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## Registration of Hedge Fund Advisers under the Investment Advisers Act

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# REGISTRATION OF HEDGE FUND ADVISERS UNDER THE INVESTMENT ADVISERS ACT

## I. INTRODUCTION

“Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”<sup>1</sup>

A hedge fund, typically an unregulated investment vehicle for the affluent investor, holds a variety of securities and other assets.<sup>2</sup> Currently, the Securities and Exchange Commission (“SEC”) maintains little reliable data on the hedge fund industry, yet instances of illegal activity involving hedge funds continue to catch the agency’s attention.<sup>3</sup> The SEC has identified fraud, misuse of leverage, and speculation as the industry’s leading problems.<sup>4</sup> These problems include recent late-trading and market-timing scandals, as well as the 1999 collapse of the massively overleveraged hedge fund run by Long Term Capital Management. The agency’s concerns about hedge funds parallel the concerns that Franklin Delano Roosevelt’s administration had about investment trusts and their kin in the early 1930s.<sup>5</sup> Those concerns led the New Deal administration to pioneer the regulatory framework for securities that is currently in effect.

Today, the hedge fund industry operates in a pre-New Deal state of regulation. Maintaining this status quo means that the SEC remains in the dark about many incidents of abuses by hedge fund advisors. Without any reliable data, the SEC cannot prevent abuses

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1. LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY, AND HOW BANKERS USE IT* 92 (A. M. Kelley 2d ed. 1986) (1914).

2. *See infra* notes 22–27 and accompanying text.

3. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisors, 69 Fed. Reg. 45,172 (July 28, 2004) (to be codified at 17 C.F.R. pts. 275, 279) [hereinafter SEC Proposed Rule].

4. *See id.*

5. *See infra* notes 39–48 and accompanying text.

that harm hedge fund and ordinary investors and that potentially harm world markets. Pressing the full weight of federal securities regulations on the hedge fund industry would be consistent with the hedge fund industry with the historical development of securities law. Such an approach, however, is not necessary, nor politically feasible, at this time. A more sensible policy dictates that the SEC require, as the SEC board finally approved in October 2004,<sup>6</sup> that hedge fund advisers register with the agency. This would enable the SEC to: (i) begin to understand the hedge fund industry, (ii) attempt to curb illegal activity of individual funds and their advisers, and (iii) prevent market disruptions by monitoring overleveraged funds.

Although the SEC proposed rule of registering hedge fund advisers won a three to two executive board vote, the rule does not require full compliance until 2006. The rule faced, and continues to face, intense opposition. According to one calculation, 73 percent of letters during the comment period for the SEC proposal opposed registration.<sup>7</sup> The voices of opposition include top law firms,<sup>8</sup> hedge fund groups,<sup>9</sup> and some writers in the academic legal community.<sup>10</sup> These groups mostly advance provocative economic arguments against registration, including arguing that registration would impede the hedge fund industry's growth.

Conspicuously absent on both sides of the registration discourse, is any attempt to examine hedge funds in the historical context of securities regulation. This Note shows that many issues that drove the original federal securities regulations are the same issues driving the push to regulate the hedge fund industry today, and explains why the current controversy concerning the hedge fund industry should

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6. See Press Release, SEC Proposes Securities Offering Reform, Requires Registration of Hedge Fund Investment Advisers (Oct. 27, 2004), available at <http://www.sec.gov/news/press/2004-150.htm> [hereinafter SEC Press Release].

7. Managed Funds Association, The SEC's Proposal: The Public Commentary—A Summary, available at <http://www.mfainfo.org/images/PDF/SEC-Summary-Comments-Memo.pdf> (last visited Apr. 10, 2005) [hereinafter Managed Funds Comment].

8. *Id.*; see also Letter from Marianne K. Smythe et al., Director, Division of Investment Management, Wilmer, Cutler, Pickering, Hale & Dorr LLP, to Jonathan Katz, Secretary, Securities & Exchange Commission 9 (Sept. 8, 2004) [hereinafter Hale & Dorr Letter].

9. Managed Funds Comment, *supra* note 7.

10. See, e.g., ERIK J. GREUPNER, *Hedge Funds Are Headed Down-market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555 (2003).

ultimately be resolved in favor of registration.

Part II of this Note examines the context and purpose behind the securities regulation framework currently in place in the United States. It is important to examine the circumstances and the intent under which those regulations were passed in order to understand why registering hedge fund advisers is consistent with the overall scheme of securities regulation.

Part III of this Note first describes what is generally known about the hedge fund industry. The focus then shifts to the details of how hedge funds avoid the complex securities regulations of the New Deal. Part III also explains the problems of fraud, leverage, and speculation that the hedge fund industry imposes onto investors and world markets as a whole.

Part IV supports registration as the proper method of dealing with these risks posed by the hedge fund industry. Finally, Part IV of this Note analyzes the utility of registration and the arguments against it. By placing the current issue of hedge fund regulation in an historical perspective, this Note shows that the SEC's October 2004 decision<sup>11</sup> to require the registration of hedge fund advisers is necessary and consistent with the overall goals of securities regulation.

## II. SECURITIES REGULATION AND THE INVESTMENT TRUSTS OF THE 1920S

The hedge fund industry currently operates under a regulatory scheme similar to that of the 1920s securities industry. Consequently, an overview of the securities industry during this period will illustrate how the current problems posed by the hedge fund industry are reminiscent of the securities problems that the New Deal Administration sought to address.

### *A. State Regulations and Problems in the Securities Industry During the 1920s and the Depression Era*

Understanding why hedge funds adviser registration comports with the overall scheme of New Deal securities regulation first

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11. See SEC Press Release, *supra* note 6.

requires examining the circumstances surrounding the passage of those regulations. Before the Federal Government established the elaborate securities regulations of the New Deal, states had passed their own Blue Sky<sup>12</sup> laws to regulate securities. By 1933 all states but Nevada had some securities or Blue Sky laws.<sup>13</sup> The Blue Sky laws were ineffective for many reasons including: (i) lobby efforts by the Investment Bankers Association, (ii) use of the mails to conduct securities operations across state lines, and (iii) reluctance by states to pass or enforce tough measures that may distract industry from the State.<sup>14</sup>

Large, uninformed increases in investor speculation in securities markets and large increases in securities fraud characterized the Blue Sky regulation period.<sup>15</sup> Congress estimates that about half of the almost \$50 billion worth of new securities issued after World War I are actually worthless.<sup>16</sup>

Promoters and managements inspired and profited by this buying extravaganza. In their . . . desire to get a portion of this easy capital they issued securities for overvalued properties, pyramided and complicated corporate structures, over-expanded, [and] over-borrowed . . . . [B]ankers likewise too frequently forgot their duty of counselors . . . they

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12. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 44 (1982). The blue sky laws were so named because they were "intended to check stock swindlers so barefaced they 'would sell building lots in the blue sky.'" *Id.*

13. *Id.* at 45.

14. See Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 332-33 (1988) (citing *Federal Securities Act: Hearings on H.R. 4314 Before the H. Interstate and Foreign Commerce Comm.*, 73d Cong. 99, 100 (1933) (DEPT. OF COMMERCE, A STUDY OF THE ECONOMIC AND LEGAL ASPECTS OF THE PROPOSED FEDERAL SECURITIES ACT), reprinted in 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 20, at 100 (comp. by J.S. Ellenberger & E. Mahar 1973)). The Investment Bankers Association riddled local securities laws with so many exceptions that they were essentially ineffectual. SELIGMAN, *supra* note 12, at 45. By operating across state lines, securities traded through interstate commerce came under the regulatory purview of the U.S. Congress, not the states. *Id.*

15. Keller & Gehlmann, *supra* note 14, at 335.

16. *Id.* at 334 (citing H.R. REP. NO. 73-85, at 2 (1933), reprinted in 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 18, at 2 (comp. by J.S. Ellenberger & E. Mahar 1973)).

reaped a harvest on the popularity of management and fixed trusts.<sup>17</sup>

“[S]everal million citizens with small incomes were raiding their savings, reducing their immediate purchasing power and mortgaging their future in order to speculate. Ninety percent of these market transactions in the twenties, it has been estimated, were gambling ventures rather than permanent investments.”<sup>18</sup> Investors were often exploited, and accounting scandals typified by “duplicity in bookkeeping”<sup>19</sup> were common. Holding companies and pyramid schemes proliferated, fooling investors into thinking they were investing in prosperous businesses when they really were investing in pools of debt laced with deceptive bookkeeping.<sup>20</sup>

This era also saw the rise of the investment trusts into which over four and a half million Americans placed their savings, ultimately losing an estimated three billion dollars.<sup>21</sup> In the four-year period from 1926 to 1929, the “good times,” the number of investment trust companies grew by 600 and their total assets increased from \$1 billion to \$8 billion.<sup>22</sup> A variety of financial players, including large investment houses, operated investment trusts that typically consisted of pooled investment vehicles and often were used to hedge risk.<sup>23</sup> The trusts “were little better than gambling establishments in which the innocent patron intrusted [sic] his stakes not even to a fellow player picked at random but to the croupier—whose main interest, of course, was to represent ‘the house.’”<sup>24</sup> Most trusts resisted disclosing their holdings, as required to be listed on the New York Stock Exchange, and consequently, traded mainly in Boston and Chicago.<sup>25</sup> Trusts often used leverage<sup>26</sup>

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17. *Id.* at 335 n.58 (quoting Laylin K. James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 626 (1934)).

18. DIXON WECTER, *THE AGE OF THE GREAT DEPRESSION* 5 (MacMillan Co. 1952).

19. *Id.*

20. *See id.* at 5–6.

21. *Id.* at 6.

