

1-1-2006

Trimming the Hedges is a Difficult Task: The SEC's Attempt to Regulate Hedge Funds Falls Short of Expectations

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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 (2007)

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TRIMMING THE HEDGES IS A DIFFICULT TASK: THE SEC'S ATTEMPT TO REGULATE HEDGE FUNDS FALLS SHORT OF EXPECTATIONS

JESSICA NATALI*

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I. INTRODUCTION

With seemingly illustrious returns over the past several years, many government officials and agencies believe that hedge funds have positioned themselves as the paradigm of investment instrumentality. Hedge funds' rapid growth in both size and influence has landed over \$1 trillion in assets in over 8,000 funds, gaining the attention and scrutiny of the Securities Exchange Commission ("SEC").¹ Hedge fund assets grew approximately 260 percent between 1999 and 2003 alone,² prompting the SEC to conduct a review of hedge fund practices and operations.³ But despite the fact that hedge fund growth slowed significantly in 2004 and 2005 as returns fell considerably short of investor expectations,⁴ the SEC maintains that hedge fund assets will continue to grow and that hedge funds will remain an increasingly popular investment opportunity for both the sophisticated and retail investor.⁵

Unfortunately for hedge fund advisors who previously thrived on the anonymity of the industry and its practices, the SEC's interest in hedge funds was accompanied by increased attention from the media, generating remarkable commotion over the hedge fund industry. This media coverage spawned a national fear of the potential effects the growth of these investments may have on U.S. financial markets.⁶ And with the highly publicized failures of several large funds as a result of allegedly questionable trading practices,⁷ the SEC resolved to take regulatory action. After completing its

¹ Brett Duval Fromson, *Hedge Funds Today, Fortunes Favor the Brave*, WALL ST. J., Nov. 22, 2005, at A14.

² Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisors Act Release No. IA-2333, 69 Fed. Reg. 72054-01 (Dec. 10, 2004) [hereinafter Investment Advisors Act Release].

³ SEC STAFF REPORT, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (2003) [hereinafter SEC REPORT].

⁴ Hedge fund growth in 2004 and 2005 was reported at 9% and 9.2% respectively. See Bloomberg.com, *Hedge Funds Gained 9.2% in 2005 After Slow First Half*, <http://quote.bloomberg.com/apps/news?pid=10000006&sid=a7XesFzLwEWs&refer=home#> (last visited Oct. 23, 2006).

⁵ Investment Advisors Act Release, *supra* note 2.

⁶ See Steven Rattner, *Don't Fence in Hedge Funds*, BUS. WK., Jan. 16, 2006, at 104.

⁷ See Justin Hibbard & Adrienne Carter, *Another Fishy Hedge Fund*, BUS. WK., Oct. 13, 2005 (detailing the collapse of Wood River Capital Management). See also Daniel Kadlec, *Watch Out, They Bite!*, TIME, Nov. 9, 2005 (explaining the collapse of the broker Refco and the demise of hedge funds as a result); Daniel Fisher & Lea Goldman, *We Wuz Robbed!*, FORBES, Dec. 12, 2005 at 166 (discussing the failures of both Wood River Capital Management and Bayou Management); *Investor Protection Implications of Hedge Funds: Before the S. Comm. on Banking, Housing and Urban Affairs* (2003) (testimony of William H.

integral study of the hedge fund industry in 2003,⁸ the SEC promulgated a new rule requiring that certain hedge fund advisors register under the Investment Advisors Act of 1940 ("Advisors Act"), seeking to increase disclosure in an industry with little transparency and to oversee an allegedly growing pool of assets.⁹ However, in light of the SEC's past inability to regulate the hedge fund industry,¹⁰ it was unclear whether this rule would provide the SEC with any real authority to regulate hedge fund practices. The SEC's efforts finally stalled in June of 2006 when the U.S. Court of Appeals for the District of Columbia Circuit vacated this rule, reasoning that the SEC exceeded its agency authority and rendering the rule unenforceable.¹¹

Because it is likely that the SEC will either petition the Supreme Court or seek an amendment to the Advisors Act from Congress that mirrors the language of the vacated rule,¹² it is necessary to evaluate the efficacy of the vacated rule in its attempt to increase disclosure. Accordingly, this article examines the various safe harbors that have allowed hedge funds and their advisors to escape federal regulation, evaluates the alleged needs for SEC oversight over hedge fund practices, and details the inadequacy of the vacated rule in its attempt to provide the SEC with oversight over the large pool of assets it sought to regulate. This article then argues that the vacated rule merely provided alternative parameters for qualifying for exemption from registration under the Advisors Act, which effectively provided an incentive for hedge fund advisors to increase investment lockup periods. Further, this article contends that because all applicable federal securities regulation provides exemptions easily accessible by hedge funds and their advisors, market efficiencies will be better served if, going forward, the SEC focuses on limiting unregistered hedge funds' access to certain markets, rather than trying to force SEC registration. Effective limitations can be achieved by further policing the investments in which hedge funds seek to invest and by preventing certain retail investors from investing in hedge funds, rather than by attempting to regulate the hedge fund industry directly.

Donaldson, Chairman, U.S. Securities and Exchange Commission) [hereinafter Chairman Donaldson].

⁸ Joseph C. Long, *A Hedge Fund Primer*, PRACTISING LAW INST., Aug., 2005, at 233.

