

**THE LESSON OF *GOLDSTEIN v. SEC*:  
IF AT FIRST YOU DO NOT SUCCEED, REGULATE AGAIN?**

JEFFREY M. SNEERINGER\*

I. INTRODUCTION

Tucked away at the end of almost every project plan is a line item for lessons learned—a time when all of the successes and setbacks can be viewed through the prism of hindsight. It is both an awkward and enlightening process during which events (both planned and unexpected), past decisions, and subsequent outcomes are analyzed and placed into context. As the first ten years of active regulation of hedge funds comes to a close, this is as good a time as any for investors, hedge fund managers, regulators, and legislators to reflect and consider possible next steps.

Hedge funds have evolved into an increasingly popular investment vehicle since their introduction the late 1940s.<sup>1</sup> While once considered an investment option for the affluent, market forces and various legislative enactments over the last two decades have led to an unprecedented influx of investment capital. There are an estimated 8,800 hedge funds in existence with a total of \$1.2 trillion in assets under management.<sup>2</sup> Even more interesting is that the Securities and Exchange Commission (SEC or Commission) estimates that hedge fund activity accounts for thirty percent of all U.S. equity trading volume even though hedge funds represent approximately just five percent of all U.S. assets under management.<sup>3</sup>

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<sup>1</sup> U.S. Securities and Exchange Commission, *Implications of the Growth of Hedge Funds*, Staff Report to the United States Securities and Exchange Commission 1 (Sept. 29, 2003), [hereinafter SEC Staff Report] <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

<sup>2</sup> *Regulation of Hedge Funds Before the U.S. Senate Committee on Banking, Housing and Urban Affairs*, 109th Cong. (July 25, 2006) [hereinafter *Regulation of Hedge Funds*] (statement of SEC Chairman Christopher Cox), available at <http://www.sec.gov/news/testimony/2006/ts072506cc.htm>.

<sup>3</sup> *Id.* See also *infra* note 104 and accompanying text.

The SEC's Hedge Fund Rule<sup>4</sup> was an attempt to provide a comprehensive regulatory scheme for domestic and off-shore hedge funds by closing loopholes in existing securities laws.<sup>5</sup> In *Goldstein v. SEC*,<sup>6</sup> the United States Court of Appeals for the District of Columbia rejected the Hedge Fund Rule holding that it was an arbitrary and unlawful extension of agency authority.<sup>7</sup> The petitioner, Phillip Goldstein, a general partner and adviser to a hedge fund, sought to enjoin the SEC from enforcing the Hedge Fund Rule.<sup>8</sup> The Commission presented evidence that indicated a possible ambiguity in the definition of the term, "client" under the Adviser's Act section 203(b)(3).<sup>9</sup> However, the court held that the rule was unreasonable because it required advisers to owe fiduciary duties to both the fund and the individual security holders and because the rule contravened years of past SEC practices.<sup>10</sup>

The *Goldstein* decision was a setback for the SEC, but it was not altogether a surprise. Much of the United States Court of Appeals for the District of Columbia's reasoning for throwing out the Hedge Fund Rule can be found in the dissenting opinions of the two Commissioners who voted against adopting the regulation in 2004.<sup>11</sup> It is fair to say that the Commission's attempt to solve a multi-variable problem with a one-size-fits-all rule was doomed to fail because it was based on assertions rather than facts and because the Commission ignored its own precedent.

Overall, the *Goldstein* decision would seem to cast doubt on SEC efforts to pass and enforce oversight rules for private investment funds. However, the case, while significant, is only one chapter in the ongoing saga of hedge fund regulation. The Commission responded in late 2006 with proposed regulations addressing fraud prosecutions ("Antifraud Rule")<sup>12</sup> and modifications to the definition of accredited investor

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<sup>4</sup> Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054 (Dec. 10, 2004) [hereinafter Adopted Hedge Fund Rule].

<sup>5</sup> See Hedge Fund Rule discussion *infra* Part III.B.

<sup>6</sup> 451 F.3d 873 (D.C. Cir. 2006).

<sup>7</sup> *Id.* at 884.

<sup>8</sup> See *infra* Part IV.A.

<sup>9</sup> See *infra* Part IV.C.1.

<sup>10</sup> See *infra* Part IV.C.2.

<sup>11</sup> See *infra* Part III.B.

<sup>12</sup> Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 400-03 (proposed Jan. 4, 2007) [hereinafter 2007 Proposed Rules]. See also *infra* Part V.C.1.

(“Accredited Natural Person Proposal”).<sup>13</sup> Both rules, while minimal in scope when compared to the Hedge Fund Rule provisions, drew criticism from many circles.<sup>14</sup> The Antifraud Rule was adopted and became effective in August 2007.<sup>15</sup>

One constant throughout this ten-year story is the generally negative news coverage of the hedge fund industry during both prosperous times and the recent economic downturn. Coupled with political uncertainty, all of this raises the question: is it possible that that same regulation struck down in June 2006 could be revived? This Note argues that the next round of regulation must account for the lessons learned from the Hedge Fund Rule episode. The Note will present a history of the hedge fund regulation debate, discuss how the dissenting Commissioner’s arguments framed the Court’s analysis of the *Goldstein* case, and outline the events following the case. All of this leads to an evaluation of the rules proposed in 2007 and a look forward to how the current economic situation may influence the next steps the Commission and Congress take to regulate the hedge fund industry.

## II. BACKGROUND: PRE-HEDGE FUND RULE REGULATIONS

### A. *What is a Hedge Fund?*

“Hedge funds are notoriously difficult to define.”<sup>16</sup> Generally, hedge funds encompass privately organized pooled investment vehicles not necessarily available to the public.<sup>17</sup> The funds may employ many types of investment strategies including using leverage<sup>18</sup> to benefit from short-term movements in market prices.<sup>19</sup> Leverage may assume the form of trading various derivatives, taking short positions on stocks, or buying on the margin.<sup>20</sup>

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<sup>13</sup> 2007 Proposed Rules, *supra* note 12, at 403–08. *See also infra* Part V.C.2.

<sup>14</sup> *See infra* Parts V.C.1 & V.C.2.

<sup>15</sup> *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44756, 44756–57 (adopted Aug. 9, 2007) [hereinafter Adopted Antifraud Rule]. *See also infra* Part V.C.1.

<sup>16</sup> *Goldstein v. SEC*, 451 F.3d 873, 874 (D.C. Cir. 2006).

<sup>17</sup> *See* SEC Staff Report, *supra* note 1, at 3.

<sup>18</sup> Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 685–86 (2000).

<sup>19</sup> *Id.* at 686.

<sup>20</sup> *Id.* at 688.

Employing leverage shifts risk away from individual investors who desire stability in prices and performance.<sup>21</sup> In addition, leverage provides liquidity to capital markets through the form of negative feedback trading.<sup>22</sup> This process entails buying and selling securities against prevailing market prices.<sup>23</sup> For instance, it is common for hedge funds to buy a security during a period when it is generally being sold by most investors.<sup>24</sup>

Another investment strategy employed by hedge funds relates to purchasing long-term positions in traditional stocks, bonds, or currencies.<sup>25</sup> The same strategic freedom is not shared by similar investment vehicles, like mutual funds, which are not permitted to trade on margins or participate in short sales of securities.<sup>26</sup> Hedge funds may also engage in financing nontraditional and much riskier activities like movies<sup>27</sup> and race horses.<sup>28</sup> Regardless of strategy, hedge funds operate in a secretive manner in order to maximize gains.<sup>29</sup>

Hedge funds are usually structured as limited partnerships with the general partner serving as the investment adviser.<sup>30</sup> The funds may also be structured as limited liability companies or business trusts.<sup>31</sup> These business entities provide tax benefits and limited liability to fund investors.<sup>32</sup> Fund manager compensation, in most cases, derives from a

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<sup>21</sup> Daniel K. Liffmann, Note, *Registration of Hedge Fund Advisers Under the Investment Advisers Act*, 38 LOY. L.A. L. REV. 2147, 2158 (2005).

