response time to sophisticated investors *and* retail investors such that requiring registration regulations will not provide any more information to protect the investor from fraud.

In sum, the conditions preceding the enactment of the respective regulation painted two very different pictures. For the mutual fund industry, Congress sought to instill a framework for the first time on an industry that had run rampant and pushed the country into the greatest recession it had ever faced. Mutual funds were the investment of choice for the average American investor and Congress was aware of their pervasive popularity when legislating. By instilling a rigid formula, Congress created a safe investment *in cooperation* with Wall Street, which needed to recapture the public's trust. Hedge funds, conversely, evidenced virtually none of these features prior to regulation. Since the creation of mutual funds, the private investment company was a carve-out because of its very private nature, and not because of the amount of assets controlled. At the time of regulation, the nation's economy was growing steadily and healthily and never witnessed a severe downturn stemming from hedge fund trading that required regulatory action. Hedge funds were specifically tailored to sophisticated investors, which underscores the fact that regulation does not compensate for the average investor's less-developed

[218] *See* NYSE STATISTICS ARCHIVE, NYSE Daily Share Volume, 1/1/04 through 12/31/04, http://www.nyse.com/attachment/Vol200412.prn.

[219] *See* NEW YORK STOCK EXCHANGE, *NYSE Market Quality*, http://www.nyse.com (Follow "Market Information"; then follow "NYSE Market Quality").

[220] *See* Henry Sender, *Citadel Pulls Up Its Withdrawal Bridge, As Hedge Funds Aim to Block the Exits*, WALL ST. J., Jan. 13, 2006 ("Hedge funds are cracking the whip to keep investors in the fold.").

investing knowledge. Today's marketplace offers significant amounts of cheap information, implying that a simple registration requirement will not provide any sort of added benefit to further deter fraud.

C. The Mutual Fund Industry's Reaction to Regulation, its Implications for Hedge Funds, and the Actual Hedge Fund Industry Response

Wall Street's reactions to the Investment Acts were quite favorable given the fact that the Street was able to negotiate the Investment Acts with Congress. In particular, the Investment Company Act was well received because "it cleared the atmosphere; it codified the rules of the game. Public confidence began to return."[221] Starting after World War II, the public acceptance of investment companies took off. Interestingly, although the general opinion is that investment company regulation was a factor in the post-war growth, Canada, which had no regulation of investment companies, witnessed comparable growth in its investment company industry.[222] It is equally important to note that while open-end funds took off, closed-end funds remained relatively static in the two decades following the adoption of the Act.[223]

In a closer study of the figures, it seems that mutual fund growth until the mid 1980s moved in a directly proportional

[221] BULLOCK, *supra* note 186, at 97.

[222] *Id.* Canada's paralleled growth provides evidence contrary to the belief that the primary reason for growth in investment companies was the enactment of regulation. This evidence also undermines the belief that, without regulation, the mutual fund industry would have kept its reputation as a dangerous and poor method of investment for investors.

[223] Open-end funds have redeemable securities (or essentially trade instantly) whereas closed-end funds generally require capital lock-up and employ leverage. As such, there was nearly a $13 billion increase of assets under management for open-end funds from 1940 to 1958 whereas closed-end funds only increased by approximately $1 billion during the same period. The lack of growth in closed-end companies was attributed to the fact that the leverage employed and lack of liquidity kept the shares of these funds trading at a discount in comparison to open-end funds. *Id.* at 97-100.

fashion to the movement of the national economy at large. For instance, the amount of assets under management with mutual funds grew correspondingly with the economy's growth throughout the 1950s and into the 1960s.[224] Then, as the economy entered a recession in the 1970s, assets under management declined and remained relatively stagnant during the entire decade.[225] The implication is that while regulation from the Investment Acts was perceived as beneficial by both investors and advisers, the biggest factor driving the success of mutual funds was actually the economy. If the lack of regulations had been a hindrance to investment, then the establishment of regulations should have created some sort of blip in the mutual fund market. No such blip exists.[226]

Moreover, after the establishment of the Investment Acts, the Commission seemed to recede from regulating mutual funds. During the 1940s and 1950s, the SEC essentially withdrew from the public's center of attention as the number of SEC employees shrunk from 1600 to less than 800 by the mid 1950s.[227] While instances of fraud still occurred, the main focus of the government was not fraud, but rather the fee structures charged by advisers.[228] The seminal 1966 report, *Public Policy Implications of Investment Company Growth*, had no mention of fraud or other illegal acts of mutual funds; instead, it focused on the changing fee structures and economic variations in the mutual fund

[224] *See* INVESTMENT COMPANY INSTITUTE, *supra* note 24.

[225] *Id.*

[226] Virtually all the data used, including the Investment Company Institute Study, Bullock's account, Geisst's account, Friedman's account, and government data, reflect the fact that the greatest driving factor in mutual fund growth has been the health of the national economy.

[227] JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 267 (2003).