22. SELIGMAN, *supra* note 12, at 222.

23. JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929*, at 46–65 (Houghton Mifflin Co. 1979).

24. WECTER, *supra* note 18, at 6.

25. GALBRAITH, *supra* note 23, at 49. Highly respected trust managers favored refusal of the hedge funds to disclose holdings as a prudent move to prevent runs on securities. *Id.*

aggressively, a practice that some critics attributed to be a main cause of the 1929 stock market crash.<sup>27</sup>

Despite the prevalence of fraud, speculation and the lack of transparency<sup>28</sup> in the investment industry, the twenties were a time of great economic growth in the United States.<sup>29</sup> Manufacturing and output rose steadily, as did industrial production and business earnings.<sup>30</sup> From May 1924 to the end of 1927, the New York Times industrial average increased almost 150%.<sup>31</sup>

Growth and speculation ran their course “[b]etween September 1, 1929, and July 1, 1932, [when] the value of all stocks listed on the New York Stock Exchange shrank from a total of nearly \$90 billion to just under \$16 billion- a loss of 83 percent.”<sup>32</sup> During a similar period, the value of New York Stock Exchange bonds declined from \$49 billion to \$31 billion.<sup>33</sup> Correspondingly, Gross National Product (“GNP”) fell by about a third during this same period.<sup>34</sup>

Some blamed the stock market crash on “bear raids” or abusive short selling of securities.<sup>35</sup> The more widely accepted explanation

26. “In an investment trust leverage was achieved by issuing bonds, preferred stock, as well as common stock to purchase, more or less exclusively, a portfolio of common stocks.” *Id.* at 57.

27. *Id.* at 56–65 (describing investment trusts and their use of leverage); see also WECTER, *supra* note 18, at 6–7 (describing the expansion of credit and investment trusts’ use of leverage).

28. “[T]he typical offering circular prior to 1933 contained little of the information needed to estimate the worth of a security.” Keller & Gehlmann, *supra* note 14, at 335.

29. While the rich enjoyed the largest economic gains, more and more people were “well-off.” GALBRAITH, *supra* note 23, at 2.

30. From the early to mid-twenties until 1928, the number of manufacturing establishments increased from 183,900 to 206,700 with a corresponding rise in the output value from \$60.8 billion to \$68 billion, and the Federal Reserve index of industrial production rose from 67 to 110. *Id.* at 2–3 (citing U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States, 1944–45*, FED. RES. BULL., Dec. 1929).

31. *Id.* at 7–9. The New York Times industrial average increased during this period from 106 to 245. *Id.*

32. SELIGMAN, *supra* note 12, at 1.

33. *Id.* at 1.

34. GALBRAITH, *supra* note 23, at 168.

35. STAFF OF THE COMMISSION’S DIVISION OF INVESTMENT MANAGEMENT AND OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 40 n.138 (2003) [hereinafter SEC STAFF REPORT] (citing 7 LOUIS LOSS & JOEL SELIGMAN,

for the crash is overall speculation in the financial markets.<sup>36</sup> The Depression has proven more difficult to explain, but probably resulted from a combination of: (i) great disparities in income, (ii) fragile corporate structures; (iii) poor banking structures, (iv) trade imbalance, and (v) flawed economic projections.<sup>37</sup> The Hoover administration responded to the initial crash by conducting investigations, holding commission hearings, and seeking voluntary compliance by corporations with suggested reforms.<sup>38</sup> When these measures failed to produce results, the American people elected Franklin Delano Roosevelt. Roosevelt swiftly moved to regulate the securities markets, employing the skills of Felix Frankfurter, then a Harvard Law professor, and a host of others.<sup>39</sup>

#### *B. The New Deal Response—Federal Securities Regulations*

After the Depression took hold, for Roosevelt and the New Dealers, “[m]aking capitalism live up to its pretensions necessitated a restoration of public confidence in the governing symbols and basic currency of the economic order—investment securities.”<sup>40</sup> In response, the New Deal securities regulations included: the Securities Act of 1933 (“SA”),<sup>41</sup> the Securities Exchange Act of 1934 (“SEA”),<sup>42</sup> the Investment Company Act of 1940 (“ICA”),<sup>43</sup> and the Investment Advisers Act of 1940 (“IAA”).<sup>44</sup> Congress passed these securities acts intending to protect potential securities investors.”

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SECURITIES REGULATION 3203–04 & 3204 n.213 (3d ed. 1989)).

36. GALBRAITH, *supra* note 23, at 168–71.

37. *Id.* at 177–86.

38. See SELIGMAN, *supra* note 12, at 2–38. Led by committee counsel Ferdinand Pecora, the Senate Banking and Currency Committee conducted investigations instrumental to later securities regulation. *Id.* at 1–2, 39.

39. See *id.* at 39–241 (giving a comprehensive account of the New Deal securities regulations).

40. MICHAEL E. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 3 (1970).

41. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (1982 & Supp. IV 1986)).

42. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78kk (1982 & Supp. IV 1986)).

43. Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64 (1982 & Supp. IV 1986)).

44. Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21 (1982 & Supp. IV 1986)).

Accordingly, to understand why registering hedge fund advisers comports with the overall scheme of New Deal securities regulation, it is important to examine the congressional intent behind those individual regulations. Any evidence regarding the intent of specific exceptions and exemptions that hedge funds currently use to avoid regulation must also be examined.

### 1. The 1933 Securities Act

In a message to Congress on March 29, 1933, Franklin Delano Roosevelt said:

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.<sup>45</sup>

Congress responded later that same year, enacting the SA largely as a disclosure statute based on the English Companies Act<sup>46</sup> and as one that remained true to Roosevelt's words.<sup>47</sup> The SA's preamble states the Act's purpose: "to provide full and fair disclosure of the character of securities sold in interstate commerce . . . and to prevent fraud in the sale thereof, and for other purposes."<sup>48</sup>

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45. James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) (citing H.R. REP. No. 73-85, at 2 (1933)). Landis was one of the main drafters of the Securities Act and a protégé of securities regulation champion Felix Frankfurter. SELIGMAN, *supra* note 12, at 61-62 (giving a concise account of Landis' legal background).

46. See SELIGMAN, *supra* note 12, at 46.

47. Landis, *supra* note 45, at 30-49. "The Securities Act of 1933 was really a 'rotten egg statute.' You could sell all the rotten eggs you wanted if you told people fully how rotten they were. Alas, a lot of rotten eggs were sold under this statute and you suspect that a lot of them are continuing to be sold." Symposium, *New Approaches to Disclosure in Registered Security Offerings*, 28 BUS. LAW. 505, 505 (1973) (remarks of panelist member A.A. Sommer).

48. Keller & Gehlmann, *supra* note 14, at 342 n.130 (quoting S. REP. NO. 73-47 at 1 (1933), reprinted in 2 LEGISLATIVE HISTORY OF THE SECURITIES

Nevertheless, the bureaucracy at the time, untrained in complex securities matters, believed it was unnecessary to regulate sophisticated investors spending their own money.<sup>49</sup> The prevailing opinion of the drafters was that the federal government should not concern itself with the sale of securities to a limited group of experienced investors.<sup>50</sup> This idea resulted in the Act's exemption for sales other than those made by "an issuer, underwriter, or dealer"<sup>51</sup> and "transactions "not involving [a] public offering."<sup>52</sup> Thus, the distinction between public and private offerings has set the scope of the SA.<sup>53</sup>

## 2. The 1934 Securities Exchange Act

"Congress intended the SEA to curb notable exchange abuses, especially speculation and market manipulation."<sup>54</sup> Congress designed the SEA to:

establish the Securities and Exchange Commission to regulate the securities business; require the stock exchanges to adopt rules of fair dealing; apply the full disclosure requirements of new securities under the Securities Act to all securities traded on a national exchange; and instruct the Federal Reserve Board to regulate the use of borrowed money in the stock market".<sup>55</sup>

Critics of the Act, however, claimed that the SEA was a step toward communism in the United States, and some "characterized the bill's proponents variously as radicals or Bolsheviks or 'a bunch of Jews

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ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 item 17, at 1 (comp. by J.S. Ellenberger & E. Mahar 1973)); *see also* A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38, 40 (1941) (citing the Securities Act of 1933, 48 Stat. 74, 78 (codified as amended at 48 Stat. 881, 905-06 (1934)).

49. *See* Landis, *supra* note 45, at 37.

50. *Id.*; SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953) (holding that "the exemption question turns on the knowledge of the offerees").

51. Landis, *supra* note 45, at 37.

52. 15 U.S.C. § 77d(2) (2000).

53. Landis, *supra* note 45, at 37.

54. Keller & Gehlmann, *supra* note 14, at 348 (citing John E. Tracy & Alfred Brunson McChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1027 (1934)); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 423 (1990).

55. Keller & Gehlmann, *supra* note 14, at 347.

out to get J.P. Morgan.”<sup>56</sup>

### 3. The 1940 Investment Company Act

The ICA “is a comprehensive regulatory scheme implemented to protect investors from abusive practices by those operating investment companies.”<sup>57</sup> “Disclosure has been the pervading philosophy of the SEC and of the other statutes they administer. Even the [ICA], which is largely regulatory, nonetheless has a large measure of disclosure requirements.”<sup>58</sup> The ICA, however, required substantial compromise by the Roosevelt administration, and some critics regard it as a great legislative defeat for the SEC.<sup>59</sup>

The Act contains an exemption for “[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.”<sup>60</sup> This exemption, used by hedge funds, “reflects Congress’ view that privately placed investment companies, owned by a limited number of investors likely to be drawn from persons with personal, familial, or similar ties, do not rise to the level of federal interest.”<sup>61</sup>

### 4. The 1940 Investment Advisers Act

Congress intended for the IAA to mitigate the abusive practices of investment advisers.<sup>62</sup> The IAA requires investment advisers to

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56. SELIGMAN, *supra* note 12, at 96; *see also* Keller & Gehlmann, *supra* note 14, at 348.

57. Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 693 (2000); *see also* SEC v. Advance Growth Capital Corp., 470 F.2d 40, 42 (7th Cir. 1972) (explaining that the ICA is a “comprehensive regulatory scheme designed to prevent abusive practices by those in control of investment companies”).

58. Sommer, *supra* note 47, at 505.

59. *See* SELIGMAN, *supra* note 12, at 222–31.

60. 15 U.S.C. § 80a-3(c)(1) (2000).

61. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,173 n.17 (July 28, 2004) [hereinafter SEC Proposed Rule] (to be codified at 17 C.F.R. pts. 275, 279) (citing *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency*, 76th Cong. 179 (1940)).

