Hedge Fund Regulation: Investors are Knocking at the Door, but Can the SEC Clean House before Everyone Rushes In

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Hedge Fund Regulation: Investors are Knocking at the Door, but can the SEC Clean House Before Everyone Rushes In?

I. INTRODUCTION

In February 2003, Guaranteed Returns Diversified Inc. (Guaranteed), a new player in the investment market with substantial backing, launched its website to attract investors to its newest hedge fund product. Guaranteed described itself as "the world's leading operator of hedge funds. Based in the Wylshock Islands in the Indian Ocean, with 68 offices world-wide, [Guaranteed had] been making money for sophisticated investors for more than 18 years." The incredible funds advertised on Guaranteed's website included "York Partner's L.P.," which claimed to have generated returns of 148% since 2000, or "Paragon Financial, L.P.," which had consistently offered returns of up to ninety-nine percent. Unfortunately, Guaranteed is too good to be true. The Securities and Exchange Commission ("SEC") created Guaranteed (Symbol GRDI, pronounced "Greedy") as a cautionary reminder to overzealous investors with more money than financial savvy. Despite the outrageous claims by Guaranteed, the site received over 80,000 hits in a ten month period.

Guaranteed illustrates the growth in popularity of the hedge fund industry that has raised concern within the SEC. As hedge funds have become more popular with affluent investors and have been marketed to smaller investors through "funds of hedge funds," the SEC has taken action to insure against fraud. On December 10, 2004, the

2. Id.
3. See id.
5. Id.
6. See Erik J. Greupner, Hedge Funds are Headed Down-Market: A call for Increased Regulation?, 40 SAN DIEGO L. REV. 1555, 1570-73 (2003) (citing several actions taken by the SEC against unregistered hedge fund advisors such as Peter Chabot, Michael Smirlock, David Mobley, Mark Yagalla, and Michael Berger).
7. See infra notes 148-57 and accompanying text.
SEC released final rules to amend the Investment Advisors Act of 1940 to include certain hedge fund advisors. There has been heated debate over whether the final rule will be effective in protecting investors or even if there is a threat to investors in the first place.

SEC regulation of the hedge fund industry is long overdue. Today, as they have throughout their existence, hedge funds have free reign over the world of investments. Hedge funds, though effective in many cases, are rife with incentives for misconduct. Unfortunately, the SEC's proposed ruling is inadequate in meeting even its own stated goals. This paper will describe the hedge fund industry, explain the reasons why hedge fund regulation is necessary, and analyze the strengths and weaknesses of the final rule with respect to these concerns.

Part II will explain how hedge funds work. Part III will give a brief history of the hedge fund industry and examine its recent trends. Part IV will discuss the existing regulations imposed on hedge funds. Part V will look at the causes for concern that inspired the SEC to take action. Part VI will examine the structure of the final rule and comment on how it differs from previous regulations on the industry. Part VII will examine the industry reaction to the final rule and examine the strengths and weaknesses of the rule. Finally, Part VIII will conclude by discussing why the rule will be ineffective.

9. See infra notes 110-257 and accompanying text.
10. See infra notes 38-41 and accompanying text.
12. See infra notes 211-51 and accompanying text.
13. See infra notes 23-105 and accompanying text.
14. See infra notes 110-64 and accompanying text.
15. See infra notes 165-257 and accompanying text.
16. See infra notes 23-41 and accompanying text.
17. See infra notes 42-56 and accompanying text.
18. See infra notes 57-105 and accompanying text.
19. See infra notes 106-64 and accompanying text.
20. See infra notes 165-210 and accompanying text.
21. See infra notes 211-57 and accompanying text.
22. See infra notes 258-66 and accompanying text.
II. WHAT IS A HEDGE FUND?

Hedge funds are the mysterious rich uncle of the investment industry family; no one agrees on his age, occupation or history, but everyone knows that he is related. Authorities differ as to the definition of "hedge fund." Although there is no legal definition, three elements are generally included in the description of a hedge fund: high leverage, elite investors, and little SEC oversight. Hedge funds have traditionally been highly leveraged small investment companies with an investment model pitting long positions against short ones in


24. See id.


26. See Russ Wiles, One Way the Rich Get Richer – Hedge Funds a Risk not all can Take, ARIZONA REPUBLIC, Mar. 18, 2002, at ID. Generally, hedge fund investment has only been open to rich, experienced investors, who can afford the sometimes great risk of hedge funds. Id.

27. See infra notes 57-105 and accompanying text. The final rule would require hedge fund advisors to register with the SEC under the Advisors Act of 1933. See infra, notes 165-210 and accompanying text. This would place a variety of reporting and accounting requirements on hedge funds, but it would not totally dissolve the freedom from regulation that hedge funds enjoy. Id.

28. See Investorguide.com, University, at http://www.investorguide.com/igustockstrategy.html (last visited Jan. 5, 2005). A “Long” position is simply the purchase of a security, with the hope of profiting from the increased value of the security over time. Id.

29. See Investorguide.com, University, available at http://www.investorguide.com/igustockshort.html (last visited Jan. 5, 2005). “Selling short” is when an investor borrows stock from a stockholder with the promise to replace it at a later date. Id. The borrowed stock is sold on the open market, and the profits from the sale are kept by borrower. Id. Hopefully, by the time the borrowed stock is due for return, the value of the stock has gone down and can be bought on the open market for a lower price. Id. Thus the investor can profit by replacing the borrowed stock by buying it at a lower price than borrowed. Id. For example, if investor A believes that Acme stock is overpriced, it could borrow shares of that stock from a current stockholder with the promise to replace them at a future date. Id.
order to reduce vulnerability to market fluctuations. Not all hedge funds follow such a sophisticated arbitrage model, however, and many do not "hedge" investments at all.

Hedge funds have traditionally been available only to wealthy investors through private issuances of stock. Each fund carries a relatively small number of investors, either 100 or 499, depending on the securities laws utilized during initial setup. Generally, hedge funds are set up as private limited partnerships or limited liability companies which qualify for pass-through taxation. The investment strategies are generally kept private, and they may span across a diverse array of investment products. Usually, one fund manager makes

30. See ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 25 (2000). Hedge funds were originally designed as a conservative investment model, pitting long term investments against short selling to insulate the total investment portfolio from market fluctuations. Id.


33. See Greupner, supra note 6, at 1561-62. Before 1996, most hedge funds exempted themselves from the Investment Company Act of 1940 under section 3(c)(1). Id. The exception allows hedge funds to sell shares to no more than 100 investors. Id. In 1996, however, the SEC passed the National Securities Markets Improvement Act (NSMIA), which amended the Investment Company Act of 1940 to include an exception to the definition of "investment company" under section 3(c)(7) for private investment funds that sell exclusive securities offerings to "qualified purchasers." Id. Under the exception, hedge funds were allowed to sell shares to a maximum of 499 investors, who must have a higher net worth in order to achieve "qualified investor" status. Id.

34. See Franklin R. Edwards, Hedge Funds and the Collapse of Long-Term Capital Management, 13 J. ECON. PERSP. 189, 190 (1999) (noting that hedge funds can be organized as limited liability companies, but most are limited liability partnerships). Many hedge funds are offshore funds organized in countries which have lenient regulatory controls of investment transactions and provide tax advantages for hedge fund investing. Id. at 191.

