Article

Join the Party but Don't Ruin it: Analysis of Pros and Cons of Hedge Fund Regulations

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ABSTRACT

This paper seeks to demonstrate that although numerous flaws exist in the hedge fund industry, a registration requirement is too drastic an approach because alternative regulatory oversight is readily available to resolve the problems. The first part of the paper argues that registration is not an appropriate response because registration neither solves the fraud problem in hedge funds nor provides the SEC more extensive reach of its jurisdictional power. Granted, it may provide information to the SEC as to what participants are currently in the industry, but such information can be easily obtained from other existing schemes with little worries about its falsity. The second part of this paper argues that despite the fact that registration is an unwarranted step, more regulatory oversight is still needed to address concerns in the hedge fund industry. Finally, this paper concludes with three alternatives to address the SEC worries, demonstrating that the problems can be dealt with in ways other than compelling all funds to file standardized registration forms. It is difficult to keep the government away from the hedge fund parties anymore; after all, few hedge funds today are working exclusively for the elite individuals alone, they also invite pension funds and charities, which include you and me as one of the few thousand beneficiaries. The paper demonstrates that the government should and is welcomed to join the party, but just not ruin it.

Keywords: *Hedge Fund, Fund, Investment Advisors Act, Securities Act, Investment Company Act, Registration, LTCM*

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I. INTRODUCTION

The wealth created by hedge fund managers is staggering. The expectation of annual returns fifteen years ago was around the 30-35% range; nowadays, it settles at 8-10%.[1] Although the investors no longer expect a wild 30% return as in the 90s,[2] there are still plenty of hedge funds that are capable of throwing lavish parties for their partners. The Children's Investment Fund Management, for example, achieved a 43% net return in 2004 and 50% in 2005.[3] In fact, some data even suggest that hedge funds have outperformed the S&P 500 since 1998 and one hedge fund monitor even went as far as to say, "the industry has beaten the S&P by an astounding 7% points per year on average since 1998."[4]

The hedge funds not only create tremendous wealth for their investors but also for the fund managers. In 2003, George Soros was paid $750 million for managing the Soros Fund Management.[5] In 2005, the top-25 hedge fund managers made $363 million, *on average*.[6] Some hedge fund managers can even bring home an annual salary of one billion dollars.[7]

However, the risk involved in managing a hedge fund may easily make anyone have many sleepless nights. The blowup of two high profile hedge funds, Long Term Capital Management ("LTCM") in 1998 and Amaranth Advisers in 2006, demonstrated the volatile nature of this industry.

LTCM was set up by Salomon Brothers' top money maker, John Meriwether, in the early 1990s.[8] It was once the most promising hedge fund start-up based in Delaware.[9] The minimum investment amount was $10 million per investor.[10] In other words, there were only a select few who were able to attend LTCM's cocktail parties.[11] At its inception, LTCM was

1. Special Report, *Growing pains- Hedge funds*, THE ECONOMIST, Mar. 4, 2006.
2. Special Report, *Growing pains- Hedge funds*, THE ECONOMIST, Mar. 4, 2006 (citing Stanley Fink, chief executive of Man Group, a global asset-management firm with a big stable of hedge funds, said "[t]he days of 30% - plus returns for hedge funds are long gone … the Wild West is over").
3. *Id.*
4. Andy Serwer, reporter associates Julia Boorstin and Melanie Shanley, *Where the Money's Really Made; Hedge funds are raking in hundreds of billions while you're losing your shirt. Is this the next bubble?*, FORTUNE, Mar. 31, 2003.
5. *The $750 Million Man: George Soros Leads Institutional Investor's Alpha's Ranking of the World's 25 Highest-Paid Hedge Fund Managers in 2003*, PR NEWSWIRE, July 20, 2004.
6. John Finneran, *Hedge Fund Wizards*, Sep. 19, 2006, *available at* http://www.fool.com/mutualfunds/mutualfunds.htm (last visited Feb. 1, 2009).
7. *Id.*, stating that James Simons, head of hyper-quant Renaissance Technologies, made $1.5 billion.
8. Jonathan H. Gatsik, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591, 594-95 (2001).
9. *Id.* at 594.
10. ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 31 (Random House Trade Paperbacks, 2001).
11. *Id.* at 38. (Investors included companies such as Merrill Lynch ($15 million), Payne Webber ($100 million), and Suminoto Bank ($100 million). Academic institutions included St. John's

fabulously successful. In 1995, it earned a 59% return and "its capital had increased from $1.25 billion to over $7.5 billion."[12] In 1996, it even eclipsed the profits of established companies such as McDonald's, Disney or Xerox.[13] Meriwether, together with his two Nobel Prize winners,[14] were cast as math wizards; they waved their magic wands and the spell kept their investors happy — until 1998.

In August 1998 alone, LTCM lost $1.8 billion, reducing its capital base to about $2.3 billion.[15] In September, its size further shrunk to $1.7 billion.[16] Meriwether's frantic scrambling for money proved to be futile. The New York Federal Reserve decided to intervene for fear of "disastrous effects on financial markets."[17] As a result, "fourteen prominent banks and brokerage houses — including UBS, Goldman Sachs, and Merrill Lynch" injected $3.6 billion to the near defunct hedge fund.[18] In return, the consortium received a 90% stake in the fund, limiting the original investors' and partners' control to 10%.[19] Meriwether was saved.

Eight years later, in the same ominous September, the financial world was once again shaken by a hedge fund blowup. Amaranth Advisors, the Connecticut hedge fund,[20] lost nearly $5 billion in a week.[21] The figure represents more than "50% of its total capital,"[22] and the loss was a result of a bad bet made by its trader, Brian Hunter.[23] The market did not react well to this news. The Dow fell 79.96 points, the "largest one-day declines since early August [2006]."[24] Similarly, Nasdaq dropped 0.67% and S&P's 500 index dropped 0.54%.[25] However, there were little effects on the overall economy.[26]

The volatile nature of the hedge fund industry could also be seen in the 2008 financial meltdown. When the U.S. and the rest of the world were still

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University, and Yeshiva University, each contributed $10 million).

12. Gastsik, *supra* note 8, at 598-99.

13. Alan Deutschman, *The Recklessness of the Nerds*, Oct. 12, 2000, *available at* http://archive.salon.com/business/feature/2000/10/12/review/ (last visited Feb. 1, 2009).

14. *Id.*

15. Gastsik, *supra* note 8, at 598.

16. *Id.* at 601.

17. Kevin Dowd, *Too Big to Fail? Long-Term Capital Management and the Federal Reserve, Cato Institute Briefing Papers*, *available at* http://www.cato.org/pubs/briefs/bp52.pdf (last visited Jan. 31, 2009).

18. *Id.*

19. Gastsik, *supra* note 8, at 598.

20. Heather Timmon, *A Familiar Story, Youthful Bent Included*, N.Y. TIMES, Sep. 22, 2006.

21. Phil Izzo, *Getting a Grip on Hedge Fund Risk,* WALL ST. J., Oct. 13, 2006, at C3.

22. Jenny Anderson, *Hedge Fund Sheds Assets In Energy*, N.Y. TIMES, Sep. 21, 2006.

23. Timmon, *supra* note 20.

24. Michael Hudson & Serena Ng, *Investors Finally Break From Calm; Dow Drops 79.96*, WALL ST. J., Sep. 22, 2006.

25. *Id.*

26. Izzo, *supra* note 21.

reeling from the credit crunch triggered by free-falling home prices, the hedge fund industry almost ground to a halt. The industry, on average, "was down about 20% through November in the year 2008."[27] One of the best-performing hedge funds had its gains for the past three years wiped out due to falling Chinese securities.[28] In fact, the cascade of panic redemption demands were expected to wreak havoc in the industry, causing the "entire hedge fund industry [to] start 2009 at 40% the size it was at the beginning of 2008."[29] Worse still, when the Madoff mess, "the world's largest Ponzi Scheme,"[30] was unearthed in December 2008, the entire hedge fund industry and fund-of-fund businesses were expected to face even bigger losses. Unfortunately, unlike the Amaranth and LTCM blowups, the evaporation of generations' of wealth was not contained in high net worth individuals alone. Going down with Bernard L. Madoff (hereafter "Mr. Madoff") was his multi-billion dollar management business as well as institutional investors, pension plans, ERISA plans, university endowments and charity organizations — in other words, from big banks within the U.S. and overseas to the smallest community charities.

The above descriptive picture sums up the charm of hedge funds: the returns are remarkable (usually 60% before fees)[31] but when things go wrong, they go very wrong. The Securities and Exchange Commission (hereinafter the "SEC" or the "Commission") first turned its inquisitive glance at the industry in the early 90s when the funds were implicated in the European Monetary System crisis.[32] It decided to stay away from this club of the ultra-rich. However, its glance turned intensive following the LTCM's collapse in 1998. Finally, on December 10, 2004, the SEC released final rules compelling funds with assets more than $25 million to register pursuant to the Investment Advisors Act of 1940. This paper will analyze the effects of the proposed rule and argue that although *registration* is not warranted, *regulatory oversight* is necessary.

Section I gives an overview about the hedge fund industry: its key features, changes undergone since its invention, and the contrast of rules before and after the SEC Proposal. It concludes with the main obligations of a fund manager after the fund has been registered with the SEC.

Section II advances the first part of the argument as to why *registration*

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27. Dan Molinski & Gregory Meyer, *Hedge Funds Face Big Losses in Madoff Case*, WALL ST. J., Dec. 12, 2008.

28. William Hutchings, *China's Markets Wipe Out Most of 788 Fund's Gains*, WALL ST. J., Dec. 18, 2008.

29. Kerry E. Grace, *Hedge Funds Fell 2.7% in November*, WALL ST. J., Dec. 18, 2008.

30. Molinski & Meyer, *supra* note 27.

31. Finneran, *supra* note 6.

32. Barry Eichengreen & Donald Mathieson, *Hedge Funds: What Do We Really Know?*, 19 IMF ECONOMIC ISSUES, *available at* http://ideas.repec.org/p/imf/imfeci/19.html (last visited Jan. 31, 2009).

is unwarranted. The anti-registration conclusion is reached based on three arguments. Section A argues that the main reasons in the SEC Proposal itself do not warrant registration. Section B points out other federal regulatory schemes which nonetheless govern exempt hedge funds; accordingly, registration does not afford material difference. Section C analyses the registration rule from policy perspective and argues that it brings more harm than benefits.

Section III advances the second part of argument as to why *regulation* is still necessary — although registration is too drastic an approach. The position is justified from risk analysis to the investors (Section III-A-1) and to the market as a whole (Section III-A-2). It concludes with three non-registration proposals to correct the current hedge funds flaws.

