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A SECRET SOCIETY: HEDGE FUNDS AND THEIR MYSTERIOUS SUCCESS

Matthew Goldstein*

INTRODUCTION

On June 23, 2006, the U.S. Court of Appeals for the D.C. Circuit invalidated the Securities and Exchange Commission’s (“SEC” or “Commission”) “Hedge Fund Rule.”¹ This act vacated the SEC’s requirement for hedge funds and their advisers to register with the SEC and to release significant financial and management disclosures to the public.² According to

* J.D. Candidate, 2007, Hofstra University School of Law. First and foremost, I wish to express the utmost appreciation for the hard work and effort of the senior staff of the Journal of International Business and Law, in particular my Notes and Comments Editor, Ms. Shari Cherno. I would like to thank Dean Miriam Albert for her encouragement and meaningful advice. Also, I want to express my love and gratitude for my girlfriend, Cassie, for believing in me. Lastly, but by no means least, I would like to dedicate this note to my family, Leslie, Barry and Mark Goldstein, whose unconditional support has been the invaluable element of my success.

¹ Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (explaining that the hedge fund rule which had required investors in a hedge fund to be counted as clients of the fund’s adviser was ruled invalid); see also Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 74,059 (Dec. 10, 2004) (codified at 17 C.F.R. §§ 275, 279). See also 15 U.S.C. § 80a-3(c)(1) (2006) (A private fund is an investment company that (a) is exempt from the registration process under the 40 Act by virtue of having fewer than one hundred investors or only qualified investors and (b) permits its investors to redeem their interests within two years of investing and (c) markets itself on the basis of the skills, ability or expertise of the investment adviser; see also 17 C.F.R. § 275.203(b)(3)-1(d)(1) (2006). For these private funds the rule specifies that “for purposes of section 203(b)(3) of the Advisers Act, you must count as clients the shareholders, limited partners, members or beneficiaries of the fund. The rule had the effect of requiring most hedge fund advisers to register by February 1, 2006).

² Goldstein, 451 F.3d at 880; see Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (explaining that private fund or hedge fund advisers, prior to the D.C. Circuit vacating the Hedge Fund Rule, were required to file Form ADV with the SEC, the data from which will provide the Commission with information they need to better understand the operation of hedge fund advisers, to plan examinations, to better develop regulatory policy and to provide data and information to members of Congress and other government agencies. The form ADV was amended to include hedge funds by labeling them as “private funds.” Registration requires hedge funds to adopt compliance policies and procedures and appoint a chief compliance officer. The hedge fund advisers are subject to Advisers Act requirements regarding examinations by the SEC, recordkeeping, personal securities transaction reporting, custody, voting of proxies, an insider
the D.C. Circuit, the SEC exceeded its authority by abruptly attempting to regulate a notoriously complex industry whose business model is far too complicated for the average investor to understand. The Commission adopted the Staff Report’s primary recommendation by voting three to two in favor of requiring hedge fund managers to register as investment advisers under the Investment Advisers Act of 1940 (“Advisers Act”). Subsequent to the SEC’s regulation to require certain hedge fund managers to register with the SEC, an investment advisory firm, Kimball & Winthrop and Opportunity Partners, L.P., a hedge fund in which Kimball & Winthrop is the general partner and investment adviser (collectively “Goldstein”) successfully challenged the Hedge Fund Rule’s equation of the term “client” with the term “investor.” Specifically, the SEC amended Rule 203(b)(3)-1 (“Safe Harbor Rule”) under the Advisers Act, effectively removing a provision which provided an exemption for registration for hedge fund advisers. In other words, prior to the

trading policy, use of performance data and other advertising activities, as well as a limitation on when a registered adviser may charge its clients performance based fees. With respect to the recordkeeping requirements, the Form ADV amendment specified that a registered adviser’s books and records also include the books and records of any private fund which it advises and for which it or any of its related persons act as the private fund’s general partner or managing member. Registration via form ADV is accomplished by way of the SEC’s Division of Investment Management Electronic Filing for Investment Advisers on the Investment Adviser Registration Depository (“IARD”) and usually may take up to 45 days to file properly; See also Division of Investment Management: Electronic Filing for Investment Advisers on IARD, available at http://www.sec.gov/iard (last visited Apr. 13, 2007).


4 See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054; 17 C.F.R. § 275.203(b)(3)-1(a) (stating that “you may deem the following to be a single client for purposes of section 203(b)(3) of the [Advisers] Act: (2)(i)...A corporation, general partnership, limited partnership, limited liability company, trust (...), or other legal organization (...) to which you provide investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members or beneficiaries”); see also Lowe v. S.E.C., 472 U.S. 181, 194 (1985) (explaining that when Congress passed the Investment Company Act in 1940, Congress also passed the Advisers Act as a companion statute to regulate persons who provide personalized investment advice to others for compensation).

5 See Goldstein, 451 F.3d at 874 (explaining that the petition for review originated by Philip Goldstein, portfolio manager of Opportunity Partners LP, alleged the SEC exceeded its authority by making new law, a process delegated to Congress).

6 Id. at 875; see also S.E.C., supra note 3, at 88-89 (discussing the purposes of exposing the hedge fund advisers to the SEC registration requirements. The SEC shall look through the entity and
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implementation of the Hedge Fund Rule, the Safe Harbor Rule, provided managers of “private funds” relief from counting each investor in a hedge fund as a separate client. As a large majority of hedge funds have more than the fourteen investor statutory maximum (“fifteen client rule”) the vacated client counting rule had “precluded most managers from relying on the ‘small adviser’ exemption under the Advisers Act.”

This Note argues that the D.C. Circuit was correct in its invalidation of the Hedge Fund Rule and that the SEC exceeded its regulatory authority by arbitrarily construing the meaning of the “Hedge Fund Rule” beyond the interpretation intended by Congress. However, given the nature of the hedge fund industry and its complicated business models, the SEC was consistent with its regulatory goal of promoting investor protection, although a distinct attempt by the SEC must be explored. Part I of this Note provides an explanation of the business model for a typical hedge fund and the relative lack of regulation the privatized industry has attracted. Furthermore, it will explain the lack of a concrete statutory definition of a hedge fund and the key differences between the trading strategies hedge funds and other investment vehicles such as those entities subject to the Advisers Act administer. Part II of this Note analyzes the SEC’s authority to enact the Hedge Fund Rule, its legislative history and purpose and whether or not the effects of the rule were consistent with the SEC’s intent in amending Rule 203(b)(3)-1. Part III of this Note analyzes the D.C. Circuit’s decision in Goldstein v. SEC, the implications of the holding and whether the court was correct in its determination that the “look through” provision of the private adviser exemption does not permit the SEC to equate the term “client” with the term “investor” of a hedge fund. Part IV concludes by recommending alternative regulatory mechanisms by which the SEC may affect the hedge fund industry in a manner which is rationally related to the Commission’s concerns for investor protection rather than by an arbitrary attempt to require the hedge fund’s advisers to register with the SEC. Finally, this Note will explore the alternative regulatory mechanisms implemented internationally.

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count each individual investor as a client, rather than refer to the hedge fund itself as the client).

7 See Bolter, supra note 3, at 596; see also 15 U.S.C. § 80b-3(b)(3) (2006) (identifying the prerequisites for the small investment adviser exemption: (1) the adviser must have fewer than 15 clients; (2) must not hold itself out generally to the public as an investment adviser; and (3) cannot act as an investment adviser to a registered investment company or business development company).

