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# Hedge Fund Regulation: The Amended Investment Advisers Act Does Not Protect Investors from the Problems Created by Hedge Funds

Sean M. Donahue

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# NOTE

## HEDGE FUND REGULATION: THE AMENDED INVESTMENT ADVISERS ACT DOES NOT PROTECT INVESTORS FROM THE PROBLEMS CREATED BY HEDGE FUNDS

SEAN M. DONAHUE\*

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#### I. INTRODUCTION

Imagine, after years of hard work, you decide to invest your money, only to be defrauded by your financial adviser. This tragedy actually occurred when the Bayou Hedge Fund (“Bayou”) stole over \$300,000,000 from thousands of investors.<sup>1</sup> Some of the investors defrauded did not willingly choose to invest in Bayou.<sup>2</sup> Among them were workers of the Massachusetts Bay Transportation Authority who were indirectly exposed to the fund through their pension plan.<sup>3</sup> In addition, others were defrauded because of their direct investment in Bayou or through their investment in a fund of a hedge fund (“fund of fund”).<sup>4</sup>

Bayou was formed in 1996 and after a few months started losing money.<sup>5</sup> Rather than report these losses, the two owners of the fund, Samuel Israel III and Daniel E. Marino, began a fraudulent scheme.<sup>6</sup> Their actions resulted in innocent investors losing approximately \$350,000,000<sup>7</sup> and Marino threatening to commit suicide.<sup>8</sup> To conceal this fraud, Israel and Marino issued false and misleading financial statements, account statements, and performance summary documents to both clients and potential investors.<sup>9</sup> Bayou fabricated its supposedly independent audit<sup>10</sup> reports

<sup>1</sup>Gretchen Morgenson, *A Hedge Fund Falls Off the Face of the Earth*, N.Y. TIMES, Aug. 28, 2005, at C1.

<sup>2</sup>Brett Arends, *T Pension \$ Mired in Bayou Hedge Fund Scandal*, BOSTON HERALD, Sept. 22, 2005, at 30.

<sup>3</sup>*Id.*

<sup>4</sup>Gretchen Morgenson, *Connect the Dots. Find the Fees.*, N.Y. TIMES, Sept. 4, 2005, § 3, at 1 (“Because Bayou’s minimum-investment requirement of \$250,000 was smaller than that of most hedge funds, the firm unfortunately attracted a lot of individual investors.”). Moreover, numerous investors were exposed to Bayou through their investments in funds of funds which have minimum investment requirements as low as \$25,000. *Id.*

<sup>5</sup>See Complaint at 2, SEC v. Israel III, No. 05-8376 (S.D.N.Y. Sept. 29, 2005), available at <http://www.sec.gov/litigation/complaints/comp19406.pdf>.

<sup>6</sup>Gretchen Morgenson, *What Really Happened at Bayou*, N.Y. TIMES, Sept. 17, 2005, at C1. The fraud perpetrated by Bayou started in 1996 and ended in 2005. *Id.*

<sup>7</sup>See Complaint, *supra* note 5, at 2.

<sup>8</sup>Morgenson, *supra* note 6.

<sup>9</sup>See *id.*

by creating a fictitious accounting firm known as Richmond-Fairfield Associates.<sup>11</sup> It executed its trades through Bayou Securities, a broker-dealer,<sup>12</sup> owned by Israel.<sup>13</sup>

While Bayou Securities earned large profits on trades, the Bayou Hedge Fund continued to suffer severe losses.<sup>14</sup> Attempting to hide money from investors, Israel and Marino transferred approximately \$100,000,000 to European bank accounts.<sup>15</sup> When the money was wired from Europe back to the United States it was seized by the Arizona Attorney General.<sup>16</sup> Two months later, Israel and Marino sent a letter to Bayou's investors stating that the fund would be liquidated and ninety percent of the clients' money would be returned.<sup>17</sup> However, redemption checks tendered to clients were returned for insufficient funds.<sup>18</sup> Therefore, it is likely that the only money available to investors out of the \$450,000,000 invested in Bayou is the \$100,000,000 seized by the Arizona Attorney General.<sup>19</sup>

Bayou is one of nearly eight thousand hedge funds.<sup>20</sup> The term "hedge fund" has no uniformly accepted definition, but generally refers to a private investment vehicle that invests in numerous assets and employs many different investment strategies.<sup>21</sup> Hedge funds differ in three important ways from mutual funds, which are the typical

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<sup>10</sup>JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 41 (2003) ("[An] audit [is a] professional examination and verification of a company's accounting documents and supporting data for the purpose of rendering an opinion as to their fairness, consistency, and conformity with GENERALLY ACCEPTED ACCOUNTING PRINCIPLES.").

<sup>11</sup>See Complaint, *supra* note 5, at 6.

<sup>12</sup>DOWNES & GOODMAN, *supra* note 10, at 160. A broker-dealer is an individual or firm acting as a principal in a securities transaction. Principals trade for their own account and risk. *Id.* When buying from a broker acting as a dealer, a customer receives securities from the firm's inventory; and the confirmation must disclose this transaction. *Id.* Since most brokerage firms operate as brokers and principals the term broker-dealer is commonly used. *Id.*

<sup>13</sup>See Complaint, *supra* note 5, at 5.

<sup>14</sup>See *id.* at 8.

<sup>15</sup>See *id.* at 9.

<sup>16</sup>See Morgenson, *supra* note 6.

<sup>17</sup>*Id.*

<sup>18</sup>See *id.*

<sup>19</sup>*Id.*

<sup>20</sup>Amanda Cantrell, *Take My Hedge Fund . . . Please: Like a Worn Out Comedian Hedge Funds are Having a Tough, Sobering 2005* (Oct. 14, 2005), <http://money.cnn.com/2005/10/14/technology/hedgefunds/index.htm>. Currently, commentators believe that the assets in hedge funds are over \$1,000,000,000,000. *Id.*

<sup>21</sup>This definition is similar to the one given in almost every government report, practitioner's guide, and scholarly work reviewed by the author. See, e.g., *IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE U.S. SEC 3* (2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter *STAFF REPORT*]; DOUGLAS L. HAMMER ET AL., SHARTSIS FRIESE LLP, *U.S. REGULATION OF HEDGE FUNDS I* (2005); Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 *TEMP. L. REV.* 681, 683 (2000).

investment for an average investor.<sup>22</sup> First, unlike mutual funds, most hedge funds charge a twenty percent profit participation fee.<sup>23</sup> This means that the hedge fund manager keeps twenty percent of the profits.<sup>24</sup> Second, while most mutual funds do not use leverage, which is the use of borrowed money to enhance returns, over seventy percent of hedge funds do use leverage.<sup>25</sup> Third, unlike mutual funds, hedge funds are not diversified.<sup>26</sup> Whereas most mutual funds diversify by investing in many different assets, hedge funds often have their money in only a few securities.<sup>27</sup> Because of hedge funds' lack of diversification, use of leverage, and profit participation fees, they are inherently more risky than mutual funds.<sup>28</sup>

Most hedge funds are limited to "qualified clients" and "qualified purchasers" to escape regulation under the federal securities laws.<sup>29</sup> Generally, a "qualified purchaser" is a natural person who owns at least \$5,000,000 in investments.<sup>30</sup> By contrast, a "qualified client" is an investor having either a net worth of \$1,500,000 or having \$750,000 invested in the fund.<sup>31</sup>

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<sup>22</sup>See INV. CO. INST. & THE SEC. INDUS. ASS'N, EQUITY OWNERSHIP IN AMERICA, 2005 1 (2005), available at [http://www.ici.org/pdf/rpt\\_05\\_equity\\_owners.pdf](http://www.ici.org/pdf/rpt_05_equity_owners.pdf). Mutual funds are the most common investment of the average investor. See *id.* at 4. However, this trend may be changing because of alternative investments such as hedge funds. See *id.*

<sup>23</sup>Mitchell D. Eichen & John M. Longo, *The Future of Hedge Funds: Five Emerging Trends*, J. FIN. PLAN. BETWEEN ISSUES E-NEWSL., Dec. 12, 2005, <http://www.fpanet.org/journal/BetweenTheIssues/Contributions/121505.cfm>.

<sup>24</sup>*Id.*

<sup>25</sup>Inv. Co. Inst., *The Differences Between Mutual Funds and Hedge Funds*, [http://www.ici.org/funds/abt/faqs\\_hedge.html](http://www.ici.org/funds/abt/faqs_hedge.html) (last visited May 20, 2007).

<sup>26</sup>Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* 36 (U. Pa. L. Sch. Scholarship at Penn Law, Working Paper No. 99, 2006), available at <http://lsr.nellco.org/cgi/viewcontent.cgi?article=1102&context=upenn/wps>.

<sup>27</sup>*Id.*

<sup>28</sup>*Id.*

<sup>29</sup>See STAFF REPORT, *supra* note 21, at 11.

<sup>30</sup>15 U.S.C. § 80a-2a(51)(A)(i) (2000). A "qualified purchaser" is not the same as a "qualified client." Additionally, it is more financially difficult to be a "qualified purchaser" than to be a "qualified client." See STAFF REPORT, *supra* note 21, at 11. According to the Commission:

Section 2(a)(51) of the Investment Company Act generally defines "qualified purchaser" to be: (1) any natural person who owns not less than \$5 million in investments; (2) any family-owned company (as described in that section) that owns not less than \$5 million in investments; (3) any other trust the trustee and settlor(s) of which are qualified purchasers that was not formed for the specific purpose of acquiring the securities of the Section 3(c)(7) fund; and (4) any person acting for its own account or the accounts of other qualified purchasers, that owns and invests on a discretionary basis not less than \$25 million in investments.

STAFF REPORT, *supra* note 21, at 12.

<sup>31</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,076 (Dec. 10, 2004) (to be codified at 17 C.F.R. pt. 275).

Funds of funds have different investment requirements than hedge funds.<sup>32</sup> Funds of funds are entities that invest in two or more traditional hedge funds.<sup>33</sup> The Securities and Exchange Commission (“SEC” or “Commission”) only imposes an investment minimum on funds of funds of \$25,000.<sup>34</sup> In addition, funds of funds have much less restrictive investment requirements than traditional hedge funds because investors only have to meet the “accredited investor” standard.<sup>35</sup> An “accredited investor”<sup>36</sup> is an investor having an individual income of \$200,000 or

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A “qualified client” under rule 205-3 is: (i) A natural person who or a company that immediately after entering into the contract has at least \$ 750,000 under the management of the investment adviser; (ii) A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either: (A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$ 1,500,000 at the time the contract is entered into; or (B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 [15 U.S.C. § 80a-2] at the time the contract is entered into; or (iii) A natural person who immediately prior to entering into the contract is: (A) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or (B) An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

*Id.*

<sup>32</sup>Nat’l Ass’n of Sec. Dealers, *Funds of Hedge Funds: Higher Costs and Risks for Higher Potential Returns* (Aug. 23, 2002), <http://www.nasd.com/InvestorInformation/InvestorAlerts/index.htm> (follow “Funds of Hedge Funds - Higher Costs and Risks for Higher Potential Returns” hyperlink).