II. HEDGE FUND IN GENERAL

A. *What Is a Hedge Fund: Key Features, Fund Structure and Management Fee*

Warren Buffett once said the term "hedge fund" is "nothing but a name."[33] Mr. Buffett is right in that the term holds no universal definitions.[34] The term does not appear anywhere in federal securities laws nor do its participants ever agree upon a unified definition.[35] It is generally defined as "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[36] The IMF identified the key determinants of hedge funds as: (1) funds that employ a wider range of investment strategies[37] and are more active in trading; (2) the manager's particular investment strategy is more important to performance than asset or market selection; (3) hedge fund managers reply primarily on performance fees for revenue.[38] The DC Circuit, when considering the Commission's recent proposal to regulate the hedge funds,

33. Serwer, *supra* note 4.

34. Rory B. O'Halloran, *An Overview and Analysis of Recent Interest in Increased Hedge Fund Regulation,* 79 TUL. L. REV. 461-62 (2004); *see also* IMF Multimedia Service Division, *Global Financial Stability Report: Market Developments and Issues*, at 45, *available at* http://www.imf.org/external/pubs/ft/GFSR/2004/02/pdf/gfsr0904.pdf (last visited Feb. 1, 2009) (stating "there is no 'typical' hedge fund") [hereinafter *IMF Global Report*].

35. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (citing SEC Roundtable on Hedge Funds, *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm (last visited Feb. 1, 2009), which provides fourteen different definitions found in government and industry publications).

36. *The President's Working Group on Fin. Mkts., Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* 1 (1999) [hereinafter *The President's Working Group on LTCM*].

37. *Panel 1: Hedge Funds – Overview, Role and Structure, Hedge Fund Roundtable Before the SEC*, May 14, 2004, *available at* http://www.sec.gov/spotlight/hedgefunds/hedge1trans.txt (last visited Feb. 1, 2009) (identifying twenty-three different hedge fund strategies).

38. IMF Global Report, *supra* note 34, at 45.

defined the industry by comparing their trading strategies and management structures with mutual funds.[39] That is, hedge funds are more aggressive in their borrowing and are not bound by detailed board of director requirements as are mutual funds. In summary, hedge funds are investment vehicles that are thinly regulated by the SEC.[40] They engage in a wider range of trading strategies,[41] such as taking a more aggressive position in leverage and short-term investments.[42] The talents and reputation of the fund manager are usually the key to investment return.[43] This buyer-be-aware feature of hedge funds exposes investors to greater risks, which are often compensated by the promise of greater returns.[44]

The majority of U.S. hedge funds are structured as a limited partnership with the fund managers (either a natural person or a separate limited liability entity)[45] as the general partners (*see* Diagram 1).[46] The fund managers have exclusive responsibility and authority for the fund's daily operation and investment strategies while the investors share losses or profits based on their capital contribution.[47] This structure affords at least two advantages pertinent to our discussion.[48] First, the fund investors only have limited liabilities. That is, the investors *could* lose their investment in the funds and profits, but *not* be liable beyond that for any hedge fund debts.[49] Second, the structure provides the greatest flexibility to the fund managers. In other words, the fund advisers are *only* subject to the fiduciary duty[50] and limitations in the agreement of limited partnership.[51] In addition, most of the

39. *Goldstein v. SEC*, *supra* note 35 (noting that significant restrictions for registered companies are instead all core elements of hedge funds' trading strategies and the requirements for independent boards of directors for mutual funds are not imposed on hedge funds, which can structure themselves as limited partnership to achieve maximum separation of ownership and partnership).

40. O'Halloran, *supra* note 34, at 462.

41. The President's Working Group on LTCM, *supra* note 36, at A-1 (distinguishing hedge funds from other investment vehicles in that hedge funds typically use more derivatives instruments and take more short positions).

42. Gatsik, *supra* note 8, at 598 (stating that hedge funds trade in a wide range of financial instruments ranging from equity securities, fixed income securities, debt instruments, commodities, future contracts, and other derivative contracts); *see also* The President's Working Group on LTCM, *supra* note 36, at A-2 (describing hedge fund trading strategies).

43. Christine Williamson, *Hidden Risk: Investors Skim over Question of Fund Valuation; Undervaluation of the Risks of Hedge Funds*, 32 PENSIONS & INVESTMENTS 19 (2004) (stating that "hedge fund manager selection is definitely an art … 80% of the decision is dependent on the quality of the manager").

44. Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 715 (2000).

45. DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS 91-92 (2005).

46. *Id.*

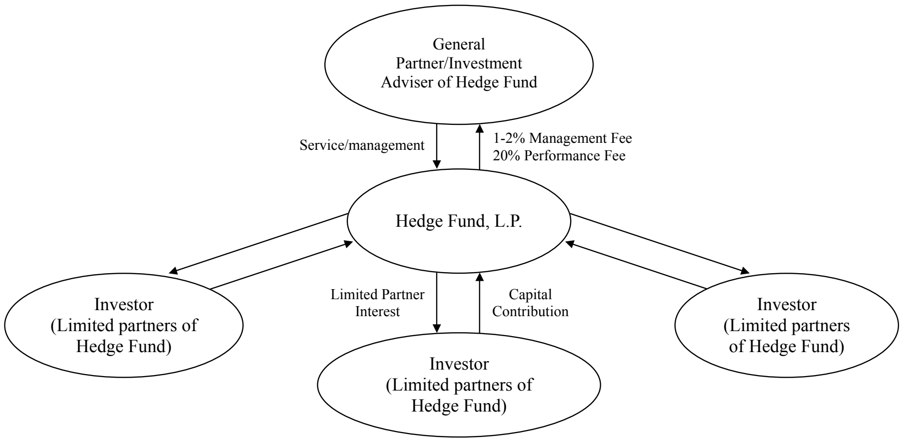
47. Gatsik, *supra* note 8, at 595.

48. HAMMER, *supra* note 45.

49. *See, e.g.*, citing Delaware General Corporation Law § 102(b)(6), the Delaware Revised Uniform Limited Partnership Act § 17-303 and the Delaware Limited Liability Company Act § 18-303.

50. Advisers Act § 206, 15 U.S.C. § 80b-6.

51. HAMMER, *supra* note 45.



fund managers are compensated based on the "one and twenty"[52] arrangement: managers are paid 1% of the fund's assets, but 20% of the fund's profits.[53] Since the conduct of the fund managers is only subject to fiduciary duty and restraints specifically withheld in the limited liability agreement and an overwhelming percentage of their income is derived from the fund's performance, the structure thus provides the strongest incentive for managers to maximize the fund profit.[54] This explains why when fund managers do have a good year, their payment can easily dwarf the pay of most Chief Executive Officers on Wall Street.[55]

B. *Hedge Fund Today: Its Growth and Size*

Alfred Winslow Jones, an Australian investor, is usually said to have created the first hedge fund in 1949.[56] He started the fund based on the same reason that many hedge funds start today: to insulate the investment from market fluctuation[57] *and* to make a profit "best or worst."[58] Yet the similarity ends there. Hedge Funds today have grown tremendously — not just in strict numerical sense, but also have reached beyond their traditional

52. HAMMER, *supra* note 45, at 327 (to be more precise, the investment advisers to hedge funds typically charge 1-4% at annual rate of the managed assets. But the majority stays at 1-2%).

53. Serwer, *supra* note 4.

54. Gatsik, *supra* note 8, at 595 (citing The President's Working Group on LTCM, *supra* note 36, at A-1. It discussed the use of leverage to increase return and profits).

55. Serwer, *supra* note 4 (for example, Ken Griffin, the manager of the $8 billion Citadel Investment Group in Chicago makes $215 million in 2001 when he managed to capture an eye-popping 20% gain in a down market).

56. Gibson, *supra* note 44, at 715.

57. Chris Frankie, *Registered Hedge Fund Demand on the Rise, Investment Mgmt.*, WKLY, Sep. 6, 2004.

58. LOWENSTEIN, *supra* note 10, at 25 (2000).

sphere to securities, bond and debt markets.[59]

The growth rate of hedge funds is astounding. In 1968, the number of existing hedge funds was estimated at 215.[60] In 1998, there were over 3,000 hedge funds managing $200 to $300 billion.[61] The global hedge fund industry was expected to reach $1 trillion by 2004.[62] According to SEC release in the end of 2004, "hedge fund assets have grown 260% [in the last five years], and in the last year, hedge fund assets have grown over 30%."[63] Today, there are more than 8,000 hedge funds, managing over $1.2 trillion in capital.[64] Moreover, hedge funds are now the dominant force in the New York and London stock exchanges, accounting for "roughly half of all trading in those markets."[65] Additionally, hedge funds have emerged as major players in debt market, a financial segment that is "more than one and a half times as big as the stock market."

C. *Current Regulatory Schemes, Concerns and Proposed Rules*

1. *Current Federal Regulatory Schemes and Exemptions*

Generally, when a company issues securities seeking public investment, it must be mindful of applicable federal disclosure and registration requirements.[66] There are three primary federal statutes that compel registration with the SEC if the parties engage in securities offering without any exemptions. The statutes include: the Securities Act of 1933 (hereinafter "Securities Act"),[67] the Investment Company Act of 1940 (hereinafter "Investment Company Act")[68] and the Investment Advisors Act of 1940 (hereinafter "Advisors Act").[69]

Section 5(a) and 5(c) of the Securities Act prohibit offering or selling a security unless its registration statement has become effective or it is exempt

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59. Gibson, *supra* note 44, at 715 (noting that although the hedge funds still pursue the same strategies by Jones, hedge funds nowadays have expanded to a wide array of trading, including securities, debt and equity, futures, options, and foreign currencies).

60. Joseph Hellrung, *Emerging Issues in Banking Regulation: Hedge Fund Regulation: Investors are Knocking at the Door, but can the SEC Clean the House Before Everyone Rushes In?*, 9 N.C. BANKING INST. 317, 318 (2005).

61. Gibson, *supra* note 44, at 682.

62. Sherry M. Shore, *SEC Hedge Fund Regulatory Implication on Asian Emerging Markets: Bottom Line or Bust*, 13 CARDOZO J. INT'L & COMP. L. 563, 565 (2005).

63. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054 (Dec. 10, 2004).

64. Izzo, *supra* note 21.

65. Anderson, *supra* note 22, at A1.

66. Gibson, *supra* note 44, at 688-99.

67. 15 U.S.C. § 77a (2000).

68. 15 U.S.C. § 80a (2000).

