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# The Hedge Fund Holdup

## THE SEC'S REPEATED UNNECESSARY ATTACKS ON THE HEDGE FUND INDUSTRY

### I. INTRODUCTION

Hedge funds have produced vastly different results for investors in 2008. Some have profited by immense amounts, while others have suffered great losses at the hands of funds that collapsed as a result of the subprime credit crisis.<sup>1</sup> Irrespective of their success, most hedge fund investors would agree on one thing: the Securities and Exchange Commission (“SEC”) should not regulate hedge funds.

The public debate over whether to regulate hedge funds began in late 2004 when the SEC released a proposed regulation of hedge funds. This proposal, known as the Hedge Fund Rule,<sup>2</sup> was finalized after a period of public comment, and took effect on February 1, 2006.<sup>3</sup> The purpose of this Rule was to

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<sup>1</sup> Beginning in the summer of 2007, the country was hit by what has become known as the “subprime credit crisis.” Borrowing money is of key importance, as credit funds everything from the mergers of large corporations to consumer home loans. The subprime credit crisis has in part been driven by the default of many home loans that were made to “subprime” borrowers, that is, those having less than stellar credit. In 2007, a series of defaults by these subprime debtors caused the credit markets to tighten and shut off the easy access to credit that borrowers enjoyed previously. This caused a chain reaction that affected even the largest of banks as many of the original loans were repackaged and sold in a variety of investment products. For a detailed account of the many stories that have been spawned by this crisis, see Reuters.com, Subprime Mortgage Trouble, <http://www.reuters.com/news/globalcoverage/subprime> (last visited Mar. 15, 2008).

Most recently, Henry Paulson, Secretary of the Treasury, introduced a sweeping proposal to change the entire financial regulatory system in the United States. See Damian Palletta et al, *Plan Begins Battle Over How to Police Market—Amid Crisis, a Bid to Shuffle Powers; Fast Fixes Unlikely*, WALL ST. J., Mar. 31, 2008, at A1. This proposal includes such long-term goals as reducing the power of the SEC and giving the Federal Reserve regulatory oversight authority. Although the short-term goal is the creation of a Mortgage Origination Commission to monitor mortgage lending, it is unlikely that anything will be accomplished, given that it is a presidential election year and that these changes would affect every executive agency affiliated with the financial markets. *Id.*

<sup>2</sup> See *Goldstein v. SEC*, 451 F.3d 873, 877 (D.C. Cir. 2006).

<sup>3</sup> See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) [hereinafter Hedge Fund Rule Release]. (The rule that was created by this release was vacated on June 23, 2006.)

increase hedge fund accountability through mandatory filings.<sup>4</sup> Prior to this regulation, hedge funds had not been required to register with the SEC and thus were exempt from regulatory and disclosure mandates. The new rule required almost all hedge funds to register, thereby giving the SEC substantially greater control and eliminating the secrecy with which hedge funds had been operating.<sup>5</sup> The rule, however, was not in effect for very long. Phillip Goldstein, co-owner of two hedge funds, challenged the rule on the basis that it misinterpreted an existing regulation.<sup>6</sup> On June 26, 2006, the United States Court of Appeals for the District of Columbia Circuit ruled in favor of Goldstein, vacating the Hedge Fund Rule.<sup>7</sup>

The SEC chose not to appeal the decision to the Supreme Court, instead formulating as a replacement for the Hedge Fund Rule two new proposals in late December 2006.<sup>8</sup> One proposal was a pair of anti-fraud provisions, increasing the accountability of hedge fund manager conduct as well as the amount of information released to investors.<sup>9</sup> The SEC later adopted this rule on September 10, 2007.<sup>10</sup> The second proposal, the “Accredited Investor Proposal”—released in December 2006 and further revised in August 2007<sup>11</sup>—is a push to increase the minimum amount that an investor must have in net worth in order to invest in hedge funds.<sup>12</sup> This is a proposed change to Regulation D,<sup>13</sup> a set of regulatory provisions that allows for certain investment vehicles to escape registration with the SEC

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<sup>4</sup> See *id.* at 72,054.

<sup>5</sup> *Id.* Hedge fund secrecy has become something of a legend throughout the financial world. Those involved in hedge funds are so tight lipped that some employees were even reluctant to discuss their daily commute with reporters for fear of reprisal from the hedge fund manager. See Michael S. Schmidt, *A Trader's Train to Wall Street*, *Conn.*, N.Y. TIMES, Aug. 4, 2006.

<sup>6</sup> *Goldstein*, 451 F.3d at 874, 878.

<sup>7</sup> *Id.* at 884.

<sup>8</sup> Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Investment Advisers Act Release No. 2,576, 72 Fed. Reg. 400 (Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230, 275) [hereinafter *Fraud & Accredited Investor Proposals*].

<sup>9</sup> *Id.* at 400.

<sup>10</sup> See 17 C.F.R. § 275.206(4)-8 (2008).

<sup>11</sup> See Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. 45,116 (Aug. 10, 2007) (to be codified at 17 C.F.R. 200, 230, and 239) [hereinafter *August 2007 Revision*].

<sup>12</sup> *Fraud & Accredited Investor Proposals*, 72 Fed. Reg. at 400 n.4 (“We are proposing a rule that would revise the requirements for determining whether an individual is eligible to invest in certain pooled investment vehicles.”).

<sup>13</sup> 17 C.F.R. §§ 230.501-508.

if they conform to specific requirements.<sup>14</sup> These latest proposals have prompted the hedge fund industry to take notice: the SEC is not walking away.

This Note will argue that the recent rules promulgated by the SEC demonstrate the Commission's insistence on keeping a regulatory hand in the hedge fund industry without considering the necessity, effectiveness, or consistency behind its rules. Moreover, the combination of existing hedge fund practices and the requirements of Regulation D make further regulation unnecessary to protect investors. Part II of this Note will briefly explain what hedge funds are and will set forth the applicable statutes and rules that control the hedge fund industry. Part III will outline the SEC proposals, the defunct Hedge Fund Rule, the anti-fraud rules, and the Accredited Investor Proposal. Part IV will analyze the reasons behind both the anti-fraud rules and the Accredited Investor Proposal, and will focus on the lack of necessity for the rules and the inconsistencies between them. Additionally, the arbitrary nature by which the SEC created the Accredited Investor Proposal will be discussed. Finally, Part V will illustrate how additional SEC regulations, with the stated purpose of protecting small investors, are unnecessary due to a combination of current hedge fund practices and Regulation D provisions that sufficiently protects small investors.<sup>15</sup>

## II. HEDGE FUNDS AND THE RULES THAT GOVERN THEM

"Hedge fund" has become a buzzword whose use has extended far beyond the financial communities of Wall Street and Greenwich, Connecticut.<sup>16</sup> As a part of the national news landscape, hedge fund activities and the regulations that affect them have become a regular feature in national newspapers and on the evening news. To provide context for a discussion of the SEC's initiatives, this Part describes what hedge funds are and briefly examines the securities regulations that affect them.

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<sup>14</sup> See Investopedia.com, Regulation D, <http://www.investopedia.com/terms/r/regulationd.asp> (last visited Mar. 16, 2008).

<sup>15</sup> "Small investors" in this Note refers to investors with a relatively small amount of capital, as opposed to wealthy individuals or institutional investors such as pension funds.

<sup>16</sup> Greenwich, Connecticut has become the Wall Street of the hedge fund industry, fast becoming a hub of this low-key industry. For an interesting article about Greenwich and its link to the hedge fund world, see Schmidt, *supra* note 5.

A. *Hedge Funds: What Are They and What Do They Do?*

Defining the term “hedge fund” is not a simple task. Securities law has never formally defined the term.<sup>17</sup> A basic working definition is that a hedge fund is a pool of money managed by a professional who designs strategies to maximize return<sup>18</sup> and that has certain limits in place as to who may invest in the fund.<sup>19</sup> In addition, hedge funds have traditionally been characterized by their lack of registration with the SEC, thereby allowing them the freedom to avoid reporting investment activities.<sup>20</sup>

Hedge funds offer three main benefits to their investors: (1) they provide diversification by investing in a wide array of typical financial products, including more complex and higher risk investments such as derivatives;<sup>21</sup> (2) they attempt to remain uncorrelated to the stock or bond markets,<sup>22</sup> giving

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<sup>17</sup> William Donaldson, Chairman, SEC, Testimony Concerning Investor Protection Implications of Hedge Funds Before the Senate Committee on Banking, Housing, and Urban Affairs (Apr. 10, 2003), available at [www.sec.gov/news/testimony/041003tswhd.htm](http://www.sec.gov/news/testimony/041003tswhd.htm).

<sup>18</sup> “Return” is defined as “the gain or loss of a security in a particular period.” Investopedia.com, Return, <http://www.investopedia.com/terms/r/return.asp> (last visited Mar. 16, 2008). Return comprises both the income from an investment as well as the capital increase of the investment. *Id.*

<sup>19</sup> See *Goldstein v. SEC*, 451 F.3d 873, 875 (D.C. Cir. 2006) (quoting the PRESIDENT’S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999) [hereinafter PRESIDENT’S WORKING GROUP ON FIN. MKTS.]); see also Jessica Natali, *Trimming the Hedges Is a Difficult Task: The SEC’s Attempt to Regulate Hedge Funds Falls Short of Expectations*, 15 U. MIAMI BUS. L. REV. 113, 116 (2007). In addition to restrictions on who may invest, hedge funds generally require lockups whereby an investor agrees to be barred from withdrawing his investment capital for a specified length of time.

<sup>20</sup> See SEC, STAFF REPORT TO THE SEC. EXCH. COMM’N, IMPLICATION OF THE GROWTH OF HEDGE FUNDS viii (2003) [hereinafter STAFF REPORT], available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

<sup>21</sup> A derivative is “a security whose price is dependent upon or derived from one or more underlying assets.” Investopedia, Derivative, <http://www.investopedia.com/terms/d/derivative.asp> (last visited Apr. 7, 2008). A “future” is a common form of a derivative consisting of a contract to buy or sell an asset at an agreed upon price on a certain date in the future. The contract itself is then bought and sold on a secondary market. Much of the risk of derivatives is whether the price of the underlying asset will decline or increase by the agreed upon date. Common underlying assets include “stocks, bonds, commodities, currencies, interest rates and market indexes.” *Id.*; see also STAFF REPORT, *supra* note 20, at 4-5.

<sup>22</sup> The advantage to investors who invest in hedge funds that attempt to be uncorrelated to these markets is that the value of the fund will not necessarily fluctuate when those markets go up or down. This allows for a counterbalancing of the risks in investing in the stock and bond markets. STAFF REPORT, *supra* note 20, at 5. For an example and in-depth explanation of how some hedge funds attempt to hedge against the general markets, see KEITH H. BLACK, MANAGING A HEDGE FUND 39-40 (2004).

investors a method of further reducing broad systemic risk;<sup>23</sup> and (3) they offer complex investment strategies, including short selling,<sup>24</sup> which allow hedge funds to “hedge” against the decline of that investment.<sup>25</sup> A typical example of a hedging technique is when a fund buys an underlying asset, a stock for example, and then sells a futures contract for that stock at a certain price.<sup>26</sup> This technique hedges against a decline in the stock’s value as the investor has ensured that he will have a buyer for the stock at the set price.<sup>27</sup> Some hedge funds still strategize to exclusively provide protection from a fall in the broader markets, although many of them have become pure profit machines at the expense of risk diversification.<sup>28</sup>

### B. *Hedge Fund Governance Law*

Most hedge funds have been able to avoid SEC registration and reporting requirements through a variety of statutory exemptions. This section provides a brief background of the current regulatory structure that allows hedge funds to operate in “secrecy” and the statutes that the SEC seeks to modify.<sup>29</sup>

In order to better understand the laws affecting hedge funds, it is important to understand generally what each of the governing acts accomplishes. When a security<sup>30</sup> is offered

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<sup>23</sup> STAFF REPORT, *supra* note 20, at 5.

<sup>24</sup> “Short selling” is defined as “[t]he selling of a security that the seller does not own . . . . Short sellers assume that they will be able to buy the stock at a lower price than that at which they sold short.” Investopedia, Short Selling, <http://www.investopedia.com/terms/s/shortselling.asp> (last visited Apr. 7, 2008).

<sup>25</sup> STAFF REPORT, *supra* note 20, at 5.

<sup>26</sup> A futures contract is a contract to buy or sell an underlying security at a set price on a specific date. Investopedia.com, Futures Contract, <http://www.investopedia.com/terms/f/futurescontract.asp> (last visited Apr. 7, 2008).