62. *See* SEC v. Capital Gain Research Bureau, Inc., 375 U.S. 180, 189–90 (1963) (citing *Investment Trusts and Investment Companies*, *supra* note 61, § 202); Johnston v. CIGNA Corp., 916 P.2d 643, 646 (Colo. Ct. App. 1996)

register with the SEC, maintain certain business records, and deliver a disclosure statement to the SEC.<sup>63</sup> The Act also creates a fiduciary duty owed by the adviser to the investor.<sup>64</sup> This duty requires the adviser to: (i) disclose conflicts of interest, (ii) seek the best execution for transactions, and (iii) have a reasonable basis for recommendations to the client.<sup>65</sup>

The IAA contains a private investor exemption that is currently utilized by hedge funds. This exemption has no legislative history, but “the SEC makes clear that “[the exemption] was not intended to exempt advisers to wealthy or sophisticated clients.”<sup>66</sup> Instead, Congress intended the Act to protect all types of investors who chose to utilize an investment adviser.<sup>67</sup> This broad protection therefore extends to the highly sophisticated, the naïve, those unfamiliar with their adviser’s strategy, and even those investors with too little time to manage their own investments.<sup>68</sup> By narrowing the categories included in the private investor exemption (essentially excluding the hedge funds), the IAA will require hedge fund advisers to register with the SEC. Consequently, the SEC would further the IAA goal of protecting all investors that utilize an investment adviser.

In summary, the hedge fund industry presents many of the same risks that the 1920s’ investment trusts posed: fraud, misuse of leverage, and speculation. These problems drove securities regulation. Therefore, applying the IAA to hedge fund advisers is a logical step in attempting to deal with the problems that the industry poses.

### III. HEDGE FUNDS

Many advisers, investors and others in the hedge fund industry have avoided the registration and regulation requirements of the SA,

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(stating the purpose of the Investment Advisers Act (IAA) was to protect the public from fraud and misrepresentation by unscrupulous advisers); W.T. Mallison, Jr., *The Investment Advisers Act of 1940*, 1 VAND. L. REV. 68, 69–70 (1947–48) (detailing adviser strategies including matching buyers and sellers within an adviser’s clientele and shifting high quality securities from a client’s account to the adviser’s account).

63. SEC Proposed Rule, 69 Fed. Reg. at 45,172–73.

64. *Id.*

65. *Id.* at 45,173.

66. *Id.*

67. *Id.*

68. *Id.*

SEA, ICA and IAA.<sup>69</sup> The little information that exists about the hedge fund industry must be examined to fully comprehend and appreciate the significance of this lack of registration and regulation.

### A. *What Are Hedge Funds?*

Generally, the SEC defines a hedge fund as “an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act.”<sup>70</sup> While no formal definition of a hedge fund exists, almost all agree on some variant of this definition.<sup>71</sup>

Hedge funds vary in their trading strategies, generally trading a diverse array of securities and equities.<sup>72</sup> Hedge funds account for significant amounts of daily trading on the New York Stock Exchange and are exceptionally active in the bond markets. By exploiting arbitrage opportunities and engaging in other investment strategies, hedge funds are seen by some, including Federal Reserve Board Chairman Alan Greenspan, as contributing to efficient market pricing and the liquidity of markets. Other benefits attributed to the hedge fund industry include: (i) helping investors diversify their portfolios, (ii) achieving returns uncorrelated to the market, and (iii) assuming risk from other sectors of the economy by taking unfavorable trading positions.<sup>73</sup>

Many hedge funds are “offshore” hedge funds, incorporated in places like the Cayman Islands, the Bahamas, the British Virgin Islands, Panama, and the Netherlands Antilles. Offshore hedge funds have attracted many investments entities, such as pension funds, charitable trusts, foundations, and endowments.<sup>74</sup>

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69. See discussion *infra* Part III.C.

70. SEC STAFF REPORT, *supra* note 35, at 3.

71. See Gibson, *supra* note 57, at 683.

72. See SEC STAFF REPORT, *supra* note 35, at 3–4, 33–43 (listing equities, fixed income securities, “convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, [and] commodity options” as traded by hedge funds and long-only equity, arbitrage, and hedging strategies as employed by hedge funds); Gibson, *supra* note 57, at 685–86 (listing different trading strategies used by hedge funds with detailed descriptions).

73. SEC STAFF REPORT, *supra* note 35, at 4–5; see SEC Proposed Rule, 69 Fed. Reg. at 45,178; Gibson, *supra* note 57, at 688.

74. SEC STAFF REPORT, *supra* note 35, at 10.

“Hedge funds are usually structured as private limited partnership[s], or limited liability companies to [maintain] pass through tax treatment.”<sup>75</sup> A general partner, whose compensation is usually about ten to twenty percent of the fund’s profits, typically manages and makes decisions for the fund.<sup>76</sup> Many funds, however, restrict compensation to managers if the fund does not exceed a performance benchmark.<sup>77</sup> In addition, hedge fund managers often have significant personal investments in the funds they manage.<sup>78</sup>

Investors typically are given little information about the hedge funds in which they invest because the SA does not require any form of disclosure to accredited<sup>79</sup> investors.<sup>80</sup> The theory behind this rule is “that accredited investors are sophisticated enough and have enough bargaining power to obtain any information they need from an issuer in making an investment decision.”<sup>81</sup> Nevertheless, to protect against liability under antifraud provisions of federal securities laws, unregistered and unregulated hedge funds make some disclosures in the form of private placement memorandum, conference calls, informal conversations, and other unofficial devices. In practice, however, accredited investors hold very little bargaining power, and beyond what they can discover by hiring investigators and consultants, essentially take whatever terms and disclosures hedge funds advisers offer them.<sup>82</sup>

### *B. Estimates of Hedge Fund Growth and the Diversification of Investors*

The SEC knows so little about the hedge fund industry that, in its 2003 Staff Report on the implications of hedge fund growth, it

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75. See Gibson, *supra* note 57, at 683.

76. *Id.* at 684.

77. See *id.* at 684 n.17 (citing Scott J. Lederman, *Securities Regulation of Domestic Funds*, in *NUTS & BOLTS OF FINANCIAL PRODUCTS: UNDERSTANDING THE EVOLVING WORLD OF CAPITAL MARKET AND INVESTMENT MANAGEMENT PRODUCTS* 551, 553 (Clifford E. Kirsch et al. eds., 1998)).

78. SEC Proposed Rule, 69 Fed. Reg. at 45,173.

79. Generally the term accredited investor equates to an investor who earns more than \$200,000 per year or meets certain minimum personal wealth requirements. See *infra* note 98 and accompanying text.

80. 15 U.S.C. § 77d (2000); 17 C.F.R. § 230.506 (1982).

81. SEC STAFF REPORT, *supra* note 35, at 46 n.161.

82. *Id.* at 47 n.163.

admitted that its “staff has no reliable data on the number of hedge funds in existence or the amount of hedge fund assets under management.”<sup>83</sup> The Report estimated that the industry grew from about 400 hedge funds in 1992 to approximately 6000 in 2003, and that the industry was quickly approaching a net worth of one trillion dollars.<sup>84</sup> By 2003 “[a]bout 44% of the 650,000 American households with a net worth of at least \$5 million had such investments” in hedge funds and private-equity offerings.<sup>85</sup> While hedge fund investors have traditionally been individuals and families, institutional investors today, including cities, university endowments, foundations, and pension plans account for a significant amount of the money invested in hedge funds.<sup>86</sup>

### C. How Hedge Funds Avoid Registration with and Regulation by the SEC

Hedge funds navigate a complex web of securities acts and rules to avoid regulation by the SEC. To qualify for exceptions and exemptions to the SA, SEA, ICA, and IAA, hedge funds limit the number of their investors, refrain from advertising, and set minimum

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83. *Id.* at 1 n.2.

84. *See id.* An updated estimate put forth by the SEC shows that the United States hedge fund industry is now worth at least \$795 billion and that there are about 7000 funds. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,174 (July 28, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (citing *Regulation of the Hedge Fund Industry: Hearing Before the H. S. Comm. on Banking, Hous., and Urban Affairs*, 108th Cong. 27 (2004) (testimony of Charles J. Gradante, Managing Principal, The Hennessee Group LLC), available at [http://banking.senate.gov/\\_files/gradante.pdf](http://banking.senate.gov/_files/gradante.pdf) (last modified Oct. 27, 2004).

85. Robert Tomsho, *Luxury Vehicle: An 18% Return? It Sounded Good to Rich Investors*, WALL ST. J., June 15, 2004, at A1 (citing statistics from the Spectrem Group, a Chicago consulting firm).

86. Endowments and foundations average about ten percent of their portfolios in hedge funds, with extreme schools such as the University of Virginia placing sixty percent of their endowment portfolios in hedge funds. SEC Proposed Rule, 69 Fed. Reg. at 45,176–77 & 45,177 n.56 (citing *Virginia Exposure Soars to 60%*, FIN. NEWS (DAILY), Apr. 28, 2003, available at [http://www.efinancialnews.com/index.cfm?page=archive\\_search&storyref=1850000000032608&uid=7805-2111-461800-980527](http://www.efinancialnews.com/index.cfm?page=archive_search&storyref=1850000000032608&uid=7805-2111-461800-980527)). Pensions have an estimated \$72 billion invested in hedge funds. 69 Fed. Reg. at 45,176 n.55 (citing *Regulation of the Hedge Fund Industry*, *supra* note 84 (testimony of Charles J. Gradante, Managing Principal, The Hennessee Group LLC), available at [http://banking.senate.gov/\\_files/gradante.pdf](http://banking.senate.gov/_files/gradante.pdf) (last modified Oct. 27, 2004).

wealth requirements for investors. Despite these compliance measures, hedge funds still effectively attract many investors, including investors of varying incomes.