69. 15 U.S.C. § 80b (2000).

from registration. Section 7(a) of the Investment Company Act "generally forbids any investment company from engaging in the business of buying and selling securities" unless it has registered with the SEC or has a valid registration exemption.[70] Similarly, one must register under the Advisers Act unless he is exempt or is excluded from the definition of "investment adviser."[71] The following section offers a brief discussion as to how hedge funds are exempt from the registration requirement under each act.[72] Although exempt, the industry is still subject to numerous federal schemes which will be addressed in Section II-B-2 (State regulatory schemes are beyond the scope of this paper so they are omitted).

(a) The Securities Act of 1933

Under the Securities Act, any offering that falls under the designated list of "securities"[73] must register with the SEC. The hedge fund offerings fall squarely to the ambit of "investment contracts"[74] — one of the designated are of "securities." As a result, it must either register or qualify under an exemption. Most hedge funds resort to the second route.

Funds today utilize the exemption under Section 4(2), the "private placement" provision[75] together with safe harbor Rule 506.[76] In other words, a hedge fund is spared from the registration obligation as long as it (1) does not engage in general solicitation[77] and (2) it engages only the "accredited investors"[78] or those who are either sophisticated themselves or

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70. Kelli L. Moll, *Investment Management Developments; SEC Sanctions Hedge Fund Advisers for Violation of Private Rules and Section 3(c) of the Investment Company Act of 1940*, SCHULTE ROTH & ZABEL LLP (2005).

71. Advisers Act § 202(a)(11), 15 U.S.C. § 80b-2(a)(11).

72. Note that although hedge funds are generally unregistered and thus not subject to the SEC scrutiny, there are still general rules, such as the Rule 10b5 of the 34 Act, that governs the exempt hedge funds; *see also* Jacob Preiserowicz, *The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?*, 11 FORDHAM J. CORP. & FIN. L. 807, 818 (2006).

73. 15 U.S.C. § 77a.

74. Preiserowicz, *supra* note 72, at 811.

75. 15 U.S.C. § 77d(2) (2006).

76. 17 C.F.R. § 230.506 (2004) (regulation D is an umbrella of three safe harbors designed to provide clearer guidance when using 4(2) exemptions. Hedge Funds are usually qualified under Rule 506).

77. 17 C.F.R. § 230.502(c) (2004) (general solicitation includes general methods in reaching out to the public through communications such as advertising. The fund and its managers will have more leeway in engaging in solicitation and promoting its fund if there is "preexisting relationship" between the fund and potential investors).

78. 17 C.F.R. § 230.501(a) (offering a list of accredited investors which include banks, savings and loans, and other institutional inventors or any natural person with net worth more than $ 1,000,000. Hedge fund investors usually satisfy this accredited investors requirement in that the investors are either investment institutions or high-net-worth individuals). *See also* Steven E. Hurdle, *A Blow to Public Investing: Reforming the System of Private Equity Fund Disclosures*, 53(1) UCLA L. REV. 239, 245 (2005).

represented by "sophisticated representatives."[79] Put simply, any hedge fund can keep dancing to their own tunes as long as they keep it quiet and invite only the crowd that the Act deems sophisticated.

(b) The Investment Company of 1940

The Investment Company Act requires an investment company to register if it engages in investing securities.[80] Since the primary function of hedge funds is to advise securities investment, they fall in the definition of the Act and accordingly, it must either register or fit under a valid exemption.

The exclusions here can be based on two provisions.[81] For funds with fewer than a hundred investors and do not "presently propose to make a public offering of its securities" are qualified under Section 3(c)(1) exemption.[82] For funds whose outstanding securities are sold to *more than* 100 persons but are *exclusively* to "qualified purchasers"[83] (investors with at least $5 million in investments)[84] come under Section 3(c)(7) exemption. As a result, hedge funds can avoid registration under the Investment Company Act through either Section 3(c)(1) or 3(c)(7).

(c) The Investment Advisors Act of 1940

The Advisors Act requires all investment advisors with more than fifteen clients and assets exceeding thirty million dollars to register with the SEC.[85] Hedge funds are generally excluded from this requirement by utilizing Section 204(b)(3) of the Advisors Act. Section 204(b)(3) provides registration exemption if, during the previous twelve months, the funds have fewer than fifteen clients and do not hold themselves out to the public as investment advisors.[86] Rule 203(b)(3)-1,[87] adopted under Section 203, states that "a corporation, general partnership, limited partnership, limited liability company, trust or other legal organization that receives investment advise based on its investment objectives rather than individual investment objectives of its shareholders, partners, limited partners, members or

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79. 17 C.F.R. § 230.506(b)(2) (2004).
80. 15 U.S.C. § 80a-1 (2004).
81. 15 U.S.C. §§ 80a-3(c)(1) and 3(c)(7) (2004).
82. 15 U.S.C. § 80a-3(c)(1) (2004).
83. 15 U.S.C. § 80a-3(c)(7) (2004).
84. 15 U.S.C. § 80a-2(a)(51) (defining "qualified investors" as "any natural person … who owns not less than $5,000,000 in investments").
85. 15 U.S.C. § 80b-3 (2000) (the act requires anyone "who, for compensation, gives investment advice as to the purchase and sale of securities" to register if asset under management exceeds $30 million).
86. 15 U.S.C. § 80b-203(b)(3).
87. 17 C.F.R. § 275.203(b)(3)-1; *see also* Preiserowicz, *supra* note 72, at 815.

beneficiaries shall be treated as *one* client for the purpose of Section 203(b)(3)" [emphasis added].

Rule 203(b)(3)-1 essentially serves as a loophole. For example, suppose there is a fund with only two participants, John Smith and California state pension plans (both have the status of "limited partners" in above Diagram 1). Prior to the SEC Proposal, there are only two investors in the fund. That is, Rule 203(b)(3)-1 allows a fund to count either an individual investor or pension plans with an entire state government employees as beneficiaries as *one* investor.[88] However, under the proposed rule, the fund will have one plus the *entire* state government beneficiaries as investors (the details of the 'look through' provision will be discussed in the following section). Needless to say, the fund would easily exceed the fifteen investor threshold under Section 204(b)(3) and hence, it must register.

2. *The SEC Proposal*

Through the above mentioned exemptions, hedge funds are generally excluded from the hawkish watch of the SEC because the fund itself is excluded from the definition of an investment company under Investment Company Act and the managers are exempt under Investment Advisers Act. Yet concerns have been mounting. In May 2003, the SEC studied sixty-five hedge fund advisers and held a two-day Hedge Fund Roundtable. On September 23, 2003, the Commission came back with a staff report, (hereinafter as "the SEC Proposal")[89] seeking to make Rule 204(b)(3)-1 unavailable. On September 15, 2004, the comment period for the proposed rule expired.[90] On October 6, 2004, SEC Commissioners voted three to two in favor of requiring hedge fund managers to register as investment advisers under the Advisers Act.

The gist of the Commissions arguments can be summed up as follows. First, the industry has grown too fast: 260% in a span of five years and 30% alone in 2002. With $1 trillion in assets under management, it is much bigger than the mutual fund markets. Second, the growth implicates more fraudulent practices, especially the fund managers' peculiar role in market timing scandals and conspiracies with mutual fund personnel. Third, the SEC has a vested interest in the industry because of the increased public

88. Note that the SEC will count each fund as one client only if the advise was provided for the purpose of entire fund rather than for the objective of each individual investor.

89. *Staff Report to the U.S. Sec. & Exch. Comm'n: Implication of the Growth of Hedge Funds* (2003), *available at* http://www.sec.gov/spotlight/hedgefunds.htm (last visited Oct. 1, 2006) [hereinafter *the SEC Proposal*].

90. Christopher Faille, *Comment Period Ends: Leaving Something for Everybody*, *available at* http://www.hedgeworld.com/news/read_news.cgi?section=dail&story=dail11142.html&search_terms=faille (last visited Oct. 1, 2006).

exposure to the industry. Not only because a growing number of pension funds, universities and charitable organizations have already invested heavily in the hedge funds, but also because the general public does not need $10 million in the bank account first to invest in hedge funds thanks to the recent inventions such as "funds of hedge funds."[91] Due to the above concerns, the SEC argued that it needed more information to detect and deter fraudulent behaviors. To achieve that goal, the Commission enacted Rule 203(b)(3)-2, the "look-through" provision, to take away abovementioned Rule 203(b)(3)-1 loophole. As a result, Section 203(b)(3) exemption is unavailable to most hedge funds and accordingly, they must either register or risk violation of federal securities law.

3. *Rule 203(b)(3) -2*

For the new rule to apply, a fund must have at least $25 million in assets under management[92] and the investors have fewer than a two-year lock up period.[93] This paper will discuss only the funds that are eligible to the registration rule; namely, funds with more than $25 million under management with investors being locked up less than two years.

Rule 203(b)(3)-2 essentially involves a two-step process that would subject a fund manager to registration: the fund must come under the SEC definition of "private funds" and if so, the "look through" provision applies. Therefore, if a fund is qualified as a "private fund" and under the new "look through" provision, it has fifteen or more investors, its manager must register under the Investment Advisers Act. The following discusses the two-step process.

First, to be qualified under the mandatory registration proposal under Rule 203(b)(3)-2(d)(1), a fund must be regarded as a "private fund." The release states that a fund will not be regarded as a "private fund" unless it is a fund: (1) that would otherwise be considered an Investment Company under the Investment Advisers Act but for the 3(c)(1) and 3(c)(7) exemptions under Investment Company Act; (2) that permits its investors to redeem their shares within two years of purchase; and (3) that the interests being offered to the investors are being offered based on the advisory skill of the fund

91. *Hedge Fund, Fund of Funds*, *available at* http://en.wikipedia.org/wiki/Hedge_fund#Fund_of_Funds (last visited Feb. 1, 2009) (stating that "a fund of funds (FoFs)" is a special type of investment fund, which "invests only in other investment fund (e.g., hedge funds) rather than trading assets directly …. Because some U.S. funds of funds may be specially registered with the SEC, they can accept investments from individuals who are not accredited investors or 'financially sophisticated individuals' … and often have lower investment minimum (sometimes as low as $25,000)").

92. Stephanie Breslow, *SEC Adopts Rule Requiring Hedge Fund Manager Registration; Compliance Date Set For February 1, 2006,* SCHULTE ROTH & ZABEL LLP PUBLICATION (2003).