<sup>22</sup> *Id.*

<sup>23</sup> See SEC Staff Report, *supra* note 1, at 34.

<sup>24</sup> *Id.* at 33.

<sup>25</sup> *Id.*

<sup>26</sup> 15 U.S.C. § 80a-12(a)(1) (2000).

<sup>27</sup> See Kate Kelly, *Defying the Odds, Hedge Funds Bet Billions on Movies*, WALL ST. J., Apr. 29, 2006, at A1.

<sup>28</sup> *Race-Horse Hedge Funds Begin to Gallop*, DEALBOOK BLOG—N.Y. TIMES, June 9, 2008, <http://dealbook.blogs.nytimes.com/2008/06/09/horse-focused-hedge-funds-go-to-the-races/>.

<sup>29</sup> Troy A. Paredes, *On The Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 986–87 (“The very nature of hedge funds requires that they operate in secrecy because hedge funds make money by exploiting market inefficiencies and by taking positions based on anticipated market moves. The opportunity to make money quickly vanishes when trading strategies or particular positions and trades are disclosed and others start to make the same investments.”).

<sup>30</sup> See SEC Staff Report, *supra* note 1, at 9.

<sup>31</sup> *Id.* at 9 n.27.

<sup>32</sup> *Id.*

management fee, usually 1–2% of the assets under management, and a performance fee ranging from 10–30% of the fund’s total return.<sup>33</sup> The fund adviser may also invest her own money in the fund, and, in some cases, investors may require that the adviser do so.<sup>34</sup> Fund shares are sold through private offerings directly to investors, and not through broker-dealers.<sup>35</sup> In addition to the single-manager fund, funds of hedge funds (FOHF) have increased in popularity over the last ten years.<sup>36</sup> There is no limit to the number of funds an FOHF may invest in, and it is typical for institutional investors to invest in these funds in order to avoid the risk associated with only one fund adviser.<sup>37</sup>

*B. Who Invests/Participates in Hedge Funds?*

Traditionally, hedge funds were not open to the public and were available only to the well-heeled or sophisticated investor.<sup>38</sup> This has changed over time because of the rise of a new investor class in the United States whose personal net worth fulfills the minimum net worth requirements to invest in hedge funds.<sup>39</sup> To accommodate investors of lower net worth, many large investment houses have introduced hedge funds into their investment portfolios alongside more heavily regulated

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<sup>33</sup> See SEC Staff Report, *supra* note 1, at 61–62. See also Principles and Best Practices for Hedge Fund Investors: Report of the Investors’ Committee to the President’s Working Group on Financial Markets 9 (Apr. 15, 2008) [hereinafter PWG IC Report], available at <http://www.ustreas.gov/press/releases/reports/investors'committeereportapril152008.pdf>. The performance fee is also known as the “carried interest.” *Id.* For a discussion of the failed attempt to close the carried interest tax loophole see Part VI.C.

<sup>34</sup> See SEC Staff Report, *supra* note 1, at 62.

<sup>35</sup> *Id.* at 44. Marketing of hedge fund is often targeted, but can also be by word of mouth or personal recommendation. *Id.* Funds websites are usually formatted to limit accessibility to fund advisers in order to avoid solicitation to the general public. *Id.* at 45.

<sup>36</sup> A fund of hedge funds is an “investment company that invests in hedge funds—rather than investing in individual securities.” Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds, <http://www.sec.gov/answers/hedge.htm> (last visited Aug. 29, 2008). The SEC report also points out that many FOHFs are not required to register with the SEC because of exemptions built into existing securities laws and regulations. See SEC Staff Report, *supra* note 1, at 68.

<sup>37</sup> See SEC Staff Report, *supra* note 1, at 67.

<sup>38</sup> *Id.* at ix–x.

<sup>39</sup> The Commission noted that greater wealth and inflation contributed to the increase in the number of persons qualifying as accredited investors under Regulation D. *Id.* at 80–81. For a detailed explanation of the accredited investor standard, see *infra* note 55.

mutual funds.<sup>40</sup> This move is partly due to the investment companies attempting to keep their fund management talent in house.<sup>41</sup> Despite these developments the 2003 SEC Staff Report did not uncover “evidence of significant numbers of retail investors investing directly in hedge funds.”<sup>42</sup>

However, the SEC Staff Report did note that investments by large institutions, such as pension funds and endowments, “fueled primarily” the overall growth of hedge funds.<sup>43</sup> This trend has not abated. The SEC General Counsel noted in 2007 the continued institutionalization of hedge fund investments.<sup>44</sup> Sometimes overlooked in the hedge fund regulation discussion are banks.<sup>45</sup> While not always investors, banks extend large amounts of credit to hedge funds.<sup>46</sup> Many of these same banks, seeing the high returns associated with hedge funds, have started up their own funds or purchased stakes in existing ones.<sup>47</sup>

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<sup>40</sup> Erik J. Greupner, Comment, *Hedge Funds are Headed Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1575–76 (2003).

<sup>41</sup> *Id.* at 1575.

<sup>42</sup> SEC Staff Report, *supra* note 1, at 80.

<sup>43</sup> *Id.* at vii. The Commission expressed concern that while institutions usually qualify as accredited investors, institutional investments “expose their participants or other beneficiaries to hedge funds.” *Id.* at 82.

<sup>44</sup> The Future of Securities Regulation by SEC General Counsel Brian G. Cartwright (Oct. 24, 2007), <http://www.sec.gov/news/speech/2007/spch102407bge.htm> (“And hedge funds have proved to be a magnet for institutional investors. Assets under management by hedge funds have been growing dramatically and now are estimated to exceed \$2 trillion. So hedge funds are yet another important—and high return—asset class just for institutional investors.”).

<sup>45</sup> Banks can be considered a counterparty to hedge funds. Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management—Report of The President’s Working Group on Financial Markets 6–10 (Apr. 1999) [hereinafter LTCM Report], available at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf>. Counterparties interact with hedge funds through activities such as trading, lending, due diligence, and risk management (including collateralization and setting credit limits). *Id.*

<sup>46</sup> Gregory Zuckerman & Jenny Strasburg, *Banks Fumble At Operating Hedge Funds*, WALL ST. J., May 31, 2008, at B1. The stakes can be significant because banks often lend hundreds of millions to hedge funds, as was the case in the Bear Stearns’ funds failure. See *infra* note 278 and accompanying text. Also banks, through their business relationships with hedge funds, can profit from a fund’s failure. This was the case with J.P. Morgan Chase and the failed Amaranth Advisors fund. See *infra* note 270 and accompanying text.

<sup>47</sup> Zuckerman & Strasburg, *supra* note 46 (noting that bank-operated hedge funds “are a huge cash machine when they are working right”). However, when the funds investment strategies are not successful losses can be substantial. *Id.* (“Bear [Stearns]’ mortgage funds  
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### C. Securities Law Governing Hedge Fund Regulation

Compared to other investment types, the push for increased regulation and oversight of hedge funds is relatively new. The prevailing wisdom at the SEC, up until roughly 1998, was that investment vehicles that remain private and available only to highly sophisticated investors were historically understood not to present the same dangers to public markets as more widely available investment companies, like mutual funds.<sup>48</sup> Prior to the SEC adopting the Hedge Fund Rule, many of the advisers in charge of the largest hedge funds voluntarily registered with the Commission.<sup>49</sup> However, the vast majority of hedge funds were constructed to avoid federal statutes and Commission regulations in the following ways.<sup>50</sup>

#### 1. Securities Act of 1933

Congress enacted the Securities Act of 1933 Act (“1933 Act”) to govern how securities are offered to the public.<sup>51</sup> The 1933 Act includes a general registration requirement.<sup>52</sup> One key exemption from registration is through a private offering.<sup>53</sup> Courts have stated various criteria to help

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lost almost \$2 billion [in 2007]; Goldman Sachs’s huge Global Alpha fund lost almost \$4 billion in 2007; and UBS’s high profile Dillon Reed fund was closed after losses in the summer [of 2007]. More recently, Citigroup’s Falcon funds ran into losses of almost \$2 billion.”). Lawsuits and damage to the banks’ reputations are also common results. *Id.* For a detailed discussion of the 2007 Bear Stearns hedge funds collapse and fallout, see *infra* notes 271–84 and accompanying text.