35. See LOWENSTEIN, supra note 30, at 24.
investment decisions\textsuperscript{36} and receives compensation through upfront management fees, commissions based on fund profitability, or a combination of both.\textsuperscript{37}

Exemption from registration with the SEC allows hedge funds to utilize investment styles that are off limits to other investment entities, such as mutual funds.\textsuperscript{38} Though some hedge funds are required to register with the Commodities Futures Trading Commission,\textsuperscript{39} and others voluntarily register with the SEC,\textsuperscript{40} hedge funds generally operate outside the scope of SEC regulation or oversight.\textsuperscript{41}

III. HEDGE FUNDS OF YESTERDAY AND TODAY

The first hedge fund was run by an Australian investor named Alfred Winslow Jones.\textsuperscript{42} Jones balanced his portfolio by selling short stocks that were overpriced and buying stocks that were a bargain.\textsuperscript{43} By setting up his portfolio to profit if the market declined or grew, Jones was able to insulate against market fluctuation.\textsuperscript{44} The strategy was dependent only upon finding the "relative best and worst."\textsuperscript{45} From Jones' original framework, hedge funds have grown to encompass all areas of the market.\textsuperscript{46}

\begin{thebibliography}{99}
\bibitem{36} See Gibson, supra note 32, at 684.
\bibitem{37} See Donaldson, supra note 31. (noting that hedge fund advisors are compensated through management fees and performance fees).
\bibitem{38} See LOWENSTEIN, supra note 28, at 24. Hedge funds may concentrate their portfolios without any regard for diversification. Id; see generally supra notes 57-102 and accompanying text. Hedge funds are subject to only a few provisions of the four major securities acts, such as the anti-fraud provisions of the Advisors Act of 1940. See supra note 96 and accompanying text. Hedge funds are not directly regulated by any of the four major securities laws, but only because they have molded themselves around the law to fit within specific exemptions. See supra notes 55-99 and accompanying text. Thus, the true force to securities laws on hedge funds is the effect they have on shaping the industry through the exceptions rather than direct statutory control or oversight. See supra notes 55-99 and accompanying text.
\bibitem{39} See LOWENSTEIN, supra note 30, at 24.
\bibitem{40} See Chris Frankie, \textit{Registered Hedge Fund Demand on the Rise}, INVESTMENT MGMT. WKLY, Sept. 6, 2004.
\bibitem{41} Id.
\bibitem{42} See LOWENSTEIN, supra note 30, at 25.
\bibitem{43} Id.
\bibitem{44} Id.
\bibitem{45} Id.
\bibitem{46} See Gibson, supra note 32, at 684. Hedge funds still pursue conservative models of investing such as those pioneered by Jones, but they have grown to encompass all areas of the market, including debt and equity securities, futures, options, over the counter
\end{thebibliography}
Hedge funds have not only evolved into different investment models but have expanded in terms of numbers and assets as well. In 1968, it is estimated there were only 215 hedge funds. By 2001, that number had grown to 6,000. By 2003, it is thought that between 6,000 and 7,000 hedge funds were in operation with over $650 billion in assets under management. Some estimates believe that hedge fund holdings will soon eclipse the one trillion dollar mark. This rapid growth has been caused by a number of factors, including changes to federal law increasing the maximum number of investors in a hedge fund, the growth in qualified investors who are able to meet the minimum investment requirements for hedge funds, the growth of new vehicles for investing in hedge funds such as "funds of hedge funds," and the underlying mystique surrounding hedge funds as a risk-free way to maximize investment returns.

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derivatives, and foreign currencies. See Lindsey supra note 23. Hedge funds have grown to the point where they can now be found in nearly any variety. Id. They trade in equities, US and foreign government securities, commodities, financial futures, options, foreign currencies, derivatives, and merger and acquisition investments. LOWENSTEIN, supra note 30, at 25. Hedge funds are present in all areas of the market. Id.

47. See LOWENSTEIN, supra note 30, at 26.
48. Id.
49. See Greupner, supra note 6, at 1561.
50. See SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS vii (Staff ed. 2003) [hereinafter Staff Report].
51. See id; see also Donaldson, supra note 31.
52. See Phillip Morton, Hedge Fund Inflows Double in Third Quarter, at http://www.investoroffshore.com/asp/story/storyinv.asp?storyname=17770 (Oct. 29, 2004). Hedge funds total inflow is estimated at 17 billion from August of 2004 to October of the same year. Id. This represents twice the capital as the previous quarter. Id.
53. See Greupner, supra note 6, at 1561. Under the change to the Investment Company Act of 1940 enacted under the NSMIA, individual hedge funds could take on as many as five times as many clients than before NSMIA was enacted (up to 499). Id. Even though the minimum net worth per investor requirement was increased under NSMIA to five million dollars, the change increased the popularity of hedge funds as it became more alluring for financial managers to enter the hedge fund industry. Id.
56. See LOWENSTEIN supra note 30, at 26. As investors have called for hedge funds to invest in, large financial institutions such as Merrill Lynch have worked hard to provide them. Analisa Nazareno, Hedge Funds Remain Shrouded As more investors become interested, the chances of greater transparency and regulation grow. But will the industry balk at changing?, SAN-ANTONIO EXPRESS NEWS, Sept. 6, 2003 at http://www.mccombs.utexas.edu/news/mentions/arts/2003/09.06.sae_goodrich.asp (citing industry demand that
Through a variety of means, the SEC and other regulatory agencies indirectly exercise authority over the hedge fund industry.\textsuperscript{57} Built in exemptions to the pertinent securities laws allow hedge funds to operate without SEC oversight.\textsuperscript{58} The exemptions\textsuperscript{59} have been effective in shaping the size, marketing, and customer base of the industry, but no set of rules has served to effectively monitor hedge funds.\textsuperscript{60}

Hedge funds are potentially subject to SEC regulation through four different statutes: the Securities Act of 1933 (Securities Act),\textsuperscript{61} the Securities Exchange Act of 1934 (Exchange Act),\textsuperscript{62} the Investment Advisors Act of 1940 (Advisors Act),\textsuperscript{63} and the Investment Company Act of 1940 (Investment Company Act).\textsuperscript{64} All four of the statutes require registration with the SEC in some form.\textsuperscript{65} In order to avoid registration, hedge funds must shape themselves around the exceptions to the rules of each act.\textsuperscript{66}

A. \textit{Securities Act of 1933}

Under the Securities Act of 1933, any entity that wishes to offer public securities must file a registration statement with the SEC,\textsuperscript{67} and may offer a prospectus about the issuer and the securities being offered.\textsuperscript{68} Hedge funds exempt themselves from this requirement by utilizing the "private placement exemption" in section (4)(2) of the

\textsuperscript{57} See Gibson, \textit{supra} note 32, at 688.

\textsuperscript{58} See Donaldson, \textit{supra} note 31. Hedge funds are able to avoid SEC regulation by meeting a set of standard exemptions. \textit{See also} Gibson, \textit{supra} note 32 at 688-98 (outlining the exemptions to statutes that have authority over hedge funds).

\textsuperscript{59} See infra notes 48-51 and accompanying text.

\textsuperscript{60} See Gibson, \textit{supra} note 32, at 688 (noting that hedge funds structure themselves around the major securities laws).