93. Paul N. Roth, *Hedge Fund Manager Registration in the Wake of Goldstein v. SEC*, SCHULTE ROTH & ZABEL LLP PUBLICATION (2006).

manager.[94] As noted in the SEC Proposal, the purpose of this definition is designed to capture most hedge funds,[95] but to leave other investment vehicles unregulated, such as private equity or venture capital funds.[96] Hence, most hedge funds fall under the ambit of "private funds" and accordingly, are subject to the new head count rule crafted by the SEC.

The second step is the "look through" requirement under Rule 203(b)(3)-2. Instead of counting each legal organization as one single client as above discussed, the amended rule requires hedge fund managers to count *each* shareholder, limited partner, member, other security holder or beneficiary of as one client towards the fifteen client cap. Putting two changes together, the amendments require the look through provision when the fund at issue is qualified as the statutory 'private fund.' Applying the rules to hedge funds will subject most participants of the industry to the registration requirement because hedge funds generally fall under the definition of "private fund" as defined in Rule 203(b)(3)-2(d)(1) and most funds will exceed the fifteen-client threshold. The compliance date was set on February 1, 2006.

4. *SEC-Registered Investment Advisers Obligations*

The implication of registering with the SEC means that the hedge fund managers are now subject to numerous accounting, disclosure and procedural requirements under the Advisors Act of 1940. The most burdensome requirement among all is the compliance program for SEC-Registered Investment Advisers. Each of these requirements is discussed below.

The first effect of registration is that the advisors will not be able to charge their clients a performance fee unless certain requirements are met.[97] That is, registered advisors are only allowed to charge performance fees to "qualified clients" (those who have a net worth of $1.5 million dollars or place $750,000 dollars under the advisors' control) .[98]

Furthermore, to comply with the Advisors Act, the registrants must submit Form ADV.[99] Part one of Form ADV asks for basic information such

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94. *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Release No. IA-2333, Fed. Sec. L. Rep. (CCH) (Sep. 2005), *available at* http://sec.gov/rules/final/ia-2333.htm#IID (last visited Oct. 1, 2006) [hereinafter "*Final Rule*"].

95. The SEC specifically explained the three factors of "private funds" are derived "by reference to three characteristics shared by virtually all hedge funds, and that differentiate hedge funds from other pooled investment vehicles such as private equity funds or venture capital funds." *Id.*

96. Private equity and venture capital funds generally do not fall in the definition of "private funds" in that these investment vehicles require a longer than two year capital commitment.

97. 17 C.F.R. § 275.205-3 (2004).

98. 17 C.F.R. § 275.205-3 (2004).

99. 17 C.F.R. § 275.203-1 (2005).

as "where the adviser does business, why the adviser is registering, and a history of the business and biographies of the principals."[100] Part two of the Form ADV requires disclosures from hedge funds, specifically in "adviser's management and ownership structure, as well as on its fee arrangements."[101] Fund managers are required to file ADV amendments within ninety days of the end of the fiscal year[102] and the disclosure statement contained in Form ADV must be made available to the clients as well.[103]

In addition to filing Form ADV and maintaining books and records under Rule 204-2, investment advisers are now required to maintain copies of "all policies and procedures in effect during the previous five years"[104] — all of which are subject to annual review. The SEC has 500 people designated for investment advisers inspections[105] and the newly registered investment advisers may be inspected on a routine basis or if their Form ADV stands out as a red flag.[106] Once chosen, the inspection occurs on-site with the SEC staff showing up unannounced. Any document or person requested by the SEC needs to be made immediately available for inspection or interview.

Last but not least is the compliance program requirement under Rule 206(4)-17.[107] It requires every SEC-registered investment adviser to:

(1) adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities law;
(2) review those policies and procedures annually; and
(3) designate a chief compliance officer to administer the policies and procedures.

The burden of this compliance program lies not just on its added expense to the fund itself, but also on the following aspects. First, failure to adopt and implement adequate procedures is "by itself unlawful, independent of nay other securities law violation."[108] Second, to what extent this duty entails is currently unresolved. At the very least, an investment adviser must "identify conflicts … that [may] create risk exposure for its clients."[109] To name just a few, the policies and procedures should address

100. Carol E. Curtis, *Registration Day*, SEC. INDUSTRIES NEWS, Nov. 8, 2004, at 15.
101. *Id.*
102. 17 C.F.R. § 275.204-1 (2005).
103. Curtis, *supra* note 100.
104. HAMMER, *supra* note 45, at 29.
105. Paul N. Roth, *Remarks at the Practicing Law Institute Program, Preparing for the New Regulatory Regime of Hedge Funds*, SCHULTE ROTH & ZABEL LLP PUBLICATION (2005).
106. *Id.*
107. C.F.R. § 275.206(4)-7.
108. C.F.R. § 275.206(4)-7.
109. HAMMER, *supra* note 45, at 28.

portfolio management processes, trading practices, business continuity plans and valuation procedures and safeguard issues — a non-exhaustive announced under Advisers Act Release No. 2204.[110]

The intrusiveness of the above requirements is one reason why most fund managers try to avoid the registration process. It is not so much because of the added burdens on personnel and expenses,[111] but on the unfamiliarity with the rules and the undefined extent of duty implicated under each provision, and quite possibly, a federal violation triggered by a mere innocent mistake.

III. WHY REGISTRATION IS A STEP IN THE WRONG DIRECTION

The proposed new rule, which required essentially all hedge funds with over $25 million under management to register, was scheduled to become effective in February 2006. However, on June 23, 2006, it was struck down by the D.C. Circuit[112] for lack of clarity. Although some would appraise the Commission's effort to regulate the industry as a laudable goal, many disagreed. As one hedge fund manager[113] put it, "I think this review of hedge funds is a distraction. They just want to look busy in the wake of the Enron Corp. collapse."[114] Whether it is a pretentious attempt to look busy or not, this paper will argue that the registration requirement is a step in the wrong direction.

Section A points out the fallacy in the SEC's reasoning to justify regulation; Section B points to the presence of other federal rules to regulate the fund industry; Section C argues that even assuming the Commission's worries regarding the hedge fund industry were well-founded, under the balancing analysis, the negative effect of the market is outweighed by any perceivable benefit of the registration.

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110. 68 Fed. Reg. 74, 214 (Dec. 13, 2003).

111. The initial filing fee and annual registration fee for small hedge funds are estimated to be $800 and $400 respectively. The required compliance structure for new advisers would approximate $20,000 in professional fees and $25,000 in internal costs. At least $75,000 staff time will be incurred in connection with the preparation of From ADV and the overall compliance costs will be "15-20% of revenues of advisers to small hedge fund (Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to Proposing Release No. IA-2266; *Proposed Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 45 (July 28, 2004) [hereinafter *Dissent to Release No. IA-2266*] (citing *Comment Letter of the Managed Funds Association*, Sep. 15, 2004).

112. *Goldstein v. SEC*, *supra* note 35.

113. David Webb is a hedge fund manager, who manages a $1.3 billion hedge fund at Shaker Investments.

114. Svea Herbst-Bayliss, *U.S. hedge fund regulations might help industry in long run*, REUTER NEWS, May 24, 2002.

A. *SEC's Proposed Reasons Do Not Warrant Registration*

Although some observations advanced by the Commission may call for more *regulation oversight* (*see* Section III of this paper), the primary arguments put forth by the Commission do not warrant mandatory *registration*.

First, the growth of hedge fund investments alone, without more, is insufficient to justify mandatory registration. The tremendous growth in the hedge fund industry is partly fueled by recent increase in gross domestic product (GDP) and the accompanied weakened equity markets. The bull markets in the 1990s created wealth for many individuals and "propelled many new investors into the ranks of accredited investors and qualified purchases."[115] In year 2001, for example, there was an increase of 40,000 high net worth individuals with more than $1 million in asset worth.[116] These investors looked elsewhere to invest when the stock market weakened in the late 1990s; the hedge funds' double-digit growth naturally looked attractive. However, the simple fact that "a sector of the investment industry has experienced remarkable growth is not dispositive of an increased risk for investors."[117]

Second, the alleged correlation of hedge fund growth and the increase in financial scandals and fraud has not been convincingly proven. The SEC claimed that along with the increase in hedge fund assets, there also came the "unfortunate growth in hedge fund-related fraud."[118] Yet there were simply no statistics demonstrating how much of an increase in fraud had actually occurred. In addition, as the dissents pointed out,[119] the majority of the fraud cases concentrated in smaller size hedge funds which did not reach the $25 million registration threshold anyway.[120] Moreover, the screening process advocated by the Commission's majority would not be effective due to the agency's already thinly spread manpower.[121] Therefore, since "it is a task the Commission is not equipped to perform" nor was there solid showing of an increase in fraud cases due to hedge fund growth, it is difficult

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115. Erik J. Greupner, *Hedge Funds Are Headed Down-Market: A Call for Increased Regulation*, 40 SAN DIEGO L. REV. 1555, 1561 (2003).

116. *Id.* (citing Merill Lynch, Cap Gemini Ernst & Young, *World Wealth Report 2002*, at 7).

117. Justin Asbury Dillmore, *Leap Before You Look: The SEC's Approach to Hedge Fund Regulation*, 32 OHIO N.U. L. REV. 169, 181 (2006).

118. Greupner, *supra* note 115 (citing Paul F. Roye, *Speech by SEC Staff: Mutual Fund Management: Taking Responsibility, Maintaining Trust and Influencing Positive Change*, Mar. 25, 2002).

119. Dissent to Release No. IA-2266, *supra* note 111, 69 Fed. Reg. 45, 197, 45, 198 (July 28, 2004).

120. *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 72054, 72092 (Dec. 10, 2004).

121. *Id.* at 72093.

to justify the imposition of the most burdensome requirement.

Third, the SEC sought support for the hedge fund regulation based on the increased exposure of the public investors through pension funds and other legal entities. Granted that the number of pension plans investing in hedge funds has increased from an estimated $13 billion to $73 billion since 1997;[122] however, if one also considers the growth in the pension fund asset in the same period,[123] the overall investment to hedge funds is then relatively insignificant, roughly 1% and 1.5%.[124] In addition, far from what the SEC suggested — that the average American workers were simply led blindly to the hedge fund pits — pension plans are monitored by experienced advisers and most of them already register with the SEC.[125] This suggests that pension fund beneficiaries are protected at least in that any unscrupulous investment practices are already subject to the SEC's regulations because the fund managers are registered advisers and therefore, they owe fiduciary duties to the beneficiaries.[126] Indeed, considering the structure of the pension plan and its advisers, the need for heavy-handed registration requirement is significantly diminished.