<sup>33</sup>JOSEPH G. NICHOLAS, *HEDGE FUNDS OF FUNDS INVESTING: AN INVESTOR’S GUIDE* 3 (2004).

<sup>34</sup>Elizabeth LeBras, *SEC Should Rethink Funds-of-Hedge Funds Sales Restrictions*, Says Eisenberg, *COMPLIANCE REP.*, Nov. 14, 2005, at 1.

<sup>35</sup>*See id.*

<sup>36</sup>*See* STAFF REPORT, *supra* note 21, at 15.

The term “accredited investors” is defined to include:

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

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

*Id.* (discussing Rule 501 under the Securities Act). *See* 15 C.F.R. § 230.501(a)(1)-(6) (2007).

joint income of \$300,000, or having individual or joint net worth of \$1,000,000.<sup>37</sup> Because of the low investment minimum and the less restrictive standards, funds of funds are readily available to average investors.<sup>38</sup>

Although participation in hedge funds and funds of funds was once limited to wealthy investors, average investors have increasing exposure to these entities.<sup>39</sup> An increasing number of average investors can meet the requirement of being an “accredited investor” and thus can invest in funds of funds.<sup>40</sup> Many individuals can meet the net worth requirement of over \$1,000,000 because of the rise in home values over the past twenty years.<sup>41</sup> In addition, 2,400,000 taxpayers who had an adjusted gross income of \$200,000 or more meet the annual income requirement.<sup>42</sup>

Increased instances of fraud like the kind perpetrated by Bayou is the one of three reasons why this industry needs more regulation.<sup>43</sup> Secondly, because hedge funds engage in high risk investments and charge excessive management fees, hedge funds and funds of funds are unsuitable for the average investor.<sup>44</sup> Finally, more regulation is needed because of the overall risk that hedge funds’ use of leverage poses to the financial markets.<sup>45</sup>

To detect and deter fraud, the SEC should require all hedge funds to register with the Commission, use a risk-based approach rather than a cyclical approach to auditing funds, and impose guidelines to determine which funds to audit. To prevent

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<sup>37</sup>*Id.*

<sup>38</sup>See Nat’l Ass’n of Sec. Dealers, *supra* note 32.

<sup>39</sup>GEORGE P. VAN, HEDGE FUND DEMAND AND CAPACITY 2005-2015, at 10 (2005), available at [http://www.blumontcapital.com/downloads/articles/082605\\_HedgeFundCommentaryFromVAN.pdf](http://www.blumontcapital.com/downloads/articles/082605_HedgeFundCommentaryFromVAN.pdf).

<sup>40</sup>Curtis Zimmermann, *Glauber Eyes Minimum Income Rule for Hedge Fund Sales*, COMPLIANCE REP., Nov. 28, 2005, at 1. Robert Glauber, the president of the National Association of Securities Dealers (NASD) is advocating that funds of funds adopt minimum investment requirements. *Id.*

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

<sup>42</sup>Brian Balkovic, *High-Income Tax Returns for 2002*, SOI BULL., Spring 2005, at 6, available at <http://www.irs.gov/pub/irs-soi/02hiinco.pdf> (last visited May 20, 2007). “[F]or 2002, there were 2,414,128 individual income tax returns reporting AGI of \$200,000 or more, and 2,464,515 returns with expanded income of \$200,000 or more. These returns represented 1.856 percent and 1.895 percent, respectively, of all returns for 2002.” *Id.* at 6.

<sup>43</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,066 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

<sup>44</sup>David F. Swensen, Op-Ed., *Invest at Your Own Risk*, N.Y. TIMES, Oct. 19, 2005, at A21. David Swensen is Yale’s chief investment officer and manages more than \$14,000,000,000 in endowment assets. *Id.* The Yale endowment has outperformed all other endowments over the past decade posting annual returns of 16%. *Id.*

<sup>45</sup>See Nicholas Chany et al., *Systemic Risk and Hedge Funds* (MIT Sloan School of Mgmt., Working Paper No. 4535-05, 2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=671443](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=671443).

average investors from investing in hedge funds, the SEC should require that investors in funds of funds meet the definition of a “qualified client” and ought to raise the minimum investment requirement for funds of funds and traditional hedge funds to \$250,000. To decrease the probability of financial market collapse, the SEC should limit hedge funds’ ability to use leverage by employing the same restrictions imposed on mutual funds.

Part II of this Note describes the history and development of hedge funds. Part III illustrates the current problems facing the hedge fund industry. Part IV discusses hedge fund regulation prior to the Amended Investment Advisers Act of 1940. Part V analyzes the amendments to the Investment Advisers Act. Part VI discusses problems with the Amended Advisers Act. Part VII proposes solutions for more effective regulation of hedge funds. Part VIII summarizes the Note and advocates for the proposed solutions. Part IX briefly discusses the case *Goldstein v. SEC* which struck down the Amended Advisers Act.

## II. HISTORY AND DEVELOPMENT OF HEDGE FUNDS

In 1949, Alfred Winslow Jones established the first hedge fund.<sup>46</sup> The fund took large investment positions in stocks, betting that the stocks would increase in value.<sup>47</sup> The fund also used leverage to enhance returns.<sup>48</sup> It hedged,<sup>49</sup> or limited its risk, by investing a smaller amount of the fund’s money in investments that would increase in value if the stocks decreased in value.<sup>50</sup> Therefore, if the stock prices did go down, the fund would make a little money on the smaller investments and thus limit the losses sustained from the larger investments.<sup>51</sup> Jones structured the fund as a limited partnership and used an incentive fee whereby he kept twenty percent of the profits.<sup>52</sup>

Most hedge funds today are set up similar to Jones’ fund in that they charge a profit participation fee of twenty percent and are structured as limited partnerships.<sup>53</sup> The limited partnership structure is used so that the profits of the fund are only taxed at the individual investor level.<sup>54</sup> The fund has several limited partner investors, and one general partner who is the hedge fund adviser.<sup>55</sup> The hedge fund adviser is

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<sup>46</sup>HedgeCo.net, *The Origin of Hedge Funds*, <http://www.hedgeco.net/hedge-fund-information.htm> (last visited May 20, 2007).

<sup>47</sup>*Id.*

<sup>48</sup>*Id.*

<sup>49</sup>DOWNES & GOODMAN, *supra* note 10, at 304 (“Hedging [is a] strategy used to offset investment risk. A perfect hedge is one eliminating the possibility of future gain or loss.”).

<sup>50</sup>HedgeCo.net, *supra* note 46.

<sup>51</sup>*Id.*

<sup>52</sup>*Id.*

<sup>53</sup>Gibson, *supra* note 21, at 684.

<sup>54</sup>*Id.* at 683-84. Some hedge funds are structured as limited liability companies which also allow for pass-through tax treatment. DOUGLAS L. HAMMER ET AL., *supra* note 21, at 3.

<sup>55</sup>*See* DOUGLAS L. HAMMER ET AL., *supra* note 21, at 10.



usually one or two individuals who structure themselves as a limited liability company or a closely held corporation.<sup>56</sup>

The hedge fund trading strategy is different from the mutual fund strategy. There are two main differences in the strategies employed by mutual funds and hedge funds.<sup>57</sup> First, mutual funds are generally buy-and-hold investors in that they buy securities and keep them for a long duration.<sup>58</sup> This passive trading strategy is very different from the active trading strategy employed by hedge funds.<sup>59</sup> Hedge funds change investments frequently to generate returns from fluctuations in market prices.<sup>60</sup> Because certain movements in asset prices are temporary, hedge funds as active traders hope to make money and unwind their positions in a short period of time.<sup>61</sup> The second major difference in strategy is mutual funds' and hedge funds' level of diversification.<sup>62</sup> Because mutual funds are diversified,<sup>63</sup> if the market moves against their investment positions in a few securities, they will not suffer severe losses. By contrast, a hedge fund used to exploit a particular trend in the market may have a lot of money invested in only a few securities.<sup>64</sup> This lack of diversification makes hedge funds inherently more risky than mutual funds because, if the market moves against the position of the hedge fund, then the fund will suffer substantial losses.

Jones' success as a hedge fund adviser did not go unnoticed. In 1966, it was reported that his hedge fund substantially outperformed the top mutual funds.<sup>65</sup> As a result of Jones's success, between 1966 and 1968, many new hedge funds were launched.<sup>66</sup> Like Jones' fund, these funds used leverage to increase returns.<sup>67</sup> However, unlike Jones, many of these managers did not hedge their risk in an effort

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<sup>56</sup>Hedge Fund World.com, Forming a Hedge Fund, [http://www.hedgefundworld.com/forming\\_a\\_hedge\\_fund.htm](http://www.hedgefundworld.com/forming_a_hedge_fund.htm) (last visited May 20, 2007).

<sup>57</sup>See Kahan & Rock, *supra* note 26, at 53.

<sup>58</sup>See Steven Lumpkin & Hans J. Blommestein, *Hedge Funds, Highly Leveraged Investment Strategies and Financial Markets*, FIN. MARKET TRENDS, June 1999, at 27, 30, available at <http://www.oecd.org/dataoecd/45/63/1923224.pdf>.

<sup>59</sup>Kahan & Rock, *supra* note 26, at 53.

<sup>60</sup>Lumpkin & Blommestein, *supra* note 58, at 32.

<sup>61</sup>Kahan & Rock, *supra* note 26.

<sup>62</sup>Inv. Co. Inst, *supra* note 25, at 36.

<sup>63</sup>*Id.*

<sup>64</sup>*Id.*

<sup>65</sup>William Fung & David Hsieh, *A Primer on Hedge Funds*, 6 J. EMPIRICAL FIN. 309, 310 (1999).

<sup>66</sup>*Id.*

<sup>67</sup>*Id.* at 311.

to limit loss.<sup>68</sup> Because these managers did not hedge risk, in the 1970's when the financial markets took a downturn, these hedge funds suffered severe losses.<sup>69</sup>

Hedge funds faded back into obscurity until 1986, when an article reported that a hedge fund had compounded annual returns of forty-three percent during its first six years of existence.<sup>70</sup> This performance increased investors' interest in hedge funds.<sup>71</sup> As a result, in the 1990's, the number of hedge funds increased dramatically.<sup>72</sup> This growth in the quantity of hedge funds<sup>73</sup> was accompanied by an increase in the number of investment strategies employed by the funds.<sup>74</sup> In 1998, the growth of these funds culminated with the collapse of a large hedge fund named Long-Term Capital Management.<sup>75</sup>

This collapse did not deter investors from investing in hedge funds. From 1999 to 2004 the amount invested in hedge funds doubled and is now more than \$1,000,000,000.<sup>76</sup> Assets in hedge fund are growing faster than mutual fund assets and already equal one-fifth of the assets of mutual funds.<sup>77</sup> Furthermore, over the past five years, the number of hedge funds has doubled, and they now number over 8,000.<sup>78</sup>

While hedge funds have experienced rapid growth, funds of funds have increased at an even greater pace.<sup>79</sup> From 1990 to 2002, the annual growth rate for the assets invested in funds of funds was forty-eight percent compared to a growth rate of twenty-six percent for the industry as a whole.<sup>80</sup> While hedge funds are a relatively

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<sup>68</sup>Dave Inglis, A Brief History of Hedge Funds, [http://www.hughestrustco.com/articles/a\\_%20brief\\_history\\_of\\_hedge\\_funds.html](http://www.hughestrustco.com/articles/a_%20brief_history_of_hedge_funds.html) (last visited May 20, 2007).