⁹ See Investment Advisors Act Release, *supra* note 2.

¹⁰ See discussion *infra* Part II.

¹¹ Goldstein v. Securities and Exchange Commission, 451 F.3d 873, (D.C. Cir. 2006).

¹² Mitchell S. Eitel, *Understanding Complex Financial Institutions*, PRACTISING LAW INST., Dec., 2006, at 717.

A. Hedge Funds are Difficult to Define

The term hedge fund has no exact legal or market definition,¹³ but it “has developed into a catch-all classification for many unregistered privately managed pools of capital.”¹⁴ Generally speaking, hedge funds are holding entities of a collection of unregistered securities and other assets that need not register their securities offerings with the SEC.¹⁵ Traditionally, hedge funds are organized as limited partnerships.¹⁶ The fund promoter acts as the general partner and all investors in the fund are issued limited partnership interests.¹⁷ Once committed to a fund, hedge fund investors have limited control over their money and are generally required to commit their investments for fixed periods of time. Typically investors cannot redeem their investments without prior notice or more than twice a year.¹⁸

Hedge fund advisors, with sole management discretion, have the flexibility to structure their securities offerings in ways that qualify for exemption from all relevant federal securities laws.¹⁹ As a result, hedge funds are not subject to the diversification requirements or borrowing and leverage restrictions with which other registered investment companies must comply.²⁰ Accordingly, hedge funds may specialize in a limited number of investments or utilize extensive leverage in their investment strategy. This freedom may assist managers in achieving above average returns, but it can also increase investors’ vulnerability to market fluctuations.²¹

Hedge funds profit by using a myriad of investment strategies and techniques to achieve maximum returns, making it difficult to limit hedge funds to any set of distinct characteristics.²² The only consistent, historic similarity between funds has been their fee structure, generally providing for management fees of approximately 2% of fund assets and 20% of fund profits.²³ It is important to note, however, that hedge fund managers are

¹³ Pete S. Michaels & Derek C. Anderson, *A Case Study of Two Hedge Funds: A Regulatory Framework and its Lessons for the Broker-Dealer Litigation*, PRACTISING LAW INST., Aug., 2005, at 259.

¹⁴ Long, *supra* note 8, at 235 (quoting SEC Chairman William H. Donaldson).

¹⁵ See discussion *infra* Part II.A.

¹⁶ Long, *supra* note 8, at 235.

¹⁷ *Id.*

¹⁸ Chairman Donaldson, *supra* note 7, at 2.

¹⁹ See discussion *infra* Part II.

²⁰ Chairman Donaldson, *supra* note 7, at 2-3.

²¹ *Id.*

²² Investment Advisors Act Release, *supra* note 2, at 72055.

²³ Dave Kansas, *Making Sense of Wall Street; As Investment Choices Pile Up, Grasping Fundamentals is Key; Hedge-Fund Boom Explained*, WALL ST. J., Jan. 14, 2006, at B1.

only paid when they return a profit, unlike mutual fund managers who take fees regardless of the bottom line.²⁴ This fee structure creates a subconscious regime of self-regulation, providing an incentive for hedge fund managers to proactively pursue investments with a greater potential rate of return while still ensuring appropriate due diligence by providing for the non-payment of compensation when managers produce negative returns. Thus, where other investments may require SEC regulation to mandate thorough due diligence investigation by managers, hedge funds' fee structure inherently provides this protection.

II. HEDGE FUNDS OPERATE OUTSIDE OF FEDERAL SECURITIES REGULATION

Hedge funds' flexible structure, limited investor group and predisposition to private offerings have permitted the majority of hedge funds and their advisors to escape registration under the federal securities laws. The relevant exemptions from the federal securities laws are detailed below.

A. *Hedge Fund Securities Are Not Regulated by the Securities Act of 1933*

The Securities Act of 1933 (the "Securities Act") demands full and fair disclosure in the *public* distribution of securities by requiring issuers to register with the SEC.²⁵ Hedge funds forced to register their securities under the Act would be subject to a panoply of disclosure requirements and SEC scrutiny effectuated by the distribution of a registration statement and prospectus.²⁶ However, hedge fund securities are typically sold through *private* offerings and subsequently avoid registration under the Securities Act. Circumventing registration with the SEC allows hedge funds to offer securities without providing the SEC with anything more than the names and addresses of the funds' owners.²⁷

Hedge fund securities are generally issued in the form of limited partnership interests²⁸ and fall within the definition of a security, pursuant

²⁴ *Id.*

²⁵ JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION (4th ed. 2004)[hereinafter SECURITIES REGULATION].

²⁶ *Id.*

²⁷ Securities that qualify for exemption under Section 4(2) are required to file a Form D with the SEC after issuing securities.