<sup>27</sup> Investopedia, Hedge, <http://www.investopedia.com/terms/h/hedge.asp> (last visited Apr. 7, 2008).

<sup>28</sup> Hedge Fund Rule Release, Investment Advisers Act Release No. 237, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004). For a full discussion of the various trading practices that hedge funds employ, see PRESIDENT’S WORKING GROUP ON FIN. MKTS., *supra* note 19, at 4-5.

<sup>29</sup> For a full account of the various statutes and regulations that affect hedge funds, see STAFF REPORT, *supra* note 20, at 11-32.

<sup>30</sup> A “security” is defined by the Securities Act of 1933 as

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any

for sale, it is governed by the Securities Act of 1933 (“Securities Act”).<sup>31</sup> This Act has two purposes: The first is to provide an investor with significant information concerning the security being offered for sale.<sup>32</sup> The second is to prohibit fraud in the offering of the security.<sup>33</sup> The Securities Exchange Act of 1934<sup>34</sup> is a broad statute that covers securities industry participants, including brokerage firms, clearing agencies, and the actual security exchanges.<sup>35</sup> It has many different components and includes the registration of exchanges, a prohibition of insider trading, and the requirement that certain investors must report their holdings to the SEC.<sup>36</sup>

The final two acts relevant to this discussion are the Investment Company Act of 1940<sup>37</sup> and the Investment Advisers Act of 1940.<sup>38</sup> The Investment Company Act regulates companies, such as mutual funds,<sup>39</sup> that invest and trade for others. The purpose of the act is to provide the public with

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interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(a)(1)(2006). This definition includes essentially every financial product and therefore puts almost every sale of a financial product under the auspices of the Securities Act.

<sup>31</sup> *Id.* § 77a.

<sup>32</sup> SEC, The Laws That Govern the Securities Industry, <http://www.sec.gov/about/laws.shtml> (last visited Apr. 7, 2008) (“This information enables investors, not the government, to make informed judgments about whether to purchase a company’s securities. . . . Investors who purchase securities and suffer losses have important recovery rights if they can prove that there was incomplete or inaccurate disclosure of important information.”).

<sup>33</sup> *Id.*

<sup>34</sup> 15 U.S.C. § 78a.

<sup>35</sup> SEC, *supra* note 32. The security exchanges that are covered by the Securities Exchange Act include the New York Stock Exchange, the American Stock Exchange, and the NASDAQ. *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> 15 U.S.C. § 80a-1.

<sup>38</sup> *Id.* § 80b-1.

<sup>39</sup> The SEC describes a mutual fund as follows:

A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The combined holdings the mutual fund owns are known as its portfolio. Each share represents an investor’s proportionate ownership of the fund’s holdings and the income those holdings generate.

SEC, Invest Wisely: An Introduction to Mutual Funds, <http://www.sec.gov/investor/pubs/inwsmf.htm> (last visited Apr. 7, 2008).

information about the fund and its objectives, including its structure and operation.<sup>40</sup> This is accomplished through regular disclosures to the SEC.<sup>41</sup> The Investment Advisers Act is a companion act, and governs the role of the investment advisor to a fund or investment company. This Act requires that the advisor register with the SEC and provide certain disclosures directly to the agency with the purpose of protecting the individual investor from fraud perpetrated by the advisor.<sup>42</sup>

### 1. The Securities Act of 1933

The purpose of the Securities Act of 1933 is to provide for disclosure and accountability to investors through mandatory registration with the SEC.<sup>43</sup> Without an exemption, any company issuing a security to the public is required to register with the SEC and provide information about the issuer and the security.<sup>44</sup> The specific requirements of disclosure include a description of the properties and business owned by the company issuing the security, a description of the security being sold, information about the management of the company issuing the security, and financial statements of the company.<sup>45</sup> Hedge funds must comply with the mandatory requirements under the Securities Act because they sell a security to their investors.<sup>46</sup> Thus, unless they fall within an exception, they must comply with all of the disclosure requirements.<sup>47</sup>

As a companion to the Securities Act, the SEC created a regulation<sup>48</sup> with the express purpose of exempting certain

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<sup>40</sup> SEC, *supra* note 32.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> STAFF REPORT, *supra* note 20, at 13-14.

<sup>44</sup> *See id.*

<sup>45</sup> SEC, *supra* note 32.

<sup>46</sup> Unless a security is registered with the SEC, it is prohibited from being sold under the Securities Act. 15 U.S.C. § 77(e) (2006) (“Unless a registration is in effect as to a security, it shall be unlawful for any person directly, or indirectly . . . to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.”).

<sup>47</sup> STAFF REPORT, *supra* note 20, at 13.

<sup>48</sup> The SEC is an administrative agency that derives its power from the executive branch. Congress will typically set up a broad statute that sets out what it would like to accomplish, and then the administrative agency creates regulations with the purpose of carrying out Congress’s mandate. Cornell University Law School, Administrative Law, [http://www.law.cornell.edu/wex/index.php/Administrative\\_law](http://www.law.cornell.edu/wex/index.php/Administrative_law) (last visited Mar. 25, 2008).

types of companies from the requirement to register with the SEC. Regulation D,<sup>49</sup> enacted in 1982, provides three exemptions for certain private companies from registering with the SEC.<sup>50</sup> These exemptions are known as Rules 504, 505, and 506.<sup>51</sup> Rule 506 is the exemption used most widely by hedge funds.<sup>52</sup> This Rule allows a company to avoid registration as long as it does not make a general solicitation or advertisement to the public, and allows only “accredited investors” to invest.<sup>53</sup> An accredited investor is an individual with a net worth or joint net worth above \$1,000,000, or total income above \$200,000 or joint income of \$300,000.<sup>54</sup> For institutional investors,<sup>55</sup> the accredited investor standard is higher, requiring \$5,000,000 in investment assets.<sup>56</sup>

Funds that take advantage of the Rule 506 exemption must obey the strict restriction on the marketing of the funds. This restriction prohibits the marketing of

securities by any form of general solicitation or general advertising, including, but not limited to, the following: (1) [a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising.<sup>57</sup>

The solicitation restriction applies to private placements of securities over the Internet as well.<sup>58</sup> This restriction complies with the thrust of the exemption, which is specifically targeted

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<sup>49</sup> 17 C.F.R. §§ 230.501-508 (2008).

<sup>50</sup> August 2007 Revision, 72 Fed. Reg. 45,116, 45,116 (Aug. 10, 2007).

<sup>51</sup> See 17 C.F.R. §§ 230.504-506.

<sup>52</sup> *Id.* § 230.506; see also August 2007 Revision, 72 Fed. Reg. at 45,116. Rules 501 through 503 “contain definitions, conditions, and other provisions that apply generally throughout Regulation D.” *Id.* Rule 504 contains an exemption for companies that offer less than \$1,000,000 in securities to the public in a 12 month period. Rule 505 exempts up to \$5,000,000 in securities offered in a 12 month period, as long as the offering company does not make a general advertisement or solicitation. *Id.* at 45,116-17.

<sup>53</sup> 17 C.F.R. § 230.506. Rule 506 states: “To qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of §§ 230.501 and 230.502.” *Id.* Rule 501 contains the definition of “accredited investor,” and Rule 502 requires the exempted issuer to comply with the prohibitions on advertising. 17 C.F.R. §§ 230.501-502; see also STAFF REPORT, *supra* note 20, at 15.

<sup>54</sup> STAFF REPORT, *supra* note 20, at 15; see also 17 C.F.R. § 230.501(a).

<sup>55</sup> Institutional investors include banks, insurance companies, pension funds and other large scale investors. See August 2007 Revision, 72 Fed. Reg. at 45,123 n.8.

<sup>56</sup> 17 C.F.R. § 230.501(a)(3).

<sup>57</sup> *Id.* § 230.502(c)(1)-(2).

<sup>58</sup> STAFF REPORT, *supra* note 20, at 16-17.

at private investment vehicles. By restricting mass advertising, the SEC ensures that the investment vehicle is indeed “private.”

## 2. Investment Company Act of 1940

The Investment Company Act is quite broad, governing any company that “holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.”<sup>59</sup> This encompasses all types of funds including hedge funds and mutual funds. The Act requires that the companies report their financial condition and investment policies to investors on a regular basis as well as when new securities are sold.<sup>60</sup> Hedge funds employ one of two exemptions to avoid the requirements of the Act.<sup>61</sup> First, if a hedge fund has less than 100 investors and does not offer the securities to the general public, it is exempt from the requirements of the Investment Company Act.<sup>62</sup> Second, a hedge fund can exempt itself from the requirements, while retaining the ability to have unlimited numbers of investors, as long as the investors in the fund are “qualified purchasers.”<sup>63</sup> A “qualified purchaser” is any investor who has at least \$5 million in investments.<sup>64</sup> Thus, although the Investment Company Act covers practically all hedge funds, most hedge funds are able to avoid registration by virtue of being “qualified purchasers” or by limiting participation in the fund to less than 100 investors.

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<sup>59</sup> 15 U.S.C. § 80a-3(a)(1)(A) (2006).

<sup>60</sup> SEC, *supra* note 32.

<sup>61</sup> *Id.*

<sup>62</sup> 15 U.S.C. § 80a-3(c)(1) (“None of the following persons is an investment company within the meaning of this subchapter. . . Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.”).

<sup>63</sup> *Id.* § 80a-3(c)(7)(A) (“None of the following persons is an investment company within the meaning of this subchapter . . . Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.”).

<sup>64</sup> *Id.* § 80a-2(a)(51) (“Any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 80a-3(c)(7) of this title with that person’s qualified purchaser spouse) who owns not less than \$5,000,000 in investments, as defined by the Commission.”).

### 3. Investment Advisers Act of 1940

The Investment Advisers Act of 1940 was created to allow the SEC to monitor advisors to funds and streamline any fraud investigations, as well as to better respond to complaints by investors against an advisor.<sup>65</sup> Almost all advisors to hedge funds fall under the definition of “investment advisor” in the Advisers Act.<sup>66</sup> The Advisers Act requires that advisors register with the SEC and provide the SEC with a bevy of information, including the manner in which the advisor provides advice, the basis upon which the advisor is compensated, and the balance sheet of the advisor.<sup>67</sup> In addition, the Advisers Act prohibits fraud by advisors perpetrated against the managed fund.<sup>68</sup>

Hedge fund advisors generally utilize an exemption to registration under the Advisers Act, thereby avoiding the disclosure requirements.<sup>69</sup> The exemption applies to advisors who have fewer than fifteen “clients” and who do not hold themselves out as advisors to the public or to a registered investment company under the Investment Company Act of 1940.<sup>70</sup> Although most advisors advise funds that have more than fifteen individual investors, the SEC traditionally in its

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<sup>65</sup> *Goldstein v. SEC*, 451 F.3d 873, 876 (D.C. Cir. 2006).

<sup>66</sup> 15 U.S.C. § 80b-2(a)(11) (“‘Investment adviser’ means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . .”).

<sup>67</sup> *Id.* § 80b-3(c)(1). Other examples of disclosure requirements under the Advisers Act include: the names and addresses of the advisor’s partners, officers, and directors of the fund; the advisor’s education and the past 10 years of business affiliations, as well as the current business affiliations of not only the advisor, but his partners, officers, and directors; whether the principal business of the investment advisor is the role of advising funds. *See id.*

<sup>68</sup> *Id.* § 80b-6 (“It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly (1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”). It is important to note the language of the act, which specifically uses the word “client.” Under the Hedge Fund Rule, the SEC attempted to change the definition of client, from the fund as a whole to an individual client. After the Hedge Fund Rule was vacated in *Goldstein*, the SEC created the anti-fraud rules, which specifically prohibited fraud promulgated by an advisor against an individual investor, as opposed to the previous version that prevented fraud against the fund as a whole. *See infra* Part III.A.

<sup>69</sup> 15 U.S.C. § 80b-3(b)(3). The following discussion about the exception and the definition of the term “client” reflect the current state of the law, after the D.C. Circuit rejected the SEC’s contrary position in *Goldstein*. *See infra* Part III.A.

