Hedge Funds Are Headed Down-market: A Call for Increased Regulation?*

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> "*Government . . . keep[s] the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.*"
>
> William O. Douglas (SEC Chairman 1937–39)[1]

I. INTRODUCTION

In May 2002, former Securities and Exchange Commission (SEC) Chairman Harvey L. Pitt responded to the "seismic boom" in the number of hedge fund managers and assets they manage by commencing a formal fact-finding investigation to determine whether the current lack of regulation is in the public interest.[2] However, proposed government regulation is nothing new to the hedge fund industry. The industry endured congressional hearings and proposed legislation on the topic in 1998 and 1999 without a resulting increase in regulation.[3]

1. DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS 82 (James Allen ed., 1940).
2. SEC Chairman Harvey L. Pitt, Remarks Before the Investment Company Institute, 2002 General Membership Meeting (May 24, 2002) (transcript available at U.S. Securities and Exchange Commission, *at* http://www.sec.gov/news/speech/spch562.htm (last modified May 24, 2002)).
3. *See Hedge Fund Operations: Hearing Before the House Comm. on Banking & Fin. Servs.*, 105th Cong. 37 (1998) [hereinafter *Hearing*] (statement of Alan Greenspan, Chairman, Board of Governors, Federal Reserve System) (discussing the issue of hedge

The 1998 regulation debate was precipitated by the high profile collapse of Long-Term Capital Management (LTCM) and the subsequent government (Federal Reserve Bank of New York) organized bailout.[4] LTCM collapsed in August 1998 because its quantitative models failed to predict the irregular market movements that left the fund with steep losses, exacerbated by leverage, and an inability to unwind its illiquid positions.[5] The bailout ensued because LTCM's collapse, given the size and extent of its positions, threatened a "global systemic crisis" that would have harmed financial institutions and investors worldwide.[6] As a result, the 1998 hedge fund regulation debate focused on market integrity and the dangers posed by very large, unregulated, and leveraged hedge funds.[7]

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fund regulation); *see also* Hedge Fund Disclosure Act, H.R. 2924, 106th Cong. § 2 (1999).

4. *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 143–60, 185–218 (2000); *see also* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 681–84 (2000) (discussing the financial collapse of LTCM); Daniel F. Zimmerman, Note, *CFTC Reauthorization in the Wake of Long-Term Capital Management*, 2000 COLUM. BUS. L. REV. 121, 124–26 (2000) (discussing the LTCM bailout). LTCM was a large hedge fund with over $3 billion in equity capital and twenty-five Ph.D.s on its payroll. At the time of its collapse in August 1998, the fund's total investment positions topped $125 billion. *See* Anita Raghavan & Mitchell Pacelle, *To the Rescue: A Hedge Fund Falters and Wall Street Giants Ante Up $3.5 Billion*, WALL ST. J., Sept. 24, 1998, at A1 (detailing the fund's $125 billion in total investment positions); Thomas A. Russo & Marlisa Vinciguerra, *Regulation in the Wake of Long-Term Capital's Rescue*, FUTURES & DERIVATIVES L. REP., Feb. 1999, at 1 (detailing the fund's "$3 billion in equity capital and 25 PhDs on its payroll").

5. Russo & Vinciguerra, *supra* note 4, at 3. LTCM used sophisticated quantitative computer models to manage risk and deploy trading strategies that sought to make money by exploiting inefficiencies in several markets. Because the fund focused on small, supposedly predictable inefficiencies, managers employed leverage to amplify the fund's trading returns. Investment leverage is the use of borrowed money in investments as a means of enhancing return. DICTIONARY OF FINANCE AND INVESTMENT TERMS 322 (5th ed. 1998). "Leverage can be achieved in a number of ways, including direct financing through margin loans, repurchase agreements, short sales, and derivatives transactions." Scott J. Lederman, *Hedge Funds*, *in* FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS § 11:2, at 11-1, 11-3 n.6 (Clifford E. Kirsch ed. 2000). Leverage acts to compound the results of an investment for better or for worse. For example, assume that you invest $10,000 to buy 1000 shares of Home Depot trading at $10 per share. If the stock goes up to $12, you have achieved a 20% return. "But if you had borrowed and invested" an additional $10,000, you would have increased your return to 40% (less transaction costs and interest on the $10,000 borrowed) "without putting any more of your own capital at stake." JAMES P. OWEN, THE PRUDENT INVESTOR'S GUIDE TO HEDGE FUNDS: PROFITING FROM UNCERTAINTY AND VOLATILITY 53–54 (2000). Alternatively, if the stock price falls to $8 per share, the use of leverage will magnify your losses as well: You will "owe all the money you've borrowed plus the additional loss." *Id.*

6. Russo & Vinciguerra, *supra* note 4, at 3.

7. *See* Gibson, *supra* note 4, at 682; *see also* Lederman, *supra* note 5, § 11:7, at

In contrast, the current hedge fund regulation debate is focused on investor protection. It is driven by SEC concerns regarding the growth in hedge fund managers and assets, the incidence of fraud among hedge fund managers, the marketing of hedge funds to less affluent investors, and the conflicts of interest for managers who run hedge funds alongside mutual funds.[8] This Comment takes the position that these four areas of SEC concern do not merit increased regulation of hedge funds.

Part II of this Comment defines the term "hedge fund" and provides background on the growth of the hedge fund industry. Part III analyzes recent industry trends that concern the SEC. These trends include the emergence of the "registered" hedge fund as the vehicle that mutual fund companies are using to market hedge funds to a lower strata of net worth investor. Part IV explains the existing regulatory framework and how unregistered hedge funds and their managers remain largely exempt from direct SEC regulation. Part IV also examines the congressional, SEC, and judicial rationales for allowing high net worth individuals to invest in hedge funds without the protections of regulation. Finally, Part V considers several potential SEC proposals for increased regulation and weighs the costs and benefits of each. This Comment concludes by recommending that the SEC issue a policy statement with recommendations for adequate disclosure to investors from unregistered hedge funds.

II. BACKGROUND

A. What Is a Hedge Fund?

There is no statutory definition for the term "hedge fund."[9] Within the investment community there are different definitions of a hedge fund, some broad and others more narrow.[10] Most definitions, however, share

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11-37. The level of leverage utilized by LTCM was particularly troubling to lawmakers and the Federal Reserve because LTCM borrowed the money from major banks that formed the cornerstones of both the domestic and world financial markets. *See* Raghavan & Pacelle, *supra* note 4, at A1.

8. *See* Pitt, *supra* note 2.

9. Gibson, *supra* note 4, at 683; Lederman, *supra* note 5, § 11:2, at 11-3.

10. *Compare* Lederman, *supra* note 5, § 11:2, at 11-3 to 11-6 (highlighting diverse hedge fund strategies), OWEN, *supra* note 5, at 49–52 (emphasizing structure and not strategy), *and* DICTIONARY OF FINANCE AND INVESTMENT TERMS, *supra* note 5, at 255 (highlighting a manager's large personal investment and fee arrangement), *with* Pitt, *supra* note 2 (emphasizing the hedge fund structure and the lack of regulation), William P. Osterberg & James B. Thomson, *The Truth About Hedge Funds*, FED. RES. BANK OF CLEV., May 1, 1999, at 1 (emphasizing investment flexibility and the lack of investor liquidity), Stephen M. Schultz & Steven B. Nadel, *Handling Hedge Funds*, BUS. L. TODAY, May/June 1996, at 54 (highlighting different hedge fund strategies and manager compensation), *and* Alternative Investment Management Association, *Hedge Funds—An Introduction*, *at* http://www.aima.org/aimasite/articles/Mar98/discovery.htm (last visited

the view that hedge funds are relatively unregulated.[11] This Comment will broadly define hedge funds as privately offered, relatively unregulated pooled investment vehicles in the form of limited partnerships or limited liability companies that have the flexibility to invest in a broad range of securities and commodities using a broad range of trading techniques.[12] Furthermore, hedge fund managers typically have a significant portion of their own capital invested in the fund[13] and are compensated primarily by a performance or incentive fee.[14] This fee is often calculated as a percentage of profits earned in the fund above a "high watermark,"[15] a "hurdle rate," or both.[16] It is helpful to further define the often enigmatic and mysterious world of hedge funds by looking at its history.

Historically, there have been two prominent investment theories.[17]

July 21, 2002) (highlighting three broad categories of hedge funds).

11. Schultz & Nadel, *supra* note 10, at 54.

12. *See* Lederman, *supra* note 5, § 11:2.2, at 11-6 (defining hedge funds as using "various types of securities and commodities" and "employing sophisticated investment techniques"); Schultz & Nadel, *supra* note 10, at 54 (defining hedge funds as "privately offered" and "relatively unregulated"); Pitt, *supra* note 2 (defining hedge funds as "limited partnerships or limited liability companies").

13. Lederman, *supra* note 5, § 11:2.2, at 11-5. This practice aligns the manager's interest with that of the client.

14. The industry average for a single fund manager performance fee (as opposed to a fund of hedge funds manager) is twenty percent of the profits earned in the fund. *Id.* § 11:2.2, at 11-5; OWEN, *supra* note 5, at 61. Performance fees align the manager's profit incentive with the client's interest in earning consistent, positive returns.

15. A high watermark is a typical feature of most hedge funds and requires a manager to "make up any prior unrecouped losses before earning a performance fee on current profits." Lederman, *supra* note 5, § 11:2.2, at 11-5 to 11-6. For example, assume that a hedge fund returns 15% in year one. In year two, the fund returns a 5% loss, only to subsequently return an additional 15% in year three. In year one, the manger will take 20% of the profits earned in the fund as her performance fee. In year two, however, there were no profits and consequently no performance fee for the manager. Then, in year three, the manager will have to recoup the 5% loss from year two before taking a performance fee on that year's appreciation. This results in the manager only getting paid a 20% performance fee on 10% of the return in year three, as opposed to the full 15%. High watermarks have the effect of motivating hedge fund managers to generate absolute returns regardless of market direction. However, performance fees subject to a high watermark may also cause perverse incentives for a manager whose fund has sustained big losses. *See* Stephen Taub, *Low-Water Mark*, INSTITUTIONAL INVESTOR, Feb. 2002, at 59, 60, 63.

16. In addition to only earning performance fees on appreciation above the fund's high watermark, managers also typically limit performance fees to be paid out only on returns in excess of a hurdle rate. Hurdle rates are usually pegged to indices that reflect a supposed risk-free rate of return, such as the Treasury bill rate or the London Interbank Offered Rate (LIBOR). OWEN, *supra* note 5, at 61.

17. Alternative Investment Management Association, *supra* note 10, at 1.

The first holds that markets are efficient and that securities mispricings will regress to the mean as investors take advantage of them.[18] The second theory holds that "within this universe of the efficient market, there exist at any given time considerable pockets of inefficiency which can be profitably exploited without incurring unacceptable risks."[19]

Alfred Winslow Jones created the first hedge fund on January 1, 1949.[20] Jones was a proponent of the second theory and the first manager to systematically use leverage and short selling to produce positive returns in both up and down markets.[21] Jones was also the first manager to use a performance fee structure of twenty percent and make substantial commitments of his own capital into the fund.[22] Hedge fund strategies have evolved greatly over the last fifty years but still remain fundamentally tied to the Jones legacy of seeking "absolute returns"[23] and aligning a manager's interest with that of his clients.[24]

B. Hedge Funds Today: Growth in Managers and Assets

The number of hedge fund managers and the assets they manage have

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18. *Id*. at 2.
19. *Id*.
20. Lederman, *supra* note 5, § 11:3, at 11-3; Osterberg & Thomson, *supra* note 10, at 1; Carol J. Loomis, *The Jones Nobody Keeps Up With*, FORTUNE, Apr. 1966, at 237. *See generally* OWEN, *supra* note 5, at 52–53 (offering an interesting historical discussion on the life of A.W. Jones).
21. OWEN, *supra* note 5, at 53–54. Jones's strategy would be labeled as "market neutral" in today's hedge fund parlance. Osterberg & Thomson, *supra* note 10, at 1. Short selling is the investment and trading practice of acting on the belief that a stock's price is going to fall by borrowing the stock and selling it at the current market price in the hope of buying back the same stock at a lower price later. The purchased stock is then used to pay back the lender. For example, assume that you think WorldCom is fundamentally overpriced at $40 per share and is going to drop to $10 per share. To execute a short sale of WorldCom, you will borrow 100 shares from a broker-dealer and sell for the current price of $40; you will then subsequently repurchase the 100 shares when the market drops to $10 and return the shares to the broker-dealer.
22. OWEN, *supra* note 5, at 55.
23. "Absolute returns" can be defined in contrast to the "relative returns" typically pursued by traditional money managers running mutual funds. Lederman, *supra* note 5, § 11:2.2, at 11-6. A relative return focuses on beating a specific benchmark by which a mutual fund's performance is measured. For example, a large cap growth mutual fund will most likely have the Standard & Poor's 500 Composite Index (S&P 500) as its selected benchmark. If the S&P 500 is down 20% in a given year, and the large cap growth fund is down 10%, it has relatively outperformed its benchmark by 10%, even though investors in the fund lost 10% of the value of their investment if they invested for the full year. By contrast, hedge funds typically focus on absolute returns that seek to make investors (partners) money regardless of market direction as measured by indices. This is part and parcel of a hedge fund's compensation structure, which awards the lion's share of a manager's compensation through the performance fee that is only earned if the manager produces a positive return.
24. OWEN, *supra* note 5, at 55.

exploded over the last decade.[25] The number of managers climbed from 300 in 1990 to nearly 6000 in 2001, and that number is projected to increase to more than 9000 by 2004.[26] This increase in managers corresponds with an equally explosive growth in assets. Assets in hedge funds rose from $39 billion in 1990 to just over $550 billion at the end of 2001 and are projected to grow to an estimated $1 trillion by 2004.[27] Comparatively, these estimates are far less than the $6.6 trillion under management in mutual funds.[28] Still, the SEC is concerned about the rapid growth of the largely unregulated hedge fund industry.[29]

1. Legislative Catalyst: The National Securities Markets Improvement Act of 1996

A combination of both market and legislative factors has fueled hedge fund industry growth over the last decade. A significant legislative catalyst occurred when Congress enacted the National Securities Markets Improvement Act of 1996 (NSMIA).[30] NSMIA amended the Investment Company Act of 1940 ('40 Act) to include an exception from the definition of "investment company" under section 3(c)(7)[31] for private investment funds that sell to an unlimited number of "qualified purchasers"[32] and do not make a "public offering of such securities."[33]

Before 1996, hedge funds almost exclusively used the exception in section 3(c)(1)[34] to avoid registration under the '40 Act and the resulting

25. *Id*. at 56–57; Yuka Hayashi, *Hedge Fund Assets Seen Rising to $1 Trillion by 2004*, WALL ST. J. ONLINE (June 19, 2002), *at* http://online.wsj.com.