\textsuperscript{65} See Gibson, \textit{supra} note 32, at 688-99.

\textsuperscript{66} See Donaldson, \textit{supra} note 31.

\textsuperscript{67} See Securities Act at § 77f.

\textsuperscript{68} See Securities Act at § 77j.
Securities Act.69

Under the private placement exemption, registration can be avoided by making a non-public offering.70 Though there are a variety of ways to make a securities offering "non-public," rule 506 of Regulation D71 is the most common means by which hedge funds qualify for the private placement exemption.72 Rule 506 of Regulation D is "a set of requirements promulgated by the Commission to govern private offerings."73 Rule 506 exempts issuers who sell securities only to "accredited investors" without any form of "general solicitation or advertising."74 An accredited investor includes:

Individuals who have a net worth, or joint worth with their spouse, above $1,000,000, or have income above $200,000 in the last two years (or joint income with their spouse above $300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than $5,000,000 in assets; and many, if not most, employee benefit plans and trusts with more than $5,000,000 in assets.75

69. See Gibson, supra note 32, at 689.

70. See Staff Report, supra note 50, at 14. Non public offerings are defined as offerings "to those who are shown to be able to fend for themselves." SEC v. Ralston Purina Co., 346 U.S. 119, 125-27 (1953). (noting that the definition of "public offering" has evolved over time, and has come to limit hedge funds primarily to those who are considered sophisticated investors).


72. See Staff Report, supra note 50, at 14. Rule 506 is not the only means by which the private offering exemption can be utilized, but since it is an established safe harbor, it is the most frequently utilized method. Id.

73. Id.

74. Id. at 15.

The restriction on "general solicitation or advertisement" relies on the traditional preexisting relationships between broker and offeree, and specifically prohibits "advertisements, articles, notices or other communications published in a newspaper, magazine or similar media, cold mass mailings, broadcasts over television or radio, material contained on a web site available to the public or an email message sent to a large number of previously unknown persons" or any meeting or seminar where persons are generally solicited to participate.⁷⁶

Finally, Rule 506 requires reasonable assurance that the interests sold will not be resold by the offeree to the general public.⁷⁷ Resale is not typically an issue for hedge funds, as they have no interest in seeing their interests resold.⁷⁸ Hedge fund interests are typically sold on the condition that resale can only be done with express permission of the fund manager.⁷⁹

B. The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 requires brokers and dealers to register with the SEC.⁸⁰ Hedge funds usually exempt themselves from this provision by defining themselves as "traders" of securities, rather than "dealers."⁸¹ Section 12(g)⁸² and Rule 12g-1⁸³ require that an issuer having 500 holders of record of a class of equity security and assets in excess of $10 million at the end of its most recently ended fiscal year register the equity securities under the Exchange Act.⁸⁴ Most hedge funds avoid these registration requirements by limiting the number of equity holders to 499 investors.⁸⁵

⁷⁶. See Staff Report, supra note 50, at 16.
⁷⁷. Id.
⁷⁸. Id.
⁷⁹. Id.
⁸¹. See Staff Report, supra note 50, at 18.
⁸³. 17 C.F.R. § 240.12g-1 (2004).
⁸⁴. See Staff Report, supra note 50, at 18.
⁸⁵. Id.
C. The Investment Company Act of 1940

The Investment Company Act of 1940 requires investment companies to register with the SEC.\(^\text{86}\) Hedge funds are exempt from regulation under this Act under the exceptions in section 3(c)(1) or section 3(c)(7).\(^\text{87}\) Under 3(c)(1), funds with fewer than 100 investors are exempt from registration.\(^\text{88}\) Under 3(c)(7), hedge funds are exempt from registration as an investment company if they sell only to “qualified investors”\(^\text{89}\) (investors with at least $5 million in investments)\(^\text{90}\) and if they do not make a public offering.\(^\text{91}\) Most recently, hedge funds have relied on section 3(c)(7) to exempt themselves from registration, as there is no limitation on the number of “qualified investors” that can invest in a hedge fund before registration becomes mandatory.\(^\text{92}\) By relying on section 3(c)(7), hedge funds are limited in size only by the registration requirements of other acts.\(^\text{93}\)

D. The Investment Advisors Act of 1940

The Investment Advisors Act of 1940 requires all investment advisors with more than fifteen clients and assets over thirty million dollars to register with the SEC.\(^\text{94}\) As part of their registration requirements, advisors must file and keep current Form ADV\(^\text{95}\) with the SEC.\(^\text{96}\) Form ADV requires advisors to disclose information about business practices and disciplinary history to the SEC and to their

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87. See Staff Report, supra note 50, at 11.
91. See Staff Report, supra note 50, at 11.
92. Id.
93. Id. at notes 56–59 and accompanying text. The Securities Exchange Act of 1934 requires registration of any investment company having 500 investors or more. Id. Thus, hedge funds limit themselves to 499 investors. Id.
94. See 15 U.S.C. § 80b-3 (2000). Advisors with less than twenty five million in assets are not permitted to register with the SEC. Id. Advisors with between twenty five and thirty million dollars under management are advised, but not required, to register with the SEC. Id. Advisors with at least thirty million of assets under management are required to register with the SEC. Id.
95. See 17 C.F.R. § 275.203-1 (2004); see also 17 C.F.R. § 275.204-1 (2004); see also 17 C.F.R. § 279.1 (2004).
investors. Registered advisors are also required to maintain certain accounting standards and are subject to periodic examinations by the SEC. Finally, registered advisors are required to maintain specific fraud prevention safeguards.

Hedge fund advisors work around registration requirements by treating each legal organization it advises as a single client. Under the small advisor exception, advisors that have had fewer than fifteen clients during the preceding twelve months and do not represent themselves to the public as an investment advisor, are exempt from registration requirements. Under the current interpretation of the Act, advisors may count each individual "legal organizations" as a single client. An organization may therefore have hundreds of members but only be treated as a single client for purposes of the Investment Advisors Act. Thus, a hedge fund may advise up to fourteen legal organizations, such as hedge funds, limited liability companies, or limited liability partnerships, without having to register. The Final Rule hopes to close this loophole, by considering each member of the legal organizations managed by investment advisors as a single client, thereby greatly multiplying the number of clients of the hedge fund and eliminating the availability of the small advisor exception.

V. CAUSES FOR CONCERN WITHIN THE HEDGE FUND INDUSTRY

The growth of hedge fund popularity and presence in the financial markets has come with some potentially harmful ramifications. The concerns can be separated into two related categories: threats to the financial industry and threats to the

97. See 17 C.F.R. § 275.203-1 (2004); see also 17 C.F.R. § 275.204-1(2004); see also 17 C.F.R. § 279.1 (2004).
100. See Staff Report, supra note 50, at 21.
103. See Staff Report, supra note 50, at 22.
104. See id.
105. See Final Rule, supra note 8, at 72,070.
106. See infra notes 110-62 and accompanying text.
107. See infra notes 110-17 and accompanying text.
investor. Though threats to the financial industry are compelling in their own right, the SEC final rule is designed for consumer protection.

