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Looking Through the Hedges: How the SEC Justified Its Decision to Require Registration of Hedge Fund Advisers

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LOOKING THROUGH THE HEDGES: HOW THE SEC JUSTIFIED ITS DECISION TO REQUIRE REGISTRATION OF HEDGE FUND ADVISERS

I. INTRODUCTION

In 1998, the infamous hedge fund, Long Term Capital Management ("LTCM"), collapsed, threatening to bring down the entire global economy.[1] Although hedge funds had been dramatically growing in popularity since the early 1990s,[2] this was the first major event in an industry that was, and still is, generally seen as an investment vehicle for the very rich and non-risk-averse.[3] In the next five years, the hedge fund industry would be the focus of reports by the President's Working Group on Financial Markets[4] ("President's Working Group") and the Security and Exchange Commission's ("SEC") Division of Investment Management;[5] would be implicated as part of the mutual fund scandal;[6] and later, would be subject to a proposed SEC regulation providing greater industry oversight.[7]

One of the SEC's most controversial proposals in recent history is its decision to amend specific rules of the Investment Advisers Act of 1940[8] ("Investment Advisers Act") to require registration of hedge fund advisers.[9] Under the new rules, a hedge fund will no longer be able to rely automatically on the private adviser exemption in the Investment Advisers Act.[10] Before the SEC took action, this exemption allowed funds that managed fourteen or fewer clients to avoid registration.[11] To restrict this loophole, the SEC's proposal includes more stringent definitions of what constitutes a single client.[12] Although this proposal was approved in October of 2004,[13] the industry, as well as two of the Commissioners of

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1. *See infra* notes 79–83 and accompanying text.
2. *See infra* notes 55–76 and accompanying text.
3. *See infra* notes 41–42 and accompanying text.
4. *See infra* note 44 and text accompanying notes 84–88.
5. *See infra* note 35 and text accompanying notes 97–104.
6. *See infra* note 93 and accompanying text.
7. *See infra* notes 105–26 and accompanying text.
8. 15 U.S.C. § 80b-1 to -21 (2000).
9. *See infra* notes 105–48 and accompanying text.
10. *See infra* notes 33–39 and accompanying text.
11. *See infra* notes 37–39 and accompanying text.
12. *See infra* notes 114–17 and accompanying text.
13. The final rule was released on December 2, 2004. *See* Barreto, *infra* note 105.

the SEC, continues to claim that registration is unnecessary and costly.[14] This Note seeks to analyze the registration requirement by juxtaposing the SEC's rationale for creating and passing the proposal against the opposition's critique of the new rules.[15]

To analyze whether the SEC's regulatory decision was an appropriate course of action, this Note first examines the founding of the SEC, the history of the SEC's investigation of hedge funds, and the operations and growth of hedge funds. Next, this Note presents the SEC's rationale for passing the registration proposal, followed by a discussion of the dissent of Commissioners Glassman and Atkins as well as other critical commentary. Finally, this Note analyzes the SEC's response to the opposition and proposes possible actions that would enable the SEC to handle future unrest in the hedge fund community.

II. HISTORY OF THE SEC

The SEC was created as a response to the stock market crash of 1929 and the ensuing economic depression.[16] Before the crash, approximately 20 million investors tried their luck with the estimated $50 billion worth of new securities that were offered during the 1920s.[17] In stark contrast to the amount of new investors and securities, there was little federal regulation

14. *See infra* notes 127–48 and accompanying text.

15. This Note will not discuss the legality of the decision to amend the Investment Advisers Act. It has been claimed that the registration requirement is outside the scope of the SEC's regulatory authority. Sibohan Hughes, *Hedge Fund Sues to Block Registry of Advisers by the SEC*, WALL ST. J., Dec. 23, 2004, at C3. Soon after the final rule was released in December of 2004, a lawsuit was brought against the SEC stating that the "rule goes beyond the intent of Congress, was never justified and amounts to an 'arbitrary, capricious,' action." *Id*. For the SEC's response to the allegations that it lacks the legal authority to increase regulation of the hedge fund industry, see Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. 72,054, 72,067-72,070 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279).

16. *See The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity*, http://www.sec.gov/about/whatwedo.shtml (last modified Sept. 20, 2004) [hereinafter *The Investor's Advocate*]. "Congress believed not only that investors had been systematically overreached and cheated during the go-go decade of the 1920's, but also that the 1929 stock market collapse had been a principal cause of the Depression . . . ." JOHN C. COFFEE, JR. & JOEL SELIGMAN, SECURITIES REGULATION 2 (9th ed. 2003). Recently, many historians have stated that the market crash may not have been the primary cause of the Depression, but instead other events like the passage of the Hawley-Smoot Tariff Act of 1930. *Id*. n.2. For a comprehensive discussion on the history and operations of the SEC, see JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (3d ed. 2003) [hereinafter THE TRANSFORMATION OF WALL STREET].

17. THE TRANSFORMATION OF WALL STREET, *supra* note 16, at 1. After the crash, half of the $50 billion of newly issued stocks became worthless. *Id.* at 1–2. Even large corporations were affected. "Leading 'blue chip' securities, including General Electric, Sears, Roebuck, and U.S. Steel common stock, would lose over 90 percent of their value between selected dates in 1929 and 1932." *Id.* at 2.

of the industry.[18] The lack of regulation was due to the strong support of laissez-faire economic policies by both American citizens and politicians.[19] In hindsight, it was only a matter of time until the bottom dropped out.[20]

On October 28, 1929, the Dow dropped 12.8 percent, followed by an 11.7 percent drop the next day.[21] Although from December of 1929 through April of 1930 the stock market recovered almost half of what was lost during the crash, starting in June of 1930, the market began its long slide, ultimately leading into the Depression.[22] By 1932, unemployment had increased to one-fourth of the labor force, and industrial productivity had fallen significantly to one-half of the 1929 rate.[23]

In 1932, the Senate responded by voting in favor of a Banking Committee investigation of the stock market.[24] The final result of this

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18. *The Investor's Advocate*, *supra* note 16.

19. THE TRANSFORMATION OF WALL STREET, *supra* note 16, at 2. "During the preceding twelve years, a majority of the country's voters had supported the laissez-faire economic policies suggested by Calvin Coolidge's often-quoted remark[,] 'This is a business country . . . and it wants a business government.'" *Id.*

20. *See The Investor's Advocate*, *supra* note 16. "Tempted by promises of 'rags to riches' transformations and easy credit, most investors gave little thought to the dangers inherent in uncontrolled market operation." *Id.* Even as early as 1925, President Hoover was concerned about the stability of the markets. THE TRANSFORMATION OF WALL STREET, *supra* note 16, at 3. "Twice in February 1929 the Federal Reserve Board cautioned member banks against borrowing money for the purpose of making speculative loans, statements that President-elect Hoover supported." *Id*. at 4 (internal quotation marks omitted).

Although both the Federal Reserve Board and Hoover had expressed their concern, neither party attempted to seriously intervene. *Id*. This apathy is somewhat striking, especially considering that even "[President] Hoover feared an inevitable collapse which [would] bring the greatest calamities upon [the country's] farmers, [the country's] workers, and legitimate business." *Id*. (citation and internal quotation marks omitted).

21. ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 83 (2000). The decline on Monday, October 28, was, until October 19, 1987, the biggest single-day drop in America's history. *Id*. at 82–83. Determining what caused the crash has puzzled many historians and economists. In Robert Shiller's book, *Irrational Exhuberance*, he notes that there was little if any news concerning the financial markets preceding the crash. *Id*. at 82. For example, on the morning of October 29, the Associated Press distributed a story that stated:

> In the absence of any adverse news developments over the week-end, and in the face of the optimistic comments on business forthcoming from President Hoover and leading industrial and banking executives, Wall Street's only explanation of today's decline was that a careful checking up of accounts over the week-end disclosed numerous weak spots, which had been overlooked in the hectic sessions of last week.

Id. at 83.

22. THE TRANSFORMATION OF WALL STREET, *supra* note 16, at 5-6. "Between September 1, 1929 and July 1, 1932, 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." *Id.* at 1.

23. *Id*. at 11.

24. *Id.* at 13. Before the Senate Banking Committee started its investigation, there were numerous bills presented by members of Congress to regulate the financial industry. "Within ten

investigation was the passage of the Securities Act of 1933[25] ("1933 Act"), and later the Securities Exchange Act of 1934[26] ("1934 Act"), which created the SEC.[27] In accordance with the underlying policy rationale behind the creation of the 1934 Act,[28] "[t]he primary mission of the [SEC] is to protect investors and maintain the integrity of the securities markets."[29] To uphold this mission, the SEC requires companies to disclose both financial and other material information to enable investors to make sound investment decisions.[30]

Besides the 1933 and 1934 Acts, two other notable laws govern the securities industry. The first is the Investment Company Act of 1940[31] ("Investment Company Act"), which, among other things, regulates the organization of mutual fund companies.[32] The second is the Investment Advisers Act,[33] which is the focus of the SEC's hedge fund adviser

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weeks of the October stock market crash, six members of Congress introduced bills to regulate corporate financial statements, margin loans, or short sales of securities." *Id.* at 5. Even with Congressional action, the economy continued to decline. *Id*. at 11.