26. Erin E. Arvedlund, *Hedging Their Bets?*, BARRON'S, Jan. 7, 2002, at F3; Hayashi, *supra* note 25. There are also reasons to view growth projections more conservatively. *See generally* Ken Brown & Gregory Zuckerman, *Hedge Funds Grew Madly—Now, the Shakeout*, WALL. ST. J., Aug. 26, 2002, at C1 (chronicling current market pressures that are forcing some startup managers to close their doors).

27. OWEN, *supra* note 5, at 56; Amanda Cantrell, *Survey: Hedge Fund Assets Will Increase 26% in 2002*, HedgeNews.com (Apr. 16, 2002), *at* http://www.hedgefund.net/ (last visited June 5, 2002); Hayashi, *supra* note 25.

28. Erin E. Arvedlund, *Peering over the Hedge*, BARRON'S, Aug. 12, 2002, at F2.

29. *See* Pitt, *supra* note 2.

30. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3432 (codified at 15 U.S.C. § 77r (2000)).

31. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(7) (2000).

32. *Id.* § 80a-2(a)(51) (defining the term "qualified purchaser"). *See generally* Lederman, *supra* note 5, § 11:4, at 11-15 to 11-17 (discussing the 3(c)(1) and 3(c)(7) exceptions and the definition of qualified purchasers); OWEN, *supra* note 5, at 59 (discussing NSMIA and the establishment of qualified purchasers under section 3(c)(7)).

33. 15 U.S.C. § 80a-3(c)(7)(A).

34. *Id*. § 80a-3(c)(1). *See generally* Lederman, *supra* note 5, § 11:4, at 11-15 to

regulation as an investment company.[35] The 3(c)(1) exception allows hedge funds to sell interests to no more than 100 "accredited investors" as defined by Regulation D (Reg. D) of the Securities Act of 1933[36] ('33 Act) as long as a "public offering" is not made.[37] By comparison, section 3(c)(7) allows hedge funds to sell interests to a greater number of investors: a maximum of 499 record holders who must meet the higher net worth requirement of a qualified purchaser.[38]

To illustrate, an accredited investor is an individual with a net worth (individual or joint with spouse) that exceeds $1 million or an individual who has had an individual income in excess of $200,000, or joint income in excess of $300,000, in each of the preceding two years, with a reasonable expectation of earning the same amount in the current year.[39] By contrast, NSMIA and section 3(c)(7) allow an additional 399 investors with a minimum liquid net worth, individual or joint with spouse, of at least $5 million.[40]

The result has been an increase in the number of high net worth investors that hedge funds can take on without jeopardizing their unregulated status under certain sections of the '33 Act, Securities Exchange Act of 1934 ('34 Act), or '40 Act. Based on the growth of total hedge fund assets before and after 1996, it appears that NSMIA has

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11-16 (offering an in-depth analysis of the 3(c)(1) exception).

35. *See* Lederman, supra note 5, § 11:3.1, at 11-7 (discussing the negative impact that registration as an investment company under the '40 Act has on a hedge fund).

36. 17 C.F.R. § 230.501 (2002). Although a $1 million net worth individual can technically invest in a private investment fund, the economic realities of running a hedge fund to scale require that managers demand minimum investments around $1 million. OWEN, *supra* note 5, at 59. The result of this high minimum investment is that investors who want to maintain a reasonable allocation of 10% to 20% of their overall portfolio to a hedge fund, or alternative investments generally, are priced out of the market unless their portfolio worth exceeds $5 million to $10 million.

37. It is important to point out that both the 3(c)(1) and 3(c)(7) exceptions to the '40 Act require that a hedge fund meet the private placement exemption from the '33 Act under section 4(2) and Rule 506 of Reg. D. These provisions establish a nonexclusive safe harbor for issuers relying on section 4(2). 15 U.S.C. § 77d(2); 17 C.F.R. § 230.506. The exact requirements that hedge funds must meet to avoid regulation under the '40 and '33 Acts are examined in Part IV.

38. Lederman, *supra* note 5, § 11:3.3, at 11-13. Although the language in (3)(c)(7) does not limit the number of qualified purchasers that may own interests in a hedge fund, section 12(g)(1)(B) of the Securities Exchange Act of 1934 ('34 Act) requires a domestic issuer of securities with assets in excess of $10 million and a class of equity securities held of record by 500 or more persons to register the securities under the '34 Act. *See* 15 U.S.C. § 78*l*(g)(1)(B) (setting the original asset threshold at $1 million); 17 C.F.R. § 240.12g-1 (changing the asset threshold to $10 million); *see* Lederman, *supra* note 5, § 11:3.3, at 11-13 (discussing the drawbacks to a hedge fund registering securities under the '34 Act).

39. 17 C.F.R. § 230.501(a)(5)–(6).

40. 15 U.S.C § 80a-2(a)(51)(A) (setting the minimum net worth at $5 million).

in part served as a catalyst for the increase.[41] Furthermore, NSMIA has facilitated growth while arguably increasing investor protection by requiring a higher net worth threshold ($5 million) for additional hedge fund investors than the threshold promulgated by the SEC ($1 million).[42]

Nevertheless, legislative action allowing increased numbers of higher net worth investors to invest in hedge funds will only fuel growth if those investors are motivated to actually allocate increasing amounts of capital. Accordingly, market factors have motivated investors to increase allocations to hedge funds and have done more to spur industry growth than legislative reform alone could have accomplished. Market factors have also combined with secular investment trends and demographic shifts to push hedge funds downstream to a lower stratum of investor net worth.[43]

2. Market Factors

Several market factors have helped to fuel the growth of hedge funds. First, the 1990s extended bull market[44] and resulting wealth creation propelled many new investors into the ranks of accredited investors and qualified purchasers.[45] The two forces behind the late 1990s wealth creation were the expanding gross domestic product (GDP) and rising stock market capitalization.[46] GDP began to fall off in 2000 and led to recession in 2001.[47] Meanwhile, the above average, double-digit U.S. stock market returns of the late 1990s declined in 2000 and 2001. Table

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41. *See* OWEN, *supra* note 5, at 57 (detailing the growth of total hedge fund assets by year in a bar chart). Compare the growth of hedge fund assets from 1990 to 1995 ($147 billion) to the growth from 1996 to 2001 ($364 billion). *Id.*; Hayashi, *supra* note 25 (stating that the assets under management in hedge funds reached $550 billion at the end of 2001).

42. Compare the net worth requirements for an accredited investor set by the SEC in Reg. D, 17 C.F.R. § 230.501, with the requirements for a qualified purchaser in 15 U.S.C. § 80a-2(a)(51)(A), which was used by NSMIA in amending section 3(c)(7) to include qualified purchasers. However, this increase in investor protection is only theoretical because most investors are priced out of a hedge fund investment unless they have a $5 million to $10 million portfolio. *See supra* note 36.

43. The trend of hedge funds heading downstream to the lower net worth retail marketplace is analyzed in Part III.

44. A bull market is defined as a "prolonged rise in the prices of stocks, bonds, or commodities. Bull markets usually last at least a few months and are characterized by high trading volume." DICTIONARY OF FINANCE AND INVESTMENT TERMS, *supra* note 5, at 69.

45. *See* MERRILL LYNCH/CAP GEMINI ERNST & YOUNG, WORLD WEALTH REPORT 2002, at 7 (2002) (citing the robust eighteen percent growth of global high net worth in 1999); Gerri Willis, *Power to the People*, SMART MONEY, June 1, 2002, at 96.

46. MERRILL LYNCH/CAP GEMINI ERNST & YOUNG, *supra* note 45, at 4.

47. *Id.*

1 shows U.S. stock market returns from 1995 through September 30, 2002 compared to average annual stock market returns.[48]

TABLE 1

STOCK MARKET RETURNS

	S&P 500	NASDAQ COMPOSITE	DJIA
1995	37.53%	40.70%	36.87%
1996	22.95%	23.17%	29.13%
1997	33.35%	21.98%	24.99%
1998	28.58%	39.95%	18.13%
1999	21.04%	85.87%	27.18%
2000	(-9.09%)	(-38.83%)	(-4.88%)
2001	(-11.88%)	(-20.13%)	(-5.46%)
2002 (THROUGH SEPT. 30)	(-28.15%)	(-39.65%)	(-23.14%)
AVERAGE ANNUAL RETURN FOR INDEX	10.62%	9.87%	10.19%

Although the deteriorating stock market and stagnant GDP have slowed the pace of wealth creation, there was still a modest increase of 40,000 high net worth individuals—people with more than $1 million in financial asset wealth—in North America in 2001.[49]

The combination of an increase in the number of wealthy investors,

48. Stock market returns are shown for the S&P's 500 Composite Index, NASDAQ Composite Index, and Dow Jones Industrial Average (DJIA). Data is taken from Standard & Poor's Micropal, Inc. (Nov. 20, 2002) (on file with author). The S&P 500 Index is a "broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks." DICTIONARY OF FINANCE AND INVESTMENT TERMS, *supra* note 5, at 586. The NASDAQ Composite Index is a "market value-weighted index that measures all domestic and non-U.S.-based securities—more than 5,400 companies—listed on the NASDAQ Stock Market." *Id.* at 596. The DJIA is a "price-weighted average of 30 actively traded BLUE CHIP stocks, primarily industrials like Alcoa, General Motors, and IBM but including American Express, Coca-Cola, McDonald's, J.P. Morgan, Walt Disney and other service-oriented firms." *Id.* at 595. Average annual returns reflect the total return for each index through September 30, 2002, divided by the number of years tracked by the index. The S&P 500 is tracked from January 1970. The NASDAQ Composite is tracked from February 1973. The DJIA is tracked from January 1964.

49. MERRILL LYNCH/CAP GEMINI ERNST & YOUNG, *supra* note 45, at 3.

who became wealthy in a rising stock market, and a subsequently declining stock market has influenced the psychology of many wealthy investors. These investors are now looking elsewhere for investments that can provide similar returns to the late 1990s stock market, but with a low correlation[50] to the volatile and weakened equity markets.[51] This has led many investors to either initiate or increase already existing allocations to hedge funds.[52]

Another factor fueling the recent growth in hedge funds is the outperformance and low correlation that many hedge funds have achieved relative to traditional equity investments—stocks and mutual funds—and global markets.[53] Because hedge funds often have a low correlation to traditional bond and equity investments, they perform well

50. The concept of correlation in an investment is used as a statistical measure of how closely related the movements of two investments are. *See* DICTIONARY OF FINANCE AND INVESTMENT TERMS, *supra* note 5, at 122 (defining "correlation coefficient"). One common measure of correlation is an investment's "beta." *Id.* at 51. For example, the S&P 500 has a beta coefficient of 1. If a hedge fund has a beta of less than 1, it will rise and fall more slowly than the S&P 500 and have less volatility. The inverse relationship to the S&P 500 is also true as an investment's beta increases above 1.

51. *See* LAWRENCE E. LIFSON & RICHARD A. GEIST, THE PSYCHOLOGY OF INVESTING 65–66 (1999) (discussing the psychology of investors in the 1990s).

52. *See* MERRILL LYNCH/CAP GEMINI ERNST & YOUNG, *supra* note 45, at 6.