[228] SEC. & EXCHANGE COMMISSION, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH 3 (1966), *available at* http://www.sechistorical.org/collection/papers/1960/1966_InvestCoGrowth/ (citing the Wharton Report as identifying the main problem with the mutual fund industry as being the different types of load fees that existed).

industry.[229] The total shift in governmental focus indicates that, at the very least, the Investment Acts were successful in making mutual funds much safer and transparent for investors.

The success of the Investment Acts for the mutual fund industry, however, was greatly dependent upon the conditions preceding the adoptions of the regulations. The remedy worked because it was fixing a serious, obvious problem. In terms of the hedge funds, however, the aftermath of regulation will likely follow historical precedents, but not in a manner identical to that of mutual funds. First, the growth of hedge funds, as previously explained, has been spurred mainly by a huge increase in personal and national wealth resulting from the growth of the stock markets and the housing markets. Just like the mutual fund industry, then, the hedge fund industry has at least grown in proportion to the national economy. Moreover, although hedge funds may have a significant amount of assets under management in the aggregate, their holdings represent less than 1% of pension funds' total holdings and are generally marketed to the top net worth individuals in the economy.[230] These individuals have sought out hedge funds for both diversification and above market returns. These sophisticated investors are capable of using their same advanced abilities of financial due diligence to scrutinize and locate hedge funds that best fit their investment characteristics. The implication, like any other investment, is that if hedge funds do not provide above market returns, the funds will properly flow to an industry or sector that is performing better.[231] Indeed, given the fact that the markets have been

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[229] *Id.*

[230] It is important to note that while assets under management are not synonymous with market positions because of the leverage employed by the hedge funds, pension funds' limited investments still limit their exposure because, ostensibly, the pension funds have accounted for the leveraged risk when limiting the size of their exposure.

[231] *See* Malkiel & Saha, *supra* note 195, at A24 ("The very success of the hedge fund industry in attracting funds is likely to make hedge fund investing an even less profitable investment strategy in the future."). *See*

less favorable to hedge funds recently, the funds have already begun to witness a significant outflow of assets.[232] The flows of hedge funds, then, emulate the mutual fund trend in tracking the success of the national economy.[233]

In terms of regulation, however, it would be expected that the hedge fund industry will emulate the securities industry in the mid 1930s by using loopholes to avoid registering with the SEC. Since a significant portion of the industry is averse to the rule and the costs that it will impose, the funds will find the most economically efficient path for regulation. As previously mentioned, only 50% of the hedge funds are expected to register with the SEC, thus skewing the SEC's census data.[234] Moreover, hedge funds have already started modifying their rules to exploit legal loopholes still allowed by the SEC. A number of hedge funds have changed their lockup terms to make sure that all investors hold their shares for the statutorily required two years; others have stopped accepting new investments momentarily.[235] Still

also Conrad De Aenlle, *So Many Hedge Funds, So Few Strategies*, N.Y. TIMES, Aug. 1, 2004; Susan Pulliam, *Private Money: The New Financial Order—The Hedge-Fund King is Getting Nervous—Inside billionaire Steven Cohen's hidden world of massive trading and lavish art; Is the party over?—At home with Van Gogh, Gauguin and a skating rink* , WALL ST. J., Sept. 16, 2006, at A1 (quoting star trader Steven Cohen, "It's hard to find ideas that aren't picked over, and harder to get real returns and differentiate yourself. . . . We're entering a new environment. The days of big returns are gone."); Gregory Zuckerman, *Hedge Funds Miss Their Target - Some Prominent Names Are Coming Up Short of Benchmarks*, WALL ST. J., Sept. 13, 2006, at C1 ("Overall, hedge-fund returns are in line with markets . . . . As hedge funds grow, and asset stream into the business, some managers may be finding it more difficult to find enough winning ideas—the more money they manage, the more likely they are to have to reach beyond their best ideas.").

232 Henry Sender, *Citadel Pulls Up Its Withdrawal Bridge, As Hedge Funds Aim to Block the Exits*, WALL ST. J., Jan. 13, 2006. *See also* Henny Sender, *Hedge Funds Hit Rough Weather But Stay Course*, WALL ST. J., June 22, 2006, at C1 ("Amid the market tumult of the past two months, a handful of hedge funds have shut down.").

233 *Id.*

234 See note 204 regarding registration expectations.

235 Zuckerman & McDonald, *Hedge Funds Avoid SEC Registration Rule*, *supra* note 199, at C1.

others have determined that if they do issue new shares to the public, they will offer different classes of shares that require a two-year lockup period.[236] By focusing on the loopholes within the statutes, the funds are emulating the response of the securities industry in the 1930s, when some mutual funds chose to make half of their offerings private because registration was too onerous.

By enacting the broad registration requirements, it seems more likely that regulation of the hedge funds will look like a governmental stamp of approval.[237] The Investment Acts were specifically meant to restore investor confidence into the financial industry and to demonstrate that the government was indeed watching over the funds to ensure that investors were duly protected. It seems ironic that the government now wishes to use regulations that were meant to make retailization easier in order to slow down retailization. Moreover, as the media continues to focus much of its attention on hedge funds, it seems highly unlikely that new regulations will be able to stop the financial industry's entrepreneurial drive to develop profitable products that operate in the grey areas of the regulatory framework. Finally, given the fact that nothing in the amended rules actually changed the types of individuals that could invest in funds of funds, investors can still use these funds to move their assets as long as the funds of funds keep their investment in the hedge fund for the required lockup period.