A. Threats to the Finance Industry

History provides the best illustration of the potential threat posed to the financial industry by hedge funds. In 1998, after providing four years of unmatched returns, Long Term Capital Management (LTCM), a hedge fund run by former Salomon Brothers partner John Meriweather, lost billions with the crash of the Russian Ruble. At the height of its problems, the fund had an enormously high leverage ratio of roughly one hundred to one. With investors pulling out, and no way to pay back its lenders, LTCM threatened to shake up the world economy if it went into default. In collaboration with the SEC and the Federal Reserve, major banks and investment companies pulled together an infusion of capital to save the firm. LTCM is an example of absence of market discipline with a lack of federal reporting requirements. Though LTCM did report to creditors and investors related to their capital structure and other financial indicators of its creditworthiness, it did not provide and was not required to provide the essential data that would have set off the sirens of lending institutions. LTCM is not entirely to blame, however, because the banks and financial companies extended the enormous levels of credit without

108. See infra notes 127-62 and accompanying text.
109. See Final Rule, supra note 8, at 72,054.
111. Id., at 601. Before the problems caused by the crash of the Ruble, LTCM was still inordinately highly leveraged. Id. at 599. It had about 7.5 billion in capital. Id. With its losses however, capital was reduced to about 1.7 billion, with around 100 billion in assets. Id.
112. Id. The effects of 100 billion dollars in losses to the finance industry would have been devastating to the world economy. Id.
114. See Gibson, supra note 32, at 704, 707. The lack of market discipline allowed LTCM to grow beyond its means. See id. at 707. The lack of reporting requirements prevented any regulator from noticing the problem. See id. at 704.
115. Id. at 708. Had the creditors to LTCM known the degree to which LTCM had leveraged their assets, customary credit lending practices would not likely have allowed such loans to be made. Id.
properly considering the risk. The market had become so faithful in LTCM, and LTCM so arrogant in its success, that no one realized the potential for disaster.

LTCM illustrates the impact that hedge funds can have on the market if they grow too large without prudent management. Despite numerous hearings and investigations on the necessity of increased regulation to prevent another LTCM disaster, no increased regulation was ever enacted.

B. Threat to Consumers

There are a variety of threats to consumers posed by the hedge fund industry. The problems are well documented, and the SEC has identified a number of public policy concerns related to hedge funds, including lack of SEC oversight, fraud, recent growth, valuation, retailization, disclosure, and conflicts of interest. The underlying focus of the current SEC action centers on consumer

116. Id.
117. See id. at 714.
119. See infra notes 120-62 and accompanying text.
120. See generally Staff Report, supra note 50 at 76-87 (discussing the many concerns of the SEC regarding hedge funds); see generally Press release, Securities and Exchange Commission, SEC Chairman Donaldson Releases Staff Report on Hedge Funds (Sept. 29 2003), available at http://www.sec.gov/news/press/2003-125.htm. For the investigation, the "SEC staff reviewed documents and information from 65 hedge fund advisors managing more than 650 different hedge funds with over $160 billion of assets." Id. "Staff also visited hedge fund advisors and prime brokers and conducted a series of examinations of registered funds of hedge funds." Id. In addition, the staff met with a variety of hedge fund industry experts and observers. Id. "The Commission also held a two-day Roundtable, during which a variety of experts discussed key aspects of hedge fund operations." Id. "The staff also analyzed approximately 80 comment letters that were received by the Commission on hedge fund issues following the Roundtable." Id.
121. See Staff Report, supra note 50, at 76.
122. See id.
123. See id. at 77.
124. See id. at 79-80.
125. See id. at 80-81.
126. See Staff Report, supra note 50, at 83.
127. See id.
protection concerns raised by the growth of the hedge fund industry.\textsuperscript{128}

1. Oversight

The SEC cites two primary concerns related to the lack of hedge fund oversight: an "inability to detect fraud and other misconduct at early stages" and a "lack of meaningful information about hedge funds and hedge fund advisors."\textsuperscript{129} Both of these factors handicap the SEC in protecting American consumers.\textsuperscript{130}

Of the thirty-eight enforcement actions instigated by the SEC against hedge funds between 1998 and 2003, nearly all resulted from investor or service provider reports to the SEC.\textsuperscript{131} By the time the SEC became involved most of the damage had been done.\textsuperscript{132} By contrast, the SEC claims that this type of fraud does not occur nearly as often with registered advisors because they are subject to examinations by the SEC.\textsuperscript{133}

The SEC has no idea how many hedge funds there are in the United States,\textsuperscript{134} how large an asset pool they control,\textsuperscript{135} or who their advisors are.\textsuperscript{136} With the growth of hedge funds, especially to non-

\textsuperscript{128} See generally Registration Under the Advisors Act of Certain Hedge Fund Advisors, 69 Fed. Reg. 45,172 (proposed July 28, 2004) (to be codified at 17 C.F.R. pts. 275 & 279) [hereinafter Proposed Rule]. In the introduction to the proposed rule, there is a description of the information that helped lead up to the proposed rule's creation. Id. at 45174. The rule cites two major studies: the SEC staff report and the President's working group in 1999. Id. The President's Working Group report focused primarily on risks to the banking and finance industry from hedge funds inspired by the LTCM hedge fund debacle in 1996. Id.

\textsuperscript{129} See Staff Report, supra note 50, at 76.

\textsuperscript{130} See id.

\textsuperscript{131} See id.

\textsuperscript{132} See Staff Report, supra note 50, at 76 n.263. (statement of Stephen M. Cutler) [I]n the case of unregistered advisors, [the Commission's Enforcement Division is] not going to be the beneficiar[y] of an examination that is going to have identified a problem, brought it to our attention in the form of an enforcement referral. So a lot of what we end up seeing in the hedge fund area is after the train wreck has already happened. We will get a complaint from an investor that finds that he's been wiped out. Id. (alteration in original) (quoting Stephen M. Cutler, Roundtable Transcript, May 15, 2002).

\textsuperscript{133} See Staff Report, supra note 50, at 76.

\textsuperscript{134} See id. at 77.

\textsuperscript{135} See id.

\textsuperscript{136} See id.
traditional investors such as pensions, and funds of hedge funds, the staff sees this lack of information regarding hedge funds as a significant inhibitor to the SEC's ability to protect the investors.

2. Hedge Fund Portfolio Securities Valuation

Another concern indicated by the staff is "the lack of independent checks on a hedge fund advisor's valuation of a... fund's portfolio securities." Hedge fund advisors are free to represent the value of the securities in any way they choose, even if they have an outside service provider confirm valuation. The SEC's lack of power to examine hedge fund accounting records leaves consumers at risk of mispricing.