25. 15 U.S.C. § 77a-77aa (2000). The Securities Act of 1933, also known as the Truth in Securities Act, requires that an issuer of a security disclose certain financial information to investors including the name under which the issuer is doing business, the location of the issuer's place of business, and the general character of the business. *The Investor's Advocate*, *supra* note 16.

26. 15 U.S.C. § 78a-78mm (2000). The Securities Exchange Act of 1934 gives the SEC the power to regulate all aspects of the securities industry, from the stock markets themselves, to brokerage firms and transfer agents. *The Investor's Advocate*, *supra* note 16. Congress enumerated its reasons for passing this act within the wording of the act itself:

> [T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets . . . .

Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (2000).

27. *The Investor's Advocate*, *supra* note 16. "[Both the Securities Act of 1933 and the Securities Exchange Act of 1934] were designed to restore investor confidence in our capital markets by providing more structure and government oversight." *Id.*

28. *See supra* note 26.

29. *The Investor's Advocate*, *supra* note 16.

30. *Id.*

31. 15 U.S.C. § 80a-1 to -64 (2000).

32. *The Investor's Advocate*, *supra* note 16. "The [Investment Company] Act [of 1940] requires these companies to disclose their financial condition and investment policies to investors . . . . The focus of this Act is on disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure. . . ." *Id.*

33. 15 U.S.C. § 80b-1 to -21 (2000).

registration proposal.[34] Subject to some exceptions, companies or individuals defined as investment advisers[35] must register with the SEC.[36]

Recently, the SEC has taken issue with a provision in the Investment Advisers Act that exempts "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company" from registering with the SEC.[37] In the past, a hedge fund was counted as a single client for registration, and therefore investment advisers could avoid registration by advising fourteen or fewer funds, even though the hedge funds themselves were comprised of numerous investors.[38] This is known as the private adviser exemption, and its widespread use is one of the main reasons the SEC decided to consider more stringent regulation.[39]

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34. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172 (proposed July 28, 2004).

35. According to the Investment Advisers Act of 1940, the term "investment adviser" means:

> [A]ny 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 . . . .

Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2000). The vast majority of all hedge funds qualify as investment advisers under this Act. SEC. & EXCH. COMM'N, DIV. OF INV. MGMT., IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 20 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS].

36. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,172-45,173. About 40% of all hedge funds are currently registered with the SEC under the Act. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,181 n.98.

37. Investment Advisers Act of 1940 § 203(b)(3), 15 U.S.C. § 80b-3(b)(3) (2000). Other exceptions include advisers whose only clients are insurance companies, advisers whose clients are all residents in the state where the adviser does business, and advisers that are charitable organizations. Investment Advisers Act of 1940 § 203(b)(1), (2), (4), 15 U.S.C. § 80b-3(b)(1), (2), (4).

38. George Mazin, *Unravelling SEC Registration* (2005), http://www.dechert.com/library/006_007_008%20EC.pdf. By pooling client assets into partnerships or business trusts, advisers can avoid SEC oversight even though they realistically have more than fifteen clients. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,173.

39. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,173. The SEC's proposal recognizes that a "growing number of investment advisers take advantage of the private adviser exemption to operate large investment advisory firms without Commission oversight." *Id*. While there is no legislative history that explains the enactment and rationale for the passage of the private adviser exemption, it can be assumed that Congress did not intend this provision to be abused by wealthy, sophisticated investors. *Id.*

III. WHAT IS A HEDGE FUND?

Hedge funds may be the most misunderstood investment vehicle:[40] at one extreme, hedge funds are considered highly risky investments available only to the very rich,[41] while at the other extreme, some investment advisers claim that hedge funds perfectly complement a traditional investment portfolio.[42] While there is no precise, universally-accepted definition of what constitutes a hedge fund, the majority of hedge funds share a number of common characteristics.[43] For example, the President's Working Group defined a hedge fund as "any pooled investment vehicle that is privately organized, administered by professionals and not widely available to the public."[44] Robert Jaeger, the vice-chairman and chief investment officer of Evaluation Associates Capital Markets, Inc., used the following definition in his book, *All About Hedge Funds*:[45]

> A hedge fund is an actively managed investment fund that seeks attractive absolute return. In pursuit of their absolute return objective, hedge funds use a wide variety of investment strategies and tools. Hedge funds are designed for a small number of large investors, and the manager of the fund receives a percentage of the profits earned by the fund.[46]

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40. The Managed Funds Association believes that there are many reasons why hedge funds are misunderstood, including:

> The absence of a legal or widely accepted definition of a hedge fund; [t]he broad universe of investment strategies encompassed by the use of [the] term "hedge fund"; [l]egal restrictions on hedge funds' ability to engage in publicity or public solicitation; [and] [t]he focus of popular press coverage on rare instances of hedge fund failure or allegations of fraud. . . .

Comments of the Managed Funds Association for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds (2003), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-mfa.htm [hereinafter Comments of Managed Funds Association].

41. Hedge funds are usually stereotyped in the media as "secretive, unregulated investment vehicles that enable wealthy individuals to make highly leveraged speculative bets in the global financial and commodity markets." ROBERT A. JAEGER, ALL ABOUT HEDGE FUNDS vii (2003).

42. FRANÇOIS-SERGE LHABITANT, HEDGE FUNDS: MYTHS AND LIMITS 1-2 (2002).

43. *Id.* at 13; *see, e.g.*, Implications of the Growth of Hedge Funds, *supra* note 35, at 3.

44. PRESIDENT'S WORKING GROUP ON HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (Apr. 28, 1999), *available at* http://www.treas.gov/press/releases/reports/hedgfund.pdf [hereinafter PRESIDENT'S WORKING GROUP].

45. JAEGER, *supra* note 41.

46. JAEGER, *supra* note 41, at x. There are many other definitions regarding what constitutes a hedge fund. George Soros used the following definition:

> Hedge funds engage in a variety of investment activities. They cater to sophisticated investors and are not subject to the regulations that apply to mutual funds geared toward the general public. Fund managers are compensated on the basis of performance rather than as a fixed

To better understand hedge funds, it is helpful to compare them with mutual funds.[47] Whereas mutual funds typically peg returns to a market benchmark, hedge funds seek absolute returns.[48] This means that a hedge fund manager always wants to deliver a positive rate of return.[49] Moreover, hedge fund managers have more freedom with investment strategies than mutual fund managers.[50] Mutual funds have to abide by SEC rules that proscribe limitations on leverage and short selling, while hedge funds, which are not subject to such regulatory constraints, have more flexibility.[51] Also, different types of investors are attracted to hedge funds, as opposed to mutual funds. Mutual funds tend to market broadly to attract retail investors, while hedge funds target high net-worth private individuals and institutional investors.[52] Finally, hedge funds are usually

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percentage of assets. 'Performance funds' would be a more accurate description.

David A. Vaughn, *Selected Definitions of "Hedge Fund"* (2003), http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm (quoting GEORGE SOROS, OPEN SOCIETY: REFORMING GLOBAL CAPITALISM 32 n.† (2000)).

At a meeting with the Senate Committee on Banking, Housing and Urban Affairs, SEC Chairman Donaldson said,

> The term 'hedge fund' is undefined, including in the federal securities laws. Indeed, there is no commonly accepted universal meaning. As hedge funds have gained stature and prominence, though, 'hedge fund' has developed into a catch-all classification for many unregistered privately managed pools of capital. These pools of capital may or may not utilize the sophisticated hedging and arbitrage strategies that traditional hedge funds employ, and many appear to engage in relatively simple equity strategies. Basically, many 'hedge funds' are not actually hedged, and the term has become a misnomer in many cases.

Testimony Concerning Investor Protection Implications of Hedge Funds Before the Senate Committee on Banking, Housing and Urban Affairs (statement of William H. Donaldson, SEC Chairman) (2003), *available at* http://www.sec.gov/news/testimony/041003tswhd.htm [hereinafter Statement of Donaldson].

47. *See* JAEGER, *supra* note 41, at xii. Jaeger notes that "you cannot understand hedge funds by looking only at hedge funds. Hedge funds are an essential part of a larger financial environment. To understand hedge funds, you have to understand how they fit into that environment." *Id.*

48. *Id*. at 3. "The fact that hedge fund strategies differ from those of mutual funds and other investment vehicles in this way allows hedge funds to provide investors with a valuable means of portfolio diversification. . . ." Comments of Managed Funds Association, *supra* note 40.

49. JAEGER, *supra* note 41, at 4. Basically, a hedge fund manager is seeking returns that are not based upon some sort of index. A manager wants a fund that will perform both when the market is down and up. *Id.* Because of this desire, "the objective of the hedge fund manager is to deliver returns that have a low correlation with the standard stock and bond markets." *Id*.

50. *Id*.