[236] *Id. See also* James M. Amend, *Hedge Funds Anxious as Registration Nears*, INVESTMENT MGMT. WKLY., Jan. 9, 2006; Susan L. Barreto, *Regulatory Countdown Continues with More Analysis*, HEDGEWORLD DAILY NEWS, Dec. 22, 2005 ("[M]any large, established fund managers are expected to avoid SEC registration by extending their lockup periods . . . ."); Carol E. Curtis, *Hedge Fund Managers Balk at E-Mail Retention Rule*, SECURITIES INDUSTRIES NEWS, Jan. 9, 2006 ("[T]he firms least likely to register are the largest. These firms take the attitude that if clients will accept the two-year lockup, they are taking it.") (quoting Terri Messina of Ernst & Young).

[237] *See, e.g.*, Kansas, *supra* note 195 ("[Hedge funds] are called 'secretive' or 'fast-moving.' And there the discussion ends.").

Indeed, the statistics provided by the SEC concerning hedge fund registration bear out the very results predicted. Of the 7500 plus hedge funds in existence, 2479 were registered with the SEC as of September 14, 2006.[238] Moreover, since January 1, 2006, 1202 of the total registered funds were newly registered with the SEC since January 1, 2006.[239] It is important to note that during the time the rule was in effect (February 1, 2006 until June 23, 2006) many hedge funds may have avoided registration because the D.C. Circuit had not yet issued its opinion. Nevertheless, the effect of the D.C. Circuit's June 2006 ruling has been clear. Within a month after the court vacated the hedge fund rule, ten managers withdrew their applications for registration.[240] As of September 14, 2006, 106 hedge funds had withdrawn from SEC registration, which was a sharp acceleration over the ten initial managers that withdrew in the first month.[241] These withdrawals do not touch upon the number of hedge funds that never registered with the SEC.[242] As former

[238] Siobhan Hughes, *Many Hedge Fund Managers Opt Out of Registration*, DOW JONES NEWS SERV., Sept. 22, 2006. It is fair to point out that although only one-third of hedge funds are registered, this number really should also be compared with the aggregate amount of assets under management represented by these registered funds.

[239] *Id.*

[240] Kara Scannell, *Moving the Market: Some Hedge Funds Pull SEC Registration Plans—Moves Follow Court Order Dismissing Oversight Effort; Will the Rule Be Revived?*, WALL ST. J., July 20, 2006, at C3.

[241] *Id.*

[242] Although there are no statistics to reflect how many hedge funds modified their investment requirements to exploit the loopholes of the rule, there was no question that a number of funds had already done so before the rule even went into effect. *See* Emma Trincal, *Hedge Fund Registration Deadline Arrives*, THESTREET.COM, Jan. 9, 2006, http://www.thestreet.com/markets/hedgefunds/10260877.html; Susan L. Barreto, *Regulatory Countdown Continues with More Analysis*, HEDGEWORLD DAILY NEWS, Dec. 22, 2005; Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule—Some Big Firms Change Lockups, Stop Accepting New Investments To Take Advantage of Loopholes,* WALL ST. J., Nov. 10, 2005; Henry Sender, *Citadel Pulls Up Its Withdrawal Bridge, As Hedge Funds Aim to Block the Exits,* WALL ST. J., Jan. 13, 2006, at C1;

Commissioner Goldschmid, who voted in favor of the rule, noted, "[U]nless there is an appeal and the Supreme Court reverses . . . or there is congressional action, a meaningful number [of advisers] will withdraw and that's setting up for a potential train wreck."[243] In sum, the implementation of the rule did indeed result in managers moving towards the path of least resistance by avoiding registration. For the most part, the industry avoided registration such that even if the rule had been upheld by the D.C. Circuit, its effect would still have been fairly muted.

In conclusion, the reaction of investors and advisers to the new hedge fund regulations emulated the reactions witnessed in the 1930s and 1940s. Initially, the hedge fund industry (along with its lawyers and other regulators) greatly resisted the implementation of the regulation. After the regulation was enacted, the industry, just like the financiers in the 1930s, sidestepped its control. In addition, much like the mutual fund industry in the years subsequent to its regulation, the size and financial success of the hedge fund industry will also likely move in tandem with the greater national economy, which is a result of an increasingly competitive industry.

V. RECOMMENDATIONS FOR FUTURE RULE IMPLEMENTATION

There is no doubt that in the eyes of the government, some regulation of the hedge fund industry is necessary. The sheer amount of capital under management and the ability of those managers to stake positions that have potentially harsh effects on the national and global economies provide strong arguments for imposing regulation. The government has clearly indicated that it will not leave the hedge fund industry to run freely. Commissioner Cox stated that the Commission "needs to move 'quickly' to address the 'hole' left by the court decision," noting that

Christine Williamson, *Hedge Fund Managers Slow in Meeting SEC Registration Rule*, PENSIONS & INVESTMENTS, Sept. 5, 2005.