8 S.E.C. Decides It Won’t Appeal on Hedge Funds, N.Y. TIMES, August 8, 2006, at Cl.
I. AN OVERVIEW OF HEDGE FUNDS

A. Overview of the Hedge Fund Structure

The federal securities laws of the United States do not define the term “hedge fund.” However, a hedge fund has been defined as “a privately offered investment vehicle that pools the contributions of its investors in order to invest in a variety of asset classes,” such as debt and equity securities, future contracts, options, over-the-counter derivatives and foreign currencies. The expectation is that hedge funds will generate positive returns in both bull and bear markets. Initially, the term “hedge” derived from the fund taking both long and short positions in debt and equity securities in order to ensure or offset inherent investment or market risks, a strategy of “hedging an investment portfolio.” Hedge funds are typically structured as limited partnerships, limited liability companies or in other business organizational

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10 Willa E. Gibson, Is Hedge Fund Regulation Necessary?, 73 TEMP. L. REV. 681 (2000) (defining a future as “standardized agreement that requires the delivery of some underlying commodity or financial instrument at a future date at a specified price.”).

11 Id. at 684, 715 n.20 (splitting options into two categories whereby a call option will give an investor a right, but not the obligation to buy a specified financial instrument during a specific time period, as distinguished from a put option whereby the investor is given the right to sell).

12 Id. at 684, 715 n.21 (defining over-the-counter derivatives as “bilateral agreements that derive their value from an underlying asset, such as stocks, commodities, or currency holdings, or from the value of an underlying reference or index rate, such as interest rates, exchange rate or indices”).

13 “A bull market is a prolonged period of time when prices are rising in a financial market faster than the historical average in contrast to a bear market which is a prolonged period of time when prices are falling.” Alternatively, a financial market is generally successful when the bulls or buyers outnumber the bears or sellers, http://en.wikipedia.org/wiki/Bull_market.

14 Long (or Long Position) is defined as the buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, http://en.wikipedia.org/wiki/Long_position.

15 Short (or Short Position) is defined as the sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, http://en.wikipedia.org/wiki/Short_%28finance%29. (The use of short selling by hedge funds has led to allegations that some hedge funds may be engaging in short selling as part of a manipulative scheme as alleged by issuers who claim that hedge funds accumulate bearish or short positions in their stocks and subsequently issue reports to drive down the security prices); see also Judith Chase, The State of Hedge Funds, SIA Research Reports, Vol. IV, No. 2 (March 10, 2003).

16 Gibson, supra note 10, at 715 n.18 (The first hedge fund was established by A.W. Jones in 1949 where he implemented a system of taking long and short positions in securities so that it would generate returns in both bullish and bearish markets).
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forms that provide for pass-through tax treatment of investor earnings.\textsuperscript{17} Given the very high levels of capital and leverage utilized in a hedge fund's investments, "hedge funds cater to sophisticated investors and [more importantly] are not subject to the [SEC] regulations that apply to mutual funds geared towards the general public."\textsuperscript{18} Since hedge funds generally trade securities on a secondary basis whereby their interests are not sold in a registered public offering ("IPO"), they are not subject to the registration requirements under the Investment Company Act of 1940 ("'40 Act").\textsuperscript{19} As an alternative, to maximize flexibility, hedge funds typically offer their investments structured as private placement or Rule 144 transactions\textsuperscript{20}, offerings exempted from the federal securities registration laws.\textsuperscript{21} As hedge funds predominately attract wealthy and sophisticated investors, it is fitting they comprise only a small portion of the investing community.\textsuperscript{22} In fact, hedge funds typically have either no more than one hundred beneficial owners\textsuperscript{23} or require their investors to meet rigid minimum size requirements.\textsuperscript{24} Management

\textsuperscript{17} Report of the President's Working Group on Financial Markets, Hedge Funds, Leverage and the Lessons of Long-Term Capital Management, B-3 (1999), http://www.ustreas.gov/press/releases/reports/hedgfund.pdf (explaining that these forms of entities are all treated as partnerships. A partnership structure eliminates the dividend tax levied upon profits realized by the owners of a corporation. The dividend tax is an income tax on money paid to the stockholders of a company through dividend payments).

\textsuperscript{18} Vaughan, supra note 12 (quoting GEORGE SOROS, OPEN SOCIETY: REFORMING GLOBAL CAPITALISM 32 n.† (2000)).

\textsuperscript{19} S.E.C., supra note 3, at 3 (recognizing that the modern hedge fund maintains a diversified investing strategy beyond equities).

\textsuperscript{20} S.E.C., Rule 144: Selling Restricted and Controlled Securities (2006), http://www/sec.gov/investor/pubs/rule144.htm (explaining that Rule 144 transactions are exempt from the registration requirements in order to sell the security in the marketplace so long as (1) before the restricted securities are sold in the marketplace they must be held for one year; (2) there must be adequate information available about the issuer of the securities; (3) The amount of securities sold in any three-month period may not exceed specific volume limitations; (4) Sales must be made in ordinary brokers' transactions or transactions directly with a market maker; (5) The sales must not be advertised nor may additional commissions be paid and (6) A Form 144 must be filed with the SEC). See also, S.E.C., supra note 3, at x (noting that Regulation D under the 1933 Securities Act governs private offerings offered exclusively to accredited investors).

\textsuperscript{21} Gibson, supra note 10, at 483.

\textsuperscript{22} Id. at 683.

\textsuperscript{23} Report of the President's Working Group, supra note 17, at 3 (defining "beneficial owner" as one who must have voting rights, generally owning 10% or more of the fund's voting securities, and is either an investment company or a private fund).

\textsuperscript{24} Id. See also 15 U.S.C. § 80a-3(c)(1) (2006) (requiring a fund relying on this exclusion to comply with the 100 beneficial owner prerequisite. The funds are not to propose or make available its securities in a public offering); 15 U.S.C. §80a-3(c)(7) (2006) (requiring hedge funds to sell their securities only to those persons who are qualified purchasers, or "(i) any natural person who owns
is compensated generally by taking a percentage of the assets investors have in their portfolios in addition to a percentage of the firm’s profits, or a performance fee.\textsuperscript{25}

\textbf{B. Hedge Fund Trading Strategy}

Generally, hedge funds are some of the more active trading entities that “can provide benefits to financial markets by enhancing liquidity and efficiency.”\textsuperscript{26} Hedge fund trading strategies are typically focused on short selling (the sale of a borrowed security), arbitrage (simultaneously buying and selling a security in different markets to exploit and profit from pricing discrepancies) and leverage (magnifying returns by investing with borrowed money).\textsuperscript{27} The use of leverage enables hedge funds to take short term positions or sell short because the hedge fund will borrow the stock, bond or other security instrument from a broker-dealer.\textsuperscript{28} If the security declines in price (as compared to the selling price it initially offered) before the fund must replace the borrowed security, the fund will realize a gain.\textsuperscript{29} Just as easily as leverage may result in enormous profits, the opposite can easily occur. Given this inherent risk, the ten to twenty percent performance-based advisory fees are presumptively justified. Still, the underlying issue with regard to leverage surrounds the possibility of a loss. Even so, hedge funds divert large levels of risk from those investors finding risk adverse investments attractive since hedge funds “have a great desire to assume such risk.”\textsuperscript{30} However, excessive use of economic leverage or a very high ratio of borrowed money to available capital can prevent hedge funds from meeting margin calls\textsuperscript{31} in the event hedge fund


\textsuperscript{26} Report of the President’s Working Group, supra note 17, at 2.

\textsuperscript{27} Id.

\textsuperscript{28} Id.

\textsuperscript{29} Id.

\textsuperscript{30} Gibson, supra note 10, at 688; see also Hedgefunds: Hearing before the House Committee on Banking and Financial Services, 105\textsuperscript{th} Cong. (1999) (statement of Patrick M. Parkinson, Associate Director, Division of Research and Statistic, Board of Governors of the Federal Reserve System) (“Leverage plays a positive role in our financial system, resulting in greater market liquidity, lower credit costs, and a more efficient allocation of resources in our economy.”). See generally Report of the President’s Working Group, supra note 17, at 4-5.