3. Retailization

Retailization is the practice of making hedge funds available to a more broad array of investors, specifically small investors with lower incomes. Though hedge funds have traditionally only been available to "sophisticated investors," retailization attempts to open the market to typical mom and pop investors. The SEC Staff report of 2003 indicates that although the number of qualified investors has grown significantly in the past fifteen years, there is no evidence of significant numbers of retail investors entering the hedge fund market. Despite these findings, the staff committee expressed its concern that brokers would begin to solicit newly minted investors as a source of new investments for hedge funds. In addition to small investors,
Retailization fears have been spurred by institutional investors, such as pension plan managers, universities, endowments, and charitable organizations, that have shown an increased interest in hedge funds.\textsuperscript{146} Such entities are an indirect means by which hedge funds can access small investors.\textsuperscript{147}

There is also a concern related to a relatively new investment model commonly referred to as Registered Funds of Hedge Funds (FOHF), which makes hedge fund investment available to small investors.\textsuperscript{148} A FOHF invests in a variety of hedge funds within one fund.\textsuperscript{149} It is like a mutual fund, except that instead of investing in individual securities, it invests in a variety of hedge funds.\textsuperscript{150} Many FOHFs have lower investment minimums than typical hedge funds, which opens them up to small investors.\textsuperscript{151} They also tend to cost the investor much more in fees than a normal hedge fund.\textsuperscript{152} Though funds of hedge funds register with the SEC, the information FOHFs receive from unregistered hedge funds is not always reliable.\textsuperscript{153}

The SEC staff's concern with FOHFs is the lack of reliable data related to calculations of net asset value.\textsuperscript{154} The staff is also concerned that investors in FOHFs will not be adequately informed as to the fees they will be charged by hedge funds within the fund.\textsuperscript{155} Finally, the lack

\begin{thebibliography}{99}
\bibitem{147} See Staff Report, \textit{supra} note 48, at 82.
\bibitem{149} \textit{Id.}
\bibitem{150} See Staff Report, \textit{supra} note 50, at 67.
\bibitem{151} See Weinberg, \textit{supra} note 143, at 186.
\bibitem{152} See \textit{id.} Hedge funds often come with a very high service fee. \textit{Id.} It can take the form of a set percentage of fund profits, and upfront fee, or both. \textit{Id.} In a fund of a hedge fund, the fund carries a similar fee, in addition to the fees of all hedge funds that are invested in. \textit{Id.} Thus, the investor is hit with a proverbial double whammy. \textit{Id.}
\bibitem{153} See Williamson, \textit{supra} note 131, at 19. The bull market for hedge funds has caused some advisors to funds of hedge funds to cut corners where possible and rely on shady information regarding the valuation of the hedge funds they invest in and the security of their investments. \textit{Id.}
\bibitem{154} See Staff Report, \textit{supra} note 50, at 81.
\bibitem{155} See \textit{id.} at 82.
\end{thebibliography}
of transparency may jeopardize the desired diversification of a fund. The bane of such oversight would fall on the investor.

4. Conflicts of Interest

The SEC has also expressed concern that hedge fund advisors may have conflicts of interest between hedge fund and non-hedge fund investors. Though a conflict of interest is permissible, provided that clients are notified of the conflict, the staff expressed concern that notice was not taking place to a satisfactory level of specificity.

Hedge fund advisors usually have significant incentives to maintain a successful hedge fund, such as the advisor's own personal investment in the fund or the heightened fees that hedge funds command. Such incentives are a temptation for a manager to favor the hedge fund over other clients or management responsibilities. Also, considering that different strategies are implemented for different funds, such as short selling for hedge funds and long positions for regular mutual funds, it is possible that a decision to benefit one client will come at the expense of another.

These concerns illustrate the threat that hedge funds can have to investment consumers and the financial industry in general. Though the final rule does not address all of these concerns, it is clear that hedge funds are at least a potential threat to investors and the finance industry as a whole.

156. See id. Investors may invest in a FOHF, as well as other mutual funds or FOHF, and have a redundant or duplicated investments. Id. For example, two hedge funds could invest in the same securities, or utilize the same investment model. Id. If an investor invests in both of them, the investment would be redundant. Id. Since disclosure is not required by hedge funds, the investor would have no idea that his attempt to diversify was failing. Id.

157. See Staff Report, supra note 50, at 81.

158. See Staff Report, supra note 50, at 83.

159. See id.

160. See Staff Report, supra note 50, at 84; See also Anne Tergesen, Time to Hedge on Hedge Funds? New Research Shows that Returns are Sliding, and Some don't Help you Diversify, BUS. WK., Sept. 13, 2004, at 105. “A hedge fund investor can expect to fork over 1% to 2% of the account balance every year to cover management fees... [In addition,] hedge funds typically pocket about 20% of any profits they generate.” Id.

161. See Staff Report, supra note 50, at 84.

162. See id.

163. See supra notes 119-62 and accompanying text.

164. See supra notes 119-62 and accompanying text.
VI. Final Rule Analysis

Guided by the 1999 President's Report, the SEC staff report, and a roundtable of industry professionals, on December 10, 2004, the SEC issued the final rule to address the concerns of hedge fund growth.

A. Justification for the Rule

The SEC cites three factors that guide the rule: growth of the hedge fund industry, concern over the increased instances of fraud, and "retailization" of hedge funds that has occurred through funds of hedge funds.

B. Purpose of the Rule

With the new rule, the SEC hopes to accomplish five goals. First, the SEC hopes to obtain an accurate count of the number, size and structure of nearly all hedge funds on the market. Second, the SEC hopes that registration will prevent fraud by catching it before it occurs,
and deterring potential defrauders.\textsuperscript{175} Third, the SEC hopes registration will prevent unqualified persons from using the unregulated status of hedge funds as a cover to commit fraud.\textsuperscript{176} Fourth, registration would require adoption of compliance controls in an effort to prevent conflicts of interest.\textsuperscript{177} Finally, the SEC believes registration would help to place a limit on retailization, because the Advisors Act requires direct investors to have a net worth of at least $1.5 million or $750,000 for the advisor to charge performance fees.\textsuperscript{178}

\section*{C. Force and Substance of the Rule}

The final rule will have three effects. First, it redefines who must register under the Advisors Act, and functions to include nearly all hedge fund advisors.\textsuperscript{179} Second, the new rule provides exceptions to registration for certain types of investment advisors.\textsuperscript{180} Finally, the rule

\begin{itemize}
\item \textsuperscript{175} Id.
\item \textsuperscript{176} See id. at 45,179-80; see e.g., SEC v. Ryan J. Fontaine and Simpleton Holdings Corporation a/k/a Signature Investments Hedge Fund Litigation Release No. 18,254 (July 28, 2003) (charging Fontaine and Signature with violating Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Investment Advisors Act of 1940; and charges Signature with violating Section 7 of the Investment Company Act of 1940). In November 2002, the SEC charged Ryan J. Fontaine, a twenty-two year old college student living with his parents in Bloomfield Hills, Michigan with fraud. Id. Using the Internet to mask himself as a reputable hedge fund advisor, Fontaine fabricated an unregistered investment group, “Simpleton Holdings Company” also known as “Signature Investments Hedge Fund,” and conducted an unregistered stock issuance. Id. Through false statements about the fund’s track record, financial backing, assets under management, accounting, and relationship with reputable financial institutions and investors, Fontaine secured investments totaling nearly $30,000 from two investors in only four months. Id. From a period from July 2002 and at least October 22, 2002, Fontaine and Signature deceived investors into investing in Signature by fraudulently claiming, among other things, that: (a) Signature “averaged over a 39.5% annual return” over its 13-year history, including returns “during the bear market of the past 2 years [of ] over 21% per year;” (b) Signature had approximately $250 million under management; (c) Salomon Smith Barney was the sub-advisor to Signature; and (d) KPMG, LLP performed certain auditing services for Signature. Id. The defendants also made false and misleading statements about various investment advisory services purportedly offered by Signature, such as a Roth IRA program and a 401(k) program. Id. All such statements were false; signature was literally a one-person shop with no financial backing from other investors, no relationship with Salomon Smith Barney, and no relationship with KPMG. Id. All representations as to the fund’s performance were fabricated, as the fund itself had no investment history whatsoever. Id.
\item \textsuperscript{177} See Proposed Rule, supra note 128, at 45,180.
\item \textsuperscript{178} See Final Rule, supra note 7, at 72,064.
\item \textsuperscript{179} See infra notes 182-203 and accompanying text.
\item \textsuperscript{180} See infra notes 195-97 and accompanying text.
\end{itemize}
defines what types of procedures must be followed to be properly "registered" with the SEC.\footnote{See infra notes 204-10 and accompanying text.}

