January 2008

How Arbitrary Really Was the S.E.C.'s "Hedge Fund Rule"? The Future of Hedge Fund Regulation in Light of Goldstein, Amaranth Advisors, and Beyond

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Hess: How Arbitrary Really Was the S.E.C.'s "Hedge Fund Rule"? The Future of Hedge Fund Regulation in Light of Goldstein, Amaranth Advisors, and Beyond

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I. INTRODUCTION

A hedge fund is most commonly described as “any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.”\(^1\) Hedge funds are sexy! Their attractive “secret society”\(^2\) mystique paired with the appeal of earning lucrative amounts of absolute profit for wealthy, business savvy investors has the securities industry (namely the Securities and Exchange Commission (the “SEC”)) and even the greater investing public shining their inquiring spotlight directly toward these largely unregulated investment devices.\(^3\) This attention should come as no surprise to the advisers of hedge funds or their individual investing “clients”\(^4\) because of (1) the ever multiplying size of the hedge fund industry, (2) the amount of assets hedge fund adviser’s have under their control, (3) the potential impact that hedge fund investments could have on the financial markets in the United States, and (4) the recent calamities surrounding the disastrous financial losses suffered by an unregulated “high-end” hedge fund.\(^5\) Today, there are some 9,700 hedge funds operating in the United States, with

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\(^1\) Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006) (citing THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999)). This definition may be the one most commonly used, but there are many more. For a substantial listing of various hedge fund definitions, see SEC Roundtable on Hedge Funds (May 13, 2003) (comments of David A. Vaughan), available at www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm. Hedge funds, like mutual funds, are “engaged in the business of issuing securities to investors and investing their assets into pools of securities, which are managed by . . . [the hedge fund’s] investment adviser.” Jay Crenshaw, HEDGE FUNDS: REGULATORY, TAX, AND ORGANIZATIONAL CONSIDERATIONS, 18 FLA. J. INT’L L. 359, 363 (2006). See infra Part II.

\(^2\) Hedge funds are investment devices utilized mostly by wealthy, sophisticated individuals and institutions. Hedge funds have significant minimum investment requirements and are not publicly advertised; therefore, a hedge fund can be aptly described as being a “secretive” investment opportunity not available to the general investing public. See infra Part II for a “foundational” discussion of hedge funds and their “secretive” investing strategies.

\(^3\) For all intents and purposes a hedge fund and its adviser are exempted from SEC regulation under the federal securities laws. See infra Part II.C for a detailed explanation of how hedge funds avoid, for the most part, SEC regulation.

\(^4\) We will see that a major point of contention in the hedge fund industry surrounds determining how to classify those individuals or institutions that actually invest their money in hedge funds. For most securities advisers, such as those who advise mutual funds, those individuals or institutions that invest are known as “clients;” however, in the world of hedge funds, those individuals or institutions that invest in a hedge fund are known simply as “investors” of the fund, not the “clients” of the hedge fund’s adviser. See infra Parts III.B & IV.

\(^5\) For a discussion of the multi-billion dollar losses suffered by the hedge fund Amaranth Advisors, see infra Part V (B).
roughly $1.7 trillion of assets invested in them. These totals are higher than those of only a few years ago, and they are considerably greater than estimates of a decade before. Furthermore, due to hedge funds’ “celebrity persona” with the investing public, and with over 300 hedge fund advisers individually managing more than $1 billion in assets, hedge funds that fail to provide their investors with above market-rate returns, or actually lose billions of dollars of investor assets through bad or unduly risky investments, are being viewed by the SEC with an increasingly more scrutinizing, but wholly non-regulating, lens.

Unlike many of their investment counterparts, hedge fund investment advisers are exempt from registering the hedge funds they advise with the SEC under the framework and exemptions of the federal securities laws. Thus, hedge fund advisers are not required to provide public financial disclosures, appropriately inform investors of their trading strategies or current investment positions, or subject themselves to SEC oversight and periodic examination. However, in 2004, a sharply divided SEC adopted a new regulation, known as the “hedge fund rule,” that redefined how a hedge fund adviser’s clients were to be counted. Ultimately, the hedge fund rule had the effect of requiring most hedge fund advisers to register with the SEC under the Investment Advisers Act of 1940 (the “IAA”) and come under its regulatory supervision. Less than six months after this “hedge fund rule” went into effect, the United States Court of

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6 Tom Petruno, A Closed Door Policy at Hedge Funds, L.A. TIMES, Aug. 2, 2007. Just a little over a year ago, these totals were 8,800 and $1.2 trillion respectively; therefore, the rapid growth of the hedge fund industry continues to this day. See Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 109th Cong. (July 25, 2006) (statement of Christopher Cox, Chairman, SEC) [hereinafter Cox Testimony]. See also Reuters, Money Still Flowing Into Hedge Funds—Survey, July 23, 2007, available at www.reuters.com /article/marketsnews/idukn2337385520070723?rpc=44 (in the first two fiscal quarters of 2007, investors poured approximately $118.7 billion into the hedge fund industry).

7 Willa E. Gibson, Is Hedge Fund Regulation Necessary?, 73 TEMP. L. REV. 681, 685 (2000) (In 1998, there were only an estimated 3,000 hedge funds in business with $200—$300 billion in capital invested in them).

8 Alex R. McClean, The Extraterritorial Implications of the SEC’s New Rule Change To Regulate Hedge Funds, 38 CASE W. RES. J. INT’L L. 105, 114 (2006) (In 1990, there were only 300 known hedge funds operating within the U.S. financial markets). See Reuters, supra note 6 (In 1990, these 300 hedge funds had only a “mere” $39 billion in assets invested in them.).


10 See infra Parts III & IV.

11 See infra notes 23, 27 and accompanying text. See infra Part II.C for a detailed discussion of how hedge fund investment advisers avoid having to register the hedge funds that they advise under the federal securities laws.

12 Codified at 17 C.F.R. pts. 275, 279 (2004). See infra Parts III, IV, and V.


14 SEC Final Rule, 1517 PLI/Corp 335, 360 (2005) [hereinafter SEC Final Rule] (hedge fund advisers required to register with the IAA under the “hedge fund rule” had until Feb. 1, 2006 to register with the SEC).
Appeals for the D.C. Circuit vacated the hedge fund rule in Goldstein v. S.E.C., holding that it was an arbitrary and unreasonable exercise of the SEC's regulatory power that was outside the scope of its own prior interpretation of the IAA. With one quick blow Goldstein knocked the air out of the SEC's first significant attempt to regulate hedge funds and their advisers—leaving a vacuum of uncertainty over whether, and to what extent, hedge fund regulation is permissible to protect the U.S. financial markets and its investors. Two months later the SEC, led by its new Chairman, Christopher Cox, declined to appeal the Goldstein decision to the United States Supreme Court. Less than four months later a large, Connecticut based hedge fund, Amaranth Advisors, would lose, in less than a month, over 60% of its total net assets ($6.5 billion of its investor's money) and be forced to liquidate all of its remaining holdings due to brash natural-gas investments that went sour in what has since been coined the "biggest ever hedge fund meltdown." Thus, after Goldstein and the sudden implosion and hasty liquidation of Amaranth Advisors, the question remains: is there a need for hedge fund regulation or would such regulation simply be arbitrary?

This Article will address the current state of hedge fund regulation after Goldstein and will analyze what potential regulatory options the SEC may have at its disposal to rein in the wholly unregulated hedge fund industry, especially in light of Amaranth. Section II of this Article will serve as a brief introductory overview of the hedge fund industry; a hedge fund will be defined, its strategies and financial benefits described, and its previous SEC treatment under the federal securities laws detailed. Section III will briefly discuss the lead up to, and the passage of, the SEC's "hedge fund rule," and it will establish and consider the almost instantaneous criticisms that were raised against it. Section IV will analyze the United States Court of Appeals for the District of Columbia Circuit's decision in Goldstein v. SEC, which vacated the SEC's "hedge fund rule." Finally, Section V of this Article will address the impact that the Goldstein decision had on the hedge fund industry, and it will analyze the latest efforts to reign in the hedge fund industry in light of Goldstein and the devastating losses suffered by Amaranth Advisors and its investors.

II. HEDGE FUND "FOUNDATIONS"

A. A "Hedge Fund" Defined

As stated at the outset of this Article, a hedge fund is most commonly described as "any pooled investment vehicle that is privately organized, admin-

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15 451 F.3d 873 (D.C. Cir. 2006).
16 Id. at 883. See infra Part IV.
istered by professional investment managers, and not widely available to the public."19 Assuming that these pooled investments are referred to as "hedge funds," one skilled in the art of investment would be quick to believe that a hedge fund's primary investment strategy consists of "hedging" risks.20 However, that is no longer the case. Today, hedge fund advisers can employ dozens of investing strategies, including or in addition to traditional hedging;21 therefore, defining what a hedge fund is based on its investment strategies provides no baseline characterization. Instead, a proper and more understandable definition of a hedge fund can be achieved by considering a hedge fund's organizational and management structure.22

Hedge funds are commonly organized as private limited partnerships so as to (1) avoid falling "victim," or so they contend, to SEC registration and oversight by utilizing various exemptions and safe harbors under the federal securities laws,23 and (2) to avoid the fund itself, as a distinct legal entity, from having to be taxed for the earnings it generates.24 Therefore, as a private limited partnership, a hedge fund has its profits taxed only at the level of the individual investor.25 These two benefits, among other things, allow hedge fund advisers to maintain their mysterious investing behaviors26 and maximize profits for their

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19 See supra note 1.
20 A "hedge" is "an investment that is taken out specifically to reduce or cancel out the risk in another investment." Wikipedia.com, Definition of Hedge, http://en.wikipedia.org/wiki/hedging (last visited Nov. 16, 2007) (defining "hedge"). See McClean, supra note 8, at 108 ("hedging" means "[t]aking a position in two or more securities that are negatively correlated to reduce risk") (quoting Stephen A. Ross et al., Corporate Finance, 262-64 (6th ed. 2002)). See Jacob Preiserowicz, The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?, 11 Fordham J. Corp. & Fin. L. 807, 809 (2006) (defining a "hedging" strategy as the "purchasing of [a] security and [then] taking an offsetting position in a related security" so as to reduce ("hedging") the overall risk of loss on the investment considered as a whole). A common example of a hedge fund "hedging" its risk is where the fund invests in both long and short equity positions. Scott J. Lederman, Hedge Funds, in Financial Product Fundamentals: A Guide for Lawyers 11-3 to -5 (Clifford E. Kirsch ed., 2000).
21 See infra Part II.B for a discussion of the various investing strategies employed by hedge fund advisers.
22 Lederman, supra note 20.
23 Preiserowicz, supra note 20, at 811-12. The securities laws that hedge funds avoid by structuring themselves as private limited partnerships are, namely, the U.S. Securities Act of 1933 [hereinafter the Securities Act], the U.S. Securities and Exchange Act of 1934 [hereinafter the Exchange Act], the Investment Company Act of 1940 [hereinafter the ICA], and the IAA. For a detailed discussion of how hedge funds are organized so as to qualify for the IAA's "private adviser exemption," see infra Part II.C.
24 SEC Staff Report to the SEC: Implications of the Growth of Hedge Funds, at 9, n.27 (Sept. 2003) [hereinafter SEC Staff Report].
25 Id.
26 See infra Part II.B for a discussion on the various investing behaviors utilized by hedge fund advisers.
high-profile investors without any considerable SEC oversight.\textsuperscript{27} Unlike mutual funds or other investment companies that sell shares to their investors, the investors in a hedge fund serve as actual partners in the private partnership and receive a proportionate share of the hedge fund’s profits while only being liable for the losses of assets that they personally invest into the fund.\textsuperscript{28} The hedge fund “adviser,”\textsuperscript{29} who also usually invests a lot of his or her own personal fortune into the fund, serves as the hedge fund’s general partner and bears the risk of unlimited liability for the fund and its assets or debts.\textsuperscript{30} But, it is important to keep in mind that in exchange for this added risk, hedge fund advisers are compensated handsomely. Hedge fund advisers make an inordinate amount of money off of the investments that they make on behalf of the hedge funds that they advise,\textsuperscript{31} it is not uncommon for a successful hedge fund adviser to make

\textsuperscript{27} Because hedge funds organize themselves around the many exemptions in the federal securities laws, their investors must meet certain net-worth and/or investment levels, as required under these exemptions, so as to avoid SEC registration. To avoid regulation under the ICA:

\begin{quote}
[H]edge funds rely on one of two exclusions from the definition of investment company.
The first exclusion is available to hedge funds that have 100 or fewer investors. The second exclusion applies to hedge funds that sell their interests only to highly sophisticated investors. To rely on either exclusion, the hedge fund must restrict its offerings so that they meet the requirements for non-public offerings.
\end{quote}

SEC Staff Report, supra note 24, at IX. See SEC Staff Report, supra note 24, at 11-13. See Gibson, supra note 7, at 696-99. See also McClean, supra note 8, at 116, 117 (citing SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953) (whether an offering is non-public depends on whether or not the offerees are considered accredited, in that the offerees have to be sophisticated enough to obtain and analyze the financial data from the offeror that would be disclosed had the offeror been registered with the SEC)). To avoid regulation under the Securities Act:

\begin{quote}
[H]edge funds may not offer their securities publicly or engage in [any] public solicitation.
Instead, hedge funds generally sell their interests in private offerings . . . [by] sell[ling] their interests to an unlimited number of “accredited investors.” Accredited investors include individuals with a minimum annual income of $200,000 . . . or $1 million in net worth and most institutions with $5 million in assets.
\end{quote}

SEC Staff Report, supra note 24, at X. See SEC Staff Report, supra note 24, at 13-18. See Gibson, supra note 7, at 688-91. See also Preiserowicz, supra note 20, at 814-16. Hedge funds also avoid SEC regulation under the Exchange Act, see SEC Staff Report, supra note 24, at 18-20. See also Gibson, supra note 7, at 691-93.