51. *Id.* at 4–5. The hedge fund manager "can combine both long and short positions, concentrate investments rather than diversify, . . . borrow and leverage [his or her] portfolio, invest in illiquid assets, trade derivatives and hold unlisted securities." LHABITANT, *supra* note 42, at 15. Robert Jaeger notes that although it may seem that hedge funds are more risky because they are not regulated as strictly as mutual funds, the high risk of investing in hedge funds may be independent of the amount of SEC regulation. JAEGER, *supra* note 41, at 5. "It is possible [for a mutual fund manager] to build a very risk-averse portfolio that conforms to all applicable SEC regulations, and it is possible to build a very risk-averse portfolio using the freedom afforded in the world of hedge funds." *Id*.

52. LHABITANT, *supra* note 42, at 19. Hedge funds are required by law to limit their funds to

managed by a small number of people who each have a stake in the investment,[53] whereas mutual fund managers may not have to personally invest in the fund.[54]

IV. GROWTH IN HEDGE FUNDS

In 1949, Alfred Winslow Jones created what is commonly believed to be the first hedge fund.[55] Although Jones' fund was created over fifty years ago, investments in hedge funds have grown most dramatically in the past decade.[56] It is estimated that there are at least five times as many hedge funds operating today as there were ten years ago, and that the assets managed by these funds have increased fifteen-fold.[57] Although exact numbers are unknown, approximately 7,000 hedge funds operate today, managing upwards of $870 billion.[58] Considering this rate of

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specific types of investors to avoid registering under the Investment Company Act. Comments of Managed Funds Association, *supra* note 40. "The specific investor qualifications with which a hedge fund must comply depend upon the exclusion from the Investment Company Act . . . that is applicable to the hedge fund." *Id*.

One exclusion states that a fund will not have to register with the SEC as an investment adviser if the fund is "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." Investment Company Act of 1940 § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (2000). To qualify for this exemption, hedge fund managers seek out "accredited investors." Comments of Managed Funds Association, *supra* note 40. The following are considered accredited investors: "Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;" and "any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years . . . ." 17 C.F.R. § 230.510(a)(5)-(6) (2005).

Although this exception to registration exists, one of the SEC's main reasons for originally considering the regulation of hedge funds was the concern that the types of investors in hedge funds were changing, with smaller investors getting more exposure to the industry whether directly through their own investment or indirectly through pension funds. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, at 80–82. *See infra* notes 61–73, 110 and accompanying text.

53. JAEGER, *supra* note 41, at 1. Often, the general partner is the largest contributor to the fund. *Id.* at 8. Jaeger mentions that one of the reasons that people invest in hedge funds might be because they are investing "alongside a star." *Id.* at 7. "The fundamental premise of hedge fund investing resembles a caveat from another industry: You should eat only in those restaurants where the chef eats his own cooking." *Id.*

54. *Id*.

55. LHABITANT, *supra* note 42, at 7. "Convinced that he was capable of implementing a better investment model than anything available, [Jones] raised $100,000 . . . and started an equity fund. It was originally structured as a general partnership to avoid the restrictive [SEC] regulation[s] and allow for maximum latitude and flexibility in portfolio construction." *Id*.

56. *Id.* at 12. According to one source, hedge funds have doubled in size and number since 2000. *The New Money Men–Hedge Funds*, THE ECONOMIST, Feb. 19, 2005, at 63, *available at* 2005 WLNR 2281511.

57. Mazin, *supra* note 38.

58. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279). "Hedge fund assets are growing

growth,[59] experts estimate that the industry will reach $1 trillion in assets in the near future.[60]

One explanation for the dramatic growth is the increase in the amount of money that pension funds are investing in hedge funds.[61] In the past year, the amount invested in hedge funds by nonunion pension funds has grown by nine percent, and the amount invested by state and municipal pension funds has grown by seven percent.[62] For example, the California Public Employees' Retirement System has invested around $900 million in hedge funds.[63] Other states are following California's lead, such as Pennsylvania, which has twenty percent of its state employees' retirement system invested in hedge funds; and Missouri, which has about twelve percent invested.[64]

Another reason for the growth could be explained by the existence of "funds of hedge funds" ("FOHF").[65] "A FOHF is a hedge fund that . . . [invests] all, or a significant portion, of its assets in hedge funds."[66] FOHFs are growing in popularity; it is estimated that in just the first three quarters of 2002 the number of FOHFs grew by thirty-two percent.[67] One explanation for the growth of FHOFs is that they allow for greater diversification.[68] Accordingly, risk-averse investors might feel more comfortable investing in an FOHF, which holds positions in many funds,[69] unlike a single hedge fund.[70] Additionally, FOHFs can reach substantially more investors than a hedge fund[71] because some FOHFs can offer their

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faster than mutual fund assets and [are] already equal [to] just over one fifth of the assets of mutual funds that invest in equity securities." Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,056. To illuminate the amount of growth in the industry, in 1990, hedge funds only managed $50 billion in assets. Statement of Donaldson, *supra* note 46.

59. It is estimated that hedge funds assets are growing at a rate of fifteen to twenty percent a year globally. Daniel Kadlec, *Will Hedge Funds Take a Dive?*, TIME, Oct. 4, 2004, at 65.

60. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,055–72,056; Aaron Lucchetti, *Little Guy Finds 'New' Investment*, WALL ST. J., Sept. 15, 2004, at C1.

61. Kadlec, *supra* note 59.

62. Lucchetti, *supra* note 60. The percentage invested by nonunion corporate pension funds has grown from six percent to fifteen percent, and the percentage invested in hedge funds by state and municipal pension funds has grown from three percent to ten percent. *Id.*

63. *Id.*

64. *Id.*

65. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, at vii.

66. *Id.* at 67.

67. *Id.* at 68. "The number of FOHFs grew from an estimated 510 to 675." *Id.* Also, the assets managed by FOHFs grew by eighty-four percent. *Id.*

68. *Id*. at 67.

69. The typical FOHF invests in fifteen to twenty-five hedge funds. *Id*.

70. JAEGER, *supra* note 41, at 37.

71. "Since the level of fund-specific risk can be very high if the investor uses only one hedge

securities to the public,[72] and currently, all FOHFs operate with a minimum investment requirement of only $25,000.[73]

In short, with the sheer amount of money invested in hedge funds[74] and with the increasing number of investors who are exposed directly or indirectly to the risk of hedge funds,[75] one can understand why the SEC decided to examine the possibility of regulating the industry.[76]

V. HISTORY OF HEDGE FUND INVESTIGATION

The history of SEC involvement with hedge funds began as early as 1969, when the SEC investigated the prevalent use of short selling and leverage in the industry.[77] However, it was not until thirty years later that the SEC considered changing the registration standards in the Investment Advisers Act to increase oversight of hedge funds.[78] In 1999, the SEC again found itself investigating hedge funds, this time in connection with the collapse of LTCM.[79] LTCM was a well-known hedge fund that,

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fund, informed investors prefer to invest in a diversified portfolio of hedge funds, often encompassing multiple hedge fund strategies." *Id*.

72. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, at 68. "In the summer of 2002, the first [FOHF] became eligible to sell its securities to the public." Statement of Donaldson, *supra* note 46. As of April, 2003, there were seventeen FOHFs allowed to offer their securities publicly. *Id*.

73. Statement of Donaldson, *supra* note 46. FOHFs chose this minimum investment requirement themselves, as there is no federal law limiting investment size. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, at 69. Therefore, this minimum requirement may be lowered or eliminated at any time if the FOHF so chooses. *Id*.

74. *See supra* notes 56–60 and accompanying text.

75. *See supra* notes 61–73 and accompanying text.

76. The SEC lists these, among others, as two reasons for considering increased regulation of hedge funds, and specifically, the changes to the registration requirement. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,175–45,177 (proposed July 28, 2004).

77. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,174. This report stated that there were approximately 200 hedge funds, which managed a total of $1.5 billion. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, app. A at 1. A few years later, in 1971, an economic study of institutional investors was conducted where the SEC "described the activities of hedge funds, noted the serious conflicts of interest that hedge fund advisers have, and noted their growth." Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,174. Also, in 1992, in connection with the Commission's study of the Investment Company Act, the Division of Investment Management decided to investigate hedge funds. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, app. A at 2. In connection with this study, the Division recommended that the SEC alter the Investment Company Act in relation to the private investment company exception. *Id.*

78. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, app. A at 3.

79. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,174. The collapse of Long Term Capital Management (hereinafter "LTCM") was one of the single most important events in the history of hedge funds. LHABITANT, *supra* note 42, at 12. "This hedge fund was founded by Robert Merton and Myron Scholes (both received the Nobel prize for economics

because of its highly leveraged international investment strategy,[80] suffered greatly when Russia defaulted on its debt and devalued its currency in August of 1998.[81] Because LTCM's portfolio was so interconnected to the global economy, "liquidating the fund would have blown up the world's financial markets."[82] Due to this concern, the Federal Reserve orchestrated a bailout by a private consortium of securities firms and banks that had extended credit to LTCM.[83]

After LTCM's collapse, the President's Working Group issued a report analyzing hedge funds.[84] "The report focused on the risk management and transparency issues raised by LTCM as well as 'highly leveraged institutions' in general."[85] Along with examining the investment strategies of hedge funds, the report made recommendations about possible changes

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in 1997), John Meriwether, a former legendary trader at Salomon Brothers, and David Mullen, a former vice-chairman of the Federal Reserve." *Id.*

80. LTCM's investment strategy included using large amounts of money that it had borrowed to invest when the fund found small price discrepancies in the market. LHABITANT, *supra* note 42, at 74. In August 1998, LTCM's leverage ratio was in excess of twenty-five to one. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, app. A at 3 n.8.