\textsuperscript{31} “When the margin posted in the margin account is below the minimum margin requirement, the broker or exchange issues a margin call. The investor now either has to increase the margin that he has deposited, or he can close out his position. He can do this by selling the securities, options or futures if he is long and by buying them back if he is short,“
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strategists incorrectly predict market movements. Therefore, hedge funds are constrained in some cases by initial margin and collateral at the transaction level. To ensure the exposure of leverage is adequately collateralized relative to the creditworthiness of the hedge fund, the leverage is acquired through derivatives transactions, short sales and direct financing. Still, the practice of leveraging investments exerts a positive influence on a hedge fund’s returns because they are only “limited in their use of leverage by the willingness of their creditors and counterparties to provide such leverage.” Beyond that, regulatory capital requirements are only applicable to financial institutions apart from hedge funds.

C. Hedge Funds versus Mutual Funds

The primary difference between hedge funds and mutual funds is that mutual funds must be registered as investment companies. Although both entities may invest in similar types of securities and offer investors the opportunity to diversify their investments through professionally managed investment pools, “mutual funds do not charge performance-based advisory fees, nor do they typically engage in the short-term investment strategies of hedge funds.”

An implication of the distinct trading strategies employed by mutual and hedge funds is the possibility of conflict of interests. For example, an investment adviser managing a mutual fund using a long-only strategy may, at the same time, manage a hedge fund using a different strategy. “The investment adviser may determine that an equity security that the mutual fund holds long is appropriate for the hedge fund to sell short,” and in turn the short sale may have a negative effect on the security and therefore the mutual fund’s performance. It follows that as facially similar hedge funds and mutual funds may appear to be, their trading strategies provide for significant differences,

http://en.wikipedia.org/wiki/Margin_call#Margin_call; see Report of the President’s Working Group, supra note 17, at 23 (suggesting that excessive use of leverage potentially causes substantial financial difficulties for the markets and in turn forces regulators to recognize the fears of market disruption).

32 See Report of the President’s Working Group, supra note 17, at 23 (“In a volatile market, high levels of leverage increase the likelihood that a leveraged entity will fail, in part because the size of potential losses can seriously deplete and even wipe out the entity’s net worth”).

33 Id.

34 Id.

35 Id.

36 Report of the President’s Working Group, supra note 17; see also Bolter, supra note 3, at 599.

37 S.E.C., supra note 3, at 84; see Definition of Long Position, supra note 14.

38 S.E.C., supra note 3.
substantial enough to adversely affect their respective performances.

D. Long Term Capital Management, L.P.

It may be argued that a direct result of the lack of regulatory restrictions placed upon hedge funds is the collapse of the hedge fund Long Term Capital Management, L.P. ("LTCM").

LTCM operated Long Term Capital Portfolio in the late 1990s when LTCM’s trading strategy caused the fund to lose substantial sums of money, through the misuse of leverage, primarily as a result of economic problems in Russia. LTCM’s loss resulted from “using borrowed money to purchase about $120 billion of its estimated $125 billion of assets, causing the fund to be leveraged 25 times over.” The problem with that approach “was that the $125 billion in capital that LTCM raised would not be sufficient to realize substantial profits.” As a result, worried creditors coupled with counterparties looked to liquidate their collateral assets to protect themselves from the fund’s failure and “bailed out the fund.”

The Federal Reserve along with a few of the prominent banks and brokerage houses provided a short-term solution to the LTCM problem by investing $3.65 billion in equity capital in LTCM in exchange for 90 percent of the firm’s equity, and in turn, provided to shareholders a better result and permitted management to continue to collect their management fees. However the long term effects of the Federal Reserve’s involvement was likely the eventual action taken by the SEC.

Although not immediate, a regulatory response by the SEC was inevitable and did eventually result in the allegedly appropriate solution of requiring hedge fund advisers to register as authorized by the Advisers Act. However, the stepping stone to the briefly implemented registration requirement was the financial securities industry tightening its credit risk management

Gibson supra note 10, at 682 (explaining how the enormous size of LTCM and its trading positions caused its counterparties and creditors to lose substantial amounts of money due to the extension of excessive credit, and in turn, the fund’s financial collapse “has led federal legislators and financial regulators to question whether additional regulatory constraints were necessary on a hedge fund’s use of leverage to protect against financial market disruption”); see also Report of the President’s Working Group, supra note 17.


Id.


Liffman supra note 40 at 2173; see also Gibson, supra note 10, at 681.

practices. Additionally, "financial regulators implemented guidelines for regulated entities when extending credit through either lending or counterparty relationships." The issues of hedge fund fraud, misuse of leverage and speculation support the pro-registration argument and accordingly compel the SEC to act.

Registration would provide for the SEC to "(i) begin to understand the hedge fund industry, (ii) attempt to curb some of the illegal activity of individual funds and their advisers, and (iii) prevent market disruptions by monitoring overleveraged funds." Although these three rationales do in fact support the need for hedge fund regulation, the hedge fund rule encompassing hedge fund adviser registration was not necessarily the best approach for the SEC in their attempt to learn more about the intricacies of a hedge fund. Concurrently, it has been suggested that "the effects of LTCM's failure on financial markets were exaggerated" and the Federal Reserve's bailout "simply helped the shareholders and managers of LTCM to get a better deal for themselves than they would otherwise have obtained." Further, the bailout may have served as a regulation wake up call for the Federal Reserve as well as the SEC in that it "encouraged more calls for regulation of hedge-fund activity, which may drive such activity further offshore," and "encourage irresponsible risk taking" of large financial institutions.

II. THE HEDGE FUND RULE

A. The Rulemaking Authority of the SEC

Section 211(a) of the Advisers Act provided the rulemaking authority for the SEC to rely on in its amendment to the Safe Harbor Rule. More specifically, Section 211(a) affords the ability to "classify and prescribe different requirements for different classes of people and allows the SEC to issue, amend and rescind rules as are necessary or appropriate." Irrespective of the SEC's broad authority, it is permissible for an appropriate court to set

46 Liffman, supra note 40, at 2174.
47 Dowd, supra note 44, at 1.
48 Id.
50 Bolter, supra note 3, at 599.
aside the Commission's rule if it is said to be inconsistent with the underlying Congressional intent. It In assessing such intent, the reviewing court must consider whether Congress has directly addressed the issue, whether the statute is ambiguous as to the issue or whether the Commission's amendment was based on a permissible reading of the legislative history.

Arguably, the legislative history of 203(b)(3) ("Small or Private Adviser Exemption") provides for the Commission's ability to maintain broad authority in their interpretation of the rule. This is because the Small Adviser's Exemption leaves unanswered the "question as to whether advisers are entitled to the no "Look Through" provision in counting beneficial owners of entities other than business development companies (more commonly known as venture capital companies) as single "clients." Additionally, there is no history addressing the purpose behind the 15 client rule within the Small Adviser Exemption. Therefore, at first glance, the Commission is presumptively justified in its interpretation and implementation of the meaning of the Safe Harbor Rule, the look through provision and the Private Adviser Exemption. However, in the case that the Commission is strikingly inconsistent with Congress, their interpretation will incur a standard of review comparable to that of strict scrutiny.

B. Rule 203(b)(3)-2: Background and Purpose

In SEC v. Capital Gains Research Bureau, the Supreme Court reasoned that the Advisers Act and the investment advisers who are subject to the Act are to prevent the continued discrepancies in knowledge between the investment adviser and their respective clients. A fundamental purpose of the

51 SEC v. Sloan, 436 U.S. 103, 118 (1978) (reasoning that courts need not hold steadfast to an agency's rulemaking or interpretation of such).
52 Chevron U.S.A. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-843 (1984) (expressing that if Congressional intent is clear or if the agency's interpretation is plainly inconsistent with said intent, the agency has exceeded their allowable scope of authority and the statute must be struck down).
53 H.R. REP. No. 1341, at 4 (1980); see also Bolter supra note 3, at 599; see also 15 U.S.C. §80a-2(a)(48) (2006) (defining a business development company as a "closed-end company which operates for the purpose of making investments in certain securities and making available significant managerial assistance with respect to the issuers of such securities").
54 Id.
55 S.E.C., supra note 3 (where the staff issued a report to the Commission suggesting the implications of the growth and hedge funds and the proposal that the Commission should consider requiring hedge fund advisers to register as investment advisers under the Advisers Act).
56 Chevron, 467 U.S. at 837 (holding that if the agency's authority has violated Congressional intent, a more exacting standard of review should be applied).
57 SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) (noting that the Advisers Act
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Advisers Act was "to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." Therein, the Advisers Act 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." An individual who engages in such services intentionally and not incidentally is generally required to register with the SEC as an investment adviser.