<sup>70</sup> 15 U.S.C. § 80b-3(b)(3).

regulations allowed for the fund itself to be considered a single “client.”<sup>71</sup> An advisor may treat the entire fund as a single client, provided that the investment advice given is based on the entire organization’s objectives, and not on the objectives of any individual investor.<sup>72</sup> This powerful exemption allows advisors that advise less than fifteen funds, although possibly hundreds of individual investors, to avoid registration with the SEC under the Advisers Act. Although the advisors to these funds are exempt from registration, the anti-fraud provisos of the Investment Advisers Act apply as they would to a registered advisor.<sup>73</sup> This exemption, categorizing a “client” as the fund itself rather than the individual investors in the fund, was the target of the SEC’s failed 2004 Hedge Fund Rule.<sup>74</sup>

In sum, the Securities Act requires the registration of any sale of a security. Most hedge funds, however, use Regulation D to avoid registration. The Investment Company Act requires registration by the company that issues the security, a requirement from which most hedge funds are exempted. Finally, the Investment Advisers Act governs the advisor to a fund and requires the registration and periodic monitoring of the advisor by the SEC. Hedge fund advisors utilize an exemption from registration for all advisors who have fewer than fifteen “clients.” Because an entire fund is deemed a “client” an advisor can avoid registration if he advises less than fifteen funds. This definition of “client” was the target of the SEC’s Hedge Fund Rule.

### III. THE SEC’S PROPOSALS: TWO ATTEMPTS

The SEC’s rules have made a significant impact not only on the hedge fund industry, but on the entire financial community as well. This is a result of the SEC’s persistent attempts, beginning with the Hedge Fund Rule, to change the regulatory landscape affecting hedge funds. After the D.C. Circuit vacated the Hedge Fund Rule in *Goldstein v. SEC*,<sup>75</sup> the SEC introduced two more provisions targeting the industry

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<sup>71</sup> 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2004). This is the version of the rule prior to the enactment of the Hedge Fund Rule. Although *Goldstein* vacated the Hedge Fund Rule, a decision that the SEC itself has not challenged, the SEC has never changed its own regulation to reflect *Goldstein*.

<sup>72</sup> *Id.*

<sup>73</sup> STAFF REPORT, *supra* note 20, at 21.

<sup>74</sup> See Hedge Fund Rule Release, 69 Fed. Reg. 72,054, 72,058 (Dec. 10, 2004).

<sup>75</sup> 451 F.3d 873, 884 (D.C. Cir. 2006).

from a different angle. This section discusses the Hedge Fund Rule as well as the recent set of regulatory proposals.

A. *Changing the Investment Advisers Act: Redefining “Client”*

On December 10, 2004, the SEC approved and released the final version of what is now known as the Hedge Fund Rule.<sup>76</sup> The purpose of the rule was to change the definition of the term “client” under the Advisers Act to include all individual investors in hedge funds. This change had the effect of requiring every advisor to a hedge fund with more than fifteen individual investors to register under the Investment Advisers Act. Additionally, the SEC sought to ensnare only hedge funds in the new regulation, purposely excluding venture capital funds<sup>77</sup> that would not be subject to the requirement to register.<sup>78</sup>

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<sup>76</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,054. The SEC articulated the rule and its purpose:

The Commission is adopting a new rule and rule amendments under the Investment Advisers Act of 1940. The new rule and amendments require advisers to certain private investment pools (“hedge funds”) to register with the Commission under the Advisers Act. The rule and rule amendments are designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission’s ability to protect our nation’s securities markets.

*Id.*

<sup>77</sup> A venture capital fund is an investment fund that specializes in providing start-up capital to small and mid-sized companies, and “[a]re generally characterized as high-risk/high-return opportunities.” Investopedia.com, *Venture Capital Funds*, <http://www.investopedia.com/terms/v/vcfund.asp> (last visited Apr. 8, 2008).

<sup>78</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,073. The SEC accomplished the targeting of hedge funds for registration by creating a separate regulation defining a “private fund.” The changed definition of “client” would only apply to a “private fund.” The SEC defined a “private fund” as containing three characteristics that are virtually uniform among hedge funds. *Id.* First, it included a fund that would be “subject to regulation under the Investment Company Act but for the exception from the definition of ‘investment company’ . . .” *Id.* This refers to the exemption to the Investment Company Act for funds with less than one hundred investors, 15 U.S.C. § 80a-3(c)(1) (2006), or that have only “qualified investors,” *Id.* § 80a-3(c)(7). Almost every hedge fund uses one of these exceptions to circumvent the requirements under the Investment Company Act. *See supra* Part II.B.2. The second characteristic of a “private fund,” is a fund that requires investors to lock up capital invested with them for a minimum of two years. Hedge Fund Rule Release, 69 Fed. Reg. at 72,074. Finally, if a fund has “interests in it [that] are offered based on the investment advisory skills, ability or expertise of the investment advisor” (that is, the fund is professionally managed), it is a “private fund.” 69 Fed. Reg. at 72,075. Although most venture capital funds would be included in this rule, the SEC specifically exempted them. *See infra* text accompanying notes 200-201.

Under the new rule, advisors could no longer count the whole hedge fund as the client, but had to consider each investor in the fund as a single client.<sup>79</sup> The effect of this amendment was to limit the registration exemption under the Act to hedge funds having fewer than fifteen investors. Funds with fifteen or more investors would be required to register with the SEC and be subject to the disclosure requirements of the Advisers Act.<sup>80</sup> Additionally, as a companion to the proposed re-definition of “client,” the SEC enacted a clarification to the disclosure requirements.<sup>81</sup> Under the new disclosure rule, the vast majority of all hedge fund managers would be forced to allow the SEC to inspect the books of the hedge funds they manage in addition to the advisor’s own books.<sup>82</sup> In doing so, the SEC could ensure that the advisor is performing his fiduciary duties to the fund.<sup>83</sup> This one-two regulatory punch moved hedge funds from relative secrecy to a status only a few regulatory steps away from its highly transparent half-brother, the mutual fund.<sup>84</sup>

Forcing hedge funds to register with the SEC was a short-lived requirement. Immediately after it took effect in February 2006,<sup>85</sup> the requirement came under attack by Philip Goldstein in *Goldstein v. SEC*.<sup>86</sup> In reaching its conclusion, the D.C. Circuit Court conducted an in-depth review of the history of the use of the word “client” in the investment advisor arena, and the definition that Congress, the courts, and the SEC itself used over the history of the Advisers Act.<sup>87</sup> In June 2006, the

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<sup>79</sup> 17 C.F.R. § 275.203(b)(3)-2(a) (2007) (“[Y]ou must count as clients the shareholders, limited partners, members, or beneficiaries . . . of a private fund. . .”).

<sup>80</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,075.

<sup>81</sup> The clarification was made to apply to those funds that were now defined as “private funds.” 17 C.F.R. § 275.204-2(e)(3)(ii).

<sup>82</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,076.

<sup>83</sup> *Id.* (“Our examiners require access to these records to determine whether a hedge fund adviser is meeting its fiduciary obligations to a private fund under the Advisers Act and rules.”).

<sup>84</sup> As a result of the Hedge Fund Rule, hedge funds and their advisors would be forced to allow the SEC to examine their operations. This has generally been the case with mutual funds, which are highly regulated and are forced to report to the SEC a tremendous amount of information including books and trading positions. See INVESTMENT COMPANY INSTITUTE, 2007 INVESTMENT COMPANY FACT BOOK app. A (47th ed. 2007), available at [http://www.icifactbook.org/pdf/2007\\_factbook.pdf](http://www.icifactbook.org/pdf/2007_factbook.pdf).

<sup>85</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,054.

<sup>86</sup> 451 F.3d 873 (D.C. Cir. 2006).

<sup>87</sup> *Id.* at 873, 878-84. The court was highly critical of the SEC’s change to the definition of the word “client.” Specifically, the court considered that the SEC was a regulatory agency, lacking the power to change a definition that was established by Congress. *Id.* at 878. Furthermore, the court criticized the policy behind the change,

court held that the SEC's attempt to shift the definition of the term "client" from the hedge fund itself to those who invest in a fund was supported neither by statutory interpretation nor by the twenty-year precedent set by the SEC in using the term.<sup>88</sup> By vacating the Hedge Fund Rule, the D.C. Circuit Court left the SEC with two options: appeal the case to the Supreme Court, or create a new rule.

*B. The SEC's Second Attempt to Regulate the Industry*

Of the two options noted above, the SEC chose the latter and never appealed to the Supreme Court. In fact, the SEC abandoned the entire effort to register hedge funds through the Investment Advisers Act. Instead, the SEC quickly attempted to bring new regulatory action to the hedge fund industry with a pair of proposals released on January 4, 2007,<sup>89</sup> just over six months after the *Goldstein* decision. The first of the proposals, the anti-fraud rules, went into effect on September 10, 2007.<sup>90</sup> The anti-fraud rules consist of two additional anti-fraud provisions to the Advisers Act.<sup>91</sup> The new anti-fraud rules enhance the existing anti-fraud provisions of the Advisers Act, which prohibit fraudulent conduct by the advisor against the fund, by explicitly prohibiting fraudulent conduct by the advisor against individual investors in the fund.<sup>92</sup> Specifically, the new rules prohibit two types of conduct. First, advisors are prohibited from making untrue or fraudulent statements to investors or prospective investors in a fund, regardless of the intent behind the statements.<sup>93</sup> Second, advisors are prohibited from "[o]therwise engag[ing] in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with

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stating that the change would not be "any more rational when viewed in light of the policy goals underlying the Advisers Act." *Id.* at 883.

<sup>88</sup> *Id.* at 883.

<sup>89</sup> See Fraud & Accredited Investor Proposals, 72 Fed. Reg. 400 (Jan. 4, 2007). The quick turnaround by the SEC in creating new regulations further exhibits the SEC's focus on regulating the hedge fund industry.

<sup>90</sup> 17 C.F.R. § 275.206(4)-8 (2008).

<sup>91</sup> *Id.* In the release accompanying the proposal the SEC cited the Advisers Act as delegating power to the SEC to create rules and regulations to prevent fraud. Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 401; see also 15 U.S.C. § 80b-6(4) (2006) ("The Commission shall, for the purposes of this paragraph . . . by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.").

<sup>92</sup> See Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 401-03.

<sup>93</sup> 17 C.F.R. § 275.206(4); see also Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 403.

respect to any investor or prospective investor in the pooled investment vehicle.”<sup>94</sup> These combined regulations are intentionally broad, allowing the SEC to prosecute anything that it later deems to be “deceptive conduct.”<sup>95</sup>

The second change that the SEC proposed in December 2006 is a change to the level of requirement in order to be exempted under the Securities Act. Most hedge funds avoid registration under the Securities Act by use of Regulation D, which exempts certain offers and sales.<sup>96</sup> Regulation D allows funds to avoid registration if they allow investment only from accredited investors—those that have at least \$1,000,000 in net worth or income of \$200,000 (or \$300,000 jointly).<sup>97</sup> Under this proposal the SEC sought to force a two-part test for exemption.<sup>98</sup> First, the investor would have had to meet the current definition of an “accredited investor.” Second, the investor would have needed \$2.5 million in investments in addition to being an “accredited investor.”<sup>99</sup> As a result, an investor who would have been able to invest in hedge funds based on his \$200,000 salary would be shut out unless he had \$2.5 million in saved capital. Both the new requirement of \$2.5 million in investments and the already established income levels would not be stagnant, but would be adjusted for inflation beginning in 2012 and would continue to adjust every five years thereafter.<sup>100</sup> The definition of “investments” under Regulation D would also be changed to specifically exclude a person’s residence or place of business or “real estate held in connection with a trade or business.”<sup>101</sup> Hedge funds would be the only target for this new requirement, as the SEC in its proposal expressly excluded venture capital funds.<sup>102</sup> The SEC’s rationale for the exclusion of venture capital funds was based on the belief that venture capital funds are necessary to help small businesses.<sup>103</sup>

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<sup>94</sup> 17 C.F.R. § 275.206(4)-8.

<sup>95</sup> Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 403.

<sup>96</sup> See 17 C.F.R. § 230.506 (2007). As of March 2008, there have not been any changes to Regulation D on the basis of any of the proposals.

<sup>97</sup> See *id.* § 230.501(a).

<sup>98</sup> August 2007 Revision, 72 Fed. Reg. 45,116, 45,127 (Aug. 10, 2007).

<sup>99</sup> *Id.*

<sup>100</sup> See Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 406.

<sup>101</sup> *Id.* at 407.

<sup>102</sup> *Id.* at 407-08.