53. *See id*. at 7 (showing 2001 hedge fund index outperformance relative to equity mutual funds, the S&P 500, and the MSCI World Equity Index); Beverly Goodman, *Hedge Funds for the Not-So-Rich*, TheStreet.com (May 13, 2002) ("In 2001, the average U.S. hedge fund . . . returned 5.6%, while the S&P 500 fell 11.9% and the average equity mutual fund fell 12.6% . . . . In 2000, the difference was even greater: The average hedge fund return was 11%, while the S&P and average equity fund fell 9.1% and 5.2%, respectively."), *at* http://www.thestreet.com/funds/mutualfundmondaybg/10021885.html; *see also* MONTGOMERY PARTNERS, HEDGE FUNDS: AN OVERVIEW 3, 8 (Dec. 2001) (unpublished marketing pamphlet, on file with author) (showing hedge fund outperformance and low correlation relative to domestic stocks, foreign stocks, and domestic bonds). There are many different strategies that hedge funds pursue, and not all strategies have a low correlation to bond and equity investments. *See generally* HedgeFund.net, *Hedge Fund Strategy Definitions*, *at* http://www.hedgefund.net (last visited Aug. 21, 2002) (offering an exhaustive breakdown of hedge fund strategies along with the year-to-date performance for each strategy); Osterberg & Thomson, *supra* note 10, at 2 (showing eight general types of hedge fund strategies, including "long only," which is a type of hedge fund strategy that invests like a mutual fund by buying a portfolio of stocks that the manager thinks will appreciate over time). For example, long only hedge fund strategies typically have a high correlation to the S&P 500 and, consequently, decline in performance as the S&P 500 declines. The majority of hedge fund strategies, however, employ various trading techniques and investments that result in low correlation to bond and equity markets. OWEN, *supra* note 5, at 136–37 (citing analysis "which found that more than 70 percent of hedge funds have correlation coefficients with the S&P 500 and Lehman bond indexes below 0.3, which is considered to be a statistically insignificant correlation") (internal quotation omitted).

on a relative basis when bond and equity markets perform poorly.[54] Thus, the low correlation of most hedge funds has meant relative outperformance for hedge funds in 2000 and 2001 as markets have declined.[55]

Hedge fund outperformance resulting from low correlation has coincided with a period of globalization that has *increased* correlation between global equity markets and rendered traditional asset allocation models less effective.[56] Table 2 illustrates the increased correlation between global equity markets.[57]

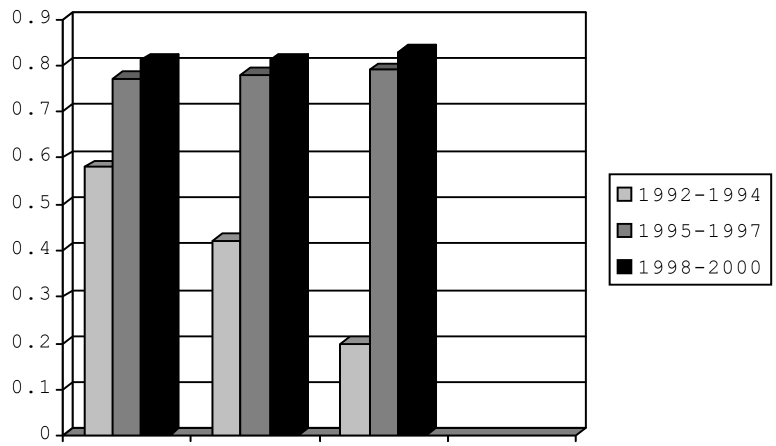
54. The inverse is also true; when traditional bond and equity investments perform well, the low correlation of most hedge funds means they will not perform as well on a relative basis.

55. *See* Goodman, *supra* note 53.

56. Most traditional asset allocation models are based on "modern portfolio theory" (MPT). *See* OWEN, *supra* note 5, at 22–23. Harry M. Markowitz first outlined MPT in a doctoral dissertation he authored at the University of Chicago in the early 1950s. *Id.* at 22. MPT is "grounded in the observation that the various asset classes—stocks, bonds, and so on—not only performed differently, but had different risk characteristics." *Id.* Markowitz, along with William F. Sharpe, "showed that by quantifying and balancing the returns and risks of various asset classes, investors could construct a diversified investment portfolio that would provide the maximum expected return for any given level of risk or, alternatively, the minimum level of risk for any expected return." *Id.* Furthermore, "[w]hen combining asset classes, the trick [is] to make sure that they [are] not correlated—that is, that their prices move[] in different patterns, and in response to different economic and market factors." *Id*. As a result, traditional asset allocation models based on MPT rely on a low correlation between different selected investments to achieve success. Thus, increased correlation among global equity markets makes lowly correlated hedge fund strategies more attractive.

57. Correlation statistics (betas) are shown for the NASDAQ Composite, Russell 2000 Index, and MSCI EAFE Index, as compared to the S&P 500, which represents a beta of 1. Data is taken from Standard & Poor's Micropal, Inc. (Nov. 20, 2002) (on file with author). The Russell 2000 Index "consists of the 2,000 smallest companies in the Russell 3000 index," which "measures the performance of the 3,000 largest U.S. companies based on market capitalization, representing about 98% of the investable U.S. equities market." DICTIONARY OF FINANCE AND INVESTMENT TERMS, *supra* note 5, at 597. The MSCI EAFE Index is composed of equity markets in approximately twenty developed market countries in Europe, Australasia, and the Far East. *See id*. at 168, 369. Table 2 shows the increase in correlation between each of the three indices and the S&P 500 from 1992 to 2000.

TABLE 2
WORLD EQUITY MARKETS BECOME MORE
CLOSELY CORRELATED



NASDAQ RUSSELL 2000 MSCI EAFE

Accordingly, many hedge fund strategies are more attractive in the recent investment environment based on their strong relative performance, low correlation to major equity markets, and beneficial impact on an investor's overall asset allocation.[58] In sum, the combination of both legislative and market factors has led to unprecedented growth in hedge funds.

58. The benefit of adding hedge funds to an investor's asset allocation can be quantitatively measured by plotting model portfolios along a risk axis and return axis. *See* MONTGOMERY PARTNERS, *supra* note 53, at 4 (illustrating three model portfolios, each containing an increased investment in an absolute return hedge fund index in addition to stock and bond investments; as investment in the hedge fund index is increased, portfolio return increases, while portfolio risk decreases).

III. TRENDS

The SEC has highlighted three worrisome trends accompanying hedge fund growth: fraud, conflicts associated with the management of hedge funds alongside mutual funds, and the marketing of hedge funds directly and indirectly to less sophisticated "retail investors."[59] In response to these trends, the SEC has initiated a formal fact-finding inquiry and has issued a private order of investigation to aid in examining the industry.[60]

A. Incidence of Fraud?

The SEC has publicly claimed that along with the increase in assets and managers has come an "unfortunate growth in hedge fund-related fraud."[61] In March 2002, Paul Roye, Director of the SEC's Division of Investment Management, stated that "[t]he Commission has had to bring far too many hedge fund fraud cases in circumstances where the losses to investors have been substantial."[62] Roye reiterated his comments two weeks later, stating, "We also have seen an increased number of [fraud] enforcement actions involving hedge funds."[63] Roye went on to offer a stinging rebuke directed at hedge fund managers who confuse their exemption from regulation under the Investment Advisors Act of 1940 (Advisors Act) with exemption from the "anti-fraud provisions" of that same act.[64]

But how much of an increase in fraud has actually occurred? More importantly, how does the amount of fraud in the hedge fund industry compare to other unregulated or regulated industries or both? Unfortunately, there is no easy method to answer these questions beyond pointing to anecdotal evidence. Some fraud actions against hedge funds

59. Pitt, *supra* note 2. The term "retail investor" is used in this Comment to refer to those investors who meet the net worth requirements to invest in hedge funds and in the past have not had access to hedge funds because of the high minimums charged, but are now able to invest in lower minimum registered hedge funds. This is different from the common use of the term, which describes all noninstitutional investors, regardless of whether or not they meet the net worth requirements.

60. Judith Burns, *Hedge-Fund Managers Brace for SEC Subpoenas Amid Probe*, WALL ST. J. ONLINE (June 24, 2002), *at* http://online.wsj.com.

61. Paul F. Roye, Speech by SEC Staff: Mutual Fund Management: Taking Responsibility, Maintaining Trust and Influencing Positive Change (Mar. 25, 2002) (transcript available at U.S. Securities and Exchange Commission, *at* http://www.sec.gov/news/speech/spch546.htm (last modified Mar. 25, 2002)).

62. *Id.*

63. Paul F. Roye, Speech by SEC Staff: Priorities in Investment Advisor Regulation (Apr. 8, 2002) (transcript available at U.S. Securities and Exchange Commission, *at* http://www.sec.gov/news/speech/spch549.htm (last modified Apr. 9, 2002)).

64. *Id.*

are pursued under state jurisdictions, while others are pursued by the SEC. In both instances, not all actions are reported and many are settled, some without admission of wrongdoing.[65] Anecdotal evidence, however, does exist and is open to fiercely conflicting interpretations between the SEC and those in the hedge fund industry.

The SEC has brought 150 enforcement actions against hedge funds over the past five years.[66] Director Roye has noted that some of these 150 cases "deal not just with miscues, but with outright misappropriation of a significant amount of investor funds."[67] Based on public statements by SEC officials,[68] the SEC is interpreting hedge fund fraud statistics as a troubling indicator of an industry that may require increased regulation.[69] Indeed, this perceived trend of increased fraud has partly prompted the SEC's formal fact-finding inquiry.[70]

Many in the hedge fund industry, however, disagree with the SEC's interpretation of the fraud statistics.[71] They claim that the "incidence of fraud is no greater than any other sector of the finance industry, but that well-known cases create[] an unfairly negative impression."[72] This argument is based on the premise that hedge fund fraud often involves individuals and surrounding circumstances that appeal to the media's thirst for larger-than-life stories. Indeed, several recent SEC fraud investigations involve cases that read like Hollywood scripts filled with flamboyant excess and tragic character flaws. These notorious cases

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65. *See, e.g.*, Edward Thomas Jung, Exchange Act Release No. 45,669, 77 SEC Docket 656, 656 (Mar. 8, 2002).

> Jung and ETJ Partners have submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the Commission's findings contained herein . . . Jung and ETJ Partners consent to the entry of this Order . . . .

Id.

66. Allison Bisbey Colter, *Roye Reiterates: SEC Cracking Down on Hedge-Fund Fraud*, WALL. ST. J. ONLINE (May 13, 2002), *at* http://online.wsj.com. The number of enforcement actions was current as of the publication date, May 13, 2002.

67. *Id*.

68. *See, e.g.*, *id.*; Pitt, *supra* note 2; Roye, *supra* note 61.

69. *See* Ben White, *With Hedge Funds Expanding, SEC to Open a Formal Probe*, WASH. POST, May 25, 2002, at E1.

70. Pitt, *supra* note 2.

71. *See* Will Swarts, *SEC Pitt's Speech on Regulation Doesn't Sway Managers*, HedgeNews.com (May 29, 2002), *at* http://www.hedgefund.net (citing responses from several in the hedge fund industry).

72. *Id.*

have garnered headlines and magnified the image of an industry rife with fraud. Jack Gaine, president of the Managed Funds Association, a hedge fund lobby group, stated that his "gut reaction is that you read the headlines and you get down into these stories [of fraud], and you are reading about the same cases."[73]

There are several recent high profile cases that support the interpretation that a media spotlight has shone on a small fraudulent segment of the industry and in turn cast a large, unrealistic shadow. In a 2002 case under investigation by the SEC, Kenneth Lipper, an Oscar-winning movie producer and former Deputy Mayor of New York, dissolved two convertible bond hedge funds he ran after admitting they were mispriced by at least $315 million in 2001.[74] This announcement came after Lipper had first told investors that the funds *gained* value in 2001.[75] Previous to this news, Lipper had been best known as a New York socialite with a Hollywood flair who collaborated with Oliver Stone as the chief technical advisor on the movie *Wall Street*.[76] Lipper's ostentatious downfall occupied headlines over a span of several months.[77]

Other recent stories have also captured the media's attention. For example, the Art Institute of Chicago filed a fraud action in Texas against Integral Investment Management.[78] Integral's manager, Conrad Seghers, is a biologist-turned-day-trader who convinced the museum's finance committee[79] to allocate over $43 million to his two funds.[80]

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73. *Id.*

74. Allison Bisbey Colter, *Several Kenneth Lipper Hedge Funds Are Being Liquidated After Big Losses*, WALL ST. J., Mar. 29, 2002, at C11. Lipper announced in early February that the fund losses totaled 40% and 8%, respectively, in 2001 only to revise those numbers down even further a month later to 45% and 10%, respectively. *Id.*

75. *Id.*

76. Ken Brown, *Kenneth Lipper's Managerial Character Makes Steep Loss Seem Unlikely Twist*, WALL ST. J., Feb. 25, 2002, at C1. Lipper was credited with creating the movie's main character, Gordon Gekko. *Hedge Funds: Seeking to Be Respectable*, THE ECONOMIST, Apr. 13, 2002, at 70. In the movie, Gekko's own tragic flaw led to an arrest for insider trading, and he perhaps foreshadowed the demise of his real life creator by uttering the words, "Money itself isn't lost or made, it's simply transferred from one perception to another." WALL STREET (20th Century Fox 1987).