<sup>48</sup> See SEC Staff Report, *supra* note 1, at 38.

<sup>49</sup> In 2003, the SEC estimated that roughly two-thirds of hedge fund advisers were not registered. *Id.* at 22. However, the report did note that roughly half of the largest domestic hedge funds did register with the SEC. *Id.*

<sup>50</sup> See Liffmann, *supra* note 21, at 2157–58.

<sup>51</sup> See Gibson, *supra* note 18, at 688.

<sup>52</sup> 15 U.S.C. § 77e(c) (2000) states: “It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security.” See also Gibson, *supra* note 18, at 689.

<sup>53</sup> 15 U.S.C. § 77d (2000) provides that § 77e does not apply to “transactions by an issuer not involving any public offering.” To be eligible, a hedge fund must comply with regulations in 17 C.F.R. § 230.506 (2008), which, in turn, references requirements for accredited investors, defined in 17 C.F.R. § 230.501(a) (2008), *id.* § 230.506(b)(1), and *id.* § 230.506(b)(2)(i) (“[T]hat there are no more than 35 purchasers of securities from the issuer.”).

determine what constitutes a private offering including the number of offerees, offeree's need and access to information, offering price, and the overall number of securities to be offered.<sup>54</sup> Hedge funds qualify for the private offering exception because the funds are offered to accredited investors (who are individuals with high net worth) or institutional investors, like banks and insurance companies.<sup>55</sup>

## 2. *Securities Exchange Act of 1934*

The Securities Exchange Act of 1934 ("1934 Act") governs securities transactions in a more comprehensive manner than the 1933 Act.<sup>56</sup> The purpose of the Act is to provide investors with the necessary information to make investment choices and protect those same investors from fraud.<sup>57</sup> Two provisions of the Act serve as exemptions for hedge funds. First, the

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<sup>54</sup> See Gibson, *supra* note 18, at 690.

<sup>55</sup> See 17 C.F.R. § 230.501(a) (defining eight types of accredited investors including individuals with a net worth of \$1,000,000). An accredited investor falls into two general categories:

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

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

SEC Staff Report, *supra* note 1, at 15 (summarizing the accredited investor definition contained in 17 C.F.R. § 230.501(a)(1)–(8)).

<sup>56</sup> See Gibson, *supra* note 18, at 691 (distinguishing the 1934 Act because it covers "all facets of the securities market and all transactions involving securities," instead of only the offering requirements set forth in the 1933 Act).

<sup>57</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (stating that the 1934 Act was intended to "provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing").

1934 Act requires broker-dealers to register with the SEC.<sup>58</sup> However, hedge funds are treated as “traders” and are not required to register.<sup>59</sup> Second, section 12 of the 1934 Act and the related SEC rules require registration and reporting when classes of equity securities satisfy the holder of record and asset tests.<sup>60</sup> Hedge funds often evade this provision because they have 499 or fewer holders of record.<sup>61</sup> There is one 1934 Act provision from which hedge funds are not exempt. Hedge funds are required to file with the SEC when the fund exceeds direct or indirect beneficial ownership of more than five percent of specified security classes.<sup>62</sup> When this occurs, both the hedge fund and the manager must file with the SEC.<sup>63</sup>

### 3. *Investment Company Act of 1940*

The Investment Company Act of 1940 (“Investment Company Act”) provides extensive protection for investors from potential abuses by investment companies.<sup>64</sup> The definition of “investment company” includes

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<sup>58</sup> See 15 U.S.C. § 78(o) (2000).

<sup>59</sup> See SEC Staff Report, *supra* note 1, at 18 (stating “[e]ntities that buy and sell securities for investment generally are considered traders, but not dealers.”) See also Gibson, *supra* note 18, at 692 (outlining the history of exclusion of hedge fund managers as both brokers and dealers).

<sup>60</sup> 15 U.S.C. § 78l(g) (2000), requires registration when assets exceed \$1 million and there are 500 holders on record. 17 C.F.R. § 240.12g-1 (2008) increases the asset threshold to \$10 million.

<sup>61</sup> See SEC Staff Report, *supra* note 1, at 18–19.

<sup>62</sup> 15 U.S.C. § 78m(g)(1) (2000). Beneficial ownership is broadly defined to include the “power to vote or dispose of any equity securities, or the power to direct the voting or disposition of those securities.” SEC Staff Report, *supra* note 1, at 19. The filing must state the number of shares and the purpose for acquiring the shares. *Id.*

<sup>63</sup> The SEC reasoned that “due to the power a hedge fund’s adviser may exercise over the equity securities held by the fund, both the hedge fund and its adviser generally will be deemed to beneficially own any equity securities owned by the hedge fund.” *Id.*

<sup>64</sup> See *Burks v. Lasker*, 441 U.S. 471, 480 (1979). For instance, 15 U.S.C. § 80a-8 (2000), requires that all investment companies register with the SEC. The Investment Company Act also stipulates the types of securities that may be issued, 15 U.S.C. §§ 80a-14, 18, 22, 23 (2000), restricts the type of transactions investment companies may undertake, 15 U.S.C. §§ 80a-12, 13 (2000), and sets forth reporting requirements in 15 U.S.C. § 80a-30 (2000). Additionally, domestic hedge funds tend to be organized as limited partnerships. This excludes hedge funds from requirements for an independent board of directors required in 15 U.S.C. § 80a-10 (2000), and shareholder approval of actions, 15 U.S.C. § 80a-13 (2000).

a firm that “is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.”<sup>65</sup> The SEC recognizes that hedge funds generally fit the definition of an investment company, but may fall under one of two statutory exemptions.<sup>66</sup>

First, section 3(c)(1) of the Investment Company Act excludes from the definition of investment company any securities issuer in which beneficial owners total less than 100 and that does not make a public offering of its securities.<sup>67</sup> An investment company will not enjoy exemption under section 3(c)(1) if any one owner acquires ten percent or more of the outstanding voting shares.<sup>68</sup> The public offering requirement is controlled by the 1933 Act.<sup>69</sup>

Second, section 3(c)(7) of the Investment Company Act excludes from the definition of investment company any securities issuer that is owned exclusively by “qualified purchasers,” and which does not make a public offering of its securities.<sup>70</sup> A qualified purchaser is any one natural person or family operated company owning at least \$5 million in investments.<sup>71</sup> There is no cap on the number of qualified purchasers a fund may have, but the 499 investor limit from the 1934 Act does serve as a default maximum number of investors for most hedge funds.<sup>72</sup> This provision was added with the passage of the National Securities Markets Improvement Act (NSMIA) in 1996<sup>73</sup> and fueled a significant expansion of hedge funds into the securities marketplace.<sup>74</sup> Section 3(c)(7) also serves as a strong

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<sup>65</sup> 15 U.S.C. § 80a-3(1)(a) (2000).

<sup>66</sup> See SEC Staff Report, *supra* note 1, at 11.

<sup>67</sup> 15 U.S.C. § 80a-3(c)(1).

<sup>68</sup> *Id.* Funds must monitor ownership stakes closely in order to take advantage of the exemption. SEC Staff Report, *supra* note 1, at 11–12.

<sup>69</sup> See *supra* Part II.C.1.

<sup>70</sup> 15 U.S.C. § 80a-3(c)(7).

<sup>71</sup> 15 U.S.C. § 80a-2(a)(51)(A) (2000). This section also defines a qualified investor as a trust in which “the trustee and settlor(s) of which are qualified purchasers” and “any person acting for its own account or the accounts of other qualified purchasers, that owns and invests on a discretionary basis not less than \$25 million in investments.” SEC Staff Report, *supra* note 1, at 12 (paraphrasing 15 U.S.C. § 80a-2(a)(51)(A)).