<sup>69</sup>*Id.*

<sup>70</sup>*See* Fung & Hsieh, *supra* note 65. This article was published in Institutional Investor and reported the returns of Julian Robertson's Tiger Fund. *Id.*

<sup>71</sup>*Id.*

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

<sup>73</sup>*See id.*

<sup>74</sup>*See* Gibson, *supra* note 21, at 685-86 ("Some hedge funds engage in conservative trading strategies, while other funds are more aggressive. . . . Trading strategy categories for hedge funds include: relative value hedge funds, event driven hedge funds, equity hedge funds, global asset allocator hedge funds, short selling hedge funds, sectoral hedge funds, and market-neutral hedge funds.").

<sup>75</sup>*See* PRESIDENT'S WORKING GROUP ON FIN. MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT viii (1999), *available at* <http://treas.gov/press/releases/reports/hedgfund.pdf> [hereinafter PRESIDENT'S WORKING GROUP].

<sup>76</sup>*See* Cantrell, *supra* note 20.

<sup>77</sup>*See generally* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

<sup>78</sup>Amy Borrus, *A Guide to the Hedge-Fund Maze*, BUS. WK., Oct. 19, 2005, at 55.

<sup>79</sup>*See* NICHOLAS, *supra* note 33, at 8.

<sup>80</sup>*Id.*

new investment vehicle, funds of funds are even newer in that less than ten percent of those that existed in 2002 were in existence in 1990, and more than seventy-five percent of the funds in existence in 2002 were started after 1996.<sup>81</sup> The assets invested in funds of funds represent over one-third of the total amount invested in hedge funds.<sup>82</sup>

### III. PROBLEMS IN THE HEDGE FUND INDUSTRY

Because of the growth of traditional hedge funds and funds of funds, three problems are now highly visible. One problem is the SEC's inability to detect or deter the increased instances of hedge fund fraud. Most of the fraud occurs before the Commission is able to detect the problem, and therefore, investors are unable to get their money back. Moreover, perpetrators of fraud are not deterred from committing this act because of the Commission's lack of resources to detect the fraud. Another problem is the unsuitability of traditional hedge funds and funds of funds to average investors. These funds' lack of diversification, high management fees, and use of leverage make them too risky for the average investor. The third problem is the potential risk hedge funds' use of leverage poses to the financial markets. If the market moves against the position of one large hedge fund or several small funds with similar investment positions, it could cause a collapse of the financial markets.

#### A. *Inability to Detect and Deter Fraud*

The SEC has brought over sixty cases of fraud against hedge fund advisers who have defrauded investors out of billions of dollars.<sup>83</sup> Specifically, in 2005 the Commission brought cases against three prominent hedge funds.<sup>84</sup> Though the SEC has filed these cases,<sup>85</sup> these suits were not brought until after the fraud occurred, with the result being that many investors will never get their money back.

The Commission's inability to detect fraud before it occurs and to deter fraud from occurring is most likely due to the nature in which such fraud is accomplished.<sup>86</sup> Most hedge fund advisers who commit fraud do so by falsifying the fund's track record to make their investments appear profitable,<sup>87</sup> luring investors to invest in the fund, and keeping the money in the fund while continuing to charge profit participation and management fees. For example, in the alleged fraud

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<sup>81</sup>*Id.*

<sup>82</sup> Paul Oranika, *Hedge Funds to Woo New Investors Through Performance Reporting*, (Aug. 18, 2005), <http://www.hedgeco.net/news/08/2005/hedge-funds-woo-new-investors-performance-reporting.html>.

<sup>83</sup>*See generally* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

<sup>84</sup>Jenny Anderson, *S.E.C. Accuses a Jersey Hedge Fund.*, N.Y. TIMES, Dec. 22, 2005, at C4. These funds are the Bayou Group, the KL Group, and Wood River LLC. *Id.*

<sup>85</sup>*Id.*

<sup>86</sup>*See generally* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054.

<sup>87</sup>*See* Morgenson, *supra* note 6.

perpetrated by Wood River LLC (“Wood River”), marketing materials claimed twenty-five percent returns in the first eight months of 2005.<sup>88</sup> However, Wood River’s largest asset, its stake in Endwave Corporation, had actually declined seventy-six percent in the final three months of this reporting period.<sup>89</sup> As with most fraud cases, by the time investors tried to get their money back, the firm stopped answering its phone, locked its doors, and the hedge fund adviser vanished.<sup>90</sup> Unfortunately, investors may never recoup the \$250,000,000 invested in the fund.<sup>91</sup>

Similarly, investors will probably not get back over \$300,000,000 invested in Bayou.<sup>92</sup> In addition to having false financial statements and continuing to charge fees, Bayou and Wood River have two other important common characteristics.<sup>93</sup> The two funds are similar in that they both had problems associated with their auditors and broker-dealers.<sup>94</sup> Bayou’s auditor was a fake accounting firm created to produce false audits of Bayou.<sup>95</sup> The broker-dealer was Bayou Securities, a dealer affiliated with the fund through which trades were made to create fraudulent commissions.<sup>96</sup> With respect to Wood River, their marketing literature listed a former American Express unit as their outside auditor, but that company did not audit the fund.<sup>97</sup> Furthermore, Wood River claimed that Morgan Stanley was one of its two prime brokers, but this firm never executed its trades.<sup>98</sup>

### B. Unsuitable for Average Investors

While hedge fund fraud affects all investors, hedge funds pose problems that are unique to average investors. These three problems are hedge funds’ lack of diversification, use of leverage, and high management fees. First, hedge funds are often not diversified<sup>99</sup> and thus a move in the market against funds’ investments can result in negative returns occurring very quickly and in substantial quantities. Second, because many of these losses are incurred while employing leverage,<sup>100</sup> a large movement against the investment position can result in much greater losses

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<sup>88</sup>Justin Hibbard & Adrienne Carter, *Another Fishy Hedge Fund: A Mysterious Money Manager, Nonstop Hype, Plunging Returns, Empty Offices, and Now an SEC Probe—the Intrigue at Wood River Deepens*, BUS. WK., Oct. 24, 2005, at 36-40.

<sup>89</sup>*Id.*

<sup>90</sup>*Id.*

<sup>91</sup>*Id.*

<sup>92</sup>See Morgenson, *supra* note 6.

<sup>93</sup>Hibbard & Carter, *supra* note 88, at 36.

<sup>94</sup>Morgenson, *supra* note 6.

<sup>95</sup>*Id.*

<sup>96</sup>*Id.*

<sup>97</sup>Hibbard & Carter, *supra* note 88, at 38.

<sup>98</sup>*Id.*

<sup>99</sup>See generally Kahan & Rock, *supra* note 26, at 36.

<sup>100</sup>See generally Inv. Co. Inst, *supra* note 25.

than in mutual funds. Third, hedge funds' twenty percent profit participation fee<sup>101</sup> means that they must generate a return that is twenty percent greater than the return generated by a mutual fund to make the same profit for an investor. While wealthy investors may be able to absorb losses in a hedge fund because they have a well diversified portfolio,<sup>102</sup> average investors could lose their entire life savings if they invest solely in a hedge fund. Furthermore, unlike wealthy investors, average investors typically have investments in a few assets<sup>103</sup> and the potential large losses of hedge funds could thus seriously impact their financial status.

In addition, the fees to invest in funds of funds are even higher than the fees associated with hedge funds.<sup>104</sup> This is because funds of funds charge two layers of fees.<sup>105</sup> The fees include the fees charged by the fund of fund and those charged by the underlying hedge funds.<sup>106</sup> For example, the fees charged by a fund of fund usually include a management fee of one and a half percent, which is paid directly to the manager of the fund.<sup>107</sup> The charges also indirectly include the profit participation fees and the management fees charged by underlying hedge funds because the fund of fund has to pay these fees to invest in hedge funds.<sup>108</sup> Additionally, funds of funds are as risky as hedge funds because they invest solely in hedge funds.<sup>109</sup> Because funds of funds have large fees and are high risk investments, they are unsuitable for average investors.<sup>110</sup>

Finally, there has been an increase in the number of investors eligible to invest in funds of funds. An investor must be an accredited investor to invest in funds of funds. An "accredited investor" is an investor having an individual income of \$200,000 or joint income of \$300,000, or having individual or joint net worth of \$1,000,000.<sup>111</sup> The number of investors who meet the "accredited investor"<sup>112</sup> standard has significantly increased since the definition was drafted in 1982.<sup>113</sup> The

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<sup>101</sup>Eichen & Longo, *supra* note 23.

<sup>102</sup>Amanda Cantrell, Hedge Funds for the Rest of Us: There's a Slew of Mutual Funds Aiming to Bring Hedging Tactics to Average Investors (July 3, 2006), [http://money.cnn.com/2006/06/30/markets/hedge\\_mutual/index.htm](http://money.cnn.com/2006/06/30/markets/hedge_mutual/index.htm).

<sup>103</sup>William N. Goetzmann & Alok Kumar, *Diversification Decisions of Individual Investors and Asset Prices* 3 (Yale Int'l Ctr. for Fin., Working Paper No. 03-31, 2003), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=469441](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=469441).

<sup>104</sup>See NICHOLAS, *supra* note 33, at 55.

<sup>105</sup>*Id.*

<sup>106</sup>See *id.*

<sup>107</sup>See *id.*

<sup>108</sup>See generally Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

<sup>109</sup>*Id.*

<sup>110</sup>*Id.*

<sup>111</sup>17 C.F.R. § 230.215(e)-(f) (2003).

<sup>112</sup>*Id.*

<sup>113</sup>See Zimmermann, *supra* note 40, at 1.

problem with using the current standard of “accredited investor” is that it has not been amended since it was adopted.<sup>114</sup> Consequently, millions of investors now meet the \$1,000,000 net worth requirement necessary to invest in funds of funds.<sup>115</sup> One reason that investors who did not meet the definition of an “accredited investor” when it was drafted but who now do enjoy this status is the increase in home values over the last twenty years, which has caused an increase in these investors’ net worth.<sup>116</sup> In addition, 2,400,000 taxpayers had an adjusted gross income of \$200,000 or more in 2002 and thus were eligible to invest in funds of funds.<sup>117</sup>

*C. Hedge Funds Use of Leverage and Risk to Financial Markets*

Hedge funds’ problematic use of leverage is exemplified by the near collapse of the hedge fund Long-Term Capital Management. In addition, hedge funds cause a serious risk to financial markets through systemic risk.