<sup>103</sup> *Id.*

After the SEC published its proposal, it extended the usual comment period.<sup>104</sup> A strong showing of displeasure with the SEC's new definition ultimately led the Commission to revise the proposal's \$2.5 million requirement.<sup>105</sup> The revised proposal, released in August 2007, eliminated the two-step test.<sup>106</sup> The revised proposal retains the accredited investor test at the existing threshold amounts, but provides in the alternative that an investor with \$750,000 in investments also qualifies as an accredited investor.<sup>107</sup>

However, remaining in place from the Accredited Investor Proposal are two extremely potent changes. First, personal real estate and the value of a place of business are excluded from the calculation of an investment for use in qualifying as an "accredited investor."<sup>108</sup> Investors that had a high net worth as a result of a property they owned would be excluded from investing in hedge funds. Second, the dollar amounts applicable to all of these exemptions would be adjusted in July 2012 for inflation occurring since 1982, the year the income levels were established, and would continue to adjust every five years thereafter.<sup>109</sup> The effect of the August 2007 revised proposal is that the changes will be made quietly, five years later when the inflation adjustment hits. This change cannot be underestimated. Although the current income requirement for a single person is \$200,000 that figure adjusted for inflation is \$442,545.08 in 2008 dollars.<sup>110</sup> By extrapolating that five more years, it is likely that in 2012 the required net income to become an accredited investor will be over \$500,000, which is \$300,000 more than it is today.

Thus, the Hedge Fund Rule sought to force hedge fund managers to register by changing the way a term was defined in the Advisers Act. This rule was vacated by *Goldstein*.<sup>111</sup> In its place, the SEC devised two sets of changes to the regulations to

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<sup>104</sup> A comment period follows the release of a proposed rule to afford the public a chance to express its views on the merits of the proposal. SEC, How to Submit Comments on SEC Rulemaking, <http://sec.gov/rules/submitcomments.htm> (last visited Apr. 17, 2008).

<sup>105</sup> August 2007 Revision, 72 Fed. Reg. at 45,123, 45,127.

<sup>106</sup> *Id.* at 45,123.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at 45,124.

<sup>109</sup> *Id.* at 45,126.

<sup>110</sup> See U.S. Dep't of Labor, CPI Inflation Calculator, <http://data.bls.gov/cgi-bin/cpicalc.pl> (last visited Apr. 17, 2008). The calculator uses the rise in the consumer price index to adjust for inflation.

<sup>111</sup> *Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006).

the Securities Act. The first set, the anti-fraud provisions, seek to allow the SEC to prosecute fraud by hedge funds both in their offering documents and in their conduct. This has been adopted by the SEC and is now a part of the regulations under the Securities Act.<sup>112</sup> The second set of proposals, first released in December 2006 and then changed in August 2007, seek to change the level of money that an investor must have in order to invest in hedge funds. As it stands after the August 2007 revised proposal, the original levels remain in place.<sup>113</sup> If the proposal was adopted, however, the levels would change in 2012 to reflect inflation from 1982 dollars. This is likely to have a significant effect on hedge funds and investors, limiting the amount of available investment dollars to hedge funds as well as the number of investors eligible to invest.

#### IV. THE HEDGE FUND RULE AND THE CURRENT PROPOSAL: TWO RULES, NO DIRECTION

The SEC has made two attempts in the past several years to insert itself into the hedge fund industry—through the Hedge Fund Rule as well as the December 2006 proposals. This section of the Note will demonstrate how the SEC's almost singular interest in regulating the hedge fund industry has led it to create regulations that are either unnecessary or that do not properly address the original concerns that the SEC cites. Part A will address the SEC's first concern, which the SEC articulated in the Hedge Fund Rule release, that hedge funds have grown by a tremendous rate in recent years.<sup>114</sup> Part B will discuss the SEC's concern regarding a number of hedge fund fraud cases brought by the enforcement division of the SEC.<sup>115</sup> Part C will address the third concern: that small investors are opening themselves up to the risks taken by hedge funds through their investment in pension funds and "funds of funds." Finally, Part D will illustrate the inconsistencies between the Hedge Fund Rule and the recent rules, further demonstrating the SEC's fixation on regulating hedge funds without regard for the consistency of its approach.

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<sup>112</sup> See 17 C.F.R. § 275.206(4)-8 (2008); see also *supra* text accompanying notes 90-95.

<sup>113</sup> See *supra* text accompanying note 106-109.

<sup>114</sup> Hedge Fund Rule Release, 69 Fed. Reg. 72,054, 72,054-56 (Dec. 10, 2004).

<sup>115</sup> *Id.* at 72,056-57.

A. *Hedge Fund Growth: Cause for Concern or a Natural Expansion?*

The SEC expressed concern in the release accompanying the Hedge Fund Rule regarding the growing rise in hedge fund assets and the rapid expansion in the number of funds.<sup>116</sup> The Hedge Fund Rule estimated that there were \$870 billion managed by approximately 7000 funds.<sup>117</sup> Highlighting the growth of the industry, the SEC demonstrated that between 1999 and 2004 hedge funds had grown by 260%, nearly becoming a \$1 trillion business.<sup>118</sup> Although the rise in hedge funds has not been completely uphill, due in part to the weak credit market beginning in late 2007,<sup>119</sup> assets managed by the largest of hedge funds in 2007 were still over \$1.6 trillion, a 34% increase over 2006.<sup>120</sup> Hedge funds have undoubtedly become a huge part of the marketplace, and by some indications they amount to the equivalent of 10% of the value of the entire New York Stock Exchange.<sup>121</sup>

The SEC cited the enormous growth of hedge funds as a basis for creating the Hedge Fund Rule, yet it never actually

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<sup>116</sup> *Id.* at 72,055-56.

<sup>117</sup> *Id.* at 72,055.

<sup>118</sup> *Id.* at 72,055-56 (“What is remarkable is the growth of the hedge funds. In the last five years alone, hedge fund assets have grown 260 percent, and in the last year, hedge fund assets have grown over 30 percent. Some predict the amount of hedge fund assets will exceed \$1 trillion by the end of the year. Hedge fund assets are growing faster than mutual fund assets and already equal just over one fifth of the assets of mutual funds that invest in equity securities.”).

<sup>119</sup> See Natali, *supra* note 19, at 125-26; see also Aaron Pressman, *Hedge Funds: The Pool Is Shrinking*, BUS. WK., Jan. 19, 2006, at 32. There has been a tremendous amount of discussion about hedge funds and their Cinderella rise. The credit crisis has taken its toll on many hedge funds including some from household name investment banks, see Finalternative.com, *Bear to Close Third Hedge Fund After 40% Decline* (Jan. 10, 2008), available at <http://www.finalternatives.com/node/3246>. In evaluating the rise in hedge funds and some of their recent declines, it is important to bear in mind that hedge funds are not a single market, akin to the stock market, but are individually managed by independent advisors who make decisions as to what to invest in. See Natali, *supra*, at 116. If a manager is considered successful over a period of time then investors will be attracted to the fund. If a fund suffers heavy losses then investors will seek to withdraw their money from that fund and find a fund with a better track record. During the credit crisis in 2007-2008, some hedge funds bore losses due to a “run on the fund.” This was not limited to hedge funds, but in fact was a phenomenon that caused the demise of one of the oldest of brokerage houses, Bear Stearns, in March 2008. See Landon Thomas Jr., *Aftershocks of a Collapse, with a Bank at the Epicenter*, N.Y. TIMES, Mar. 18, 2008.

<sup>120</sup> Press Release, Hedgefundintelligence.com, *Top Hedge Fund Assets Surpass \$1.6 Trillion According to Absolute Return Survey* (Mar. 4, 2008).

<sup>121</sup> Kevin G. Hall & Robert A. Rankin, *Hedge Funds May Pose a Risk to U.S. Economy*, MCCLATCHY, Aug. 8, 2007, <http://www.mcclatchydc.com/227/story/18766.html>.

defined the “problem.”<sup>122</sup> In contrast, the Accredited Investor Proposal and the anti-fraud rules never mention the extreme growth of hedge funds as a reason for concern. In the Hedge Fund Rule release, the SEC detailed the growing size of funds, but failed to connect that to a concern that warrants the further regulation of hedge funds.<sup>123</sup> In fact, the SEC, after listing a host of statistics regarding hedge fund growth, stated that “[a]s a result, hedge fund advisors have become significant participants in the securities markets.”<sup>124</sup> This basically ended the section regarding this problem, leaving the reader to wonder why the fact that hedge funds are market players is a logical basis for changing regulatory rules. Former Chairman of the SEC, William Donaldson, expressed similarly vague concerns about the growth of hedge funds in April of 2003 when he testified before the Senate Committee on Banking, Housing and Urban Affairs, and began lobbying on behalf of the 2004 Hedge Fund Rule.<sup>125</sup> Donaldson called for an investigation into “market impact issues” stemming from hedge funds and maintained that it “may be that there are other, more subtle or nuanced results of hedge fund activity that merit attention.”<sup>126</sup> Creating regulations to deal with unknown problems is akin to hunting in the dark: you never know what you may hit.

One plausible concern that the SEC might have is that the larger the hedge funds are, the harder they could fall.<sup>127</sup> This concern is borne out of the near failure of Long Term

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<sup>122</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,055-56. 72,054

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> Donaldson, *supra* note 17.

<sup>126</sup> *Id.* at 9. William Donaldson has been the chairman of the SEC board of commissioners since 2003. SEC, SEC Biography: Chairman William H. Donaldson, <http://www.sec.gov/about/commissioner/donaldson.htm> (last visited January 23, 2008). Since taking over the helm of the SEC, Donaldson has spearheaded the campaign to regulate the hedge fund industry. He has introduced three separate regulations that target the industry: the Hedge Fund Rule, the anti-fraud rules, and the Accredited Investor Proposal. Perhaps not coincidentally, he became chairman and began his push to regulate hedge funds shortly after a number of scandals rocked the financial markets, including the great Enron collapse and the fallout from it. *Id.* Although President George W. Bush appointed Donaldson as chairman of the SEC, see Press Release, President Bush Announced His Intention to Nominate William Donaldson to be Commissioner of the Securities and Exchange Commission (Dec. 10, 2002), available at <http://www.whitehouse.gov/news/releases/2002/12/20021210-9.html>, he has disagreed with Donaldson’s targeting of hedge funds for further regulation. See Stephen Labaton, *Officials Reject More Oversight of Hedge Funds*, INT’L HERALD TRIB., Feb. 23, 2007, <http://www.iht.com/articles/2007/02/23/business/web-0223hedge.php>.

<sup>127</sup> See Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities Exchange Commission is Appropriate?*, 80 NOTRE DAME L. REV. 909, 945 (2005).

Capital Management (“LTCM”).<sup>128</sup> LTCM was a hedge fund that started in 1994 with \$1.25 billion in capital.<sup>129</sup> The fund quickly amassed \$102 billion in assets, almost completely in borrowed funds, as the equity in the fund was only \$3.6 billion.<sup>130</sup> In late 1998, after a series of crippling losses for the fund, the fund was left with between \$1.75 to \$1.85 billion in equity, but over \$100 billion in debt.<sup>131</sup> In other words, LTCM was dangerously overleveraged<sup>132</sup> and heading to a failure that would cause catastrophic market tremors.<sup>133</sup> Consequently, the Federal Reserve was forced to put together a syndicate of leading investment banks who agreed to invest \$3.65 billion of capital in exchange for 90% of the shares of LTCM.<sup>134</sup> Following the near collapse, LTCM was able to recover and regain profitability.<sup>135</sup> This Note assumes that the SEC fears that the risks taken by hedge funds could cause a collapse like the one narrowly avoided by LTCM. An assumption about the nature of the risk is necessary because although the Hedge Fund Rule cites the growth of hedge funds as requiring regulation, it fails to explicitly state what specific risk this growth poses.<sup>136</sup> The SEC presumably believes that the growth of the hedge fund

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<sup>128</sup> See Matthew Goldstein, Note, *A Secret Society: Hedge Funds and Their Mysterious Success*, 6 HOFSTRA J. OF INT'L BUS. & L. 111, 118 (2007).

<sup>129</sup> See Justin Asbury Dillmore, *Leap Before You Look: The SEC's Approach to Hedge Fund Regulation*, 32 OHIO N.U. L. REV. 169, 170 (2006).

<sup>130</sup> See *id.* at 171. LTCM's debt was approximately \$98.4 billion, while the fund's equity was \$3.6 billion. *Id.* The ratio of debt to fund equity in LTCM was 27.33. A ratio of 1 or less would mean that the fund only borrows against the amount of its equity. The 27.33 figure signifies significant risk because the fund could not sustain itself if its value dropped and some of the debt would be called by the lenders. Consider the example of purchasing items on a credit card. Using the card only to the extent that the cardholder has money in a bank account to cover the charges would keep the debt/equity ratio under 1. Spending twenty-seven times the amount in the account in a month would be similar to LTCM's position.