81. JAEGER, *supra* note 41, at viii. "The fund was basically playing on convergence between various pairs of government bonds and other credit instruments." LHABITANT, *supra* note 42, at 74. Investors soon fled to safer investments. JAEGER, *supra* note 41. In 1999 the President's Working Group estimated that a dollar invested in LTCM in March of 1994 was worth only ten cents after the Russian crisis. LHABITANT, *supra* note 42, at 74.

82. LHABITANT, *supra* note 42, at 74. "Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own." *Systemic Risks to the Global Economy and Banking System from Hedge Fund Operations: Hearing Before the House Banking and Fin. Services Comm.*, 105th Cong. (1998) (statement of Alan Greenspan, Chairman, Federal Reserve), *available at* 1998 WL 694498 [hereinafter *House Hearing on Hedge Funds*].

83. *Id*. "[Fourteen] banks and securities firms agreed to participate in the recapitalization . . . ." *Id*. (statement of William McDonough, President, New York Federal Reserve Bank). The members of the consortium slowly took their money out of the fund, and soon thereafter, the fund stopped operating. JAEGER, *supra* note 41. Although LTCM has closed shop, most founders have since moved on to create or advise other hedge funds. LHABITANT, *supra* note 42, at 74-75.

> John Meriwether has been managing a new relative value hedge fund called JWM Partners. . . . [I]t manages $850 million and pursues bond arbitrage strategies similar to those used by LTCM, but with leverage limited to 20 : 1. Most of Meriwether's partners in LTCM joined JWM Partners, with a few notable exceptions. Robert C. Merton returned to Harvard. Myron Scholes started advising Oak Hill Platinum Partners, a hedge fund affiliated to Texas billionaire Robert Bass and whose founding principal is Chi Fu Huang, a renowned derivatives modeler and fellow alumnus of LTCM. And James McEntee and Gregory Hawkins joined Caxton Corporation to set up a relative value bond hedge fund.

Id.

84. *See* PRESIDENT'S WORKING GROUP, *supra* note 44.

85. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, app. A at 3. *See also* PRESIDENT'S WORKING GROUP, *supra* note 44.

to the existing federal securities laws.[86] Notably, the President's Working Group recommended that the exemptions in the Investment Company Act and the Investment Advisers Act should not be altered.[87] In particular, the report noted that requiring registration of hedge funds would not be an effective method for monitoring the operations of hedge funds.[88]

Although since 1998 there has not been an event in the hedge fund industry as extreme as LTCM, the SEC continues to monitor hedge fund operations by looking for fraudulent activities as well as by examining possible regulatory changes.[89] Due to the lack of information about hedge funds, the SEC, in the past, has only been able to investigate and take action against hedge funds after the misconduct has taken place.[90] Although the SEC has not been able to act proactively to deter fraud, in the past five years the Commission has brought fifty-one cases alleging fraud by hedge fund advisers.[91] It is estimated that the investors in these cases were defrauded by over $1.1 billion.[92] Also, the SEC estimates that approximately 400 hedge funds were involved in the recent mutual fund scandal.[93]

Recently, the SEC, concerned about the growth of the industry,[94] the types of investors who were being exposed to risk,[95] and the amount of fraud,[96] resumed its investigation of hedge funds.[97] This time the staff

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86. PRESIDENT'S WORKING GROUP, *supra* note 44, app. B-13 to -16.

87. *Id*.

88. *Id*. at B-16.

89. *See infra* notes 94–104 and accompanying text.

90. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, at 14.

91. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279). The number of fraud cases brought by the SEC has increased since the publication of the proposal from forty-six to fifty-one. *Id.* at n.28. Although the proposal calls this number proof of "a substantial and troubling growth . . . of hedge fund fraud enforcement cases," Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,175 (proposed July 28, 2004), Chairman Donaldson noted that fraud in the hedge fund industry is not significantly greater than in other investments. Statement of Donaldson, *supra* note 46. He stated that the problem is that the number of fraud enforcement cases is increasing significantly, with the number in the past two years being almost double than those a few years ago. *Id*. According to the SEC, these frauds included hedge fund advisers who:

> for years grossly overstated the performance of their hedge funds to investors who were actually incurring tens or hundreds of millions of dollars in losses on their investments in the funds; [c]aused hedge funds to pay unnecessary and undisclosed commissions; and used parallel unregistered advisory firms and hedge funds as vehicles to misappropriate client assets.

Registration Under the Advisers Act of Certain Hedge Funds Advisers, 69 Fed. Reg. at 45,175.

92. *Id.* at 72,056.

93. *Id.* at 72,057.

94. *See supra* notes 56–60 and accompanying text.

95. *See supra* notes 61–73 and accompanying text.

96. *See supra* notes 90–93 and accompanying text.

considered the possibility of increasing the regulatory authority of the agency.[98] The SEC held a roundtable and invited key industry participants to share their thoughts and concerns.[99] After the roundtable, the staff of the Division of Investment Management prepared a report entitled "Implications of Growth of Hedge Funds" ("Hedge Fund Report").[100] Focusing on investor protection,[101] the Hedge Fund Report "outlines the staff's factual findings [about the size and operations of hedge funds], identifies concerns and recommends that the Commission should consider certain regulatory and other measures to improve the current system of hedge fund regulation and oversight."[102] One of the proposed regulations in the Hedge Fund Report stated that the SEC should consider amending the Investment Advisers Act to require hedge fund advisers to register.[103] This would allow the SEC "to 'look through' any hedge funds that they manage and count each separate investor as a client."[104]

VI. THE SEC'S REGISTRATION PROPOSAL

On July 14, 2004, three out of five Commissioners approved for comment a controversial proposal to amend the rules of the Investment Advisers Act to require hedge fund advisers to register with the Commission.[105] In the proposal, the SEC stated that one of its major

97. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,174. This investigation started in 2002. *Id.*

98. *Id*.

99. *Id*. Participants included, among others, representatives from Soros Fund Management, PriceWaterhouseCoopers, the Managed Funds Association, the Yale School of Management, the NASD, the California Public Employee Retirement System, the Commodity Futures Trading Commission, the American Association of Individual Investors, Harvard Law School, Ernst & Young, Goldman Sachs Group, Schulte Roth & Zable, and Dechert. *See* List of Participants and Comments for the SEC Hedge Fund Roundtable, *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-parts.htm. For a transcript of the roundtable, see Securities and Exchange Commission, Hedge Fund Roundtable (May 14, 2003), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge1trans.txt, and Securities and Exchange Commission, Hedge Fund Roundtable (May 15, 2003), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge2trans.txt.

100. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35.

101. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,174.

102. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, at viii. Some of the recommendations included that the SEC should consider additional discloser requirements for FOHFs, *Id.* at 99; that the SEC should encourage the hedge fund industry to develop best practices, *Id.* at 101; and that the SEC should consider requiring hedge funds to use specific valuation procedures. *Id.* at 99.

103. *Id.* at 89. This goes against the recommendation of the President's Working Group in 1999. *See supra* notes 87–88 and accompanying text.

104. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, at 89.

105. Mazin, *supra* note 38; Deborah Solomon, *Hedge Fund Oversight Moves Closer*, WALL ST. J., July 15, 2004, at C3. Chairman Donaldson, and Commissioners Goldschmid and Campos voted for the

concerns was that the staff lacked information about the hedge fund industry, and moreover, that the staff lacked the regulatory authority to deter the increasing rate of fraud[106] and to protect the growing number of investors.[107] More specifically, the staff of the SEC worried that with the increase in the number of hedge funds, managers would have to work harder to outperform the industry and would have to find new, and possibly riskier ways to invest funds.[108] Also, with the increase in number of investors in hedge funds via pension funds and FOHFs,[109] the SEC expressed concern that a growing number of smaller investors were being exposed to the risks of hedge funds.[110] Finally, the SEC noted that it did

proposal, while Commissioners Glassman and Atkins voted against the proposal. *Id*. The proposal also included changes to Rule 204-2, 17 C.F.R. § 275.204-2 (2005), providing "relief from a recordkeeping requirement for hedge fund advisers that would be required to register with us under [the new rules]," Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,185, and changes to Rule 205-3, located at 17 C.F.R. § 275.205-3, requiring certain hedge fund investors to divest their current interest in the funds. *Id.* at 45,186.