<sup>72</sup> See SEC Staff Report, *supra* note 1, at 13.

<sup>73</sup> National Securities Markets Improvement Act of 1996, Pub L. No. 104-920, 110 Stat. 3432 (codified at 15 U.S.C. § 77r (2000)).

<sup>74</sup> Gruepner, *supra* note 40, at 1561. Gruepner posits that section 3(c)(7) opened up the door for increased hedge fund investment because the funds could seek out 499 high net  
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indication that Congress believed hedge funds to still be vehicles for sophisticated investors.<sup>75</sup>

#### 4. *Investment Advisers Act of 1940*

The Investment Advisers Act of 1940 (“Advisers Act”)<sup>76</sup> requires that all investment advisers register with the SEC,<sup>77</sup> and was intended to regulate “the business of rendering personalized investment advice.”<sup>78</sup> The Advisers Act defines an investment adviser to be a person who “for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. . . .”<sup>79</sup> Registered advisers must open their records to the Commission upon request<sup>80</sup> and cannot charge their clients a performance fee unless those clients have at least \$1 million of assets under management with the adviser.<sup>81</sup>

Again, as with other statutes,<sup>82</sup> hedge fund advisers, prior to adoption of the Hedge Fund Rule, could avoid registering with the Commission by relying on a statutory exemption. In this instance, the Advisers Act’s exemption is found under section 203(b), also known as the Safe Harbor Provision.<sup>83</sup> The section excludes from registration investment advisers that have had fewer than fifteen clients during the preceding twelve months, do not hold themselves out generally to the public as an investment adviser and are not an investment adviser to a registered

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worth investors (qualified purchasers) instead of being limited by the 100 accredited investors worth \$1 million threshold under section 3(c)(1). *Id.* at 1562–64.

<sup>75</sup> The SEC recognized this in its own reports based on relevant legislative history. *See* SEC Staff Report, *supra* note 1, at 13. It is also worth noting that section 3(c)(7) does not contain any look-through provisions similar to 3(c)(1). *Id.*

<sup>76</sup> 15 U.S.C. § 80b-1 (2000).

<sup>77</sup> 15 U.S.C. § 80b-3(a) (2000). The statute requires advisers to disclose basic details such as advisor contact information, financial details and the nature of the business. 15 U.S.C. § 80b-3(c). Advisers must file a Form ADV per 17 C.F.R. § 275.203-1(a) (2008).

<sup>78</sup> *Lowe v. SEC*, 472 U.S. 181, 182 (1985).

<sup>79</sup> 15 U.S.C. § 80b-2(a)(11) (2000).

<sup>80</sup> 15 U.S.C. § 80b-4(a) (2000).

<sup>81</sup> 15 U.S.C. § 80b-5 (2000).

<sup>82</sup> *See* previous discussions related to the 1933 Act, 1934 Act and the Investment Company Act, *supra* Parts II.C.1–3.

<sup>83</sup> 15 U.S.C. § 80b-3(b).

investment company.<sup>84</sup> Section 203(b) does not specify a method for counting clients. Under a 1985 rule interpreting section 203(b), the Commission allowed investment advisers to count a hedge fund as a single client.<sup>85</sup> Therefore, an adviser may manage up to fourteen hedge funds before being required to register with the Commission as an investment adviser, so long as it satisfies the “no holding out” condition.<sup>86</sup> Investment advisers who are exempt from registration nevertheless are subject to the antifraud provisions of the Advisers Act.<sup>87</sup>

### 5. *Commodities Futures Trading Commission*

The Commodities Futures Trading Commission (CFTC) has a hand in regulating hedge funds if the funds have U.S. investors and undertake commodities transactions.<sup>88</sup> Hedge fund general partners usually qualify as a commodity pool operator (CPO), but are exempted under a series of CFTC rules.<sup>89</sup> What is important to remember is that hedge fund advisers engaging in commodities trading must be careful to ensure compliance with both CFTC and SEC regulations in order to remain exempt.

## III. 1998–2004: THE HEDGE FUND RULE TAKES SHAPE

It is important to have a basic understanding of the market dynamics and past history in order to flesh out how and why the Commission formulated the Hedge Fund Rule. During the 2004 adoption phase of the overturned rule, the Commission noted that the hedge fund industry encompassed approximately \$870 billion of assets across 7000 funds.<sup>90</sup> The rule’s adoption did not inhibit growth—hedge funds have continued to grow in terms of the number of funds and total dollars invested. The SEC’s 2006 estimates place the total number of funds in the range of 8,800 and the total dollars under management at approximately \$1.2 trillion.<sup>91</sup>

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<sup>84</sup> *Id.*

<sup>85</sup> 17 C.F.R. § 275.203(b)(3)-1(b)(3) (2008). This rule was revoked by the Hedge Fund Rule. *See infra* Part III.B.

<sup>86</sup> The “holding out” condition is not violated by an adviser’s participation “in a non-public offering of interests in a limited partnership under the [1933 Act].” 17 C.F.R. § 275.203(b)(3)-1(c) (2008). This is important because many hedge funds are setup as limited partnerships. *See supra* notes 30–32.

<sup>87</sup> 15. U.S.C. § 80b-6. *See also* SEC Staff Report, *supra* note 1, at 21.

<sup>88</sup> *See* Gibson, *supra* note 18, at 699–700.

<sup>89</sup> For a detailed list of the exemptions, *see id.* at 699–704.

<sup>90</sup> Adopted Hedge Fund Rule, *supra* note 4, at 72056.

<sup>91</sup> *Regulation of Hedge Funds*, *supra* note 2.

*A. Long-Term Capital Management, Sarbanes-Oxley, and Mutual Fund Trading Scandals*

Professor Troy Paredes<sup>92</sup> in a 2006 article noted that two forces drove the Commission's adoption of the Hedge Fund Rule—one psychological, and the other political.<sup>93</sup> The following discussion outlines key political events, or put another way, the “regulators’ responsiveness to the political agenda of the day.”<sup>94</sup>

*1. Long-Term Capital Management*

A pivotal event in the development of the Hedge Fund Rule was the near-collapse of Long-Term Capital Management (LTCM) in 1998. The hedge fund was started in 1994 by a group of investment advisers with “substantial reputations in the financial markets.”<sup>95</sup> The fund traded across many markets with almost eighty percent of its assets in government bonds

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<sup>92</sup> Professor Paredes was recently nominated to serve as an SEC Commissioner. Press Release, The White House: Office of the Press Secretary, Personnel Announcement (May 6, 2008), <http://www.whitehouse.gov/news/releases/2008/05/20080506-11.html> (announcing nomination of Troy A. Paredes to be a Commissioner on the Securities and Exchange Commission).

<sup>93</sup> Paredes, *supra* note 29, at 1006. Under the psychological approach overregulation may occur “even as regulators act in what they honestly believe is the public’s best interest but unknowingly go too far.” *Id.* at 1009.

<sup>94</sup> *Id.* at 1011.

<sup>95</sup> LTCM Report, *supra* note 45, at 10. A detailed history of events and personalities at the center of the LTCM episode can be found in ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* (2000). The group of partners running LTCM included experienced bond traders, *id.* at 28, the former number two official at the Federal Reserve, *id.* at 36–37, and even a pair of Nobel Laureates, *id.* at 116.

of the G-7 countries.<sup>96</sup> The early returns were promising—“approximately 40 percent in 1995 and 1996, and slightly less than 20 percent in 1997.”<sup>97</sup>

In August 1998 LTCM lost \$1.8 billion in the wake of international market reactions to the Russian devaluation of the ruble.<sup>98</sup> Investors fled and liquidity became an issue.<sup>99</sup> In addition, the fund was unable to reduce large market positions because of the overall size of those positions.<sup>100</sup> Concerns arose that LTCM might collapse without a capital infusion, and that the failure of the fund might cause a ripple effect across world markets.<sup>101</sup> In response, various large investment houses, with assistance from the Federal Reserve Bank of New York, led an effort to re-capitalize the fund.<sup>102</sup>

The LTCM affair highlighted the potential “systemic risk” a single hedge fund failure may cause in the wider financial markets. This concern is often mentioned, but, as one commentator pointed out “too much should not be made of systemic risk.”<sup>103</sup> Unlike the highly leveraged LTCM fund, the “risk associated with a hedge fund’s dramatic collapse is relatively remote” even though hedge fund trading activities do make up a substantial portion of daily market activity.<sup>104</sup>

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<sup>96</sup> LTCM Report, *supra* note 45, at 11. The report offered the following assesment of LTCM’s activites:

Overall, the distinguishing features of the LTCM Fund were the scale of its activities, the large size of its positions in certain markets, and the extent of its leverage, both in terms of balance-sheet measures and on the basis of more meaningful measures of risk exposure in relation to capital.