First, the possibility that hedge funds could cause a financial crisis affects both investors and non-investors. In 1998, the near collapse of the hedge fund Long-Term Capital Management proved that the potential for such a crisis is not mere theory.<sup>118</sup> Long-Term Capital Management started in 1994 and by 1997 the amount invested in the fund increased substantially.<sup>119</sup> At the end of 1997, even after returning over \$2,500,000,000 to investors, there was still nearly \$5,000,000,000 in the fund.<sup>120</sup> Despite reducing the amount of money invested in the fund, Long-Term Capital Management did not reduce its investment positions and continued to use leverage to maintain its current investment levels.<sup>121</sup>

With respect to leverage, in August of 1998, the fund had \$125,000,000,000 of investments financed with less than \$5,000,000,000 of actual money.<sup>122</sup> This means

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<sup>114</sup>*Id.* The SEC, when given the opportunity to address the definition of an “accredited investor” declined to change the requirements. See STAFF REPORT, *supra* note 21, at 5.

<sup>115</sup>See Zimmermann, *supra* note 40, at 1.

<sup>116</sup>*Id.*

<sup>117</sup>See *supra* text accompanying note 42.

<sup>118</sup>See PRESIDENT’S WORKING GROUP, *supra* note 75, at A-2. The SEC staff, in summarizing the information contained in this report, concluded that:

The report examined hedge funds in general as well as LTCM, analyzed the public policy issues presented to the markets by leverage, risk and bankruptcy, and recommended a number of measures designed to constrain excessive leverage in the financial system.

The report focused on the risk management and transparency issues raised by LTCM as well as “highly leveraged institutions” in general. It also focused on the exposure of banks and others to the counterparty risks of highly leveraged entities such as hedge funds.

STAFF REPORT, *supra* note 21, app. A, at 3.

<sup>119</sup>See PRESIDENT’S WORKING GROUP, *supra* note 75, at 11.

<sup>120</sup>*Id.*

<sup>121</sup>*Id.*

<sup>122</sup>*Id.* at 12.

the fund had a leverage ratio,<sup>123</sup> which is the amount of debt compared to the amount of assets, of more than twenty-five to one.<sup>124</sup> The fund's leverage made it vulnerable to market conditions which are highly unpredictable and always changing.<sup>125</sup> In August of 1998, following Russia's devaluation<sup>126</sup> of its currency, the ruble, Long-Term Capital Management's assets went from slightly over \$4,000,000,000 to less than \$2,000,000,000 bringing its losses for the year to over fifty percent.<sup>127</sup>

To stave off the potential impact of the collapse to other financial institutions, the Federal Reserve Bank of New York persuaded fourteen commercial lenders to inject over \$3,500,000,000 into the fund.<sup>128</sup> This capital infusion prevented a potential collapse of the fund, a collapse which would have negatively impacted the world financial markets.<sup>129</sup> Had Long-Term Capital Management not been able to meet its debts, the financial institutions who originally loaned money to the fund may not have been able to meet the debts they owed to other creditors.<sup>130</sup> If this occurred, a domino effect would have resulted whereby financial institutions defaulted on their loans.<sup>131</sup> Such defaults could cause chaos to the financial system.<sup>132</sup>

Second, hedge funds' use of leverage contributes to systemic risk. Systemic risk is commonly used to describe the possibility of a series of defaults on loans by financial institutions in a short period of time caused by a single major event.<sup>133</sup> It occurs when one participant in a financial market who is unable to pay its debt causes others who need to pay their debt to be unable to meet their obligations when due.<sup>134</sup> Because the financial markets are interdependent, a sudden default by one large borrower or several small borrowers because of one major event can cause the financial markets to collapse.<sup>135</sup>

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<sup>123</sup>DOWNES & GOODMAN, *supra* note 10, at 378-79. The leverage ratio is often referred to as the debt-to-equity ratio because it reflects the amount of debt compared to the amount of shareholder's equity on a financial balance sheet. *Id.* A firm with \$3,000,000 in investments and \$1,000,000 in debt would have a leverage or debt-to-equity ratio of thirty-three percent.

<sup>124</sup>See PRESIDENT'S WORKING GROUP, *supra* note 75, at B-13.

<sup>125</sup>*Id.*

<sup>126</sup>DOWNES & GOODMAN, *supra* note 10, at 175 ("Devaluation [is the] lowering of the value of a country's currency relative to gold and/or the currencies of other nations. Devaluation can also result from a rise in value of other currencies relative to the currency of a particular country.").

<sup>127</sup>See PRESIDENT'S WORKING GROUP, *supra* note 75, at 13.

<sup>128</sup>*Id.* at 13-14.

<sup>129</sup>*Id.*

<sup>130</sup>*Id.*

<sup>131</sup>*Id.*

<sup>132</sup>*Id.*

<sup>133</sup>Chan, *supra* note 45, at 1.

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

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

In September of 2005, the same fourteen commercial lenders who had visited the Federal Reserve during the Long-term Capital Management crisis returned to discuss hedge fund practices.<sup>136</sup> The Federal Reserve's invitation was issued in response to several reports by regulators, academics, and market participants expressing concerns about the increase of systemic risk caused by the investment positions of hedge funds.<sup>137</sup> Because the market events that cause systemic risk are highly unpredictable, the most effective way to prevent them from occurring is limiting large institutions' use of leverage.<sup>138</sup>

#### IV. REGULATION PRIOR TO THE AMENDED INVESTMENT ADVISERS ACT

Historically, hedge funds went largely unregulated because they qualified for a variety of exceptions which exempted them from regulation under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.<sup>139</sup> Even after adoption of the Amended Investment Advisers Act, hedge funds may still be subject to these regulations.<sup>140</sup>

##### A. Securities Act of 1933

Section 5 of the Securities Act of 1933 mandates that issuers of securities register with the Commission and comply with the various provisions of the Act.<sup>141</sup> Therefore, hedge funds that issue securities must register with the SEC unless they qualify for an exemption.<sup>142</sup> One such exemption is section 4(2) of the Act, which exempts from registration issuers of securities that do not make a public offering.<sup>143</sup> Hedge funds take advantage of this requirement by only offering investment in their funds to private investors.<sup>144</sup> These private investors include both "institutional investors,"<sup>145</sup> which are organizations that invest in large volumes of securities, and

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<sup>136</sup>Tim Reason, *Who's Holding the Bag? Everyone Knows Banks are Shedding More Risk These Days So Where Does it Go?*, CFO MAG., Oct. 27, 2005, at 40.

<sup>137</sup>See Chan, *supra* note 45, at 1.

<sup>138</sup>*Id.*

<sup>139</sup>See Gibson, *supra* note 21, at 688.

<sup>140</sup>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, 279).

<sup>141</sup>See STAFF REPORT, *supra* note 21, at 13.

<sup>142</sup>*Id.* at 13.

<sup>143</sup>15 U.S.C. § 77d(2) (2000). The provisions of section 5 do not apply to transactions by an issuer not involving any public offering. *Id.*

<sup>144</sup>See Gibson, *supra* note 21, at 689.

<sup>145</sup>DOWNES & GOODMAN, *supra* note 10, at 335-36.

[An] institutional investor [is an] organization that trades large volumes of securities. Some examples are mutual funds, banks, insurance companies, pension funds, labor union funds, corporate profit-sharing plans, and college endowment funds. Typically, upwards of 70% of the daily trading on the New York Stock Exchange is on behalf of institutional investors.  
*Id.*



individual investors with high net worth.<sup>146</sup> Hedge funds can also claim the section 4(2) exemption by meeting the requirements of Rule 506 of Regulation D, which governs private offerings.<sup>147</sup> While Rule 506 is not the exclusive means for establishing the exemption, the rule is often described as a “safe harbor” provision because satisfaction of the provision establishes entitlement to the exemption.<sup>148</sup>

### *B. The Securities Exchange Act of 1934*

Hedge funds can be subject to regulation under the Securities Exchange Act of 1934 in two ways.<sup>149</sup> First, this Act requires that broker-dealers register with the Commission, and such registration mandates that they comply with its requirements.<sup>150</sup> Hedge funds typically do not meet the definition of a broker-dealer but are instead classified as traders and are thus exempted under this portion of the Act.<sup>151</sup> The second part of the Act requires traders holding certain securities positions to register with the Commission.<sup>152</sup> Section 12g and Rule 12g-1 require that a trader of securities with 500 investors and assets in excess of \$10,000,000 register with the Commission.<sup>153</sup> Hedge funds exempt themselves from this requirement by limiting their funds to 499 investors.<sup>154</sup>

### *C. The Investment Company Act of 1940*

The Investment Company Act of 1940 requires investment companies, companies that invest the pooled funds of small investors, to register with the SEC and comply with the provisions of the Act.<sup>155</sup> Nearly all hedge funds come within the definition of an investment company.<sup>156</sup> However, hedge funds escape

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<sup>146</sup>See Gibson, *supra* note 21, at 689.

<sup>147</sup>See STAFF REPORT, *supra* note 21, at 14.

<sup>148</sup>See Gibson, *supra* note 21, at 689.

<sup>149</sup>*Id.* at 691.

<sup>150</sup>*Id.* at 691-92.

<sup>151</sup>See STAFF REPORT, *supra* note 21, at 18 (“The Commission historically has distinguished ‘dealers’ from ‘traders.’ A trader is a person that buys and sells securities, either individually or in a trustee capacity, but not as part of a regular business. Entities that buy and sell securities for investment generally are considered traders, but not dealers.”).

<sup>152</sup>See Joseph Hellrung, Note & Comment, *Hedge Fund Regulation: Investors are Knocking at the Door, but can the SEC Clean House Before Everyone Rushes In?*, 9 N.C. BANKING INST. 317, 325 (2005).

<sup>153</sup>See STAFF REPORT, *supra* note 21, at 18.

<sup>154</sup>See Hellrung, *supra* note 152, at 325.

<sup>155</sup>See DOWNES & GOODMAN, *supra* note 10, at 351 (“[An] investment company [is a] firm that, for a management fee, invests the pooled funds of small investors in securities appropriate for its stated investment objectives. It offers participants more diversification, liquidity, and professional management service than would normally be available to them as individuals.”).

<sup>156</sup>STAFF REPORT, *supra* note 21, at 11 n.32.