1. New Classes of Registrants

The primary force of the final rule would be to require nearly all "private fund"\footnote{See Final Rule, supra note 7, at 72,073. "Private Fund" is a company that would be defined as and investment company under 3a of the investment company act of 1940 (15 U.S.C. 80a-3(a)), but for exceptions provided in either 3(c)(1) or 3(c)(7) of the act, that permits its owners to redeem their interest within two years of purchase, the interests of which have been offered on the basis of the expertise of the investment advisor. \textit{Id.}} advisors to register with the SEC under the Advisors Act of 1940.\footnote{See Final Rule, supra note 7, at 72,054.} The rule creates this heightened registration requirement by reinterpreting the word "client" within the context of the "Small Advisor Exception" to the Advisors Act.\footnote{Id. The "Small Advisor Exception," contained in section 203(b)(3)-1 exempts from registration investment advisors who have had fewer than fifteen clients over the past twelve months. 15 U.S.C. 80b-3 (2004) (listing investment advisors exempt from registration). The provision provides five exceptions from the registration requirement, though Section 80b-3(b)(3) is the only section relevant to the proposed rule. \textit{Id.} It defines the Small Investor Exception requirements. \textit{Id.}}

Though the Small Advisor Exception would seem to limit hedge funds to fourteen investors, the exception as it is currently interpreted is practically worthless to limit the size of a hedge fund.\footnote{See infra notes 186-88. The only real limitation to the number of clients in a hedge fund comes from the Securities Exchange Act of 1934. \textit{See supra} note 85 and accompanying text.} Under the exception, advisors are permitted to treat each individual hedge fund under management as a single client.\footnote{See Gatsik, \textit{supra} note 110, at 607. Under the current rule, hedge funds can have up to 499 members and still be counted as one client under the Small Advisor Exception. \textit{Id.}} The final rule seeks to close this loophole by adding a new provision to section 203b(3) of the rule, which would

require investment advisors to count each owner of a 'private fund' as a client for purposes of determining the availability of the private advisor exemption of section 203(b)(3) of the Act. As a result, an advisor to a 'private fund'... could no longer rely on the private advisor exemption if the advisor, during the course of

\footnotetext[181]{See infra notes 204-10 and accompanying text.}  
\footnotetext[182]{See Final Rule, supra note 7, at 72,073. "Private Fund" is a company that would be defined as and investment company under 3a of the investment company act of 1940 (15 U.S.C. 80a-3(a)), but for exceptions provided in either 3(c)(1) or 3(c)(7) of the act, that permits its owners to redeem their interest within two years of purchase, the interests of which have been offered on the basis of the expertise of the investment advisor. \textit{Id.}}  
\footnotetext[183]{See Final Rule, supra note 7, at 72,054.}  
\footnotetext[184]{Id. The "Small Advisor Exception," contained in section 203(b)(3)-1 exempts from registration investment advisors who have had fewer than fifteen clients over the past twelve months. 15 U.S.C. 80b-3 (2004) (listing investment advisors exempt from registration). The provision provides five exceptions from the registration requirement, though Section 80b-3(b)(3) is the only section relevant to the proposed rule. \textit{Id.} It defines the Small Investor Exception requirements. \textit{Id.}}  
\footnotetext[185]{See infra notes 186-88. The only real limitation to the number of clients in a hedge fund comes from the Securities Exchange Act of 1934. \textit{See supra} note 85 and accompanying text.}  
\footnotetext[186]{See Gatsik, \textit{supra} note 110, at 607. Under the current rule, hedge funds can have up to 499 members and still be counted as one client under the Small Advisor Exception. \textit{Id.}}
the preceding twelve months, advised a private fund that
had more than fourteen investors.¹⁸⁷

Thus, advisors to private funds would be required to "look through" each fund under management and count all investors as individual clients.¹⁸⁸ The new rule also contains a special provision¹⁸⁹ regarding hedge funds to which registered funds, including FOHFs, invest.¹⁹⁰ The provision requires advisors to "look through" each fund that the advisor serves, and count each investor in the FOHF as an individual client.¹⁹¹ As a result of the Final Rule, unless they qualify for one of the exceptions,¹⁹² most hedge fund advisors will be forced to register with the SEC.¹⁹³

2. Exceptions to the Rule: Exemptions from Registration

Under the Final rule, two entities are exempt from the proposed registration requirements.¹⁹⁴ The SEC does not seek to include certain long term investment structures, such as private equity funds and venture capital funds.¹⁹⁵ As such, the SEC exempts from registration any fund that has a lock up period over two years.¹⁹⁶ Additionally, even though overseas advisors are included in the registration rule, such advisors who manage publicly offered funds overseas would not be required to register under the act, "provided they are regulated as a public investment company by the laws of a country other than the

¹⁸⁷. See Proposed Rule, supra note 128, at 45,182.
¹⁸⁸. See id.
¹⁸⁹. See Final Rule, supra note 8, at 72,071 (explaining proposed portion of the rule 203(b)(3)-2(b)).
¹⁹⁰. See id.
¹⁹¹. See id.
¹⁹². See infra notes 195-97 and accompanying text.
¹⁹³. See Final Rule, supra note 7, at 72,070.
¹⁹⁴. See id. at 72,071-75.
¹⁹⁵. See Proposed Rule, supra note 128, at 45,185. A lock up period is basically the period of time during which an investor cannot access his or her investment without receiving a significant penalty. Joy Ferguson, Lock-up Periods May Grow Longer for Hedge Funds, BANK LOAN REPORT, Nov. 22, 2004. Most funds require a lockup period of at least one year. Id.
¹⁹⁶. See Final Rule, supra note 7, at 72,074.
United States," and their offices and primary place of business are overseas.\footnote{197}{See \textit{id.} at 72072 (explaining section 203(b)(3)-1(d)(3)). For private foreign hedge fund advisors, however, the rule applies as it would to domestic private advisors. \textit{id.} There has been some question as to whether direct regulation of hedge funds such as this one would drive advisors overseas. \textit{See \textit{Hedge Fund Operations: Hearing Before the House Comm. on Banking \\& Fin. Servs.}, 105\textsuperscript{th} Cong. 37 (1998) (statements of Alan Greenspan, Chairman of the Board of Governors, Federal Reserve System, discussing the implications of hedge fund regulation).}

\section{Registration Requirements and Procedures as Outlined in the Final Rule}

In addition to establishing the new requirements for who must register with the SEC,\footnote{198}{See \textit{supra}, notes 182-91 and accompanying text.} the rule has some effect on the way in which funds have to charge their clients, keep accounting records, and come into compliance under the Advisors Act of 1940.\footnote{199}{See \textit{infra}, notes 193-210 and accompanying text.}