\textsuperscript{28} Preiserowicz, supra note 20, at 812.

\textsuperscript{29} The IAA defines an “investment adviser” as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . .” 15 U.S.C. § 80b-2(a)(11) (2006).

\textsuperscript{30} Id.

\textsuperscript{31} A hedge fund adviser gets paid essentially two times for his or her “investment advice.” First, the adviser makes an “investment management fee,” usually one to two percent of the hedge fund’s net assets. SEC Staff Report, supra note 24, at 61. And, unlike advisers of other investment vehicles, the hedge fund adviser, as the general partner of the hedge fund, makes an “incentive allocation” of partnership earnings and profits (known in the industry as the adviser’s “performance fees”) that total typically around 20% of the hedge funds yearly net income. Id. There-
tens of millions of dollars in one year as compensation for his investment expertise.

B. Typical Hedge Fund Investing Strategies and Benefits

Hedge fund advisers are in the business of making money for their investors. In fact, the benchmark for any hedge fund adviser's investing strategy is to achieve an "absolute return" for their investors by generating profits for the hedge fund regardless of what way the markets are moving. To ensure that they can provide this positive absolute return, hedge fund advisers engage in a wide variety of investment strategies. And, because hedge funds are wholly unregulated by the SEC, hedge fund advisers are "essentially free to employ any (legal) [investment] strategy that they please," no matter what the risk, in order to meet the higher, above market, levels of return expected from their savvy investors. To generate these returns, hedge fund advisers will typically engage in three types of investing strategies: relative value, event driven, and opportunistic investing. First, under a relative value strategy, a hedge fund adviser will attempt to generate returns "by extracting profits from the price inefficiencies in specific financial instruments . . . [which] occur when the price of the financial

fore, just like any other investment adviser, a hedge fund adviser does not get paid unless his or her investors get paid. However, the difference is that hedge fund advisers have much more of a fiscal incentive to make money for the hedge funds they advise; therefore, there is the increased risk that a hedge fund adviser's personal monetary objectives may come into conflict with those of the investors in the hedge fund they advise. For limitations on a hedge fund adviser's "incentive allocation," see id. at 62-63.

By no means is this an exhaustive overview of the investment strategies of hedge fund advisers or the benefits derived from such strategies. The purpose of this Subsection is only to establish a background for which the reader of this Note may be better able to understand the need, if any, for SEC regulation over the hedge fund industry based on a hedge fund's typical investment strategies. For such a discussion, see infra Parts III-V.

Jonathan Bevilacqua, Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds, 54 BUFF. L. REV. 251, 259 (2006). A hedge fund adviser's investing strategy is one that:

[emphasizes] . . . absolute returns as opposed to relative returns. While registered investment vehicles such as mutual funds measure their success by relative returns and performance in relation to a benchmark such as the [Dow Jones or the] S&P 500 (even if this may be accomplished with a negative return), hedge funds are striving to meet a certain level of expected return for the investor, regardless of the market's current performance.

Preiserowicz, supra note 20, at 809.


SEC Staff Report, supra note 24, at 4.

Preiserowicz, supra note 20, at 813.

Id. at 808-10.

McCLean, supra note 8, at 110. See Gibson, supra note 7, at 685-88.
Instruments differs from its historical value." To accomplish this, the adviser will, assuming securities are historically undervalued, take a long position in an undervalued security and a short position in an overvalued security with the hope that one position will surpass the other. Second, under an event driven strategy, a hedge fund adviser will attempt to generate a return to his or her investors by taking “financial positions based on whether a [certain] company will or will not go through a structural change,” such as a merger or acquisition, which could ultimately affect the restructured company’s stock price. To do this, the adviser will take a long position in such a company hoping that the value of its debt or equity securities will increase due to the company’s likely restructuring. Finally, under an opportunistic investing strategy, a hedge fund adviser will attempt to make his investors a profit by manipulating the markets through the use of short selling funds, emerging market funds, long/short funds, etc. This strategy is contentious—advisers are making the market a “puppet” and getting it to do what they want in order to maximize profits for their investors. To the adviser’s investor such a strategy is brilliant; to the market such a strategy is manipulative and self-centered in that advisers are attempting to play both sides of the market at the same time.

In all three of these general investment strategies, hedge funds make use of, to varying degrees, their secret weapon—leverage. Leverage is, basically, the hedge fund’s debt-to-asset ratio maintained by the fund’s adviser. It enables the adviser to borrow money without collateral, so to speak, in order to increase the fund’s market exposure and potentially increase the fund’s profits; however, the use of leverage magnifies a hedge fund’s potential risk of loss. Unlike other SEC registered investment vehicles, unregistered and unregulated hedge funds’ use of leverage is not restricted. Therefore, a hedge fund adviser willing to take a big risk by taking on more leverage can obtain huge profits for the fund and its investors; but, one bad and highly leveraged investment could

39 McClean, supra note 8, at 110.
40 Gibson, supra note 7, at 685 n.29.
41 McClean, supra note 8, at 110.
42 Gibson, supra note 7, at 686 n.30.
43 McClean, supra note 8, at 110-11.

Many hedge funds employ strategies that involve betting on one asset against another asset. One might bet on ice-cream stocks rising, winter-parka stocks falling and then pray for warm weather. Another might bet against government debt with low interest rates, invest in company bonds with high interest rates and hope corporate finances stay healthy.

45 Id.
46 Id.
47 Id.
spell catastrophe for the hedge fund and, if the hedge fund was extremely leveraged, the financial markets as a whole.48

As mentioned above, the goal of a hedge fund adviser is to achieve an absolute positive return for his or her wealthy investors. Advisers are able to achieve this goal generally through investment strategies focused towards market neutrality, namely by ensuring investor returns regardless of how the stock market is performing.49 To this end, hedge funds benefit U.S. financial markets in many ways.50 “[Hedge funds] contribute substantially to . . . market efficiency . . . and liquidity.”51 Namely, hedge funds provide liquidity in that they invest “substantial sums [of assets] in otherwise illiquid markets and . . . take positions, formulate strategies, and make trades based on sophisticated and extensive market research. [H]edge funds provide markets with price information.”52 They “act as risk absorbers . . . by serving as ready counterparties to those wishing to hedge their risk, even when the markets are volatile. In addition their active trading and research contribute to greater pricing efficiencies.”53 Furthermore, “hedge funds also can serve as an important risk management tool for investors by providing valuable portfolio diversification. Hedge fund investment strategies are typically designed to protect investment [capital] . . . [and] to preserve wealth;”54 therefore, their “hedging” investment strategies often appeal to investors with other investments carrying more inherent risk.

48 The $3.5 billion dollar loss to the hedge fund Long-Term Capital Management in 1998 resulted from it being leveraged at a debt-to-asset ratio upwards of 50 to 1. O’Halloran, supra note 44, at n.18. For a detailed discussion and analysis of the Long-Term Capital Management’s leveraged implosion, and its effect on the financial markets, see Justin Asbury Dillmore, Comment, Leap Before You Look: The SEC’s Approach to Hedge Fund Regulation, 32 OHIO N.U.L. REV. 169, 170-74 (2006). It must be noted that a hedge fund may suffer huge losses even though the fund itself refrained from highly leveraged positions. For a further discussion on the dynamics surrounding the implosion of a hedge fund due to a “bad” bet, see infra Part V, in which the recent liquidation of the hedge fund Amaranth Advisors will be discussed in detail.

49 McClean, supra note 8, at 111. But, it is worth noting that, at least as of late, hedge fund returns have been volatile and, once the investment adviser is compensated with 20% of the hedge fund’s profits, typical investor returns have recently lagged behind those produced within the broader stock market. Gregory Zuckerman et al., Fortress’s IPO Bonanza May Draw Private-Equity Firms to Market, WALL ST. J., Feb. 10-11, 2006, at A1 (hedge funds returned, on average, 12.9% to investors in 2006, behind overall returns to investors in the broader stock market).

50 Cox Testimony, supra note 6.

51 Id.

52 O’Halloran, supra note 44, at 465.

53 McClean, supra note 8, at 114.

Many hedge fund advisers take speculative trading positions on behalf of their managed hedge funds based on extensive research about the true value or future value of a security . . . . Because securities markets are dynamic, the result of such trading is that market prices . . . will move toward their true value . . . . [This] bring[s] [correct] price information to the securities markets, which can translate into market price efficiencies.

SEC Staff Report, supra note 24, at 4.

54 SEC Staff Report, supra note 24, at 5.
C. How Hedge Funds Avoid Regulation under the IAA

As stated above, the adviser (general partner) of a hedge fund will organize the fund as a limited liability partnership in order to avoid SEC registration and oversight under the various federal securities laws, namely the Securities Act, the Exchange Act, the ICA, and the IAA. Each of these federal securities laws, their exemptions and how hedge funds have utilized them are important to understanding how hedge funds are ultimately structured to avoid SEC registration and oversight; however, due to United States Court of Appeals for the D.C. Circuit’s decision to vacate the SEC’s “hedge fund rule” under the IAA in Goldstein v. SEC, this Article will focus solely on the IAA, its private adviser exemption and how hedge fund advisers employ the exemption to avoid SEC oversight.

Pursuant to the IAA, “it shall be unlawful for any investment adviser, unless [already] registered [with the SEC] . . . , to make use of the mails or any means or instrumentality of interstate commerce in connection with his or [her] business as an investment adviser.” Thus, the IAA requires that all “investment advisors” register with the SEC and, as a result, disclose certain information and documents that are “necessary or appropriate . . . [for protecting] investors.” This IAA registration requires advisers to maintain certain business records, deliver to clients a disclosure prospectus before they invest, and avoid engaging in any fraudulent activity when providing investment advice to the investors of the fund in which the adviser manages. IAA registration creates a fiduciary relationship between the investment adviser and his or her clients and requires the adviser to “disclose any material conflicts the adviser has with [his or her] clients, to seek [the] best execution for client transactions, and to have a reasonable basis for client recommendations.” Finally, an investment adviser that registers under the SEC is “subject at any time . . . to such reasonable . . .

55 Preiserowicz, supra note 20, at 811.
56 See infra Part IV.
57 For an explanation of how hedge funds avoid SEC regulation under the Securities Act, the Exchange Act, and the ICA, see supra note 27.
59 See supra note 29.
60 15 U.S.C. § 80b-3(c)(1) (2006). See 15 U.S.C. § 80b-3(c)(1)(A)-(H) (listing the information that an adviser is initially required to disclose to the SEC when registering under the IAA). Specifically, the adviser’s registration must disclose to the SEC “the nature of the business of such . . . adviser, including the manner of giving advice and rendering analyses or reports,” “a balance sheet . . . and other financial statements,” and “the nature and scope of the authority of such . . . adviser with respect to clients’ funds and accounts.” 15 U.S.C. § 80b-3(c)(1)(C)-(E).
62 SEC Final Rule, supra note 14, at 338.
examinations . . . as the [SEC] . . . deem[s] necessary or appropriate . . ." It is this SEC regulatory oversight which, in theory, guarantees investors access to material information regarding their investment advisers and protects them from their adviser’s fraudulent investments or use of their money in any manner which is against their pecuniary interests. Therefore, the question remains: is a hedge fund’s general partner an “investment adviser” subject to SEC registration?

In 1977, that question was answered with an emphatic “yes.” In Abrahamson v. Flescher, the United States Court of Appeals for the Second Circuit held that the general partner of a hedge fund was an “investment adviser” under the IAA and was, therefore, subject to SEC registration and oversight. But, if that is the “law,” then why are the majority of hedge fund advisers not registered with the SEC? Alas, the IAA has a de minimis “private adviser exemption” that allows hedge fund advisers to escape SEC registration.

Under the private adviser exemption of the IAA, an investment adviser, including one who advises a hedge fund, does not have to register with the SEC if “[the adviser,] during the course of the preceding twelve months[,] has had fewer than fifteen clients and who neither holds [themselves] out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the IAA].” Why such an exemption from registration? First, the IAA was enacted by Congress according to the SEC’s recommendation that:

[I]nvestment advisers [were] of national concern, in that . . . their advice, counsel, publications, writings, analyses, and reports customarily relate to the purchase and sale of securities traded on national securities exchanges, . . . issued by companies engaged in business in interstate commerce, . . . [which] occur in such volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, . . . and the national economy.  