<sup>131</sup> *Id.* at 171-72.

<sup>132</sup> Leverage is defined as “the amount of debt used to finance a firms assets.” Investopedia, *Leverage*, <http://www.investopedia.com/terms/l/leverage.asp> (last visited Mar. 19, 2008). The amount of leverage that a fund employs is an important indicator of its health. If it has only a small amount of equity (the money actually invested in the fund) and a high amount of debt and the fund starts to decrease in value, it may become impossible for it to continue to finance its debt, which often leads to a further decrease in fund value as investors become concerned that about its financial health.

<sup>133</sup> See Dillmore, *supra* note 129, at 172.

<sup>134</sup> *Id.* at 173.

<sup>135</sup> *Id.*

<sup>136</sup> See Hedge Fund Rule Release, 69 Fed. Reg. 72,054, 72,055-56 (Dec. 10, 2004). Although the release accompanying the Hedge Fund Rule is over 100 pages long, the discussion regarding the risk posed by the growth of hedge funds is a single paragraph. *Id.*

industry creates risks that could lead to larger market ripples if hedge funds collapse, thus making regulation necessary.

Although a risk to the general markets caused by the increasing growth of hedge funds is a legitimate SEC concern,<sup>137</sup> the Hedge Fund Rule and the anti-fraud rules, as well as the Accredited Investor Proposal and August 2007 revision, all fail to address the risk caused to the market by hedge funds. The Hedge Fund Rule forced hedge funds advisors to register under the Advisers Act.<sup>138</sup> The requirement to register would have subjected the funds to examination by the SEC.<sup>139</sup> This includes enforcement agents reviewing the procedures for valuing client assets, procedures for placing trades, arranging for custody of client funds and securities, and the full disclosure of any conflict of interests.<sup>140</sup> The SEC would not have been privy to the actual positions of the hedge funds and would not have had any say over the strategy that the hedge fund employs.<sup>141</sup> The

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<sup>137</sup> See Karmel, *supra* note 127, at 945. Professor Karmel gives a more detailed background to the LTCM's near collapse. The focus of the article is on the risks to the general market that stem from positions and trading strategies of hedge funds, mutual funds, and pension funds. The article is broad and devotes a small section to examining the risks that arise from hedge funds. *Id.* at 934-35. Part of the problem of examining the risks that hedge funds pose is that there is a lack of empirical evidence showing how the collapsing of hedge funds has affected the broader markets. Although some articles address this potential threat, they almost exclusively use LTCM as their example of hedge funds' detrimental effects on broader markets. See, e.g., Dustin G. Hall, Note, *The Elephant in the Room: Dangers of Hedge Funds in Our Financial Markets*, 60 FLA. L. REV. 183, 185 (2008). This is likely a result of a lack of other examples of spectacular hedge fund collapses that have led to broader market ripples. Although the LTCM episode is telling, a single example is not enough to tell the whole story. Contrary to the belief that hedge funds have a purely negative impact on the broader markets, Paul F. Roye, former Director of the Division of Investment Management at the SEC, in a speech at a hedge fund conference extolled the value that hedge funds provide the general markets in the way of liquidity and efficiency. See Paul F. Roye, Speech by SEC Staff: General Session Speaker at the SIA Hedge Funds Conference: New Regulation: Weighing the Impact (Nov. 30, 2004), *available at* <http://www.sec.gov/news/speech/spch113004pfr.htm>. The debate about the potential fallout from hedge fund collapses will probably continue until there is more empirical evidence gleaned from hedge fund collapses and their effects on the general markets.

<sup>138</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,060.

<sup>139</sup> *Id.* at 72,061.

<sup>140</sup> *Id.* at 72,061 n.85 ("During an examination, our staff may review the advisory firm's internal controls and procedures; they may examine the adequacy of procedures for valuing client assets, for placing and allocating trades, and for arranging for custody of client funds and securities. Examination staff also may review the advisor's performance claims and delivery of its client disclosure brochure. Each of these operational areas presents a greater opportunity for misconduct if it is not open to examination.").

<sup>141</sup> *Id.* at 72,060 n.68 ("Nor does the Act restrict the ability of advisers to engage in short-selling. Moreover, nothing in the Act or our rules requires any investment adviser to disclose its securities positions. Indeed, we recently declined

SEC, therefore, would have lacked the necessary ability to act upon the risks taken by the funds,<sup>142</sup> including how much leverage a fund could employ.<sup>143</sup> Thus, the SEC would be unable to prevent the same type of problem that caused the near collapse of LTCM. Moreover, the recently enacted anti-fraud rules do not give the SEC a say in hedge fund strategies or investments, as they focus solely on fraud.<sup>144</sup> Finally, the Accredited Investor Proposal to raise the accredited investor standard seeks only to change the threshold of who can invest in hedge funds, not what hedge funds can invest in.<sup>145</sup>

In addition, the releases accompanying both the anti-fraud rules and the Accredited Investor Proposal completely ignore the concern of hedge fund growth that the Hedge Fund Rule addressed, as they do not even list it as a reason to regulate.<sup>146</sup> Neither of them ameliorates the risks that the funds take, which the SEC considered so important when it formulated the Hedge Fund Rule. Thus, the SEC is creating rules that are inconsistent with the problems it sees in the hedge fund industry.

*B. Hedge Fund Fraud: Never a Good Thing, But Worthy of Regulation?*

The SEC cited a “substantial and troubling growth in the number of . . . hedge fund fraud enforcement cases” as one of the reasons for implementing the Hedge Fund Rule.<sup>147</sup> The agency pointed to fifty-one cases of hedge fund fraud in the

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requests to require advisers to publicly disclose how they voted client proxies out of a concern that they would thereby divulge client securities positions.”)

<sup>142</sup> *Id.* at 72,061-63.

<sup>143</sup> Although leverage is an increased risk, it is also one of the ways that a hedge fund can increase its profit. Borrowing money against capital invested in the fund allows the fund managers to take larger positions in investments, thereby increasing the possible return. A very simplified example of how leverage can increase return is borrowing money to bet on a horse race. If an investor has \$10 and borrows \$90, the total bet will be \$100. If the investor wins, and it was a 10 for 1 payout, the investor walks away with \$910, the \$1000 won less the \$90 loan (less the interest on the loan, which can vary). Compare this to betting only the \$10 that the investor has on the horse, and a win will only garnish a total of \$100. Of course if the investor borrows the \$90 and loses, then he will have to pay the \$90 back, in addition to the \$10 of his own money that is lost. This example demonstrates the risk that is inherent in leverage, yet also the possible reward.

<sup>144</sup> See 17 C.F.R. § 275.206(4)-8 (2008).

<sup>145</sup> See Fraud & Accredited Investor Proposals, 72 Fed. Reg. 400, 400 (Jan. 4, 2007).

<sup>146</sup> See *supra* text accompanying notes 122-125.

<sup>147</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,056.

five-year period ending in 2004.<sup>148</sup> Additionally, the SEC made much of the fact that several hedge funds were deeply involved in the 2003 market-timing scandal involving mutual funds<sup>149</sup> and noted that the SEC was continuing to bring enforcement actions.<sup>150</sup> This type of suspicious activity provided an impetus not only for the Hedge Fund Rule, but also for the recently implemented anti-fraud rules.<sup>151</sup>

Although there have been several instances of fraud in the hedge fund industry, it is not apparent that the Hedge Fund Rule could have prevented a substantial number of the fraudulent acts.<sup>152</sup> This argument was made by SEC Commissioner Paul Atkins at a meeting in 2004 discussing the Hedge Fund Rule.<sup>153</sup> Atkins broke down all of the hedge fund fraud cases and concluded that registration under the Hedge Fund Rule would have prevented a total of twenty-six cases of fraud in an industry with, at the time, over 7000 funds.<sup>154</sup> Out of the original forty-six cases of fraud that the SEC cited as a basis for the implementation of the Hedge Fund Rule, eight of the funds were previously registered with the SEC, while twenty of them were too small to be covered by the registration rule.<sup>155</sup> Many of the other cases involved the fraudulent valuation of funds, something that has been traditionally difficult to detect, even in a registered fund.<sup>156</sup> Although the rule's effect on preventing fraud is debatable, the fact that the SEC was going forward with a proposal that would affect over 7000 hedge funds on the basis of several cases undermines the SEC's push to act. This effort's limited utility in eliminating fraud is further demonstrated by the SEC's acknowledgment that only

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<sup>148</sup> *Id.*

<sup>149</sup> The market-timing scandal involved mutual fund managers profiting from short-term market moves. ICI.org, Questions and Answers About the Mutual Fund Investigations, [http://www.ici.org/funds/abt/faqs\\_timing.html](http://www.ici.org/funds/abt/faqs_timing.html) (last visited Mar. 20, 2008). Although market timing itself is not illegal, mutual funds discourage it as it disrupts the price of the funds. *Id.* Much of the scandal focused on certain funds' selective enforcement of market timing, allowing some managers to escape inquiry while others received a penalty for their actions. *Id.*

<sup>150</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,056 n.29.

<sup>151</sup> See Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 401-02.

<sup>152</sup> Paul S. Atkins, Statement by SEC Commissioner at Open Meeting Considering Proposed Regulation Under the Advisers Act of Certain Hedge Fund Advisors, (July 14, 2004), available at <http://sec.gov/news/speech/spch071404psa.htm>.

<sup>153</sup> *Id.* Atkins was publicly critical of the Hedge Fund Rule, and voted against it when it was brought before the commission. *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> See Dillmore, *supra* note 129, at 183.

about half of the funds involved in the fraud cases would have been forced to register under the new rule.<sup>157</sup> The agency nevertheless supported its position by stating that the number of fraud cases indicates an increase in overall hedge fund fraud.<sup>158</sup> Thus, the SEC's implementation of the Hedge Fund Rule illustrates how the SEC is trying to regulate the hedge fund industry regardless of both the size of the problem and the effectiveness of its proposed solution.

Under the anti-fraud rules, hedge funds are strictly liable for fraud,<sup>159</sup> evidencing the SEC's interest in creating a regulatory system that targets hedge funds. The recently approved anti-fraud rules prohibit the dissemination of untrue or fraudulent information by hedge fund advisors to their investors.<sup>160</sup> It also implements a broad anti-fraudulent conduct provision.<sup>161</sup> It appears that the SEC is so eager to have a regulatory role in hedge funds that it has created the rules with a negligence standard,<sup>162</sup> abandoning the scienter standard that is used in other anti-fraud provisions.<sup>163</sup> The scienter standard has been interpreted to require at a minimum knowledge of the wrongdoing, if not an always an intent to deceive.<sup>164</sup> With the

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<sup>157</sup> Hedge Fund Rule Release, 69 Fed. Reg. 72,054, 72,056 n.28 (Dec. 10, 2004).

<sup>158</sup> *Id.* (“[R]egardless of whether any particular adviser would be required to register with us, these cases demonstrate the increased prevalence of fraud associated with hedge funds.”).

<sup>159</sup> See 17 C.F.R. § 275.206(4)-8 (2008). It is a violation under the anti-fraud rules to “[m]ake any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made . . . to any investor or prospective investor in the pooled investment vehicle.” *Id.*

<sup>160</sup> *Id.*; see also Fraud & Accredited Investor Proposals, 72 Fed. Reg. 400, 402 (Jan. 4, 2007).

<sup>161</sup> See 17 C.F.R. § 275.206(4)-8 (covering not only advisor misrepresentations and deceptive omissions, but also “any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle”); see also Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 403.

<sup>162</sup> Under the anti-fraud provisions, all untrue information that is disseminated to an investor is subject to prosecution, even if the advisor was unaware of the inaccuracy. This is a negligence standard under which advisor intent is irrelevant. See Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 403.

<sup>163</sup> Scienter is required for a violation of Rule 10b-5, the SEC's regulation banning insider trading. See 17 C.F.R. § 240.10b-5 (2007). Scienter is defined in the 10b-5 context by the Supreme Court as requiring an “intent to deceive, manipulate or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.7 (1976). Rule 10b-5 has such widespread implications and has such notoriety that there are even websites dedicated to the rule. See The 10b-5 Daily Home Page, <http://www.the10b-5daily.com> (last visited Mar. 30, 2008).