As is common practice in agency rulemaking, the SEC solicited public feedback on the proposal. Solomon, *supra*. Following the commentary period, the SEC decided, even in the face of both internal and external pressure to discontinue the proposal, to officially adopt the registration requirements. SEC Proposes Securities Offering Reform, Requires Registration of Hedge Fund Investment Advisers (Oct. 27, 2004), http://www.sec.gov/news/press/2004-150.htm. While the proposal was passed on October 26, the final rule was not released until December 2, 2004. *See* Susan L. Barreto, SEC Releases Final Hedge Fund Rule, with No Surprises, HedgeWorld News, Dec. 2, 2004, *available at* 2004 WL 72853918. Although the bulk of the commentary about the proposal was in opposition to the new registration rules, there was some outside support backing the SEC's decision to increase its regulation of hedge funds. *See infra* note 143. Some of the supporters of the proposal include the Investment Company Institute and the Investment Counsel Association of America, both of whom work with mutual funds but still have many members who advise hedge funds. Paul F. Roye, Speech by SEC Staff: Open Commission Meeting: Considering Registration Under the Investment Advisers Act of Certain Hedge Fund Advisers (Oct. 26, 2004), *available at* http://www.sec.gov/news/speech/spch102604pfr.htm. Both of these associations agreed with the fact that the burdens of registration are minimal. *Id*. Also, both the Ohio Public Employee's Retirement System and the New Jersey State Investment Council were in favor of the rule. *Id.*

106. *See supra* notes 91–93 and accompanying text.

107. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,177 (proposed July 28, 2004). "The growing demand for hedge funds has resulted in asymmetries of information: even institutional investors are often unable to acquire information on an ongoing basis about the hedge fund adviser, its operations and conflicts." *Id*.

108. *Id*.

> As substantial inflows chase absolute returns, hedge fund managers will have powerful incentives to pursue riskier strategies in order to generate substantial absolute returns under all market conditions. The capacity of hedge fund advisers to generate large absolute returns is limited because the use of similar financial strategies by other hedge fund advisers narrows spreads and decreases profitability.

Id.

109. *See supra* notes 61–73 and accompanying text.

110. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 45,176–45,177. The SEC labels the growth of smaller investors as an increase in "retailization." *See id.* at 45,176. A "significant concern [of the SEC] is the growing exposure of smaller investors,

not want to hurt the performance of hedge funds with new regulations.[111] "[Hedge funds] play an important role in allocating investment risks by serving as counterparties to investors who seek to hedge risks[,] . . . [and] [t]hey also provide their investors with greater diversification of risk by offering them exposure uncorrelated with market movements."[112]

Due to these concerns, the SEC wanted to amend the rules of the Investment Advisers Act in a way that would give the staff of the SEC more information about hedge funds, but would not deter trading or increase costs substantially.[113] The first provision that the SEC sought to change was the definition of the term "client" under the Investment Advisers Act.[114] In 1985, the SEC stated that if an adviser made decisions for a group of clients as a single investing entity rather than as individuals, the group of investors could be treated as a single client.[115] "Today, advisers to hedge funds manage multiple hedge funds having hundreds of investors, and tens of millions of dollars of assets, without registering with the [SEC]."[116] Due to this loophole, the SEC decided to amend Rule 203(b)(3)-1 of the Investment Advisers Act to state that an investment adviser may not count a hedge fund as a single client.[117]

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pensioners, and other market participants, directly or indirectly, to hedge funds. Hedge fund investors are no longer limited to the very wealthy." *Id*.

111. *Id.* at 45,178. In the proposal, the SEC states that it understands that hedge funds contribute greatly to market efficiency and liquidity. *Id*. "Therefore, in evaluating alternative courses . . . [the SEC has] paid particular attention to the extent to which [its] actions might encumber the operation of hedge funds and thus damage the very markets [the SEC] seeks to protect." *Id.*

112. *Id.*

113. *Id*.

114. *Id.* at 45,182. Currently, there is no definition for the term "client" in the Investment Advisers Act. *Id*. Due to the lack of definition, in the past, many hedge funds would qualify for the private adviser exemption, even when they had multiple clients. *See supra* note 38 and accompanying text. "[F]or many years it was unclear whether the Act required an adviser that served as a general partner to a limited partnership holding investment securities to count each limited partner as a client . . . ." Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,181.

115. *Id*. at 45,182. In 1985 the SEC adopted rule 203(b)(3)-1, which allows an adviser to treat the entire partnership as a client "if . . . the advice provided to the limited partnership is based on the investment objectives of the partnership rather than those of the various limited partners." *Id*. The Commission now notes that the situation has changed and that the 1985 rule should be changed. *Id.*

116. *Id*.

117. *Id.* at 45,185. The text of the proposed rule amendment follows.

> § 275.203(b)(3)-1 Definition of "client" of an investment adviser.
>
> *Preliminary Note to § 275.203(b)(3)-1.* This section is a safe harbor and is not intended to specify the exclusive method for determining who may be deemed a single client for purposes of section 203(b)(3) of the Act. Under paragraph (b)(6) of this section, the safe harbor is not available with respect to private funds.
>
> (a) *General.* You may deem the following to be a single client for purposes of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)):
>
> (1) a natural person, and:

Besides altering the definition of a client, the SEC sought to require that hedge fund advisers count each owner of a private fund[118] as one

(i) Any minor child of the natural person;

(ii) Any relative, spouse, or relative of the spouse of the natural person who has the same principal residence;

(iii) All accounts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries; and

(iv) All trusts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries;

(2)(i) A corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to in paragraph (a)(1)(iv) of this section), or other legal organization (any of which are referred to hereinafter as a "legal organization") to which you provide investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, other securityholders or beneficiaries (any of which are referred to hereinafter as an "owner"); and

(ii) Two or more legal organizations referred to in paragraph (a)(2)(i) of this section that have identical owners

(b) *Special rules.* For purposes of this section:

(1) You must count an owner as a client if you provide investment advisory services to the owner separate and apart from the investment advisory services you provide to the legal organization, *provided, however*, that the determination that an owner is a client will not affect the applicability of this section with regard to any other owner;

(2) You are not required to count an owner as a client solely because you, on behalf of the legal organization, offer, promote, or sell interests in the legal organization to the owner, or report periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters;

(3) A limited partnership or limited liability company is a client of any general partner, managing member or other person acting as investment adviser to the partnership or limited liability company;

(4) You are not required to count as a client any person for whom you provide investment advisory services without compensation;

(5) If you have your principal office and place of business outside of the United States, you are not required to count clients that are not United States residents, but if your principal office and place of business is in the United States, you must count all clients; and

(6) You must not rely on paragraph (a)(2)(i) of this section with respect to any private fund as defined in § 275.203(b)(3)-2(d).

(c) *Holding out*. If you are relying on this section, you shall not be deemed to be holding yourself out generally to the public as an investment adviser, within the meaning of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)), solely because you participate in a non-public offering of interests in a limited partnership under the Securities Act of 1933.

Id. at 45,195.

118. Under the new Rule 203(b)(3)-2, a private fund is defined by three characteristics. *Id.* at 45,184.

First, the private fund would be limited to a company that would be subject to regulation under the Investment Company Act . . . . By limiting the scope of the look-through provision to those entities relying on these two sections of the Investment Company Act, [the SEC] would exclude advisers to most business organizations, including insurance companies, broker-dealers, and banks, and include advisers to many types of pooled investment vehicles investing in securities, including hedge funds.

client under the private adviser exemption.[119] This objective was incorporated into proposed Rule 203(b)(3)-2 of the Investment Advisers Act.[120] According to this Rule, if an adviser manages more than fourteen

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> Second, a company would be a private fund only if it permits investors to redeem their interests in the fund (i.e., sell them back to the fund) within two years of purchasing them. Hedge funds typically offer their investors liquidity access following an initial "lock-up" period, and thus most hedge fund advisers would be included within the rules. This "redeemability" requirement would, however, exclude persons who advise private equity funds, venture capital funds, and similar funds that require investors to make long-term commitments of capital. . . .
>
> Third, interests in a private fund would be based on the ongoing investment advisory skills, ability or expertise of the investment adviser. . . . [H]edge fund advisers emphasize the record of the manager and often provide prospective investors with information about the adviser and individual manager. This reliance by hedge fund investors implicates the need for the protections that the Advisers Act offers.

Id. at 45,184–45,185. For the full text of the new rule, see *infra* note 120.

119. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,182. *See supra* notes 37–39 and accompanying text.

120. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,182. The text of the proposed rule follows.