Hedge fund managers rely on the Small Adviser Exemption or 15 client rule, providing those managers who would normally fit within the definition of an investment adviser with an exemption from registration. If the hedge fund manager has not advised more than 15 clients in the preceding 12 months, the managers may properly utilize the exemption. This rule works in conjunction with the Safe Harbor rule which provides that for purposes of determining who constitutes a client under § 203(b), investment advisers may count a "legal organization," such as a corporation or any form of a partnership as a single client.

was prompted by Congress' hope that its impact would relieve advisers and their clients of any conflicts of interest which may be detrimental to a client's best interests. Discrepancies in knowledge may refer to insider information that an investor's investment adviser may possess and is reluctant to disclose to the investor due to the possibility of adversely affecting the investor's portfolio.

Id. (stating that those professionals such as lawyers or broker-dealers performing services incidentally and without compensation are not required to register with the SEC).
Identifying the prerequisites to comply with the Small Adviser Exemption: (1) the adviser must have no more than 14 clients; (2) must not hold itself out generally to the public as an adviser; and (3) cannot act as an investment adviser to a registered investment company or development company. The recently vacated Look-Through Provision temporarily removed the Small Adviser Exemption from investment advisers not generally subject to registration with the SEC.
Bolter, supra note 3, at 602; see also 17 C.F.R. §275.203(b)(3)-1(a)(2)(i) (2003) (stating you may deem the following a single client including "a corporation, general partnership, limited partnership, limited liability company...or other legal organization to which you provide investment advice based on its investment objectives rather than the individuals investment objectives of its shareholders, partners, limited partners, members or beneficiaries"). The issue of advising individuals in the form of a shareholder or a partner is yet to be addressed as fiduciary relationships between the investment adviser and the client are considered in Goldstein. The rule goes on to clarify that so long as the investment adviser is providing advice to the entity itself and not the individual, the manager of a legal organization need not "look through to the beneficial owners of
Upon the findings spelled out in the Staff Report, the SEC Commissioners voted to disregard the current Safe Harbor Rule in order to remove the presumptive secrecy the exemption afforded hedge fund managers and their private funds. This amendment to the Safe Harbor Rule is arguably inconsistent with Congressional intent because of §§3(c)(1) and §3(c)(7) of the Investment Company Act of 1940 ("'40 Act"). This broad provision excluded from the "definition of an investment company any issuer whose securities are owned exclusively by qualified purchasers (sophisticated investors) and who does not propose a public offering of such securities." Since hedge funds fit within this definition as they are private funds who do not engage in the proposition of public offerings, the Hedge Fund Rule "seemingly contradicts congressional intent by specifically requiring advisers funds relying on §§3(c)(1) and §3(c)(7) to register under the Advisers Act." Irrespective of Congressional intent, the SEC went forward with its reinterpretation of the term "client," prompting the D.C. Circuit's consideration of the rule in Goldstein.

C. The "Client" of a Hedge Fund and the Advisers Act

The definition of a "client" is not defined anywhere within the Advisers Act but was amended by the SEC to bring hedge fund advisers within the boundaries of the Commission's registration regulations. Until 2004, both the SEC and Congress were consistent in treating a "legal organization receiving advice from an investment adviser as a single client, declining to look through the entity and count individual shareholders as clients." Although the
SEC broadened the Safe Harbor Rule to encompass hedge fund advisers, it reaffirmed the plain meaning of a “client.”  As a result, it seemed that the SEC, in adopting the Hedge Fund Rule focused more on the Staff Report’s finding that hedge fund growth itself along with changed circumstances has warranted their changed interpretation.

The Hedge Fund Rule requiring that each shareholder or beneficiary of a “private fund,” including hedge funds, be considered a separate client in counting towards the “15 client rule” within the Small Adviser Exemption. It is arguable that the SEC’s redefinition of a “client” is inconsistent with Congressional intent as it is a term so pertinent to the meaning of the Advisers Act. For example, the term “client” is generally accepted as an individual or organization that receives direct advice from an investment adviser rather than passive or inactive investors in the legal organization such as those whose only role is capital contribution. As a result, “not only does the plain language of the term conflict with the SEC’s reinterpretation in the Hedge Fund Rule, but judicial interpretation and the legislative intent behind the Advisers Act affirm the longstanding interpretation that a “client” is a party who receives particularized advice.”

However, from the SEC’s perspective, the reinterpretation of the term “client” and the implementation of the Hedge Fund Rule are consistent with the regulatory framework of the securities industry. The practices of fraud, misuse of leverage and speculation are three enormous and worrisome issues that the SEC cites to as authority for their change of the definition of “client.” As far back as the 1920’s and the Depression Era, these concerns have been prevalent in the securities markets and were problems that prompted the adoption of the Securities Act of 1933. Therefore, the government had to and did respond by regulating the securities industry “in order to restore public confidence and make capitalism live up to its promise.”

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69 Id.

70 Id.


72 Bolter, supra note 3, at 602.

73 Id.

74 Id. at 603.

75 Liffman, supra note 40.

76 Id.

77 Id. at 2174.
In consideration of the Staff Report’s findings, the sheer growth of hedge funds have transcended the private fund boundaries and have dived into the public arena where the SEC would serve its functional goal of securities regulation through the registration of hedge fund advisers, requiring them to provide data, including financial and trading practice disclosures for the purpose of protecting investors.\(^7\)

Even if the SEC was in fact attempting to hold fast to their primary objective of investor protection, their method in doing so may be inconsistent with Congress and legislative history. Consistent with regulation is arguably bestowing registration upon hedge fund advisers since it is overwhelmingly consistent with the SEC goal of disclosure. However, in considering Congressional intent, the language of the Advisers Act “advance[s] the argument that the term “client” refers to a person or organization that receives personalized investment advice,” rather than equating the term “client” with a legal organization or more specifically a hedge fund.\(^7\)\(^9\) Further, it has been emphasized that the Advisers Act is supposed to administer those situations where “individualized advice is given specific to a client’s particular needs.”\(^8\) Again, a hedge fund’s business model does not provide for individualized advice, as its objectives are to advise the partnership itself, whereby the look through provision should prevent the SEC from looking through the entity to the partners themselves. Further evidence of Congressional intent to exclude private funds or hedge funds from registration under the Advisers Act was at the recommendation of the SEC, requiring advisers of registered investment companies, such as mutual funds to register under the Advisers Act.\(^8\)\(^1\) Congress looked to amend the Small Adviser Exemption, explicitly removing the “fewer than 15” exemption for advisers of companies registered under the ‘40 Act.\(^8\)\(^2\) In doing so, it is apparent that Congress did not design the Small Adviser Exemption to “count each individual as a “client,” because if that were true, there would be no need to specifically deny the exemption to advisers of registered funds.”\(^8\)\(^3\) Instead, the provision would have read more broadly and generally included advisers of private funds. Therefore, it may be argued that the SEC has not currently justified registration in order to protect investors.

\(^7\) Id. at 2176.

\(^9\) Bolter, supra note 3, at 602 (arguing that the SEC is guilty of this in their implementation of the Hedge Fund Rule).

\(^8\) See Lowe, 472 U.S. at 208 (holding that in order to come within the purview of the Advisers Act individualized advice must be given).