64 568 F.2d 862 (2d Cir. 1977).
67 Id. Basically, the IAA’s private adviser exemption states that a hedge fund adviser does not have to register with the SEC so long as (1) during the previous calendar year the adviser did not manage (advise) more than fourteen hedge funds (his or her “clients”); (2) the adviser does not publicly advertise or solicit investors from the general investing public, but rather privately seeks out such investors, and (3) the adviser does not manage (advise) any other type of investment vehicle that was registered with the SEC under the IAA.
Therefore, the SEC believed that investment advisers were generally engaged in a type of financial activity that greatly impacted the U.S. economy and, therefore, required SEC regulatory oversight. However, the SEC conditioned this general proposition with the private adviser exemption—investment advisers who did not engage in investment activities of such significance to affect the national securities markets should not be required to register under the IAA.  
Second, the purpose of this private adviser exemption was to “afford small groups of private investors the freedom to conduct their investment decisions in the manner they believe[d] to be most fruitful [because] ordinarily such [small groups of] investors are wealthy and financially sophisticated persons who do not need the protection that [SEC] registration is intended to provide.” But, it is important to note that the main principle behind the private adviser exemption was not to allow ultra-rich investors to escape SEC regulation, but rather to allow advisers whose activities did not have a substantial effect on the national security market to avoid being under the oversight of the SEC, regardless of how wealthy their investing clients were. By doing such, the SEC would allow those “small-time” advisers (who did not significantly impact the U.S. financial markets) to side-step SEC regulation without impeding on the SEC’s overall responsibility of protecting investors and maintaining a fair, orderly, and efficient securities market. Therefore, as per the private adviser exemption, hedge fund advisers will not have to register under the IAA if (1) they do not hold themselves out generally to the public as an investment adviser, and (2) they had less than fifteen clients during the last twelve months. But, who are the advisers’ “clients?” Remarkably, nowhere in the IAA is the term “client” defined. Therefore, through regulatory promulgation, the SEC has defined a “client” of a hedge fund adviser to include a natural person or a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization. Thus, a hedge fund adviser may count each hedge fund he or she advises as an individual client instead of each individual investor of a hedge fund

69 SEC Final Rule, supra note 14, at 339.
72 Hacker & Rotunda, supra note 70. Determining whether the adviser held themselves out to the investing public requires an assessment as to whether the security offering was “public” or “non-public,” and deciding that an offering is “non-public,” and therefore not requiring SEC registration, “should turn on whether the particular class of persons affected need the protections of the [securities laws].” Id. at n.35 (quoting SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953)). For statistics on the number of hedge fund advisers registered with the SEC under the IAA, see infra note 77.
under the adviser’s management. This “no look-through provision” allows a hedge fund adviser to directly give investment advice to up to fourteen separate hedge funds, and indirectly make investment decisions that will affect the investments of hundreds or thousands of actual individuals, and still qualify for the private adviser exemption under the IAA. So long as the adviser provides the investment advice based on the investment objectives of the hedge fund, and not the individual investors themselves who are investing in those hedge funds, this “no look-through” provision applies. The typical result of this method of counting clients is that even the largest hedge fund advisers are exempt from IAA registration and, consequently, SEC oversight.

Nevertheless, even if an adviser is exempted from registering his or her hedge fund with the SEC because they qualify for the private adviser exemption, the adviser is still subject to the IAA’s anti-fraud provisions. These provisions prohibit any investment adviser from (1) “employing any device, scheme, or artifice to defraud any client or prospective client,” (2) “[engaging] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client,” or (3) “[engaging] in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.” These anti-fraud requirements may provide the hedge fund protection against its ad-

75 Id. at n.133. In essence, the adviser may count each hedge fund as his or her client and, therefore, even the largest hedge fund advisers will be exempt from registering under the IAA so long as they do not advise more than fourteen individual hedge funds, even if those hedge funds have hundreds of investors investing in them. Goldstein v. SEC, 451 F.3d 873, 876 (2006).
77 Nonetheless, some otherwise exempted advisers have chosen to register under the IAA. Such an atypical result will occur when the hedge fund adviser has advised more than fourteen hedge funds in the past year or when the individual investors of those hedge funds under the control of the adviser demand that the adviser be registered before they will commit to investing in the funds under the adviser’s control. This demand, however, is far from being the status quo in a typical hedge fund adviser-investor relationship. As of September 2003, 48% of the hedge fund advisers listed in The Hedge Fund 100 were registered with the SEC under the IAA. SEC Staff Report, supra note 24, at n.74. In 2004, approximately 25% of all hedge fund advisers that qualified for the private adviser exemption nevertheless decided to register under the IAA. O’Halloran, supra note 44, at 470.
79 Id. (emphasis added). The IAA’s anti-fraud provisions apply to any and all investment advisers, even those who advise hedge funds, regardless of whether or not they qualify for the private adviser exemption.
82 15 U.S.C. § 80b-6(4) (2006). Furthermore, for the purposes of § 80b-6(4), the “[SEC] shall, . . . by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.” Id. See infra Parts V.C.2 - 3.
viser employing fraudulent or deceitful investment practices. They do not, however, ensure that individual investors will have access to important financial disclosures before deciding whether or not to invest in the hedge fund, nor do they provide a meaningful shelter for the hedge fund’s individual investors against similar fraud.

Many commentators believe that it is reasonable to allow hedge fund advisers to escape IAA registration and SEC regulation under the private adviser exemption because the securities laws were not enacted to protect affluent, business-minded investors who typically have close personal relationships with the advisers investing their money and who have access to the information required for them to make well-informed investment decisions. Nonetheless, at the turn of the 21st Century the SEC began to reconsider its promulgated position that hedge fund advisers should be exempt from registration via the private adviser exemption, in part because of (1) the 1998 hedge fund implosion of Long-Term Capital Investment, (2) the public blame put on the SEC after the Enron and Worldcom corporate debacles, (3) the rapid increase in the number of hedge funds and the amount of invested assets under the control of hedge fund advisers, and (4) the fear that the lack of oversight over hedge funds could pose a potential risk to individual hedge fund investors and to the U.S. financial markets. As a result, the then-Chairman of the SEC, William Donaldson, asked his staff to prepare for the SEC Commissioners a report recommending what, if any, increases in regulation should be taken to reign in hedge funds under the umbrella of the SEC’s purview. His staff came back with such a report, and, less than two years later, the SEC promulgated a regulation under the IAA, known as the “hedge fund rule,” which changed how the number of clients of a hedge fund adviser were counted and (more importantly) required the majority of hedge fund advisers to register with the SEC under the IAA.

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83 See Cox Testimony, supra note 6 (“[H]edge funds today remain subject to SEC regulations and enforcement under the antifraud . . . provisions of the federal securities laws . . . . Hedge funds are not, should not be, and will not be [totally] unregulated”).
84 See infra Parts III.A - B.
85 See infra Parts V.C.2 - 3.
86 Hacker & Rotunda, supra note 70.
87 See Dillmore, supra note 48.
89 See supra notes 6-9 and accompanying text.
90 See infra Part III.B.
III. The SEC’s 2004 “Hedge Fund Rule”—From Staff Report to Promulgation

A. “The Implications of the Growth of Hedge Funds”—The SEC’s 2003 Staff Report

In 2002, Chairman Donaldson requested that the SEC’s staff investigate the growth of hedge funds in the United States. Specifically, the staff investigated (1) the recent amazing increase in the number of hedge funds, (2) the increased interest of institutional investors, the coined "retailization" of hedge funds; (3) the SEC’s lack of information about hedge funds and their advisers due to the IAA’s private adviser exemption, and (4) if this lack of information prevented the SEC from ensuring that material information was made available to hedge fund investors to assist them in making the fully informed investment decision of whether or not to invest in a particular hedge fund. After a two year investigation, the SEC’s staff primarily recommended that the SEC should “[amend] Rule 203(b)(3)-1 under the [IAA] to require hedge fund advisers to ‘look through’ any hedge funds that they manage and count each separate investor as a client [for purposes of determining if a hedge fund adviser is eligible for the private adviser exemption].” The SEC staff believed an amendment to

91 See supra notes 6-9 and accompanying text.
92 SEC Staff Report, supra note 24, at VII-X. The SEC Staff Report details major concerns with the growth of the hedge fund industry. Id. at 76-83. First, the SEC’s staff was concerned that it lacked sufficient regulatory oversight over hedge funds and their advisers. Id. Second, the SEC’s staff was concerned that this lack of oversight prevents the SEC from having any meaningful information about how many hedge funds exist in the U.S., how much assets hedge fund advisers control, what investment practices hedge fund advisers were utilizing throughout the securities markets, and what affect, if any, such practices could have on the U.S. financial markets. Id. Third, the SEC’s staff was anxious about the possible increase of hedge fund “retailization” (institutional investment in hedge funds from non-typical hedge fund investors, such as pension funds, endowments, universities, and other public investment funds, i.e. mutual funds, investing in hedge funds (“funds of hedge funds”)), and the likely increase of less sophisticated investors purchasing interests in hedge funds as a result of such “retailization.” Id. Fourth, the SEC’s staff was concerned that there was a lack of sufficient disclosure in that investors may not always receive material information regarding the adviser and their management of the hedge fund. Id. Finally, the SEC’s staff feared that hedge fund advisers were investing their investor’s assets in ways contrary to the financial interests of their investors and for their own pecuniary benefit. Id.
93 Id. at 89. In all, the SEC Staff Report put forth nine recommendations for the SEC to consider regarding hedge funds, the regulation of hedge funds, and the possible effects that hedge funds could have on U.S. financial markets. See id. at 89-103. For purposes of this Note, the Staff Report’s major recommendation of requiring hedge fund advisers to register under the IAA is probative; but, it is worth noting that three of the Staff Report’s recommendations specifically were tailored for the benefit of the individual investor. First, the Staff Report recommended that the SEC should require all hedge fund advisers to provide financial disclosure prospectuses to investors before they invest in the hedge fund. Id. at 97-99. Second, the Staff Report recommended that individual investors that invest in “funds of hedge funds” should be informed by the investment vehicle that they are investing in what the hedge fund adviser will collect as their “performance fee” for the assets the initial fund invests in the hedge fund. Id. at 99-100. Finally,
Rule 203(b)(3)-1 would be within the spirit of the IAA, and the overall federal securities laws, because “the underlying purpose of [the private adviser exemption] . . . was . . . to exempt advisers whose advisory business [was] so limited that it [did] not warrant federal attention.”94 Furthermore, the SEC staff saw this proposal as the “least intrusive form of regulation available to address many of the concerns identified [due to the growth of the hedge fund industry because it):

. . . would not result in any changes with respect to those advisers’ ability to effectuate their investment strategies[,] . . . [it] would not place any restrictions on hedge fund advisers’ ability to trade securities, use leverage, sell securities short or enter into derivatives transaction[,] . . . [it] would not result in hedge funds having to register [their] [securities] offerings . . . with the Commission, nor would it require that they modify their organizational structures[,] . . . [and it] would [generally] not restrict the amount of fees that hedge fund advisers may charge hedge funds . . .”95

The SEC’s staff did not make such a recommendation without having what they believed to be credible justifications for why a hedge fund adviser’s “clients” should be re-defined under the IAA, so as to require the majority of hedge fund advisers to register with the SEC and fall under its watchful eye. First, registration would serve as a potential deterrent to fraud and would increase the likelihood that the SEC could spot hedge fund advisers committing fraud before the hedge fund suffered substantial losses.96 Second, by re-

the Staff Report recommended that the SEC should focus on ensuring that hedge fund investors are well educated and understand the risky nature of their investment before investing in hedge funds by requiring hedge fund advisers to make improvements in the amount of information that they willingly make available to potential investors. Id. at 103.

94 Id. at 89. This is one of the SEC’s pillar arguments when it comes to closing off hedge funds’ access to the private adviser exception. The SEC’s logic is essentially that (1) the private adviser exemption was intended to apply to private investment vehicles that attract a few wealthy, knowledgeable investors who have close ties with their adviser; (2) because of the way “clients” are determined under the IAA, hedge fund advisers are allowed to advise up to fourteen separate hedge funds; (3) each one of these hedge funds can have hundreds of separate individual investors; therefore, hedge fund advisers are controlling the investments of literally thousands of individual investments without being registered under the IAA; and (4) this lack of regulation could have negative consequences on the individual hedge fund investors and the financial markets of the U.S.; therefore, how a “client” is defined violates the underlying purpose of the private adviser exemption and, thus, should be amended. However, the question becomes: does the Staff Report’s proposed “look-through” provision violate the plain meaning of the word “client” as established in the IAA? See infra Part IV (in which the United States Court of Appeals for the D.C. Circuit in Goldstein v. SEC held that it did).