[243] Scannell, *supra* note 240, at C3.

"right now the regulatory regime implemented by the SEC is inadequate."[244] Further, the SEC has stated that it would not appeal the court's ruling vacating the rule and would propose an "antifraud rule that would deem hedge-fund investors to be clients . . . and [would] consider increasing minimum asset and income requirements for hedge-fund investors."[245]

Moreover, a number of issues have been raised by a commentators regarding different problems that may occur with hedge funds. One of the concerns recently addressed is the fear that hedge funds are using privileged information to make decisions and reap substantial gains.[246] These sorts of information flows could potentially amount to insider trading violations. Another hedge fund practice is the use of separate accounts to hold harder-to-value investments, known as "side pockets," in order to overstate performance and collect fees on these inflated and illiquid valuations.[247] Perhaps the biggest fear that stems from these commentators and the government is the fact that they actually do not know how severely markets will be shaken by the downfall of a single hedge fund or a group of hedge funds because of the significant leverage employed.[248] Timothy Geithner, President of the Federal Reserve Bank of New York, addressed this specific issue when he indicated that "margin

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[244] Kara Scannell, *Moving the Market: Cox Cites 'Hole' In Regulatory Net On Hedge Funds—Legislation May Be Needed, SEC Chairman Observes; Traversing a Fine Line*, WALL ST. J., July 26, 2006, at C3.

[245] Judith Burns, *SEC to Redo Hedge-Fund Rules Instead of Appealing Rejection*, WALL ST. J., Aug. 8, 2006, at A8.

[246] Henny Sender & Anita Raghavan, *Private Money: The New Financial Order—First Call—Worry Amid Hedge Fund Boom: Privileged Access to Information—Risk of Insider Trading Rises As Brokers Offer a Flood Of Market Data and Ideas—When Did Marshall Wace Sell?*, WALL ST. J., July 27, 2006, at A1.

[247] Gregory Zuckerman & Scott Patterson, *Moving the Market—Tracking the Numbers/Street Sleuth: 'Side-Pocket' Accounts of Hedge Funds Studied*, WALL ST. J., Aug. 4, 2006, at C3.

[248] See discussion *supra* Part III.A, Reasons for Commission Action, for an in-depth discussion of the government's fear of the unknown as one of the driving factors in originally implementing the rule.

requirements that are sensible in normal times may prove too thin in stressful market conditions and could actually aggravate violent market moves."[249]

In order to make the regulations more effective while preserving the competitive advantage of hedge funds, the government (both through the Commission and Congress) should customize its approach to directly address the main concerns in order of importance: (i) preserving the solidity of the national and global economies from the systemic risk of correlated hedge fund failures; (ii) protecting investors, more specifically pension funds and public funds, and then individual, unsophisticated investors; and (iii) deterrence of fraud. The proposed solutions attempt to remedy the concerns of the government while minimizing the costs of compliance. The recommendations are also ordered from no governmental involvement (examination of margin requirements) to increasing governmental involvement (substantive regulation and disclosure).

A. Limiting Volatility with Stricter Margin Requirements and Limits on Leverage

The first concern of hedge fund regulation should be to ensure the stability of the national economy and reduce the effects of financial meltdowns that have the potential to derail the national economy. In other words, the economy is much better suited when another LTCM is not looming in the near future. If the government is insistent upon implementing substantial regulation, then it should consider forcing the parties in transactions with hedge funds to impose stricter margin requirements on the funds. This option should be less burdensome to both the hedge funds and the counterparties and will provide the greatest flexibility to both parties. The government could also simply impose a leverage limitation on hedge funds.

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[249] Greg Ip, *Hedge Margins Draw the Focus of Fed Official—Geithner Speech in Hong Kong Notes Need to Examine Rules In the Case of Stressful Markets*, WALL ST. J., Sept. 15, 2006, at C1.

The most desirable outcome would be for the government, through the Federal Reserve rather than the SEC, to essentially push the contracting parties to further examine their margin requirements. The entities with the greatest institutional knowledge in terms of credit risk management should be the contracting entities. As compared to the SEC, the Federal Reserve is a more sophisticated and knowledgeable party in so far as capital adequacy is concerned.[250]

In addition, hedge funds have been especially instrumental in the development of the derivatives instruments,[251] credit risk models, and the derivatives markets as a whole. The practice of managing risk has become highly sophisticated on Wall Street.[252] Moreover, in the wake of

[250] One of the Federal Reserve's four duties is to "[maintain] the stability of the financial system and [contain] systemic risk that may arise in the financial markets." THE FEDERAL RESERVE SYSTEM, PURPOSES & FUNCTIONS 1 (2005). The SEC's primary mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." U.S. SECURITIES & EXCHANGE COMMISSION, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, http://www.sec.gov/about/whatwedo.shtml. The SEC's description fleshes out that its primary goal is the proper dissemination of information to investors in order to ensure the functioning of the market; the SEC is not in the business of substantial risk mitigation like the Federal Reserve.

[251] Recall that it was LTCM (and the work of its principals) that placed hedge funds, derivatives, and their risks on the national radar. *See supra* note 109.