> § 275.203(b)(3)-2 Definition of "client" for certain private funds.
>
> (a) For purposes of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)), you must count the shareholders, limited partners, members, other securityholders or beneficiaries (any of which are referred to hereinafter as an "owner") of a private fund as clients.
>
> (b) If you provide investment advisory services to a private fund in which an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 to 80a-64) is, directly or indirectly, an owner, you must count the owners of that investment company as clients for purposes of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)).
>
> (c) If both you and the private fund have your principal offices and places of business outside the United States, you may treat the private fund as your client for all other purposes under the Act, other than section 206(1) and 206(2) (15 U.S.C. 80b-6(1) and (2)).
>
> (d)(1) A private fund is a company:
>
> (i) That would be an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exception provided from that definition by either section 3(c)(1) or section 3(C)(7) of such Act (15 U.S.C. 80a-3(c)(1) or (7));
>
> (ii) That permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and
>
> (iii) Interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.
>
> (2) Notwithstanding paragraph (d)(1) of this section, a company is not a private fund if it permits its owners to redeem their ownership interests within two years of the purchase of such interests only in the case of:
>
> (i) Events you find after reasonable inquiry to be extraordinary and unforeseeable at the time the interest was issued; and
>
> (ii) Interests acquired with reinvested dividends.
>
> (3) Notwithstanding paragraph (d)(1) of this section, a company is not a private fund if it has its principal office and place of business outside the United States, makes a public offering of its securities in a country other than the United States, and is regulated as a public investment company under the laws of the country other than the United States.

private funds,[121] the hedge fund cannot claim the private adviser exemption and must register with the SEC.[122] There are several other notable details of the proposed rule that affect hedge funds wanting to claim the exception. First, the SEC did not alter the exception that hedge funds with less than $25 million in assets do not have to register with the SEC.[123] This means that some funds will be exempted from registering because of their small size.[124] Next, advisers of FOHFs must count every single investor in the fund as a client.[125] Finally, even if a hedge fund is located in a foreign country, the fund will be required to count investors that are United States residents as clients.[126]

VII. OPPOSITION TO THE REGISTRATION PROPOSAL

Even before it was approved for comment in July of 2004, the SEC's proposal to require registration for hedge fund advisers garnered significant opposition.[127] Interestingly, some of the strongest voices against the proposal came from within the SEC. Both Commissioners Glassman and Atkins voted against the proposal.[128] In their dissent filed with the proposal, Glassman and Atkins stated that "[t]he majority proposes a solution to an ill-defined problem without having given proper consideration to viable alternative solutions in light of the limitations of our own capabilities."[129] Although the dissenting Commissioners acknowledged the fact that the Hedge Fund Report recommended that advisers be registered,[130] they took issue with the given rationales for this

Id. at 45,195–45,196.

121. The adviser could also advise a combination of individual investors, as defined in Rule 203(b)(3)-1. *See supra* note 117. As long as the hedge fund has more than fourteen individual clients, the hedge fund will not be able to claim the private adviser exemption. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,182.

122. *Id*.

123. *Id*. at 45,182–45,183. Also, "[h]edge fund advisers with assets under management between $25 and $30 million would be eligible, but not required, to register with the Commission." *Id*.

124. *Id*.

125. *Id.* at 45,183.

126. *Id*.

127. Deborah Solomon, *SEC Pushing Proposal to Regulate Hedge Funds*, WALL ST. J., July 1, 2004, at C4.

128. *See supra* note 106 and accompanying text. Even after the rule was adopted, Commissioners Glassman and Atkins continued to state their belief that the registration requirement was unnecessary and ill-conceived. Deborah Solomon, *Election Run-Up Could Slow SEC's Chief*, WALL ST. J., Aug. 13, 2004, at A4.

129. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,197. Although the Commissioners note that the SEC does not know much about the operations of hedge funds, they believe that there are other alternatives that would better suffice. *Id*.

130. *See supra* notes 103–04 and accompanying text.

decision, claiming that increases in retailization[131] and fraud[132] were nonexistent.[133] The dissenters also noted that the cost for the SEC would be too high,[134] taking away resources from other priorities, especially mutual funds.[135]

Most of the opposition to the SEC's proposal agreed with Commissioners Glassman and Atkins.[136] Included in the large number of opponents were hedge funds themselves, the Managed Fund Association,[137] legal professionals who represent the industry, and the U.S. Chamber of Commerce.[138] One of the most vocal critics of the proposal

131. *See supra* notes 61–73, 110 and accompanying text. The dissent notes that while the amount of pension funds investing in hedge funds is increasing, this number is only about one percent of the total amount invested in private or public pension plans. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,198. The Commissioners also note, in reference to FOHFs, that if a fund wishes to offer its securities to the public, it must already comply with the other securities laws. *Id.*

132. *See supra* notes 91–93 and accompanying text. The dissent notes that while the SEC has brought forty-six actions against hedge funds, this number seems insignificant compared to the total 2,600 enforcement actions brought by the SEC between 1999 to 2003. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,197. "The 46 cases suggest that the typical 'hedge fund' fraud is perpetrated by an adviser that is too small to be registered with the Commission, was already registered with the Commission, or evaded registration requirements." *Id.* at 45,197–45,198. Therefore, the dissent states that the proposal will do nothing to combat fraud. *Id.* at 45,198. While the dissent states that there were forty-six cases brought by the SEC, between the time the dissent was written and the final rule release, the number has increased to fifty-one. *See supra* note 91.

133. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,197. The dissent also notes that this proposal disregards the decision made by the Presidents Working Group, to not amend the Investment Advisers Act. *Id. See supra* text accompanying notes 87–88.

134. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 45,199. The dissent notes that the hedge funds investors themselves will have to bear the cost of making hedge funds register. *Id*.

135. *Id*. "The Commission does not have unlimited resources. Resources we devote to regulating hedge fund advisers are resources that we could be devoting to other, perhaps higher, priorities." *Id.* The dissent states the SEC should reexamine its oversight in other industries, rather than finding new areas of the market to regulate. *Id.* at 45,198. The dissent also questions whether investors are better served by enhanced oversight of hedge funds compared to taking away resources from the oversight of mutual funds, in which over ninety million Americans invest. *Id.* at 45,199.

136. *See infra* notes 140–44 and accompanying text.

137. The Managed Funds Association ("MFA") "is an international trade association of more than 650 members that represents the global alternative investment industry." About MFA, *at* http://www.mfainfo.org/Join/about.htm (last visited May 9, 2005).

> MFA membership is composed primarily of financial and commodity trading advisors, pool operators, and trading managers who are responsible for the discretionary management of the vast majority of the estimated $35 billion currently invested in managed futures, as well as significant amounts of the $700 billion invested in hedge funds and other financial commodity-linked investments.

Id.

138. The SEC's Registration Proposal: The Public Commentary–A Summary 1 (Oct. 13, 2004), *available at* http://www.mfainfo.org/images/PDF/SEC-Summary-Comments-Memo.pdf [hereinafter MFA Commentary Summary].

was Alan Greenspan, Chairman of the Federal Reserve.[139] Greenspan's concerns focused mainly on his belief that continued regulation of the hedge fund industry would hurt market liquidity.[140] He believed that because the proposal would not deter fraud, the SEC would want to expand its regulatory authority in the future "from hedge-fund advisers to 'hedge funds themselves.'"[141] In Greenspan's opinion, increased regulation would decrease the ability of hedge funds to operate effectively, and would drive some hedge funds out of the U.S. market.[142]

There was also a considerable amount of opposition to the hedge fund proposal in the letters received by the SEC during the commentary period.[143] Most of the arguments raised by the comment letters echoed the beliefs of the dissenting Commissioners and Alan Greenspan.[144] In addition, many of the letters suggested alternatives to the registration proposal, including: the SEC should require hedge funds taking the private adviser exception to provide an annual report to investors;[145] the SEC should increase the wealth requirements for hedge funds;[146] the SEC

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139. Allison Bisbey Colter, *Hedge Funds Are Back in Spotlight*, WALL ST. J., Feb. 17, 2004, at D11.

140. *Id*. Greenspan believes "that hedge funds provide essential market liquidity, meaning they are often willing to buy when everyone else is selling." Greg Ip, *A Less-Visible Role for the Fed Chief: Freeing Up Markets*, WALL ST. J., Nov. 19, 2004, at A1.

141. *Hedge-Fund Proposal Troubles Greenspan*, WALL ST. J., Aug. 26, 2004, at A6. Greenspan was quoted as saying, "I grant you that registering advisers in and of itself is not a problem . . . . The question is, what purpose does it serve unless it's going to go further?" Colter, *supra* note 139. Greenspan believes that the success of hedge funds is partially because they have not been overregulated. *SEC Crime Spree*, WALL ST. J., Sept. 27, 2004, at A18.

142. *Id.*; *supra* note 140. Greenspan believes that "[r]egistration would scare [hedge funds] away, 'to the significant detriment of our economy,' while doing little to stop fraud . . . ." *Id*.

143. According to the MFA, the SEC received 156 letters as of October 13, and 124 of the letters specifically stated the author's position on the proposal. MFA Commentary Summary, *supra* note 138. Of the 124 letters, the Manage Fund Association classified 91 letters, or 73% of the letters, as being against the proposal, while 33 letters were in favor of the proposal. *Id*. For the text of all the comment letters submitted to the SEC concerning the registration proposal, see Comments on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, *at* http://www.sec.gov/rules/proposed/s73005.shtml (last visited May 9, 2005).

144. *See supra* notes 128–35 and accompanying text. To reiterate, these concerns included that there was no evidence of retailization in the hedge fund industry, see *supra* note 131, 133 and accompanying text; that the proposal impeded industry growth, see *supra* notes 140–42 and accompanying text; and that the mandatory registration would divert scarce SEC resources. *See supra* notes 134–35 and accompanying text. Another argument raised in the comment letters against the proposal was that the SEC does not have the legal authority to proceed. *See supra* note 16. However, this topic is beyond the scope of this Note.

145. *See, e.g.*, Letter from Kynikos Associates 2 (Sept. 15, 2004), *available at* http://www.sec.gov/rules/proposed/s73004-52.pdf; Letter from Willkie Farr & Gallagher 1-2 (Sept. 13, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/zeigler091304.pdf.