<sup>164</sup> See Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 403; see also WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 690 (2d ed. 2007).

current formulation of the rule, the SEC need only show that there was some untrue statement in the offering documents; something as trivial as mislabeling an advisor's address would be actionable under the current setup of the rule.<sup>165</sup> Accordingly, the SEC has shown it intends to break into the relative free reign of hedge funds, creating an intentionally overbroad rule.

The SEC has exaggerated the claim that concerns for fraud necessitate new regulations. More importantly, the rules that the SEC has created to deal with the fraud are either ineffective in the case of the Hedge Fund Rule, or are so overbroad as to find many hedge fund advisors, even those that are merely negligent, in the SEC's regulatory crosshairs.

*C. Institutional Investors: The Institution Protects Itself*

When releasing the Hedge Fund Rule, the SEC stated that its greatest motivation was the fear that small investors would open themselves up to the large risks that hedge funds take by way of the small investors investing indirectly in hedge funds. Specifically, the SEC pointed to two different ways that small investors were indirectly becoming hedge fund investors. First, the SEC in the Hedge Fund Rule attached the greatest significance to the growing number of pension funds,<sup>166</sup> endowments, and charities that invest in hedge funds like never before.<sup>167</sup> Fearing massive losses to pension funds as a result of losses in hedge funds, the SEC was concerned that pension beneficiaries would lose their entitlements.<sup>168</sup> Second, a phenomenon known as "funds of hedge funds," which are funds that invest in multiple hedge funds to reduce risk,<sup>169</sup> was becoming

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<sup>165</sup> See Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 402-03.

<sup>166</sup> See Hedge Fund Rule Release, 69 Fed. Reg. 72,054, 72,057-58 (Dec. 10, 2004). Pension funds are retirement vehicles in which employers contribute to a fund to benefit employee retirement. There are many variations of pension plans, some are fully funded by the employer while others also allow employees to decide to contribute a percentage of their paycheck. Citibank.com, Investment Center Glossary: Defined Contribution Plans, <http://www.citibank.com/bahrain/gcb/invest/glossary.htm> (last visited Mar. 20, 2008). Many Americans rely on their pension plans to supplement their social security retirement benefits.

<sup>167</sup> See Hedge Fund Rule Release, 69 Fed. Reg. at 72,057-58.

<sup>168</sup> *Id.*

<sup>169</sup> JOSEPH G. NICHOLAS, HEDGE FUND OF FUNDS INVESTING 6 (2004). "Funds of funds" are an important part of the hedge fund industry. As of 2004, funds of funds represented one third of all of the assets invested in hedge funds. *Id.* at 3-4. As of April 2007, fund of funds controlled \$684 billion in assets worldwide. *Hedge Funds Record Inflows of USD 60 Billion in Q1 2007, Nearly 300 Per Cent Gain over Q4*

the investment choice for many small investors.<sup>170</sup> Each of these investment vehicles will be examined for both its validity as a threat to small investors and whether the regulations offered by the SEC effectively protect small investors.

The SEC cited the investment of small investors in pension funds as a basis for the Hedge Fund Rule, but this overlooks the fact that pension funds are inherently protected by the pension fund managers. In the Hedge Fund Rule, the SEC stated that the rise in the number of pension funds that were investing in hedge funds was perhaps the most significant reason to create more reporting requirements for hedge funds.<sup>171</sup> Pension fund managers who invest in hedge funds, however, are likely to invest in conservative hedge funds, aware of their responsibilities to investors. This is supported by practices taken by hedge funds that seek to attract pension funds. Those hedge funds that seek pension funds as investors have taken steps to register themselves voluntarily and have put more internal compliance controls into place in order to attract pension fund managers.<sup>172</sup> This is due to the nature of pension funds, a historically risk-averse segment of the market.<sup>173</sup> Even assuming that pension funds significantly increase their risk by investing in hedge funds, pension fund managers are hired by investors to manage those risks and to formulate plans that balance overall investment risks.<sup>174</sup> The argument that pension fund managers are sophisticated and that accordingly their investors do not need protection is hardly

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2006, HEDGEWEEK, Apr. 23, 2007, available at [http://www.hedgeweek.com/articles/detail.jsp?content\\_id=95061](http://www.hedgeweek.com/articles/detail.jsp?content_id=95061) (last visited Apr. 18, 2008).

<sup>170</sup> See Hedge Fund Rule Release, 69 Fed. Reg. at 72,057.

<sup>171</sup> See *id.* at 72,057-58 (“Finally, and perhaps most significantly, in the last few years, a growing number of public and private pension funds, as well as universities, endowments, foundations, and other charitable organizations, have begun to invest in hedge funds or have increased their allocations to hedge funds.”).

<sup>172</sup> See Wang Fangqing, *Regulators and Investors a One-Two Compliance Punch*, FIN. TIMES, Jan. 23, 2007.

<sup>173</sup> See Riva D. Atlas & Mary Williams Walsh, *Pension Officers Putting Billions into Hedge Funds*, N.Y. TIMES, Nov. 27, 2005. It is important to remember that not all hedge funds are alike. Although many hedge funds take large risks, the SEC has categorized all hedge funds as high risk, ignoring funds that adhere to the “hedging” principle of lowering investor risk.

<sup>174</sup> Russel Read, chief investment officer of the California Public Employees Retirement System, a pension fund that holds \$225 billion in retirement assets, decided not to invest in hedge funds because he felt that the enormous fees that they charged did not justify returns that he felt he could mimic. David Clarke, *Hedge Funds Charge Too Much for Returns, Calpers Says (Update 1)*, BLOOMBERG.COM, Feb. 9, 2007.

a novel one.<sup>175</sup> It bears repeating, however, because the SEC's failure to account for the choices made by professional pension fund managers is further evidence that the SEC is intent on regulating even where regulation is unnecessary.

Even if a pension fund investing in hedge funds poses a risk to beneficiaries, the Hedge Fund Rule would have failed to remedy the problem of beneficiaries losing benefits due to a hedge fund collapse. Although hedge fund fraud could cause the collapse of a fund,<sup>176</sup> much of the purported risk to hedge fund investors comes from the trading strategy and positions that hedge funds take. The SEC would not have had any knowledge of or control over these areas.<sup>177</sup> The Hedge Fund Rule governed only the reporting of practices that hedge funds employ with regard to their books and investors, not the positions that hedge funds take.<sup>178</sup> The Hedge Fund Rule, therefore, would not have corrected the problem that the SEC claimed existed.

Furthermore, the SEC was inconsistent when it later discounted the threat to pension funds that hedge funds pose in its discussion in the Accredited Investor Proposal release.<sup>179</sup> In the Accredited Investor Proposal, the SEC stated that pension funds that invest in hedge funds are protected by their pension managers.<sup>180</sup> According to the SEC, pension fund investors do not need protection.<sup>181</sup> Did the risk to pension fund investors evaporate in the six months between the vacating of the Hedge

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<sup>175</sup> See Jacob Preiserowicz, *The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?*, 11 FORDHAM J. CORP. & FIN. L. 807, 840-41 (2006) (noting the position of the SEC's commissioners opposing the Hedge Fund Rule).

<sup>176</sup> *Hedge Fund Founder Admits Guilt in Fraud*, N.Y. TIMES, Dec. 15, 2006 (discussing the collapse of the Bayou hedge fund due to fraud on the part of its founder and two other top officers).

<sup>177</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,060 n.68 ("Nor does the Act restrict the ability of advisers to engage in short-selling. Moreover, nothing in the Act or our rules requires any investment adviser to disclose its securities positions. Indeed, we recently declined requests to require advisers to publicly disclose how they voted client proxies out of a concern that they would thereby divulge client securities positions."); see also *supra* notes 139-143 and accompanying text.

<sup>178</sup> Hedge Fund Rule Release, 69 Fed. Reg. at 72,060.

<sup>179</sup> See *Fraud & Accredited Investor Proposals*, 72 Fed. Reg. 400, 404 (Jan. 4, 2007).

<sup>180</sup> *Id.* ("We note that natural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles.").

<sup>181</sup> *Id.*

Fund Rule by the D.C. Circuit and the Accredited Investor Proposal? The SEC has once again been inconsistent in its treatment of the problems it claims exist.

In addition to the concern about pension fund investors, fear that investors would have more opportunity to invest through funds of hedge funds led the SEC to implement the Hedge Fund Rule. "Funds of funds," as they are commonly known, are companies that invest in a diversified range of hedge funds. Their main benefit to investors is the opportunity to diversify risk by having the fund itself invest in several different hedge funds.<sup>182</sup> The SEC pointed to the growing number of funds of funds that small investors are investing in.<sup>183</sup> In reality, funds of funds have generally been intent on attracting institutional clients, rather than small investors.<sup>184</sup> In fact, institutional investors make up a consistently high percentage of funds of funds' assets.<sup>185</sup> Even if funds of funds were attracting "small investors," this is a phenomenon that the SEC should be encouraging, not attempting to prevent. Funds of funds are run by professional investment managers who choose to invest in hedge funds.<sup>186</sup> This professional management is very beneficial to a small investor, allowing the investor to diversify risk among hedge funds.<sup>187</sup> Although the SEC has made it seem that hedge funds themselves bear incredible risks, many funds of funds, especially the smaller ones, have styled themselves toward the institutional investor who is looking to minimize risk.<sup>188</sup> This concern of the SEC seems to be based on an almost irrational fear: stop small investors from getting involved in hedge funds even if they use a vehicle that is created to limit risk.

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<sup>182</sup> NICHOLAS, *supra* note 169, at 4.

<sup>183</sup> See Hedge Fund Rule Release, 69 Fed. Reg. at 72,057 n.35.

<sup>184</sup> Christine Williamson, *Hedge Funds of Funds: Institutions Lead the Way*, PENSION & INV., Sept. 17, 2007, available at <http://www.pionline.com/apps/pbcs.dll/article?AID=/20070917/PRINTSUB/70914002>.

<sup>185</sup> *Id.*

<sup>186</sup> NICHOLAS, *supra* note 169, at 64.

<sup>187</sup> *Id.* ("The low investment size, professional portfolio management, and investment diversification afforded by funds of funds are benefits superior to what a small or medium-sized investor could achieve on its own.")

<sup>188</sup> Williamson, *supra* note 184.

*D. The Hedge Fund Rule and the Recent Rules: Two Faces, One Agency*

There are inconsistencies between the Hedge Fund Rule and the Accredited Investor Proposal that the SEC has promulgated. This further illustrates that the SEC is so intent on creating more regulation for the hedge fund industry that it has contradicted itself. In the Accredited Investor Proposal, the SEC sought to change the level of required capital to become an “accredited investor.”<sup>189</sup> In the Hedge Fund Rule release, which took place prior to the Accredited Investor Proposal, the SEC downplayed the effectiveness of changing the accredited investor standard. The SEC believed that raising the accredited investor standard would not prevent small investors investing in hedge funds because they could still invest indirectly in hedge funds through pension funds.<sup>190</sup> Yet once the Hedge Fund Rule was struck down, the SEC introduced this precise change merely six months later.<sup>191</sup> This inconsistency of approach is evidence of the SEC’s blatant attempt to further regulate the hedge fund industry, even if it has to contradict itself.

In addition to the inconsistency between the rules, the SEC’s Accredited Investor Proposal is arbitrary and targets the hedge fund industry while exempting other investment options. In the December 2006 release, the SEC juxtaposed the percentage of all investors able to invest in hedge funds under the old accredited investor standard against the percentage of investors who would be eligible under the Accredited Investor Proposal.<sup>192</sup> The SEC’s Office of Economic Analysis estimated that in 1982 when the accredited investor standard was put

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<sup>189</sup> Fraud & Accredited Investor Proposals, 72 Fed. Reg. 400, 400 (Jan. 4, 2007).

<sup>190</sup> Hedge Fund Rule Release, 69 Fed. Reg. 72,054, 72,064 (Dec. 10, 2004) (“Raising the accredited investor standards would not address the broader concerns, discussed above, of the indirect exposure to hedge funds by an increasingly large number of persons who are beneficiaries of pension plans . . .”).

<sup>191</sup> See Fraud & Accredited Investor Proposals, 72 Fed. Reg. 400 (Jan. 4, 2007).