77. *See, e.g.*, Brown, *supra* note 76, at C1; *Hedge Funds: Seeking to Be Respectable*, *supra* note 76, at 70; Colter, *supra* note 74, at C11.

78. Ianthe Jeanne Dugan et al., *Portrait of a Loss: Chicago Art Institute Learns Tough Lesson About Hedge Funds*, WALL ST. J., Feb. 1, 2002, at A1. Integral is also under investigation by the SEC. *Id.*

79. *Id.* Other committee members included A. Steven Crown, "scion of a billionaire family with big stakes in General Dynamics Corp. and Rockefeller Center"; Marshall Field, former owner of the *Chicago Sun-Times*; David J. Vitale, Chief Executive of the Chicago Board of Trade; Arthur M. Wood, former Chairman of Sears, Roebuck & Co.; David C. Hilliard, partner at the Chicago law firm of Pattishall, McAuliffe, Newbury, Hilliard & Geraldson; and Andrew Rosenfield, "a wealthy Chicago entrepreneur." *Id.*

80. *Id.*

Seghers told the committee that one of the funds "generally combined safe cash holdings with stocks and riskier index options" and combined investments in "a way that he could guarantee profits of 1% to 2% a month in flat or rising markets."[81] Seghers then lost $20 million of the museum's money on investments unrelated to the fund's stated purpose, including distressed consumer holdings and an Internet startup company his business partner operated.[82]

Several other cases of hedge fund fraud have recently crowded the media landscape. These include the cases of Peter Chabot,[83] Michael Smirlock,[84] David Mobley,[85] Mark Yagalla,[86] and Michael Berger.[87]

81. *Id.*

82. *Id.*

83. Chabot was a twenty-seven-year-old former Goldman Sachs analyst who had only worked for the firm for ten months and claimed to run the Sirens Synergy and Synergy hedge funds. The funds were bogus and Chabot used a large portion of the $1.2 million he raised from fourteen investors on "cars, lavish vacations, expensive clothes and pricey tickets to New York Knicks basketball games" in addition to supporting a drug habit. Will Swarts, *Chabot Gets 27 Months for $1.2M Fund Fraud*, HedgeNews.com (Feb. 27, 2002), *at* http://www.hedgefund.net. Investors began asking about their funds after the September 11, 2001 terrorist attacks, and in response, Chabot stopped returning their calls and fled for the Mexican border via Biloxi, Mississippi, where he was eventually apprehended in a hotel. *Id.*

84. Smirlock and his investment management firm, Laser Advisers Inc., defrauded investors by falsely inflating the value of three hedge funds by $71 million in order to conceal losses. Michael L. Smirlock, Litigation Release No. 16,838, 73 SEC Docket 3964, 3964 (Dec. 21, 2000); Christopher Faille, *Smirlock Surrenders to Bureau of Prisons*, HedgeWorld.com (Aug. 1, 2002), *at* http://www.hedgeworld.com/news/read_news.cgi?section=dail&story=dail 7795.html. Like Lipper, Smirlock had a high profile reputation. *Id.* Smirlock's reputation was due in part to an important paper he coauthored with two University of Southern California School of Business professors "on the value of 'Tobin's q' as an index of management performance." *Id.* Smirlock is also a recidivist who was previously penalized as a result of a 1993 SEC enforcement action for fraud. *Id.*

85. Mobley defrauded investors of at least $59 million from 1993 to 2000. David M. Mobley, Litigation Release No. 16,446, 71 SEC Docket 1782, 1782 (Feb. 22, 2000). He falsely claimed that his Maricopa hedge funds averaged a 51% return per year, while in reality, he lost $59 million. *Id.* He also claimed to have $450 million under management when he actually only had $33 million of investor funds left. *Id.* at 1783.

> [Mobley] failed to disclose to his investors that he had invested their money in a number of his own business ventures—including a mortgage company, a golf and country club development, a research and polling company, a cigar lounge, and a plan to build a stadium on a golf course—most of which failed. [He also] diverted millions of dollars of investor funds to pay for a luxurious lifestyle for himself and his family. He [paid] himself a salary of $1 million a year, and helped himself to a $2 million bonus . . . after he knew he was under investigation by the Commodity Futures Trading Comission. He . . . purchased a $98,000 Porsche[,] . . . bought a number of houses using investor funds[,] . . . bought an $864,000 home[,] . . . bought a $1million lot[,] . . . [and] bought two

Many in the hedge fund industry argue that cases like these represent the minority of all hedge fund managers and yet create a perception of fraud that is taken as an industry-wide reality.

The SEC, however, like many regulators, may *only* bring high profile cases to deter because it does not have the resources to bring many cases.[88] Therefore, the same high profile cases that support the industry argument also support the SEC concern that more fraud exists. If the SEC favors high profile cases for enforcement, the cases highlighted above may represent a larger underlying problem.

Have these cases become the fraudulent tail that is wagging the hedge fund industry dog? Or are they just the tip of a large iceberg of fraud that permeates the industry, which can only be deterred by increased regulation? There is no clear-cut answer to these questions. Furthermore, the SEC will only gain more *anecdotal* evidence regarding hedge fund fraud through its formal fact-finding inquiry. Anecdotal evidence will not provide definitive answers to these questions. As a result, the SEC must determine whether the benefits of increased regulation, including lowering whatever amount of fraud currently exists, justify the costs associated with such regulation.

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homes for his sister and daughter.

Id. He also "paid nearly $1.7 million for a new vacation house outside of Vail . . . and spent another $300,000 finishing and furnishing it. The same month, he presented his wife with a $40,000 diamond ring. None of these diversions were disclosed to the investors." *Id.*; *see also* Robert Clow, *Hedge Fund Expansion Brings Fraud to the Fore*, FIN. TIMES, Feb. 7, 2002, at 25, *available at* 2002 WL 3316627.

86. Yagalla was twenty-three years old when he "portrayed himself to potential investors as a successful trader . . . [who], by trading securities over the last nine years, . . . [had] achieved an average of 80% return on his investments." Mark Yagalla, Litigation Release No. 16,770, 73 SEC Docket 1392, 1393 (Oct. 17, 2000). In reality, Yagalla had no such track record and proceeded to misappropriate $50 million of investor funds in his Ashbury Fund for personal use, "much of which went to buy presents for Sandra Bentley, his Playboy centrefold girlfriend." Clow, *supra* note 85. Furthermore, "[t]o conceal the misappropriation of fund assets and trading losses, [Yagalla] sent investors falsified monthly statements significantly overstating the holdings and performance of investment accounts." *Yagalla*, 73 SEC Docket at 1393.

87. Berger immediately began to defraud investors upon opening his Manhattan Investment Fund in 1996. Michael W. Berger, Litigation Release No. 17,230, 76 SEC Docket 701, 701 (Nov. 13, 2001). He concealed $400 million in losses by sending out "fictitious account statements which substantially overstated the market value of the Fund's holdings." *Id.* Once his scheme was uncovered, Berger bolted and became a federal fugitive; meanwhile $1.9 billion in claims were filed against him. *See* Clow, *supra* note 85; Will Swarts, *Bear Stearns Avoids $1.9B in Berger Damage Claims*, HedgeNews.com (Apr. 8, 2002), *at* http://www.hedgefund.net.

88. *See generally* Jesse Eisinger, *Pay the Cops*, WALL ST. J., Oct. 22, 2002, at C1 (arguing that the SEC needs more funding to fight fraud); Michael Schroeder & Greg Ip, *Imperfect Guardian: SEC Faces Hurdles Beyond Low Budget in Stopping Fraud*, WALL ST. J., July 19, 2002, at A1 (detailing low budget hurdles facing the SEC in deterring fraud).

B. Marketing Hedge Funds Down-market

The perceived increase in fraud becomes a more pressing issue when combined with the trend of hedge funds moving down-market to less affluent, retail investors. The move down-market raises concerns ranging from investor protection[89] to potential conflicts of interest.[90] Before dealing with these concerns, it is important to highlight the factors that have fostered the down-market trend.

1. 1990s Wealth Creation: The Burgeoning Class of the "Mass Affluent"

The late 1990s were a time of massive wealth creation for many Americans,[91] and although recent market decline has dissipated some of the wealth created, an imprint remains on the demographic landscape.[92] This imprint represents a newly defined category of individuals known as the "merely affluent" or the "mass affluent," generally defined as those with a net worth between $1 million and $5 million.[93] It is estimated that the merely affluent represent approximately ninety percent of all millionaires in the United States.[94] More importantly, they represent a large pool of investable assets and meet the net worth requirements for hedge fund investing.[95] They also have an appetite for previously

89. *See* Pitt, *supra* note 2.
90. *Id*.
91. *See* MERRILL LYNCH/CAP GEMINI ERNST & YOUNG, *supra* note 45, at 4, 7; Willis, *supra* note 45, at 96.
92. Willis, *supra* note 45, at 96.
93. *See* Arvedlund, *supra* note 26, at F3 (using the $1 million to $5 million definition); Karen Damato & Allison Bisbey Colter, *Hedge Funds, Once for the Exclusive Only, Lure Less-Elite Investors—But Also Scrutiny*, WALL ST. J., Jan. 3, 2002, at C1 (using the term "mass affluent"); June Fletcher, *When a Million Isn't Enough*, WALL ST. J., Mar. 16, 2001, at W1 (using the term "merely affluent").
94. Lewis Braham, *Hedge Funds Go Wide*, BUS. WK., Jan. 21, 2002, at 78; Spectrem Group, Montgomery Partners Hedge Fund Survey 5 (Jan. 2002) (unpublished survey results, on file with author). "The Affluent Market, those with $1 Million plus net worth, comprises over 6 million households. Just under one half million are Pentamillionaires." *Id.* Using data from the Spectrem Group, *2001 Profiles of Wealth in America Study*, the Montgomery Partners survey shows that there are a total of 6,482,000 individuals in the United States with at least $1 million in net worth (not including personal residence). *Id.* However, only 480,000 of those individuals have a net worth in excess of $5 million. *Id.* That leaves 6,002,000, or 93% of all American millionaires in the $1 to $5 million net worth range. *Id.*
95. *See* 17 C.F.R. § 230.501(a) (2000) (defining "accredited investor"); *id.* § 275.205(3)(d)(1) (defining "qualified client").

unattainable hedge funds.[96] Accordingly, mutual fund companies are bringing registered hedge funds down-market to the merely affluent by offering lower investment minimums.[97]

2. Exodus of Top Mutual Fund Managers

Another factor prompting the down-market trend is the continued exodus of top mutual fund managers to hedge funds.[98] Top mutual fund managers typically move to hedge funds for two reasons: the potential for higher compensation[99] and the freedom to employ investment and trading techniques that are limited or not possible because of mutual fund regulation.[100]

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96. *See* Spectrem Group, *supra* note 94, at 14 (noting that seventy-nine percent of all respondents in the survey indicated that they are highly attracted to the absolute return characteristic of hedge funds). *See generally id.* at 2 (explaining the parameters of the survey, including the methodology employed). The appetite for hedge funds comes from a desire to earn positive returns in declining markets through lowly correlated investments. *See supra* Part II.B.2. The merely affluent also desire the caché associated with hedge fund investing because hedge funds have been an exclusive investment for the very rich. One article detailing the down-market trend compared the caché of hedge fund investing to the "glitterati who fly their own planes." Goodman, *supra* note 53.

97. *See infra* Part III.C.

98. *See* Arvedlund, *supra* note 26, at F3; Donna Rosato, *Hedge Funds for All? Well, Not Quite*, N.Y. TIMES, Apr. 14, 2002, at 6.

99. *See* Erin E. Arvedlund, *Hopping to Hedges*, BARRON'S, Sept. 2, 2002, at F2; Rosato, *supra* note 98, at 6.

100. *See* 15 U.S.C. § 80a-18(f)(1) (2000) (limiting the amount of leverage an investment company may employ to 300% of the portfolio's value); *id.* § 80a-5(b)(1). A diversified investment company is limited to having:

> *at least 75 per centum of the value of its total assets* . . . represented by cash and cash items . . . , Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount *not greater in value than 5 per centum* of the value of the total assets of such management company.