### 1. Securities Act of 1933

To avoid registration and prospectus requirements<sup>87</sup> under the SA, hedge funds rely on the Act's private offering exemption under section 4(2) and Code of Federal Regulations rule 506.<sup>88</sup> Section 4(2) reads, "The provisions of [section 5 (15 U.S.C. § 77e)] shall not apply to . . . (2) transactions by an issuer not involving any public offering." Congress enacted this exemption "to allow issuers to avoid cumbersome registration requirements when the likelihood that the public would benefit from the registration was very remote."<sup>89</sup> Thus, Congress intended this exemption to apply to private offerings of wealthy investors where the "public interest is not strongly implicated."<sup>90</sup>

The Supreme Court delineated an anecdotal standard for what constitutes a public offering in *SEC v. Ralston Purina*.<sup>91</sup> That standard can be summed in the negative: "[a]n offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'"<sup>92</sup> Whether a sale qualifies for the private offering exemption has been construed by subsequent court decisions and by the SEC. Considerations include the number of offerees, their need for information, their access to information, and the size of the offering.<sup>93</sup>

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87. Registration and prospectus requirements are contained in section 5 of the Securities Act. 15 U.S.C. §§ 77e(b), 77e(c) (2000). Among other requirements, the Securities Act mandates that the issuer register with the SEC and provide investors with an SEC mandated prospectus. See SEC STAFF REPORT, *supra* note 35, at 13.

88. See 15 U.S.C. § 77d(2) (2000); 17 C.F.R. § 230.506. (2004); SEC STAFF REPORT, *supra* note 35, at 14; Gibson, *supra* note 57, at 689. The exemption seemingly runs contrary to the purpose of the Securities Act, which was to ensure adequate disclosure to investors. See discussion *supra* Part II.B.1.

89. Gibson, *supra* note 57, at 689 (citing THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 225 (3d ed. 1996)).

90. *Id.* (citing HAZEN, *supra* note 89, at 225).

91. 346 U.S. 119 (1953).

92. *Id.* at 125.

93. Gibson, *supra* note 57, at 690.

Accordingly, hedge funds ensure that they engage in private offerings by maintaining thirty-five or fewer investors.<sup>94</sup> Under rule 506, this guarantees compliance with section 4(2).<sup>95</sup> Compliance with rule 506 is sufficient but not necessary to qualify for the private offering exemption promised by section 4(2).<sup>96</sup> Compliance with rule 506 limits hedge funds to thirty-five investors,<sup>97</sup> but this limit is a farce since “accredited investors” do not count toward the thirty-five purchaser limit.<sup>98</sup>

Hedge funds still sometimes file a “notice of sale” on a Schedule D form with the SEC within fifteen days of making an exempt sale.<sup>99</sup> Schedule D, however, requires minimal information about the hedge fund: an explanation of how investor money will be used, fund expenses, and the amount of securities bought and sold.<sup>100</sup>

One negative consequence for a hedge fund using rule 506 is that the fund must also abide by the requirements of rule 502(c), limiting almost all forms of advertising.<sup>101</sup> Rule 506 further restricts investors in that they cannot turn around and resell their investment

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94. SEC STAFF REPORT, *supra* note 35, at 14.

95. *Id.*

96. *Id.*

97. 17 C.F.R. § 230.506 (2004).

98. SEC STAFF REPORT, *supra* note 35, at 14–15 nn.43–44 (discussing the provisions of rule 506(b)(2)(1) and rule 501(e)(1)(16)). The bar is set low to qualify as an accredited investor. As delineated in rule 501, an individual need only have a net worth of over one million dollars or a minimum income of \$200,000 (\$300,000 if married) with reasonable expectation of earning comparable income in the coming year. SEC STAFF REPORT, *supra* note 35, at 15; *see also* 17 C.F.R. § 230.501(a) (defining eight categories of accredited investors); 17 C.F.R. § 230.215 (defining the term accredited investor). Hedge fund directors, general partners, and officers are also accredited investors. SEC STAFF REPORT, *supra* note 35, at 15. Institutional investors, trusts, employee benefit plans, and the like need only have more than five million dollars in net assets to be accredited investors. *Id.* at 15.

99. HEDGE FUNDS INVESTMENT AND PORTFOLIO STRATEGIES FOR THE INSTITUTIONAL INVESTOR 149 (Jess Lederman & Robert A. Klein eds., 1995) [hereinafter PORTFOLIO STRATEGIES].

100. *Id.* Failure to file Schedule D does not affect the availability of the 4(2) exemption, but can be grounds for the SEC denying future use of the exemption. *Id.*

101. *See* 17 C.F.R. § 230.502(c); SEC STAFF REPORT, *supra* note 35, at 16. In its report on hedge funds, the SEC provides a more detailed description of advertising restrictions under rule 502 as well as a discussion of issues involving advertising and the internet. *See* SEC STAFF REPORT, *supra* note 35, at 16; *see also* Gibson, *supra* note 57, at 690–91.

in a hedge fund without registering under the SA.<sup>102</sup> Another negative consequence of using the section 4(2) exception is that it does not apply when an action is brought pursuant to sections 12(2) or 17, the anti-fraud provisions of the SA.<sup>103</sup>

## 2. Securities Exchange Act of 1934

Under the SEA, broker-dealers must submit to SEC regulatory oversight, and investors must report the holding of certain specified securities positions to the SEC.<sup>104</sup> Hedge fund managers, however, avoid classifications as either brokers or dealers. The SEA defines a broker as one “engaged in the business of effecting transactions in securities for the account of others.”<sup>105</sup> It defines a dealer as one “engaged in the business of buying and selling securities for his own account through a broker or otherwise.”<sup>106</sup> Dealer does not include a bank, or any “person [that] buys or sells securities for his own account, either individually or in [a] fiduciary capacity, but not as a part of a regular business.”<sup>107</sup> Hedge fund managers are not brokers because they engage in transactions for their own accounts, not those of others.<sup>108</sup> Similarly, hedge fund managers are not dealers—neither as they engage in transactions for their own account nor as part of a regular business.<sup>109</sup>

Other registration and reporting provisions contained in section 12 of the SEA take effect when an issuer has 500 “holders of record”<sup>110</sup> of a class of equity security and “assets in excess of \$10 million.”<sup>111</sup> Hedge funds, however, typically avoid registration

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102. SEC STAFF REPORT, *supra* note 35, at 17. An investor can resell his investment in a hedge fund without registration if there is an applicable exemption to registration. *Id.* (citing 17 C.F.R. § 230.502(d)). Usually hedge funds prohibit transfers of investor interests without the written consent of the general partner or other manager, and “there is limited liquidity of the interests through sales and redemptions by the hedge funds.” *Id.* at 18.

103. Keller & Gehlmann, *supra* note 14, at 347 n.183.

104. 15 U.S.C. §§ 78a–mm (2000); Gibson, *supra* note 57, at 691.

105. 15 U.S.C. § 78c(a)(4).

106. *Id.* § 78c(a)(5)(A)–(C).

107. *Id.*

108. See Gibson, *supra* note 57, at 692.

109. *Id.*; PORTFOLIO STRATEGIES, *supra* note 99, at 149–50 (providing a more detailed look at what constitutes “brokers” and “dealers”).

110. SEC STAFF REPORT, *supra* note 35, at 18–19. “Holders of record” for hedge funds are generally the investors. *Id.*

111. 15 U.S.C. § 78l(g)(1)(B); SEC STAFF REPORT, *supra* note 35, at 18–19.

under section 12 by maintaining less than 500 holders of record.<sup>112</sup>

Sections 13(d), 13(g), and 16(a) of the SEA require certain disclosures by funds purchasing substantial “equity securities” registered under section 12.<sup>113</sup> These provisions place investors and entities on notice that an entity may be targeted for takeover.<sup>114</sup> To avoid registration with the SEC under these sections, hedge funds restrict the amount within each class of equity securities that they purchase.<sup>115</sup>

### 3. Investment Company Act of 1940

Although domestic hedge funds typically fall under this definition of an investment company, they often structure their business to utilize exceptions and avoid registration and regulation.<sup>116</sup> Congress designed the ICA as a comprehensive regulatory scheme to protect investors from the abusive practices of investment companies.<sup>117</sup> Section 3(a)(1)(A) of the ICA defines an investment company as “any issuer which . . . is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities . . . .”<sup>118</sup>

Many hedge funds rely on section 3(c)(1) of the ICA to avoid regulation. Section 3(c)(1) exempts from the definition of investment company, “[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not

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112. SEC STAFF REPORT, *supra* note 4135, at 18.–19.

113. 15 U.S.C. §§ 78m(d), (g); 15 U.S.C. § 78p(a); SEC STAFF REPORT, *supra* note 35, at 19–20. The term “equity securities” includes securities convertible into equity securities, warrants, and rights to subscribe to or purchase equity securities. Gibson, *supra* note 57, at 692 n.87 (citing HAZEN, *supra* note 89, at 224). When a party purchases more than five percent of a class of registered equity securities, section 13(g) requires the party to make substantial disclosures to the SEC. SEC STAFF REPORT, *supra* note 35, at 19–20; 15 U.S.C. §§ 78m(d), (g). When a party purchases at least ten percent of a class of registered equity securities, section 16 requires further disclosures to the SEC. SEC STAFF REPORT, *supra* note 35, at 20; 15 U.S.C. § 78p(a).

114. See Gibson, *supra* note 57, at 692–93.

115. Jonathan H. Gatsik, *Hedge Funds: The Ultimate Game of Liar’s Poker*, 35 SUFFOLK U. L. REV. 591, 612 (2001).

116. See Gibson, *supra* note 57, at 694.

117. *Id.* at 693.

118. 15 U.S.C. § 80a-3(a)(1)(A).

presently propose to make a public offering of its securities.”<sup>119</sup> To comply with section 3(c)(1), hedge funds must not make, or propose to make, public offerings, and can avoid making such offerings by complying with section 4(2) of the SA.<sup>120</sup> A corporation, registered investment company, or hedge fund using section 3(c)(1) to avoid regulation, counts as only one investor for the purposes of the section 3(c)(1) exemption.<sup>121</sup>

Hedge funds use section 3(c)(7) as an alternative to section 3(c)(1) to avoid regulation under the ICA.<sup>122</sup> Section 3(c)(7) requires that: (i) fund securities to be owned exclusively by qualified purchasers; and (ii) the fund refrain from making a public offering.<sup>123</sup> Qualified purchasers include individuals or families maintaining a minimum of five million in investments, certain trusts, or any person who owns and discretionarily invests over twenty-five million dollars.<sup>124</sup> One advantage for hedge funds using the section 3(c)(7) exemption is that they can conceivably take on an unlimited number of qualified investors.<sup>125</sup> Another advantage of employing section

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119. *Id.* § 80a-3(c)(1). Offshore hedge funds can exclude non-United States investors in determining compliance with section 3(c)(1). SEC STAFF REPORT, *supra* note 35, at 11 n.33.