Section 3(a)(1)(A) of the Investment Company Act defines an investment company as an issuer which is or holds itself out as being engaged primarily, or proposes to engage

registering by relying on one of two exclusions from the definition of an investment company.<sup>157</sup>

The first exclusion is under section 3(c)(1) of the Investment Company Act, which exempts from the definition of an investment company any issuer of securities with not more than 100 investors and which does not make a public offering.<sup>158</sup> A limited partnership or corporation that invests in a hedge fund is treated as one investor for the purposes of the 100 investor limitation.<sup>159</sup> Hedge funds take advantage of this exemption by limiting their funds to less than 100 private investors.<sup>160</sup>

The second exclusion is under section 3(c)(7) of the Investment Company Act, which exempts from registration investment companies whose investments are owned only by “qualified purchasers” and which do not make or propose to make a public offering.<sup>161</sup> Generally, a “qualified purchaser” is a natural person who owns at least \$5,000,000 in investments.<sup>162</sup> While this exemption is not limited to a certain number of investors, a fund using this exclusion typically limits the number of investors to less than 500 to escape regulation under the Securities Act of 1934.<sup>163</sup>

#### D. *The Investment Advisers Act of 1940*

The Investment Advisers Act of 1940 requires an investment adviser with more than fifteen clients and over \$30,000,000 in assets to register with the Commission and comply with its regulations.<sup>164</sup> Nearly all hedge fund advisers meet the definition of an investment adviser.<sup>165</sup> They satisfy the requirements because they

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primarily, in the business of investing, reinvesting or trading in securities. Section 3(a)(1)(C) of that Act defines an investment company as an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis. Many hedge funds meet both of these definitions.

*Id.*

<sup>157</sup> See Gibson, *supra* note 21, at 694.

<sup>158</sup> 15 U.S.C. § 80a-3(c)(1) (2000).

<sup>159</sup> See Gibson, *supra* note 21, at 698.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.* at 695.

<sup>162</sup> See STAFF REPORT, *supra* note 21, at 11.

<sup>163</sup> See Gibson, *supra* note 21, at 696.

<sup>164</sup> See Hellrung, *supra* note 152, at 326.

Advisors with less than twenty five million in assets are not permitted to register with the SEC. Advisors with between twenty five and thirty million dollars under management are advised, but not required, to register with the SEC. Advisors with at least thirty million of assets under management are required to register with the SEC.”

*Id.* at 345 n.94 (citations omitted).

<sup>165</sup> See STAFF REPORT, *supra* note 21, at 20.

counsel clients regarding investment opportunities.<sup>166</sup> However, most hedge fund advisers escape regulation because they qualify for an exemption under section 203(b) of this Act.<sup>167</sup> This exemption is often referred to as the “private adviser exemption” because it exempts from registration investment advisers who have had less than fifteen clients during the preceding twelve months, who do not hold themselves out to the public as an investment adviser, and who are not advisers to a registered investment company.<sup>168</sup>

Prior to the amendment of the Investment Advisers Act, section 203(b) allowed advisers to count each “legal organization”<sup>169</sup> as a single client.<sup>170</sup> This meant that a hedge fund structured as a limited partnership, with numerous limited partner investors and one general partner, was treated as a single client for purposes of the Act.<sup>171</sup> Therefore, a hedge fund adviser could manage up to fourteen hedge funds and, by using this type of organizational structure, escape regulation.<sup>172</sup> So long as the adviser managed less than fifteen funds, did not make a public offering of these funds, and such funds were not registered investment companies, the hedge fund adviser did not have to register with the Commission.<sup>173</sup>

In sum, hedge funds have organized themselves to be exempt from registering and complying with federal securities laws. Those funds that do not qualify for exemptions are subject to regulation under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. The Amended Investment Advisers Act requires more hedge funds to register with the Commission and comply with its requirements.

#### V. THE AMENDMENTS TO THE INVESTMENT ADVISERS ACT

In December of 2004, the SEC amended the Investment Advisers Act, closing the 203(b) exemption in an attempt to require hedge fund advisers to register with the Commission.<sup>174</sup> The Act also sets forth requirements that hedge funds must meet to charge profit participation fees.<sup>175</sup> Additionally, it mandates that funds of funds

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<sup>166</sup>*Recent Development in Hedge Funds: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 108th Cong. 35 (2003) (prepared statement of William H. Donaldson, Chairman, U.S. SEC), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108\\_senate\\_hearings&docid=f:92703.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_senate_hearings&docid=f:92703.pdf) (“Managers of hedge funds meet the definition of ‘investment adviser’ under the Investment Advisers Act of 1940 because they are in the business of providing investment advice about securities to others.”).

<sup>167</sup>See STAFF REPORT, *supra* note 21, at 20.

<sup>168</sup>15 U.S.C. § 80b-3(b)(3) (2000).

<sup>169</sup>See Gibson, *supra* note 21, at 698.

<sup>170</sup>*Id.*

<sup>171</sup>*Id.*

<sup>172</sup>*Id.*

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

<sup>174</sup>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, 279).

<sup>175</sup>*Id.* at 72,071.

register with the Commission.<sup>176</sup> Finally, registration under the Act subjects hedge funds and funds of funds to various compliance requirements.<sup>177</sup>

*A. Hedge Funds Must Register with the Commission*

The Amended Advisers Act requires that all “private funds” register with the Commission.<sup>178</sup> In section 203(b)(3)-1, the SEC defines a “private fund” to reflect three common characteristics of hedge funds.<sup>179</sup> A private fund is a firm that would be an investment company under section 3(a) of the Investment Company Act of 1940 but for the exception provided from that definition by either section 3(c)(1) or section 3(c)(7) of the Act;<sup>180</sup> that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests;<sup>181</sup> and whose interests are or have been offered based on the investment advisory skills, ability, or expertise of the investment adviser.<sup>182</sup>

Provided that a hedge fund meets the requirements of a “private fund,” section 203(b)(3)-2 requires advisers of “private funds” to count each client for purposes of determining the availability of the 203(b) “private adviser exemption.”<sup>183</sup> If the hedge fund adviser advises more than fourteen clients, the adviser must register with the Commission.<sup>184</sup> However, an adviser may no longer count each legal organization as a single client.<sup>185</sup> The Act redefines the term client to include the shareholders, limited partners, members, or beneficiaries of a “private fund.”<sup>186</sup> Thus, advisers to private funds have to “look through” each fund under management

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<sup>176</sup>*Id.* at 72,076.

<sup>177</sup>*Id.* at 72,071.

<sup>178</sup>*Id.* at 72,069.

<sup>179</sup>*Id.* at 72,073 (“We proposed to define a ‘private fund’ by reference to three characteristics shared by virtually all hedge funds, and that differentiate hedge funds from other pooled investment vehicles such as private equity funds or venture capital funds.” (footnote omitted)).

<sup>180</sup>*Id.*

<sup>181</sup>*Id.* at 72,074.

Hedge funds typically offer their investors liquidity access following an initial “lock-up” period, which is typically for less than two years. Thus, this provision will include most hedge fund advisers, but will exclude advisers that manage only private equity funds, venture capital funds, and similar funds that require investors to make long-term commitments of capital.

*Id.* (footnotes omitted).

<sup>182</sup>*Id.* at 72,068. Other securities laws, such as rule 205-3(b) also require that investors meet the “qualified investor” criteria if the investment company adviser charges a performance fee. *Id.*

<sup>183</sup>*Id.* at 72,070.

<sup>184</sup>*Id.*

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

<sup>186</sup>*Id.*

and count each limited partner investor or shareholder as only one client.<sup>187</sup> The result of this “look through” provision is that hedge fund advisers who manage “private funds” with more than \$30,000,000 in assets and fifteen individual investors must register with the Commission.<sup>188</sup> Before the Amended Act, most of these funds escaped regulation, but now all of them must register and are, thus, subject to certain compliance requirements.<sup>189</sup>

*B. Requirements for Charging Profit Participation Fees*

For hedge funds to charge their customary profit participation fees, they must limit the availability of their funds to “qualified clients” or “qualified purchasers.”<sup>190</sup> A qualified purchaser is a natural person who owns at least \$5,000,000 in investments.<sup>191</sup> A “qualified client” is an investor having either a net worth of \$1,500,000 or having \$750,000 invested in the fund.<sup>192</sup> Prior to amendment of the Act, some hedge funds only required individuals to be “accredited investors,” a standard which has less stringent financial requirements.<sup>193</sup> An “accredited investor”<sup>194</sup> is an investor having an individual income of \$200,000 or joint income of \$300,000, or having individual or joint net worth of \$1,000,000.<sup>195</sup> While some advisers required their clients to be “accredited investors,” others allowed individuals to invest in the fund by meeting lower investment requirements.<sup>196</sup> The Amended Act grandfathered in those investors who are neither “qualified purchasers” nor “qualified investors” by allowing the fund to continue to charge them profit participation fees.<sup>197</sup> However, all new participants must be “qualified purchasers” or “qualified clients.”<sup>198</sup>

To continue to charge profit participation fees, funds relying on the 3(c)(1) exemption must limit their funds to “qualified clients,” while funds relying on the 3(c)(7) exemption must limit their funds to “qualified purchasers.”<sup>199</sup> Therefore, investors in 3(c)(1) funds will likely have either a net worth of \$1,500,000 or have

<sup>187</sup>*Id.* at 72,071.

<sup>188</sup>*Id.*

<sup>189</sup>*Id.* 72,071.

<sup>190</sup>*Id.*

<sup>191</sup>*See supra* note 30.

<sup>192</sup>*See generally* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

<sup>193</sup>*Id.*

<sup>194</sup>*See supra* note 36.

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

<sup>196</sup>Nancy R. Mandell, *Hedge Funds Beware: Ready or Not, Here Comes Regulation*, SEC. WK., Sept. 19, 2005, at 1.

<sup>197</sup>*See generally* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054.

<sup>198</sup>*Id.* at 72,073.

<sup>199</sup>*Id.* at 72,076.

\$750,000 invested in the fund.<sup>200</sup> By contrast, investors in 3(c)(7) funds will have \$5,000,000 of assets.<sup>201</sup> Because hedge funds will continue to charge performance fees, they will only make their funds available to “qualified clients” and “qualified purchasers.”<sup>202</sup>

### C. Funds of Funds Must Register with the Commission

Just as an adviser to a hedge fund that is a “private fund” must register with the SEC, an adviser to a fund of fund (which falls under the definition of a “private fund”) must register with the Commission.<sup>203</sup> Before the enactment of the Amended Advisers Act, most funds of funds escaped regulation by exempting themselves from the federal securities laws.<sup>204</sup> Now, in addition to requiring funds of funds that meet the definition of a “private fund” to register with the Commission, the Act also includes a section that requires registration for funds of funds that do not meet the definition of a “private fund.”<sup>205</sup> Section 203(b)(3)-2(b) prescribes a special rule for a fund of fund, which is a registered investment company under the Investment Company Act that does not qualify for the 3(c)(1) or 3(c)(7) exemption.<sup>206</sup> This section requires an adviser of a fund of fund to “look through” the fund and count each investor as a client for purposes of the 203(b) “private adviser exemption.”<sup>207</sup> Therefore, even if a fund of fund does not fall under the definition of a “private fund,” an adviser of a fund of fund with more than \$30,000,000 in assets and at least fifteen clients must register with the Commission.<sup>208</sup>

While advisers to funds of funds must register with the Commission, because such funds do not charge profit participation fees, they may allow investors who are neither “qualified purchasers” nor “qualified clients” to invest in the fund.<sup>209</sup> Additionally, funds of funds typically only sell their funds to “accredited

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<sup>200</sup>See STAFF REPORT, *supra* note 29, at 11.