[252] The current Secretary of the Treasury, Henry Paulson Jr., rose to prominence as the head of Goldman Sachs Group, where the firm consistently reported record earnings by developing cutting edge risk models. Business Week's special section about Mr. Paulson and Goldman elaborated about risk modeling noting, "[t]he subject has become an obsession at Goldman: how to find profitable risks, how to control and monitor them, and how to avoid catastrophic missteps that can bring down whole companies." Michael Mandel, *Mr. Risk Goes To Washington; Hank Paulson's profound understanding of risk and reward makes him the perfect pick for the Treasury*, BUS. WEEK, June 12, 2006, at 46. *See also* Emily Thornton, *Inside Wall Street's Culture of Risk; Investment Banks Are Placing Bigger Bets Than Ever and Beating the Odds – At Least For Now*, BUS. WEEK, June 12, 2006, at 52 (describing exactly how the banks have started employing a myriad of risk models and the limitations of those models).

LTCM, the many players that interacted with hedge funds reexamined their credit risk models. As such, the government should continue its approach with these major financial players and allow them to continue to evaluate, critique, and improve their risk models.

Further, without injecting superficial governmental influence into the banks' and funds' way of business, the government ensures that the competitiveness in the marketplace will force the banks and funds to continue to develop products and models that minimize risk.[253] Competitiveness in the market will impose discipline because hedge funds and public institutional investors (i.e., super-banks like Goldman Sachs and Citigroup) will not be able to receive funds from investors once they have effectively frightened the market. In sum, market discipline will most effectively mitigate the investment and fraud risks by continuing to place pressure on the funds and their counterparties to modernize their risk management.

1. Stricter Margin Requirements

If the government does insist on imposing margin requirements on hedge funds, then it remains advisable that it rely upon the Federal Reserve and not the SEC for implementation. As a result, hedge funds would have to be brought under the ambit of the government's power.[254] In

[253] The fluid functioning of the market has actually been the foundation upon which the government has *had* to rely in order to fix the major blowups of recent years. LTCM was effectively managed by Wall Street with some Federal Reserve help. Even the more recent blow up of Amaranth—where a hedge fund lost $6 billion in a matter of weeks on a bad bet on the direction of natural gas futures—was totally mitigated by two other financial players, JPMorgan Chase & Co. and hedge fund Citadel Investment Group LLC. The latter situation did nothing to roil markets or even create so much as a blip in the stock markets. Gregory Zuckerman, *Moving the Market—Tracking the Numbers/Outside Audit: How the Wreck From Amaranth Was Contained—J.P. Morgan and Citadel Swooped In, Assumed Risk, Proving Markets' Resilience*, WALL ST. J., Oct. 5, 2006, at C3.

[254] For sake of the argument, we will assume that the government has jurisdiction over hedge funds. Nevertheless, this definitional problem was

the vast majority of the investing strategies utilized by hedge funds, it is amazingly rare that the funds have provided 100% of the capital necessary to sustain the notional amount of a leveraged position.[255] Margin requirements vary greatly depending on the type of lender and the type of contracts. For example, an unsophisticated stock investor may have a 50% margin requirement from a major trading house for equity trading, but may also have a 5% margin requirement for trading in the futures market.[256] Big investors and institutional investors also benefit from very low margin requirements, sometimes as low as zero.[257] As Geithner stated:

> In market conditions where initial margin may be low relative to potential future exposure, the self-preserving behavior of leveraged funds and their counterparties may be more likely to exacerbate rather than mitigate an unexpected deterioration in asset prices and market liquidity. As financial firms demand more collateral, funds are forced to liquidate

dealt with by the SEC in its original rule formulation. Rather than attempting to define hedge funds, the government could expand the section in the Investment Company Act, 15 U.S.C. § 80a-12, that limits margin for mutual funds and require that any entity with assets over a minimum threshold that is not registered as an investment company be required to use "reasonable" margin. This provides legal pressure on the funds and provides a foothold for the government to impose more stringent standards. Also, using a reasonableness standard allows flexibility for other types of funds that would be caught by the restriction (such as venture capital or private equity funds).

[255] Although some of the strategies such as "long only" or "long/short" do not necessarily require the funds to use margin, in practice the vast majority of funds use leverage to amplify their returns. Equally, other strategies such as "managed futures" deal directly in transactions that only require a nominal amount of initial capital. LINS ET AL., *supra* note 11, § 1:2.

[256] A 50% margin requirement is the initial margin requirement for leveraged trading as of October 1, 2006 with Fidelity Investments. The 5% requirement is considered a standard for futures contracts. BODIE ET AL., *supra* note 29, at 747.

[257] Zuckerman & Patterson, *supra* note 247, at C3. In this case, the margin requirements may also refer to loans provided by institutional investors to the funds.

> positions, adding to volatility and pushing down asset prices, leading to more margin calls and efforts by the major firms to reduce their exposure to future losses. In the context of the previous discussion of externalities, firms' incentives to minimize their own exposure can amplify the initial shock and impose on others the negative externality of a broader disruption to market liquidity.[258]

Geithner's comments do not go so far as to suggest how exactly the margin requirement should be implemented.