<sup>192</sup> See *id.* at 72 Fed. Reg. at 406. In August 2007, the SEC released a revision to its original proposal in which it left the accredited investor standard at the original levels, with the caveat that the rates would be raised in 2012 to reflect inflation since 1982, the year that the original levels were established. See August 2007 Revision, 72 Fed. Reg. 45,116, 45,123-26 (Aug. 10, 2007). Regardless of this revision, the argument here is centered on the actions that the SEC is taking and its ultimate goals. This goes beyond the pure percentages and requirement level, but focuses on a pattern that the SEC has taken since the introduction of the Hedge Fund Rule.

into place, 1.87% of the U.S. population qualified as accredited investors able to invest in hedge funds.<sup>193</sup> As of 2003, 8.47% were eligible—a significant rise, due in part to general inflation and also to the increase in real estate values over that period.<sup>194</sup> This means that an investor who had property that increased in value over the years would become eligible for accreditation, even if the investor's income level remained the same. Under the December 2006 proposed levels, only 1.3% of the population, less than the original 1982 level, would be eligible to become an accredited investor.<sup>195</sup>

The SEC offered justification for establishing an all-time low percentage of the population eligible to invest in hedge funds because of the “increasing complexity of financial products, in general, and hedge funds, in particular, over the last decade.”<sup>196</sup> There are two flaws with this rationale. First, the SEC did not explain how it arrived at 1.3% of the population as its target.<sup>197</sup> If the SEC was looking to create an all-time low, it could have picked 1.5% or 1%, both of which are below the 1982 level. This is another instance where the SEC is arbitrarily regulating the hedge fund industry and is clearly ignoring the parting shot of the D.C. Circuit's repudiation of the Hedge Fund Rule: “This is an arbitrary rule.”<sup>198</sup> Second, the SEC is looking at only the hedge fund side of the equation. Even given the increased complexity of hedge funds, the SEC ignored the substantial increase in accessibility of investment information since 1982. For example, the Internet offers a plethora of investment information that was unavailable to the average American twenty-six years ago.<sup>199</sup> By taking into account only the increased sophistication of hedge funds and ignoring increased investor sophistication, the SEC has engaged in faulty reasoning.

In addition to the SEC arbitrarily picking a restriction for the number of investors, it arbitrarily ensnares only hedge funds in its new proposal, while excluding other types of funds

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<sup>193</sup> See Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 406.

<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> See *id.*

<sup>198</sup> Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006).

<sup>199</sup> Although many websites are unreliable or inaccurate, investors can choose from many reputable investment sites that provide a host of information about every investment concept. See, e.g., Forbes Home Page, <http://www.forbes.com> (last visited Mar. 24, 2008); CNBC Home Page, <http://www.cnbc.com> (last visited Mar. 24, 2008).

from the Accredited Investor Proposal. Although the SEC made it clear that it wanted to protect investors, it did not require investors in venture capital funds to meet the increased accredited investor standard in the December 2006 proposal.<sup>200</sup> The rationalization for the exception was that the SEC “recognize[s] the benefit that venture capital funds play in the capital formation of small businesses.”<sup>201</sup> The rationale for this exception was questioned by Paul Atkins, an SEC commissioner.<sup>202</sup> Atkins pointed out that the risks that venture funds take are similar to those taken by hedge funds, and voiced his incredulity as to why the SEC would purposefully exclude venture funds while targeting hedge funds.<sup>203</sup> When evaluating risk to small investors it is important to note that venture capital funds take enormous risks, and many of them have closed in recent years due to heavy losses.<sup>204</sup> If the SEC has a legitimate interest in protecting small investors, then it follows that the same protection provided for hedge fund investors should be extended to those who invest in venture capital funds. Furthermore, hedge funds also provide benefits to the national economy, as has been touted by the former chairman of the Federal Reserve, Alan Greenspan.<sup>205</sup> Greenspan made the point that hedge funds that take large positions in the equity markets eliminate inefficiencies by “aligning markets and providing liquidity to markets.”<sup>206</sup> Creating exceptions that favor venture capital funds, which arguably share the same

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<sup>200</sup> Paul S. Atkins, SEC Commissioner, Remarks Before the Federal Reserve Bank of Chicago Seventh Annual Private Equity Conference (Aug. 2, 2007). Venture capital funds provide capital to small businesses and often help manage the business. See *Fraud & Accredited Investor Proposals*, 72 Fed. Reg. at 407-08.

<sup>201</sup> *Id.* at 408 (“In proposing to exclude the offer and sale of securities issued by venture capital funds from the application of the proposed definition, therefore, we recognize the benefit that venture capital funds play in the capital formation of small businesses.”).

<sup>202</sup> Atkins, *supra* note 200 (“Oddly, the changes in accreditation would not apply to venture capital funds. Is there a principled reason for treating venture capital funds differently than other private investment vehicles?”).

<sup>203</sup> *Id.*

<sup>204</sup> Miguel Helft, *A Kink in Venture Capital's Gold Chain*, N.Y. TIMES, Oct. 7, 2006. The SEC also suffers from short-term memory loss when it comes to the impact that venture capital funds can play in the national economy. The “Internet bubble” of the late 1990s that led to the crash of the financial markets in 2001 was partially a result of venture capital funds’ incessant drive to launch more and more Internet businesses. See Peter Elstrom, *The Great Internet Money Game*, BUS. WEEK, Apr. 16, 2001, available at [http://www.businessweek.com/magazine/content/01\\_16/b3728602.htm](http://www.businessweek.com/magazine/content/01_16/b3728602.htm).

<sup>205</sup> Ron Oral, *Greenspan Dislikes SEC Hedge Fund Rules*, N.Y. L.J., July 22, 2004, at 5.

<sup>206</sup> *Id.*

qualities as those of hedge funds, is further evidence of the SEC's interest in targeting the hedge fund industry with increased regulation.

The SEC has created inconsistent regulations that are either unnecessary or represent a misguided attempt to address a poorly defined problem. The SEC never translated the increased size of the hedge fund industry into an identifiable problem. Even assuming that the increased size leads to an increased risk, the SEC has failed to create rules that would reduce the risk. As for hedge fund fraud, very few of the known cases of fraudulent activity in the industry would have been prevented by the Hedge Fund Rule.<sup>207</sup> Finally, the SEC downplayed the effectiveness of the change in the accredited investor standard, yet made it a proposal once the Hedge Fund Rule was vacated.<sup>208</sup> The SEC has apparently adopted a mission to regulate the hedge fund industry regardless of the necessity for or effectiveness of its rulemaking.

#### V. NEW REGULATION: IS IT REALLY NECESSARY OR ARE SMALL INVESTORS PROTECTED?

The SEC has made it a top priority to protect small investors from losing their investment in hedge funds. Protecting small investors from directly investing in hedge funds has been the cornerstone of the recent regulatory push by the agency.<sup>209</sup> This has been the rallying cry for the SEC,

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<sup>207</sup> Atkins, *supra* note 152.

<sup>208</sup> Hedge Fund Rule Release, 69 Fed. Reg. 72,054, 72,064 (Dec. 10, 2004).

<sup>209</sup> *Id.* at 72,057 (“[Of] significant concern is the growing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds. Hedge fund investors are no longer limited to the very wealthy.”); Fraud & Accredited Investor Proposals, 72 Fed. Reg. 400, 400 (Jan. 4, 2007) (“We are concerned that the definition of ‘accredited investor’ . . . may not provide sufficient protection for investors.”).

The current credit crisis and economic downturn has greatly affected even the most “traditional” and stalwart of investment banks and funds. See Julie Creswell, *A Nervous Wall St. Seems Unsure What's Next*, N.Y. TIMES, Mar. 31, 2008, at C1. Specifically, the collapse of Bear Stearns in March 2008 has caused considerable alarm in the investment community. *Id.* It is interesting to note that although many investors were wiped out on their investment in Bear Stearns, some hedge funds made huge profits. Gregory Zuckerman et al., *Stocks Tumble Again, But Some Traders Win Big*, WALL ST. J., Mar. 20, 2008, at C1. Hedge funds sold short stock of Bear Stearns in the weeks leading up to the collapse. *Id.* Hedge funds were not alone, as a quarter of the total shares of Bear Stearns were sold short when the investment bank collapsed, thereby giving great returns to those that had bet against Bear Stearns. *Id.* This is just a small example of how hedge funds have made money by taking non-traditional and contrarian positions in the financial markets. Although there were obviously large risks in taking the position, those that invest in hedge funds often look to the fund as a

and is what apparently will continue to push the SEC to create more regulations. In the Accredited Investor Proposal, the SEC sought to protect small investors by excluding those it deemed too “small” to absorb a major loss in a hedge fund.<sup>210</sup> The issue that will continue to be a dominant theme in the coming years is whether small investors are in need of the protection that the SEC has continued to offer. The practices that hedge funds employ when investors invest in a fund, in addition to certain requirements that hedge funds are forced to take under Regulation D, are arguably sufficient to protect small investors, making both the current proposals, as well as further regulation, unnecessary.

The SEC has claimed that small investors need more protection against the risk of investing in hedge funds because small investors “may find it difficult to appreciate the unique risks of these pools.”<sup>211</sup> Hedge funds must conform to a variety of Congressional Acts, including the Securities Act of 1933, which by its terms would require hedge funds to register and disclose.<sup>212</sup> While Regulation D was set up as a safe harbor to allow private funds to avoid this regulation, it does not allow it free of charge. Investment companies that use Regulation D to avoid registration and reporting, as most hedge funds do, are forbidden from using advertisements, solicitations or online information to attract investors.<sup>213</sup> Accordingly, Regulation D, together with the other legal structures unique to hedge funds, protects the small investor from “accidentally” investing in a vehicle that he thinks is safe and carries the same level of risk as any other investment option. The small investor is protected, therefore, from unknowingly investing in hedge funds because of the many red flags that are put up as warnings.

The advertisement prohibitions, as well as the other unique hedge fund practices, can best be understood when compared to the investment procedures that mutual funds employ. Mutual funds are very similar to hedge funds. Mutual

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way to balance out the risks of investing in more traditional investment vehicles. *See supra* notes 21-25 and accompanying text.

<sup>210</sup> *See* Fraud & Accredited Investor Proposals, 72 Fed. Reg. at 412-13.

<sup>211</sup> *See id.* at 404. Under the Securities Act, offerors of securities must provide the SEC with certain disclosures. SEC, *supra* note 32. The specific disclosure requirements include a description of the properties and business owned by the issuer, a description of the security being sold, information about the issuer’s management, and the issuer’s financial statements. *Id.*

<sup>212</sup> STAFF REPORT, *supra* note 20, at 13.

<sup>213</sup> *See* 17 C.F.R. § 230.502(c)(1)-(2) (2008).

funds invest in many different types of investments, including stocks and bonds, just as hedge funds do. Mutual funds are highly regulated and are limited in the risks that they can take and must report a tremendous amount of information to their investors and to the SEC.<sup>214</sup> Hedge funds, on the other hand, have few requirements. In order to illustrate the protection afforded to small investors by hedge funds, it is valuable to compare the way that a small investor invests in hedge funds compared to mutual funds. The difference between the methods of investing is what raises the red flags for potential hedge fund investors. The differences put the investor on notice that this is not a lower-risk and more regulated mutual fund, but is a higher-risk investment vehicle.

Mutual funds are inherently different than hedge funds, both in the reporting requirements and the rules governing their investment options. A mutual fund is a company that invests in stocks, bonds, and other types of securities with monies invested in it by investors.<sup>215</sup> Mutual fund companies offer many different types of funds as options for investment, each with a specific target.<sup>216</sup> The entire fund is its portfolio and investors buy shares in the combined portfolio where each share is the investor's ownership portion of the fund.<sup>217</sup> Mutual funds have three main identifying features. First, shares of mutual funds are bought and sold back to the fund itself and are not traded on a secondary market exchange.<sup>218</sup> Second, mutual funds continuously create new shares of the fund as monies are received, thereby increasing the total assets of the fund.<sup>219</sup> This allows easy access for new investors to invest in a mutual fund at any point in time.<sup>220</sup> Third, mutual funds and

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<sup>214</sup> Shauna Croome-Carther, *Watch Out for the Mutual Fund Metamorphosis*, INVESTOPEDIA.COM, <http://www.investopedia.com/articles/mutualfund/03/040203.asp> (last visited Mar. 30, 2008).

<sup>215</sup> SEC, *Invest Wisely: An Introduction to Mutual Funds*, <http://www.sec.gov/investor/pubs/inwsmf.htm> (last visited Mar. 25, 2008).