95 Id. at 92.

96 Id. at 92-93. From 1999 to 2003, the SEC brought 38 enforcement actions against hedge fund advisers for fraudulent practices. Id. at 73. However, it is noteworthy that the SEC Staff
defining a hedge fund adviser’s “clients” to include the individual investors of the adviser’s hedge funds, the advisers would now owe a fiduciary duty to these individual investors to avoid conflicts of interest. Advisers would, therefore, have to implement certain compliance guidelines to avoid making investment decisions solely for the adviser’s own personal fiscal gain. Finally, requiring hedge fund advisers to register under the IAA would

permit the [SEC] to collect basic information about virtually all hedge fund advisers, including the number of hedge funds that they manage, the amount of assets of those hedge funds and the identity of persons controlling the hedge fund advisers[,] . . . [which] would enable the [SEC] to more comprehensively and effectively observe the trading [practices] of . . . [hedge fund] advisers.98

Although the SEC Staff Report was firm in its conviction that greater hedge fund regulation was essential to protecting investors and the securities markets as a whole, the Report did not avoid addressing the concerns it had with requiring hedge fund advisers to register under the IAA, namely the costs that both hedge fund advisers and the SEC would incur due to mandatory registration.99 For the advisers themselves, registration would require them to pay initial and yearly filing fees, implement recordkeeping procedures so as to ensure accumulation of information required to be reported under the IAA, and face the ongoing costs associated with regulatory compliance.100 As for the SEC, it would have to figure out a way to stretch its resources to ensure that it remained vigilant and comprehensive in its examination of the thousands of adviser registrations that would be filed as a result of the amended “look-through” provisions under the private adviser exemption.101

B. The SEC’s Final “Hedge Fund Rule” Requiring the Majority of Hedge Fund Advisers to Register Under the IAA

We believe that, in light of the growth of hedge funds, the broadening exposure of investors to hedge fund risk, and the growing number of instances of malfeasance by hedge fund ad-

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Report found that hedge fund advisers were not engaging in a disproportionate amount of fraudulent activity as compared to other investment advisers. Id. This concession is used by many of the opponents of the SEC’s “hedge fund rule” to argue that increased hedge fund regulation is not necessary. See infra Part III.C.

97 Id. at 93.
98 Id. at 94.
99 Id. at 96-97.
100 Id. at 96.
101 Id. at 97.
visers, our current regulatory program for hedge fund advisers is inadequate. We do not have an effective program that would provide us with the ability to deter or detect fraud by unregistered hedge fund advisers. We currently rely almost entirely on enforcement actions brought after the fraud has occurred and investor assets are gone. We lack basic information about hedge fund advisers and the hedge fund industry . . . Requiring hedge fund advisers to register under the [IAA] will give us the ability to oversee hedge fund advisers without imposing burdens on the legitimate investment activities of hedge funds . . . No commenter identified any provision of the [IAA] that would provide an impediment to an adviser’s successful operation of a hedge fund [upon now having to register with the SEC under the IAA].102

Armed with the findings and primary recommendation of the SEC Staff Report, a divided SEC Board of Commissioners passed the “hedge fund rule” to amend Section 203(b)(3) of the IAA in November of 2005 by a vote of three to two.103 This new rule drastically changed how a hedge fund adviser’s “clients” would be determined under the IAA and its private adviser exemption. In essence, the rule provided for a “look-through” provision in which the adviser of a hedge fund could no longer count the hedge fund itself as his or her client, but rather each individual private investor of the adviser’s hedge fund would be counted as a client for purposes of determining whether the adviser was exempt from SEC registration via the private adviser exemption of the IAA.104 Thus, “an adviser to a private [hedge] fund . . . [could] no longer rely on the private adviser exemption if the adviser, during the course of the preceding twelve months, [had] advised [a hedge fund] that had more than fourteen [individual] investors.”105 The effect of the “hedge fund rule” would be extraordinary: the

102 SEC Final Rule, supra note 14, at 342-43.
103 See supra note 12 and accompanying text. The dissenting SEC Commissioners believed the majority’s “hedge fund rule” greatly overstepped the SEC’s regulatory authority under the IAA. See infra Part III.C.1 for the dissenting Commissioners’ reasoning and alternate recommendations.
104 SEC Final Rule, supra note 14, at 354. The effective date of the “hedge fund rule” was February 10, 2005, and non-exempt hedge fund advisers had until February 1, 2006, to apply for registration with the SEC. Id. at 360.
105 Id. at 354 (hedge fund advisers remained exempt from IAA registration only if they advised no more than fourteen individual investors, not fourteen individual hedge funds). There is one small caveat to the hedge fund rule that remains in effect under the private adviser exemption: a hedge fund adviser with more than fourteen individual investors only has to register under the IAA if the adviser has a minimum of $25 million under his or her management. Id. Regardless of how many clients they have, advisers do not fall under the purview of the SEC via the IAA unless they manage at least $25 million in assets. This makes sense when considering the private adviser exemption because private investment advisers with only minimal clients and assets under their control are not a risk to the U.S. securities markets and, thus, are deemed not to be of such a significant concern that SEC oversight is needed to protect the general investing public.
majority of hedge fund advisers would no longer be exempt under the private adviser exemption and, therefore, they would have to register under the IAA, become compliant with SEC regulations, and fall "victim" (as many opponents of the "hedge fund rule" viewed it) to SEC investigations and oversight. In essence, these "sexy" investment pools and their business savvy advisers would no longer receive preferential SEC treatment, even if they served as the investment playgrounds for institutional investors and the very rich.

Believing that the "hedge fund rule" reflected the proper administration of the IAA and its private adviser exemption, the SEC relied on a multitude of justifications for implementing the new Section 203(b)(3) amendment. First, requiring advisers to register with the SEC would provide it with "the ability to collect important information that [it lacked] about [a] growing segment of the U.S. financial system." This information was important to the SEC because there was a genuine lack of "reliable data on even the number of hedge funds [in the U.S.] or the amount of their assets." Second, because the rule would require advisers to register under the IAA, the SEC would be in a better position to detect, prevent, and deter fraud than it would have been had hedge funds remained unregistered.

Third, requiring hedge fund advisers to register under

Registration under the IAA will require:

hedge funds to disclose information such as their trading strategy, the amount of money they manage, and the manager’s disciplinary history. Also required . . . is a description of who its clients are, the educational and business background of those running the fund, and audited financial statements prepared in accordance with generally accepted accounting principles. Finally, hedge funds subject to the new rule will have to adopt a code of ethics and implement a compliance program.

McCLean, supra note 8, at 120 (internal quotations omitted). The "hedge fund rule" has its benefits. The rule’s increased disclosure requirements will (1) allow the SEC to determine the systemic risk that hedge funds pose on financial markets, (2) ensure the free flow of accurate information to investors and regulators, which will make the markets more efficient, while at the same time discouraging fraud and inaccurate reporting of information, and (3) will result in better informed investors who are able to make more informed, rational investment decisions. Id. at 137-39.

The SEC viewed its promulgation of the new "hedge fund rule" as being within its legal authority under § 211(a) of the IAA because the term "client" was not defined by Congress in the IAA, nor did the word "client" have one clear definition; therefore, the SEC believed it had the power to alter how a "client" was defined when doing so would seemingly keep in the spirit of the IAA and the private adviser exemption of only exempting those advisers whose activities were not significantly large enough to impact the national securities markets. Id. at 351-53.

Id. at 344.

Id.

Id. at 345 (explaining that a key part of the SEC’s purpose to protect hedge fund investors from fraud will be aided through registration because the SEC will be able to “identify compliance problems at an early stage, identify practices that may be harmful to investors, and provide a deterrent to unlawful conduct”) (internal citations omitted). The SEC addressed the fact that hedge fund fraud was not disproportionately higher than instances of fraud in other investment vehicles; however, it did not find this fact to be fatal to the new rule because it believed that there
the IAA would force them, in order to comply with SEC regulations pursuant to the IAA, "to adopt policies and procedures . . . to ensure compliance with the securities laws, and to foster more effective compliance practices."112 Fourth, to limit the amount of "retailization" occurring as pension funds, endowments, universities and funds of funds increasingly invest their investor's money in hedge funds, SEC registration and oversight under the IAA would ensure that hedge funds continue to maintain high minimum "buy-in" standards to ensure that potentially unsophisticated investors remained protected.113 Finally, the SEC reasoned that the passage of the new "hedge fund rule" would ensure the proper administration of the IAA and its private adviser exemption because it would prevent hedge fund advisers from "[managing] large amounts of securities indirectly through hedge funds that may have, collectively, hundreds of investors" without first being registered with the SEC.114 The SEC believed that re-defining a hedge fund adviser's "client" as the individual investor of the hedge fund, instead of the actual hedge fund itself, was appropriate because:

advisers to hedge funds market their services based on the skills, ability, and expertise of the persons who will make the fund's investment decisions. Thus, the clients [the individual investors of a hedge fund] will still rely exclusively on the efforts and skill of the investment adviser, and any new investors will be attracted to the hedge fund as a means to obtain the asset management services of the adviser. The clients will periodi-

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112 Id. at 346-47. The SEC admitted that the hedge funds would incur costs as a result of complying with this new regulation; however, it noted that such costs were not uncommon amongst other registered investment vehicles, many of which with much smaller investing constituents and much fewer resources available for implementing such compliance. Id. at 347. Furthermore, the SEC reminded hedge fund advisers that such de minimis compliance costs could simply be deducted from the adviser's generous management and performance fees and, therefore, the hedge fund would not bear any additional cost for complying with the new regulation. Id. at 347.

113 Id. at 347-48.

114 Id. at 348-49. In essence, the SEC's logic was that the private adviser exemption was enacted by Congress only to allow advisers to be exempt from registration under the IAA when their "business activities [were] too limited to warrant federal attention [because] . . . [their] activities were not national in scope[,] and . . . provided advice to only a small number of clients," regardless of how rich or sophisticated its clients may have been. Id. Therefore, the SEC reasoned, the way in which a hedge fund adviser's "clients" were calculated needed to be amended because hedge fund advisers were impersonally investing the assets of hundreds and even thousands of individual investors, which, the SEC believed, was clearly not the Congressional intent of the private adviser exemption.
cally receive reports from the adviser about the hedge fund, and their decisions whether or not to withdraw their assets from the fund will necessarily rely heavily on those reports [and the returns realized from their investments due to the adviser’s investment decisions].

However, to many critics, these justifications for re-defining a hedge fund adviser’s “client” and, thus, requiring most hedge fund advisers to register with the SEC under the IAA, were not sufficient. And, these criticisms would be quickly voiced.

C. The Critics of the SEC’s “Hedge Fund Rule”

1. The Dissenting SEC Commissioners

As mentioned above, the SEC narrowly passed the “hedge fund rule.” The two dissenting Commissioners, Cynthia Glassman and Paul Atkins, argued that the promulgated “hedge fund rule” would not address or correct the problems and issues cited by the majority as justifications for why mandatory IAA registration was necessary. The dissenters did not debate the “ends” of what the SEC was trying to accomplish. They agreed that hedge funds were a rapidly growing industry in the U.S. financial markets and that more qualified information was necessary for the SEC to understand what affect hedge funds would have on both the marketplace and investors; but, they disagreed that the promulgated “hedge fund rule,” the “means,” would adequately resolve those concerns. Namely, the dissenters argued (1) that there were better alternatives that could have been effectuated to more adequately address the majority’s concern with hedge funds being wholly unregulated; (2) that the ultimate reasons put forth by the majority as justification for the new “hedge fund rule” were not adequately supported, in that the cited trends of both increased hedge fund fraud and hedge fund “retailization” were not occurring at the detrimental rate...

\[115\] Id. at 353-54.
\[116\] Id. at 430-41.
\[117\] Id. at 431.
\[118\] The dissenting Commissioners believed that the SEC should have pursued alternative means for obtaining the necessary information regarding hedge funds, such as through the “pooling of information from [SEC] registrants and other government agencies and self-regulatory organizations that collect data on hedge funds, enhanced oversight of existing [hedge fund] registrants, a census of all hedge funds, and requiring additional periodic and systematic information to be filed with [the SEC by hedge fund advisers].” Id. at 431-32.
\[119\] The dissenting Commissioners argued that the instances of fraud cited by the majority as one of its bases for implementing the “hedge fund rule” did not realistically provide an adequate justification for implementing the regulation because “in most [instances], the hedge fund advisers...
suggested by the majority;\(^{120}\) (3) that it would be impossible for the SEC to successfully implement its new “hedge fund rule” because the SEC simply did not have the resources to evaluate thousands of registration applications, oversee all of the investment activities engaged in by hedge fund advisers, or investigate and prosecute in a timely manner any instance of fraudulent or unlawful hedge fund activity that occurred;\(^{121}\) and (4) that the SEC’s re-defining of hedge fund adviser’s “clients” marked a major departure from the SEC’s previous determination of whether an individual investor was the “client” of an investment adviser, based on whether or not the adviser tailored their investment advice to the investor’s financial objectives.\(^{122}\)

2. The Scholarly Debate and its Ensuing Criticisms

At the heart of the SEC’s “hedge fund rule” was the need for greater disclosure of information from hedge fund advisers. The “hedge fund rule,” by requiring the registration of a majority of hedge fund advisers, would necessitate that this information be disclosed to both the SEC and those individuals investing in the hedge funds under the management of the newly registered adviser. These disclosures would provide the SEC with a better understanding of the intricacies of hedge funds in order to evaluate how they affect the U.S. financial markets. Additionally, these disclosures would provide investors, at least in theory, with better tools to use when making the decision of whether or not to invest in a hedge fund. Thus, these more fully equipped investors would be better protected from potential hedge fund abuses.\(^{123}\) This premise has served as the battlefield for the policy debate on whether or not the SEC’s promulgated “hedge fund rule,” and resulting increase in regulation, was necessary for the hedge fund industry.\(^{124}\) Namely, should the SEC be looking out for the rich, sophisticated investor choosing to invest large amounts of money into an un-

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\(^{120}\) In response to the majority’s justification of the new regulation on grounds that hedge fund “retailization” was increasing, the dissenting Commissioners cited to the SEC Staff Report, which found that hedge fund “retailization” was truly of little concern because (1) the current minimum investment requirements precluded most unsophisticated individuals from investing in a hedge fund, (2) pension fund investments in hedge funds accounted for “only eight percent of total hedge fund investments,” and (3) pension funds, endowments and universities are “managed by fiduciaries . . . [who] . . . are highly-skilled . . . [and] responsible for determining whether to invest in hedge funds, the types of hedge funds in which to invest, and how to weigh risk . . . in making these [investment] determinations.” \textit{Id.} at 435.