Under the final rule, advisors will not be able to charge their clients performance fees\footnote{200}{Anne Tergesen, \textit{Time to Hedge on Hedge Funds? New Research Shows that Returns are Sliding, and Some don't Help you Diversify}, \textit{BUSINESSWEEK}, Sept. 13, 2004, at 105. Performance fees are fees collected by the advisor based on the performance of the fund. They can be structured in a variety of ways, including such that investors only collect off of profits above a certain percentage. Though high performance fees are atypical with other types of funds such as mutual funds, hedge funds usually charge up to 20\% on any profits generated by the fund. \textit{id.}} unless certain requirements are met.\footnote{201}{17 C.F.R. § 275.205-3 (2004).}

Under the Advisors Act, registered advisors are only allowed to charge performance fees to "qualified clients."\footnote{202}{See Final Rule \textit{supra} note 8, at 72,076 and accompanying text. "Rule 205-3(a) and (b). Rule 205-3 permits registered advisors to charge performance fees that would otherwise be prohibited by section 205(a). [15 U.S.C. 80b-5(b)(4)]. To be a qualified client, the} This requirement effectively
raises the bar regarding the minimum net worth necessary to invest in hedge funds.\textsuperscript{203}

An obvious effect of the final rule is that registrants will be required to come into compliance with all of the accounting, disclosure, and procedural requirements of the Advisors Act of 1940.\textsuperscript{204} This includes submitting a Form ADV,\textsuperscript{205} complying with Rule 204-2 record-keeping procedures,\textsuperscript{206} on-site inspections of books and records,\textsuperscript{207} designation of a chief compliance officer,\textsuperscript{208} and development of comprehensive compliance procedures.\textsuperscript{209} Ideally, these requirements would provide the SEC with some oversight regarding hedge fund activity, and "protect the nation's securities markets."\textsuperscript{210}

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\textsuperscript{203} See Proposed Rule, supra note 128, at 45,186.

\textsuperscript{204} See Final Rule, supra note 7, at 72,054.

\textsuperscript{205} 17 C.F.R. § 279.1 (2004).

\textsuperscript{206} 17 C.F.R. § 275.204-2 (2004).


\textsuperscript{208} See 17 C.F.R. § 275.206(4)-7 (2002).

\textsuperscript{209} Id.

\textsuperscript{210} See supra note 8, at 72,054.
VII. EFFECTIVENESS OF THE RULE AND INDUSTRY REACTION

Despite the call from industry experts to extend the deadline, the comment period for the proposed rule expired on September 15, 2004.211 Those in favor of the rule agree with the SEC that hedge funds have grown too large and are long overdue for regulation.212 More interesting, however, are the comments in opposition to the proposed regulation.213 Among the comments in opposition to the rule are some relatively loud voices within the financial world, including Cynthia Glassman,214 Paul Atkins,215 and Federal Reserve Board Chairman Alan Greenspan.216 Those who disagree with the rule present a slew of compelling argument as to why hedge fund regulation is impractical, ineffective, and irrational.217

A. Dissent of Commissioners Cynthia Glassman and Paul Atkins

Commissioners Cynthia Glassman and Paul Atkins wrote a joint dissent to the Final Rule.218 The dissent acknowledges the fact that there is information the SEC could use to help understand the hedge fund industry,219 but notes the final rule would not provide all the necessary information while imposing an unnecessary cost to both the agency and the industry.220 Citing the 2003 Staff report, the dissent argues the increased instances of fraud have been insignificant, "retailization" has not occurred, the final rule is an unnecessary waste of

212. Id.
213. Id.
215. See id.
216. See Eric Schurenberg, Put More Cops on the Street; The SEC chief won a split vote to head off potential problems with hedge funds. More power to him, MONEY, Dec. 2004, at 22. Greenspan has publicly expressed his concern regarding hedge fund regulation. Id.
217. See infra notes 218-57 and accompanying text.
218. See Final Rule, supra note 8, at 72,089. The dissent is especially rare, as there have only been 16 splits of opinion out of 1,606 agency votes since William Donaldson took office as SEC Chairman. Carrie Johnson, Independent Chairmen Required for Funds: SEC Aims to Eliminate Conflicts of Interest, WASH. POST, June 24, 2004, at E04.
219. See Final Rule, supra note 8, at 72,089.
220. See id. (dissenting opinions of Commissioners Cynthia A. Glassman and Paul S. Atkins).
time and resources, and even if the rule is an effective means of enforcement, loopholes in the rule are too wide to make the rule effective.\(^{221}\)

The dissenters argue that the instances of fraud within the hedge fund industry are mild in comparison to the total number of cases brought by the SEC each year.\(^{222}\) By the SEC's own admission, the instances of fraud within the hedge fund market are disproportionately low to the instances of fraud within the investment industry generally.\(^{223}\) Of fraud actions that have been brought against hedge funds, the majority would not have been prevented had the advisors to those funds been registered with the SEC.\(^{224}\) In the past five years, the SEC has only brought forty-six fraud actions against hedge fund managers.\(^{225}\) Of those forty-six, only a small number could have been prevented by registration.\(^{226}\) Add to these minor instances of fraud the fact that the vast majority of hedge fund investors are sophisticated or institutional investors,\(^{227}\) and one may ask why SEC oversight is necessary at all.\(^{228}\) Furthermore, the dissenters believe that the final rule will not scare

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\(^{221}\) See id.

\(^{222}\) See id. at 72,090.

\(^{223}\) See Donaldson, supra note 31. Chairman Donaldson states, "I have no reason to believe that fraud is more prevalent in hedge funds than it is anywhere else." Id.

\(^{224}\) See Final Rule, supra note 8, at 72,092.

The 46 cases suggest that the typical 'hedge fund' fraud is perpetrated by an advisor that is too small to be registered with the Commission, was registered already with the Commission, or evaded registration requirements. Specifically, eight of these forty-six cases involve hedge fund advisors who were already registered with the Commission. In five of the forty-six cases, the fund should have been registered under the Investment Company Act, so their advisors already should have been registered under current rules. In twenty of the forty-six cases, the hedge funds were too small to be covered by the proposed rulemaking. In two cases, the fraud involved a principal of a registered broker-dealer or investment advisor, over whom we [the SEC] already had full regulatory oversight. Three of the forty-six cases were garden-variety fraud designed to swindle investors, regardless of whether the vehicles were called hedge funds, venture capital funds, limited partnerships or prime banks. Registration might have deterred them from using the term 'hedge fund,' but would not have deterred the fraud itself. In only eight of the forty-six cases the existence of the rule might have increased in the Commission's oversight.

Proposed Rule, supra note 128, at 45197.

\(^{225}\) See Final Rule supra note 8, at 72,092.

\(^{226}\) See id.

\(^{227}\) See Lowenstein, supra note 30, at 25.

\(^{228}\) See Final Rule, supra note 8, at 72,092.
advisors into conforming. Though the threat of inspection would
loom over the industry, the SEC does not have the resources to inspect a
significant number of hedge funds.

The dissent also dismisses the retailization concerns of the
majority. If unsophisticated investors are not currently investing in
hedge funds, and hedge fund managers are not currently marketing or
seeking out unsophisticated investors, then the final rule is
anticipatory and currently unnecessary. The dissent acknowledged
the increasing number of qualified investors within the marketplace, but
calls for adjusting the eligibility criteria rather than forcing advisors to
register.