120. *See* SEC STAFF REPORT, *supra* note 35, at 12. Section 4(2) of the Securities Act exempts “transactions by an issuer not involving any public offering.” 15 U.S.C. § 77d(2). This is almost an identical requirement as that of section 3(c)(1) of the ICA. *See supra* note 119 and accompanying text.

121. *See* SEC STAFF REPORT, *supra* note 35, at 11. When a corporation, registered investment company, or unregistered hedge fund owns more than 10 percent of the voting securities of the principle fund, then each of the company or hedge fund investors counts as an investor in the section 3(c)(1) exempt principle fund. *Id.* at 11 n.34; *see* PORTFOLIO STRATEGIES, *supra* note 99, at 155–57; Gibson, *supra* note 57, at 694–95.

122. *See* SEC STAFF REPORT, *supra* note 35, at 12. Section 3(c)(7) exempts “[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.” 15 U.S.C. § 80a-3(c)(7)(A) (2000).

123. SEC STAFF REPORT, *supra* note 35, at 12–13. In 1996 Congress added this exemption because it judged that qualified purchasers were sufficiently sophisticated to evaluate the quality and risk of the hedge fund they contemplated investing in. *Id.* at 13 (citing S. REP. NO. 104-293, at 10 (1996)).

124. 15 U.S.C. § 80a-2(a)(51)(A)(ii)–(iv); Gibson, *supra* note 57, at 695–96.

125. SEC STAFF REPORT, *supra* note 35, at 13. However, to avoid regulation and reporting under the SEA, the number of investors must be below 499, and to avoid registration under the IAA, the fund must take on less than fifteen investors. *Id.* at 13, 21.

3(c)(7) is that at no point does a look-through provision kick in as under 3(c)(1).<sup>126</sup> The one caveat is that the hedge fund manager must ensure that no one forms a corporate investor solely to invest in the fund, since such a corporation does not qualify for the qualified purchaser label.<sup>127</sup>

#### 4. Investment Advisers Act of 1940

One who qualifies as an investment adviser must register with the SEC and follow SEC rules for investment advisers.<sup>128</sup> The SEC estimates that two-thirds of hedge fund advisers are unregistered.<sup>129</sup> The IAA defines an investment adviser as:

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. . . .<sup>130</sup>

Hedge fund advisers avoid registration under the IAA by using the private adviser exception contained in section 3(b)(3), withholding investment advisor status from “any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who [does not hold] himself out generally to the public as an investment adviser . . . .”<sup>131</sup> Hedge fund advisers remain unregistered pursuant to section 3(b)(3) by maintaining fewer than 15 clients, not holding themselves out to the public as investment advisers, and not acting as investment advisers to

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126. *Id.* at 13.

127. *Id.* at 13 & n.41. A corporation formed to invest in a hedge fund is still a qualified purchaser if each of its “beneficial owner[s]” is a qualified purchaser. *Id.* at 13 n.41.

128. *Id.* at 20–21. Investment advisors must also keep the SEC and their investors informed about matters, including their disciplinary history and current practices, by filing a current disclosure form with the SEC and disclosure statement for clients. *Id.* Registered investment advisers must, among other requirements, maintain required books and records and submit to periodic examinations by the SEC. *Id.* at 21.

129. *Id.* at 22.

130. 15 U.S.C. § 80b-2(a)(11) (2000).

131. 15 U.S.C. § 80b-3(b)(3).

registered investment companies.<sup>132</sup> As under the ICA, corporations and other hedge funds count as one investor.<sup>133</sup>

The antifraud provisions of the IAA, however, still affect unregistered hedge fund advisors.<sup>134</sup> Under the antifraud provisions of the IAA, hedge fund advisors cannot make material omissions or misrepresentations to investors.<sup>135</sup>

Summarily, while hedge funds are subject to some minimal protections of the securities acts, they avoid substantial regulation and registration requirements through exceptions and exemptions to the SA, SEA, ICA, and IAA. To qualify for these exceptions and exemptions, hedge funds limit the number of their investors, refrain from advertising, and set minimum wealth requirements for investors. These compliance measures, however, do not ensure that hedge funds affect only a small number of investors with minimum requirements for wealth.

#### *D. Current Risks Hedge Funds Pose to Investors and the Economy*

Hedge funds currently place ordinary investors at risk by exposing them to fraud involving mutual funds, misuse of leverage that can lead to the potential for world financial crises, and speculation drives the pricing of common securities and commodities. Despite such risks to the investing community, the SEC knows almost nothing about unregistered hedge funds. For the SEC to effectively protect these investors, the SEC needs information about the industry and its practices and has sensibly required, as approved by the SEC board in October 2004, that hedge fund advisers register with the agency.

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132. 15 U.S.C. § 80b-3(b)(3) (2001); SEC STAFF REPORT, *supra* note 35, at 21; *see* Gibson, *supra* note 57, at 698–99 (describing what “holding out” means in more detail).

133. *See* 15 U.S.C. § 80b-3(b)(3). The result of this no look-through clause is that hedge funds can have hundreds of actual clients and manage enormous sums of money and still qualify for the private adviser exemption. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,173 (July 28, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

134. SEC STAFF REPORT, *supra* note 35, at 21.

135. *See In re Taubenheim*, SEC Order, Investment Advisers Act of 1940, Release No. 1843 (Oct. 4, 1999), 1999 SEC LEXIS 2082, available at <http://www.sec.gov/litigation/admin/ia-1843.htm>; Gibson, *supra* note 57, at 697 n.121.

### 1. A general void of information

Currently, the SEC has “no oversight program that would provide [it] with the ability to deter or detect fraud by unregistered hedge fund advisers at an early stage.”<sup>136</sup> Today’s regulatory controls “do not provide regulators with the authority to require hedge funds to make comprehensive disclosures about their risk management practices and their trading positions and exposures.”<sup>137</sup> What little the SEC knows about unregistered hedge funds it gleans from third party data. Even large institutional investors have difficulty obtaining the necessary information to adequately evaluate an unregistered hedge fund.<sup>138</sup>

Leaving a one trillion dollar industry largely unregistered and unregulated has significant consequences. Growth in the hedge fund industry has been accompanied by growth in hedge fund fraud, which directly affects hedge fund investors.<sup>139</sup> Hedge funds also “have the potential to impact the U.S. financial markets [and ordinary investors] significantly because, unlike mutual funds and pension funds, hedge funds engage in more active, short-term trading and use leverage more aggressively.”<sup>140</sup>

In summary, a hedge fund or group of hedge funds pose the following risks to the following groups: (i) fraud, which affects hedge fund investors and ordinary investors, and (ii) reckless use of leverage and irresponsible speculation, which affects all investors as well as world markets.<sup>141</sup> Without regulation or registration, hedge funds can cause enormous disruptions to investors and world markets virtually undetected by the SEC.<sup>142</sup>

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136. SEC Proposed Rule, 69 Fed. Reg. at 45,177.

137. Gibson, *supra* note 57, at 704.

138. *See id.*

139. *See id.* at 45,175–76. *But see id.* at 45,197 (Glassman, Atkins, Comm’rs, dissenting) (stating that the SEC Staff Report did not find a significant increase in fraud).

140. *See* Gibson, *supra* note 57, at 685 (citing REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 2 (1999)); PAUL KRUGMAN, THE RETURN OF DEPRESSION ECONOMICS 118–36 (1999).

141. SEC Proposed Rule, 69 Fed. Reg. at 45,175–80.

142. *See* Gatsik, *supra* note 115, at 591–93 (describing how the hedge fund Long Term Capital Management (LTCM) nearly took world markets to the brink); *see generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2001) (providing a more

## 2. Hedge fund fraud affecting hedge fund investors

The SEC states that the commission has brought forty-six fraud actions<sup>143</sup> against hedge funds by the commission in the five years leading up to 2004.<sup>144</sup> Hedge fund fraud accounts for at least an estimated one billion dollars in losses to investors.<sup>145</sup> The types of fraud actions the SEC has brought against unregistered hedge fund advisers include “misappropriation of assets, portfolio pumping, misrepresentation of portfolio performance, falsification of experience, credentials and past returns, misleading disclosure regarding claimed trading strategies and improper valuation of assets.”<sup>146</sup>

The SEC has brought many actions for misrepresentation of portfolio performance with hedge fund advisers grossly overstating returns for extended periods.<sup>147</sup> Valuation problems contribute to thirty-five percent of hedge fund failures and are driven by the adviser’s need to show consistent performance and the overall complexity of hedge fund portfolios.<sup>148</sup> The SEC has also brought actions against advisers paying “unnecessary and undisclosed commissions.”<sup>149</sup> Hedge fund advisers have also been indicted for

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detailed account of LTCM).

143. SEC Commissioner Paul Atkins has challenged the significance of the forty-six fraud actions. SEC Proposed Rule, 69 Fed. Reg. at 45,198 nn.14–15 (Glassman, Atkins, Comm’rs, dissenting); *SEC Crime Spree*, WALL ST. J., Sept. 27, 2004, at A18.

144. SEC Proposed Rule, 69 Fed. Reg. at 45,175.

145. *Id.*

146. *Id.* at 45,179.

147. *Id.* at 45,175; see also *New York Hedge Fund Manager Haligiannis Indicted for Fraud*, BLOOMBERG NEWS, Sept. 30, 2004, at C2 (reporting the arrest and charges filed by the SEC against the president of the Sterling Watters Group hedge fund for allegedly cheating investors out of tens of millions of dollars by informing them of a 1,565% return while the fund was actually losing money). The SEC Proposed Rule highlights the following actions among other civil actions alleging similar fraud: SEC v. Jung, Litigation Release No. 17,417 (Mar. 15, 2002); SEC v. Mobley, Litigation Release No. 18,150 (May 1, 2001); SEC v. Berger, Litigation Release No. 17230 (Feb. 27, 2003). SEC Proposed Rule, 69 Fed. Reg. at 45,175 n.40.