²⁸ See discussion *supra* Part I.

to Section 2(a)(1) of the Securities Act.²⁹ Accordingly, hedge funds would be required to comply with the strict disclosure requirements set forth in Section 5 of the Securities Act but for the private offering exemption provided in Section 4(2) of the Act and Rule 506 of Regulation D.³⁰

Section 4(2) of the Securities Act provides that "the provisions of Section 5 shall not apply to. . . transactions by an issuer not involving any public offering."³¹ A hedge fund can be assured the protections of a Section 4(2) exemption by satisfying the following provisions provided for in Rule 506 of Regulation D: (1) the fund cannot utilize general solicitation or advertising in marketing its securities; (2) the fund can only sell its securities to "accredited investors"³² and up to 35 other purchasers (who must possess sufficient financial and business knowledge and experience in order to evaluate the risks associated with the fund); (3) the fund advisor must be available for questions from prospective purchasers; and (4) the securities issued by the fund cannot be redeemed for at least a year after purchase and cannot be resold.³³

Further, Rule 506 explicitly states, in addition to the aforementioned standards, that to qualify for exemption, an issuer must comply with the requirements set forth in Rule 502 of Regulation D.³⁴ Rule 502 provides that if an issuer sells its securities to any purchaser that is not an accredited investor, the issuer must furnish the purchaser with non-financial information material to an understanding of the business and of the securities being offered, as well as any relevant financial statements and the information contained therein.³⁵

²⁹ SECURITIES REGULATION, *supra* note 23, at 46.

³⁰ SEC REPORT, *supra* note 3, at 13-14.

³¹ Securities Act of 1933, 15 U.S.C.A § 77a (2005).

³² Interpreting rule 501, the SEC REPORT defines accredited investor as:

Individuals who have a net worth, or joint worth with their spouse, above \$1,000,000, or have income above \$200,000 in the last two years (or joint income with their spouse above \$300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and

Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than \$5,000,000 in assets; and many, if not most, employee benefit plans and trusts with more than \$5,000,000 in assets.

SEC REPORT, *supra* note 3, at 15.

³³ U.S. Securities and Exchange Commission, Rule 506 of Regulation D, *available at* <http://www.sec.gov/answers/rule506.htm>.

³⁴ Rule 506 under the Securities Act of 1933, 17 C.F.R. § 230.506 (2005).

³⁵ Rule 502(b) under the Securities Act of 1933, 17 C.F.R. § 230.502(b) (2005).

Accordingly, hedge funds typically only allow “accredited investors” to purchase their securities³⁶ and require these investors to commit their investment for a minimum of one year. Even though hedge funds are not required to comply with the conditions set forth in Rule 506 to qualify for exemption under Section 4(2), compliance with this rule guarantees the availability of the exemption.³⁷ Thus, hedge funds generally comply with the requirements of Rule 506 to ensure that their offerings are not subject to the disclosure requirements of the Securities Act.³⁸

B. Hedge Funds Avoid the Continuous Disclosure Requirements of the Securities Exchange Act of 1934

The Securities Exchange Act of 1934 (the “Exchange Act”) seeks to achieve efficient trading on national markets through the continuous disclosure of material information.³⁹ Hedge fund securities generally fall outside of the parameters of the Exchange Act, which allows hedge funds to avoid compliance with the Act’s continuous disclosure requirements. Generally, continuous disclosure is required for three types of companies: (1) those with securities listed on a national securities exchange pursuant to Section 12(b); (2) those with assets in excess of \$10 million and a class of equity securities held by at least 500 persons pursuant to Section 12(g); and (3) companies with an effective registration statement under the Securities Act filed pursuant to Section 15(d).⁴⁰

The SEC requires the aforementioned types of companies to register their securities and make periodic filings regarding their financial position and material business developments through Forms 10K, 10Q and 8K.⁴¹ Because hedge fund securities are not listed on any national security exchange and generally avoid registration under the Securities Act,⁴² hedge funds merely need to limit the number of investors they allow to purchase securities in order to avoid the disclosure requirements imposed by the Exchange Act.⁴³ The SEC staff report on the implications of hedge fund growth provides:

³⁶ SEC REPORT, *supra* note 3, at 14.

³⁷ *Id.*

³⁸ U.S. Securities and Exchange Commission, *supra* note 31.

³⁹ SECURITIES REGULATION, *supra* note 23, at 7.

⁴⁰ *Id.*

⁴¹ *Id.* at 8.

⁴² See discussion *infra* Part II.A.

⁴³ SEC REPORT, *supra* note 3, at 18.

Section 12(g) and Rule 12g-1 thereunder require that an issuer having 500 holders of record of a class of equity security (other than an exempted security) and assets in excess of \$10 million at the end of its most recently ended fiscal year register the equity security under the Exchange Act. Registration of a class of equity security subjects domestic registrants to the periodic reporting requirements of Section 13, proxy requirements of Section 14 and insider reporting and short swing profit provisions of Section 16 of the Exchange Act.⁴⁴

Again, even though hedge funds generally issue securities in the form of limited partnership interests that fall within the definition of a security under the Exchange Act,⁴⁵ hedge funds can easily escape the parameters of the Exchange Act by capping holders of record at 499, while still managing an unlimited pool of assets.⁴⁶ Thus, hedge funds seeking to avoid the continuous disclosure requirements of the Exchange Act simply avoid listing their securities on any national exchange, refrain from registering their securities offerings under the Securities Act, and limit the number of investors to 499.

C. Hedge Funds Circumvent the Regulations Under the Investment Company Act of 1940

Hedge funds can easily manipulate their corporate form to avoid the regulations of the Investment Company Act of 1940 (the "Investment Company Act"). While hedge funds may fall within the meaning of "investment company" as defined by the Investment Company Act,⁴⁷ both

⁴⁴ *Id.*

⁴⁵ The definition of a security under the Exchange Act and the Securities Act are sufficiently similar. See discussion *supra* Part II.A.