\(^1\) Bolter, supra note 3, at 605.

\(^2\) Id.

\(^3\) Id.
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D. The “Look Through” Provision

In prompting the challenge in Goldstein, the SEC justified the Hedge Fund Rule on the supposition that an increasing number of investment advisers were taking advantage of the Small Adviser Exemption, allegedly providing for circumvention of the purpose of the rule. The SEC contended that investment advisers created limited partnerships solely to incur the benefits of the Exemption rather than manage their clients’ money directly. To support such a contention, the SEC cited only a district court case where an investment adviser persuaded a client to reorganize its trust accounts in order to avoid regulation. Furthermore, the Proposed Release of the Safe Harbor Rule notes the rule was strictly available to circumstances where the general partner advises the partnership based on the fund’s investment objectives, not those of its partners. As a result, contrary to the SEC’s belief, it seems the Safe Harbor Rule was “itself established to prevent circumvention, not solely to exempt from registration those advisers whose business is so limited that it does not raise federal interest.” In other words, the Small Adviser Exemption seems to reflect that there is no federal interest in regulating investment advice on a personal level to friends or family. Therefore, as argued in petitioner’s complaint in Goldstein, the use of the “look through” provision by the SEC functions as an instrument to create new law, rather than a legitimate means of enforcing the rule’s primary objective.

III. GOLDSTEIN V. SEC

A. Background

Phillip Goldstein, a shareholder activist mainly participating in proxy

84 Id. at 608.
85 Id. at 609. (citing Adopting Release, supra note 1, at 72,054.)
87 Liffman, supra note 40.
88 Regulation Under the Advisers Act of Certain Hedge Fund Advisers; Proposed Rule 69 Fed. Reg. at 45,199 (dissenting from the majority’s opinion that the Hedge Fund Rule is a loophole allowing advisers to manage the assets of more than 14 clients while remaining unregistered); see also Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054.
89 Liffman, supra note 40, at 2177 (stating that where critics of this argument suggest that Congress created the exemption specifically for advisers who have a few clients consisting of family and friends but did not intend it to be used by fund managers who take advantage of the look through provision and maintain hundreds of clients).
90 Goldstein, 451 F.3d at 873.
battles, is the President of Kimball & Winthrop, Inc., the general partner of Opportunity Partners L.P.\footnote{Phillip Goldstein is a hedge fund adviser to Opportunity Partners, a hedge fund partnership and its general partner, Kimball & Winthrop.} He has been described as “the most visible of a new breed of closed-end-fund activists known as a fundbuster.”\footnote{Blake A. Bell, \textit{Do Shareholder Activists Violate Federal Proxy Solicitation Laws Through Internet Message Boards?}, Sept. 15, 1998, http://www.stblaw.com/content/publications/pub275.pdf, (last visited Jan. 7, 2006) (describing a fundbuster as an activist who seeks to buy shares at deep discounts and then maneuvers to reduce the discounts, thereby increasing their overall returns vis-à-vis the funds’ market performance).} He is a retired New York City civil engineer operating a $40 million hedge fund from the basement of his Brooklyn, New York home. Staying true to his activist role, Goldstein, in conjunction with Kimball and Winthrop and Opportunity Partners, petitioned for review of an order of the SEC regulating hedge funds under the Advisers Act via the “Look Through” Provision and the accompanying Hedge Fund Rule. Previously exempt because Goldstein had fewer than 15 clients, the SEC’s adoption of the Hedge Fund Rule required Goldstein’s advisers to register with the Commission since the funds they advise have fifteen or more shareholders, limited partners, members or beneficiaries.\footnote{See 15 U.S.C. § 80b-3(b)(3) (2006); see also 17 C.F.R. § 275.203(b)(3)-2(a) (2006).}

B. Petitioner Goldstein’s Argument

Goldstein advances two main theories in order to invalidate the Hedge Fund Rule. First, Goldstein argues the Hedge Fund Rule violates Congressional intent by regulating private investment entities and advisers which Congress has expressly exempted from regulation under the Investment Company Act and Advisers Act.\footnote{Brief for Petitioner, \textit{Goldstein}, 451 F.3d 873 (No. 04-1434).} Goldstein claims the Commission does not have the authority to regulate hedge funds by rewriting a statute as delineated by Section 211(a) of the Advisers Act.\footnote{See supra section II. A. (where it is argued that the SEC does indeed have broad rulemaking authority).} Secondly, Goldstein focuses squarely on the definition of “client” as used in the Advisers Act and argues that it’s definition is unambiguous and clear as interpreted by Congress and as such requires no further interpretation by the SEC.\footnote{Brief for the Petitioner, \textit{supra} note 94.} More specifically, Goldstein alleges the Hedge Fund Rule transforms the term “client” to include the security holders who have invested in the hedge fund. Goldstein posits the term “client” should signify the entity or fund itself that engaged the adviser to provide investment advice to the fund as a whole rather than based on the investment objectives of...
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any individual investor. Additionally, Goldstein diligently contends that the SEC's regulatory position until the adoption of the Hedge Fund Rule was consistent with congressional intent and the Safe Harbor Provision. Therefore, Goldstein claims the adjustment to the Safe Harbor Provision is justified solely on arbitrary and capricious grounds where no satisfactory reasoning is advanced.

C. Respondent SEC's Argument

The SEC attempted to take a step away from petitioner's arguments, focusing on statutory language and the definition of "client" by simply promoting the need for hedge fund regulation. As previously stated, the SEC relied on growth in hedge funds and the impact of hedge fund advisers on the markets, an increase in fraud cases involving hedge fund advisers and an increase in exposure of retail investors to the risks of hedge fund investing. The growth stems from the increase in hedge fund activity. As a result, hedge fund advisers have become significant participants in the national securities markets since their trading represents a reported 10 to 20 percent of the equity trading volume in the United States as of December 2004. Further, between 1999 and 2004, the Commission instituted 51 enforcement actions alleging that hedge fund advisers defrauded either their own investors or other market participants in amounts estimated to exceed $1.1 billion. The Commission also argues that hedge fund advisers were actively involved in the recent scandals regarding "late trading" and "market timing" of mutual fund shares that harmed mutual fund investors. Additionally, the SEC focuses on

97 Id.
98 Id.; see Lowe, 472 U.S. at 194 (the SEC had recently adopted the safe harbor rule to ensure that security holders of a limited partnership were not considered "clients" of an adviser to the entity. The SEC articulated in Lowe that the Advisers Act addressed a client relationship in which an adviser provided personalized investment advice based upon an understanding of the investment objectives and the financial situation of the client).
99 Brief for the Petitioner, supra note 94.
100 Brief for Respondent, Goldstein, 451 F.3d 873 (No. 04-1434).
102 Brief for the Respondent, supra note 100; see Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054.
103 Brief for the Respondent, supra note 100; see Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054.
104 Brief for the Respondent, supra note 100; see Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054; see Banc of Am. Cap. Mgmt., LLC 84 S.E.C. Docket 2780, at *4, (Feb. 9, 2005) (defining 'market timing' as "the practice of "(a) frequent buying and selling of shares of the same mutual fund or (b) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing, both of which can dilute the value of the shares of
the increased involvement of non-traditional investors or those investors not generally considered wealthy in the activities of hedge funds. This was a direct result of hedge funds decreasing their minimum investment capital requirements through the development of funds of hedge funds and the increase of pension funds, universities and charitable organization investment. It seems that the SEC's attempt to justify the Hedge Fund Rule relied heavily on their goal of protecting the investor rather than promoting or stabilizing the prominent effect on capitalism that hedge funds employ. However, it seems consistent with the changing times and economy that the SEC sought out a measure of regulation for hedge funds since it is clear their services have become available to those investors who simply can't afford to lose their investments and may in fact do so without having sufficient knowledge to understand what their investments entail. Therefore, it is logical to argue that hedge funds and their privatized nature dove into a realm that is no longer predominately secretive, one that as the SEC correctly points out, has reached retail investors.