Margin could be required on behalf of the lender, meaning that the lender must have adequate capital to ensure that the collapse of one of its debtors would not have an adverse effect on the rest of its investments, or it could be required to be posted by the borrower. In this case, the impetus should initially be placed on the hedge funds to provide a minimal level of collateral because the valuation of the hedge funds' potential liability is best reserved for those individuals with the most intimate knowledge of the investments: the fund advisers and managers.[259] Similarly, since the hedge funds are requesting the capital—the potential liability against which the banks are hedging—placing the impetus on the

[258] Timothy F. Geithner, President & Chief Executive Officer, Fed. Reserve Bd. of N.Y., Remarks at the Distinguished Lecture 2006 (Sept. 15, 2006).

[259] Indeed, hedge fund asset valuation is a problem unto itself. Hedge fund valuation is difficult because of the illiquid and unusual types of investments that hedge funds are now entering into; the lack of transparency and regulations in the market and in their general dealings; the significantly looser requirements of the hedge fund managers to disclose assets to its investors; and the overconfidence in investments and need to boost returns to generate fees and lure investors. In fact, according to the Alternative Investment Management Association, 20% of the assets held by hedge funds in the fourth quarter of 2004 were difficult-to-value assets. Dan Waters, Sector Leader Asset Management, Hedge Funds: Are Their Returns Plausible? FSA National Associate of Pension Funds Investment Funds Conference (Mar. 16, 2006). *See also Strategies, Products & Mandates—Valuation Headache Dogs Hedge Funds*, FIN. TIMES MANDATE, May 1, 2005; ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION, ASSET PRICING & FUND VALUATION PRACTICES IN THE HEDGE FUND INDUSTRY (2005).

hedge funds also imposes another level of regulation over the investment decisions of the advisers. If they are required to explicitly value their assets and investments for all margin investments, there is an added level of transparency. That transparency is amplified by the ability of the banks and lenders to further scrutinize the valuation and safety of certain investments.

Although the margin requirements should first be placed on the funds, it is also worth noting that the banks should be willing to allocate more capital for catastrophic events that stem from their loans to highly leveraged investors such as hedge funds.[260] The difficulty of managing each bank's credit risk was clearly recognized by Geithner, as he did not provide any minimum capital requirements but instead strongly suggested that, in general, the banks should further investigate the capital required to provide a cushion against unregulated leveraged entities.[261] Evaluating the bank's capital requirement mitigates correlative risk differently in that it provides a point at which a potential downward spiral will stop.

The attractiveness of placing the margin requirement on hedge funds rather than on the lenders is the emphasis on preventing the meltdown of a fund, rather than making sure lenders can endure the meltdown of a debtor. Any requirement on the funds necessarily limits the leverage to a fraction of the leverage employed by LTCM. Capital requirements will also provide implicit regulation whereby the funds' operations and positions are examined in much greater detail by its creditors. Greater scrutiny by banks should allow the funds to continue to innovate their risk valuation models. Conversely, by placing the impetus on the banks, there is virtually no limit on the types of leverage that the fund can employ and there is no attempt to stem any of the margin risk incurred by the hedge funds. Thus, placing the burden on the hedge funds is an effective ex ante

[260] Geithner, *supra* note 258.

[261] *Id.*

approach whereas placing the burden on the lenders is an ex post approach.

The arguments against limiting the freedom of the funds are insufficient to overcome the necessity for higher margin requirements. First, the margin requirements will not be set arbitrarily by the government, but will be reached in the same manner that the government has imposed other margin requirements: by allowing the major entities to research and develop sophisticated models that are continuously innovated.[262] Thus, the margin requirements should adequately reflect the actual value of the risk incurred by the funds. This model would replicate the same sort of environment that existed during the regulation of mutual funds, an amicable environment that proved successful for generations. By allowing the lenders and hedge funds to establish their limits with the cooperation of the government, the regulations implemented should prove to be more efficient and more susceptible to changes in a fluid and liquid market.

Given the funds' increasing competitiveness and move towards more average returns, little argument remains that the funds will see a decrease in returns. Hedge funds currently enjoy total freedom from outside influence in regard to leverage (not counting the implicit restrictions placed by investors and the need to be able to answer margin calls) and have seen their returns reflect those of an efficient, competitive market. In addition, hedge funds will still have the ultimate freedom to employ more leverage than other market players and will simply become a higher risk investment for individuals.

[262] Perhaps the best example is the Basel Accord and the work of the Basel Committee. The 1988 Basel Accord was reached as a result of the work of many regulators and banks around the world in the wake of the Bank Herstatt meltdown in the 1970s. The Basel Committee has continued to be an influential player in the bank regulatory industry. A similar committee, or even the same committee, could be used to understand the risk undertaken by hedge funds and impose margin requirements on hedge funds. BANK FOR INTERNATIONAL SETTLEMENTS, HISTORY OF THE BASEL COMMITTEE AND ITS MEMBERSHIP (July 2006), *available at* http://www.bis.org/bcbs/history.htm.