⁴⁶ SEC REPORT, *supra* note 3, at 18-19. For a discussion of the minimal disclosure requirements that may be applicable to hedge funds pursuant to section 13(g) of the Exchange Act, see SEC REPORT, *supra* note 3, at 19.

⁴⁷ 15 U.S.C.A. § 80a-3(a)(1) (2005) defines an investment company as any issuer which:

(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having

Sections 3(c)(1) and 3(c)(7) provide exemptions that allow hedge funds to escape regulation.⁴⁸

Section 3(c)(1) exempts an issuer from regulation when its securities are neither beneficially owned by more than 100 investors nor issued through a public offering. Section 3(c)(7) exempts an issuer from the regulation when its securities are wholly owned by “qualified purchasers” as defined by Section 2(a)(51)⁴⁹ and not issued through a public offering. By providing this exemption, it appears that Congress is of the opinion that extremely sophisticated investors understand and appreciate the risks associated with hedge funds and do not require the protections afforded by the Investment Company Act.⁵⁰

It is important to note that a hedge fund qualifying for exemption pursuant to Section 3(c)(7) is not subject to the 100-investor limitation. Accordingly, these funds are permitted to accept investments from an infinite number of qualified purchasers. However, in order to maintain exemption from the Exchange Act, most hedge funds relying on Section 3(c)(7) still cap investors at 499.⁵¹

D. The SEC Fails to Command Hedge Fund Advisor Registration Under the Investment Advisors Act of 1940

Hedge fund advisors have historically avoided the regulations under the Advisors Act. As a result, in December of 2004, the SEC attempted to mandate hedge fund advisor registration with the SEC under the Advisors Act by adopting amendments to Rule 203(b)(3)-1 and creating Rule 203(b)(3)-2 (collectively, the “Vacated Rule”).⁵²

Generally speaking, hedge fund advisors qualify as “investment advisors” within the meaning of the Advisors Act. Section 202(a)(11) defines an investment advisor as:

a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

⁴⁸ SEC REPORT, *supra* note 3, at 11-12.

⁴⁹ 15 U.S.C.A. § 80a-2(a)(51) (2005) generally defines a qualified purchaser as (1) any natural person who owns not less than \$5,000,000 in investments, (2) any company that owns not less than \$5,000,000 in investments and that is owned by 2 or more persons who are related as siblings or spouse, (3) any other trust that was not formed for the specific purpose of acquiring the securities offered, where the trustee and each settlor is deemed a qualified purchaser, or (4) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests \$25,000,000 or more in investments.

⁵⁰ SEC REPORT, *supra* note 3, at 30.

⁵¹ See discussion *infra* Part II.B.

⁵² See Investment Advisors Act Release, *supra* note 2.

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.⁵³

Section 203A(a)(1)(A) requires investment advisors who have \$25 million or more in assets under management to register under the Act.⁵⁴ Accordingly, hedge fund advisors with at least \$25 million in assets under management are required to register with the SEC.⁵⁵ Pursuant to the regulations, registered investment advisors must maintain certain business records, provide clients with a disclosure statement and implement compliance procedures to prevent violations of the Act.⁵⁶

a. THE HEDGE FUND ADVISOR EXEMPTION

Despite the fact that hedge fund advisors qualify as investment advisors pursuant to Section 202(a)(11) and thus should be subject to the regulations under the Advisors Act, Section 203(b) of the Advisors Act exempts from registration "investment advisors who: (i) have advised fewer than 15 *clients* during the preceding 12 months, (ii) do not hold themselves out generally to the public as an investment advisor and (iii) do not serve as an investment advisor to a registered investment company."⁵⁷ Prior to the SEC's adoption of the Vacated Rule and now after the decision in *Goldstein v. SEC*,⁵⁸ Section 203(b) permits investment advisors to count a hedge fund as a single client for purposes of the 203(b) safe harbor, regardless of the number of limited partnership interests sold in the fund. Consequently, hedge fund advisors are permitted to manage up to 14 hedge funds without registering with the SEC, controlling the investments of an unlimited number of investors holding limited partnership interests in the various funds.⁵⁹

⁵³ 15 U.S.C.A. § 80b-2(a)(11) (2005).

⁵⁴ 15 U.S.C.A. § 80b-3a(a)(1)(A) (2005) (stipulating that this asset minimum only applies to advisors whose principal place of business is in the United States).

⁵⁵ *Id.*

⁵⁶ Investment Advisors Act Release, *supra* note 2, at 72054.

⁵⁷ SEC REPORT, *supra* note 3, at 21.

⁵⁸ *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873, (D.C. Cir. 2006).

⁵⁹ *Id.*

b. THE HEDGE FUND ADVISOR EXEMPTION UNDER THE VACATED RULE

The SEC specifically sought to close the extensive loophole that counting hedge funds as a single client provides and increase the number of hedge fund advisors required to register under the Advisors Act. By enacting the Vacated Rule, the SEC sought to change the counting method that hedge fund advisors currently use to qualify for the private advisor exemption under Section 203(b).⁶⁰ The Vacated Rule required an investment advisor to “look through” a private fund and count each owner of the fund toward the threshold of fourteen clients regardless of whether the owner of the fund was a shareholder, limited partner, member, or beneficiary of the private fund.⁶¹ Where a hedge fund advisor is currently permitted to count each hedge fund as one client, the Vacated Rule required an advisor to count each owner of any hedge fund security as one client to determine whether she qualified for the exemption under 203(b).