Id. (emphasis added). Also, section 22(e) of the '40 Act requires mutual fund companies to complete share redemptions within seven days. *Id.* § 80a-22(e). As a result, the SEC has made clear through interpretive releases that mutual fund companies are required to hold no more than 15% of their net assets in "illiquid assets." *See* Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828, 9829 (Mar. 20, 1992) (codified at 17 C.F.R. pts. 239, 274). The term "illiquid security" was defined by the SEC as "any security which cannot be disposed of promptly and in the ordinary course of business without taking a reduced price. A security is considered illiquid if a fund cannot receive the amount at which it values the instrument within seven days." Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, 51 Fed. Reg. 9773, 9777 (Mar. 21, 1986) (codified at 17 C.F.R. pt. 270). These '40 Act and SEC restrictions limit the types and amounts of certain securities that portfolio managers may invest in and the amount of leverage they may employ. By contrast, hedge fund managers operating under a 3(c)(1) or 3(c)(7) exception to the '40 Act have no limits on the types of securities in which they invest (either liquid or illiquid), the amount of portfolio assets they can allocate to a single security, or the amount of leverage they can employ.

When top managers leave mutual fund firms to start their own hedge funds, the firms lose valuable talent and performance typically suffers. Now that many mutual fund firms are either managing registered hedge funds or planning to launch such products,[101] when a top manager leaves to start a hedge fund, that firm also loses the talent needed to manage a new hedge fund in-house. Thus, a mutual fund firm that launches a registered hedge fund can now offer almost all of the enticements that have lured top portfolio managers away in the past while simultaneously offering a product that is appealing to a coveted cross section of investors and makes more money for the firm through performance fees. The result of all of these factors is that more and more mutual fund firms are entering the hedge fund fray and bringing new retail investors with them.[102]

3. The Move Down-market

The factors highlighted above and the mutual fund industry's subsequent response have set in motion an unprecedented trend of hedge funds coming down-market to the merely affluent.[103] This trend is democratizing the asset class of hedge funds for the first time in its fifty plus years of existence and has the SEC concerned. Ironically, the product structures that mutual fund companies are using to take traditionally unregulated hedge funds down-market are themselves subject to SEC regulation under the '40 Act and, in some cases, the '33 Act as well.[104] By packaging hedge funds in a registered '40 Act structure, mutual fund companies can sell to an unlimited number of accredited investors and qualified clients. Moreover, mutual fund companies are built to accommodate large numbers of investors and do not share the back office limitations that hinder the scale of individual hedge funds.[105] As a result,

101. *See, e.g.*, Arvedlund, *supra* note 26, at F3; Rosata, *supra* note 98, at 6.
102. Arvedlund, *supra* note 26, at F3.
103. *See id.* at F3; Braham, *supra* note 94, at 78; Jonathan Clements, *Wall Street's Latest: Mini-Hedge Funds*, WALL ST. J., Mar. 26, 2002, at C1; Damato & Colter, *supra* note 93, at 78.
104. The mechanics of registered hedge funds are discussed at Part III.C.1.
105. Most partnerships and limited liability companies that manage hedge funds have a small number of employees in their "back office" who open, maintain, and service investor accounts. This is because most hedge funds, to be profitable, focus on fewer investors who must invest at higher minimums. By contrast, most mutual fund firms focus on more investors who can invest at lower minimums in their mutual funds. As a result, mutual fund firms already have the capacity to handle the large number of investor accounts that come with a lower investment-minimum hedge fund.

investment minimums for registered hedge funds have come down as low as $25,000, well below the traditional $1 million minimum investment that most unregistered hedge funds require.[106]

Lowered minimums have opened the door for the merely affluent to the exclusive club of hedge funds. However, these investors pay a higher price of admission to access hedge funds than investors who can afford a $1 million minimum. This higher price comes in the form of additional fees paid to compensate financial advisors who sell the funds and mutual fund companies that package and distribute the funds.[107] Many fund companies have launched such products, believing that investors are willing to absorb higher fees for the chance to access the benefits of hedge funds, especially in a declining market. Given the recent outperformance of hedge funds relative to stocks and mutual funds, many investors view a positive return net of high fees as better than a negative return net of lower fees.[108]

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106. *See* Braham, *supra* note 94, at 78.

107. Fees paid at the time of purchase to financial advisors or brokers for their efforts in selling funds to investors are referred to as a "load" or "commission." In addition, fees referred to as a "trailing commission" or "trail" are often paid out to the financial advisor on a quarterly or annual basis as long as the investor stays invested in the fund. Fund companies also take a portion of investor fees referred to as a "management fee" and "other expenses" or "fund operating expenses." The management fee and other expenses are layered on top of the traditional 1% management fee and 20% incentive fee that the actual hedge fund manager will charge or the 10% incentive fee that a "fund of funds" manager will charge. Fund of funds add yet another layer of fees because the underlying managers will still charge a 1% management fee and 20% incentive fee despite the fund of funds manager charging a 10% incentive fee. A "fund of hedge funds" or fund of funds is a hedge fund that invests solely in other hedge funds. *See* Osterberg & Thomson, *supra* note 10, at 2. The advantage of a fund of funds structure is that an investor gains diversification across several underlying hedge fund strategies that are professionally selected by a fund of funds manager who has expertise in evaluating and compiling a combination of managers and strategies to achieve the fund's objective. The additional 10% incentive fee paid to a fund of funds manager, on top of the 20% incentive fee paid to the underlying managers, is the price for a professionally managed and diversified hedge fund portfolio. To illustrate the overall fee structure (fees vary from fund to fund, but the following are indicative of fees charged on a registered hedge fund offered by a mutual fund company), a $50,000 investment into a registered fund of hedge funds offered by a mutual fund company will be subject to a one-time initial load of 1.25%, from which financial advisors are paid their commission, an ongoing annual fee of 1% paid out as a trail to the financial advisor, a 1% management fee shared by the mutual fund company and the fund of funds manager, .46% of other expenses to compensate the mutual fund company for operating the fund, a 10% incentive fee for the fund of funds manager, and a 1% management fee and 20% incentive fee for the underlying hedge fund managers. This adds up to 3.46% of annual ongoing management fees, trails, and fund operating expenses and 30% of incentive fees on profits earned in addition to a one-time 1.25% load. Compare this to a $1 million investment into an unregistered hedge fund, where an investor will pay only a 1% annual ongoing management fee and 20% incentive fee, or into an unregistered fund of hedge funds with a 1% annual ongoing management fee, 10% incentive fee, and then a 1% and 20% fee structure on the underlying funds. *See* Braham, *supra* note 94, at 78 (describing the high fees charged for lower minimum hedge funds).

108. *See* Goodman, *supra* note 53 (showing hedge fund outperformance of the S&P 500 and mutual funds in 2000 and 2001).

4. *Conflicts of Interest*

The SEC is concerned about potential conflicts of interest now that mutual fund companies are launching and managing registered hedge funds.[109] These potential conflicts arise when the same manager or team of managers runs both a traditional "long only"[110] mutual fund and a hedge fund side-by-side. One concern is that a manager who must decide where to allocate a winning trade between the two portfolios will favor the higher fee hedge fund over the lower fee mutual fund.[111] Another concern is that "potential abuses could arise if short selling by hedge funds adversely effect [sic] long positions held by related mutual funds or if mutual fund selling of shares is coordinated to support the shorting of shares by hedge funds."[112]

These specific types of conflict, however, are unique to fund companies that register and run '40 Act hedge funds alongside mutual funds (an area *already* subject to SEC regulation).[113] Thus, the proper issue for the SEC to analyze regarding these conflicts is whether the '40 Act needs to be amended or a ruling issued to deal with such conflicts of interest, not whether *unregistered* hedge funds need greater regulation. Furthermore, although the trend of fund companies offering hedge funds is growing, it still only represents "a handful of firms and . . . is a recent phenomenon."[114]

109. *See* Pitt, *supra* note 2.

110. A long only mutual fund refers to registered investment companies that exclusively or predominantly take long only positions in underlying securities, buying stocks or bonds with the goal of appreciation. These are the mutual funds with which most investors are familiar.

111. Alison Sahoo, *SEC Cites Advisor for Illegal Trading*, Ignites.com (Sept. 10, 2002), *at* http://www.ignites.com; Alison Sahoo, *What the SEC Eyes When Firms Offer Hedge Funds*, Ignites.com (June 7, 2002), *at* http://www.ignites.com.

112. Lederman, *supra* note 5, § 11:4A, at 11-22.

113. Similar conflicts of interest may arise in unregistered hedge funds where a manager must choose between allocating a winning trade to a higher or lower fee portfolio, or to a portfolio that is above a high watermark and therefore yielding an incentive fee versus a portfolio that is below a high watermark and not yielding a fee. However, the SEC has only publicly singled out conflicts of interest associated with hedge funds alongside mutual funds. *See* Pitt, *supra* note 2.

114. Angela J. Ottomanelli, *Hedge Fund Biz Wary of SEC Regulation*, FundFire.com (Aug. 20, 2002), *at* http://www.fundfire.com (quoting Sol Waksman, President, Barclay Trading Group).

5. *Investor Protection*

SEC concern over conflicts of interest, fraud, and the marketing of hedge funds to the merely affluent is centered on the policy of investor protection. Accordingly, the current hedge fund regulation debate, as framed by the SEC, focuses entirely on the issue of investor protection.[115] The SEC points to fraud among hedge fund managers at a time when hedge funds are headed down-market as the main investor protection issue.[116] Nevertheless, the down-market trend has yet to produce even one *accusation* of fraud against a *registered* hedge fund. Also, the merely affluent investors targeted by fund companies have *always* qualified under existing regulations to invest in hedge funds, but were previously priced out of the market.

The SEC is charged with protecting investors while also promoting stability, integrity, and efficiency in securities markets.[117] One can easily envision a market that is stifled rather than enhanced by a regulatory agency with a myopic drive to protect investors. For example, regulatory action aimed at eliminating every vestige of fraud in a given market would place such a heavy and costly burden of compliance upon issuers that investors would be safe but unable to achieve any meaningful return on their investments. The regulatory agency would also incur a high cost of enforcement. Carried to its logical end, investor protection as a sole reason for regulation, without also granting markets the freedom to reward those who take risk, ironically keeps investors safe and yet fails to fully protect the investors' sole interest in investing in the first instance: to achieve the highest return commensurate with their *individual* tolerance for risk. As a result, Congress made clear in creating the SEC that the goal of investor protection must be balanced against the "promot[ion] [of] efficiency, competition, and capital formation."[118]

The fundamental benefit of unregulated hedge funds is that they

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115. New money laundering regulation proposals issued by the Treasury Department and spurred by the USA Patriot Act of 2001 are a peripheral occurrence and not a contested issue in the current debate. *See generally* Glenn R. Simpson & Michael Schroeder, *Treasury Department Proposes Increased Hedge-Fund Scrutiny*, WALL ST. J., Sept. 18, 2002, at C1.

116. *See* Charles A. Jaffe, *SEC Aims to Oversee Auditors, Pitt Says Will Set Up Board If Congress Doesn't Act*, BOSTON GLOBE, May 25, 2002, at D1, *available at* 2002 WL 4129097; Alison Sahoo, *Deutsche Offers SEC Compromise on Fund of Funds*, Ignites.com (June 21, 2002), *at* http://www.ignites.com.

117. *See* 15 U.S.C. § 78c(f) (2000); *see also* U.S. Securities and Exchange Commission, *The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity*, *at* http://www.sec.gov/about/whatwedo.shtml (last modified July 21, 2003) (describing the SEC's primary mission).

118. 15 U.S.C. § 78c(f).

provide a private market where sophisticated investors, who can better sustain economic loss,[119] can select lowly correlated investments that may provide superior returns to those available in the regulated public markets. This benefit results from lower regulation costs imposed on managers and less restriction on the investment and trading techniques that managers may pursue. Lower regulation costs for the managers means incrementally greater returns for the investors. It also means a potentially greater risk of fraud. Similarly, less restriction on investment and trading techniques may also provide greater returns and greater risk for the investors.

Any effort by the SEC to regulate this market risks harming investor return by increasing costs and limiting the ability to select an investment that matches one's tolerance for risk.[120] One might counter that in the presence of fraud, investors are not able to measure the amount of risk they are actually taking on, or else they would not select that investment. However, fraud is a constant risk, even in regulated securities markets.[121] Furthermore, in the long view of the private market, fraudulent hedge fund managers and defrauded investors either will eliminate themselves from the market (through loss of wealth, or criminal or civil sanction), or if they persist as repeat players, become known by their former acts or learn from their experience.[122]

There is also a pragmatic concern at the root of investor protection that was foremost in Congress's mind when the '34 Act was passed, creating the SEC.[123] At the time, public confidence in the securities markets

119. *See* Regulation D Revisions, Securities Act of 1933 Release No. 6683, 52 Fed. Reg. 3015, 3017 (Jan. 30, 1987) (describing the rationale behind withholding the protections of registration under the Securities Act for wealthy individuals).

120. Other consequences of increasing regulation of unregistered hedge funds are discussed in Part V.

121. Consideration of recent fraud perpetrated by companies such as Enron and WorldCom support this point. *See, e.g.*, Dan Morse & Richard B. Schmitt, *Mississippi Lawyers Can't Get Enough of WorldCom Case*, WALL ST. J., Sept. 17, 2002, at A1 (detailing WorldCom's fraud); Jonathan Weil & Kathryn Kranhold, *First Guilty Plea in Enron Case Expected Today*, WALL ST. J., Aug. 21, 2002, at A1 (detailing the prosecution of Enron's fraud).