2. Directly Limiting Leverage

The government could also take the position that it took with mutual funds and directly limit, by way of legislation, the amount of leverage the funds can use.[263] Whereas the mutual funds can employ no leverage, the government would likely choose to allow the hedge funds to employ some amount of leverage that would not force hedge funds to become identical to mutual funds. There are clear benefits from the government's imposition of a bright-line rule and it could be expected that the hedge fund industry would emulate the mutual fund industry in its use of leverage.[264] By imposing a uniform margin requirement on the entire industry, individual hedge funds will not be disadvantaged vis-à-vis each other, nor will the industry be disadvantaged vis-à-vis any other industry. The industry will merely have to expect lower returns as compared to its previous more leveraged returns.

However, there are fundamental problems with the government imposing this type of restriction. One problem is that such restrictions undermine the competitive advantage of the hedge funds and greatly limit the ability of hedge funds and lenders to innovate. Unless the government chooses to disallow hedge funds from using leverage at all, any limitation it chooses will be an arbitrary limitation. In extremely competitive industries, imposing an arbitrary limitation creates inefficiencies in the market and places those funds at a disadvantage to other jurisdictions. It also encourages the funds to exploit loopholes and avoid government regulation. Further, imposing such a static limitation weakens the ability and incentive of the funds and

[263] This would again cause a definitional problem but the government could again reach the hedge funds by inserting a clause in the Investment Company Act (15 U.S.C. § 80a-12) that would catch the hedge funds.

[264] As noted in Part II.D.3.a, mutual funds have very limited abilities to employ leverage. For hedge funds, the only rationale would be that the hedge funds would be able to boost their returns vis-à-vis mutual funds because they are allowed to incur more risk. The direct limit on leverage would require a definition akin to mutual funds, which would necessarily limit the types of investment strategies allowed.

lenders to innovate and develop more complex credit risk models. As the market continues to change and evolve, the amount of leverage that is suitable for any individual fund to undertake will vary. By setting the leverage limitation in statute, the modification process will be more difficult and will not be able to adapt as quickly to market changes.

B. Limitations Regarding Pension Funds and Other Institutional Investors

1. Limits on Hedge Funds' Ability to Receive Funds from Pension Funds

Another solution is that the Commission could limit the amount of funds that hedge funds can accept. For private investment companies, the Commission could patently limit the amount of funds that the company could accept from any single institutional investor like pension funds. The Commission could make the limitation a part of the exemptions under the Investment Company Act for both Section 3(c)(1) and Section 3(c)(7) funds. Section 3(c)(1) funds already lose their exemption if any of the 100 beneficial owners owns more than 10% of the issuer's securities.[265] The Commission could simply lower the threshold below 10%, which would necessarily limit the amount *any* investor could invest with the fund. Not only would this provide protection for the pension funds but the breadth of the provision would also capture other investors and limit individual loss.

For Section 3(c)(7) funds, the government could add a limitation to the "qualified purchaser" definition by limiting the amount of funds that may come from qualified purchasers subject to Title I of ERISA or Section 4975 of the Internal Revenue Code ("ERISA plans").[266] Currently, any hedge fund that accepts more than 25% of its money from

[265] Investment Company Act § 80a-3(c)(1).

[266] The definition would need to be structured to avoid a single adviser operating multiple funds in tandem to avoid the fiduciary obligations.

pension funds is required to become a fiduciary.[267] Restricting the limit on Section 3(c)(7) funds to ERISA plans comports with Congress's latest potential legislative change whereby non-ERISA plans (governmental and foreign pension plans) would no longer count towards the 25% test (The Pension Protection Act of 2006) and reflects legislative intent that non-ERISA plans are not to be as thoroughly overseen and controlled by the government.[268] Effectively, this requirement may need to work in tandem with a limitation on the amount that pension funds can invest to block the creation of multiple funds by a single manager to sidestep this provision. Congress could also lower the 25% threshold at which advisers assume fiduciary obligations. Although Congress has not done so with its pending legislation, lowering the threshold would have the effect of requiring more hedge fund managers to register and be subject to significantly greater scrutiny. The lowered threshold would need to apply to newly acquired funds in order to avoid confusion. The lowered threshold for assuming fiduciary obligations would have the effect of making the adviser both register with the Commission and potentially face liability for negligent investment tactics.

2. Limits on Pension Fund Investments

Instead of placing the limit on hedge funds, the government could require pension funds (subject to ERISA obligations) to limit the percentage of their investments that are concentrated in hedge funds.[269] This approach essen-

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[267] Simpson, Thacher & Bartlett, *Pension Protection Act of 2006 – Plan Assets and Prohibited Transaction Matters*, Aug. 8, 2006, *available at* http://www.stblaw.com/content/publications/pub562.pdf.

[268] *Id. See also* Deborah Solomon, *Congress May Let Hedge Funds Manage More Pension Money*, WALL ST. J., July 28, 2006, at A1.