<sup>201</sup>See *supra* note 30.

<sup>202</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,056.

<sup>203</sup>*Id.* at 72,071.

<sup>204</sup>*Id.*

<sup>205</sup>*Id.*

<sup>206</sup>*Id.* at 72,077. Because this type of “fund of a hedge fund” is a registered investment company to which the 3(c)(1) and 3(c)(7) exceptions do not apply, it is not a private fund and the adviser is not subject to regulation under the Amended Advisers Act absent another section requiring the adviser to register. *Id.*

<sup>207</sup>*Id.* at 72,071 (“Without the look-through requirement, an adviser could provide its services through fourteen or fewer top tier funds and continue to indirectly manage the assets of hundreds or, in the case of registered funds of hedge funds, thousands of investors, without registering or being subject to the Commission’s oversight.”).

<sup>208</sup>See Hellrung, *supra* note 152, at 326.

<sup>209</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,071 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

investors,”<sup>210</sup> and the new rules mimic current practice by requiring that these funds only be sold to “accredited investors.” One way someone qualifies as an “accredited investor” is to have an individual income of \$200,000 or joint income of \$300,000.<sup>211</sup> The other way is to have individual or joint net worth of \$1,000,000.<sup>212</sup> In addition to the requirement that individuals be “accredited investors,” the new rules also mimic current practice<sup>213</sup> by requiring funds of funds to impose a minimum investment requirement of \$25,000. In addition to investment requirements, all funds of funds and hedge funds that do register with the Commission are subject to compliance requirements.

#### D. Compliance Requirements

Registered advisers of hedge funds and funds of funds will have to comply with the rules of the Investment Advisers Act.<sup>214</sup> Compliance with the Act mandates that hedge fund advisers meet five major requirements.<sup>215</sup> These requirements are: (1) filing an adviser registration form, (2) keeping records, (3) providing a brochure, (4) developing compliance procedures, and (5) designating a chief compliance officer.<sup>216</sup> In addition, it subjects these advisers to random audits conducted by SEC examiners.<sup>217</sup>

The first requirement is that hedge fund advisers file an investment adviser registration form (“Form ADV”) with the Commission and identify themselves as hedge fund advisers.<sup>218</sup> Secondly, hedge fund advisers must keep books and records

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<sup>210</sup>See STAFF REPORT, *supra* note 21, at 5.

<sup>211</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,071.

<sup>212</sup>*Id.*

<sup>213</sup>See STAFF REPORT, *supra* note 21, at 5.

<sup>214</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,071.

<sup>215</sup>See PRESIDENT’S WORKING GROUP, *supra* note 75, app. B, at B-15-16. Advisers are also subject to less costly requirements imposed by the Investment Advisers Act. *Id.* For example, registered advisers “cannot assign their advisory contracts without client consent, cannot engage in principal transactions with their clients without prior client consent, must take steps to protect client assets that are in their custody, and are limited in the types of performance fees they can charge.” *Id.* (footnotes omitted).

<sup>216</sup>See Hellrung, *supra* note 152, at 339.

<sup>217</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,071.

<sup>218</sup>*Id.* at 72,077. “[A]dvisers’ responses to Form ADV are made available to the investing public on the Internet through the Investment Adviser Public Disclosure system.” *Id.* at 72,077 n.271. Thus, investors will have access to information about their advisers. *Id.* Furthermore, Form ADV will provide the Commission with information about the adviser because these forms are quite detailed. *Id.* at 72,083.

in accordance with rule 204-2.<sup>219</sup> The third requirement is that hedge fund advisers must provide a brochure to prospective and existing clients disclosing business practices and the background of the adviser.<sup>220</sup> Fourth, hedge fund advisers must develop comprehensive compliance procedures.<sup>221</sup> These procedures include ethics practices for advisory personnel,<sup>222</sup> controls to protect clients' assets,<sup>223</sup> solicitations procedures for sales personnel,<sup>224</sup> policies designed to insure advisers vote in the best interests of clients,<sup>225</sup> and procedures designed to prevent violation of the Investment

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<sup>219</sup>*Id.* at 72,085. Two requirements are particularly important. *Id.* at 72,076. The first important requirement is that advisers advertising their past track record of performance must keep:

All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser); provided, however, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirements of this paragraph.

17 C.F.R. § 275.204-2(a)(16) (2003). Such information is vital because many of the hedge funds charged with fraud have used false marketing materials to persuade new investors to put money into the fund and to keep current investor's money in the fund. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054. The second important requirement is that the vast amount of records the adviser must keep under Section 204-2 have to be maintained for five years. 17 C.F.R. § 275.204-2(e)(3) (2003).

<sup>220</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,085 ("Rule 206(4)-4 requires registered investment advisers to disclose to clients and prospective clients certain disciplinary history or a financial condition that is reasonably likely to affect contractual commitments.").

<sup>221</sup>*See* Hellrung, *supra* note 152, at 339.

<sup>222</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,084 ("Rule 204A-1 requires SEC-registered investment advisers to adopt codes of ethics setting forth standards of conduct expected of their advisory personnel and addressing conflicts that arise from personal securities trading by their personnel, and requiring advisers' 'access persons' to report their personal securities transactions.").

<sup>223</sup>*Id.* ("Rule 206(4)-2 requires advisers with custody of their clients' funds and securities to maintain controls designed to protect those assets from being lost, misused, misappropriated, or subjected to financial reverses of the adviser.").

<sup>224</sup>*Id.* at 72,085 ("Rule 206(4)-3 requires advisers who pay cash fees to persons who solicit clients for the adviser to observe certain procedures in connection with solicitation activity.").

<sup>225</sup>*Id.* ("Rule 206(4)-6 requires an investment adviser that votes client securities to adopt written policies reasonably designed to ensure that the adviser votes in the best interests of clients, and requires the adviser to disclose to clients information about those policies and procedures.").



Advisers Act.<sup>226</sup> Lastly, advisers must designate a chief compliance officer.<sup>227</sup> In addition, registration under the Act empowers the SEC to randomly audit hedge fund advisers at any time to assure that they are complying with these procedures.<sup>228</sup>

## VI. PROBLEMS WITH THE AMENDED ADVISERS ACT

While the Amended Advisers Act is a step in the right direction, it will not adequately regulate hedge funds. There are five reasons why this Act is ineffective. These reasons are: (1) the various loopholes in the Act, (2) the SEC's inability to conduct random audits, (3) the ineffectiveness of random audits in preventing fraud, (4) the failure of the rule to limit hedge funds' use of leverage, and (5) the failure of the rule to limit retailization of funds of funds.

### A. Various Loopholes in the Rule

The first reason the rule is ineffective is because some funds will escape regulation due to three loopholes in the rule.<sup>229</sup> The first loophole is that a hedge fund can avoid registration by extending its lock-up period to two years.<sup>230</sup> This means that funds can avoid regulation by disallowing investors from withdrawing money from the fund for twenty-four months.<sup>231</sup> In doing so, it escapes the definition of a "private fund" and thus does not have to register with the Commission.<sup>232</sup>

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<sup>226</sup>*Id.* ("Rule 206(4)-7 requires each registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.").

<sup>227</sup>*Id.* at 72,085 ("Rule 206(4)-7 requires each registered investment adviser to . . . designate an individual to serve as chief compliance officer."). *See also* 17 C.F.R. § 275.206(4)-7 (2003).

<sup>228</sup>15 U.S.C. § 80b-4 (2000) ("All records . . . of such investment advisers are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission as the Commission deems necessary or appropriate in the public interest or for the protection of investors.").

<sup>229</sup>Chidem Kuras, *Use of Registration Loophole Seen as Risky*, HEDGEWORLD DAILY NEWS, Nov. 17, 2005, at 1; Jeff Benjamin, *Hedge Funds Exploit a Loophole: Some Funds Extend Lockup to Avoid Regulatory Oversight*, INVESTMENTNEWS, Sept. 26, 2005, (News), at 1. Thomas Kostigen, *New Rules Won't Add Much Oversight on Hedge Funds*, MARKETWATCH, Nov. 15, 2005, <http://www.marketwatch.com/News/Story/Story.aspx?guid={C0E86627-7ABA-4657-A1AE-E956C17B6FDF}&siteid=tradehaven>.

<sup>230</sup>*See* Benjamin, *supra* note 229.

<sup>231</sup>*Id.*

<sup>232</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,096 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (Glassman, Comm'r, & Atkins, Comm'r, dissenting).

[T]his criterion [the two year lock-up period for private funds] will encourage advisers to extend their redemption periods beyond two years in order to avoid registration. Therefore, it will be more difficult for investors, once they have made the decision to invest in a hedge fund, to "vote" on the quality and integrity of the hedge fund manager by leaving the fund.

*Id.* (footnotes omitted).

Moreover, giving hedge funds an incentive to extend lock-ups may be counterproductive because hedge funds prefer longer access to capital and now have justification for requiring investors to leave their money in the fund for a greater duration.<sup>233</sup> This lock-up period could also adversely affect investors because they cannot withdraw their money from the fund even if the fund is experiencing severe losses.<sup>234</sup>

The second loophole is that some hedge funds have interpreted the Act to apply only to new investments.<sup>235</sup> This interpretation is based on the requirement that a “private fund” must have a lock-up period of less than two years.<sup>236</sup> Because only new investments are subject to this requirement, some hedge fund advisers believe that, for their fund to be defined as a “private fund,” it must accept new money.<sup>237</sup> Accordingly, some funds are choosing not to register with the Commission by either not accepting new money or by accepting new money subject to a two-year lock-up period.<sup>238</sup> While there is not a specific grandfather provision,<sup>239</sup> some hedge funds are capitalizing on this interpretation of the rule to avoid SEC registration.<sup>240</sup>

The third loophole is that funds with less than \$25,000,000 in assets do not have to register with the Commission.<sup>241</sup> The SEC exempts these funds from registration<sup>242</sup> because of its lack of resources to conduct random audits. However, according to the Commission, twenty of the forty-six cases brought at the time this amendment was proposed were committed by funds too small to register under the Amended Act.<sup>243</sup> Therefore, exempting funds with \$25,000,000 or less in assets ignores nearly

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Furthermore, the Commissioners had parted ways just sixteen times during former Chairman William Donaldson’s tenure as director of the SEC. Carrie Johnson, *Independent Chairmen Required for Funds: SEC Aims to Eliminate Conflicts of Interest*, WASH. POST, June 24, 2004, at E4. Such disagreement only occurred in one percent of the 1,606 votes the agency conducted during this period. *Id.*

<sup>233</sup>See Kostigen, *supra* note 229, at 1.