\(^{121}\) \textit{Id.} at 431, 435.

\(^{122}\) \textit{Id.} at 431, 439-40.

\(^{123}\) For instances of hedge fund abuses, see generally \textit{supra} notes 48, 111 and accompanying text. \textit{See also infra} Part V (B).

\(^{124}\) Greupner, \textit{supra} note 34, at 1585.
regulated hedge fund in hopes of achieving huge returns? The critics’ definitively answer “no.”

One prevalent argument against SEC regulation of hedge funds is that a hedge fund is solely an investment device where wealthy and well-informed investors, willing to take substantial financial risks, invest their assets in order to realize above market average returns. Therefore, the argument goes, increased regulation over this industry would result in “harming investor return[s] by increasing [regulation] costs and limiting the ability [of the investor] to select an investment that matches [their] tolerance for risk.” 125 Critics argue that because of the inherent characteristics encompassing the investors that make up the “private investment pool” in a hedge fund, SEC regulation is neither needed nor desired. 126 In essence, the argument is that the purpose of the securities laws and the SEC is only to provide protection, via full disclosure of all material information necessary for the investor to make an informed decision of whether or not to invest, to those investors who can not protect themselves. 127 Thus, assuming hedge fund investors are wise enough to invest prudently in a hedge fund because of their high level of wealth and supposed financial sophistication, the critics of the “hedge fund rule” argue that the role of the SEC in regulating hedge funds should be limited to a de minimis reminder of caveat emptor— investors of a hedge fund do so at their own risk. 128

125 Id. at 1578-79.
126 See Preiserowicz, supra note 20, at 808 (arguing that the SEC’s hedge fund rule is a “purely political move [by the SEC] that plays off the public’s fear of another Enron and threatens to obstruct a useful investment tool of the wealthy, as well as damage . . . [the use of hedge funds as a] useful market efficiency tool.”) (quotations omitted). See also Troy A. Paredes, Insights From the SEC’s Decision to Regulate Hedge Funds, 31 SPG ADMIN. & REG. L. NEWS. 12, 12-14 (2006) (arguing that the SEC is taking a proactive and precautionary approach in unnecessarily regulating hedge funds as a result of the criticisms that SEC received in wake of its failure to prevent the Enron and WorldCom disasters).
127 See SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (stating that the Congressional purpose of the Securities Act was “to protect investors by promoting full disclosure of information thought necessary to informed investment decisions”).
128 For a recap of the concerns that the SEC has with the wholly unregulated hedge fund industry, see supra Part III (A) & (B). Whether the SEC should have increased regulation over the hedge fund industry is a question of balancing two very different concerns: investor and market protection via increased regulation vs. the possible detrimental effects that regulation will have on the hedge fund industry without any tangible assurances that such regulation will actually benefit the same.

On the one hand, increased disclosure is generally healthy for investors, markets, and regulators . . . . Further, the burden of registration [under the IAA] on hedge fund advisers seems very light . . . . On the other hand, the tangible benefit that registration provides is not readily apparent . . . . [I]t is not obvious that increased hedge fund disclosure to the SEC and to the public would decrease incidences of fraud or of financial collapse. Further, . . . the SEC will [have] . . . little manpower and other resources to begin reviewing and investigating . . . [the hedge fund] industry.

Critics do, however, understand that the "[hedge fund] industry has gotten too big to be [totally] unregulated[,]"129 and they have put forth several alternatives to the SEC’s "hedge fund rule." First, most agree that:

some type of "[l]imit[ed] regulation is ... necessary to require hedge funds ... to disclose comprehensive information about their trading strategies, exposures, and positions . . . . Without such disclosures, hedge funds can assume very large, risky positions by acquiring excessive leverage, possibly significantly impacting [the U.S.] financial markets without the foreknowledge of [the SEC].130

Furthermore, some have recommended that the SEC only require certain hedge funds to register under the IAA, such as those hedge funds that have an investor base comprised of other registered investment vehicles (pension funds, funds of hedge funds, etc.).131 Others suggest that the SEC should require all hedge fund advisers who utilize the IAA’s private adviser exemption to submit the fund’s financial data and other management information to the SEC in lieu of requiring full-blown registration under the IAA.132 Finally, one critic recommended that the SEC should have adopted a “default rule” of hedge fund adviser registration under the IAA that could be opted out of by the adviser upon making formal disclosures to the fund’s investors of why the adviser believed registration was not in the best interests of the hedge fund or its individual investors.133

Nevertheless, the SEC promulgated the “hedge fund rule” in what they believed was an effective means of dealing with the explosive growth of the hedge fund industry, potential “retailization,” and a marked increase in fraud.134 It would be only a short time after hedge fund advisers were required to register, February 1, 2006, before the critics challenged the SEC’s legal authority to implement its new rule. With these challenges the question turned to whether the SEC’s “hedge fund rule” could withstand judicial scrutiny under the IAA. In June of 2006, the United States Court of Appeals for the D.C. Circuit (“the Court”) held that it could not.135

130 Gibson, supra note 7, at 715.
131 Greupner, supra note 34, at 1592-93.
132 Preiserowicz, supra note 20, at 44.
133 Paredes, supra note 126, at 13.
134 See supra Part III.B.
135 Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).
IV. Goldstein v. SEC — The Unanimous Decision to Vacate the SEC’s “Hedge Fund Rule”

Phillip Goldstein was the co-owner of the investment advisory firm of Kimball & Winthrop.\(^{136}\) His advisory firm was the general partner and investment adviser of a hedge fund called Opportunity Partners, L.P. (“O.P.”).\(^{137}\) Goldstein, O.P.’s investment adviser, had previously been exempt from registering with the SEC under the IAA because of the private adviser exemption; however, as a result of the SEC’s “hedge fund rule,” Goldstein would have to register O.P. under the IAA because of the SEC’s re-defining of how his “clients” were to be calculated for purposes of the exemption.\(^{138}\) As a result of this required registration, Goldstein brought suit against the SEC challenging their legal authority to promulgate the “hedge fund rule.” He argued, as did the dissenting SEC Commissioners who voted against the “hedge fund rule,” that the SEC misinterpreted how an adviser’s clients should be determined under the private adviser exemption of the IAA.\(^{139}\) The SEC responded that it had the authority to interpret the word “client” under the IAA because the statute was “ambiguous as to a method for counting [a hedge fund adviser’s clients].”\(^{140}\) Thus, the validity of the SEC’s new “hedge fund rule” would turn on whether the SEC’s new interpretation of a hedge fund adviser’s “client” was contrary to the clear Congressional meaning of “client” under the IAA. In a unanimous holding, the Court held that it was indeed contrary to Congress’s intent and vacated the SEC’s “hedge fund rule” as being an unreasonable interpretation of the term “client” under the IAA that “comes close to violating the plain language of the [Act].”\(^{141}\)

The prime issue addressed by the Court was who should be the hedge fund adviser’s “client” for purposes of the IAA’s private adviser exemption. The Court noted that the IAA did define an investment adviser as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.”\(^{142}\) The Court determined that it was the directness of the adviser’s financial advice that should be looked at when determining who the adviser’s “clients” were. If the adviser is not giving advice to an investor directly, then the investor should not be con-

\(^{136}\) Id. at 874.
\(^{137}\) Id.
\(^{138}\) Id.
\(^{139}\) Id. at 878.
\(^{140}\) Id.
\(^{141}\) Id. at 880-81 (the SEC’s interpretation of a hedge fund adviser’s “clients” under the new “hedge fund rule” “falls outside the bounds of reasonableness.” The SEC’s construction of the IAA “cannot survive judicial review” because the “hedge fund rule” “reflects an action that exceeds the [SEC’s statutory] authority.”). Id.
\(^{142}\) Id. at 880 (quoting the IAA at 15 U.S.C. § 80b-2(11)) (emphasis added).
sidered the adviser’s “client.”¹⁴³ Thus, if a hedge fund adviser is not directly giving investment advice to each individual investor of the hedge fund and, therefore, the adviser is not the investment adviser of each individual investor, then “a fortiori each investor cannot be [the] ‘client’ of that [hedge fund adviser].”¹⁴⁴ The Court then noted that this same reasoning had been used by the SEC every time it had interpreted a hedge fund adviser’s “clients” under the IAA until its recent promulgation of the “hedge fund rule.”¹⁴⁵ Moreover, the Court reasoned that an individual hedge fund investor is not the “client” of the hedge fund’s adviser because the investor and adviser do not share a “[f]iduciary, person-to-person relationship” that is “characteristic of the investment adviser-client relationship.”¹⁴⁶ Given this, the Court opined, the SEC’s redefining of a hedge fund adviser’s “clients” came “close to violating the plain language of the [IAA]”¹⁴⁷ in that it was “counterintuitive [for the SEC] to characterize the investors in a hedge fund as the ‘clients’ of the adviser”¹⁴⁸ because the hedge fund adviser “owes fiduciary duties only to the [hedge] fund, not to the [hedge] fund’s investors.”¹⁴⁹

¹⁴³ *Id.* at 879-80. The Court opined:

An investor in a private [hedge] fund may benefit from the adviser’s advice (or he may suffer from it) but he does not receive the advice directly. He invests a portion of his assets in the [hedge] fund. The fund manager—the adviser—controls the disposition of the pool of capital in the fund. The adviser does not tell the investor how to spend his money; the investor made that decision when he invested in the [hedge] fund. Having bought into the [hedge] fund, the investor fades into the background; his role is completely passive.

*Id.*

¹⁴⁴ *Id.* at 880.

¹⁴⁵ *Id.* The Court opined:

As recently as 1997, [the SEC] explained that a “client of an investment adviser typically is provided with individualized advice that is based on the client’s financial situation and investment objectives. In contrast, the investment adviser of [a hedge fund] . . . need not consider the individual needs of the [hedge fund’s] . . . shareholders when making investment decisions, and thus has no obligation to ensure that each security purchased for the [hedge fund] . . . is an appropriate investment for each shareholder.”

*Id.* (citation omitted).

¹⁴⁶ *Id.* at 880 (quotations omitted). The existence of an advisory relationship depends on the character of the advice that the investment adviser gives to the investor. *Id.* An investment adviser gives their “clients” “personalized advice [that is] attuned to [the] client’s concerns.” *Id.* Because a hedge fund adviser does not give the individual investors of the hedge fund such personalized advice, a hedge fund adviser is not the “investment adviser” to each individual hedge fund investor. “This type of direct relationship exists between the adviser and the [hedge] fund, but not between the adviser and the investors in the [hedge] fund. The adviser is concerned with the [hedge] fund’s performance, not with each investor’s financial condition.” *Id.*

¹⁴⁷ *Id.* at 881.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* (emphasis added). The Court addresses in depth the fact that a hedge fund adviser and the individual investors in the hedge fund that the adviser advises are not fiduciaries and, therefore, the adviser owes the investor no duty of loyalty. *Id.* Because the adviser does not have a
Furthermore, the Court held that the SEC's sudden alteration in how it would count a hedge fund adviser's "clients" made little judicial sense because "over the years, the advisory relationship between hedge fund advisers and investors has [not] changed." The Court noted that:

The Commission cited, as justification for its rule, a rise in the amount of hedge fund assets, indications that more pension funds and other institutions were investing in hedge funds, and an increase in fraud actions involving hedge funds. All of this may be true, although the dissenting Commissioners doubted it. But without any evidence that the role of fund advisers with respect to investors had undergone a transformation, there is a disconnect between the factors the Commission cited and the rule it promulgated. That the Commission wanted a hook on which to hang more comprehensive regulation of hedge funds may be understandable. But the Commission may not accomplish its objective by a manipulation of [the clear] meaning of [who a hedge fund adviser's "clients" are] . . . . The Commission has not justified treating all investors in hedge funds as clients for the purpose of the rule.151

In the Court's eyes the "hedge fund rule" was completely arbitrary because the SEC had not satisfactorily justified its new interpretation of a hedge fund adviser's "clients." The Court found that the SEC failed to note any change in the relationship between the investment adviser and the individual investors of the hedge fund which would suggest to the SEC that a re-defining of an adviser's "clients" was necessary.152 Furthermore, the Court opined that the "hedge fund rule's" policy goal of granting the SEC regulatory oversight over an investment industry that "substantially affect[s] . . . [the] national securities exchanges . . . and the national economy" improperly reigns in hedge funds and their advisers because "[i]t is the volume of assets under management or the extent of indebtedness of a hedge fund . . . that determines a [hedge] fund's importance to

duty of loyalty to the individual investor, the adviser is not required to "disclose self-interested transactions [to the individual investor], . . . manage [the individual investor's] portfolios in the best interests of [the investors], or "fully disclose any material conflicts that adviser has with the [individual investor]." Id.