Granted that the SEC Proposal did advance many valid concerns about the industry, such as the issue of valuation, manipulation and possible financial meltdown triggered by a mega fund blowup, these concerns do not dictate registration as the *only* viable solution. Section III of this paper will demonstrate that other alternatives are more efficient in addressing these concerns and accordingly, forced registration is unnecessary.

B. *Other Federal Schemes Regulating the Hedge Funds*

This section seeks to demonstrate two things. First, the registration requirement, by itself, has a very limited role of fraud detection/prevention and regulatory oversight. Second, even assuming any of the registration's tangential effect is warranted, there are other lesser intrusive federal schemes that are presently in action to aid the SEC enforcement action. From analyzing other federal regulatory schemes and disclosure requirements, this section demonstrates that the majority of hedge funds, although exempt under the primary federal securities acts,[127] are nonetheless subject to

122. *U.S. Securities and Exchange Commission, Statement by SEC Commissioner at Open Meeting considering Proposed Registration under the Advisers Act of Certain Hedge Fund Advisers*, Commissioner Cynthia A. Glassman (July 14, 2004), *available at* http://www.sec.gov/news/speech/spch071404cag.htm (last visited Feb. 1, 2009) [hereinafter *Statement at Opening Meeting*].

123. *Id.* (citing the total of private and public pension fund assets is over $6 trillion).

124. *Id.*

125. Dillmore, *supra* note 117, at 177.

126. Herbst-Bayliss, *supra* note 114 (stating "pension plans and plan advisers have their own fiduciary obligations to plan participants").

127. Refer to the Acts this paper discusses on Section I. Namely, the Securities Act of 1933, the

extensive disclosure rules. In other words, the registration requirement does not give investors more cause of actions than they already have, nor provide the SEC more information than it could have obtained from other sources.

1. *Registration Does Not Aid Fraud Detection Nor Information Gathering*

The forced disclosure requirement has little or no impact in aiding the SEC enforcement action. As the SEC Proposal itself admits, stalling fraud in advance is not the intended goal[128] of the proposed new rule. Moreover, ironically, a brief characterization of the cases cited by the SEC in its "more fraud so registration is necessary" argument actually supports the notion that forced disclosure plays little role in fraud detection. There were forty-six cases brought against hedge funds between 1998 and 2003; among them, 38 stayed unpreventable "even if the fund is registered:"[129]

(1) 13 out of the 46 cases involved fund managers already registered with the SEC; hence, registration would not help.
(2) 20 out of the 46 cases involved funds too small to be covered by the proposed disclosure (i.e. they manage assets under $25 million).
(3) 2 cases involved registered BD or IA, i.e. situations where full regulatory oversight was already in place; and
(4) 3 cases were instances where funds were set up to swindle investors.[130] Hence, registered or not would not have deterred the fraud itself.

As shown above, registered or not is of little relevance in the majority of hedge fund cases. This explains why most industry participants believe that "routine examinations are notoriously ineffective at ferreting out fraud in these cases. Fraudsters lie, cheat and steal — they do not notify the Commission of their fraudulent intentions."[131] Indeed, as the dissents pointed out, the mandatory disclosure "is unlikely to provide the information that the Commission needs."[132] Accordingly, the argument "registration

Investment Company Act of 1940 and the Investor Advisers Act of 1940.

128. The SEC Proposal, *supra* note 89.

129. Dillmore, *supra* note 117 (stating that the majority of fraud cases are difficult to detect even with the registration statements are in place; citing *U.S. Securities and Exchange Commission, Statement by SEC Commissioner at Open Meeting Considering Proposed Registration under the Advisers Act of Certain Hedge Fund Advisers*, Commissioner Paul S. Atkins (July 14, 2002), *available at* http://www.sec.gov/news/speech/spch07/1404psa.htm (last visited Feb. 1, 2009)).

130. *Id.*

131. *Id.*

132. 69 Fed. Reg. 72054.

would provide the Congress, the Commission and other government agencies with important information" failed because strong suspicion remains as to *how* this proposal would aid the Commission in its regulatory power.

2. *Other Regulatory Schemes Governing Hedge Funds*

In fact, the SEC can supervise and obtain necessary information about the industry's activity through means *other than* registration. Unlike the picture that the SEC painted in the SEC Proposal which suggested the public and other government agencies are left wondering about hedge funds, the industry has already been subject to numerous federal rules. The following section discusses relevant federal schemes besides the federal securities acts that currently regulate the registered *and* unregistered hedge funds.

(a) Information/Disclosure Obligation

The hedge fund industry typically has an affirmative disclosure duty. The U.S. Commodity Futures Trading Commission (CFTC), for example, requires daily reporting of all futures positions above certain designated level. Hence, funds active in trading futures are subject to CFTC reporting duty.[133] In addition, although hedge funds are exempt under federal securities statutes, the exemption *itself* "requires disclosure of or access to the information that would be required to be disclosed in a registration statement under the Securities Act."[134] For example, an issuer exempt under Section 4(2) private offering of the Securities Act is still required to give *offerees* "the same kind of information that the [Securities] Act would make available in the form of a registration statement."[135] As a result, *un*-registered hedge funds are under the duty to provide investors with "all material information about their securities and activities through an offering memorandum and regularly audited financial statements."[136]

Notice, however, the above requirement is to provide information to the *offerees* instead of the SEC. Yet it is not fatal. The Commission can simply enlist itself as one of the recipients; or, to take one step further, it can require the industry to supply additional pages addressing specific concerns that would aid the SEC in its enforcement and fraud-prevention goal. This specifically tailored Q&A questionnaire will be more efficient in notifying

133. Eichengreen & Mathieson, *supra* note 32.
134. HAMMER, *supra* note 45, at 143.
135. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125-126, 73 S. Ct. 981 (1953).
136. HAMMER, *supra* note 45, at 161 (2006) (citing *Doran v. Petroleum Mgmt. Corp.*, et al., 545 F.2d 893, 902 (5th Cir. 1977)).

the Commission as to who the participants are and their activities. It will also be more popular in the industry.

(b) Anti-Fraud Provisions

One may argue that the above suggestion will not be effective because a fund manager can simply lie or omit material information either on the document submitted to the SEC or prospective investors. This argument, however, will fall. An unregistered status does not mean a fund adviser is free to lie on the above disclosure form. Federal and state anti-fraud laws apply to all hedge fund managers — whether or not registered with the SEC or in any state.[137] In other words, an *unregistered* hedge fund manager is still subject to federal anti-fraud provisions such as the Exchange Act Section 10(b) and Rule 10b-5. These provisions are helpful in two ways. First, they provide cause of action to ensure that the statements submitted to the Commission to be truthful. Second, more importantly, the broad statutory language affords the Commission an extensive reach of its jurisdiction. The next discussion utilizes the first "failure to supervise" SEC enforcement case against an *unregistered* investment adviser to illustrate the Commission's extensive reach under Section 206, the fraud provision under the Advisers Act.

Section 206 states that it is unlawful for "any investment adviser, directly or indirectly, to employ any device, scheme, or artifice to defraud any client or any prospective client; or to engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client."[138] In 1960, Congress allowed Section 206 liability to be imposed on unregistered advisers.[139] Later, the SEC successfully brought the first "failure to supervise" action against an unregistered investment fund adviser.[140] The case held that the SEC could convict hedge fund managers based on false communication, and also on the theory that fund's senior managing director failed to adequately supervise the fund's manager. The case should serve as a warning to the industry regarding the "broad application of Section 206 by the SEC staff and … its new focus regarding supervisory personnel."[141]

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137. Advisers Act Release No. 2203, 2003 (Dec. 15, 2003).
138. Advisers Act §§ 206(1) and (2).
139. Investment Advisers Act of 1940, Pub. L. No. 86-750, Section 8, 74 Stat. 885 (amended 1960).
140. Jeffrey C. Blockinger & Rebecca M. Palmer, *Hedge Fund Managers In the Era of Heightened Regulatory Scrutiny*, 37(15) THE SECURITIES & COMMODITIES REGULATION, Sep. 15, 2004 (citing *In the Matter of Robert T. Littell and Wilfred Mechel*, INV. ADV. ACT REL. NO. 2203 (2003)).
141. *Id.*

(c) CFTC and NASD

Registered or not, most hedge funds are still subject to numerous other registration and reporting duties *in addition to* the SEC ones. For example, Commodity Future Trading Commission ("CFTC") has been directly involved in regulating hedge funds since 1947 when a fund was qualified as commodity pool operators ("CPOs"). Similarly, the industry also falls under the regulatory regime of NASD — "the world's largest private-sector regulator of financial services."[142] The following discussion seeks to demonstrate that a hedge fund, even though exempt under federal statutes, is nonetheless under extensive federal watch.

(i) CFTC

In light of recent development and lack of general understanding in the area of pooled investment vehicles, the concept of CPO was first introduced into federal regulation in 1974 together with CFTC under the Commodity Futures Trading Commission Act.[143] Once a person falls under the definition of CPO,[144] he is required to register as CPO with the CFTC and National Futures Association ("NFA").[145] LTCM, for example, was regulated by the CFTC as a CPO since 1994 albeit its exempt status under Investment Company Act. Thus, LTCM was subject to "a system of registration and disclosure requirements for sophisticated investor pools that is more evolved than the one administered by the SEC."[146] Besides regulating federal-securities-act exempt hedge funds and subjecting them to registration requirements just as extensive as those under SEC jurisdiction, CFTC's regulation for hedge funds has the following noticeable advantages.

First, unlike the Investment Company Act, CFTC Rule 1.3(z) specifically identifies the distinct economic activities that the fund industry typically engages in. Both the Investment Company Act and CPOs purport to regulate pooled investments. However, the former defines the underlying market as "activity of investing in securities markets,"[147] which relates more closely to companies "channel capital to firms and government organs."[148] CPO, on the other hand, defines the underlying market by the "activity of investing in future markets"[149] — a market dominated by "price discovery and hedging." As a result, hedge funds fall squarely under CPO's definition.

142. *Finra – Regulation*, *available at* http://www.nasd.com/RulesRegulation/index.htm (last visited Feb. 1, 2009).

143. Daniel F. Zimmerman, *CFTC Reauthorization in the wake of Long-Term Capital Management*, 2000 COLUM. BUS. L. REV. 121 (2000).

144. Commodity Exchange Act § 1(a)(4), 7 U.S.C. § 1(a)(4).

145. 7 U.S.C. §§ 6m, 6n.

146. Zimmerman, *supra* note 143.

147. *Id.*

148. *Id.*, citing Investment Company Act § 3(a)(1)(C), 15 U.S.C. § 80a-3(a)(1)(C).