<sup>234</sup>*Id.*

<sup>235</sup>See Kurdas, *supra* note 229.

<sup>236</sup>*Id.*

<sup>237</sup>*Id.* (“By the logic of the rule as written, there has been an inference that such managers [managers who do not take new money] would . . . be exempt.”).

<sup>238</sup>*Id.*

<sup>239</sup>*Id.* (“When the registration rule was being prepared, there was discussion as to whether to grandfather in managers that no longer take money . . . [b]ut in the end a grandfathering clause was not included in the rule.”).

<sup>240</sup>*Id.* (“SEC Chairman Christopher Cox told a gathering in China that he was well aware some hedge funds were skirting the registration requirement by closing their funds to new investors.”).

<sup>241</sup>Anuj Gangahar, *SEC Rule Ignores Highest-risk Category of Fund Fraud*, FIN. NEWS ONLINE US, Oct. 31, 2005, [http://www.financialnews-us.com/index.cfm?content\\_id=537169](http://www.financialnews-us.com/index.cfm?content_id=537169).

<sup>242</sup>*Id.*

<sup>243</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,198 (July 28, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (Glassman, Comm’r, & Atkins, Comm’r, dissenting).

half of the funds charged with committing fraud.<sup>244</sup> In addition, the SEC is now considering exempting from registration hedge funds with less than \$50,000,000 in assets<sup>245</sup> due to their lack of resources.

#### B. SEC's Inability to Conduct Random Audits

The Commission does not have the resources to conduct random examinations of hedge funds.<sup>246</sup> In fact, it barely has enough examiners to audit mutual funds.<sup>247</sup> Moreover, the SEC's budget was cut in 2006, and it is thus unlikely that the Commission will be able to hire more inspectors.<sup>248</sup> Even assuming that random audits are an effective method to regulate hedge funds, because the solution is too expensive, the SEC will not be able to successfully employ this practice.<sup>249</sup>

#### C. Ineffectiveness of Random Audits in Preventing Fraud

Random audits, in addition to being too expensive, are unlikely to effectively detect fraud.<sup>250</sup> This is primarily because such audits are done on a cyclical basis.<sup>251</sup> A conservative estimate of how often the SEC will conduct these examinations is once every five years, but the audits may be even more infrequent.<sup>252</sup> While a perfectly timed examination may expose fraud, these examinations are so isolated that most fraudulent funds can successfully conceal their illegal activity.<sup>253</sup> For example, a hedge fund may be able to register with the Commission, conduct business for up to five years, defraud investors, and close the fund before the SEC ever conducts an audit.<sup>254</sup> While these audits could be performed retrospectively, it

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<sup>244</sup>*Id.*

<sup>245</sup>*See* Gangahar, *supra* note 241.

<sup>246</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,093 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (Glassman, Comm'r, & Atkins, Comm'r, dissenting). ("The Commission lacks the resources necessary to conduct frequent, comprehensive hedge fund adviser examinations, and our lack of resources is a matter of public record." (footnote omitted)).

<sup>247</sup>*See* Swensen, *supra* note 44, at A21 ("The prospect of random audits likewise carries little potential benefit; the already overburdened Commission can barely deal with its mutual fund caseload.").

<sup>248</sup>Chidem Kuras, *Commissioner: Sound Industry Practices Offer Better Control than SEC Registration*, HEDGEWORLD DAILY NEWS, Sept. 30, 2005, at 1.

<sup>249</sup>*See* Swensen, *supra* note 44, at A21.

<sup>250</sup>Letter from W. Hardy Callcott, Partner, Bingham McCutchen LLP, to Commissioners of the SEC, at 2 (Sept. 15, 2004), available at <http://www.sec.gov/rules/proposed/s73004/whcallcott091504.pdf>.

<sup>251</sup>*Id.* at 1-2.

<sup>252</sup>*Id.* ("I think most investors would be very surprised to learn that the Commission staff does not examine SEC-registered advisers even as often as twice a decade.").

<sup>253</sup>*Id.* at 2.

<sup>254</sup>*Id.*

is unlikely that the fund will even exist, and if it does it will probably not be able to pay back investors.<sup>255</sup>

In addition to the problems posed by cyclical examinations, regulation of the mutual fund industry shows that random audits alone do little to detect fraud.<sup>256</sup> Moreover, hedge funds are more complex than mutual funds and are therefore more difficult to audit.<sup>257</sup> Because auditing hedge funds is complex and mutual fund audits show that this method alone does not prevent fraud, solely conducting random audits of hedge funds will not detect fraud.<sup>258</sup>

With respect to deterrence, the threat of examination will not discourage individuals from committing fraud.<sup>259</sup> Such a threat will not deter fraud because it is public knowledge that the SEC lacks the resources to frequently conduct audits.<sup>260</sup> Consequently, perpetrators will not be discouraged by only a slight increase in the risk of being apprehended for their actions.

#### *D. Failure of the Rule to Limit Hedge Funds' Use of Leverage*

The Amended Advisers Act does not address the problem that hedge funds' use of leverage poses to financial markets.<sup>261</sup> Concededly, the Advisers Act is not the appropriate regulation by which the SEC could limit hedge funds' use of leverage.<sup>262</sup> However, leverage restrictions could be imposed by subjecting hedge funds to regulation under the Investment Company Act of 1940.<sup>263</sup> Failing to address the issue of leverage ignores the problem that started the government's examination of

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<sup>255</sup>*Id.*

<sup>256</sup>See Kurdas, *supra* note 248, at 1. Other measures taken in conjunction with random audits have been effective in detecting and deterring mutual fund fraud. *Id.* However, these measures are very expensive and even if they were employed, it is unlikely that they would help detect hedge fund fraud because of the complexity of these investments. *Id.*

<sup>257</sup>*Id.*

<sup>258</sup>*Id.*

<sup>259</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,093 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (Glassman, Comm'r, & Atkins, Comm'r, dissenting).

<sup>260</sup>*Id.*

<sup>261</sup>*Id.* at 72,055-59 (majority) (explaining that the only reasons for amending the Investment Advisers Act are the growth of hedge funds, the growth of hedge fund fraud, and the retailization of hedge funds, and thus acknowledging by negative implication that the amendments do not address hedge funds' use of leverage).

<sup>262</sup>*Id.* at 72,058.

The principal concerns of the President's Working Group report were the stability of financial markets and the exposure of banks and other financial institutions to the counterparty risks of dealing with highly leveraged entities such as the LTCM hedge fund. The focus of the Advisers Act is different, and includes such concerns as the prevention of frauds on investors.

*Id.* at 72,058 n.43.

<sup>263</sup>*Id.*

this industry.<sup>264</sup> Though the SEC chose not to address this problem at the time the Amended Act was proposed, it should have adopted a comprehensive legislative scheme regulating hedge funds. Consequently, when the SEC decided to amend the Advisers Act to regulate hedge funds, it should have amended the Investment Company Act to restrict hedge funds' use of leverage.

#### *E. Failure of the Rule to Limit Retailization of Funds of Funds*

While the Amended Advisers Act increases the requirements for individuals to invest in hedge funds and requires funds of funds to register with the Commission, it does not restrict the sale of funds of funds to average investors.<sup>265</sup> An individual who has income of \$200,000 a year and \$25,000 to invest in the market may invest in a fund of fund.<sup>266</sup> Moreover, many individuals and married couples filing a joint return can meet the net worth requirement of \$1,000,000, but some of these individuals are not experienced investors.<sup>267</sup> Because average investors can invest in funds of funds and such funds are increasing their marketing to such investors, the Amended Advisers Act does not effectively limit the retailization of these funds.<sup>268</sup>

### VII. PROPOSED SOLUTIONS

There are three cost effective and highly efficient solutions to remedy the problems created by hedge funds. Each proposed solution is specifically designed to counteract the main problems<sup>269</sup> caused by the hedge fund industry. First, to prevent fraud, the SEC should require all hedge funds to register with the Commission, adopt a risk-based approach for conducting audits, and impose guidelines for determining which funds to audit. Second, to restrict average investors' access to funds of funds, the SEC should adopt the "qualified client" criteria for funds of funds and raise the minimum investment requirements for both funds of funds and traditional hedge funds. Third, to prevent the risk of market collapse, the SEC should restrict hedge funds' use of leverage by requiring that such use does not exceed a maximum leverage ratio.

#### *A. Preventing Fraud*

To prevent fraud, the SEC should require all hedge fund advisers to register with the Commission.<sup>270</sup> Such registration would allow the SEC to examine hedge funds with less than \$30,000,000 worth of investments.<sup>271</sup> Consequently, the Commission

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<sup>264</sup>See PRESIDENT'S WORKING GROUP, *supra* note 75, at 29 ("The LTCM episode well illustrates the need for . . . hedge funds, to face constraints in the amount of leverage they can assume.").

<sup>265</sup>See Zimmermann, *supra* note 40, at 1 ("[T]here are many unsophisticated investors who have the financial means to qualify.").

<sup>266</sup>*Id.*

<sup>267</sup>*Id.*

<sup>268</sup>*Id.*

<sup>269</sup>See *supra* text accompanying notes 83-138.

<sup>270</sup>See Gangahar, *supra* note 241.

<sup>271</sup>*Id.*

would be empowered to monitor and audit hedge fund advisers who have been charged with nearly half of the counts of hedge fund fraud.<sup>272</sup>

To prevent fraud, the SEC should also adopt a risk-based approach for conducting audits. The reason the SEC must exempt from registration hedge fund advisers with fewer assets is because their system of random audits contains excessive administration costs. Instead of using this cyclical approach, the SEC should adopt a risk-based system to determine which hedge funds pose the highest risk of fraud.<sup>273</sup> In fact, the Commission is trying to develop such a system for all investment advisers, which will be specifically designed for the investment vehicle offered by each registrant.<sup>274</sup> Under this system, risk factors for fraud would be developed for each investment vehicle.<sup>275</sup> Then, when investment advisers exhibited one or more of the risk factors, the SEC would be prompted to audit the fund.<sup>276</sup> With respect to hedge funds, the SEC ought to conduct mini sweeps of hedge fund advisers to determine what criteria to use in this risk-assessment model.<sup>277</sup> Such a system should be adopted because it allows the Commission to audit those funds that create the highest risk of fraud while conserving resources on funds that are complying with regulations.

Finally, to prevent fraud, the SEC should impose guidelines for assessing which funds to audit. A fundamental part of the risk-based approach should result in the Commission examining Form ADV to determine whether the hedge fund has listed a legitimate auditor and broker-dealer and to ascertain whether the fund has any affiliation with these firms.<sup>278</sup> A legitimate auditor and broker-dealer would need to be an established business with a proven track record rather than a start-up company.