150 Id. at 882.
151 Id. (emphasis added). Although the Court uses strong disfavoring language against the "hedge fund rule," this statement by the Court is important for considering what the future of SEC hedge fund regulation could entail. The Court did not hold that the SEC's desired "end" of regulating hedge funds was impermissible under the IAA, but rather only that the "hedge fund rule" was an inappropriate "means" of achieving such increased hedge fund regulation. See generally id.
152 Id. at 883.
153 Id. (citation omitted).
national markets,"^{154} not the number of investors that are investing in such a hedge fund.\(^{155}\)

As a result of what the Court termed as "arbitrary," the "hedge fund rule" was vacated and the SEC was left virtually powerless to regulate an area of the U.S. financial markets that continues to grow at an unprecedented pace.\(^{156}\)

V. THE AFTERMATH—FROM GOLDSTEIN TO AMARANTH ADVISORS, WHAT WILL THE FUTURE OF HEDGE FUND REGULATION ENTAIL?

A. The Response to Goldstein

"It would be an understatement to say that [the Goldstein ruling] . . . was a setback for the SEC."\(^{157}\) This sentiment best describes the position the SEC found itself in after the Goldstein Court struck down its "hedge fund rule" and, thus, allowed hedge fund advisers to return to their previous method of counting clients for purposes of the "private adviser exemption" under the IAA. The Goldstein decision resulted in a "regulatory black hole"\(^{158}\) to which the SEC found itself inadequately able to regulate a financial industry whose continuing growth will have a substantial impact on U.S. financial markets.\(^{159}\) Nonetheless, the SEC maintains that it's concerns regarding hedge funds will continue, even after Goldstein.\(^{160}\) However, indications that the SEC will remain vigilant in its

\(^{154}\) Id.

\(^{155}\) Id.

\(^{156}\) For an account of the increased growth of the hedge fund industry, see supra notes 6-9 and accompanying text.

\(^{157}\) Terry Stanton, Hedge Funds Register Surprise over Court Ruling, HEDGEWORLD DAILY NEWS, June 23, 2006. But see Part III.C.1 for a discussion of the views of the dissenting SEC Commissioners who viewed the "hedge fund rule" as the inappropriate "means" for addressing the problems cited by the majority of the Commissioners as justification for enacting the "hedge fund rule." Particularly, Commissioner Atkins had voiced concerns that the "hedge fund rule" would divert the SEC's already thinning resources and oversight away from protecting the everyday investor of a mutual fund to instead providing unneeded protection to hedge fund investors the "likes of Warren Buffet and Jimmy Buffet, Michael Dell and Michael Jordan, Bill Marriott and Paris Hilton." Emma Trincal, Commissioner Atkins Criticizes SEC's Zeal, HEDGEWORLD DAILY NEWS, Jan. 30, 2007. Commissioner Atkins's point is well taken and reiterates the major contention amongst those for and against the regulation of hedge funds—should the SEC be regulating a class of investment vehicles (hedge funds) that are privately run, not available to the vast majority of the investing public, and which are almost entirely invested in by wealthy, well-informed investors who already have access (debatably) to the type of material information that SEC registration would otherwise require disclosure of? It is the vast disagreement over this policy question that will serve as the foundation for any future hedge fund regulation and the arguments in opposition resulting therefrom. See infra Parts V.C.3 & 4.


\(^{159}\) Cox Testimony, supra note 6.

\(^{160}\) Id. In his testimony, Chairman Cox noted:
pursuit of extensive hedge fund regulation appears uncertain, especially after the SEC, now led by Chairman Cox, announced that it would not appeal the Goldstein holding to the United States Supreme Court as a last ditch effort to save its “hedge fund rule.” 161

Perhaps to the surprise of those who criticized the SEC’s now defunct “hedge fund rule,” the largest hedge fund financial collapse in U.S. history would occur less than two months later when Amaranth Advisors lost $6.5 billion of its investors’ assets on imprudent natural-gas investments and was ultimately forced into a liquidation that left their investors “out of luck” and out of money. 162

B. The Collapse of Amaranth Advisors

Amaranth Advisors, a Connecticut based hedge fund led by Brian Hunter (Amaranth’s energy investment adviser) traded substantially in natural-gas futures and options contracts and had been successfully producing profits for its investors for most of 2006. 163 In fact, up through the end of August 2006, Hunter had returned Amaranth and its investors 22% on their energy investments for the year. 164 However, forecasts for a warm winter caused the volatile price of natural-gas to sink and those above market returns quickly evaporated as Amaranth, whose 6,670 trading positions were leveraged out on average four and a half times, 165 lost approximately $5 billion in one week due to untimely

The remarkable pace of hedge fund growth, which we noted at the time [of the promulgation of the “hedge fund rule”], has continued unabated. The potential for retail investors to be harmed by hedge fund risk remains as serious a concern now as then. And the growth in hedge fund fraud that we have seen accompany the growth in hedge funds implicates the very basic responsibility of the SEC to protect investors from fraud, unfair dealing and market manipulation.

Id. Chairman Cox maintained that hedge funds, even after Goldstein, “are not, should not be, and will not be unregulated” because hedge fund advisers remain accountable to the hedge funds they advise under the anti-fraud provisions of the IAA. Id. See infra Parts V.C.2 & 3.


162 See Anderson, supra note 18.

163 Ann Davis, Blue Flameout: How Giant Bets on Natural Gas Sank Brash Hedge-Fund Trader, WALL ST. J., Sept. 19, 2006, at A1. Amaranth Advisors was one of the first hedge funds to trade substantially in energy investments after the collapse of Enron. Id. Amaranth hired Hunter in 2004 and he quickly began to post above market gains for Amaranth’s investors. Id.


165 See Jenny Anderson, Hedge Fund Sheds Assets in Energy, N.Y. TIMES, Sept. 21, 2006, at C1. Amaranth made 6,670 natural gas investments and had a debt-to-asset ration of $4.50 to $1. Therefore, for every $1 of assets that Amaranth had invested in natural gas, it had invested another $4.50 of borrowed assets (or debt) — money Amaranth did not have, but rather merely borrowed so as to increase their “leveraged” position in hopes of making more money contingent on the value of natural gas increasing.
purchases of billions of dollars worth of natural-gas option contracts that went sour when the projected future value of natural-gas plummeted.\textsuperscript{166} In all, Amaranth’s misguided bets caused the hedge fund to lose about 60% of its net assets ($6.5 billion in investor money) in less than a month.\textsuperscript{167} These losses forced Amaranth to sell off all of its remaining energy holdings and literally “shell-shock” its investors, 50% of which were “retailed” funds of hedge funds.\textsuperscript{168} Amaranth’s investors, who were reassured by the hedge fund that it would reduce its risks after the initial natural-gas losses were realized, quickly demanded answers for why the advisers of the fund never fully disclosed how risky their energy positions really were or how the fund suffered such unimaginable and almost instantaneous losses.\textsuperscript{169}

Immediately after receiving the news that their hedge fund had suffered severe losses, many Amaranth investors made redemption requests in hopes of withdrawing their remaining investments from the fund.\textsuperscript{170} However, these requests were met by Amaranth’s announcement that it was suspending all redemptions for the following two months in order to “enable the Amaranth funds to generate liquidity for all investors . . . with the goal of maximizing the proceeds of asset dispositions.”\textsuperscript{171} With this, Amaranth conceded that its losses were insurmountable and, therefore, it would have to close down.

Early considerations of the Amaranth Advisors financial disaster suggest that the hedge fund’s implosion will not have a major affect on the U.S. financial markets, as was the case when Long Term Management Capital’s demise “threw [the] global [financial] markets into a severe crisis” due to the fund being leveraged out 100 times at the time of its impending failure.\textsuperscript{172} Despite

\textsuperscript{166} Davis, supra note 163.

\textsuperscript{167} Anderson, supra note 18.

\textsuperscript{168} Anderson, supra note 165. See supra note 92 for a definition of “retailization.” Two of these “retailed” investors were a Massachusetts’s state employee pension fund, which had $56 million invested in Amaranth, and a San Diego Retirement Fund, which had over $175 million invested at the time of Amaranth’s losses. Bloomberg News, Citing Mounting Losses, Amaranth to Liquidate, THE BOSTON GLOBE (Online Edition), Sept. 30, 2006, http://boston.com/business/globe/articles/2006/09/30/citing_mounting_losses_amaranth_to_liquidate/.

\textsuperscript{169} Id.

\textsuperscript{170} Anderson, supra note 18.

\textsuperscript{171} Id. For a detailed explanation of how Amaranth attempted to minimize its losses so as to provide this liquidity, see Ann Davis, et al., Amid Amaranth Crisis, Other Players Profited, WALL ST. J., Jan. 30, 2007, at A1.

\textsuperscript{172} Id.

\textsuperscript{173} Emma Trincal, Struggling to Survive, Amaranth May Offer Lessons to Learn From, HEDGEWORLD DAILY NEWS, Sept. 20, 2006. Amaranth’s collapse does not pose the same risk to the U.S. financial markets that Long-Term Capital Management’s impending losses in 1998 did because (1) Amaranth’s positions were in no way as leveraged as Long-Term’s at the time of Amaranth’s collapse—Long-Term was leveraged at 100 to 1 when it collapsed; Amaranth only 4.5 to 1; (2) Long-Term’s $4 billion dollar loss in 1998 would have amounted to over a $9 billion
early indications that Amaranth’s implosion will not have a major impact on U.S. financial markets, what is important about Amaranth and its unforeseen demise is the extent to which Amaranth, and its investment advisers, failed to make timely disclosures to its investors as to the strategies and risk management policies that the hedge fund was implementing. It was this lack of disclosure that prevented Amaranth investors from truly knowing what Amaranth’s investing strategies and positions were. And, it was this lack of proper dissemination of information that likely prohibited the investors from being able to make an informed decision on whether to request redemption on their investment (if the investor believed Amaranth’s positions to be too risky) or continue their investment in Amaranth (if they viewed Amaranth’s positions as not posing a substantial risk to their invested assets). Amaranth investors were probably not given a choice before being notified that the fund’s bad natural-gas bets resulted in losing over one-half of all of its investor’s assets, in less than one month. 174 Would the SEC’s “hedge fund rule” have prevented the Amaranth collapse and subsequent harm to its individual investors? Had the investors of Amaranth had the information that the “hedge fund rule” would have required their advisers to disclose to the SEC, those investors may have had a more knowledgeable understanding of the hedge fund in which they invested and could have, potentially, used such information to decide whether or not to remain invested in Amaranth before the loss was realized. Without access to such valuable information, many supposedly “sophisticated” investors lost billions of dollars from the sudden collapse of Amaranth.

To this Author, the collapse of Amaranth Advisors reinforces the need for increased hedge fund regulation. The critics of the SEC’s “hedge fund rule” argued that hedge fund investors were sophisticated enough to make well-informed decisions of whether or not to invest in an un-regulated hedge fund; however, Amaranth’s sudden collapse suggests otherwise. Amaranth lost $6.5 billion of its investor’s assets in one month. That amounts to losses of over $216 million per day. And, the investors of Amaranth did not even have the opportunity to protect their investment once the fund’s advisers informed them of the impending huge losses to the fund because the fund blocked all redemption requests for a period of two months. So, for all intents and purposes, Amaranth’s “sophisticated” investors had no real meaningful financial protection. The only thing they could do was sit back and hope that after the fund liquidated they would get some of their investment back. This scenario suggests the need for hedge fund regulation to protect those that choose to invest in such funds, regardless of what level of “sophistication” the law assumes in an investor based on his or her net-worth. This Author concedes that Amaranth’s collapse, impacted in part because of its relatively small use of leverage, will not burden the

dollar loss today, and (3) Long-Term was one of the biggest hedge funds when it collapsed in 1998; whereas, Amaranth was not even in the top 30 biggest funds when it collapsed in 2006. Id. 174 See Anderson, supra note 18.
U.S. financial markets to the extent that Long Term Capital Management’s loss did in 1998; however, Amaranth’s effect will substantially burden its investors who were blind-sided by the funds collapse and, unfortunately, lost over one-half of their investments without even having the luxury of a heads-up from Amaranth’s advisers. Because Goldstein struck down the SEC’s “hedge fund rule,” Amaranth’s advisers may not have had an affirmative duty under the IAA to disclose the risky positions that its energy traders were engaging in; however, this Author believes that had such information been disclosed to Amaranth’s investors, they would have at least been given the opportunity to decide for themselves whether they wanted their assets invested in such volatile natural-gas positions. Without such opportunity it is clear that Amaranth’s investors were treated unjustly, regardless of their supposed investing “intellect.” Because Amaranth’s advisers did not have to register the hedge fund under the IAA, Amaranth’s investors were not afforded the same protection (via mandatory disclosure requirements) that the SEC would have provided to other investors choosing to invest in other investment vehicles required to be registered under the IAA.