149. *Id.*

Moreover, the regulation under the Commodity Exchange Act ("CEA") is more flexible. Unlike the federal securities acts, CEA does not mandate CPOs to be in a corporate form. Hence, hedge funds' partnership form and its associated advantages, as discussed in Section I-A of this paper, can be preserved.[150]

The most significant advantage under CFTO regulation is its filing and disclosure requirements — whether or not a fund manager is exempt as a CPO. Under federal securities law, once an investment adviser is exempt from registration, although he is still under all securities anti-fraud provision, he is *completely* excluded from SEC Disclosure obligations (as mentioned in Section II of this paper, the exempt hedge funds only have duty to supply information to *offerees* of the fund, instead of the SEC).[151] By contrast, a fund exempt under CFTC and NFA is *still* required to file "a notice of a claim for exemption … with CFTC and the NFA."[152] Additionally, the exempt funds are required to distribute summary quarterly reports and annual reports to its investors. Granted that this information, like that required under federal securities act, is distributed to the investors instead of the CFTC (or the SEC) and it is made publicly available under the Freedom of Information Act. Moreover, as discussed above, the anti-fraud provision will operate as an effective safeguard to ensure the truthfulness of the submitted statement. Therefore, these disclosures effectively notify the public the "operation of the CPO, its exempt status and … general financial health on an annual basis."[153] In summary, unless the above suggested questionnaire form is adopted, an exempt hedge fund under the federal securities acts is generally "invisible to the public and to bank examiners."[154] LTCM, for example, was a registered CPO but exempt under CFTC. But its information was still publicly available due to the above discussed filing duty.[155]

(ii) NASD

NASD is yet another regulator that is involved in hedge fund regulation. Mary L. Schapiro, the NASD's Vice Chairman and President of Regulatory Oversight summed up its broad regulatory power as: "communications by members with the investing public must provide a sound basis for evaluating an investment and must adequately disclose the risks. This is no less true for

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150. *Id.* at 135-36.
151. *Id.* at 139.
152. *Id.* citing 17 C.F.R. § 4.7(a)(3).
153. *Id.* at 138.
154. *Id.*
155. *Id.* at 139. ("[P]ublic available records indicated that LTCM was in fact a registered CPO, and it claimed a Rule 4.7 exemption for each of the nine pools it reported to the NFA, as well as the one off-shore pool operated as Long-Term Capital Portfolio Group, LP, in the Cayman Island.")

hedge funds than for any other investment products."[156]

Similar to the anti-fraud provision under Section 206 of the Advisers Act, NASD had a similar mechanism to ensure that information conveyed to investors is not only truthful, but also that fund managers have due diligence to vouch the adequacy for such communication. In other words, *any* hedge fund related activities can be swept under NASD's regulatory regime.[157] A case on point is Altegris Investments' violation.[158] The fund managers were found guilty under the "failure to supervise" duty and more importantly, on the premise that the fund's failure in addressing *each* risk in *each* piece of offering documents used by a member to sell hedge fund interests.[159] In other words, whether a fund is registered or exempt, it is still subject to the same extent of duty and potential liability.

In conclusion, registered or not, a fund is still reachable under federal anti-fraud provisions, CFTC and NASD. As a result, the only rationale to compel registration is that its benefit to the public clearly outweighs its burden to the industry and market, and the proposed rule is applicable under the current SEC manpower. The next section will argue that under a balancing test, forced registration must fail not only because the SEC does not have enough recourses to enforce the rule, but also because it brings more harm to the market than any imaginable benefit to the investing public.

C. *Policy Reason Against Registration Requirement: SEC Resources and Negative Effect on Market*

This section seeks to argue from a policy perspective why the registration requirement brings more harm than its purported benefits. First, the SEC resources are currently inadequate to support any valid enforcement of the rule. Second, forced registration harms the market more than benefits the selected few.

In hedge funds' zealous quest for high returns, it is doubtful that the SEC staff would have enough expertise to understand the rationale behind each strategy. For example, because the goal of hedge funds is to make money under all financial circumstances, they often employ the most complex strategies to adapt to the ever-changing markets and to state their investment objectives in the broadest possible terms in order to maintain maximum flexibility.[160] To make sense of the information provided by the

156. NASD Notice to Members, *Disciplinary and Other NASD Actions*, at 337, June 2003, *available at* http://www.nasdr.com/news/pr2003/release 03 015.html (last visited Feb. 1, 2009).
157. Blockinger & Palmer, *supra* note 140.
158. *Id.*
159. *Id.* at 162.
160. Dissent to Release No. IA-2266, *supra* note 111.

registration statements, the Commission would have to incur substantial training costs "in order to understand and oversee the newly registered hedge fund advisers."[161] Therefore, applying the limited SEC manpower to supervise the highly volatile hedge funds worlds is pointless at best, harmful at worst.

It is pointless because as Chairman Greenspan observed, "by the time of [the SEC] detection, hedge funds would have long since moved on to different strategies."[162] It is harmful because two potential outcomes are likely. First, as the SEC enforcement threat looms largely in the background, hedge fund managers might be discouraged from engaging in complex trading strategies that cannot be easily explained to the Commission examiners.[163] This deprives the investors of the potential to maximize their returns and the market of its innovative brainpower. Second, although disclosure and transparency are generally encouraged, they shall not be applied universally to every nook and cranny of the financial markets. For example, when money is captured based on which participant has the better strategies, the requirement of disclosure should be cautiously structured and guarded. Hedge funds have been notoriously secretive precisely because the managers are no different from players sitting at the poker table. Moving in and out of various markets before others do is often the (only) key to success. As a result, forced disclosure posts a difficult dilemma for fund managers because non-compliance invites more SEC probing, while compliance means an open invitation for their competitors to trade secrets.

In addition, the overall market would not benefit if the industry were made to register with the SEC. Hedge funds are valuable to the financial systems in several ways. First, they are the key source of supplying liquidities. Accordingly, markets are made more efficient based on such timely capital injection.[164] Second, hedge funds create value not only because they have consistently spawned the greatest managers in recent history,[165] but also because their profit-driven mind tends to "unlock corporate value by pressuring managements to make necessary changes."[166] More importantly, hedge funds function as a neutralizing factor in the midst of financial crisis.[167] The IMF summarized the significance of hedge funds'

161. *Id.*

162. *Id.*

163. Lawrence Aragon, *Gives up PE Performance Data*, VENTURE CAP. J., Nov. 2003, at 14.

164. Martin J. Gross, *Hedge Funds Today: Seven Myths*, WALL ST. J., July 7, 2005.

165. *Id.*

166. *Id.*

167. *United States Congress House Committee on Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: U.S. House of Representatives, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Committee on Financial Services*, MAY 22, 2003, p. 3. (Statement of Hon. Paul E. Kanjorski, House Representative).

power in establishing the global stability in the following three accounts:

(1) It is an active and leveraged counter-party to systemically important and regulated financial institutions;
(2) Broadly speaking, hedge funds can employ leverage much more extensively and diversely than other investment vehicles; and
(3) Industry assets are growing rapidly, and it is an increasingly important investor base in the international capital market.[168]

To sum up, considering the tangible benefits of registration on one hand,[169] and the burden, cost, and the potentially unlimited liability due to unfamiliarity with the rules on the other hand, the SEC's proposal is certainly unwarranted. First and foremost, the SEC could easily obtain necessary information from other means. Moreover, anti-fraud provisions under federal securities law not only safeguard the truthfulness of such communication, but also provide the Commission with supervisory function over *unregistered* hedge funds, as above discussions and cases amply demonstrated.

Secondly, as shown in the mutual funds industry, the SEC's long extensive disclosure requirement did not prevent frauds; it is difficult to see how increasing hedge fund disclosures would reduce incidences of fraud or collapses such as the Amaranth.[170]

Additionally, the SEC, a historically small and under-funded agency,[171] is already dealing full course with the recent mutual fund scandals. In fact, the SEC could only afford to investigate a registered investment adviser once every five years[172] — that is, if it chooses to investigate at all. The massive Madoff blowup was a prime example to counter the argument *for* registration. Madoff Investment Securities, LLC, before its implosion in late 2008, was effectively the world's largest hedge fund company "with estimated assets under management of at least $20 billion to perhaps $50 billion."[173] It was also a SEC registered firm since September 2006. However, despite its state as a registered investment adviser, the SEC was not the one to spot a multibillion dollar Ponzi scheme in the midst of its operation. In fact, the SEC should not be shocked by Madoff's collapse. The

168. Shore, *supra* note 62.
169. O'Halloran, *supra* note 34, at 486.
170. Dissent to Release No. IA-2266, *supra* note 111 (stating that "it is a logical conclusion that advisers registration would not add to the Commission's ability to combat … fraud").
171. O'Halloran, *supra* note 34.
172. Allison B. Colter, *Hedge Funds Are Back in Spotlight,* WALL ST. J., Feb. 17, 2004, at D11.
173. *The World's Largest Hedge Fund is a Fraud*, November 7, 2005 Submission to the SEC, *available at* http://online.wsj.com/documents/Madoff_SECdocs_20081217.pdf (last visited Feb. 1, 2009) (identifying twenty-nine red flags concerning Madoff Investment Securities, LLC) [hereinafter *the Madoff Submission*].

financial analysts have long suspected Mr. Madoff's business and the first letter to the SEC accusing Madoff's operation as a Ponzi Scheme could be traced back to 1999. More warnings found their way to the Commission but not even a routine examination was conducted until 2007. The examination was quickly closed and no enforcement action was ever taken. Still, warnings about Madoff's business kept flooding in the Commission and plenty of red flags were there. Yet there was simply not enough smoke to inspire the SEC to look for a fire.[174] What eventually caused the Madoff empire to collapse was not an SEC investigation nor any sort of examination due to Madoff's status as a problematic registered company, but his own confession to his employees.[175]

Madoff's operation was a registered company, and despite ongoing warnings from various financial analysts and reporters for nearly ten years, the Commission missed the largest securities fraud in history. It is then hard to understand what the Commission could have stopped or stalled in advance if all the hedge funds were registered. Alan Greenspan, the formal Federal Reserve Chairman, also voiced his confusion regarding registration: "I grant you that registering advisers in and of itself is not a problem. The question is, what purpose does it serve unless it's going to go further?"[176]

IV. Why Regulation Is Necessary

The SEC Proposal which sought to compel hedge fund registration was struck down on June 23, 2006 by the D.C. Circuit. The court noted that the SEC's interpretation of the term "client" falls outside the bounds of reasonableness. On August 7, 2006, Chairman Cox issued a public statement that the SEC would not appeal the decision. On July 31, 2006, the ABA Subcommittee on Private Investment Entities submitted a letter arguing that some segments of the industry should stay registered.[177] The next possible step is that many regulators including the Treasury/President's Working Group on Financial Markets will get involved.[178] Together, they hold the future of the industry.