122. This claim assumes that certain portions of the efficient market hypothesis are correct, specifically, Milton Friedman's premise that in an efficient market, irrational investors lose money. *See* ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 4 (2000). Furthermore, irrational investors "cannot lose money forever: they must become much less wealthy and eventually disappear from the market. . . . [M]arket efficiency prevails because of competitive selection." *Id.* This proposition is best summarized by the saying: "A fool and his money soon part."

123. *See* U.S. Securities Exchange Commission, *supra* note 117 (detailing the

was shaken. It follows that investors who lose confidence in the integrity of a given market will be reluctant to invest.[124] Congress understood the vitally important role that the securities markets play in capital formation and viewed increased regulation as needed to restore investor confidence and reinvigorate markets.

By analogy, the current unregistered hedge fund market is not plagued by a widespread loss of investor confidence. Rather, it is growing at a healthy pace. The SEC may fear that a perceived increase in fraud is a harbinger of a loss in confidence. However, to take regulatory action based on such a speculative premise may impose too great a cost on managers and investors in return for too little investor benefit.

C. The Emergence of the Registered Hedge Fund

The investment vehicle carrying hedge funds down-market is the registered hedge fund. A registered hedge fund is a limited liability company or private partnership that registers with the SEC as an investment company under the '40 Act and may also register under the '33 Act.[125] In addition, the entity serving as investment adviser to the fund must register as an investment adviser under the Advisers Act.[126]

1. 1940 Act and 1933 Act Registration: Unlimited Investors and Advertising

By registering a hedge fund or a fund of hedge funds under the '40 Act, mutual fund companies and managers willingly subject themselves to the regulatory provisions of the '40 Act and its subsequent limits on investment[127] in exchange for the ability to market the fund to an unlimited number of accredited investors and qualified clients. By offering shares or interests in a private placement, these "closed-end"[128] funds are still limited to accredited investors under the Reg. D exemption to

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circumstances present in 1929–34 leading to congressional action).

124. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 296–97 (1991).

125. It is helpful to explain the mechanics of how these vehicles are registered and regulated before moving on to look at the structure of unregistered funds.

126. Investment Advisers Act of 1940, 15 U.S.C. § 80b-3 (2000).

127. *See supra* note 100 (detailing the limitations on investment).

128. The term "closed-end investment company" is defined in the '40 Act as "any management company other than an open-end company." 15 U.S.C. § 80a-5(a)(2). Practically, a close-end fund only accepts investments and allows redemptions on a periodic (monthly, quarterly, semiannually, etc.) basis, as opposed to an open-end fund, which accepts investments and allows redemptions on a daily basis. The salient aspect of this comparison is the liquidity offered to an investor. A closed-end fund offers limited liquidity, while an open-end fund offers daily liquidity.

the '33 Act.[129] Furthermore, by charging a performance-based incentive fee, these funds are further limited to "qualified clients."[130] A qualified client is defined in relevant part as "[a] natural person who . . . has at least $750,000 under the management of the investment adviser; . . . [or] [h]as a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000."[131] Based on the greater of these two limitations, registered hedge funds charging an incentive fee have only made it as far down-market as investors with a net worth of $1.5 million or at least $750,000 invested with the adviser.

In addition, a few closed-end funds that charge incentive fees have registered successfully under the '33 Act. This registration allows funds more freedom in advertising and marketing to qualified clients.[132] Moreover, at least one fund company has sought SEC approval for '33 Act registration of a '40 Act registered fund of hedge funds *charging no incentive fee* and therefore eliminating any wealth requirements for investors.[133] The SEC denied the application, effectively limiting the down-market trend to accredited investors.[134] In response, the fund company amended the original filing to include an accredited investor limitation.[135]

Despite the many similarities between the '40 Act registered hedge funds that are making their way down-market and traditional unregistered hedge funds, an essential difference exists between the two. Registered funds are subject to all of the regulatory provisions in the '40 Act, while unregistered hedge funds are largely exempt from regulation. The '40

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129. *See* 17 C.F.R. § 230.501 (2002). However, some '40 Act registered hedge funds or fund of hedge funds have also registered under the '33 Act in order to avoid restrictions on advertising private placements. *See id.* § 230.502(c)(1)–(2). Although a '33 Act registered fund is not limited to accredited investors under the Reg. D exemption, each of these funds has thus far also charged a performance-based incentive fee and are therefore limited by Rule 205-3 under the Advisers Act to only take investments from qualified clients. *See id.* § 275.205-3(a)(1).

130. *Id.* § 275.205-3(a).

131. *Id.* § 275.205(3)(d)(1).

132. *See id.* § 230.502(c)(1)-(2).

133. *See* Sahoo, *supra* note 116 (detailing Deutsche Bank's application).

134. *Id.*

135. *Id.* It is important to note that some '40 and '33 Act *open-ended* mutual funds that employ limited hedge fund techniques but charge no incentive fees are able to market to investors regardless of wealth. *See* Arvedlund, *supra* note 99, at F2; Allison Bisbey Colter, *Montgomery Looks to Hedge One of Its Funds*, WALL ST. J., Oct. 2, 2002, at B5M; Yuka Hayashi, *Former Tech Fund Exec Samson Launches Hedged Mutual Fund*, WALL ST. J. ONLINE (Aug. 21, 2002), *at* http://online.wsj.com.

Act requires that an investment company, among other things, have a board of directors, of which no more than sixty percent of the members are "interested persons," providing oversight,[136] adopt a written code of ethics,[137] register with the SEC,[138] disclose annual,[139] audited[140] holdings to the SEC and shareholders, and disclose detailed semiannual holdings to shareholders.[141] As an additional measure of investor protection, the '40 Act regulations contain broad antifraud prohibitions.[142] Hence, the purpose of '40 Act regulation is to set up a system of disclosure, reporting, and fund governance as a safety net to protect investors.[143]

These regulations only partially mitigate concerns regarding hedge fund fraud coming down-market via registered funds. Every '40 Act registered hedge fund manager is subject to the regulation and SEC oversight discussed above, in addition to registration under the Advisers Act.[144] Nevertheless, several registered funds are structured as a fund of hedge funds, where the investment adviser allocates the fund's assets to several underlying hedge fund managers. Generally, in this structure only the fund of funds manager, and not the individual underlying managers, is forced to register under the Advisers Act and '40 Act.[145] In addition, the '40 Act only requires that the registered fund of funds manager disclose the *names* of the underlying funds and not their *actual*

136. *See* 15 U.S.C. § 80a-10(a) (2000); *see also* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 20.6 (3d ed. 1996) ("Independent directors serve primarily as 'watchdogs' over an investment company to protect the interests of shareholders against abuses by investment advisers and others in a position to profit illegally from the company.").

137. 17 C.F.R. § 270.17j-1(b)(1). The code of ethics is to be followed by each of the company's "access persons." *Id*. § 270.17j-1(a)(1).

138. 15 U.S.C. § 80a-8(b).

139. *Id.* § 80a-29(a).

140. *Id.* § 80a-29(g).

141. *Id.* § 80a-29(e).

142. 17 C.F.R. § 270.8b-20. Rule 8b-20 requires that "[i]n addition to the information expressly required to be included in a registration statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." *Id.*

143. *See* HAZEN, *supra* note 136, § 17.1.

144. Advisers Act registration is discussed in Part III.C.2.

145. Exemption from the Advisers Act for private investment advisers is discussed below. It is generally true that the underlying managers in a registered fund of hedge funds are exempt from registration. However, one exception to the exemption exists where more than 10% of the managers' assets are derived from the registered fund of funds. If more than 10% of assets come from a registered fund, the no-look-through provision of Rule 203(b)(3) (discussed below) is no longer applicable, and the underlying fund takes on the number of clients of the registered fund. 15 U.S.C. § 80a-3(c)(1)(A). This almost always results in a number of clients greater than fourteen and the subsequent loss of exemption from the Advisers Act.

holdings.[146] As a result of this opacity and lack of regulation, an increased potential for fraud still exists among the underlying unregistered hedge fund managers. This potential for fraud, however, is theoretically slight because both the fund company and the registered fund of funds manager, composed of sophisticated and experienced individuals, provide extra layers of due diligence to detect fraud in the underlying managers.[147] Moreover, they each have a vested interest in avoiding the allocation of assets to fraudulent managers.[148]

2. Advisers Act Registration: SEC Oversight

Entities serving as investment advisers to '40 Act registered funds must also register with the SEC under the Advisers Act.[149] By contrast, most hedge fund managers acting as investment advisers to unregistered private investment funds are not registered under the Advisers Act. This is because most hedge fund managers qualify for the private investment adviser exemption under section 203(b)(3) of the Advisers Act.[150]

Section 203(b)(3) exempts from federal registration any adviser with fewer than fifteen clients during the preceding twelve months who neither holds himself out to the public as an investment adviser nor serves as an adviser to a registered investment company or a business development company.[151] In determining the number of clients, Rule 203(b)(3)-1 provides a nonexclusive safe harbor by defining who is "a single client for purposes [of the exemption]."[152] This safe harbor contains a "no-look-through provision"[153] that treats as a single client

146. 15 U.S.C. § 80a-29(e)(2).

147. One more layer of fraud detection is worth noting. Because almost all of the registered hedge funds coming down-market are only sold to investors through NASD registered financial advisors, the financial advisors and the brokerage firms they work for will both perform their own due diligence to insure that they are comfortable with the funds. These additional parties also have a vested interest in making sure the funds are free of fraud and suitable for their clients. The vested interest comes from the brokers' and brokerage firms' desire to guard their professional reputations and keep their clients.

148. The vested interest comes from the desire of the mutual fund companies and managers to guard their professional reputations and keep their clients.

149. 15 U.S.C. § 80b-3.

150. *See id.* § 80b-3(b)(3).

151. *Id.*

152. 17 C.F.R. § 275.203(b)(3)-1 (2002).

153. There has been speculation among practitioners that the SEC is considering amending the rule that provides for the no-look-through provision, effectively requiring all hedge fund managers with more than fourteen clients, as defined by the number of natural persons and not partnerships, to register with the SEC. Telephone Interview with Thao

"[a] corporation, general partnership, limited partnership, limited liability company . . . or other legal organization . . . that receives investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, [or] limited partners."[154] Practically, this rule allows hedge fund managers who manage no more than fourteen funds based on the fund's overall investment objectives, rather than on an investor-by-investor basis, to avoid the costs and burdens of registering under the Advisers Act.[155]

Despite the Rule 203 safe harbor, managers of registered hedge funds must register under the Advisers Act and are subject to its provisions.[156] These provisions include, among other things, requirements that advisers file Form ADV with the SEC, disclosing detailed information about themselves and their businesses, which is then made publicly available,[157] file annual reports with the SEC on Form ADV,[158] maintain certain records and make them available for periodic inspection,[159] and provide prospective clients with a brochure or disclosure document containing the information required in Part II of Form ADV.[160] The spirit and letter of these provisions, especially the SEC's ability to demand periodic inspection of adviser records, is firmly rooted in the policy of investor protection.[161]

Ngo, Associate, Paul, Hastings, Janofsky & Walker (Sept. 10, 2002). The effects of such a regulatory change are discussed in Part V.B.

154. 17 C.F.R. § 275.203(b)(3)-1(a)(2).

155. *See* Lederman, *supra* note 5, § 11:5.2, at 11-25. For example, a hedge fund manager may manage fourteen different funds, twelve of which are managed based on an overall fund objective and two of which are managed specifically for an individual client and still qualify for the safe harbor of Rule 203(b)(3)-1, despite having an actual number of individual clients (in the nonrule sense) in excess of fourteen.

156. 15 U.S.C. § 80b-3(b)(3).

157. 17 C.F.R. § 275.203-1; *see* HAZEN, *supra* note 136, § 18.3 (providing a synopsis of all the details an adviser must disclose on Form ADV, including an adviser's principle business, nature of business, scope of authority, basis of compensation, balance sheet, criminal record that would affect qualification for registration, educational and business background, other business activities, and a list of services provided, including the types of clients served and types of securities for which advice is rendered).

158. *See* 15 U.S.C. § 80b-4; 17 C.F.R. § 275.204-1(a)–(c).

159. *See* 15 U.S.C. § 80b-4.

> These records include balance sheets, income statements and a journal of all accounts; copies of all communications sent and received relating to investment advice or the executions of orders; copies of all notices, letters, reports and advertisements distributed by the adviser to more than ten customers; and records of all securities transactions.

HAZEN, *supra* note 136, § 18.3, at 1033 (footnotes omitted).

160. 17 C.F.R. § 275.204-3(a).

161. "All records (as so defined) of such investment advisers are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission as the Commission deems *necessary or appropriate in the public interest or for the protection of investors.*" 15 U.S.C. § 80b-4 (emphasis added).