148. See SEC Proposed Rule, 69 Fed. Reg. at 45,179 (citing Christopher Kundro & Stuart Feffer, *Valuation Issues and Operational Risk in Hedge Funds*, Capco White Paper (Dec. 2003), available at [http://www.capco.com/uploadedFiles/Capco\\_institute/ValuationIssuesWhitepaperDocument/j10art06.pdf](http://www.capco.com/uploadedFiles/Capco_institute/ValuationIssuesWhitepaperDocument/j10art06.pdf) (subscription required) (on file with Loyola Law Review)).

149. *Id.* at 45,175 & n.40. The SEC Proposed Rule cites *In re Portfolio*

using “parallel unregistered advisory firms and hedge funds as vehicles to misappropriate client assets.”<sup>150</sup> Due to a lack of “basic information about hedge fund advisers and the hedge fund industry,”<sup>151</sup> it is entirely possible that fraud within the industry and amongst advisers takes on many more shapes and forms and is far more pervasive than the forty-six representative cases the SEC has filed in the last five years.<sup>152</sup>

Relevant to fraud committed against hedge fund investors, the recurring justification for the use of exceptions and exemptions that leave the hedge fund industry largely unregistered and unregulated is that wealthy investors are more sophisticated and less susceptible to fraud.<sup>153</sup> In practice, “sophisticated professional investors can be just as vulnerable as amateurs.”<sup>154</sup> The complex nature of hedge funds requires due diligence that even sophisticated investors cannot perform.<sup>155</sup>

### 3. Hedge fund fraud affecting ordinary investors

Hedge fund advisers have played a central role in the recent market timing and late trading<sup>156</sup> scandals brought to the forefront by

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Advisory Servs., LLC, Investment Advisers Act Release No. 2038 (June 20, 2002). SEC Proposed Rule, 69 Fed. Reg. at 45,175 n.41.

150. SEC Proposed Rule, 69 Fed. Reg. at 45,175. The SEC Proposed Rule cites the following enforcement action as an example: SEC v. Hoover, Litigation Release No. 17,487 (Apr. 24, 2002), Litigation Release No. 17,981 (Feb. 11, 2003). SEC Proposed Rule, 69 Fed. Reg. at 14,175 n.42.

151. SEC Proposed Rule, 69 Fed. Reg. at 45,177.

152. *Id.*

153. Securities regulations exceptions and exemptions use terms such as accredited investor, holder of record, and qualified purchaser, and cases refer to wealthy investors that can fend for themselves. *See supra* notes 87–135 and accompanying text; KRUGMAN, *supra* note 140, at 120.

154. Randall Smith, *Affinity Fraud: Harvard Parents Got a Hard Lesson in Investing Perils*, WALL ST. J., June 11, 2004, at A1 (telling the story of Karen Fleiss, a hedge fund adviser, who was defrauded out of a \$1.8 million dollar investment by Gregory Earls, a contact she knew through the Harvard University Parents Fund). This controversy was significant in that Ms. Fleiss, a sophisticated investor, became involved in the fraudulent investment out of respect for Mr. Earls and the appeal of his promised investment (much the same way many investors probably become involved with unregistered hedge funds). *Id.*

155. *See Tomsho, supra* note 85.

156. Market timing, legal but discouraged by mutual fund prospectuses, is the practice of “rapidly buying and selling mutual-fund shares in order to profit

New York Attorney General (“NYAG”) Elliot Spitzer. Many SEC “enforcement cases involve[ ] hedge funds that sought to exploit mutual fund investors for their own gain.”<sup>157</sup> Typically, hedge fund advisers strike deals with mutual fund advisers, mutual fund management, or brokers, which allow them to engage in late trading and/or market timing.<sup>158</sup> In exchange for providing late trading and market timing privileges, mutual fund advisers, management, and brokers see higher returns on their investments in the hedge funds and/or receive “sticky assets.”<sup>159</sup> The SEC estimates that as many as forty different hedge funds are involved in market timing and late trading cases.

Canary Investment Management, LLC, managed hedge funds engaged in market timing schemes.<sup>160</sup> What did the SEC know about Canary and its widespread use of market timing strategies? The SEC contended, “Because the advisers to these hedge funds were unregistered, our examination staff had no opportunity to review their

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from discrepancies between the fund’s share price and the values of its underlying holdings.” Allison Bisbey Colter, *Investors Take Their Money and Run from Tainted Hedge Funds*, THE RECORD (Bergen County, N.J.), Feb. 6, 2004, at B1. Late trading, an illegal and highly unfair practice, allows investors placing orders after the 4 P.M. Eastern Standard Time cut-off to obtain the same day price and not, as is normal, the next day price. See *id.* Late trading allows hedge funds to invest based on news that comes out after the 4 P.M. trading bell. See *id.*

157. SEC Proposed Rule, 69 Fed. Reg. at 45,157.

158. See *id.* at 45,175 n.43.

159. *Id.* at 45,175. “Sticky assets” are “placement of other assets in other funds managed by the mutual fund adviser.” *Id.* The SEC has recently brought an increased number of market timing actions against mutual funds, involving hedge fund improprieties, including: SEC v. Columbia Mgmt. Advisors, Inc., Litigation Release No. 18,590 (Feb. 24, 2004) (“[A]lleging mutual fund adviser entered into arrangements allowing hedge funds to engage in market timing transactions in nine funds, including one aimed at young investors”) and *In re Banc One Inv. Advisers Corp.*, Investment Advisers Act Release No. 2254 (June 29, 2004) (“Commission found that investment adviser permitted hedge fund manager to time the adviser’s mutual funds, contrary to the funds’ prospectuses; helped arrange financing for the timing trades; failed to disclose the timing arrangements; and provided the hedge fund manager with nonpublic portfolio information.”). SEC Proposed Rule, 69 Fed. Reg. at 45,175 n.43.

160. *Id.*; Complaint, *New York v. Canary Capital Partners, LLC*, (Sept. 3, 2003), [http://www.oag.state.ny.us/press/2003/sep/canary\\_complaint.pdf](http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf) (unfiled version of complaint).

trading activities in the mutual funds.”<sup>161</sup> Consequently, the Canary hedge funds made a profit of eighty-five million dollars off of market timing.<sup>162</sup> The mutual fund managers took large management fees from the sticky assets left in their funds, and intermediaries such as the Security Trust Co. received millions directly from Canary.<sup>163</sup> Additionally, parent companies of mutual fund managers and other lenders earned high-yield interest on money borrowed by Canary to finance its late trading and market timing activities.<sup>164</sup> While all this money was being made, “long-term investors in the mutual funds targeted by Canary lost tens of millions of dollars.”<sup>165</sup>

#### 4. Hedge funds affecting world markets— Merriweather and Long Term Capital Management

The failure of obscenely overleveraged large funds can cause significant waves in international financial markets. Traditionally, funds obtained leverage “by purchasing securities with borrowed money, [but] today futures, options and other derivative contracts [are a] major source of leverage.”<sup>166</sup> Funds use leverage to increase profits, but when a fund does not make enough money to cover its borrowing costs, the use of leverage endangers the fund’s viability.<sup>167</sup> Enacted in response to investment trusts’ reckless use of leverage in the 1920s,<sup>168</sup> the IAA limits and imposes restrictions on the use of leverage by a regulated hedge fund or corporation qualifying as an investment company.<sup>169</sup>

An example of a hedge fund misusing leverage occurred in the late 1990s when Long Term Capital Management, L.P., (“LTCM”),

161. SEC Proposed Rule, 69 Fed. Reg. at 45,176 n.44. SEC commissioners Glassman and Atkins argue that a hedge fund adviser disclosure would not have made a difference as the SEC failed to discover market timing and late trading by mutual funds that are regulated and registered. *See id.* at 45,198 (Glassman, Atkins, Comm’rs, dissenting).

162. *See id.* at 45,176.

163. *See id.*

164. *See id.*

165. *Id.*

166. SEC STAFF REPORT, *supra* note 35, at 37.

167. *See* Gibson, *supra* note 57, at 687–88 (explaining that when borrowing costs exceed profits, hedge funds may have to sell assets to satisfy the demands of their creditors).

168. *See supra* at Part II.B.3.

169. SEC STAFF REPORT, *supra* note 35, at 38–39, & 39 nn.131–35.

the company that operated Long Term Capital Portfolio, almost defaulted.<sup>170</sup> LTCM's trading strategy caused the fund to lose substantial sums, primarily due to economic problems in Russia.<sup>171</sup> In reality, LTCM's loss resulted from using borrowed money to purchase about \$120 billion of its estimated \$125 billion in assets, causing the fund to be leveraged twenty-five times over.<sup>172</sup> When a highly leveraged fund like LTCM fails, it often depletes its entire existing capital.<sup>173</sup> This causes creditors to liquidate their collateral assets so that they can protect themselves from the hedge fund's failure, and as a result, markets decline.<sup>174</sup> Some of the fund's creditors and lending counterparties feared what were predicted to be "extreme price movements in the credit and interest rate markets" on account of investors liquidating their positions in LTCM.<sup>175</sup> These parties, facilitated by banking regulators, bailed out the fund.<sup>176</sup>

The immediate response to LTCM did not result in regulation of the hedge fund industry or supervision of leverage practices.<sup>177</sup> The financial securities industry, however, tightened its credit risk management practices, and financial regulators "implemented guidelines for regulated entities when extending credit through either lending or counterparty relationships."<sup>178</sup>

In addition to dangerous uses of leverage, regulators fear that hedge funds are using manipulative schemes such as selling a security short and issuing critical reports about the security issuer to

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170. See Gatsik, *supra* note 115, at 591–93 (describing the LTCM story); Gibson, *supra* note 57 at 681–82; see generally LOWENSTEIN, *supra* note 153 (giving a fuller account of LTCM manager John Meriweather and the fund's activities).