This section of the paper will argue that the question in the wake of D.C. Circuit decision was not 'whether or not the industry should be compelled to file registration. Before there is any final adjudication on the industry, this paper strives to demonstrate that the decision should not be this clear-cut.

174. Peter Eavis, *Letting Madoff Slip Through the Net*, WALL ST. J., Dec. 13, 2008.
175. John Carney, *Why Did Madoff Confess?*, *available at* http://clusterstock.alleyinsider.com/2008/12/why-did-madoff-confess (last visited Feb. 1, 2009).
176. Curtis, *supra* note 100.
177. Roth, *supra* note 105.
178. *Id.*

Instead, the regulators ought to pursue the middle ground through *regulatory oversight*, either through the SEC or others, so that the concerns from the rest of the SEC Proposal would be appeased.

Section A discusses the reasons why *regulation* is still necessary and section B proposes alternatives as to how to regulate the industry in the least intrusive way so that its benefit and vitality will still be preserved. The position of this paper should not be taken as a formal proposition to each problem raised; instead, it merely seeks to *confirm* the SEC concerns yet argue alternatives *other than* registration.

A. *Why Hedge Funds Need to Be Regulated*

To regulate or not, that is the first question we should answer. There are two problems about the hedge fund industry that have nothing to do with the dizzying amount of the dollar involved, but have everything to do with the risks that the markets as a whole cannot afford to take. It is based on this risk-analysis that this note argues that although *registration* is uncalled for, *regulation* is necessary.

1. *Risk to Investors — Asset Valuation Problems*

Evaluating the "assets under management"[179] is typically the first step to determine whether or not an investment adviser must register with the SEC. The term is defined to include the "entire value of the accounts, and not only the value of the securities portion."[180] This is an area of concern because of three reasons. First, as hedge funds become more complicated, their securities have become notoriously hard to value even for market professionals.[181] Second, a fund manager typically uses the market-to-market approach to evaluate the fund's asset and as a result, his compensation fluctuates accordingly with the asset value. The reason is that because a manager's compensation comes overwhelmingly from the fund's assets (the "one and twenty" mechanism discussed in Section I of this paper), and the manager's calculation is not subject to any independent check, he can thus inflate his own salary or at least have a take-home salary

179. Advisers Act § 203A(a)(2), 15 U.S.C. § 80b-3A(a)(2).

180. Form ADV, Instructions for Part 1A, Item 5.F, 17 C.F.R. § 279.1.

181. Jane J. Kim, *Digging for Hedge-Fund Dirt*, WALL ST. J., Aug. 8, 2005, at C1; *see* Williamson, *supra* note 43 (quoting Leslie Rahl, president and chief executive officer of Capital Market Risk Advisors LLC, a hedge fund risk analysis firm and consultant, as saying "there are a lot of nuisances [about hedge fund asset valuation] that people are not fully comprehending. Questions have to be very carefully tailored for each kind of strategy. Valuation is an issue any time you have an instrument that's not traded in a transparent, liquid market. Intelligent, well-meaning people will often price the same securities very differently").

that is valued more than the real market value of the fund's worth. Third, as the SEC Report pointed out, the process lacks "independent checks on a hedge fund advisor's valuation of a … fund's portfolio securities."[182] In other words, the assets reported to investors as well as methods used to arrive at these numbers are problematic because fund managers are free to represent the value of the fund in *any* way they choose.[183] This is discussed in greater depth in the following paragraph.

It is true that large funds typically employ outside auditors for securities valuation; however, the results are subject to the fund managers' control. Fund managers, in other words, have the discretion to either override the external valuation results or to disregard them entirely. For example, when Madoff's company was asked by investors for an audit conducted by independent accountants, Mr. Madoff refused and stated that only his brother-in-law's accounting firm was allowed to audit his firm's performance.[184] The situation is worse in small funds because they simply do not have the means to even employ outside auditors. The risks for consumers in this free-pricing phenomenon are threefold. First, because of the SEC's lack of power to inspect hedge funds' accounting records, consumers are thus subject to the risk of mispricing.[185] Second, investors are likely to receive a lesser amount than they are entitled to when they withdraw early due to this arbitrary portfolio valuation method.[186] Third, the uncertainty surrounding the funds' portfolio also presents difficulties "when attempting to compare the returns of different funds."[187] The bottom line is, the investors and the public need an independent and reliable means to understand how the returns have been achieved and a way to assess the process. It is thus critical for the government to intervene in order to safeguard investors' interests.

2. *Risk to Financial Markets — Leverage Problems*

When asked what he did for a living, David Modest, a manager in LTCM answered: "I tried to blow up the world financial system."[188] Ironically, there is certain truth in this joke. The SEC Proposal correctly observed that a hedge fund blow up may trigger a financial system meltdown

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182. *See* the SEC Proposal, *supra* note 89, at 79.
183. Hellrung, *supra* note 60.
184. The Madoff Submission, *supra* note 173.
185. *See* the SEC Proposal, *supra* note 89, at 80.
186. Preiserowicz, *supra* note 72, at 818.
187. Hellrung, *supra* note 60, at 318 (citing Paul N. Roth, Schulte Roth & Zabel LLP, *Remarks at the Practicing Law Institute Program, Preparing for the New Regulatory Regime of Hedge Funds* (2005)).
188. Mitchell Pacelle et al., *Investors May See 'LTCM, the Sequel'*, WALL ST. J., May 20, 1999.

on a national or even international level. The operation of hedge funds poses systematic threats to the financial markets at least in the following three respects.

(a) First, uncertainty. The risk the hedge funds bring to the financial market has not been agreed upon. Some argue that hedge funds are merely an ostensible culprit. Using the comparison of Amaranth and LTCM collapse as an example, the argument defending the industry works as follows. First, the financial system has grown more robust since 1998. This point is amply demonstrated in that (1) Amaranth managed $9 billion assets, many times more than LTCM ever managed;[189] (2) leverage is currently a lesser problem compared to 1998 (3 to 8 times in Amaranth vs. 40 to 100 times in LTCM); and (3) most importantly, the market itself has grown tremendously resilient to financial wrecks today than ten years ago. The wreck in LTCM relied primarily on the federal bailout so that the disruption to the global markets was limited.[190] Amaranth, on the other hand, relied *exclusively* on the Wall Street giants. Within forty eight hours of the fund's collapse, J. P. Morgan and Citadel came in and smoothly assumed Amaranth's energy portfolio.[191] As a result of the speedy response, the aftermath threat of Amaranth was contained. Moreover, the opponents of hedge funds regulations point to the fact that the blowup and collapse are merely a healthy cycle of the overall macro economics. Hedge funds are "one of the most dynamic forces in finance … and some are bound to go bust. That's healthy."[192] The blowup may be financially painful for its high-income investors, but it also serves as a wake up call for the industry as a whole to reconsider its next step.

However, according to the most recent survey of private economists, 60% agreed that "hedge funds post a risk to the financial system and tighter regulations are needed."[193] Whether or not one is of the view that hedge funds are threats to the markets, it is precisely this splitting of opinions that should prompt the SEC for regulation. Not only because it is simply too risky to expect the Wall-Street giants' rescue whenever a fund collapses (especially when the hedge fund collapse rate is hovering at 9%, four times the rate for mutual funds),[194] but also because it is irresponsible to wait and see if the markets are indeed self-disciplined and capable to handle future blowups. As Diane Swonk at Mesirow Financial pointed out, "we just don't

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189. Alex Dumortier, *Lessons From Amaranth*, Sep. 27, 2006, *available at* http://www.fool.com/mutual funds/mutualfunds.htm (last visited Feb. 1, 2009).

190. *Id.*

191. Gregory Zuckerman, *How the Wreck From Amaranth Was Contained*, WALL ST. J., Oct. 5, 2003, at C3.

192. Special Report, *The Wilder Side of Finance: Regulating Hedge Funds*, THE ECONOMIST, July 1, 2006.

193. Zuckerman, *supra* note 191.

194. Finneran, *supra* note 6.

know if [the hedge funds] are dangerous," and when it comes to financial markets the "unknowns is acceptable."[195]

(b) The second concern stems from hedge funds' aggressive borrowing (so called "leverage") and the risks that lending institutions and the world's economy are exposed to during crisis. "Leveraged" is defined as "the degree to which an investor or business is utilizing borrowed money."[196] Hedge funds are typically aggressive leverage users because it *can* bring in tremendous profits; but in the meantime, it may result in disastrous downfalls. It is profitable when the fund "makes more money than its borrowing cost."[197] On the other hand, it is dangerous because it exposes the borrowers to the risk of bankruptcy if they fail to meet the debt payments. It is this later aspect that spurred concerns in the financial industry. The worries are twofold. First, when a hedge fund makes a bad bet and subsequently is unable to meet its payment obligation, it goes bankrupt. As a result, its investors lose money and its lenders suffer from a significant sum of capital loss.[198] Second, the rippling effects of such a loss will then snowball to other financial segments' and threaten the U.S. and the global economic stability. In fact, it has been well-documented that hedge funds played a pivotal role in the 1997 Asia Economic Crisis.[199] The prime minister of Malaysia called the industry the "highwaymen of the global economy" and some even suggested that "the world would be better off without them."[200] The threat of a hedge-fund-blow-up to the macro economy will be illustrated by using LTCM's highly leveraged position as an example.

LTCM took highly complex leveraged positions in order to reap oversized profit from market discrepancies in bond, option and stock prices.[201] In 1998, with capital of just $4.8 billion, LTCM managed a balance sheet "totaling about $120 billion." That is, an average of 25 times leverage position.[202] By late 1998, LTCM's net asset "stood at just $600 million" but it supported a balance-sheet position over $100 billion. In other words, this is a leverage of 167 times capital. A bad bet would thus easily wipe out "90% of its equity"[203] and trigger chain reaction of financial meltdown in countries in which LTCM traded which included the United

195. Zuckerman, *supra* note 191.
196. *Leverage Definition*, *available at* http://www.investorwords.com/2786/leverage.html (last visited Feb. 1, 2009).
197. Gibson, *supra* note 44, at 686.
198. Gatsik, *supra* note 8, at 592.
199. *Id.*
200. Special Report, *A hitchhiker's guide to hedge funds*, THE ECONOMIST, June 13, 1998.
201. Eichengreen & Mathieson, *supra* note 32.
202. *Id.*
203. *Id.*

States, Japan and Europe.[204] This was why when a bad bet did happen in September 1998, the federal government was compelled to step in and rescue.