C. The Future of Hedge Fund Regulation: Recommendations Presented after Goldstein and Amaranth

After over two years of investigating the impact that hedge fund growth had on the U.S. financial markets, the SEC promulgated its “hedge fund rule” in 2004 to require hedge fund advisers to register under the IAA. Then, less than six months after the SEC’s “hedge fund rule” took effect, the United States Court of Appeals for the D.C. Circuit unanimously vacated the rule in Goldstein v. SEC as being an arbitrary and unreasonable extension of the SEC’s regulatory authority under the IAA. Afterwards, the SEC sealed the fate of its deceased “hedge fund rule” when it announced that it would not appeal Goldstein to the Supreme Court. And, shortly thereafter, the SEC received notification that a marginally leveraged hedge fund, Amaranth Advisors, had suffered the worst financial “meltdown” in the history of the U.S. hedge fund industry when it lost over $6 billion of its investor’s assets in less than one month, forcing it into an unexpected liquidation. In light of this history, it becomes vital to consider what the SEC’s next move should be when considering whether or not to attempt to regulate the hedge fund industry. And, since Goldstein and Amaranth}
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ranth, there have been a plethora of recommendations made throughout the political spectrum and the investing industry regarding what type of increased hedge fund regulation, if any, is desirable.

1. Hedge Funds say "Regulate Thyself"

In light of the sparked interest surrounding the extent to which hedge funds should be increasingly regulated, the industry itself has proposed the creation of a self-regulatory organization, similar to that of the National Association of Securities Dealers, in an effort to avoid further SEC oversight over the industry. 180 This hedge fund "self-policing" initiative was originally proposed in the wake of the Long-Term Capital Management debacle in 1998, and it has received attention once again as a result of the recent liquidation of Amaranth Advisors. 181 In essence, this proposed association would establish certain disclosure standards that hedge fund advisers must adhere to, and it would have the authority to penalize those advisers which fail to comply with such disclosure. However, this proposal has not been universally considered throughout the hedge fund community and, therefore, is nowhere close to becoming a regulatory reality. 182

2. Congress Weighs In

On September 27, 2006, the U.S. House of Representatives passed the "Hedge Fund Study Act," 183 requiring the President's Working Group on Financial Markets to once again conduct a study on the hedge fund industry and its effects on both the U.S. financial markets and its investors. 184 This Act sought recommendations from the President's Working Group in three areas:

amount of assets that hedge fund advisers control is well over $1 trillion. \textit{Id.} "Retailization" of institutional investors, including pension plans and funds of funds, remains a valid, although potentially unrealized, issue to be considered. \textit{Id.} As hedge funds have grown in size, so have the number of instances of fraud associated with their advisers. \textit{Id.} Finally, hedge fund investors generally remain insufficiently knowledgeable as to the investment positions and risks being implemented by the advisers of the hedge funds in which they invest.


181 \textit{Id.}

182 \textit{Id.} Many questions remain as to the feasibility of this hedge fund self-policing organization, including: (1) how much hedge fund adviser approval is needed before such a plan is implemented, (2) what extent should this association be able to enforce hedge fund advisers to disclose information, and (3) is the hedge fund industry even capable of regulating itself, or should the task of regulation remain with the SEC? \textit{Id.}


184 Christopher Faille, \textit{Political Reflex: Order Up a Study}, \textit{HEDGEWORLD DAILY NEWS}, Sept. 29, 2006. For a description of the President's Working Group unfortunate finding that the future of hedge fund regulation should be "hands off," see infra Part VI.
(1) proposed legislation relating to appropriate disclosure requirements, (2) what information should such disclosures include, and (3) what potential oversight responsibilities should the President's Working Group have over the hedge fund industry.\footnote{Id. In Goldstein, the D.C. Circuit struck down the SEC's "hedge fund rule" under the IAA; however, Congress may still enact its own amendment to the IAA to require hedge fund advisers to register. But, it is worth noting that the hedge fund industry would likely concede regulatory authority to the SEC before Congress stepped in, via an amendment to the IAA, because many hedge fund advisers fear that such Congressional legislation could be modeled after the Sarbanes-Oxley Act, which was passed by Congress in response to the corporate scandals of Enron, WorldCom, etc. See Bunge, supra note 161.}

On February 22, 2007, the President's Working Group, upon this congressional request, published its findings on the need for increased hedge fund regulation.\footnote{Id. Debra Solomon, Regulators' Hedge-Fund Approach: Hands Off, WALL ST. J., Feb. 23, 2007, at C1. See supra notes 180-182 and accompanying text.} Sadly, the President's Working Group's conclusions can be summed up as: due to recent increases in market discipline (interestingly unelaborated on), the SEC should not require the hedge fund industry to make greater disclosures to potential and current hedge fund investors because these investors are savvy enough to demand the sort of information that they need before investing in a hedge fund and, therefore, hedge funds will freely disclose such material financial information for fear of losing potential investment capital.\footnote{Id. See SEC Proposed Rule 509, 216, infra note 202. However, the President's Working Group did not give the same recommendation for the SEC's new anti-fraud rules. See SEC Proposed Rule 206(4)-8, infra note 202, and Part V.C.3.} To this Author, this imprudent approach seems circular and representative of the status quo assumption that hedge fund investors can protect themselves to the same degree that the SEC protects the investors of other registered investment vehicles.\footnote{As the financial meltdown of Amaranth Advisors should clearly suggest, a de minimis reminder of caveat emptor is not sufficient to protect hedge fund investors. See supra note 128 and accompanying text.} This is simply not the case. Yes, hedge fund investors are "sophisticated" in the sense that they meet certain arbitrary net-worth requirements; however, to say that all of these investors (comprised to a decipherable extent of the newly rich and other "retailized" investment funds) can fend for themselves is a fallacy. Yes, a large portion of hedge fund investors are business savvy and well versed in investing in the high risk, volatile markets that most hedge funds invest their "clients'" assets in. However, not all hedge fund investors meet this minimum threshold. Not all hedge fund investors have the level of expertise or investing prowess to demand that their hedge fund advisers disclose all pertinent financial information about the hedge fund that they are about to invest in, or continue investing in. And, because of this fact alone, meaningful measures must be taken to ensure that all hedge fund investors are
as fully protected as their investing counterparts in other registered investment vehicles.

Only months after the President's Working Group put forth its recommendation for "hands-off" hedge fund regulation, far-reaching tax legislation was introduced in both houses of Congress to regulate hedge fund advisers where it hurts—their pocket books. On June 14, 2007, the ranking members of the Senate Finance Committee in the U.S. Senate\(^{189}\) introduced S. 1624;\(^{190}\) legislation to characterize a publicly traded hedge fund’s adviser’s management fees, which historically have been characterized as a capital asset\(^{191}\) and taxed at a 15% rate under the Internal Revenue Code (the "IRC"),\(^{192}\) as ordinary corporate income\(^{193}\) and taxed at rate as high as 35%.\(^{194}\) And, S. 1624 will impose this tax increase on all advisers who advise publicly traded hedge funds, regardless of whether or not the adviser is registered under the IAA. Furthermore, only eight days after S. 1624 was introduced in the Senate, the U.S. House of Representatives, on June 22, 2007, introduced their own legislation, H.R. 2834, to expand S. 1624’s proposed tax increases to all hedge fund advisers, regardless of whether or not the hedge fund that the advisers managed was publicly traded.\(^{195}\) Specifically, H.R. 2834 will amend the IRC to re-characterize the net income earned by all hedge fund advisers as ordinary corporate income for purposes of imposing taxes thereto.\(^{196}\)

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\(^{189}\) The Honorable Max Baucus (D-MT) and The Honorable Charles Grassley (R-IA). It is worth noting that unlike many economic political issues, hedge fund regulation has not divided Congress down traditional partisan lines (with Democrats being for and Republicans being against increased hedge fund regulation). Emma Trincal, Election Day and Hedge Funds: A Lipper HedgeWorld Preview, HEDGEWORLD DAILY NEWS, Nov. 6, 2006.

\(^{190}\) S. 1624, 110th Cong. (2007). S. 1624 will amend § 7704(c) of the Internal Revenue Code (the "IRC") to re-classify publicly traded hedge funds, which historically have been organized under the federal securities laws as limited liability partnerships, as corporations for purposes of imposing taxes on the income that such advisers generate. Id.


\(^{193}\) Proponents of this reclassification argue that the fees hedge fund advisers receive should be classified as ordinary income because hedge fund advisers receive such fees as compensation for their investment management advice and, therefore, these fees should not represent a gain on "capital." See Close Hedge Fund Loophole, BOSTON HERALD (Online Edition), July 29, 2007, http://www.bostonherald.com/news/opinion/editorial/view.bg?articleid=10139195&src=hom.

\(^{194}\) See Stephen Grocer, Trading Shots: Taxing Private Equity, WALL ST. J. (Online Edition), July 24, 2007, http://newsuchicago.edu/citations/07/07/07/24.kaplan-wsj.html. If enacted into law, S. 1624 would increase the amount of taxes that hedge fund advisers would have to pay on their performance fees by as much as $6 billion. Jenny Anderson & Andrew Ross Sorkin, Congress Weighs End to Private Equity Tax Break, THE NEW YORK TIMES, June 21, 2007, at A1. It must be noted that, although outside the scope of debate for purposes of this Note, the Congressional determination to reclassify hedge fund adviser management fees as ordinary income instead of a capital asset is debatable.

\(^{195}\) H.R. 2834, 110th Cong. (2007).

\(^{196}\) Id. Whether hedge fund advisers’ performance fees should be re-classified as ordinary income instead of capital gains brings up issues of tax law that are outside the scope of this Note;
This legislation, if enacted, may have a marked impact on the hedge fund industry. Hedge fund advisers, accustomed to paying very little by way of taxes on the millions of dollars that they earn every year due to their investing “expertise,” would now be forced to cough up a much higher percentage of their annual income back to Uncle Sam. However, there are many questions remaining as to the efficiency of these congressional proposals for “monetary sacrifice” from hedge fund advisers. Will monetarily penalizing hedge fund advisers protect hedge fund investors and the funds that they choose to invest? Probably not. Will having to pay heavier taxes on their performance fees encourage hedge fund advisers to provide the type of disclosure and transparency that registering under with the SEC would otherwise require? It is doubtful. And, as some early critics of S. 1624 and H.R. 2834 have suggested, such increased tax burdens may cause many hedge fund advisers to flee the U.S. financial markets and relocate their hedge funds abroad. Thus, it remains to be seen whether or not S. 1624 and H.R. 2834 can serve as suitable hedge fund regulation. However, one thing is for certain, with its introduction of S. 1624 and H.R. 2834, Congress has brought hedge funds back into the regulatory spotlight, regardless of whether or not a hedge fund adviser has to register under the IAA in the wake of Goldstein.

However, it is worth noting that some tax scholars have already disapproved of these congressional proposals on the grounds that hedge fund advisers should have their “earnings” taxed in the same fashion as those profits earned by the investors in such advisers’ hedge funds, as a capital gain resulting from their limited partnership interest in the fund. See David Weisbach, Professor Says Carried Interest Legislation is Misguided, 116 TAX NOTES 505, Aug. 6, 2007. See supra note 31 and accompanying text. See supra notes 189-194 and accompanying text.

In his July, 2007 testimony before the House Financial Services Committee and the Senate Finance Committee, Federal Reserve Chairman Ben S. Bernanke opined that Congress’s proposed tax increases will not affect the investment activities of hedge fund advisers, but may affect the location of where such activities take place. See Michael Crittenden, Bernanke Says Higher Taxes Could Drive Equity Firms, Hedge Funds Abroad, CQ Today (Online Edition), July 19, 2007, http://public.cq.com/docs/cq/news110-000002554713.html. To this Author, it is unlikely that Chairman Bernanke’s premonition will become a reality because, at the end of the day, hedge fund advisers’ operations in the U.S. financial markets remain wholly unregulated and their annual earnings continue to grow at a staggering pace. Simply, these Congressional proposed tax increases will not effectively reduce a hedge fund adviser’s incentive to remain in the United States.

Opponents of S. 1624 and H.R. 2834 would argue, however, that this congressional legislation has nothing to do with protecting hedge fund investors and the U.S. financial markets, but rather amount to nothin more than revenue generating activities stemming from equity principles of tax allocation (i.e., hedge fund advisers can afford to be taxed at higher, non-capital, rates and, therefore, they should be so taxed).

See supra Part IV.
3. The SEC’s most recent go-around: The “Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles.” Will this new SEC Rule protect hedge fund investors sufficiently?