However, the Vacated Rule failed to close the loophole completely. The language of the Vacated Rule explicitly required “look through” counting only for advisors of private funds. Consequently, hedge fund advisors would have only needed to utilize “look through” counting for purposes of the exemption if their hedge fund qualified as a private fund pursuant to 203(b)(3)-1.⁶² If a particular hedge fund would not constitute a private fund, the Vacated Rule would not require the advisor to look through the business form and thus would not require the advisor to utilize this new method of counting clients.

The Vacated Rule provided that a hedge fund would not qualify as a private fund unless it is a company that: (1) relies on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act to avoid regulation there under,⁶³ (2) allows investors to redeem their security interests in the fund within two years of purchase and, (3) offers its security interests based on the investment advisor’s skills, ability or expertise.⁶⁴ Because the Vacated Rule dictated that only those funds allowing investors to redeem their security interests within two years of purchase qualify as private funds, it

⁶⁰ Investment Advisors Act Release, *supra* note 2, at 72065.

⁶¹ 17 C.F.R. § 275.203(b)(3)-2 (2006).

⁶² If an advisor advises individual clients directly in addition to investors in a private fund, the advisor must count those individuals as well as the private fund clients as clients for purposes of determining whether the advisor meets the threshold under 203(b)(3). *See id.*

⁶³ *See* Investment Advisors Act Release, *supra* note 2. *See also* discussion *infra* Part II.C.

⁶⁴ 17 C.F.R. § 275.203(b)(3)-1(d) (2006).

effectively provided a safe harbor from the "look through" counting method. An advisor seeking to avoid the "look through" counting requirement could have simply increased the investment lockup period in the fund to two years.

Consequently, rather than limiting the availability of the private advisor exemption, the SEC effectively provided an incentive for hedge fund advisors to increase their lockup periods. By conditioning the exemption on a two-year lockup period, the SEC gave hedge fund advisors a choice: either register with the SEC or increase their lockup period.⁶⁵ If a hedge fund advisor chose to increase the lockup period in her fund to over two years, the advisor could continue to count the fund as one client under the private advisor exemption and would have experienced the same regulatory freedom she currently enjoys.

III. THE SEC'S FEARS OF GROWTH, FRAUD, AND RETAILIZATION UNDERLYING THE ADOPTION OF THE VACATED RULE ARE UNFOUNDED

Despite the fact that hedge funds and their advisors generally avoid registration with the SEC, they have been, and continue to be, subject to the anti-fraud provisions of the federal securities laws. These laws allow the SEC to file suit for misappropriation of assets, misrepresentation of portfolio performance, falsification of experience, credentials and past returns, misleading disclosures regarding claimed trading strategies, and improper valuation of assets.⁶⁶ In fact, the SEC has brought over 51 enforcement actions in the last five years, 38 of which were filed between January 2004 and the middle of October 2005, asserting that hedge fund advisors defrauded investors or used the fund to defraud others.⁶⁷ Because of the recent increase in enforcement actions, the SEC contends that the anti-fraud provisions alone do not provide sufficient protection from or deterrence of fraudulent behavior.⁶⁸

In September of 2003, the SEC completed a detailed investigation of the hedge fund industry.⁶⁹ This staff report outlined the operation of hedge funds and introduced several public policy concerns. In this report and in the reasoning behind the subsequent adoption of the Vacated Rule, the SEC maintained the position that hedge funds are a danger to the stability of the U.S. financial markets and subject investors to inordinately high levels of

⁶⁵ See discussion *infra* Part IV.

⁶⁶ See Investment Advisors Act Release, *supra* note 2, at 72062-63.

⁶⁷ Kit R. Roane, *Hedge Funds Get Clipped*, U.S. NEWS & WORLD REP., Jan. 9, 2006, at 49.

⁶⁸ See Investment Advisors Act Release, *supra* note 2, at 72062-63.

⁶⁹ See SEC REPORT, *supra* note 3.

risk.⁷⁰ The SEC predicated this belief primarily on its inability to detect fraud in its early stages due to a lack of transparency in the industry and its inability to examine and monitor unregistered hedge fund advisors.⁷¹ The SEC alleged that, if given the opportunity to continuously monitor and examine the practices of hedge fund advisors, it would effectively detect fraud and misconduct at much earlier stages, deter fraudulent activities, better protect the investing public, and increase the quality and fairness of hedge fund price valuation.⁷² Consequently, in an effort to acquire access to hedge fund practices, the SEC adopted the Vacated Rule, expecting that a majority of hedge fund advisors would be forced to register under the Act.⁷³

A. *The SEC's Fear of Rapid Growth are Outdated*

In justifying the Vacated Rule, the SEC expressed concern regarding the rapid growth of the hedge fund industry and the impact this growth could have on the U.S. securities markets. At the time the Vacated Rule was adopted, the growth of hedge funds was on the rise. Despite the fact that overall hedge fund assets merely constituted a fifth of total mutual fund assets, the SEC assumed that cash flows into hedge funds would continue to rapidly increase and that hedge fund advisors would become even bigger market participants than their mutual fund counterparts, controlling an infinitely large pool of assets. Accordingly, the SEC asserted that its oversight was necessary to monitor an industry that was poised to account for a significant portion of market trading in the imminent future.