<sup>216</sup> For a list of the many different mutual funds that Fidelity alone offers, see Fidelity.com, *Four and Five Star Fidelity Funds*, [http://personal.fidelity.com/products/funds/framesets/four\\_and\\_five\\_frame.shtml](http://personal.fidelity.com/products/funds/framesets/four_and_five_frame.shtml) (last visited Mar. 30, 2008). Funds range from those that focus on certain sectors such as international investments or real estate to index funds that encompass the market more broadly. *Id.*

<sup>217</sup> SEC, *supra* note 215.

<sup>218</sup> *Id.* Although there might not be a secondary market for the shares, shares of the fund can be easily redeemed and are priced at the funds' "per share net asset value (NAV) plus any shareholder fees that the fund imposes at the time of purchase (such as sales loads)." *Id.*

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

their investment advisors must register with the SEC, and provide disclosure statements.<sup>221</sup> The SEC, therefore, has a strong presence in the mutual fund world by forcing advisors to report details of the funds' holdings and by governing their structure. These characteristics, including increased liquidity, the ease of purchasing and redeeming shares, the ability to invest in a fund mid-cycle, and the added protection of SEC oversight, are what give mutual fund investments their allure.

It is therefore not surprising that mutual funds have become extremely popular. Part of this popularity can be attributed to the increased knowledge investors have about the funds and the ease of purchasing shares. Mutual funds advertise constantly and through every available medium.<sup>222</sup> The Internet has opened up a new arena in which funds can target the average consumer.<sup>223</sup> In addition to more streamlined advertising, it is relatively simple to invest online in a mutual fund. This ease is similar to that typically associated with stocks. Mutual fund companies invite investors to open an account online and invest in a variety of their products, all with easy-to-read screens and simple instructions.<sup>224</sup> For example, by clicking on one of the many mutual funds found on the website of Vanguard Investments, a popular mutual fund and retirement investment company, one can easily access the fund's investment information and a link to "buy this fund."<sup>225</sup>

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<sup>221</sup> INVESTMENT COMPANY INSTITUTE, *supra* note 84, app. A.

<sup>222</sup> Drive on a popular highway and you will almost undoubtedly see a billboard for a mutual fund company. See Aaron Baar, *Schwab's 'Talk to Chuck' Plays Chicago*, ADWEEK.COM, Apr. 8, 2005, [http://www.adweek.com/aw/research/article\\_display.jsp?vnu\\_content\\_id=1000874489](http://www.adweek.com/aw/research/article_display.jsp?vnu_content_id=1000874489). Open a magazine or turn on the television and there will likely be at least one ad touting the virtues of some mutual fund.

<sup>223</sup> For example, at Vanguard.com, when potential investors enter the website, they are greeted with a full advertisement spread. See Vanguard Investments Home Page, [www.vanguard.com](http://www.vanguard.com) (last visited Apr. 6, 2008).

<sup>224</sup> Vanguard Investments, <https://personal.vanguard.com/us/home> (last visited Apr. 6, 2008).

<sup>225</sup> See, e.g., Vanguard Capital Value Fund Overview, <https://personal.vanguard.com/us/funds/snapshot?FundId=0328&FundIntExt=INT> (last visited Mar. 24, 2008). This is similar to the process of purchasing stocks over the Internet through online brokerage houses like E-trade Financial and Charles Schwab. See E-trade Financial, [www.etrade.com](http://www.etrade.com) (last visited Mar. 24, 2008); Charles Schwab, <http://charlesschwab.com> (last visited Mar. 24, 2008). Part of the popularity of online trading stemmed from the so called "day trade craze" of the late 1990's through 2000. Day trading became popular through a combination of a stock market boom in the late 1990s and the Internet's increased accessibility to trade stocks. Day trading became part of the popular culture and spawned legendary ad campaigns, including one about a tow truck driver who owns his own island and drives a truck "for fun." Patrick McGeehan, *Morgan Stanley Dean Witter Drops a Familiar Image to Take Aim at Electronic Brokerage Firms*, N.Y. TIMES, Aug. 28, 2000.

Hedge funds, and the rules that bind them, are a stark contrast to mutual funds. The small investor is put on notice many times before investing in a hedge fund that all funds are not alike. Hedge funds do not allow the ease of entry that characterizes mutual funds, nor do they offer instant liquidity or redemption benefits.<sup>226</sup> Hedge funds neither advertise nor interact with the public the way that mutual funds do. Even the casual investor cannot mistake a hedge fund for a mutual fund, and therefore knows that this is not a typical investment.

To become an investor in a hedge fund there are certain requirements. Hedge funds are set up with two companies: one company manages the fund and runs the other company, which holds the assets.<sup>227</sup> There are three documents that an investor must be given before joining a hedge fund: a risk disclosure statement, a subscription agreement, and an operating agreement.<sup>228</sup> The purpose of the risk disclosure agreement is to warn the investor about every conceivable risk that could befall the fund.<sup>229</sup> This document also lists the risks that are associated with the specific fund, in addition to the risks associated with all hedge funds.<sup>230</sup> The subscription agreement requires the investor to list the amount of money he is investing in the fund, as well as a collection of personal information including investment history.<sup>231</sup> One of the most important functions of the agreement is to certify that the investor is an “accredited investor” and is therefore authorized to invest in the fund.<sup>232</sup> An investor must declare that he is in compliance with both the income and net worth rules, as laid

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<sup>226</sup> SEC, Hedging Your Bets: A Heads Up On Hedge Funds and Funds of Hedge Funds, <http://www.sec.gov/answers/hedge.htm> (last visited Mar. 24, 2008) (“Hedge funds typically limit opportunities to redeem, or cash in, your shares (e.g., to four times a year), and often impose a ‘lock-up’ period of one year or more, during which you cannot cash in your shares.”) *Id.*

<sup>227</sup> See DANIEL A. STRACHMAN, THE FUNDAMENTALS OF HEDGE FUND MANAGEMENT 39 (2007).

<sup>228</sup> See STUART A. MCCRARY, HOW TO CREATE AND MANAGE A HEDGE FUND 105 (2002); STRACHMAN, *supra* note 227, at 41.

<sup>229</sup> See MCCRARY, *supra* note 228, at 105.

<sup>230</sup> *Id.* at 105-06. The primary purpose of the hedge fund manager’s listing every possible risk is to insure against any potential litigious fallout as a result of a fund collapse. In fact, it is in the best interest of the manager to disclose all of the dire risks to investors, if only to further protect the manager. This disclosure may, however, be a double-edged sword: listing every remote risk may cause investors to ignore all of the risks due to “risk overload.” Still, disclosure puts investors on notice that a hedge fund has certain risks that are not found in mutual funds, where a separate risk disclosure is not a part of the investment procedure.

<sup>231</sup> STRACHMAN, *supra* note 227, at 41.

<sup>232</sup> See MCCRARY, *supra* note 228, at 106.

out by the accredited investor standard, and has sufficient investment knowledge and sophistication to invest in a fund.<sup>233</sup> The third document is the operating agreement where the investor agrees to have his money managed by the advisor.<sup>234</sup> Part of the agreement is the assent to the lock-up period that the hedge fund requires, during which time an investor's money cannot be withdrawn.<sup>235</sup> The liquidity that is common to stocks and mutual funds is all but absent from hedge funds. Hedge fund investors typically face a lock-up period of at least a year from the time they make the investment.<sup>236</sup>

These requirements as a whole create a different investing environment for hedge funds than for mutual funds. The risk disclosure is given instead of a prospectus<sup>237</sup> to the potential investor, thereby making the investor aware, not only of the investment style of the fund, but of the very real potential for loss. Furthermore, the investor must give a multitude of information and sign a document certifying himself as an accredited investor, one who understands the nature and risks involved. Finally, the investor must sign a document agreeing to have his money managed and to have it locked up for a specific period of time, only to be made available for a specific day after which it gets locked up again. All of these steps to become a hedge fund investor put the investor on notice that he is investing in a different and higher risk vehicle.

In addition to the internal procedures required to become an investor, Regulation D prohibits hedge funds from soliciting or advertising to the general public. If a hedge fund wants to avoid registration with the SEC under the Securities Act, it must comply with Regulation D and refrain from advertising to the public.<sup>238</sup> The effect of this ban is that the average investor is often unable to identify individual hedge fund companies, and cannot determine how to invest in the

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<sup>233</sup> *Id.*

<sup>234</sup> See STRACHMAN, *supra* note 227, at 41.

<sup>235</sup> See MCCRARY, *supra* note 228, at 44.

<sup>236</sup> SEC, *supra* note 226.

<sup>237</sup> A prospectus is a legal document offered to investors that detail the facts about the investment that are needed to make an informed decision. Investopedia.com, Prospectus, <http://www.investopedia.com/terms/p/prospectus.asp> (last visited Mar. 24, 2008). In the case of a mutual fund, the prospectus "contains details on its objectives, investment strategies, risks, performance, distribution policy, fees and expenses, and fund management." *Id.*

<sup>238</sup> See 17 C.F.R. § 230.502(c)(1)-(2) (2008).

fund.<sup>239</sup> This is in sharp contrast to how mutual funds target investors with “one-click buying.” Accordingly, the protection of small investors with the Regulation D provisions, coupled with the legal and practical structures that hedge funds employ, has the effect of preventing the casual investor from investing in hedge funds without understanding, or at least realizing the potential risks that are involved.

As a result of this combination, small investors are adequately protected from investing in hedge funds. If a small investor chooses to invest in hedge funds directly, the investor must seek out a hedge fund due to Regulation D’s ban on advertisement of any kind. Once a small investor finds a fund to invest in, the investor is warned many times throughout the process that becoming an investor in a hedge fund is unlike investing in traditionally safer, less risky mutual funds. This knowledge is the protection that investors need to prevent them from “accidentally” investing in a high risk vehicle. The decision to invest, however, remains theirs alone.

## VI. CONCLUSION

Underpinning every instance of SEC rule-making is the presumption that there is an identifiable problem whose solution lies in more regulation. This Note has shown, however, that in the case of hedge funds the SEC has rushed to address a problem that has not been fully substantiated, and further it has proposed a solution that fails to solve the purported problem. In addition, the arbitrary and inconsistent manner in which the SEC has formulated the proposals demonstrates a singular motive to regulate, regardless of the wisdom of its approach. This singular focus has largely been premised on the need to protect small investors from investing in hedge funds. The agency argues that small investors should be protected from hedge funds because of the high risks that hedge funds take—risks that a small investor is presumed to be too small to bear. Small investors, however, are adequately protected. The

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<sup>239</sup> It is difficult to find information on the Internet for Grosvenor Capital Management, one of the world’s largest funds of funds, having almost \$20 billion in assets. Press Release, Hedge Fund Intelligence, Funds of Funds Industry Sees Stellar Growth in 2006 (Feb. 12, 2007), available at <http://www.hedgefundintelligence.com/images/590/investhedgebilliondollarrelease.pdf>. Its home page contains a logo, a company address, and an e-mail link for employment interest. Grosvenor Capital Management, <http://www.grosvenorcapitalmanagement.com> (last visited Mar. 24, 2008). The site does not even mention what the company does. *Id.*

average investor would have great difficulty in finding a hedge fund due to the advertisement prohibition of Regulation D.<sup>240</sup> Even once a hedge fund is found, the process of becoming a hedge fund investor puts the investor on notice that it is not a typical investment and is likely to involve higher risks. Investors must sign an agreement asserting that they meet the accredited investor standard in addition to a risk disclosure document outlining the many risks associated with the fund. Also, investors must agree to lock up their investment for a specified period of time. All of these requirements are generally absent from other similar investments, including mutual funds, and they have the effect of warning the investor of the risks associated with hedge funds. Once an investor knows of the risks, it is then his decision whether to take on those risks.

Beginning with the Hedge Fund Rule, the SEC has made clear that it wants to regulate hedge funds. Releasing proposed regulations only months after the Hedge Fund Rule was invalidated by *Goldstein* is firm evidence that the SEC is intent on regulating the industry. The regulation trend is likely to continue, spurred by the SEC's success in passing its anti-fraud rules. With a national recession looming in 2008, the SEC is likely to use any hedge fund that collapses as evidence of the risks involved in investing in hedge funds as well as the need for more regulation. Prior to the bout of regulations beginning in 2004,<sup>241</sup> the SEC was satisfied in its role as a hedge fund spectator. Now it seems that the SEC will not stop until it is holding the hedge fund playbook.

*Joseph Lanzkron*<sup>†</sup>

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<sup>240</sup> See 17 C.F.R. § 230.502(c)(1)-(2).

<sup>241</sup> This was the year the SEC released the Hedge Fund Rule. Hedge Fund Rule Release, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

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