The final development, which serves as the launching point for this Note’s concluding evaluation, comes from a newly enacted SEC rule under the IAA, the “Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles” (the “SEC’s New Rule”). This Rule will extend the anti-fraud provisions of the IAA (which currently only prohibit the hedge fund adviser from

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202 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Exchange Act Release No. 33-8766, (August 3, 2007) [hereinafter SEC’s New Rule] (to be codified at 17 C.F.R. § 275.206(4)-8 et seq.). The SEC’s Rule is based on its authority to adopt rules under the anti-fraud provisions of § 80b-6(4) of the IAA. Id. at 6. Furthermore, in December of 2006, the SEC also proposed two new rules (Rule 509 and Rule 216) under the Securities Act, which would cut the number of individual investors eligible to invest in hedge funds by raising the “accredited investor” requirement from anyone owning at least $1 million in investments to anyone owning at least $2.5 million in investments. Accredited Investors in Certain Private Investment Vehicles, Exchange Act Release No. 33-8766, at 19 (Dec. 27, 2006) (to be codified at 17 C.F.R. § 230.216 et seq.). See supra note 27 for an explanation of “accredited investor” and how hedge funds escape SEC regulation under the Securities Act. By raising the “accredited investor” level under the Securities Act, hedge funds will not be able to avoid SEC regulation if their advisers allow investors with less than a $2.5 million net-worth to invest in the hedge fund. Some believe that these rules “could reduce the number of qualified [hedge fund] investors by [as much as] 88%.” Kara Scannell, SEC to Investors: More Internet, Less Hedge Funds, WALL ST. J., Dec. 14, 2006, at C1. This reduction in qualified investors will hopefully lessen one of the SEC’s major concerns—the investment sophistication of many hedge fund investors are not high enough to ensure that these investors will make rational, well-informed investment decisions without additional SEC protection. Under the Securities Act, an investor is presumed to be sophisticated if he or she meets this level of “accreditation;” however, courts have warned that potential investors deemed to be sophisticated still require the protection that mandatory disclosure would provide (unrestricted access to the material information of the hedge fund’s adviser). See SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953) (holding that issuers of securities should not be exempt from the registration requirements of the Securities Act unless the issuers’ investors do not need the protection that the Act provides—full disclosure of information thought necessary to informed investment decisions); Doran v. Petroleum Management Corp., 545 F.2d 893, 902-03 (5th Cir. 1977) (holding that “sophistication is not a substitute for access to the information that [under the Securities Act] would disclose). See also Jacob Bunge, SEC, Pît and Others Weigh Hedge Fund Rules, HEDGEWORLD DAILY NEWS, Feb. 23, 2007 (“Being wealthy doesn’t equate to increased investor knowledge . . . [or the] ability to ascertain a good/bad investment . . . “).

However, at the time of this Article’s publication, the SEC has not approved Proposed Rules 509 and 216. Principally, the entirety of the criticisms received by the SEC during the public comment period for Rules 509 and 216 were from hedge fund investors who currently qualified as “accredited investors,” but who would lose such qualification and be forced to withdraw their hedge fund investments due to the Proposed Rules’ increased net-worth requirements. See Accredited Investors in Certain Private Investment Vehicles, Comments on Proposed Rule: Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Exchange Act Release No. 33-8766.
defrauding his or her "clients"—the hedge fund itself)—to protect the actual individual investors of a hedge fund by creating a "new . . . 'look-through' [in] the organizational form of a hedge fund Adviser's clients" for purposes of the anti-fraud provisions of the IAA. It is the SEC's position that this new look-through will "[strengthen] protections for investors against hedge fund advisers who commit "fraudulent, deceptive, or manipulative" acts against those individuals who invest in the hedge funds under the adviser's management.

As stated, the SEC adopted its new rule in hopes of protecting individual hedge fund investors against the fraudulent and deceptive acts of the hedge fund's advisers. This Rule came in response to the Goldstein decision, which "created uncertainties regarding [the] obligations that investment advisers to [hedge funds] . . . have to the [hedge funds'] . . . investors." The Goldstein decision clearly opined that the hedge fund itself was the adviser's client for IAA purposes; therefore, Section 80b-6(1) and (2) of the IAA, which clearly prohibit fraudulent practices by an adviser to the hedge fund's "clients," would not provide such protection for the hedge fund's individual investors. However, the Goldstein decision did not have the same effect on the SEC's anti-fraud regulatory powers under Section 80b-6(4) of the IAA because that Section does not only prohibit advisers from engaging in fraud against their "clients," but rather more broadly prohibits the adviser from engaging in any fraudulent act or practice, regardless of who such act or practice is directed towards. Furthermore, Section 80b-6(4) expressly grants the SEC the power to adopt rules and regulations to specifically prevent the adviser from engaging in any fraudulent act or practice. Therefore, the SEC's New Rule would extend the anti-fraud provisions of Section 80b-6(4) of the IAA to protect the individual investors of a hedge fund.

206 SEC's New Rule, supra note 202, at 3.
209 Id. at 6.
210 Id.
211 Therefore, the SEC believes that its new rule under § 80b-6(4) would "clarify that the SEC is authorised to take action against investment advisers to hedge funds... who mislead or defraud investors, whether or not the advisers are registered with the SEC [under the IAA]." SEC to Strengthen Rules on Hedge Fund Fraud and Qualifying Investors, HEDGEWEEK, Dec. 15, 2006.
213 Believing that the Goldstein decision had many negative "side-effects" on the individual investors of hedge funds, deemed by Goldstein not to be the "clients" of the hedge fund's adviser for purposes of financial disclosure under the IAA, the SEC believes that its New Rule will enable the Commission to "fulfil its mission of investor protection" through the IAA's anti-fraud provi-
Under Section 80b-6(4) of the IAA specifically:

it would constitute a fraudulent, deceptive, or manipulative act, practice, or course of business . . . for any investment adviser to a [hedge fund] to make any untrue statement of a material fact to any investor or prospective investor in the [hedge fund], or to omit to state a material fact necessary in order to make the statements made to any investor or prospective investor in the [hedge fund], in the light of the circumstances under which they were made, not misleading.\textsuperscript{214}

Furthermore, the Rule will prohibit a hedge fund’s adviser from “otherwise engag[ing] in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the [hedge fund].”\textsuperscript{215} Thus, all hedge fund advisers would be prohibited from making false or misleading statements, or otherwise engaging in any deceptive conduct, to the individual investors (or potential investors) of the advisers’ hedge fund.\textsuperscript{216} And, the SEC would be able to bring enforcement actions under the IAA against a hedge fund adviser who disseminates such false statements or engages in such fraudulent or deceptive conduct,\textsuperscript{217} even if such fraud or deception is not aimed at the fund’s investors directly.\textsuperscript{218}

This New Rule amounts to another attempt by the SEC to rein in the wholly unregulated hedge fund industry; however, the question remains: assuming the New Rule does not meet the same fate as the SEC’s previous “hedge fund rule,” will it provide hedge fund investors (or potential investors) with the same meaningful protection that the SEC and the federal securities laws guarantees to the greater investing public?\textsuperscript{219} Unfortunately, this Author believes that

\textsuperscript{214} SEC’s New Rule, supra note 202, at 11-12.

\textsuperscript{215} Id. at 14 (emphasis added).

\textsuperscript{216} Id. at 7 (emphasis added). As stated, this New Rule would apply to all hedge fund advisers. Therefore, a hedge fund adviser exempted from SEC regulation under the IAA’s private adviser exemption would nonetheless be required to comply with the IAA’s anti-fraud provisions in § 206b-6(4) and the SEC’s New Rule.

\textsuperscript{217} Id. at 40.

\textsuperscript{218} See Clair, supra note 213.

\textsuperscript{219} The “protection” that other, non-hedge fund, investors receive under the IAA principally derives from the information that SEC registration under the IAA requires an investment adviser to disclose, which in turn becomes public information and guarantees that those investors (or
this question will ultimately be answered in the negative. The SEC’s New Rule may guarantee that a hedge fund adviser has a fiduciary duty to not to “engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative [to clients or perspective clients],” however, this requirement falls short of the blanket disclosure of information that hedge fund investors would have had access to as a result of the adviser being required to register their hedge fund with the SEC. Thus, the SEC’s New Rule will only provide hedge fund investors with the same anti-fraud protection that the Commission already provides other investors in the U.S. financial markets after the investor chooses to invest (or is considering to invest) in the hedge fund under the adviser’s management. The Rule does not impose an affirmative duty on the hedge fund adviser to disclose material financial information about the hedge fund itself. Therefore, a potential hedge fund investor will not be protected to the same extent as other non-hedge fund investors because these potential investors will simply not have access to the same type of information about the investment vehicle they are contemplating investing in. And, without such access, there is simply no way that the SEC will be able to protect hedge fund investors to the extent that other financial investors are duly protected. Therefore, to this Author, the SEC’s New Rule falls short of fulfilling the purpose of the SEC and the federal securities laws—ensuring investor protection through disclosure.

potential investors) of the adviser have access to such information before deciding to invest (or to continue to invest) with the adviser. See supra note 60.

220 The anti-fraud provisions of the IAA “were intended to establish federal fiduciary standards to govern conduct of . . . advisers, . . . and [the] investment adviser has [an] affirmative duty of utmost good faith, and full and fair disclosure of all material facts.” SEC v. Financial News Associates, 1985 W.L. 25023 (E.D. Va. 1985).


222 See supra note 63. It is access to this blanket financial information that the SEC’s previous “hedge fund rule” would have required, and that the decision in Goldstein struck down as arbitrary.

223 This Author realizes that the opponents of increased hedge fund regulation argue that the vast majority of hedge fund investors are wealthy and highly sophisticated and, therefore, will have access to the financial information they need without SEC registration; however, as is evident in the Amaranth Adviser’s “meltdown,” it is clear that many allegedly “sophisticated” investors simply do not have as much access to such information as many opponents believe. Gone are the days when only experienced, wealthy, business savvy investors are investing in hedge funds. Hedge fund investors, to some extent, are now classified as newly-rich, financially unsophisticated investors trying to take quick advantage of the lucrative, absolute profit for which hedge fund advisers claim as the “selling point” for investing in these highly volatile and risky investments. However, as Amaranth may have made apparent, these investors are investing in hedge funds without having access to the same information they would have had if they had chosen to invest in another IAA registered investment vehicle, such as a mutual fund. And, it is this Author’s contention that such “restricted” access to the financial information of a hedge fund will ultimately cause more financial harm to the fund’s investors than cost to the hedge fund had its adviser been otherwise required to register under the IAA and make public disclosures to the SEC.
of all financial information relating to the investment vehicle for which the investor is contemplating investing in.\textsuperscript{224}

VI. CONCLUSION

"When the tide goes out, you find out who is naked."\textsuperscript{225}

The future of hedge fund regulation is, unfortunately, uncertain. Since Goldstein\textsuperscript{226} and the unexpected collapse of Amaranth Advisors,\textsuperscript{227} there has been no consensus as to whether, or to what extent, hedge funds, and hedge fund advisers, should be federally regulated. And, it remains to be seen what impact the most recent regulatory attempts—Congress’s proposed tax increases\textsuperscript{228} and the SEC’s New Rule\textsuperscript{229}—will have on the hedge fund industry. However, two things are certain: (1) the hedge fund industry continues to grow at an unprecedented pace\textsuperscript{230} and (2) hedge fund investors continue to be the victims of hedge fund abuses.\textsuperscript{231} And, because these reoccurring abuses could have potentially

\textsuperscript{224}See SEC v. Ralston Purina Co, 346 U.S. 119, 124-25 (1953) (holding that “the design of . . . [SEC registration] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions").


\textsuperscript{226}See supra Part IV.

\textsuperscript{227}See supra Part V.B.

\textsuperscript{228}See supra Part V.C.2.

\textsuperscript{229}See supra Part V.C.3.

\textsuperscript{230}See supra note 6 and accompanying text. But see Sree Vidya Bhaktavatsalam, Grantham Says Hedge Funds, LBO Funds to Collapse, BLOOMBERG NEWS (Online Edition), July 31, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aov51Qwu2pE&refer= (stating that more than one-half of U.S. hedge funds could close in the next five years due to the impending collapse of the home mortgage market).

\textsuperscript{231}Two such notable abuses occurred during the Summer of 2007 with the drastic losses suffered by Sowood Capital Management LP, a Boston based hedge fund that lost approximately $1.5 billion of its investors assets (of which at least $280 million of which were investments from pension funds and universities) during the month of July on brash bets in the credit market, and the bankruptcy and liquidation of two large hedge funds managed by The Bear Stearns Co., Inc. after such funds suddenly lost over $1 billion of its investors' assets as a result of the unexpected meltdown of subprime mortgage-related securities for which the funds invested principally in. For a description of the losses suffered by Sowood Capital, see Ross Kerber, Pension Officials in State Defend Hedge Funds Despite Sowood Loss,” THE BOSTON GLOBE (Online Edition), Aug. 3, 2007,http://www.boston.com/business/globe/articles/2007/08/03/pension_officials_in_state_defend_hedge_funds/. For the same regarding Bear Stearns, see Jeff St. Onge & Bill Rochelle, Bear Stearns Caymans Filing May Hurt Bankrupt Funds' Creditors, Bloomberg News, Aug. 7, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aX9aWxCf9y3o&refer=home; Kevin Hall and Robert Rankin, Hedge Funds Worrisome to Many Experts, Detroit Free Press (Online Edition), Aug. 8, 2007.
been prevented had proper regulatory oversight been established, it is the conclusionary opinion of this Author that the future of hedge fund regulation must be marked by a substantial increase in the amount of protection the federal government (namely the SEC) ensures to those investors who wish to invest their assets in the hedge fund industry. Without such protection, it is obvious that hedge fund investors, regardless of their level of investing prowess or expertise, will remain "naked" in the ever-growing tide that is the hedge fund industry.

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