171. See Gibson, *supra* note 57, at 681–82.

172. Diana B. Henriques & Joseph Kahn, *Back from the Brink; Lessons of a Long, Hot Summer*, N.Y. TIMES, Dec. 6, 1998, at C1.

173. See Gibson, *supra* note 57, at 705–06.

174. See *id.*

175. *Id.* at 682 n.8.

176. See *id.*

177. See *id.* at 708 & n.181 (citing *Hearing Before the H. Comm. on Banking and Fin. Servs.*, 106th Cong. (1999) (testimony of Anne Nazareth, Director of Division of Market Regulation, U.S. Securities and Exchange Commission, Concerning the Report of the President's Working Group on Financial Markets on Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management), available at 1999 WL 16947258).

178. *Id.*

drive prices down.<sup>179</sup> Although difficult to detect, an example of hedge fund speculation may have been the increases in the price of oil during September and October of 2004.<sup>180</sup> Hedge fund speculation schemes can thus affect all areas of the national and global economies.<sup>181</sup>

Hedge fund fraud, misuse of leverage, and speculation pose significant risks to investors and world markets. Accordingly, these problems compel the SEC to act. The SEC needs information about the industry and has sensibly required, as approved by the SEC board in October 2004,<sup>182</sup> that hedge fund advisers register with the agency. Registration would allow the SEC to: (i) begin to understand the hedge fund industry, (ii) attempt to curb some of the illegal activity of individual funds and their advisers, and (iii) prevent market disruptions by monitoring overleveraged funds.

#### IV. ADDRESSING THE PROBLEMS

Consistent with the history of securities regulation, the appropriate solution to problems with the hedge fund industry is to require registration of hedge fund advisers under the IAA. In October 2004, the SEC moved in this direction by amending the section 80b-3(b)(3) exemption to include a look-through definition of the term "client" targeted at hedge fund advisers. Registration will help the SEC discover fraud and prevent potential financial disasters. Registration will also be a deterrent to advisers committing future frauds and may render further regulation of the industry unnecessary. Despite the utility of registration, many critics including top law firms and hedge fund groups oppose the SEC's move. Their concerns merit consideration, but are ultimately insignificant compared to the utility of registration.

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179. See SEC STAFF REPORT, *supra* note 35, at 42 & n.146 (citing Randall Smith, *Regulators Review Complaints About Hedge Funds*, WALL ST. J., Jan. 22, 2003).

180. See, e.g., Jonathan Fuerbringer, *Guess Who's Pushing Up Oil Prices*, N.Y. TIMES, Oct. 10, 2004, at C8; *Oil's Crude Awakening*, FORTUNE, Sept. 6, 2004, at 31.

181. See Fuerbringer, *supra* note 180; *Oil's Crude Awakening*, *supra* note 180.

182. See SEC Press Release, *supra* note 6.

*A. Recommendation for Addressing  
Concerns About the Hedge Fund Industry*

Imposing the complete regulatory framework of the SA, the SEA, the ICA, and the IAA on hedge funds would be consistent with the original purpose of the acts. Such an approach, however, is not necessary, nor politically feasible, at this time. Rather, simply imposing the registration requirements of the IAA on hedge fund advisers is a more sensible solution to problems in the hedge fund industry.

The definition of a “client” of an investment adviser contained in 17 C.F.R. 275.203(b)(3)-1 should be amended to bring hedge fund advisers within the boundaries of these regulations. Currently, 17 C.F.R. 275.203(b)(3)-1 treats almost all legal entities, including companies and hedge funds, as single clients. For hedge fund advisers, section 275.203(b)(3)-1 should be amended to “look through” all legal entities, such that the owners and investors in companies, and hedge funds investing in another hedge fund count as clients. Such an amendment would force many of the most potentially problematic hedge funds (those funded by corporate and institutional money) to register. The rule, however, should leave the following groups unregistered as they are distinct from hedge funds: (i) family partnerships and trusts, and (ii) entities subject to regulation under the ICA but falling within the exception in section 3(c)(1) or 3(c)(7) that do not permit investors to redeem their interests in the fund within two years of purchase.<sup>183</sup>

*B. Why Changing the Definition of “Client” for  
15 U.S.C. § 80b-3(b)(3)s and Regulation of Hedge Funds is  
Consistent with the History and Goals of Securities Regulation*

The problematic practices that have driven the move toward hedge fund registration and regulation are fraud, misuse of leverage, and speculation.<sup>184</sup> The SEC has taken the correct approach to these problems by imposing part of the securities regulation framework—

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183. See SEC Proposed Rule, 69 Fed. Reg. at 45,184–85. The goal of these exceptions is to: (i) maintain the IAA’s exemption for small funds made up of family and friends, and (ii) not encompass private equity funds and venture capital funds. *Id.*

184. See *supra* Part III.D.

the IAA—on the hedge fund industry.<sup>185</sup> Registration is necessary to gauge the prevalence of problematic practices that hedge funds currently engage in.

The legislative history behind the adoption of the securities acts supports the registration of hedge fund advisers. The main problems that securities markets faced coming out of the 1920s boom were fraud, the use of leverage, and uncontrolled speculation.<sup>186</sup> These problems posed by investment trusts and their kin in the Depression Era exist today in exactly the same manner in the hedge fund industry.

During the Depression Era, the government responded to the problems of the investment trusts by passing securities regulations in order to restore public confidence and make capitalism live up to its promise.<sup>187</sup> The overarching theme of this system of regulations was disclosure.<sup>188</sup> The proper response to the current growing concern over hedge fund practices should be to incorporate this New Deal framework. Requiring hedge fund advisers to register with the SEC reflects the methods used to reign in the same problems posed by investment trusts in the 1920s.

Furthermore, the goals of the IAA in particular are consistent with the SEC's current aims of protecting investors and learning more about hedge fund advisers.<sup>189</sup> The Act not only protects advisers' clients but also serves as "a continuing census of the Nation's investment advisers."<sup>190</sup> In 1940 Congress noted "that it was difficult to ascertain the number of investment advisers in operation or the amount of funds under their influence and control."<sup>191</sup> Registering hedge fund advisers provides the SEC with such data and may be sufficient to protect investors, while staving off the need for further regulation.

Congress created the specific exemption, section 80b-3(b)(3), for advisers who have a few clients consisting of family and

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185. See SEC Proposed Rule, 69 Fed. Reg. at 45,178-87.

186. See *supra* Part II.A.

187. See *supra* Part II.B.

188. See *id.*

189. SEC STAFF REPORT, *supra* note 35, at 20-21.

190. SEC Proposed Rule, 69 Fed. Reg. at 45,178 n.68 (citing H.R. REP. NO. 86-1760, at 2 (1960)).

191. *Id.*

friends.<sup>192</sup> Although used by hedge funds, Congress did not intend it to be used by these fund managers, who by using the no look-through policy, maintain in effect hundreds of clients and manage hundreds of millions of dollars. Changing the definition of “client” to look-through legal entities ensures that section 80b-3(b)(3) will be used in a manner more closely related to its purpose.

*C. Utility of Registration Under the Investment Advisers Act of 1940*

Registration under the IAA would give the SEC information about, among other things: (i) the number of hedge funds the adviser manages, (ii) the amount of assets in the funds, (iii) employees of the funds, (iv) clients of the funds, (v) other business activities that the adviser conducts, and (vi) the identity of those in control of the fund. By requiring disclosure of this information, the SEC expects to catch more instances of fraud and gain enough information to prevent a future Long Term Capital Management from once again taking markets to the brink.

Registration also gives the SEC authority to conduct examinations that serve the dual purpose of catching fraud in its early stages and deterring future fraud.<sup>193</sup> The SEC could even bar criminals and those with long disciplinary records from managing funds.<sup>194</sup> Hedge fund advisers would also have to protect against the adverse consequences of any conflicts of interest with their clients or with the funds themselves.<sup>195</sup> Registration would compel compliance with minimum requirements for investors under rule

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192. *See id.* at 45,173 n.17, 45,182; Letter from Deborah Tuchman, Counsel, Skadden, Arps, Slate, Meagher & Flom, to the SEC (Sept. 14, 2004) (on file with SEC). The drafters left exceptions to securities laws, in part, under the traditional view that sophisticated investors do not need protection. *See* Comment from ABA Section of Business Law to the SEC 23–24 (Sept. 28, 2004) (responding to the SEC Proposed Rule dissent) (on file with SEC). The basis for this proposition needs to be re-examined and reconsidered, not merely accepted. *See supra* note 154, (showing that this premise is not a sound basis for exceptions and exemptions from the securities acts). *But see* Hale & Dorr Letter, *supra* note 8 (taking the position that the traditional approach to securities law is still warranted, but, if not, that Congress, not the SEC, should consider whether sophisticated investors need protection).

193. SEC Proposed Rule, 69 Fed. Reg. at 45,173 n.17, 45,182.

194. *See id.* at 45,179–80.

195. *See id.* at 45,180.

205-3 of the act and limit any retailization<sup>196</sup> that may be occurring in the hedge fund industry.<sup>197</sup> In summary, registration will help the SEC discover fraud, prevent potential financial disasters, and deter advisers from committing future frauds.<sup>198</sup>

*D. The Arguments Against Registration  
Under the Investment Advisers Act of 1940*

Critics of registration assert the following: (i) registration would move the hedge fund industry offshore;<sup>199</sup> (ii) the SEC does not have the legal authority to redefine the term “client” under section 80b-3(b)(3);<sup>200</sup> (iii) appropriate regulatory framework already exists;<sup>201</sup> (iv) the SEC has no evidence of retailization;<sup>202</sup> (v) the proposal impedes the growth of the industry;<sup>203</sup> and (vi) the SEC lacks sufficient resources to deal with the increased registration.<sup>204</sup> These objections are valid, yet unpersuasive.

If requiring registration caused a race to move offshore, then the SEC rule certainly would defeat its own purpose. Such a race is unlikely to occur. The choice to move offshore is already available to hedge fund advisers, yet up to one half of the top one hundred hedge funds have chosen to stay in the United States and are currently registered under the IAA.<sup>205</sup> None of the registered hedge fund advisers have stated that registration made them less

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196. Retailization is the expansion of hedge fund investment. *See id.* at 45,176.