*Id.* The fund “had an exceptionally balance-sheet leverage ratio of 25 to 1.” Paredes, *supra* note 29, at 984.

<sup>97</sup> LTCM Report, *supra* note 45, at 11.

<sup>98</sup> *Id.* at 12.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 13.

<sup>102</sup> *Id.*

<sup>103</sup> Paredes, *supra* note 29, at 985. Systemic risk “goes to the safety and soundness of financial markets.” *Id.* at 983.

<sup>104</sup> *Id.* at 985–86 (citing “studies indicating that hedge funds account for between 40 to 50% of trading activity in major stock markets, such as the New York Stock Exchange and the London Stock Exchange, and account for over 70% of daily activity in the convertibles market, the U.S. distressed debt market, and the U.S. exchange traded fund market”).

## 2. *Sarbanes-Oxley, and Mutual Fund Trading Scandals*

Long-Term Capital Management's near-collapse led to a lengthy study by the President's Working Group (PWG).<sup>105</sup> The report issued by the group was the first attempt by the federal government to assess the impact of hedge funds on domestic and financial markets.<sup>106</sup> However, Long-Term Capital was only the beginning of many well-publicized hedge fund collapses and scandals.<sup>107</sup> Another important development was the series of accounting scandals that surfaced from 1998–2002 and that involved upper level management at Enron, MCI Worldcom, Adelphia, and Cendant. The massive financial aspect of the scandals and the generally shocking behavior of the senior management of each company led to the passage of the Sarbanes-Oxley legislation in 2003.<sup>108</sup> In addition to the criminal prosecutions, many civil actions were brought by investors who lost billions when these companies' stocks rapidly devalued upon the revelation of widespread accounting issues.

Finally, mutual fund investigations led by state Attorneys General increased external pressure on the SEC to step up regulation. For instance, hedge funds engaging in market-timing practices<sup>109</sup> were prosecuted and convicted under New York laws by former New York Attorney General

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<sup>105</sup> The PWG is comprised of the heads of the Treasury, the Federal Reserve Board, the Commodity Futures Trading Commission, and the SEC. Exec Order No. 12, 631, 3 C.F.R. 559 (1988). The PWG was established in 1988 to enhance the "integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets and maintaining investor confidence." *Id.*

<sup>106</sup> See LTCM Report, *supra* note 45. The report concluded that "requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity." *Id.* at B-16.

<sup>107</sup> See Gruepner, *supra* note 40, at 1570–71 (outlining a series of 2002–2003 SEC investigations into hedge funds advisers misappropriating hedge fund assets, falsely inflating the value of funds, and concealing losses in the hundreds of millions).

<sup>108</sup> See Justin Asbury Dillmore, Comment, *Leap Before You Look: The SEC's Approach to Hedge Fund Regulation*, 32 OHIO N. L. REV. 169, 185 (2006) (noting that these scandals caused federal regulators to expand their reach as well).

<sup>109</sup> Market timing involves buying up mutual shares fund shares at the end of the trading day in order to take advantage of differences in the fund share price and the underlying holdings. See Rory B. O'Halloran, Comment, *An Overview and Analysis of Recent Interest in Increased Hedge Fund Regulation*, 79 TULANE L. REV. 461, 482–83. For a detailed discussion of how hedge funds figured into the mutual fund scandals of 2001–2004 see *id.* at 482–87.

Eliot Spitzer.<sup>110</sup> The SEC responded to the state investigations by proposing new rules to penalize short traders and mandating the orders for mutual fund purchases be placed by set times each day.<sup>111</sup>

*B. The Hedge Fund Rule: Proposal & Adoption*

The Hedge Fund Rule eliminated the Safe Harbor Provision, section 203(b) of the Advisers Act, by redefining how to count clients of a private fund. The Hedge Fund Rule defined a private fund to include (1) a fund that would normally be exempt under the Investment Company Act sections 3(c)(1) or 3(c)(7); (2) a fund that permitted its investors to redeem their interests in the fund within two years of purchase;<sup>112</sup> and (3) a company would be a private fund only if interests in it were “offered based on the investment advisory skills, ability or expertise of the investment adviser.”<sup>113</sup> For these private funds, the rule then specified that section 203(b)(3) of the Advisers Act would be construed to require that the hedge fund adviser “count as clients the shareholders, limited partners, members, or beneficiaries . . . of [the] fund.”<sup>114</sup> The rule required affected hedge fund advisers to register by February 1, 2006.<sup>115</sup>

The Commission presented three justifications for the rule. One, despite the failure of Long-Term Capital Management, hedge fund assets grew by 260% from 1999 to 2004.<sup>116</sup> Second, the Commission observed a trend toward “retailization” of hedge funds that increased the exposure of ordinary investors to such funds.<sup>117</sup> This retailization was driven by hedge funds loosening their investment requirements, the birth of FOHFs that offered shares to the public, and increased investment in hedge funds by pension funds, universities, endowments, foundations, and other charitable organizations.<sup>118</sup> Third, the Commission was concerned about an increase

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<sup>110</sup> *Id.* at 484–86.

<sup>111</sup> *Id.* at 486–87.

<sup>112</sup> This was known as the lock-up period provision.

<sup>113</sup> See Adopted Hedge Fund Rule, *supra* note 4, at 72073–75.

<sup>114</sup> *Id.* at 72088.

<sup>115</sup> *Id.* at 72054.

<sup>116</sup> *Id.* at 72055.

<sup>117</sup> *Id.* at 72057–58. The majority worried that the proliferation of hedge funds and FOHFs was drawing in less sophisticated investors, who, in turn, were not as readily able to judge and bear out the risks associated with investment strategies employed by the funds.

*Id.*

<sup>118</sup> *Id.*

in the number of fraud actions brought against hedge funds.<sup>119</sup> Concluding that its “current regulatory program for hedge fund advisers [was] inadequate,” the Commission moved to require hedge fund advisers to register under the Advisers Act so that it could gather “basic information about hedge fund advisers and the hedge fund industry,” oversee hedge fund advisers, and “deter or detect fraud by unregistered hedge fund advisers.”<sup>120</sup>

The majority also opined of the SEC’s almost exclusive reliance on “enforcement actions brought after fraud has occurred and investor assets are gone.”<sup>121</sup> Finally, the Commissioners noted that lack of basic information about individual hedge fund advisers and the entire hedge fund industry required SEC reliance on third-party data that “often conflict and may be unreliable.”<sup>122</sup>

The Hedge Fund Rule was proposed on July 28, 2004.<sup>123</sup> The comment period lasted until September 15, 2004, generating a great deal of feedback.<sup>124</sup> However, despite requests to extend the comment period, the Commission declined,<sup>125</sup> and on October 26, 2004, over the strong dissents

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<sup>119</sup> *Id.* at 72056–57. The majority’s implicit position was that the growth in the total number of hedge funds prior to 2004 opened up more opportunities for fraudulent activity by hedge fund managers. *Id.* The dissent was not convinced that the Hedge Fund Rule would prevent any of the investigations cited by the majority. *See infra* note 128 and accompanying text.

<sup>120</sup> Adopted Hedge Fund Rule, *supra* note 4, at 72059.