The exception to the rule for funds with a lock up of two years
or longer is also questioned by the dissent. Under the rule, funds or
investment entities that hold their investors’ money for longer than two
years are exempt from registration. The dissent questions whether
this two-year provision would only cause hedge fund advisors to require
a two-year redemption period and thus remain exempt from the rule.
Though the SEC’s rationale for the exemption may be well founded, the
two-year lock up period exception may act as a loophole, and ruin
whatever effectiveness the final rule would have on preventing fraud or
gathering information on the market. Hedge funds may simply
change their investment requirements to fit within the exemptions.
The SEC acknowledges that hedge funds typically have a mandatory
lock-up period, in which investors may not withdraw funds without
significant penalties. The lock-up period for most hedge funds is

229. See Proposed Rule, supra note 128, at 72,093.
230. See Daniel Strachman, Hedge Funds Ruled: How the New Regulations Will Affect
Brokers—and Why Clients May Not Receive the Benefits Regulators are Promising, ON
WALL STREET, Oct. 1, 2004. “It is clear that the commission does not have enough
resources to police the areas they are currently responsible for policing.” Id.
231. See Final Rule, supra note 8, at 72,096.
232. See Weinberg, supra note 5, at 186.
233. See Staff Report, supra note 50, at 80.
234. See Final Rule, supra note 8, at 72,093.
235. See id.
236. See id. at 72,096.
237. See id.
238. See id.
239. See Ferguson, supra note 195.
240. Id.
241. Id.
usually no more than one year, and it is questionable as to whether providing an exemption for funds that have a two year lock up period would only encourage hedge funds to adopt a similar lockup.\textsuperscript{242} Would hedge fund investors demand liquidity to the point where they would not invest in a fund that froze access to their money for two years?\textsuperscript{243} The Final Rule fails to properly address this issue.\textsuperscript{244}

There is also the concern that the registration of hedge funds, assuming the final rule would be successful in compelling registration, would put an unwarranted stamp of approval on hedge funds without actually confirming their worthiness.\textsuperscript{245} The approval associated with successful registration, however, could be seen as a false green light for investors to take the plunge into hedge fund investment.\textsuperscript{246} Small investors who may have heeded the warnings of the SEC and others in the past to avoid hedge funds, may erroneously see the SEC registration as an indication of new safety standards within the industry.\textsuperscript{247}

Finally, the dissenters cite the added cost of the proposed regulation both to the agency and to the hedge fund industry.\textsuperscript{248} With the increased costs of enforcing registration, the SEC would have to take time and money away from its other duties, while investors would lose returns.\textsuperscript{249} This objection is well taken, as the SEC’s resources may already be spread too thin in its ability to regulate its current oversight.\textsuperscript{250} Adding hedge funds to the docket may have a high opportunity cost; the brunt of which would be felt by efforts to deter fraud within other investment entities such as mutual funds.\textsuperscript{251}

\section*{B. Legality of the Final Rule}

Some believe that the final rule is illegal, and that the SEC is

\begin{footnotesize}
\begin{enumerate}
\item Id.
\item Id.
\item See Final Rule, supra note 7, at 72,096.
\item Id.
\item Id.
\item Id.
\item Id.
\item See Final Rule, supra note 8, at 72,094.
\item See Michael Schroeder, SEC Gets a Raise, but Will it Be Enough?, WALL ST. J., Aug. 12, 2002, at C1.
\item See Final Rule, supra note 8, at 72,094.
\end{enumerate}
\end{footnotesize}
powerless to require hedge funds to register under the Advisors Act of 1940. Comments to the SEC have suggested that counting clients with the look through provision runs contrary to the Advisors act, and is thus outside the authority of the SEC. The crux of the argument is based on the rule established in Chevron U.S.A., Inc., v. Natural Resources Defense Council, Inc., that Congress' use of the word "client" in the Advisors Act is unambiguous, and therefore not subject to agency interpretation. Such an argument is compelling, though the Final Rule aptly addresses this issue by pointing out that the word "client" is not defined in the Advisors Act, and that the first hedge fund did not exist until after the Advisors Act was created. Even with evidence suggesting Congress did speak directly to the definition of "client," any ambiguity may be enough to stifle such an argument.

VIII. CONCLUSION

Based on the objections proposed by dissenters Glassman and Atkins, as well as the objections submitted during the comment period, compelling arguments can be made in opposition to the rule. Despite these objections, the SEC's final rule to require

253. See Final Rule, supra note 8, at 72069.
254. See generally, Chevron U.S.A., Inc. v. Nat'l Resources Def. Council, Inc., 467 U.S. 837, 842-43 (1984). The Supreme Court held that where Congress directly addresses an issue within the statute in question, the administrative agency must follow the direction of the statute. Id. The court may utilize the "traditional" tools available, such as legislative history and the language of the statute itself. Id.
255. See Final Rule, supra note 7, at 72,069.
256. See Smythe, supra note 252. Smyth and her colleagues cite numerous authorities supporting the notion that the word "client" has been directly addressed by congress. Id. Such references include Black's Law Dictionary, Commission reports which inspired the Advisors Act, the Supreme Court holding in SEC v. Lowe, the very structure of the Advisors Act, the 1970 amendment to the Advisors Act, and past SEC interpretation of the word. Id.
257. See Chevron, 467 U.S. 837, 842-43.
258. See supra notes 218-51 and accompanying text.
259. See, e.g., Comment Letter of Sidley Austin Brown & Wood, LLP (Sept. 14, 2004); Comment Letter of Chamber of Commerce of the United States of America (Sept. 15, 2004); Comment Letter of International Swaps and Derivatives Association (Sept. 15, 2004).
260. See supra notes 218-57 and accompanying text.
registration under the Advisors Act of 1940 is a necessary step in the right direction. The rapid growth of the industry, both in size and diversity of clients calls for some degree of regulation.\textsuperscript{261} Though there is no current retailization to small investors within the hedge fund industry, there is no question that hedge funds are among the hottest investment conduits on the market today.\textsuperscript{262} The increased popularity of hedge funds may not qualify as "retailization," but there is no denying that hedge funds have a huge stake in the market and should be respected as such.\textsuperscript{263} Unfortunately, the remedy proposed by the SEC is inadequate to address these concerns. The final rule is as easily avoided as any of the other four statutes that require registration.\textsuperscript{264} As the dissenters to the final rule point out, exceptions to the rule would make it easily avoided and thus ineffective.\textsuperscript{265} Even those who agree to fall under the new rule and submit to registration will not be effectively monitored, as the SEC does not have the resources to oversee so many funds.\textsuperscript{266} The SEC should reexamine its approach to hedge fund regulation, and adopt a more stringent registration requirement or none at all. In the end, it is better in this instance to have more regulation than not, though the effectiveness of the present rule is questionable.

\textit{JOSEPH HELLRUNG}

\textsuperscript{261} See generally Lenzer, supra note 11.
\textsuperscript{262} See supra notes 1-5 and accompanying text.
\textsuperscript{264} See supra notes 236-38 and accompanying text.
\textsuperscript{265} See supra notes 236-44 and accompanying text.
\textsuperscript{266} See supra notes 248-51 and accompanying text.