197. *See id.*

198. *See id.* at 45,187–89.

199. Federal Reserve Board Chairman, Alan Greenspan, expressed concerns that regulation of the hedge fund industry would drive it overseas, where federal oversight would diminish even more. *Hedge Fund Operations: Hearing Before the H. Comm. on Banking & Fin. Servs.*, 105th Cong. 26 (1998). Off-shore hedge funds present issues unto themselves which are beyond the scope of this Note.

200. *See* Managed Funds Comment, *supra* note 7 (summarizing the arguments against registration); Hale & Dorr Letter, *supra* note 8, at 1–8.

201. *See* Managed Funds Comment, *supra* note 7.

202. *See id.* This Note does not address the issue of retailization. The SEC discusses concerns about retailization of hedge funds in its Proposed Rule. *See* SEC Proposed Rule, 69 Fed. Reg. at 45,176–77, 45,180–81.

203. *See* Managed Funds Comment, *supra* note 7.

204. *See id.*

205. *See* Henny Sender & Deborah Solomon, *SEC Plans to Propose New Hedge-Fund Rules*, WALL ST. J., July 14, 2004, at C4.

competitive.<sup>206</sup> Rather, this might indicate a preference among investors for American hedge funds and American hedge fund advisers about whom more reliable information is available.

The SEC proposed rule addressed offshore hedge funds, requiring such fund advisers to look though all funds they manage and count investors that are United States residents as clients.<sup>207</sup> Thus, if a fund advised more than fourteen United States clients, under the proposed rule's look-through provision, it would have to register despite a move offshore. Unless hedge funds are willing to forego United States residents' capital, there will not be strong incentive to move offshore.

Critics of registration also argue that Congress, not the SEC, has legal authority to define the word "client" for purposes of 15 U.S.C. § 80b-3(b)(3). In support of this argument they assert the following: (i) the plain meaning of the word "client" does not include legal entities;<sup>208</sup> (ii) the commission report and early Supreme Court case understood the adviser-client relationship to be one of personalized advice;<sup>209</sup> (iii) Congress "indisputably" intended to except from registration any adviser whose clients were strictly investment companies;<sup>210</sup> (iv) Congressional amendments show that the SEC has no power to change the definition of the word "client";<sup>211</sup> (v) the SEC's previous dealings with the definition of the word "client" comported with a no look-through interpretation and occurred when the SEC had authority to address the issue;<sup>212</sup> and (vi) Congress has consistently excluded hedge funds from regulation under the ICA.<sup>213</sup>

These arguments do not directly address the overarching claim that the SEC lacks authority to define the term "client," except for (v), which expressly acknowledges that the SEC had the authority in the past to define the term. Section 80b-11(a) of the IAA gives the SEC "authority to classify, by rule, persons and matters within [its] jurisdiction and to prescribe different requirements for different classes of persons, as necessary or appropriate to the exercise of [its]

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206. See SEC Proposed Rule, 69 Fed. Reg. at 45,180.

207. *Id.*; see *id.* at 45,183.

208. Hale & Dorr Letter, *supra* note 8, at 1-8.

209. *Id.* at 5.

210. *Id.* at 6.

211. *Id.* at 6-8.

212. *Id.* at 1-2.

213. *Id.* at 2-3.

authority under the Act.”<sup>214</sup> The historical interpretation of the word “client” as defined in 17 C.F.R. 275.203(b)(3)-1 did not look through corporate entities.<sup>215</sup> The SEC, however, for many years has had constitutional authority in that section to define the term “client.”<sup>216</sup> Further, Congress, probably intended that the exception contained in IAA section 80b-3(b)(3) apply to those who advised a small group of family and friends—not hedge fund advisers (who did not exist until 1949)<sup>217</sup>—making the use of SEC authority appropriate.<sup>218</sup> The SEC’s “client” interpretation is also the opposite of how the Commodity Futures Trading Commission (“CFTC”) interpreted the Commodities Exchange Act (“CEA”). Pursuant to constitutional authority, the CFTC counted each partner in a limited partnership and each stock holder in a corporation as a client until 2003.<sup>219</sup> Thus, the SEC, like the CFTC, can reinterpret the word “client.”

The next concern voiced by the opposition is that a proper regulatory framework already exists.<sup>220</sup> The argument is that hedge funds are already subject to the anti-fraud provisions of the IAA, and hedge funds and their managers are also subject to other Federal regulations.<sup>221</sup> This concern is not a critique of the SEC’s proposed rule, but a claim that there is no hedge fund problem. The SEC and others concede, however, that there are problems with undetected fraud, speculation, and the misuse of leverage in the hedge fund industry that need to be addressed.<sup>222</sup> From Long Term Capital Management to the Canary Group, the record speaks for itself. When the chief regulatory body for securities knows little about unregistered hedge funds at the center of emerging financial scandals,<sup>223</sup> it is obvious that there is no appropriate regulatory

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214. SEC Proposed Rule, 69 Fed. Reg. at 45,194 (citing 15 U.S.C. §§ 80b-3, 80b-4, 80b-6(4), and 80b-11(a) as authority for amending the definition of the word “client”).

215. *See id.*

216. *See id.* at 45,194.

217. *See Hale & Dorr Letter, supra* note 8, at 8.

218. *See supra* notes 128–135 and accompanying text (describing the fifteen-or-fewer investor requirement of the IAA exception).

219. *See* SEC Proposed Rule, 69 Fed. Reg. at 45,182.

220. *See* Managed Funds Comment, *supra* note 7.

221. *See id.*

222. *See* SEC Proposed Rule, 69 Fed. Reg. at 45,172; Comment from ABA Section of Business Law to the SEC 24 (Sept. 28, 2004).

223. *See supra* note 85 and accompanying text.

framework already in place.

The argument that there is no retailization in the hedge fund industry has some merit. Presumably, if hedge funds remain in the hands of only the wealthiest investors, these investors do not need SEC protection. Ordinary investors who entrust their money to a mutual fund or a pension fund, however, have felt negative effects from the hedge fund industry, most notably in the recent market-timing and late trading scandals.<sup>224</sup> Hedge fund speculation, such as George Soros's fund<sup>225</sup> that was at least partly responsible for the devaluation of the British Pound in 1992 and over-leveraged disasters like Long Term Capital Management, also potentially affect ordinary investors. The need for more information on this expansive industry, which has such a pervasive impact on ordinary investors, overshadows the issue of retailization.

Opponents also voice the concern that the rule will impede the growth of the industry and entrepreneurship. Most notably, critics cite the increased costs posed by registration.<sup>226</sup> Hedge fund advisers, however, are not unsophisticated investors with limited financial resources. Critics seek to portray them as helpless in dealing with the filing requirements of the IAA and the costs of such filings. This is a false image—hedge fund advisers necessarily have established wealth or have tapped into the wealthier parts of society, since the government limits advertising hedge funds and minimum investment requirements are often above \$500,000. The transactional cost of registration would stop a struggling entrepreneur with limited access to capital, but likely would not impede a hedge fund adviser. Further, any judgment as to the effects of the rule on the growth of the industry is speculative. Given the fact that one-third of hedge funds are already currently registered, there is no reason to believe the industry will suffer.<sup>227</sup>

Finally, opponents of regulation claim that the SEC lacks sufficient resources to make the rule effective. The SEC, however,

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224. SEC Proposed Rule, 69 Fed. Reg. at 45,175–76.

225. See Patrick McGeehan, *Portfolios, Etc.*, N.Y. TIMES, June 25, 2000, at C10.

226. See Managed Funds Comment, *supra* note 7.

227. The existence of a burgeoning market for registered hedge funds does not support an argument that required registration would curb the growth of the industry. See SEC Proposed Rule, 69 Fed. Reg. at 45,189. Registration also could legitimize the hedge fund industry. See *id.*

has anticipated an increased workload,<sup>228</sup> and registration would allow the SEC to engage in deterrence-targeted, individual examinations that do not expend excessive resources.<sup>229</sup> The goals of registration can be accomplished without closely examining every hedge fund filing.

## V. CONCLUSION

Despite a lack of reliable data, the SEC has identified fraud, misuse of leverage, and speculation as some of the risks that the hedge fund industry poses to investors and global economic markets. Currently, the SEC lacks the ability to deter or detect fraud by unregistered hedge fund advisers. Today's regulatory controls do not require hedge funds to make comprehensive disclosures about their risk management practices, trading positions, or exposures. As the chief regulatory body for securities, the SEC needs access to more information about the hedge fund industry in order to prevent fraud and broad market disruptions.

The SEC's concerns about the hedge fund industry are identical to those that drove regulation of the investment trusts and their kin during the New Deal. During the New Deal, the federal government regulated securities, in part to manage the problems posed by investment trusts. The context and purpose with which securities regulations were originally passed support regulation of the hedge fund industry under the SA, SEA, ICA, and IAA. Such regulation, however, is not necessary nor politically feasible today.

The appropriate solution to problems with the hedge fund industry is to require hedge fund advisers to register under the IAA. The SEC has moved in this direction by approving a proposed rule in October 2004, amending the section 80b-3(b)(3) exemption to include a look-through definition of the term "client," targeted at hedge fund advisers. Registration will give the SEC necessary information to begin to understand the hedge fund industry and to attempt to curb some of the illegal activity of individual funds and their advisers. Registration will also prevent market disruptions by monitoring overleveraged funds. Registration will thus allow the SEC to more effectively discover and handle threats posed by hedge

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228. *See id.* at 45,189-90.

229. *See id.* at 45,188.

funds. Furthermore, registration may render further regulation of the industry unnecessary.

Although the SEC approved the proposed rule requiring registration of hedge fund advisers, future implementation of the rule is far from certain. Many oppose registration, including top law firms and hedge fund groups. Continuing to allow the hedge fund industry to operate in a pre-New Deal state, however, puts investors and world markets at risk, much as they were in the years leading up to and during the Great Depression. Registration will provide the SEC with the much needed sunlight in the form of reliable information necessary to disinfect the hedge fund industry and prevent major financial market disruptions.

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