In light of hedge funds' recent growth and their extensive involvement in many countries' securities markets, it is simply too much risk to leave this $1.2 trillion industry alone and rely exclusively on the markets' self-imposed disciplinary power. Whether the LTCM and Amaranth's trouble is unique in its own kind or indicative of what happens when the industry is under macroeconomic stress, nobody can guarantee the next Amaranth will be swiftly controlled and its effects isolated. Regulations are needed to address the proper disciplinary standards both the lenders and the borrowers' side. First, more oversight is needed to control the "excessive" lending of banks to the hedge fund industry. (The proper standard to determine excessiveness is beyond scope of this paper; it should be left to the SEC, other federal and/or state regulators to decide the proper ratio in light of overall market risk.) In addition, there must be standards to address the hedge fund industries' aggressive borrowing and to assess the risks it collectively and individually takes.

(c) Furthermore, the above mentioned concern has not only taken hold of the traditional securities and banking segments, but also has spread to areas where the hedge funds have been known to have little involvement — the debt markets. With easier access to capital and a more aggressive mindset for profits, hedge funds have grown to become a dominant player (i.e. buyer) in commercial lending markets[205] as well as the Chapter 11 bankruptcy filings.[206] According to Reuters Loan Pricing Corporation, hedge funds, together with other institutions, bought loans $224 billion in 2005, compared with "$50 billion in 2000."[207] The danger of hedge funds' growing control in these fields lies in its privity to insider information and accordingly, its potential to manipulate the markets for illegal gains. To understand this, a detour to the lending industry is necessary.

Lending was once a privileged club dominated by banks. When a loan agreement was struck, it was generally agreed that the borrower would provide the lender with some information and updates so as to assure the lenders that they were doing the best with the capital provided. Such information is sensitive and very likely to fall within the ambit of the

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204. *Id.*

205. Jenny Anderson, *As Lenders With Easy Access to Data, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, at A1.

206. *Id.* ("Hedge funds have become a dynamic force in Chapter 11 cases," said Harvey R. Miller, vice chairman at Greenhill & Company and the former head of the bankruptcy and reorganization group at Weil, Gotshal & Manges. "[W]here you used to have a syndicate of banks, today you have a syndicate that is mostly hedge funds.")

207. *Id.*

securities laws' definition of being "material" because of its market-moving potentials. Other investors and the general public are typically not privy to such information because their information is updated only monthly.[208] In light of the non-public nature of the shared information, the lending banks were highly regulated and were required in great depth to "separate their various lines of business."[209] To keep bankers from sharing, some banks "even separate their divisions on different floors and use coded identification tags to restrict access."[210] Hedge funds, on the other hand, are not subject to the same strict regulatory oversight as the banks. Therefore, it is very likely that "the person trading loans, who may have access to confidential information, often sits next to the person trading on bonds — or, in some cases, may be the same person." To sum up, the third reason to support regulating hedge funds is to stall the abuse of potential insider trading in the hedge fund industry.

B. *Solutions to Hedge Fund Problems — Alternatives Other Than Registration Requirement*

Albeit their supportive stance for regulation, many economists in a recent Wall Street Journal Survey nonetheless warned against over regulation.[211] As Dana Johnson, a banker with Comerica Bank, pointed out, "[it is] better to have them onshore with light regulation … than push them offshore if we tried to regulate with a heavy hand." This section purports to demonstrate that specifically tailored regulatory measures *can* address the three problems raised in the previous section while avoid implementing the forced disclosure requirement as the SEC championed.

1. *The Proposed Alternative to Asset Valuation Problem*

As Barry Colvin, the manager of Tremont Capital Management, pointed out the key to independent pricing is "not really so much what the exact price is, but rather, what *process* was utilized to arrive at that price." [Emphasis added][212] In order to make sure that the evaluation process is not subject to external influences, several funds have already initiated an internal review process to assure the independence of their portfolios. These practices can be roughly broken down to two categories. The first group of

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208. *Id.*
209. *Id.*
210. *Id.*
211. Izzo, *supra* note 21.
212. Christine Williamson, *Hidden Risk: Investors Skim over Question of Fund Valuation; Undervaluation of the Risks of Hedge Funds*, THE ECONOMIST, July 12, 2004.

funds set up a separate branch to review the pricing result arrived by the fund managers. Tremont Capital Management, Rye, N.Y., for example, added to its internal evaluation process in the year 2003 by requiring its managers to "report their portfolio characteristics" and return the result to the Risk Assessment group for yet another independent pricing verification.[213] Goldman Sachs Assess Managements, on the other hand, rely more on emphasizing the ethical obligation of the fund managers. It drills the sense of due diligence into the evaluation process and assures the compliance of such duty through questionnaires and analysts who are sent to "observe manager practice."[214] If the SEC or other regulators like this approach, they can adopt the following two-step approach so that the mechanism can be implemented throughout the fund industry without a forced registration process.

First, the SEC should be fully informed as to the participants in the industry and the extent of their activities. As shown above, registration is not the only way to achieve this; the SEC can simply require a one-page questionnaire that a hedge fund must submit *before* it is qualified for any exemption status. Note that the truthfulness of such a disclosure does not hinge on whether or not a fund is registered — the anti-fraud provision is universally applied to all funds, exempt or not.

Next, the SEC can use its rulemaking authority to compel a fund manager to file a "notice of exemptions" relied upon and creatively structure that notification to include as much information as the SEC deems appropriate.[215] For example, included in the notification could be the internal evaluation process the fund relies on and what procedures are in place to assure such compliance. As a result, this indirect monitoring requirement will be a less intrusive means to assure the independence of the industry's evaluation process.

2. *The Proposed Alternative to Leverage Problem*

With respect to averting systematic threats to the world's financial system, detailed regulatory procedures are necessary to limit the bank's imprudent extension of credits and the excessive borrowing position taken by the hedge fund industry. These concerns can be addressed in a two-step process.

First, one or several reliable credit rating mechanisms must be

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213. Tremont Capital Management, Rye, N.Y. which manages more than $11 billion has implemented this step in 2003, *id.*

214. *Id.*

215. Adam R. Bolter, *Regulation of Hedge Fund Adviser: A Valid Exercise of Rulemaking Authority or the Promulgation of New Law?*, 57 ADMIN. L. REV. 595, 618 (2005).

established in order to bridge the information gap in the industry.[216] The heart of the leverage problem is not so much on bank's failure or laziness to adequately monitor their credit risk before loaning to the hedge funds; the problem stems more from the dearth of the information on hedge funds and the lack of the sophistication in general "to understand fully all the risks associated with the hedge fund industry."[217] Therefore, before any regulatory steps are taken, a rating system must be set up first to enable the participants to fully understand, or at least, to appreciate the risks involved. Indeed, there are already demands from the pension funds investors about setting up such a rating system after the Amaranth collapse.[218] Moody's Investors Service, for example, has developed a model to rate the likelihood of a fund's potential fraudulent practice.[219] Similarly, Standard & Poor's, a McGraw-Hill Cos. Unit, also provides credit ratings on a few individual funds, criteria to assess the asset valuation system, and even background checks on fund managers.[220]

The second step involves the prudential requirements on lenders and borrowers. The Commission must set up standards regarding how much risk the banks and the funds can take under normal and stressed market conditions, and to curtail excessive risk takers accordingly (note that what is "appropriate" is beyond scope of this paper). After arriving at a desirable ratio of leverage that the SEC deems appropriate, the SEC can then address the problem of lending by raising the "margin and collateral requirements" so as to effectively limit the "ability of hedge funds to leverage."[221] In addition, constant monitoring is required on the part of the lending institutions. For example, the banks and prime brokers must "recalculate their provisions vis-à-vis hedge funds daily at market prices, require daily payments, and collateralize their lending." They must assess the "funds' investment strategies, monthly returns, and investor withdrawals" and readjust the limit on their credit exposure to each fund based on the results they arrive. The extent of the supervising work and the fact that lenders also have their money on the line underscore the point why it is more preferable to rely on the middle-ground approach of regulatory oversight *plus* the markets' self-discipline power, rather than on the SEC's heavy-handed crackdown.

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216. Serena Ng & Shefali Anand, *Hedge Funds' Next Wrinkle: Ratings*, WALL ST. J., Aug. 25, 2006, at C3.
217. Eichengreen & Mathieson, *supra* note 32.
218. *Id.*
219. *Id.*
220. *Id.*
221. *Id.*

3. *Proposed Solution to Hedge Funds' Potential Abuse on Non-Public Information*

To tackle the potential abuse of insider trading, the solution is simple: hedge funds should set up similar information barriers like their peer banks engaging in both securities and debt markets. There are three typical ways to set up the barrier. First, the funds can simply physically separate the people "who have insider information from those who do not."[222] Second, funds can also choose to refrain from trading in the area where they receive the non-public information. For example, Highland Capital Management, a $28.5 billion investment manage firm with hedge fund divisions, said that "when [its] public side receives any nonpublic information about a company, [it] restricts itself from trading any securities in that company."[223] Third, the funds can simply adopt the easiest method. That is, it can choose to receive "only [the] public information."[224]

One may argue that the above proposal is not practical for small funds; yet the funds at issue here are what the SEC singled out and what this paper purports to cover: the funds valued at or more than $25 million. Accordingly, this practicability argument will not stand.

V. CONCLUSION

This paper seeks to demonstrate that although numerous flaws exist in the hedge fund industry, a registration requirement is too drastic an approach because alternative regulatory oversight is readily available to resolve the problems. The first part of the paper argues that registration is not an appropriate response because registration neither solves the fraud problem in hedge funds nor provides the SEC more extensive reach of its jurisdictional power. Granted, it may provide information to the SEC as to what participants are currently in the industry, but such information can be easily obtained from other existing schemes with little worries about its falsity. The second part of this paper argues that despite the fact that registration is an unwarranted step, more regulatory oversight is still needed to address concerns in the hedge fund industry. Finally, this paper concludes with three alternatives to address the SEC worries, demonstrating that the problems can be dealt with in ways other than compelling all funds to file standardized registration forms. It is difficult to keep the government away from the hedge fund parties any more; after all, few hedge funds today are working exclusively for the elite individuals alone, they also invite pension funds and

222. Anderson, *supra* note 205.
223. *Id.*
224. *Id.*

charities, which include you and me as one of the few thousand beneficiaries. The paper demonstrates that the government should and is welcomed to join the party, but just not ruin it.

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