D. A Call for Increased Regulation?

Should the emergence of registered hedge funds and the down-market trend be viewed as a reason for increased regulation? The SEC is concerned with the perceived increase in hedge fund fraud coupled with a down-market trend targeting mainstream retail investors. The qualified clients targeted, however, are not the embodiment of main street American investors. Rather, they are the type of investor that the SEC's own rule holds to be sophisticated and affluent enough to operate outside of the regulatory framework.[162]

Furthermore, the vehicle taking hedge funds down-market is already subject to extensive regulation by the SEC designed to protect investors from fraud. To deny this point is to deny the very efficacy of the '40, '33, and Advisers Acts to regulate not only the registered hedge fund market, but the much larger mutual fund market as well.

There are still some potentially troubling issues that the SEC should monitor as a result of recent trends. Most notable are potential conflicts of interest for a manager running a mutual fund alongside a hedge fund and the potential for fraud by an unregistered underlying hedge fund manager in a registered fund of hedge funds. In response, the SEC should monitor potential conflicts of interest going forward and examine the trade sheets of managers who run both types of products *if problems are suspected*. Also, the several layers of due diligence imposed by the '40 Act fund governance requirements,[163] combined with the market realities of several sophisticated parties that have a vested interest in detecting and avoiding fraudulent unregistered managers,[164] should mitigate the SEC's concern that merely affluent investors are at risk of fraud.

Determining that the down-market registered hedge fund trend is not a sufficient reason alone to increase the regulation of hedge funds does not dispose of the more imperative question: whether the *unregistered* hedge fund industry is in need of increased regulation. Before answering this question, it will help to consider how most hedge funds avoid direct SEC regulation.

162. The policy of wealth as a proxy for sophistication is discussed in Part IV.E.
163. *See supra* notes 136–45 and accompanying text.
164. *See supra* note 147.

IV. REGULATORY EXEMPTION OF PRIVATE INVESTMENT FUNDS

Most hedge funds avoid direct SEC regulation through a series of exemptions and safe harbors built into the '33, '40, and Advisers Acts. This Part will explore those exemptions and lay the groundwork for analyzing potential SEC proposals for increased regulation.

A. 1933 Act

Most hedge funds avoid registration under the '33 Act by qualifying for the exemption found in Reg. D.[165] This exemption applies to nonpublic offerings sold to accredited investors.[166] Congress added the accredited investor concept and section 4(6) to the '33 Act as part of the Small Business Investment Incentive Act of 1980.[167] In 1982, the SEC promulgated Reg. D, which contains a definition of accredited investor that includes the statutory categories of accredited investor plus the additional categories the SEC created.[168]

The practical impact on a hedge fund of Reg. D exemption from the '33 Act is to limit interests to no more than thirty-five nonaccredited investors and to refrain from general solicitation or advertising.[169] No standard disclosure is mandated when a hedge fund offers interests to accredited investors. Nevertheless, there is a mandatory disclosure requirement when dealing with a nonaccredited investor that is similar to the level of disclosure required in a registered offering.[170] However, in light of various federal and state antifraud provisions, most hedge funds will customarily prepare a comprehensive offering memorandum, even if the offering is limited to accredited investors.[171] Furthermore, although exempt from '33 Act registration (and other acts discussed below), hedge funds are still subject to the antifraud provisions of the '33 and '34 Acts.[172]

B. Antifraud Provisions: Rule 10b-5 and the Implied Private Right of Action

Even though unregistered hedge funds are exempt from direct SEC regulation, defrauded investors have a powerful implied private right of

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165. *See* 17 C.F.R. § 230.501.
166. *See supra* Part II.B.1 (defining "accredited investors").
167. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 602, 94 Stat. 2275, 2294 (codified at 15 U.S.C. § 80a-51 (2000)).
168. *See* 17 C.F.R. § 230.501.
169. *See id.*
170. *Id.* § 230.502(b)(1)–(2).
171. *See* Lederman, *supra* note 5, § 11:3.1, at 11-8.
172. *See* 15 U.S.C. §§ 77q(a), 78j(b) (2000).

action under Rule 10b-5 of the '34 Act.[173] In 1946, a federal district court held that Rule 10b-5 allows a private remedy to injured investors.[174] Two decades later, the United States Supreme Court approved the private right of action.[175] Consequently, although a hedge fund is exempt from '33 Act registration, this exemption does not preclude an action for fraud under Rule 10b-5.

C. The 1940 Act

In addition to exemption from '33 Act registration, most hedge funds also qualify for exemption from the costs and burdens of '40 Act registration through either the section 3(c)(1) or section 3(c)(7) exceptions.[176] Hedge funds avoiding registration under these exceptions are limited to selling interests to either no more than ninety-nine accredited investors or no more than 499 qualified purchasers (individuals with a net worth of at least $5 million).[177] Nevertheless, market realities force most unregistered hedge funds to require a minimum investment of $1 million. As a result, although accredited investors and lower net worth qualified purchasers are technically allowed to invest in such funds, they will most likely be unable to afford a $1 million minimum while also maintaining an appropriately sized allocation to alternative investments.[178]

D. The Advisers Act

Additionally, most hedge fund managers avoid the costs and burdens of registration under the Advisers Act through the fourteen-client private investment adviser exemption found in section 203(b)(3) of the Act.[179] Because of Rule 203(b)(3)-1, the SEC does not look through to the actual number of natural persons invested in a manager's funds, but instead considers a limited partnership or limited liability company that is managed based on the fund's overall investment objectives as one client.[180] As with the '33 and '34 Acts, advisers who are exempt from

173. 17 C.F.R. § 240.10b-5.
174. Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513–14 (E.D. Pa. 1946).
175. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12–13 (1971).
176. *See supra* Part II.B.1 (discussing these two exemptions).
177. *Id.*
178. *See supra* note 36 (explaining market realities).
179. *See* 15 U.S.C. § 80b-3(b)(3) (2000).
180. *See supra* note 153 and accompanying text.

registration under the Advisers Act are *not* exempt from the Act's antifraud provisions.[181]

Furthermore, to the extent that hedge fund managers are exempt from registration under the Rule 203(b) no-look-through provision, they are not limited by the Act's prohibition on charging an incentive fee to nonqualified clients.[182] This means that unregistered hedge fund managers are only bound by the offeree net worth requirements consistent with a 3(c)(1) or 3(c)(7) exception.

E. Accredited Investors, Qualified Purchasers, and Qualified Clients: Net Worth as a Proxy for Sophistication

> "*The very rich are different from you and me. . . . [T]hey have more money.*"
>
> Ernest Hemingway[183]

Net worth as a proxy for sophistication is the common thread of policy that runs through congressional action and SEC regulation concerning which individuals do not need the protections of federal securities regulation. The development of the accredited investor concept began with the United States Supreme Court's decision in *SEC v. Ralston Purina Co.*[184] Because the '33 Act does not define nonpublic offering transactions under section 4(2), the courts began the interpretive process in *Ralston Purina*. In *Ralston Purina*, the Court indicated that the exemption for a nonpublic offering depended on whether the offerees were able to fend for themselves and had access to the same kind of information that would be disclosed in registration.[185] Also, the Court "noted that such persons, by virtue of their knowledge, would not need to rely on the protections afforded by registration."[186]

The SEC followed the Supreme Court's lead in 1979 and created the accredited investor concept as part of former Rule 242.[187] Shortly thereafter, Congress added the accredited investor concept to the '33

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181. *See* 15 U.S.C. § 80b-6.

182. *Id.* § 80b-5(a).

183. ERNEST HEMINGWAY, *The Snows of Kilimanjaro*, *in* THE FIFTH COLUMN AND THE FIRST FORTY-NINE STORIES 150, 170 (1938).

184. 346 U.S. 119 (1953).

185. *Id.* at 124–25.

186. Defining the Term "Qualified Purchaser," Securities Act of 1933 Release No. 8041, 66 Fed. Reg. 66,839 (Dec. 27, 2001) (codified at 17 C.F.R. pt. 230).

187. Exemption of Limited Offers and Sales by Qualified Issuers, Securities Act of 1933 Release No. 6180, 45 Fed. Reg. 6362 (Jan. 28, 1980) (codified at 17 C.F.R. pts. 230, 239).

Act.[188] In so doing, Congress established several categories of accredited investors in sections 2(a)(15)(i)-(ii), authorizing the SEC to adopt additional categories based on "such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management."[189] This led the SEC to promulgate Reg. D in 1982, defining accredited investors in part by their net worth and income as a proxy for sophistication and the ability to sustain economic loss.[190] As a result of this progression, the definition of accredited investor has moved from the original judicial concept of knowledge to the current SEC concept of net worth as a proxy for sophistication.

Additionally, both Congress and the SEC have used net worth as a proxy for sophistication under the '40 and Advisers Acts. In defining "qualified purchaser" under section 3(c)(7) of the '40 Act, Congress "determined that the level of a person's investments should be used to measure the person's financial sophistication."[191] Likewise, in defining "qualified purchaser" in Rule 205-3 of the Advisers Act, the SEC determined that net worth and assets under management are a sufficient proxy for the sophistication needed to enter into an incentive fee arrangement with an adviser.[192]

Some commentators have questioned whether net worth and a subsequent ability to sustain economic loss are an effective proxy for investor sophistication. In a 1988 article, C. Edward Fletcher noted the congressional and SEC departure from the "*Ralston Purina* line of cases."[193] Fletcher thinks the move from private placement purchasers needing to be smart to only needing to be rich raises an important question: "[S]hould the law presume that wealthy investors, who can bear investment risks, are sophisticated investors, and treat them as such, no matter how financially naive they may be? Conversely, should the

188. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 602, 94 Stat. 2275, 2294 (codified at 15 U.S.C. § 80a-51 (2000)).

189. 15 U.S.C. § 77b(a)(15) (2000).

190. *See* Regulation D Revisions, Securities Act of 1933 Release No. 6683, 52 Fed. Reg. 3015, 3017 (Jan. 30, 1987) (codified at 17 C.F.R. pts. 230, 239). The SEC has explained the accredited investor definition as "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary." *Id*.

191. 66 Fed. Reg. at 66,842.

192. *Id*.

193. C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1123 (1988).

law treat poor, but financially sophisticated investors, who cannot bear investment risks, like other sophisticated investors?"[194] Regardless of how one answers the foregoing questions, current securities regulation clearly accepts net worth as a proxy for investor sophistication and the ability to sustain economic loss.

V. Proposals for Increased Regulation

Past proposals for the increased regulation of hedge funds have focused on the dangers that highly leveraged hedge funds pose to market integrity.[195] In 1999, the President's Working Group on Financial Markets emphasized the need to improve disclosure and risk management in the area of credit extension to hedge funds rather than imposing direct regulation.[196] During the 1998 debate before Congress, Federal Reserve Chairman Alan Greenspan made an observation about hedge fund regulation that is relevant to the current debate:

> [D]oes the fact that investors have lost most of their capital and creditors may take some losses on their exposure to LTCM call for direct regulation of hedge funds? It is questionable whether hedge funds can be effectively directly regulated in the United States alone. . . . [H]edge funds' physical presence is small. Given the amazing communication capabilities available virtually around the globe, trades can be initiated from almost any location. Indeed, most hedge funds are only a short step from cyberspace. Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. The best we can do, in my judgment, is what we do today: Regulate them indirectly . . . . We are thus able to monitor far better hedge funds' activity, especially as they influence U.S. financial markets. If the funds move abroad, our oversight will diminish.[197]

As with past proposals, any future congressional or SEC proposals for regulation of hedge funds must weigh the very real possibility that Chairman Greenspan's comments will prove prophetic if direct regulation is applied.

A. Cost-Benefit Analysis

The SEC has used cost-benefit analysis as a tool for evaluating proposed rules and regulations dealing with investor protection.[198] The

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194. *Id.* at 1123–24.

195. *See* Hedge Fund Disclosure Act, H.R. 2924, 106th Cong. 2–4 (2000).

196. President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management 29–32 (1999), *available at* http://www.ustreas.gov/press/releases/reports/hedgfund.pdf.

197. *See Hearing*, *supra* note 3, at 26.

198. Defining the Term "Qualified Purchaser," Securities Act of 1933 Release No. 8041, 66 Fed. Reg. 66,839 (Dec. 27, 2001) (codified at 17 C.F.R. pt. 230); *see* Regulation D, Securities Act of 1933 Release No. 6825, 54 Fed. Reg. 11,369, 11,371 (Mar. 20, 1989)

SEC's method takes into account the costs and benefits to both issuers and investors, in addition to the policy of investor protection.[199] The current hedge fund regulation debate should be no different. The following three proposals for increased regulation will be analyzed by taking into account the costs and benefits to both issuers and investors, in addition to the policy goal of investor protection.

B. Amend the No-Look-Through Provision and Force Adviser Registration

One proposal for increased regulation involves the SEC amending Rule 203(b)(3) to eliminate the current no-look-through provision and force all hedge fund managers with fifteen or more natural persons as clients to register under the Advisers Act. This amendment would increase manager disclosure and reporting to the SEC while also giving the SEC unfettered power to inspect a hedge fund's books. Because the vast majority of hedge fund managers have at least fifteen natural persons as clients, the SEC would gain greater jurisdiction over, and more information about, the hedge fund industry.