However, with the extensively publicized exposure of fraudulent practices and the subsequent collapse of several large hedge funds,⁷⁴ it is of no surprise that the stunning growth of the hedge fund industry has lost a significant amount of its momentum. Net cash flows into hedge funds actually dropped 44% in the third quarter of 2005 compared to the third quarter of 2004.⁷⁵ And as these cash flows dried up, so did a number of hedge funds themselves. 848 hedge funds closed their doors in 2005, representing more than 11% of the overall U.S. industry at the onset of that

⁷⁰ *Id.* See also Investment Advisors Act Release, *supra* note 2.

⁷¹ See SEC REPORT, *supra* note 3, at 76-80.

⁷² *Id.*

⁷³ See discussion *infra* Part II.D.

⁷⁴ See *supra* note 7.

⁷⁵ Aaron Pressman, *Hedge Funds: The Pool Is Shrinking*, BUS. WK., Jan. 30, 2006, at 32.

year.⁷⁶ This trend has continued in 2006 and will likely continue through 2007.⁷⁷

The decline in the cash flows and the closure of numerous hedge funds seems to evidence the market's minimal tolerance for fraudulent activities, proving that securities markets have some ability to regulate themselves without the interference of the SEC. The decline in cash flows also indicates that the SEC's scrutiny over hedge fund practices may not be necessary, as investors have seemingly punished the hedge fund industry for its abuses by pursuing other investments. While the SEC may have believed that the hedge fund industry would experience continuous growth based on prior predictions, investors are clearly seeking alternative investment options. Consequently, the SEC can no longer rely on hedge fund growth as a predicate for increased regulation as market statistics clearly indicate a reduction in the number of operative hedge funds.⁷⁸

B. The SEC's Fear of Fraud on Collateral Investors Cannot be Solely Attributed to Unregistered Hedge Fund Advisors

Further, as an alternative justification for the Vacated Rule, the SEC expressed a need to protect investors from hedge fund advisors who have not only defrauded their own investors, but who have used funds to defraud additional market participants.⁷⁹ According to the Vacated Rule release, some mutual fund investors have fallen prey to hedge fund advisors utilizing late trading and market timing strategies to bump up returns from mutual funds at the expense of other mutual fund investors, strategies that are both difficult to detect and in contravention of the law.⁸⁰ In several SEC actions, hedge fund advisors were sanctioned for collaborating with mutual fund advisors to achieve high returns, offering to invest in other funds managed by a particular mutual fund advisor in exchange for a waiver of restrictions on market timing.⁸¹

However, it is important to note that the SEC has sanctioned both hedge fund advisors and mutual fund advisors for engaging in these types of transactions.⁸² Despite the fact that the SEC has extensive scrutiny over

⁷⁶ Anita Raghavan ET. AL., *Despite Blue-Chip Gains, Hedge Funds Increasingly Are Faltering and Closing*, WALL ST. J., Oct. 4, 2006, at C1.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ Investment Advisors Act Release, *supra* note 2, at 72056-57.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.* at 72057.

mutual fund practices,⁸³ it was only able to detect these fraudulent trading activities after they had occurred.⁸⁴ Accordingly, the SEC cannot blame these conspiracies solely on the fact that it was unable to monitor and scrutinize unregistered hedge funds, as the SEC has ample discretion to investigate and monitor mutual fund practices pursuant to the Investment Company Act, giving the SEC ample opportunity to uncover these types of transactions. It is unclear why the SEC believes that by requiring hedge fund advisors to register under the Advisors Act, it will be able to detect these same fraudulent activities it failed to discover in its regulation of mutual funds. The Vacated Rule would not provide the SEC with any additional monitoring ability over these types of trading activities; it merely parallels the SEC's existing ability to monitor these activities pursuant to mutual fund registration. Because the Vacated Rule fails to provide any additional protection in the context of market timing conspiracies between mutual fund advisors and hedge fund advisors, the SEC cannot predicate the adoption of the Vacated Rule on the basis that it will aid the SEC in generally detecting fraud against innocent mutual fund investors.

C. The SEC's Fear of Retailization Fails to Account for the Financial Sophistication of Institutional Investment Managers

Finally, the SEC's leading concern is that "a growing number of public and private pension funds, as well as universities, endowments, foundations, and other charitable organizations, have begun to invest in or have increased their allocations to hedge funds."⁸⁵ The SEC fears that participation in hedge fund investing by these entities will expose the beneficiaries of these organizations to increased risk and potentially major losses resulting from insufficient strategies or fraud, thus preventing some entities from satisfying their obligations to beneficiaries.⁸⁶ Accordingly, the SEC contends that beneficiaries who depend on these investments for financial stability are more vulnerable to the current risks associated with hedge funds and require the protections provided by hedge fund advisor registration and SEC oversight.

However, the SEC fails to take into consideration the experience and financial sophistication of the investment managers employed by

⁸³ Mutual funds are required to register with the SEC under the Investment Company Act. See Laurin Blumenthal Kleiman & Carla G. Teodoro, *The ABCs of Mutual Funds*, PRACTISING LAW INST., July 2005, at 9.