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

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

<sup>123</sup> *See* Registration Under the Adviser’s Act of Certain Hedge Fund Advisors; Proposed Rule, 69 Fed. Reg. 45172, 45172 (proposed July 28, 2004) [hereinafter Proposed Hedge Fund Rule].

<sup>124</sup> The Commission received 161 responses from a variety of investment advisers, securities industry experts, legal professionals and investors. *See* Adopted Hedge Fund Rule, *supra* note 4, at 72058. Slightly more than 50% of the responses received opposed the rule. *Id.* at 72059. Only 25% were in support of it. *Id.*

<sup>125</sup> The dissenting Commissioners noted that the significance of the rule changes and the amount of interest warranted a longer comment period. *See id.* at 72090. They pointed out that ten commenting parties requested an extension of the comment period and the Commission denied that request and closed the comment period on September 15, 2004. *Id.* Another reason for extending the comment period was that federal agencies making up the PWG all had a stake in the rules making process and the Commission did not consult the other affected agencies such as the Department of Labor (which oversees private pension plan advisers). *See id.* at 72091.

of two Commissioners, the majority adopted the Hedge Fund Rule by a vote of 3-2.<sup>126</sup>

The dissenting Commissioners observed that the concerns of increased hedge fund fraud cited by the majority in the Hedge Fund Rule did not follow simply because of the overall growth in the industry.<sup>127</sup> The dissenters also analyzed the cited hedge fund fraud actions brought by the Commission concluding that the new rule would have prevented only a handful.<sup>128</sup> The majority was also criticized for failing to assess the costs to advisers who register and maintain an ongoing compliance operation.<sup>129</sup> The dissenters expressed reservations related to how the increased number of registrants would stretch the Commission's already over-worked investigatory arm.<sup>130</sup> There was also a fair deal of skepticism regarding the majority's retailization claims because one less invasive solution would be to raise the eligibility requirements for beneficial ownership.<sup>131</sup> Finally, the dissenting Commissioners, in what would ultimately prove to be the

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<sup>126</sup> See *id.* at 72054. Commissioners Glassman and Atkins dissented. See *id.* at 72089.

<sup>127</sup> *Id.* at 72091-92. The dissenters also noted that the SEC Staff Report, *supra* note 1, issued in 2003, did not identify "rampant fraud" or a dramatic upswing in retailization as concerns. Adopted Hedge Fund Rule, *supra* note 4, at 72089.

<sup>128</sup> Adopted Hedge Fund Rule, *supra* note 4, at 72092. The dissenters analyzed the forty-six fraud actions brought by the Commission prior to the Hedge Fund Rule passage and concluded that the new registration rule would not have independently revealed fraud because the funds held investments of less than \$25 million and would have never registered, were required to register under the Investment Company Act and failed to do so, were already engaged in known fraudulent activities, or were engaged in undetectable forms of fraud. See Proposed Hedge Fund Rule, *supra* note 123, at 45197-98.

<sup>129</sup> Even before the adoption of the Hedge Fund Rule, the potential costs of the rule change outweighed any benefits of increased information and protecting investors against fraud. See Greupner, *supra* note 40, at 1591-92 (noting that increased compliance costs would be passed from advisers along to the investors thus lowering returns or even putting smaller firms out of business and that the SEC would be under a greater burden to spread out already sparse resources investigate claims). The dissenting Commissioners also raised the issue of the Commission shifting the cost burden without providing a full empirical analysis of the effects. See Adopted Hedge Fund Rule, *supra* note 4, at 72094-95.

<sup>130</sup> See *id.* at 72093.

<sup>131</sup> *Id.* See also discussion *infra* notes 134 and 135. The dissenters were also skeptical of the majority's concerns about increased hedge fund investment by pension funds because less than 1 percent of the \$6.4 trillion invested in pension funds (as of 2004) was invested in hedge funds. See Adopted Hedge Fund Rule, *supra* note 4, at 72093.

rule's demise, termed the attempt to equate the statutory terms "client" and "investor" as arbitrary.<sup>132</sup>

Commentators also weighed in following the rule's passage. One concern was that the regulations would encourage offshore investment activities, effectively eliminating the ability of the Commission to monitor any activity and institute fraud investigations.<sup>133</sup> Another issue was that other regulatory options existed such as: (1) amending the definitions of accredited investor and qualified client;<sup>134</sup> (2) encouraging industry reform by issuing model disclosure recommendations for unregistered hedge funds;<sup>135</sup> and (3) requiring non-registering hedge fund managers to file notice regarding the relied upon exemptions.<sup>136</sup>

#### IV. THE GOLDSTEIN CASE

##### A. *Who is Phillip Goldstein?*

At the time of the filing of his suit Phillip Goldstein was a resident of New York and a fifty percent owner of the investment advisory firm, Kimball & Winthrop.<sup>137</sup> Kimball & Winthrop served as the investment

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<sup>132</sup> Adopted Hedge Fund Rule, *supra* note 4, at 72096 (noting that only the two year lock-up distinguished hedge funds from other private investment vehicles).

<sup>133</sup> See Dillmore, *supra* note 108, at 184.

<sup>134</sup> The idea behind modifying both definitions springs from the notion that if "wealth is used as a proxy for investor sophistication, the wealth requirement chosen should be adjusted periodically for inflation." Greupner, *supra* note 40, at 1593. Such an act would naturally price some investors out of the market, but would ultimately serve as low cost investor protection. *Id.* at 1594. It was also noted that the SEC had not adjusted the definition of accredited investor since 1982 (even though it did push the definition of qualified client upward to account for inflation in 1998). *Id.*; see also Adam R. Bolter, Note, *Regulation of Hedge Fund Advisers: A Valid Exercise of Rulemaking Authority or the Promulgation of New Law?*, 57 ADMIN. L. REV. 595, 617-18 (2005).

<sup>135</sup> The SEC could have issued a series of recommended disclosure guidelines because when "faced with the prospect of impending regulation, the majority of hedge fund managers will be willing to take on a recommended increase in disclosure to avoid the increased costs of regulation." Greupner, *supra* note 40, at 1595. As standards were accepted industry-wide the increased transparency would improve the ability of investors to spot fund managers engaged in fraudulent activities. *Id.*

<sup>136</sup> See Bolter, *supra* note 134, at 618-20 (discussing that the notification could include basic details such as the fund's investment policy, the minimum investment amount, fund's management and legal structure of the fund).

<sup>137</sup> Opening Brief of Petitioners Philip Goldstein, et. al. at Certificate, *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (No. 04-1434).

adviser for Opportunity Partners L.P. and was the firm's lone client.<sup>138</sup> Mr. Goldstein was the only hedge fund adviser to sue to block enforcement of the final rule.<sup>139</sup>

*B. Standard of Review for Administrative Rulings*

Judicial review of federal administrative regulations is controlled by both statute and case law. The Administrative Procedure Act ("APA") provides that agency regulations will be vacated as unlawful when the reviewing court determines the rule is "arbitrary, capricious, an abuse of discretion," or "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right."<sup>140</sup> Additionally, the two-part *Chevron* test sets forth the order of review by a court stating that "if the intent of Congress is clear . . . the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."<sup>141</sup> If the first prong is not met because of possible ambiguity, then the court must determine whether "the agency's answer is based on a permissible construction of the statute."<sup>142</sup> Statutory construction is evaluated based on the plain meaning of statute, the overall structure, the canons of construction, and legislative history.<sup>143</sup> In addition, departure from long standing precedent or policy

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<sup>138</sup> *Id.* at Certificate (citing 15 U.S.C. §§ 80b-1-21).

<sup>139</sup> Chris Clair, *The SEC Rule: Looking Back, Looking Ahead*, HEDGEWORLD DAILY NEWS, Aug. 9, 2006, 2006 WLNR 13786077.

<sup>140</sup> 5 U.S.C. § 706(2)(A),(C) (2000).