Although Goldstein argued the SEC did not have the authority to adopt the Hedge Fund Rule and contradicted congressional intent, it is arguable that registration may have been the correct approach to "gauge the prevalence of problematic practices that hedge funds currently engage in," as the Safe Harbor Provision has not been used in a manner closely related to its purpose. For the brief period that registration under the Advisers Act was in effect for hedge fund advisers, the SEC was able to gather information about the number of hedge funds which an adviser manages, the amount of assets in the funds, employees of the funds, clients of the funds, other business activities the adviser conducts and the identity of those in control of the fund. It seems that disclosure of the information is specifically related to preventing future instances of fraud and may decrease the likelihood of a disaster comparable to mutual fund shareholders, disrupt the management of the mutual fund's investment portfolio and cause the targeted mutual fund to incur costs borne by other shareholders to accommodate frequent buying and selling of shares by the market timer and defining 'late trading' as "the practice of placing orders to buy or sell mutual fund shares after the time as of which a mutual fund has calculated its [net asset value] (usually as of the close of trading at 4:00 p.m. ET), but receiving the price based on the prior [net asset value] already determined as of 4:00 p.m., thus allowing the trader to profit from market events that occur after 4:00 p.m. but that are not reflected in that day's price").

105 See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054; see Jenny Anderson & Riva D. Atlas, If I Only Had a Hedge Fund: Is This the New Emerald City, or the Road to the Next Crash?, N.Y. TIMES, Mar. 27, 2005, §3, at 1.
106 Liffman, supra note 40, at 2176.
108 See Liffman, supra note 40, at 2177.
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that of LTCM by recognizing fraud in its early development.

Additionally, registration barred criminals with long criminal records from managing funds and arguably erased the decrease in minimum investment problems by compelling compliance with minimum requirements for investors under rule 205-3 of the Advisers Act.109 As a result, it seems that registration does curb some of the illegal activity and investor abuse that hedge funds attract and as such the SEC’s requirement of registration was rationally related to hedge fund regulation. However, a rational relationship may not be sufficient as hedge fund regulation, vis-à-vis registration, has garnered a higher level of scrutiny since the Hedge Fund Rule has arguably departed from the purpose and intent of the Safe Harbor Rule.110

D. The D.C. Circuit’s Decision

Statutory Interpretation

The D.C. Circuit held the Hedge Fund Rule to be arbitrary and capricious on its face and upon its application invalidated the SEC’s attempt to regulate hedge funds vis-à-vis registration.111 The court was emphatic in siding with Goldstein by agreeing that although the term “client” is not defined in the Advisers Act, this fact does not confer a right upon the Commission to imply its own definition on grounds on ambiguity.112 Rather than allowing the Commission to redefine the term “client,” the Second Circuit Court of Appeals (“court”) appropriately considered the legislative history of § 203(b)(3) of the Advisers Act dating back to 1970.113 The court points to an amendment in 1970 which in the court’s opinion, is a reflection of congressional understanding that investment company entities, not the shareholders, be it an individual or other entity, were the advisers’ clients.114 The court goes on to explain that the prohibition of a separate exemption for advisers who advised only investment companies would be unnecessary if the shareholders of investment companies

109 Id.; see Regulation Under the Advisers Act of Certain Hedge Fund Advisers; Proposed Rule 69 Fed. at 45,176.
110 See S.E.C., supra note 3; see Bolter, supra note 3 at 601 (discussing how a reviewing court will engage in a more scrutinizing analysis where an agency, like the SEC has departed from the consistent and longstanding precedents or policies where the presumption of agency regulatory authority has been slighted).
111 See Goldstein 451 F.3d 873.
112 Id. at 878 (explaining that the lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous and the presence of a definition does not necessarily make that term clear).
113 Id.
114 Id.

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could be counted as clients. Further, the court implicates the probative value of a Second Circuit decision in holding that hedge fund general partners were investment advisers under the Advisers Act. Although the Second Circuit did not explicitly hold that general partners were advisers to the limited partners, therefore giving merit to the ambiguity of the term “client” as suggested by the Commission, the mere mention of those words may be construed as reiterating the definition of a client to not be equal to that of an investor. It seems the court associates the Commission’s reliance on the Second Circuit’s interpretation of the 1980 amendment to demonstrate such ambiguity of “client” as hypocritical because it was the Commission who established the Safe Harbor provision in 1985.

Investment Adviser, “Client” and Fiduciary Duties

With all the doubt surrounding the existence or lack thereof a concrete definition for the term “client,” the court emphasizes the existence of a statutory definition for the term “investment adviser.” The court reasons that an investor in a private fund may benefit or suffer directly from the investment adviser’s advice but he does not receive that advice directly like that of a general retail investment relationship between an investment representative and an individual who is neither a shareholder nor a corporation. For example, it is not as if the investor walked into a brokerage and openly discussed his investment strategy with another investment representative. In the hedge fund scenario, the investor invests a portion of his assets in the fund and in turn he receives no direct advice. In a hedge fund, the court explains the fund manager is the adviser, and in turn, “controls the disposition of the pool of capital in the fund.” Further, it is not the adviser who tells the investor how to spend his money because the investor made that initial decision when he embarked on investing in the hedge fund. Acting out the investor-adviser relationship leads the court to demonstrate the investors’ maintenance of a passive role. Since the person or entity controlling the hedge fund is not an investment adviser by definition to each individual investor, it follows that each investor can not be

117 Goldstein, 451 F.3d at 879 (explaining that the Safe Harbor provision allowed advisers to count certain limited partnerships as single clients specifically in order to provide some form of certainty about the meaning of the term); see Definition of “Client” of Investment Adviser for Certain Purposes Relating to Ltd Partnerships, 50 Fed. Reg. 8740 (Mar 5. 1985).
119 Goldstein, 451 F.3d at 879.
120 Id. at 880.
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a “client” of that person or entity. As the court explains, “these are just two sides of the same coin.”

This relationship in and of itself seems simple, fair and may lend credence to resolve the issue of when an investor receives direct advice from an adviser and how this situation does not arise in the context of a hedge fund. Ironically enough, this was the view of the SEC until it issued the Hedge Fund Rule. The SEC had agreed with the court’s reasoning when it provided hypothetical scenarios demonstrating the impact of individualized advice. As mentioned above, a “client” of an investment adviser will receive individualized advice on his investment objectives given his financial situation. But if the investment adviser works for an investment company or corporation, he will not and is not required to consider the individual needs of the company’s shareholders when making investment decisions. Also, in contrast to the former situation with the “client,” the adviser is not obligated to ensure that each security purchased for the company’s portfolio is also a financially responsible investment for each shareholder. Coincidentally, it was the SEC and subsequently the court, who reasoned that when an adviser to an investment pool manages the assets of the pool on the basis of investment objectives of a group of investors rather than an individual it seems appropriate to consider the pool rather than each individual investor as a client of the adviser.