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<sup>272</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,096 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) (Glassman, Comm'r, & Atkins, Comm'r, dissenting).

<sup>273</sup>*Regulation of the Hedge Fund Industry: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 108th Cong. 13 (2004) (statement of William H. Donaldson, Chairman, U.S. SEC), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108\\_senate\\_hearings&docid=f:29308.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_senate_hearings&docid=f:29308.pdf). Donaldson gave this testimony to support the release, issued thirteen days later, which proposed amendments to the Investment Advisers Act.

<sup>274</sup>*Id.*

I have asked the staff to develop a phased approach to oversight and examination of our investment adviser registrants, including hedge fund advisers. Toward that end, we have formed a working group within the Commission which is comprised of senior staff from different offices and divisions within the Commission to explore how the Commission goes about overseeing investment adviser registrants in general and specifically including hedge fund advisers.

*Id.*

<sup>275</sup>*Id.*

<sup>276</sup>*Id.*

<sup>277</sup>*Id.* (“[O]ur examination staff could conduct mini-sweeps of hedge fund advisers to garner critical information about hedge fund services.”).

<sup>278</sup>Jenny Anderson, *A Modest Proposal to Prevent Hedge Fund Fraud*, N.Y. TIMES, Oct. 7, 2005, at C6.

The effectiveness of basing inspections on this information is best exemplified by re-examining the fraud perpetrated by Bayou and Wood River.<sup>279</sup>

Wood River listed a former American Express unit as their outside auditor, but that company did not audit the fund.<sup>280</sup> Had the SEC used the legitimate auditor criteria to assess the risk of fraud created by Wood River, the Commission would have been prompted to audit the fund. With respect to Bayou, its auditor was a fictitious accounting firm that was affiliated with the fund.<sup>281</sup> If the SEC had used the affiliated auditor criteria to inspect the fund, the discovery of this auditor would have caused the Commission to examine Bayou. The results of these methods are similar regarding the firms' broker-dealers. Bayou's broker-dealer, Bayou Securities, was a dealer affiliated with the fund.<sup>282</sup> Had the SEC employed a risk-based system using the criteria of an affiliated broker, it would have been prompted to examine Bayou. With respect to Wood River, the company claimed as a broker-dealer a firm that never executed any of its trades.<sup>283</sup> If the SEC used the legitimate broker-dealer risk criteria, they would have conducted an examination of Wood River.

Wood River and Bayou illustrate that it is difficult for a hedge fund adviser to commit fraud when it has legitimate and nonaffiliated auditors and broker-dealers.<sup>284</sup> By implementing a risk-based system, it is likely that audits of advisers can be conducted annually or bi-annually at the same cost as the current system of cyclical examinations. The result will be the auditing of the highest-risk advisers more frequently<sup>285</sup> at the same cost.

#### *B. Restrict Average Investors Access to Funds of Funds*

To restrict average investors' access to funds of funds, the SEC should adopt the "qualified client" criteria for funds of funds. The SEC should require that investors in funds of funds be "qualified clients" rather than "accredited investors." The "accredited investor" standard<sup>286</sup> allows average investors to invest in funds of funds. On the other hand, the "qualified investor" standard strikes the appropriate balance between preventing average investors from investing in hedge funds and allowing sophisticated individuals to make such investments. Moreover, the SEC has already considered the "qualified investor" definition to be the correct standard for traditional hedge funds.<sup>287</sup> Using the same standard will simplify the regulation of this industry. Such uniformity will also reduce the confusing and conflicting nature of these requirements for investors because they do have quite different standards. Additionally, this standard is proper because funds of funds indirectly charge profit

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<sup>279</sup>*Id.*

<sup>280</sup>Hibbard & Carter, *supra* note 88, at 38.

<sup>281</sup>*Id.*

<sup>282</sup>*Id.*

<sup>283</sup>*Id.*

<sup>284</sup>Anderson, *supra* note 278, at C6.

<sup>285</sup>*See generally supra* note 274.

<sup>286</sup>*See supra* note 36.

<sup>287</sup>*See supra* text accompanying notes 190-202.

participation fees and the “qualified investor” standard was specially designed for funds that charge such fees.<sup>288</sup>

Other alternatives for increasing the requirements to invest in funds of funds are inappropriate because they interfere with the regulation of other investment vehicles. For example, changing the definition of an “accredited investor” to the definition of a “qualified investor” is not appropriate because it interferes with the use of this standard by private equity funds. Similarly, changing the definition of an “accredited investor” to that of a “qualified purchaser” would have similar adverse effects. Because mandating that an investor be a “qualified client” to invest in funds of funds increases the requirements to a sufficient amount but does not cause interference with other investments, it is the correct standard.

To restrict average investors’ access to funds of funds, the SEC should also raise the minimum investment requirements for both funds of funds and traditional hedge funds. In addition to requiring that individuals satisfy the definition of a “qualified client” to invest in funds of funds, the SEC should mandate that all hedge funds and funds of funds have a minimum investment requirement of \$250,000. While most hedge funds impose such a requirement, some hedge funds have decreased their requirements over time.<sup>289</sup> Moreover, funds of funds already have investment minimums as low as \$25,000.<sup>290</sup> Requiring a \$250,000 minimum accompanied by the “qualified client” definition creates uniformity for hedge funds and funds of funds. This standard assures that average investors are restricted from investing in traditional hedge funds and funds of funds.

### *C. Limiting the Risk of Market Collapse*

To prevent the risk of market collapse, the SEC should restrict hedge funds’ use of leverage. While traditional hedge funds and funds of funds pose unique problems to average investors, the possibility of hedge funds causing a market crisis affects the entire financial system. Because hedge funds are exempt from the Investment Company Act, they use large amounts of leverage to engage in risky investments.<sup>291</sup> A market shift against one large fund using leverage or against small funds that use leverage and have the same investment positions could cause these funds to default on their loans.<sup>292</sup> When many debtors cannot pay creditors at the same time, it can cause the financial system to collapse.<sup>293</sup>

To stop this excessive use of borrowed money, the SEC should restrict hedge funds’ use of leverage.<sup>294</sup> The way to accomplish this goal is for the Commission to

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<sup>288</sup>*Id.*

<sup>289</sup>Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,057 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

<sup>290</sup>*See* LeBras, *supra* note 34, at 1.

<sup>291</sup>*See* PRESIDENT’S WORKING GROUP, *supra* note 75, app. A, at A-1 (“[Hedge] funds typically operate with a balance-sheet leverage of less than 2-to-1, but higher balance-sheet leverage is not uncommon.”). This means that many hedge funds have more than twice the amount of debt as compared to its number of assets.

<sup>292</sup>*See supra* text accompanying notes 133-35.

<sup>293</sup>*Id.*

<sup>294</sup>*See* PRESIDENT’S WORKING GROUP, *supra* note 75, at 29.



employ the same method used for mutual funds, which is the requirement of a maximum leverage ratio.<sup>295</sup> Like mutual funds, hedge funds have a large amount of assets invested in the markets.<sup>296</sup> However, hedge fund investments cause a greater risk of market collapse than do mutual funds due to their use of leverage and lack of diversification.<sup>297</sup> Because hedge funds are formidable in size and threaten the financial system, the SEC should limit hedge funds' use of leverage by using a maximum leverage ratio.<sup>298</sup>

An effective rate for the maximum leverage ratio would be the rate used for mutual funds. Under such regulation, hedge funds' use of debt would be limited to one-third of its investments.<sup>299</sup> For example, a hedge fund with \$3,000,000 in assets could only borrow \$1,000,000 to make investments. To enact this requirement, the SEC should amend the Investment Company Act of 1940 to require that any fund exempted from registration as an "investment company" by either section 3(c)(1) or 3(c)(7) of the Act, be subject to the leverage restrictions imposed by section 18 of the Act.<sup>300</sup>

Employing a maximum leverage ratio would limit the amount of systemic risk created by hedge funds. Systemic risk would be reduced because a hedge fund suffering large losses would have sufficient assets to pay off its debts. Therefore, if the market caused one large hedge fund or several small funds with similar positions to lose large amounts of money, the fund or funds could still pay their creditors. Because funds would be able to pay their creditors, these funds would not default on their loans. The problem of systemic risk would be eliminated and a situation analogous to the collapse of Long-Term Capital Management would be unlikely to occur.

#### VIII. CONCLUSION

Hedge funds are a viable investment alternative for financially sophisticated investors. However, because traditional hedge funds and funds of funds are unsuitable for average investors, these investors should be restricted from making such investments. Regardless of who invests in hedge funds, advisers of these entities must be regulated to assure that they do not commit fraud. In addition to monitoring advisers, the SEC must limit hedge funds' use of leverage to assure that market collapse does not occur.

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<sup>295</sup>See *id.* app. A, at A-1.

<sup>296</sup>*Id.* at 1-2.

<sup>297</sup>See *supra* text accompanying notes 99-100.

<sup>298</sup>See Jonathan H. Gatsik, Note, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591, 621 (2001). See generally PRESIDENT'S WORKING GROUP, *supra* note 75, at 42 ("For highly leveraged hedge funds, regulatory restraints . . . could serve to constrain more effectively their degree of leverage and the probability of a failure with systemic implications.").

<sup>299</sup>See PRESIDENT'S WORKING GROUP, *supra* note 75, app. A, at A-1 ("In practice, a mutual fund's debt effectively may not exceed 33 1/3% of its total assets.").

<sup>300</sup>15 U.S.C. § 80a-18 (2000).

While the amendments to the Investment Advisers Act addressed some of the problems created by hedge funds, it is insufficient to regulate these entities. More SEC action is needed to adequately protect investors from the problems created by hedge funds. While some of these actions were suggested in this Note, more measures are necessary to effectively regulate this growing industry.

#### IX. ADDENDUM

In *Goldstein v. SEC*,<sup>301</sup> the Court of Appeals for the District of Columbia vacated the amendments to the Investment Advisers Act holding that the rule was “arbitrary.”<sup>302</sup> The hedge fund challenging the law successfully argued that the SEC misinterpreted section 203(b)(3) of the Advisers Act when it redefined the word “client” to include shareholders, limited partners, members, or beneficiaries of a “private fund.”<sup>303</sup> The court reasoned that both Congress and the SEC had historically and recently concluded that individuals such as limited partners or shareholders are not “clients” for purposes of the Advisers Act.<sup>304</sup> It further pointed out that it was “arbitrary” for funds with one hundred or fewer investors to be exempt from the more demanding Investment Company Act, while those with fifteen or more investors were subject to the Advisers Act.<sup>305</sup> Consequently, the court vacated and remanded the Amended Investment Advisers Act.<sup>306</sup>

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<sup>301</sup>*Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

<sup>302</sup>*Id.* at 884.

<sup>303</sup>*Id.* at 878.

<sup>304</sup>*Id.* at 880.

<sup>305</sup>*Id.* at 884.

<sup>306</sup>*Id.*