[269] This is partially based on modern portfolio theory which dictates that as the number of securities (or types of securities) increases, eventually the correlation between investments drops and the only remaining risk is systematic risk as opposed to unique risk. RONALD GILSON & BERNARD BLACK, THE LAW & FINANCE OF CORPORATE ACQUISI-

tially places a greater burden on the pension funds rather than on the hedge funds.

Ideally, this percentage would not be explicitly set by the government, but would rather be calculated according to a formula that calculated the risk that the pension funds had undertaken through their investments in the funds.[270] Utilizing a model approach acknowledges and respects the fact that pension funds are operated by very capable and sophisticated money managers.[271] Different pension fund managers will seek to employ different investment styles; some may choose to spread the investments along semi-risky assets, while others may choose to invest mostly in safe assets with a very small percentage in high-risk assets. Notably, hedge fund investments may actually lower risk for some pension funds because they provide another type of asset into which the pension funds can diversify their portfolios.[272] The model-based approach provides the investment freedom for the pension funds and places the least burden on the function of the markets. It also allows pension funds and hedge funds to continue using financial innovation most efficiently in order to boost return while minimizing risk.

Nevertheless, given the current bright-line rule (25%) that is used in computing whether the adviser owes a fiduciary obligation, it is expected that the government would place an explicit limit on what percentage of ERISA-

TIONS 91 (West 1995) (1986). Also, the limitation to ERISA plans is an adjustment for the Pension Protection Act of 2006.

[270] The justification in favor of fluidity, investor freedom, and minimal governmental involvement in this case are the same as for setting stricter margin requirements.

[271] The dissent aptly noted that not only are pension funds overseen by highly-skilled money managers, but those money managers have a specific fiduciary duty. Furthermore, pension funds are overseen by the Department of Labor and subject to many state laws. Final Rule, *supra* note 3, at 72,093.

[272] Riva D. Atlas & Mary William Walsh, *Pension Officers Putting Billions Into Hedge Funds*, GLOBAL ACTION ON AGING (Nov. 27, 2005), *available at* http://www.globalaging.org/pension/us/private/2005/hedgefunds.htm.

plan pension fund assets may be invested in non-public equities. This would create significantly greater inefficiency in the market for the pension funds, especially since they would have their investment methodologies further limited. It would, however, clearly limit the total exposure any pension fund would have to hedge fund volatility.

C. Disclosure Related Recommendations

1. Special Disclosures

Alternatively, the Commission could require special disclosure forms from private placement companies that verify or legally attest to the validity of the adviser's background and investment performance. The disclosure scheme would be divided into classes according to the source of the hedge fund's assets. At a minimum, all advisers that operate private, unregistered funds that accept funds from accredited investors or qualified purchasers could be required to file a Form ADV with the Commission.[273] The Form ADV requires no release of proprietary information regarding trading or investment tactics. Most importantly, filing this form would *not* constitute registration with the Commission and make the funds susceptible to the Sarbanes-Oxley Act and potential SEC inspections. The forms would be readily available for all investors and would not only provide a significant amount of census information for the Commission, but would also open the adviser up to a quick examination of his criminal background. Preparing a Form ADV is not particularly time-consuming or costly and would serve as a simple alert to the government that the individual operates a private investment fund and as a legally enforceable background check for investors.

For hedge funds whose assets are comprised of a minimum percentage of pension fund investments, the Commission could require a more detailed disclosure that includes a brief description of investment strategies, general explanation of asset allocation including a liquidity analysis,

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[273] This definition would pick up every private investment fund.

and past fund performance. Forcing a disclosure about asset allocation also opens the adviser up for potential misrepresentation liability, which in turn forces the advisers to be more forthcoming about illiquid asset valuations. Pulling the asset allocation of advisers into the public spotlight will also make it more difficult for advisers to use side-accounts and other "tricks" to boost returns. The investment strategy disclosure would be broadly defined (e.g., long/short and managed futures) to protect the fund's proprietary trading strategies. Requiring disclosure of the fund's historic performance simply provides more data upon which investors can base their decisions. As the database of advisers grows, eventually it would be ideal to supplement fund historic performance with adviser historic performance. This again provides the Commission with valuable census data about hedge funds and provides more data for pension funds to use in their decision-making processes.

VI. CONCLUSION

This note provided an analysis of the hedge fund industry by recapping the major reasons for the growth of the industry and by giving a comprehensive analysis of the current legal framework under which hedge funds operate. The history surrounding the adoption of the major securities acts is strong evidence for why applying these same rules to hedge funds today is inappropriately placed because of the difference in market conditions, liquidity, technological advancements, and investor psychology. Further, the mixed response by investors and financiers to the securities acts indicates that hedge funds will attempt to avoid the rule, undermining all of the Commission's purported goals. This note also argued that the competitive marketplace will ultimately provide the best protection against potential economic derailments at the hands of hedge funds. Nevertheless, since the government insists on implementing hedge fund regulations, the suggestions each address one of the Commission's stated reasons for imposing regulation. With each suggestion, the least intrusive and most market-oriented approach was presented and advocated. The hope is that if hedge fund regulation is inevitable, it will emulate the same process of negotiation and result in the same mutual satisfaction that came about with the original adoption of the Investment Acts.