Another important aspect which the court considers in Goldstein is the character of the advice rendered. More specifically, the court cites a Supreme Court case where it was held that those engaged in the investment advisory industry will “provide personalized advice to a client’s concerns” and a fiduciary relationship is indicative of the investment adviser-client relationship. Consistent with the legislative history of the Advisers Act it seems as though this direct relationship only exists between the adviser and the hedge fund, but not between the adviser and the investors in the fund. As explained above, the adviser is concerned with the fund’s performance, not with each investor’s financial status. This is the crux of the case against the Commission’s Hedge Fund Rule and more importantly, the correct

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122 Goldstein, 451 F.3d at 880.
124 Id.
125 Goldstein, 451 F.3d at 880.
126 Id.
127 Id.
128 Id. (quoting Lowe, 472 U.S. at 208).
129 Id. (quoting Lowe, 472 U.S. at 208).
interpretation of the intent of the Advisers Act. Therefore, the court is correct in its assertion that the Commission’s interpretation of the term “client” is beyond reasonable bounds and illegitimately characterizes the investors in a hedge fund as the “clients” of the adviser.130 The court unequivocally refuses to define the term “client” but makes clear that the Commission’s interpretation is inconsistent with the fiduciary duties owed in the adviser-client relationship since the adviser owes fiduciary duties to the fund, not the individual investors.131 Therein, a breach of the fiduciary duty by the adviser is a violation of the duty of loyalty owed to the client.132 This cause of action for breach will only extend to investors in a hedge fund alleging fraud against the fund’s adviser.133 Coincidently, the Hedge Fund Rule expands upon the duty of loyalty by recognizing that advisers must manage their clients’ portfolios in the best interest of the client and in the result of any conflict of interest the adviser is obligated to disclose such conflict that exists with the client.134 A conflict of interest is assured if the adviser owes a fiduciary duty to the investors and the hedge fund entity.135 As the court correctly opines, investment advisers cannot be the “servants of two masters in this way.”136 Therefore, contrary to the Commission’s argument, suggesting that hedge funds are structured with the intent of avoiding significant legal obligations such as registration with the Commission, “form does matter in this area [Small Adviser Exemption] of the law because it dictates to whom fiduciary duties are owed.”137

130 Id.
131 Id.
132 15 U.S.C. § 80b-6 (stating it is “unlawful for any investment adviser…[registered or not,] to engage in any transaction…which operates as a fraud or deceit upon any client or prospective client”); see SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (holding that 15 U.S.C. §80b-6 created a fiduciary duty of loyalty between an adviser and his client).
133 Abrahamson, 568 F.2d at 869-71.
135 Goldstein, 451 F.3d at 880 (explaining how a conflict of interest will arise if the adviser owes a fiduciary duty to both the investor and the entity by considering “an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to the investor in the fund, however, will likely be to sell.” On the same level, the shareholders in the corporation are not deemed clients of the corporation’s lawyer. For example, an adviser, or more easier understood a lawyer, can’t represent both side sides of the same coin. For the adviser to owe a fiduciary duty to the investors and the fund itself is analogous to a lawyer representing both the corporation and the shareholders or beneficial owners of a corporation. Even though the shareholders may indeed benefit indirectly from the lawyer’s representation of the corporation, “their individual interests easily can be drawn into conflict with the interests of the entity.”).
136 Id.
137 Id. at 883.

132
The court is correct in suggesting that the Commission has used an illegitimate course to require hedge fund regulation. Although the Commission justifies its Hedge Fund Rule by pointing to the surrounding growth of hedge funds, an increase in fraud actions and retail exposure, these factors are inconsistent with manipulating the use of the term “client.” The Commission has failed to explain away the obvious conflict of interests which may occur amongst fiduciary duties which as a result of the Hedge Fund Rule. Therefore, the court is correct in its reasoning that the relationship between hedge fund investors and advisers does not currently justify treating the former as clients of the latter. Moreover, even if a hedge fund is comprised of separate investment accounts, which in turn must be counted as separate clients, this is not evidence to support the claimed relationship between the investor and the adviser. Even if the alleged activity does exist, the court correctly suggests that the Commission has not supported the argument that all investors in hedge funds are clients. If in fact there exists investors within a hedge fund with different rights or privileges, the Commission may have been successful if they adequately explained how these rights justify treating each of those investors with such rights as separate clients. Simply, the court refuses to look past the Commission’s former interpretation of the Safe Harbor Rule in order to allow the Hedge Fund Rule to hold merit.

The court then correctly explains how it is the Commission who was responsible for the creation of the Safe Harbor Rule and its Small Adviser Exemption and in turn the Commission can not carve out another exception to the rule. The Hedge Fund Rule seems to provide an exception from the Safe Harbor Rule solely for investment entities that have fewer than one-hundred but more than fourteen investors. This rule outlandishly creates a situation in which investment companies with one hundred or fewer investors are exempt from the Investment Company Act, but those with fifteen or more investors triggers registration under the Advisers Act. The court goes on to call the hedge fund rule arbitrary because of its lack of justification for any change in nature of the investment adviser-client relationship since the Commission only points to growth and fraud involving hedge funds, not incidents specifically

138 Id.
139 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2004), (confirming the court’s reasoning that advice to a collective investment vehicle will allow such vehicle or partnership to be treated as a single client since the objectives are based on that of a group and not that of individuals).
140 Goldstein, 451 F.3d at 883.
141 Id.; see 17 C.F.R. § 275.203(b)(3)-1 (making available the benefits of the Safe Harbor provision to hedge funds taking the form of corporations, limited liability companies and business trusts).
142 Goldstein, 451 F.3d at 884.
related to the adviser-client relationship.\textsuperscript{143} For example, the number of investors in a hedge fund does not reveal anything about the fund’s activities that relate to the Commission’s purported justifications of hedge fund growth, an increase in fraud and retail exposure. Further, the relationship between the investor and adviser does not bear upon the nationals securities markets; it is the volume of assets or level of indebtedness of a hedge fund that determines the fund’s influence on the U.S. securities markets.\textsuperscript{144} As a result, the Commission’s justifications for the hedge fund rule are irrational and their argument for registration is misplaced since it incorrectly targets the relationship between investment adviser and client.

IV. IMPACT ON INTERNATIONAL MARKETS AND DOMESTIC REGULATORY ALTERNATIVES

A. Asian Markets

It is arguable that the Asian Market Crisis was the catalyst in prompting international recognition of the hedge fund industry’s significant role in the plight of emerging markets as well as the likelihood of a global regulatory effort.\textsuperscript{145} Given that it was the affected nations who made the emergency call for regulation, it is worth mentioning that the U.S. regulatory authorities may have overlooked the need to temporarily halt U.S. hedge fund abuse of the struggling regions abroad.\textsuperscript{146} Surprisingly, the U.S. or the generally stringent regulatory body that is the SEC allowed for the sudden withdrawal of highly leveraged activity in Southeast Asia currency trading and other speculative investments.\textsuperscript{147} This lack of intervention by the Commission, whereby their attention focused squarely on a decidedly arbitrary attempt to regulate hedge funds domestically was exhibited by the Staff Report’s purported focus on the U.S. market and the overriding concern of rebuilding U.S. investor confidence.\textsuperscript{148} Despite the lack of involvement by the U.S. in international...
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hedge fund regulation, several affected Asian nations stepped up to the plate. Unlike the U.S., the Monetary Authority of Singapore as early as 2002 kept retail investors informed of the risk involved in hedge fund activity and implemented certain disclosure requirements. Additionally, rather than simply claiming the hedge fund industry has become endangered due to retail exposure in the U.S., both Hong Kong and the United Kingdom installed regulations to allow hedge fund product offerings to the retail investor. Coincidentally, it is Hong Kong, Singapore and the United Kingdom who are deemed the most active in regulating the hedge fund industry. Further, it is Hong Kong, rather than the U.S., who took the right approach in trying to mitigate the risk associated with hedge funds. Hong Kong implemented a difficult licensing exam for potential hedge fund managers and investment advisers. It seems odd that the U.S., the most highly sophisticated and well-funded nation, took an approach akin to hedge fund investment adviser registration via statutory reinterpretation rather than a means similar to that of Hong Kong. The SEC criticized a hedge fund’s structure before allowing it to start its operations. Rather than exhibit the unity that the Hong Kong Monetary Authority maintained when it regulated hedge fund activity, the divisiveness amongst SEC commissioners likely resulted in the extensive criticism that domestic hedge fund regulation attracted.

B. Canadian Markets

Since the collapse of two large Canadian hedge funds whose presence was felt most by retail, the Chair of the Ontario Securities Commission has designed measures to “ensure that hedge fund managers provide fair, full, accurate and timely information to their investing clients, [in] addition to improving transparency surrounding management fees and risk.” Most hedge funds once had a short position in Thai currency so significant that it amounted to approximately five percent of Thailand’s Gross Domestic Product at its peak).