146. *See, e.g.*, Letter from the Managed Funds Association (Sept. 15, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/jggaine091504.pdf); Letter from Katten Muchin Zavis

should share information with other regulatory bodies like the Commodities Futures Trading Commission ("CFTC");[147] and, the SEC should hold training sessions for hedge fund advisers.[148]

VIII. THE FINAL RULE RELEASE AND THE SEC'S RESPONSE TO THE OPPOSITION

On December 2, 2004, the SEC released the final version of its registration proposal.[149] There was little difference between the final rule and the original proposal, except for a lengthy discussion regarding the SEC's rationale for passing the new rules in spite of the vocal opposition.[150] Among other things, the final rule sought to counter the opposition's concerns regarding the lack of evidence of fraud and retailization,[151] and the possible harm that the registration requirement would have on liquidity and market growth.[152]

Roseman 2 (Sept. 14, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/rosenman091404 .pdf. For more information on the wealth requirement, see *supra* note 52.

147. *See, e.g.*, Letter from Katten Muchin Zavis Roseman, *supra* note 146; Letter from National Futures Association 4 (Sept. 14, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/djroth091404.pdf. "The mission of the [CFTC] is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets." About the Commodity Futures Trading Commission, http://www.cftc.gov/cftc/cftcabout.htm (last modified Apr. 22, 2004). The CFTC was created in 1974 to regulate commodities, futures, and options markets in the United States. *Id.*

148. Letter from Bryan Cave 3 (Aug. 16, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/byrancave081604.pdf.

149. *See* Barreto, *supra* note 105.

150. Barreto, *supra* note 105. "Most of the SEC final rule release is spent defending the [Commissioners'] decision." *Id*.

151. *See supra* notes 131–33 and accompanying text.

152. *See* Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. 72,054, 72,057–72,064 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279). *See also supra* notes 140–42 and accompanying text. The SEC also addressed the opposition's belief that the SEC was overstepping its legal authority by passing the rule, Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 72,067–72,070, as well as many of the alternatives addressed in the comment letters. *Id.* at 72064, 72,066–72,067. One alternative discussed was that the SEC should work with the CFTC instead of requiring advisers to register with two different regulatory bodies. *Id.* at 72,064–72,065. *See supra* note 147 and accompanying text. The SEC disagreed with this alternative because unlike the hedge funds that register with the CFTC, "[m]ost hedge fund portfolios consist primarily of securities," not futures. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 72,065. Another alternative was the suggestion to increase minimum wealth requirements for hedge funds. *Id.* at 72,066. *See supra* note 146 and accompanying text. The SEC rebuffed this suggestion by stating:

> [This alternative] would address one aspect of our concern about the prospect of direct ownership of hedge funds by investors who may not previously have participated in these types of risky investments, but would not permit us to protect the interests of those whose exposure is through intermediaries such as funds of funds and pension funds.

The opponents of the registration proposal stated that there was not enough evidence of fraud and retailization to justify increased regulation.[153] Concerning fraud, the SEC responded that even though the SEC had brought only fifty-one cases relating to hedge fund fraud in the past five years,[154] a disturbing number of hedge funds were involved in the mutual fund scandals of 2003–04.[155] However, the SEC estimated that approximately 400 hedge funds were connected with those scandals.[156] Although the SEC originally had stated in the Hedge Fund Report that there "was no evidence indicating that hedge fund advisers engaged disproportionately in fraudulent activity,"[157] the SEC believed that the recent revelation of the number of funds involved in the mutual fund scandal had proven otherwise.[158] Next, concerning the opposition's claim that there was not enough evidence of retailization,[159] the SEC stood by its original statement that the development of FOHFs,[160] as well as the increase in the amount that pension funds are investing in hedge funds,[161] proved that smaller investors were being exposed to the risks of hedge funds.[162]

Besides discussing the opposition's concerns with fraud and retailization, the SEC also addressed the belief that the registration proposal would harm market liquidity and hurt hedge fund operations.[163] The SEC stated that the "commentators [had] not persuaded [the SEC] that requiring hedge fund advisers to register under the [Investment Advisers] Act . . . [would] impose undue burdens on [hedge funds] or interfere

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Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 72,066.

153. *See supra* notes 131–33 and accompanying text.

154. *See supra* note 91 and accompanying text.

155. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 72,056. "Many of [the] enforcement cases involved hedge fund advisers that sought to exploit mutual fund investors for their funds' and their own gain." *Id*.

156. *See supra* note 93 and accompanying text.

157. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 35, at 73.

158. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 72,062.

159. *See supra* notes 131, 133 and accompanying text.

160. *See supra* notes 65–73 and accompanying text.

161. *See supra* notes 61–64 and accompanying text.

162. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 72,057–72,058. The final rule release also notes that many hedge funds are increasing their marketing activities to attract new investors to their funds. *Id.* at 72,057. While many hedge funds have no interest in attracting retail investors, "some hedge fund's minimum investment requirements have decreased over time." *Id*. For example, "[i]n developed markets outside the United States, hedge funds have sought to market themselves to smaller investors, and we can expect similar market pressures to develop in the United States as more hedge funds enter our markets." *Id*; *see* Letter from Vantis Capital Management (Aug. 6, 2004), *available at* http://www.sec.gov/rules/proposed/s73004/s73004-31.pdf.

163. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 72,059–72,061.

significantly with their operations."[164] Supporting this conclusion, the SEC cited to a recent study that found no difference between the performance of unregistered and registered hedge funds.[165] Along with the concerns regarding liquidity, the SEC discounted the opposition's belief that the Commission would increase their regulatory authority in the future.[166] The final release noted that "[s]uch inchoate fears . . . do not provide reason for our not going forward with this important rulemaking."[167]

IX. ANALYSIS OF THE SEC'S RESPONSE TO THE OPPOSITION

In the final rule release, the SEC justified its decision to increase regulation through its presentation of evidence concerning fraud, retailization, and the lack of effect that the proposal would have on the operations of hedge funds.[168] Even though the SEC was biased predictably in favor of its original proposal, the rationale presented in favor of registration in the final rule release is persuasive. While the dissenting Commissioners' opposition of the proposal is strongly supported by the hedge fund community, the SEC's decision to amend the registration requirements is a step in the right direction.

First, the hedge fund industry is growing at a rapid pace.[169] The SEC based its decision to pass the proposal in part on its concern about the growth of retailization.[170] It remains undisputed that pension funds are increasing their investments in hedge funds, and that FOHFs are growing in popularity.[171] Even so, the opposition questioned whether the exposure of smaller investors to hedge funds was significant enough to warrant increased regulation.[172] The SEC would have been more persuasive had it focused on the exposure of all types of investors to the risks inherent to the

164. *Id.* at 72,059. The SEC noted that there are many hedge funds that currently register with the commission. *Id.* at 72,060; *see supra* note 37. Many of these hedge funds that are already registered have reported to the SEC that the burdens of registration are not excessive. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 72,060 n.64.

165. *Id.* at 72,060 (citing *Bids and Offers*, WALL ST. J., July 23, 2004, at C4).

166. *Id.* at 72,060. *See supra* notes 141–44 and accompanying text.

167. Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. at 72,060. The SEC additionally noted that its history of working with the Advisers Act proves that the concerns of the opposition are baseless. *Id*. In fact, the SEC stated that the concerns relating to this proposal are very similar to the concerns expressed when the original Advisers Act was passed in 1940. *Id.*

168. *See supra* notes 149–67 and accompanying text.

169. *See supra* notes 56–60 and accompanying text.

170. *See supra* notes 109–10 and accompanying text.

171. *See supra* notes 65–73 and accompanying text.

172. *See supra* notes 131, 133 and accompanying text.

industry.[173] With the dramatic growth of the number of people connected to the hedge fund industry and with the increase in the amount invested in the funds,[174] the SEC could have emphasized the macroeconomic effects a crash like LTCM would have on the global capital markets.[175] It was believed that if LTCM was allowed to self-destruct, the global economy would have been severely destabilized, resulting in losses not only for direct participants in LTCM but also for so-called innocent bystanders.[176]

While the Federal Reserve organized a bailout of LTCM to protect the market,[177] the government will not always intervene.[178] In the future, while a hedge fund could possibly collapse, the estimated result may not be so severe as to warrant Federal Reserve intervention.[179] As mentioned above, part of the SEC's mission is to insure the integrity of the nation's securities markets.[180] By requiring registration, the SEC, financial media, and other regulatory bodies[181] will be able to access information about the operations of specific funds and detect when a fund is involved in highly risky behavior. The increase in available information about hedge funds could help the government more reliably estimate the extent of the disruption in the market caused by a collapse of a fund.

Although in hindsight it is clear that LTCM was unstable,[182] it is highly likely that many investors were uninformed about the operations of the fund.[183] If investors knew the extent of the fund's leveraged position, they might not have invested and thus would not have lost their money. While the SEC currently cannot prevent funds like LTCM from collapsing,[184] the SEC, by releasing information about hedge funds to the public, would be

173. *See supra* notes 61–64 and accompanying text.

174. *See supra* notes 56–76 and accompanying text.