⁸⁴ Investment Advisors Act Release, *supra* note 2.

⁸⁵ *Id.* at 72057-58.

⁸⁶ *Id.*

institutional investors. Because institutional investments generally account for large pools of capital, the managers of these investments tend to be seasoned investment advisors.⁸⁷ Accordingly, these managers possess the skills necessary to differentiate between superior and inferior investments and have the education and experience required to evaluate the risks associated with different investment options.⁸⁸ Further, many of these managers are required to perform significant due diligence in selecting investments mandated by law and can be subject to liability for failure to exercise sound judgment.⁸⁹ As a result, managers of institutional investors demand to see business plans, financial statements, pro forma statements and other relevant information when considering an investment and thus should be able to detect any blatant—and possibly even latent—signs of fraudulent activity. At the very least, these seasoned investment advisors are able to understand valuation principals and investment strategies and can reject a potential hedge fund investment if the valuation information provided is inadequate or the trading strategies appear too risky.

In addition, the recent decline in performance coupled with the excessive fees charged by hedge fund managers has led many institutional investors to redeem hedge fund investments.⁹⁰ Many institutional investors are more reluctant to place any assets in hedge funds and are now pursuing “more promising areas such as timber, oil and gas, and distressed debt.”⁹¹ Thus, with the current investment trend among institutional investors moving away from hedge fund investing, the SEC cannot maintain that the alleged rapid retailization of hedge funds necessitates SEC oversight, especially when institutional investment managers have comparable, if not superior, investment expertise compared to SEC staff members.

IV. THE VACATED RULE FAILS TO PROVIDE THE SEC WITH INCREASED OVERSIGHT OVER HEDGE FUND ADVISORS

Pursuant to the Vacated Rule, the SEC provided investment advisors one year to bring their activities in compliance with the rule, requiring that hedge fund advisors who met the requirements of the Vacate Rule register with the SEC no later than February 10, 2006. But as the deadline for compliance approached, several of the largest hedge funds refused to register, contending that “the additional administrative burden of SEC

⁸⁷ SECURITIES REGULATION, *supra* note 23, at 270.

⁸⁸ *Id.*

⁸⁹ See Employment Retirement Income Security Program 29 U.S.C. §§ 1001-1461 (2000)..

⁹⁰ Pressman, *supra* note 72.

⁹¹ *Id.*

registration [could] result in a distraction to senior management with no discernible benefit to [their] investors.”⁹²

Fearing that SEC examiners lack a sufficient understanding of hedge fund trading strategies and that the SEC audit following registration would be overly burdensome for traders and management, a large number of hedge funds capitalized on the loophole provided by the Vacated Rule.⁹³ Because the Vacated Rule only required registration by hedge fund advisors who allow investors to redeem their investments within two years,⁹⁴ a large number of hedge funds merely increased their lockup period to two years in order to avoid registration.⁹⁵ Hedge fund advisors who actively avoided registration voiced concerns about the burdensome cost of compliance, fearing that fulfillment of the SEC requirements could cost over \$500,000.⁹⁶

It was estimated that 15% to 20% of hedge-fund advisors would not register with the SEC.⁹⁷ And even though 80% of then existing hedge funds advisors filed for registration, some of the largest funds managing a majority of hedge fund assets, including SAC Capital Management LLC, Kingdon Capital Management LLC, GLG Partners LP and Lone Pine Capital LLC had no intention of following suit.⁹⁸ Thus, the Vacated Rule failed to provide the SEC with the control over the extensive pool of assets it sought to gain, regardless of the fact that a number of hedge funds actually registered. Rather than generally mandating hedge fund advisor registration, the SEC merely created an alternative safe harbor allowing hedge fund advisors to continue to escape registration under the Advisors Act.⁹⁹

Because the Vacated Rule, as drafted, created an incentive for hedge fund advisors to increase lockup periods in order to continue to operate outside of SEC scrutiny, investors' ability to redeem funds to defend themselves against inadequate performance had been significantly limited. Investors, who previously were able to redeem funds after just a year if unsatisfied with hedge fund management, would be forced to hold investments for at least two years, potentially subjecting these investors to greater losses. These investors would not only be at the mercy of unregistered hedge fund advisors, but they would also be exposed to market fluctuations for an even greater period of time.

⁹² Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, WALL ST. J., Nov. 10, 2005, at C1.

⁹³ *Id.*

⁹⁴ See discussion *infra* Part II.D.b.

⁹⁵ Zuckerman & McDonald, *supra* note 89.

⁹⁶ *Id.*

⁹⁷ Kara Scannell, *Making Hedge Funds Less Secret*, WALL ST. J., Feb. 3, 2006, at C1.

⁹⁸ *Id.*

⁹⁹ See discussion *infra* Part II.D.b.

V. A BETTER WAY TO ALLEVIATE THE CONCERNS ASSOCIATED WITH HEDGE FUNDS

Hedge funds that opt to keep their trading practices secret and that are unwilling to voluntarily comply with the federal securities laws have shown that there is no easy solution to increase transparency into hedge fund practices. Limited investor pools and structural elasticity provide hedge funds with the flexibility necessary to adjust to the varying safe harbor provisions provided for in all the of the federal securities laws,¹⁰⁰ as evidenced by those hedge fund advisors who increased their investment lockup periods to two years to avoid compliance with the Vacated Rule.