149 See S.E.C., supra note 3.
150 Id. at 584.
151 Id.
152 Id.
153 Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (explaining that where the adoption of the Hedge Fund Rule ignited great uproar amongst the hedge fund and financial communities as well as the SEC itself as the SEC commissioners voted 3-2 in approving the amendment, prompting one of the most publicized and controversial regulatory conflicts in modern financial history).
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recently, the Ontario Securities Commission announced its intent to force hedge fund managers to register with regulators and to pass tests to prove their proficiency. This is likely in response to the collapse of hedge funds Portus Alternative Asset Management, and Amaranth Advisors who lost $6.5 billion due to wrong bets on natural gas prices by a Calgary-based trader.\(^\text{155}\) For the sake of the U.S. securities markets, the SEC should coordinate some logical form of regulation to prevent an occurrence similar to that of the Canadian hedge funds or the Asian Market crisis.

C. Domestic Alternatives

Since the D.C. Circuit vacated the Hedge Fund Rule, several alternatives to the rule have gained attention. First, Commissioner Cox recommended that the anti-fraud provisions of the Investment Advisers Act should apply only to clients, not to investors in hedge funds, or in the alternative, examine whether the Advisers Act may proscribe fraud by advisers against investors in hedge funds.\(^\text{156}\) This suggestion seems superfluous given the overarching and well-defined rule 10b-5 of the Securities and Exchange Act of 1934 which suffices to prosecute insider trading and other methods of securities fraud. If the Commissioner follows through with this antifraud rule, a subsequent court challenge is imminent.

Citing the Staff Report’s finding that hedge fund products have attracted less wealthy investors through retailization, the Commissioner suggested that the definition of accredited investor as applied to retail investment in hedge funds without registration may be worthy of a limited change.\(^\text{157}\) As the foundation of the SEC is investor protection, an individual with insufficient assets that is investing in a product (like a hedge fund) incurs high risks encompassing the potential loss of their assets and in turn will need society to support them. Therefore, the purpose of this law would likely serve to ensure those with insufficient assets won’t lose everything. However, if the


\(^{157}\) Id. (explaining that the accredited investor will be redefined to be called an "accredited natural person" and that person would need a net worth of $1 million, an old requirement, but would also have to have $2.5 million worth of investable assets, excluding the value of a primary residence. The proposed rule provides for inflation adjustments, with the first adjustment to $2.5 million to the nearest $100,000 on April 1, 2012 and an adjustment every five years thereafter); see Regulation Under the Advisers Act of Certain Hedge Fund Advisers; Proposed Rule 69 Fed. Reg. 45,172.
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purpose of this accredited investor definition is to prevent such a risk, a version that places a cap on the amount invested in proportion to an investors’ net worth in certain investment categories would be more efficient. Given that it is a virtual certainty that any legislation significantly amending the text of the SEC’s rules is subject to challenge, amending minimum financial requirements is a practical solution. Up until now, the SEC’s attempt to regulate hedge funds has seemed overly intrusive and has allegedly precluded the creativity, liquidity and flexibility of hedge funds that existed prior to the Hedge Fund Rule. At the same time, the collapse of Amaranth Advisors, a Greenwich, Connecticut based hedge fund in September of 2006 is a blow to the argument that hedge funds need not be regulated.158 In response, it is assumed that local lawmakers will respond by introducing legislation that would require more disclosure and eliminate conflicts of interest between investors and fund managers,159 laws that would seemingly resemble that of the vacated Hedge Fund Rule. Although Connecticut is home to a significant amount of hedge funds, this is a poor idea by Connecticut regulators. By unilaterally imposing regulations that no other state has, hedge funds will likely move their offices elsewhere and adversely affect the state’s economy. This transition would be disliked by the federal government given the revenues contributed to the United States Treasury by Connecticut’s hedge funds. Regulation at the state level is undoubtedly a catalyst for increased costs and inconsistent rules across state lines.

In order for hedge funds to be as successful as they were previously and concurrently promote investor protection and confidence, the SEC must focus its regulation on informing its investors of the risks involved in hedge fund trading activity without significantly disclosing any trading strategy, portfolio or irrelevant information. This approach is akin to that of the Financial Services Authority (“FSA”), the United Kingdom’s securities regulator whose culture provides for daily dialogue with hedge funds.160 This dialogue seems more practical than the SEC’s approach because hedge funds presumably know what the risks are and will have procedures in place so that if something does indeed go wrong, there is a connection at the FSA or the SEC. Coincidentally, Hong Kong, Singapore, France and Dubai have all altered their regulatory mechanisms to mirror the FSA.161

160 Id.
There is also the suggestion that hedge funds themselves should be left alone, diverting our regulatory resources to those sophisticated and wealthy investors who so frequently support hedge fund growth. Most recently, the President's Working Group proposed a series of nonbinding principles, placing the onus primarily on companies, investors and buyers and sellers of hedge fund securities to impose a "market discipline." It has been the large financial institutions that have brought despair to the economy as well as the homes of certain American taxpayers. The collapse of Long Term Capital Management and the Savings and Loan Industry is likely attributable to the insurmountable levels of leverage taken on by lenders that resulted in economic disaster rather than the investment decisions of someone with a net worth of a million dollars. By regulating hedge funds, the SEC arguably has it in reverse. Although some pension funds invest the funds of unaccredited investors (by the SEC standard of an accredited investor) in hedge funds, the funds invested are presumably substantial enough to hire the expertise necessary to evaluate the hedge fund products. If not, perhaps the SEC needs to promulgate requirements for pension funds, such as acquiring a minimum level of expertise similar to the idea of an intermediate financial exam serving to qualify an individual as an eligible investor. Additionally, the accredited investor standard restricts certain financial opportunities to the wealthy and supports the "rich get richer" notion. It is one thing to limit one's freedom of choice. It is another thing entirely to make sure people have the information they need to make these choices. Therefore, informing the investors of the risks associated with hedge funds vis-à-vis pension fund managers is a plausible regulatory mechanism.

**CONCLUSION**

It is questionable as to how far the SEC can and will go in their subsequent attempt to regulate hedge funds. The boundaries of patience and efficiency will be tested as hedge funds may look to the advantages of offshore fund establishment as regulation may hinder the foundations of financial success generated in the private sector. If the majority of hedge fund assets do

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162 Id.

163 *Many Investors Fume over Hedge-Fund Rule*, Dealbook, http://dealbook.blogs.nytimes.com/2007/02/12/many-investors-fume-ove-hedge-fund-rule/(Feb. 12, 2007, 12:37 EST) (explaining that board members of pension funds are charged with the task of making asset allocation decisions which undoubtedly play into the hedge fund business model. These assets come from the salaries and savings of individuals who do not necessarily meet the SEC's accredited investor standard such as that of a firefighter contributing to his local county's pension plan. Therefore, a wealth requirement such as the accredited investor standard is seemingly missing a large portion of investors whose assets find their way into hedge fund products).
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indeed find their way offshore, thus potentially incurring virtually zero transactional disclosure or prohibitions, the largest and most liquid securities market that is the U.S. will undoubtedly face a situation analogous to that of driving foreign issuers of initial public offerings ("IPO") to register with foreign exchanges rather than entering the U.S. capital markets.\textsuperscript{64} If a statute is written in haste like that of the Hedge Fund Rule, subsequent measures will serve as barriers to further enhancement of the U.S. securities markets.

\textsuperscript{64} In fact, of the top 25 global IPOs in 2005, only one took place in the U.S. Prior to Sarbanes Oxley’s implementation, in 2000, 9 of the top 10 were listed on U.S. soil; see W. Carson McLean, The Sarbanes Oxley Act: A Detriment to Market Globalization & International Securities Regulation, 33 SYRACUSE J. INT’L L. & COM. 319, 319 (2005).