The benefits of this proposal are two-fold. First, the SEC could easily issue an amendment to Rule 203(b)(3) without congressional action. Second, the SEC could gain detailed information about hedge fund managers and work to preempt fraud through targeted inspections. This proposal would certainly increase investor protection, but at what cost?

Imposing the additional costs and burdens of Adviser Act registration on hedge fund managers is a costly method of protecting affluent investors. First, the increased costs and burdens of having to file and maintain all the reports required under the Advisers Act[200] will translate into increased fees passed on to investors, resulting in lower returns.[201] Alternatively, if fees are not passed on, smaller managers[202] and managers who have fallen behind their high watermark and are only earning a one percent management fee may be forced out of business.[203]

(codified at 17 C.F.R. pts. 200, 230, 239).

199. Regulation D, Securities Act of 1933 Release No. 6825, 54 Fed. Reg. at 11,371.

200. *See* 15 U.S.C. § 80b-4 (2000); 17 C.F.R. § 275.203-1 (2002).

201. Consider by analogy the estimates of how much money fund firms will spend to comply with the new anti-money laundering rules promulgated by the Treasury Department. Alison Sahoo, *Study: Money Laundering Regs Carry Steep Price Tag*, Ignites.com (Oct. 4, 2002), *at* http://www.ignites.com.

202. Manager size is measured here by assets under management.

203. *See* Brown & Zuckerman, *supra* note 26, at C1 (describing pressures many

Moreover, those managers already at the margin may take on more risk and employ more leverage in an effort to generate enough return to stay in business, leading to steeper investor losses.[204]

Second, the SEC will subject itself to the increased costs of having to regulate several thousand additional advisers. This comes at a time when the SEC is already stretched beyond capacity in dealing with corporate fraud and reform.[205] The only justification for this increased cost to investors, managers, and the SEC is a perceived need to begin protecting a class of affluent investors that have always been allowed to operate outside of the regulatory framework.[206] Such an SEC amendment would subject the hedge fund industry to full, direct regulation and would reverse a long-held policy of allowing affluent investors to fend for themselves.

An additional cost could come in the form of Chairman Greenspan's prediction as to how the hedge fund industry would respond to direct regulation. With further advances in technology since 1998, hedge funds today are even better equipped to operate offshore and beyond the SEC's jurisdiction if subjected to direct regulation.[207] On balance, it appears that the costs to investors, hedge fund managers, and the SEC from forcing registration under the Advisers Act outweigh the beneficial increase in investor protection. Furthermore, this increase in protection would be directed at the very investors that the SEC, Congress, and the courts have previously allowed to operate outside of the regulatory framework.

A more tenable version of the amendment to Rule 203(b)(3) would force all underlying unregistered hedge fund managers who take assets from a registered fund of funds to register under the Advisers Act. This would directly address the SEC's concern regarding protecting the merely affluent and close the only unregulated loophole in the current down-market trend.

Such an amendment would increase investor protection but most certainly raise the ire of the mutual fund industry. The amendment would effectively shrink the pool of hedge fund managers willing to accept money from a mutual fund company that operates a registered fund of hedge funds. Furthermore, it would most likely eliminate a

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hedge funds are already facing to stay in business).

204. *Id.*

205. *See* Michael Schroeder, *SEC Gets a Raise, but Will It Be Enough?*, WALL ST. J., Aug. 12, 2002, at C1 (detailing the SEC's struggle to keep up with its entire workload).

206. The merely affluent have always met the net worth requirements set by Congress and the SEC but have been unable to afford the $1 million minimums that most unregistered hedge funds charge.

207. Examples of technological advancement are higher speed Internet connections and better prime broker web applications.

disproportionate number of the best hedge fund managers who already have significant assets and will decide that the additional assets from registered funds are not worth the increased costs of regulation. Once again, this amendment would signify a policy shift for the SEC to now impose regulation to protect wealthy and sophisticated investors.

Additionally, the '40 Act already has a safeguard in place that eliminates the no-look-through provision and forces advisers to register under the Advisers Act if more than ten percent of their assets under management come from a registered fund.[208] As a result, forcing every adviser who accepts assets from a registered fund of funds to submit to the costs and burdens of Advisers Act registration will adversely affect the quality of underlying managers in registered fund of funds and only marginally increase investor protection beyond current rules.

C. Amend Definitions of Accredited Investor and Qualified Client

Another proposal for regulatory reform does not directly impose additional costs of registration upon hedge fund managers, but increases investor protection. This proposal involves the SEC amending the Reg. D definition of accredited investor and the Rule 205-3 definition of qualified client. This amendment is built on the intuitive premise that if wealth is used as a proxy for investor sophistication, the wealth requirement chosen should be adjusted periodically for inflation. In a 1998 amendment, the SEC adjusted the Rule 205-3 definition upward to account for inflation.[209] However, the Reg. D definition of accredited investor, promulgated in 1982, has never been adjusted for inflation.

The SEC can use historical inflation rates based on consumer price index data to determine revised net worth, income, and assets under management requirements.[210] When adjusted for inflation, the accredited

208. *See* 15 U.S.C. § 80(c)(1)(A) (2000); *supra* note 145.

209. Exemption to Allow Investment Advisers to Charge Fees Based upon a Share of Capital Gains upon or Capital Appreciation of a Client's Account, Investment Advisers Act of 1940 Release No. IA-1731, 67 SEC Docket 1235, 1236 (July 15, 1998).

210. Using the CPI/Inflation calculator on the Federal Reserve Bank of Minneapolis website, the $1 million accredited investor definition in 1982 becomes $1,858,031.09 in 2002; the $200,000 and $300,000 income requirements become $371,606.22 and $557,409.33, respectively. The $1.5 million qualified client definition as revised in 1998 becomes $1,650,000 in 2002; the $750,000 assets under management requirement becomes $825,000. Federal Reserve Bank of Minneapolis, *What Is a Dollar Worth*?, *at* http://minneapolisfed.org/research/data/us/calc (last visited June 25, 2003). Accordingly, the proposed amendment could include an upward revision to $1.8 million net worth or either $370,000 in single or $560,000 in joint income for accredited

investor definition actually becomes a more restrictive net worth test ($1.8 million) than the inflation-adjusted qualified client standard ($1.65 million). The impact of this change would be largely isolated to the registered hedge fund marketplace because most unregistered hedge funds either limit investors to the qualified purchaser standard ($5 million net worth) in the 3(c)(7) exception or require a minimum investment too steep for a $1.8 million net worth investor. As a result, the investor protection benefit from this proposal would only touch the already regulated realm of registered hedge funds. Furthermore, investor protection would only increase marginally from a $1.5 million net worth requirement to $1.85 million.

One cost to such an amendment is the slight decrease in availability of hedge funds to the merely affluent. Some hedge funds have the ability to offer absolute returns regardless of market direction and can provide superior risk-adjusted returns over time. The benefits to an investment portfolio of including these hedge fund characteristics can be substantial.[211]

In addition, keeping net worth requirements where they stand may be appropriate considering increases in investor sophistication over the last two decades. More sophisticated investors would justify allowing proportionately lower net worth investors access to unregulated investments. Any increase in sophistication is attributable to the growth in both quantity and variety of investment information and options now available to retail investors. In 1982, neither CNBC nor widespread access to the Internet existed. Today, many retail investors are deluged with information and investment options that they would have struggled to access in 1982. Nevertheless, increased information does not always result in increased sophistication.

D. Issue Policy Statement with Recommendations for Adequate Disclosure and Allow Industry Custom to Evolve

One final proposal for regulatory reform involves the SEC issuing a policy statement with recommendations for adequate disclosure to investors from unregistered hedge funds.[212] The current SEC fact-finding inquiry will yield more information about the hedge fund

investors and $1.65 million net worth or $825,000 in assets under management for qualified clients.

211. *See* MONTGOMERY PARTNERS, *supra* note 53, at 4.

212. For an example of an SEC policy statement, see Automated Systems of Self-Regulatory Organizations, Securities Exchange Act of 1934 Release No. 29185, 48 SEC Docket 1498 (May 15, 1991).

industry than was previously known.[213] From this inquiry, the SEC will, for the first time, have a baseline from which to measure future trends in the hedge fund industry. The SEC should analyze the information gathered and publish recommendations encouraging the industry to provide a minimum amount of disclosure regarding manager background, investment style, and portfolio holdings to current and prospective investors. The policy statement should include the message that future trends in industry custom will be measured from the current baseline and that varying forms of regulation remain possible.

This proposal is likely to increase investor protection through the internal mechanism of industry custom. The hedge fund industry has already demonstrated its desire to prove that it does not need increased regulation through distributing best practices recommendations.[214] For example, the International Association of Financial Engineers' Investor Risk Committee (IAFE) "is charged with finding the optimum level of disclosure between hedge funds and their investors."[215] The IAFE released recommended disclosure standards for hedge funds in 2001[216] and plans to release updated recommendations in 2003.[217]

Furthermore, when faced with the prospect of impending regulation, the majority of hedge fund managers will be willing to take on a recommended increase in disclosure to avoid the increased costs of regulation. This should lead to an industry custom of increased disclosure and transparency that will enable investors to more easily spot fraudulent managers. Even without the proposed policy statement, industry custom has already moved toward greater disclosure and transparency.[218] Realistic and well-informed recommendations by the

213. *See* Burns, *supra* note 60; Amanda Cantrell, *SEC Expands Hedge Fund Inquiry*, HedgeFund.net (Sept. 13, 2002), *at* http://www.hedgefund.net.

214. *See* Lederman, *supra* note 5, § 11:7, at 11-41 n.81 (citing a February 2000 report prepared by five prominent hedge funds which makes recommendations regarding risk management and disclosure practices); *see also* Amanda Cantrell, *Money Laundering Guidelines Aimed at Hedge Funds*, HedgeNews.com (Apr. 5, 2002), *at* http://www.hedgefund.net (detailing the Managed Funds Association's release of preliminary guidelines that offer sound guidance to hedge fund managers on how to establish anti-money laundering programs ahead of the Department of Treasury's rule promulgation).

215. Jamie LaReau, *Experts Push for Limited Hedge Fund Transparency*, Fundfire.com (Oct. 10, 2002), *at* http://www.fundfire.com.

216. *See* Lederman, *supra* note 5, § 11:7, at 11-41 n.81 (citing IAFE's July 27, 2001 release, entitled "Hedge Fund Disclosure for Institutional Investors").

217. LaReau, *supra* note 215.

218. *See* Craig Karmin, *Investors' Desire for Hedge-Fund Data Prompts New*

SEC regarding minimum disclosure and transparency, backed by the threat of regulation, will only serve to solidify and accelerate this trend.

VI. CONCLUSION

Hedge fund industry growth, a perceived increase in fraud, and the unprecedented move down-market by registered hedge funds raise legitimate concerns for the SEC. Nevertheless, because there is already an extensive regulatory scheme dealing with '40 Act registered hedge funds, and because the SEC's own policy allows merely affluent investors to invest in hedge funds, the only sensible regulatory proposal is to force registration by those managers who take assets from registered funds.[219] Furthermore, the hedge fund industry is a beneficial private market that allows affluent and sophisticated investors to find reward for the additional risk of operating outside of the regulatory framework. The SEC should come away from its fact-finding inquiry with a greater understanding and appreciation for the beneficial role of the hedge fund industry.[220] The SEC's best course of action is to encourage the *industry* to reduce the incidence of fraud through establishing a custom of greater disclosure and transparency to investors. The SEC can accomplish this by issuing a policy statement and giving the hedge fund industry a glimpse of its well-oiled regulatory shotgun, ready for use but with the hope that it will never have to be used.

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Firms to Peddle Specifics, WALL ST. J., Feb. 22, 2001, at C16; Amanda Cantrell, *Transparency Demands Rise Amid Increased Institutionalization*, HedgeNews.com (June 4, 2002), *at* http://www.hedgefund.net; *See generally* Jamie LaReau, *Institutions Demand Hedge Fund Risk Controls*, Fundfire.com (Aug. 29, 2002), *at* http://www. fundfire.com.

219. Even this regulatory proposal would only marginally increase investor protection in the segment of the hedge fund industry that is already subject to regulation under the '40 Act. This proposal would also decrease the quality of underlying hedge fund managers that retail investors can access.

220. Additional benefits of hedge funds beyond those previously discussed include their contribution to market efficiency.

> [Hedge funds] contribute to market efficiency in two ways: First, the identification of arbitrage opportunities requires extensive research. By executing trading strategies based on their market research, hedge funds improve the informational efficiency of markets by embedding that information into market prices. Second, whether hedge fund trades reflect an arbitrage strategy or speculation, their active presence in the market improves liquidity. Given that hedge funds often bet against the direction of the market, they provide ready counterparties in trades and thus help to complete the market.

Osterberg & Thomson, *supra* note 10, at 4.