Justice Brandeis is renowned for his insight on the need for transparency in the securities markets, advocating that "sunlight is said to be the best of disinfectants."¹⁰¹ But when the federal securities laws repeatedly fail to provide sufficient transparency, such deficiencies necessitate an alternative solution to investor protection. Rather than slowly chipping away at the barriers to hedge fund transparency, the SEC would better serve market efficiencies by further regulating those investments in which hedge funds seek to invest and further restricting the types of investors permitted to invest in hedge funds.

First, if the SEC seeks to eliminate hedge fund advisors' ability to perpetrate fraud against mutual fund investors through the use of market timing, the SEC should regulate these advisors' access to mutual fund investments, rather than trying to force all hedge fund advisors to register with the SEC. The SEC could adopt a new rule under the Investment Company Act that effectively prevents entities that qualify for the Section 3(c)1 or Section 3(c)7 exemptions¹⁰² from investing in both open- and closed-ended registered investment companies (mutual funds). This proposed rule could further provide that an entity qualifying for either exemption may be permitted to invest in a registered investment company only if the investment advisor of the entity registers with the SEC under the Advisors Act. This language would effectively limit mutual fund investments to those hedge fund advisors that register with the SEC. While the Vacated Rule adopted by the SEC attempted to force registration upon hedge fund advisors with little success, this proposed rule would create an incentive for hedge fund advisors to proactively register with the SEC by

¹⁰⁰ See discussion *infra* Part IV.

¹⁰¹ See LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 92 (Frederick A. Stokes Company ed., 1914) (1913).

¹⁰² See discussion *infra* Part II.C.

conditioning access to mutual fund investments on SEC registration. If hedge fund advisors continue to refuse to register with the SEC, this proposed rule would nevertheless protect mutual fund investors from the alleged fraudulent activities of unregistered hedge fund advisors by eliminating their ability to invest in mutual funds.

Alternatively, the SEC could further limit the types of investors permitted to invest in hedge funds. In order to shelter pension funds, universities, endowments, foundations, and other charitable organizations from the purportedly higher risks of hedge fund investing, the SEC could simply eliminate these entities' ability to invest in unregistered funds. The SEC could add language to the Investment Company Act that eliminates the availability of the Section 3(c)1 or Section 3(c)7 exemptions¹⁰³ to those investment companies that permit any pension, endowment or other charitable organization to purchase its securities. Even if this approach seemingly discriminates against institutional investors, in light of the hedge fund industry's poor performance and decreasing popularity among institutional investors,¹⁰⁴ it seems unlikely that institutional investors would oppose this solution. Because a hedge fund would lose its ability to sell its securities to institutional investors if it did not register with the SEC under the Investment Company Act, this proposed rule would also create an incentive for hedge funds to register with the SEC to increase their potential investor pool.

Both suggested rules eliminate the concerns identified by the SEC in its Vacated Rule release without forcing hedge fund registration with the SEC. While neither rule may increase the SEC's ability to regulate hedge funds directly, both suggested rules do foreclose unregistered hedge funds' access to certain markets in which they have previously thrived. Thus, unregistered hedge funds would be at a disadvantage compared to registered funds.

VI. CONCLUSION

The comparatively higher returns that hedge funds historically produced were actually the cause of much ado about nothing in the securities arena. Because the flexible structure of hedge funds, their abstinence in public securities offerings, and their limited investor pools have allowed the majority of hedge funds and their advisors to avoid the mandates of the federal securities laws and SEC registration, the industry has enjoyed

¹⁰³ See discussion *infra* Part II.C.

¹⁰⁴ Pressman, *supra* note 75.

operating in an environment free from SEC oversight. But the recent publicity surrounding the fraudulent activities of a few established hedge funds generated an unwarranted fear of a market collapse and ultimately caused the SEC to enact the Vacated Rule. The SEC feared that the hedge fund industry's rapid growth in size, influence, and appeal to retail investors would leave an extensive pool of assets unregulated, adopting the Vacated Rule in an attempt to gain oversight over the industry. The SEC alleged that if given the opportunity to continuously monitor and examine the practices of hedge fund advisors, it would effectively detect fraud and misconduct at much earlier stages and further deter fraudulent activities.

However, the SEC can no longer rely on hedge fund growth as a predicate for increased regulation as market statistics clearly prove that hedge fund growth has stalled. Further, with the current investment trend among institutional investors moving away from hedge fund investing, the SEC cannot maintain that the alleged rapid retailization of hedge funds necessitates SEC oversight, especially when institutional investment managers have comparable, if not superior, investment expertise.

Nevertheless, even if the SEC's concerns have some merit, the Vacated Rule fails to provide the SEC with sufficient oversight. Rather than generally mandating hedge fund advisor registration, the SEC effectively created an alternative safe harbor that allowed hedge fund advisors to continue to escape registration under the Advisors Act, as evidenced by the number of hedge fund advisors who increased investment lockup periods. Thus, rather than chasing hedge funds and trying to force SEC registration and disclosure to alleviate concerns, the SEC would better serve investor interests by regulating those investments in which hedge funds seek to invest and further restricting the types of investors permitted to invest in hedge funds.