<sup>141</sup> *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). The D.C. Circuit states that "*Chevron* is principally concerned with whether an agency has authority to act under a statute." *Arent v. Shalala*, 70 F.3d 610, 615 (D.C. Cir. 1995). In addition, *Chevron* analysis "is focused on discerning the boundaries of Congress' delegation of authority to the agency; and as long as the agency stays within that delegation, it is free to make policy choices in interpreting the statute, and such interpretations are entitled to deference." *Id.*

<sup>142</sup> *Chevron*, 467 U.S. at 843. See also *Aid Ass'n for Lutherans v. U.S. Postal Service*, 321 F.3d 1166, 1174 (D.C. Cir. 2003). In this case, the postal service argued that the court should limit the *Chevron* inquiry to whether the regulation at issue was invalid on its face, and not analyze the "permissible construction" step. *Id.* The court rejected the argument stating that "an agency construction of a statute cannot survive judicial review if a contested regulation reflects an action that exceeds the agency's authority." *Id.* The court elaborated that "it does not matter whether the unlawful action arises because the disputed regulation defies the plain language of a statute or because the agency's construction is utterly unreasonable and thus impermissible." *Id.*

<sup>143</sup> See *Dunn v. Commodity Futures Trading Comm'n*, 519 U.S. 465, 470-78 (1997).

will also be evaluated.<sup>144</sup> The court of appeals often sets up its analysis by applying the APA when reviewing final agency decisions under the second prong of the *Chevron* test.<sup>145</sup>

Two cases were central to the arguments of both sides and the D.C. Circuit's subsequent analysis in *Goldstein*. First, in *Lowe v. SEC*,<sup>146</sup> the Supreme Court analyzed the Advisers Act to determine whether a newsletter publisher was an investment adviser under the Act.<sup>147</sup> The Commission contended that Lowe was not exempt from registration under the Act because the content of the newsletter was securities-related advice.<sup>148</sup> However, the Court held that the newsletter was not the type of advice that Congress intended to regulate through the Advisers Act because the newsletter did not "offer individualized advice attuned to any specific portfolio or to any clients particular needs."<sup>149</sup>

Second, in *Abrahamson v. Fleschner*,<sup>150</sup> the Second Circuit reviewed the Advisers Act to determine if the general partners of a limited partnership were investment advisers.<sup>151</sup> The plaintiffs were limited partners in a private fund created by Fleschner (who was also one of the general partners), but did not participate in the managing the partnership's investments.<sup>152</sup> The fund's investment strategy failed and the plaintiffs lost

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<sup>144</sup> See Nat'l Res. Def. Council, Inc. v. SEC, 606 F.2d 1031, 1049–50 n.23.

<sup>145</sup> See *Shays v. FEC*, 414 F.3d 76, 96–97 (D.C. Cir. 2005). The *Shays* decision provides a comprehensive example of the Court applying the *Chevron* test and APA § 706. In *Shays*, the court affirmed a lower court invalidation of Federal Election Commission rules related to campaign financing. *Id.* at 96.

<sup>146</sup> 472 U.S. 181 (1985).

<sup>147</sup> *Id.* at 183. The newsletter contained general recommendations for subscribers concerning the securities and bullion markets, reviews of investment strategies and advice on specific securities to buy, sell or hold. *Id.* at 185. It was not published on a regular schedule. *Id.*

<sup>148</sup> *Id.* at 184. The Commission also noted that Lowe was not registered under the Advisers Act. *Id.* In fact, the Commission had placed restrictions on his association with investment advisers because of Lowe's previous conviction for a host of crimes related to misappropriation of client funds, hiding the fraud of client and bank theft. *Id.* at 183.

<sup>149</sup> *Id.* at 208. The court also noted that the exclusion was limited to conditions in which communications remained "entirely impersonal" and did not develop "into the kind of fiduciary, person-to-person relationships" that Congress intended to regulate. *Id.* at 210.

<sup>150</sup> 568 F.2d 862 (2d Cir. 1977).

<sup>151</sup> *Id.* at 869–70.

<sup>152</sup> *Id.* at 866. The fund's reports portrayed a conservative investment strategy, but in reality, the fund was investing heavily in unregistered securities. *Id.* at 867.

a considerable amount of their investments.<sup>153</sup> In concluding that the general partners fulfilled the requirements of investment advisers, the court noted that Congress intended to reach “persons who receive compensation for investing funds of their clients.”<sup>154</sup> However, *Abrahamson* is also noteworthy for what was omitted from the court’s final opinion. The Commission pointed out in its brief that the original *Abrahamson* opinion included language that the general partners were investment advisers to the limited partners.<sup>155</sup>

### C. The Court’s Analysis

#### 1. Did Congress Intend to Leave “Client” Undefined?

The D.C. Circuit opened its discussion by addressing the definable boundaries of what constituted a client under section 203(b)(3) of the Advisers Act. It was not persuaded by the Commission’s argument that the lack of a statutory definition rendered the statute ambiguous.<sup>156</sup> The court stated that “the lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous, just as the presence of a definition does not necessarily make the meaning clear.”<sup>157</sup> Further, the court noted that “if Congress employs a term susceptible of several meanings, as many terms are, it scarcely follows that Congress has authorized an agency to choose any one of those meanings.”<sup>158</sup>

The court then engaged in a lengthy discussion of how the term client may be construed in different contexts. It pointed out that the specific indicia of a client relationship such as contracts, fees, and duties vary not only by profession (lawyer, banker or architect), but also by particular

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<sup>153</sup> *Id.*

<sup>154</sup> *Id.* at 871.

<sup>155</sup> Brief of SEC at 23, 26, *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (No. 04-1434).

<sup>156</sup> *Id.* at 20–21. The Commission was responding to Goldstein’s charge that the definition of client was clear and unambiguous and that the Commission and that the Hedge Fund Rule “transmogrified the term ‘client’ to include security holders who have invested in a hedge fund.” Opening Brief of Petitioners, *supra* note 137, at 28. Specifically, Goldstein pointed out that when Congress created the Investment Company Act exemption in 15 U.S.C. § 80a-3(c)(1) it used the words “security holders” and not “client.” *Id.* at 27.

<sup>157</sup> *Goldstein*, 451 F.3d at 878.

<sup>158</sup> *Id.* The determination of whether Congress has foreclosed the agency’s interpretation ultimately depends on reading the words of the statute in context, assessing where the statute fits into the overall statutory scheme, and the overall issue Congress sought to remedy. *Id.* (citing *PKD Labs. Inc. v. DEA*, 362 F.3d 786, 796 (D.C. Cir. 2004)).

circumstance.<sup>159</sup> This introduction to the many definitions of client led to a longer discussion concerning one of the Commission's key arguments—that 1980 amendment to section 203(b)(3) suggested a desire by Congress to count hedge fund investors as clients of the fund adviser.<sup>160</sup> The court then opined that the language in question was inserted against a backdrop of uncertainty created by the *Abrahamson* decision in which the final published opinion omitted language that made limited partners the clients of the general partners.<sup>161</sup> The court reasoned that such an omission suggested “that the [*Abrahamson*] court expressly declined to resolve any ambiguity in the term, client.”<sup>162</sup>

However, the court did note that the legislative history of the 1980 amendment presented at least the possibility that Congress acknowledged that client could be an ambiguous term.<sup>163</sup> In a related footnote the D.C. Circuit found irony in the fact that the Commission in 1985 relied on the same 1980 amendment to establish the Safe Harbor Provision “allowing advisers to count certain limited partnerships as single clients specifically in order to provide ‘greater certainty’ about the meaning of the term.”<sup>164</sup> The court then analyzed a 1970 amendment to section 203(b)(3) that, to it, reflected “Congress’s understanding at the time that investment company entities, not their shareholders, were the advisers’ clients.”<sup>165</sup>

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<sup>159</sup> *Id.*

<sup>160</sup> *Id.* The court directly quoted Pub. L. No. 96-477, § 202, 94 Stat. 2275, 2290 (1980), as follows: “For purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company . . . shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner.” *Id.*

<sup>161</sup> See *Abrahamson v. Fleschner*, 568 F.2d 862, 862 (2d Cir. 1977). The Commission argued that the *Abrahamson* decision coupled with the 1980 amendment provided sufficient support for its proposition that section 203(b)(3) was “open to interpretation.” Brief of SEC, *supra* note 155, at 22.