175. *See supra* notes 79–83 and accompanying text.

176. *House Hearing on Hedge Funds*, *supra* note 82 (statement of William McDonough, President, New York Federal Reserve Bank).

177. *See supra* notes 82–83 and accompanying text.

178. Federal Reserve Chairman Alan Greenspan stated that "there is no reason for central bank involvement unless there is a substantial probability that a fire sale would result in severe, widespread and prolonged disruptions to financial market activity." *House Hearing on Hedge Funds*, *supra* note 82.

179. *See supra* note 178.

180. *See supra* note 29 and accompanying text.

181. As LTCM was bailed out by the Federal Reserve, it would follow that the Fed would be equally interested in information about the operations of hedge funds to determine if a collapse of the magnitude of LTCM would be likely to happen again. *See supra* note 83 and accompanying text.

182. *See supra* notes 81–82 and accompanying text.

183. Many investors were probably drawn to LTCM because of the supposed genius of the creators of the fund. *See supra* note 79.

184. Currently, the SEC does not impose any rules on the operations of hedge funds, including limits on leverage. *See supra* notes 50–51 and accompanying text.

protecting individual investors, which is clearly a part of its well-established mission.[185] Part of this mission is to assist investors in making sound decisions, often requiring disclosure of material financial information.[186] Thus, if the staff of the SEC remained ignorant about the operations and size of the hedge fund industry, the SEC would be acting contrary to its own mission.[187] By requiring registration, the SEC can disclose information about the hedge fund industry to all investors.[188] It follows that with more information being made available to the public, investors can make better informed decisions.[189]

The SEC also justified its decision to increase regulation based on the increase in fraud within the industry, as well as the fact that the SEC believes that the costs of registration are not detrimental to the operation of hedge funds.[190] Although it is not clear that the SEC will be able to better detect malfeasance in the hedge fund industry because of the registration proposal, the current evidence of fraud in the industry is unsettling, especially considering the number of funds involved in the recent mutual fund scandal.[191] The SEC could have further strengthened its position in the final rule release by discussing the effect that the fraud would have on the market for hedge funds. Because the SEC will have more information available to investors and will be able to detect fraud more proactively,[192] investors may be less skeptical about the operations of the industry.[193] While some opponents feel that registration will hurt market liquidity,[194] ultimately the opponents have failed to recognize that if investors do not trust the company, fund, or industry in which they are investing, whether or not their opinions are correct, they will eventually

185. *See supra* text accompanying note 29.

186. *See supra* note 30 and accompanying text.

187. *See supra* text accompanying notes 30, 90.

188. This information can help both smaller as well as institutional investors. While institutional investors have more resources than smaller investors, that does not mean that they would not benefit from the availability of more information about the industry.

189. Some commentators claim that more information is not actually better for investors. For example, the SEC notes in the final rule release that "[s]ome commentators urged [the SEC] not to adopt the rule because Commission oversight of hedge fund advisers might tend to cause hedge fund investors to rely on that oversight instead of performing appropriate due diligence before making an investment in a hedge fund." Registration Under the Advisers Act of Certain Hedge Funds, 69 Fed. Reg. 72,054, 72065 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279).

190. *See supra* notes 154–58, 164–65 and accompanying text.

191. *See supra* notes 91–93 and accompanying text.

192. In the past, the SEC has only been able to investigate and take action against fraudulent hedge funds after the misconduct has taken place. *See supra* note 90 and accompanying text.

193. Most people still think that the hedge fund industry is too secretive and too risky to invest in. Increasing oversight could alleviate these concerns. *See supra* notes 40–42 and accompanying text.

194. *See supra* notes 140–42 and accompanying text.

pull themselves out of the market. This results in a reduction of the amount of money flowing into hedge funds. On the other hand, SEC registration could entice more risk averse investors to try their luck in hedge funds because they would see the industry as more legitimate.[195] If the registration proposal encourages more investors to invest in hedge funds, this may help the industry and increase liquidity.[196]

X. WHAT THE SEC SHOULD DO TO REDUCE UNREST

Overall, the SEC's response to the opposition in the final rule release justifies its decision to require the registration of hedge fund advisers. Even so, there is one notable omission in the SEC's rationale: the SEC did not consider implementing any of the alternatives mentioned in the comment letters. Instead, the SEC discounted most of the suggestions by stating that they would be ineffective.[197] Clearly, there is a significant amount of unrest in the industry.[198] Even after the proposal was officially approved, the opposition continued to argue that the proposal would do more harm than good.[199] Although the SEC does not have to address the complaints, to ensure full participation with the registration proposal and to appear more democratic, the Commission should try to listen to some of the concerns, especially before considering further regulation of the hedge fund industry.[200]

While most of the opposition would have been silenced only if the SEC abandoned its plan altogether in favor of one of the alternatives, some of the suggestions can nonetheless be implemented concurrently with the registration requirement. First, there was the suggestion that the SEC should work more closely with the CFTC to share resources instead of registering the funds.[201] The SEC responded that because the organizations investigate different types of investments, the information collected by the

195. *See supra* note 189.

196. In the end, it remains unclear why hedge funds are opposing this standard. If they have nothing to hide, then they are unlikely to be harmed by the proposal, beyond having to pay the costs associated with registration.

197. *See supra* notes 145–48, 152 and accompanying text.

198. *See supra* notes 127–48 and accompanying text.

199. *See supra* notes 134–35, 140–42 and accompanying text.

200. While the MFA has noted that they will cooperate with the SEC with the registration proposal even though they disagree with the proposal, many other groups may not be so willing to assist the SEC. Managed Funds Association Pledges Leadership Role as SEC Proceeds Toward Implementation of New Regulatory Regime (Oct. 26, 2004), *available at* http://www.mfainfo.org/images/PDF/Statement_Following_SEC_Vote_Oct26_2004.pdf.

201. *See supra* note 147 and accompanying text.

CFTC would not be useful to the SEC.[202] While this may be the case, the SEC should nonetheless work with the CFTC to gather more data about the industry. Many hedge funds have registered with the CFTC, and the SEC could make this information available to the public on its website.[203] This would give investors a better idea about all hedge funds, no matter what type of investment the funds primarily make.

Another suggestion was that the SEC could hold training sessions for hedge fund advisers concerning securities laws and compliance procedures.[204] While the proponents of this alternative would prefer that unregistered hedge funds be certified in these training sessions instead of required to register,[205] the SEC should still consider holding optional training sessions for advisers. During these sessions, the SEC could explain the process of registration, and if possible, present cost effective methods for registration and compliance with the new rules, and explain how registration has affected funds that are already registered.[206] Once it has been shown that registration is not burdensome, the SEC will have alleviated the industry's concern that registration will negatively effect hedge fund operations.

Finally, one of the opposition's major concerns about the registration proposal was that the SEC would increase the scope of hedge fund regulation in the future.[207] Although there does not seem to be an alternative suggested in the comment letters that would alleviate this concern, the SEC should nonetheless take action to show the industry that it will not consider increasing regulation unless necessary. For example, the SEC periodically could hold roundtables or discussion groups consisting of industry representatives to discuss both the benefits and detriments of the registration process. The SEC could then take the suggestions from these roundtables to determine if changes ought to be made to the registration process to make it more streamlined or cost effective. Also, as industry representatives know the business of hedge funds better than the SEC, they could give the SEC suggestions on how to

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202. *See supra* notes 147, 153.

203. The SEC's website is http://www.sec.gov. Currently, the SEC posts certain registration information on the Electronic Data Gathering, Analysis, and Retrieval System ("EDGAR"), a database that is available through its website. The SEC could post information about hedge funds on EDGAR or on a similar database.

204. *See supra* note 148 and accompanying text.

205. *See supra* note 148.

206. Some funds that have already registered with the Commission have told the SEC that the process is not burdensome. *See supra* note 164.

207. *See supra* notes 140–42 and accompanying text.

better detect fraud. Therefore, both sides would be satisfied: the industry would have input on how to keep costs down and about the scope of the SEC's regulation, and the SEC would have more tools to use in its fight against fraud. By working with the industry, the SEC would demonstrate that it will not attempt to expand its regulatory authority without input from hedge fund advisers. This would help the SEC garner more support and cooperation, and would aid the SEC in its ultimate goal to gather more data about hedge funds and to detect and deter fraud in the industry.[208]

XI. CONCLUSION

The SEC has a long history of investigating and analyzing hedge funds, from analyzing the techniques hedge funds use[209] to its involvement with the President's Working Group after the collapse of LTCM.[210] Even with all this involvement, the registration proposal is by far the most proactive the SEC has ever been in regulating the hedge fund industry. In the end, it is unclear how much information the SEC will receive from the registration proposal, and whether or not the SEC will be able to detect and deter fraud. This aside, not even the dissenting Commissioners can claim logically that the investors will not benefit from having access to more information about the industry. If the SEC chooses to work with the industry and understands its concerns about increased costs and future regulation, the registration proposal will be successful in getting information to the investing public.

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208. *See supra* notes 29–30 and accompanying text.

209. *See supra* note 77 and accompanying text.

210. *See supra* notes 84–88 and accompanying text.

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