<sup>162</sup> *Goldstein*, 451 F.3d at 879.

<sup>163</sup> *Id.* The court was skeptical of this point noting that there is a danger to inferring the intent of an earlier Congress using the views of a later one. *Id.*

<sup>164</sup> *Id.* at 879 n.5.

<sup>165</sup> *Id.* at 879. *Goldstein* argued that the 1970 amendment’s exclusion of advisers who sole clients were registered investment companies showed that Congress understood security holders of an investment were not the same thing as client’s of the investment adviser. Opening Brief of Petitioners, *supra* note 137, at 34. The 1970 amendment can be found at Investment Company Amendments Act of 1970, Pub. L. No 91-547 § 24.

Next, the court looked to other sections of the Advisers Act to foreclose the notion that Congress intended for hedge fund shareholders, limited partners, members, or beneficiaries to be individually counted as clients.<sup>166</sup> Reviewing the Advisers Act definition of investment adviser, the court stated that while “an investor in a private fund may benefit from the adviser’s advice (or he may suffer from it) but he does not receive the advice *directly*.”<sup>167</sup> The court supported this statement by positing that individuals invest assets in the hedge fund and that the adviser controls the fund’s capital.<sup>168</sup> The D.C. Circuit discussed further that advisers do not instruct investors on what to buy because the investor has already purchased fund shares,<sup>169</sup> and noted that as recently as 1997, the Commission agreed with this position.<sup>170</sup>

The Commission did score a point in its favor. The court agreed that Goldstein’s interpretation of *Lowe* was incorrect.<sup>171</sup> Despite the Supreme Court’s references to client, *Lowe* centered upon other exceptions to the definition of investment adviser under the Advisers Act.<sup>172</sup> However, the court noted that *Lowe* generally supported its position that the relationship between investment advisers and hedge funds was directly related to whose interests the adviser served—the fund’s overall performance and not the individual investor’s needs.<sup>173</sup>

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<sup>166</sup> *Goldstein*, 451 F.3d at 879.

<sup>167</sup> *Id.* (emphasis retained).

<sup>168</sup> *Id.* at 879–80.

<sup>169</sup> *Id.* at 880. The Court noted that “[h]aving bought into the fund, the investor fades into the background; his role is completely passive.” *Id.*

<sup>170</sup> *Id.* at 880 (citing 1997 SEC report which stated that an investment advisor to an investment company does not need to consider individual investors needs when directing the portfolio). The court also revisited the 1985 Safe Harbor Provision adoption language concluding that it was similar to the 1997 SEC report. *Id.*

<sup>171</sup> *Id.* Goldstein asserted that the Supreme Court in *Lowe* interpreted client to mean a personalized relationship with an advisor. Opening Brief of Petitioners, *supra* note 137, at 31. The Commission countered by pointing out that *Lowe* dealt with an entirely different statutory exclusion under the Advisers Act, 15 U.S.C. § 80b-2(11)(d) (2000), for publishers of bona fide newspapers, magazines, etc. Brief of SEC, *supra* note 155, at 34. This provision did not mention client and the court did not discuss or provide a definition. *Id.* at 36.

<sup>172</sup> *Goldstein*, 451 F.3d at 880.

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

2. *Was the Hedge Fund Rule a Reasonable Exercise of SEC Rule-Making Authority?*

The D.C. Circuit then moved forward through its *Chevron* analysis by accepting the ambiguity arguments<sup>174</sup> in order to discuss the reasonableness of the rule. The court opened this section by stating that even if it accepted the Commission's interpretation of client, "the interpretation falls outside the bounds of reasonableness."<sup>175</sup> The court reasoned that the Commission's interpretation of client came close to violating the plain language of the statute.<sup>176</sup> In the court's eyes, the Hedge Fund Rule was at its very best "counterintuitive" in its characterization of hedge fund investors as clients of the adviser<sup>177</sup> given the fiduciary responsibilities set forth in Advisers Act section 206.<sup>178</sup>

The panel was unimpressed with the Commission's response to the concerns over conflicting fiduciary duties stating, "if the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest."<sup>179</sup> The court then directly quoted the Hedge Fund Rule's language concerning duty of loyalty<sup>180</sup> to

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<sup>174</sup> The court conceded that a possible ambiguity existed at least in the sense that the definition of client changed over time. *Id.* The court has shown a propensity to run a full *Chevron* analysis in the past, even when there is little to support a holding that Congress's intent is unclear. *American Bar Ass'n v. FTC*, 430 F.3d 457, 471–72 (D.C. Cir. 2005). In this case, the court addressed a FTC regulation regarding financial institutions that arguably reached to practicing attorney. *Id.* The court observed that while it could not conclude that Congress intended to leave sufficient ambiguity to support a deferential review, "the interpretation is not reasonable even if we afford it deference," and then proceeded through the second step of the *Chevron* analysis, ultimately deciding that the regulation was not reasonable. *Id.* at 472.

<sup>175</sup> *Goldstein*, 451 F.3d at 881. The court's test for reasonableness of agency construction included the fit of the rule with the statutory language and conforming to statutory goals. *Id.*

<sup>176</sup> *Id.*

<sup>177</sup> *Id.*

<sup>178</sup> *Id.* 15 U.S.C. § 80b-6(2) (2000), makes it unlawful for an investment advisor to undertake fraudulent activities against a client.

<sup>179</sup> *Goldstein*, 451 F.3d at 881. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192 (1963) sets forth the widely-accepted fiduciary duty to provide disinterested advice.

<sup>180</sup> The Hedge Fund Rule stated that the duty of loyalty "requires advisers to manage their clients' portfolios in the best interests of the clients." Adopted Hedge Fund Rule, *supra* note 4, at 72054. In addition, the duty requires the adviser to "fully disclose any  
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highlight the conflict of interest that the rule created for investment advisers.<sup>181</sup> Of prime concern for the court was the fact that while the individual investors may benefit from the adviser's actions, requiring the adviser to serve both the entity and the individual investor was a practical impossibility.<sup>182</sup> Nor was the court persuaded by the Commission's attempt to argue that the Hedge Fund Rule only changed the method for counting clients under the Advisers Act section 203(b)(3) and that it did not alter other obligations owed by advisers to clients.<sup>183</sup>

The court finally reasoned that the rule "might be more understandable if, over the years, the advisory relationship between hedge fund advisers and investors had changed."<sup>184</sup> However, in the court's view the Commission offered only evidence of general trends to support its comprehensive regulation,<sup>185</sup> and noted that the dissenting Commissioners came to the same general conclusion.<sup>186</sup> Minus a transformation in the relationship between fund adviser and investors, there was a "disconnect between the factors the Commission cited and the rule it promulgated."<sup>187</sup> The Commission's argument that the differences among individual investor accounts<sup>188</sup> justified counting of each investor separately was rejected as illogical because none of the cited differences explained how the relationship actually changed.<sup>189</sup> Moreover, none of the proffered

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material conflicts the adviser has with clients, to seek the best execution for client transactions, and to have a reasonable basis for client recommendations." *Id.*

<sup>181</sup> The court analogized the non-client individual hedge fund investor—investment adviser relationship to that of shareholders of a corporation not being considered clients of the of the corporation's lawyers or accountants. *Goldstein*, 451 F.3d at 881.

<sup>182</sup> Both the Hedge Fund Rule and the Commission's oral argument attempted to rely on *Abrahamson* to assert the proposition that hedge fund advisers owed fiduciary duties to individual advisers. *Id.* The court rejected this argument noting that *Abrahamson* stood merely for the premise that hedge fund investors could bring a fraud action against a hedge fund. *Id.*

<sup>183</sup> "The Commission cannot explain why 'client' should mean one thing when determining to whom fiduciary duties are owed, 15 U.S.C. § 80b-6(1)–(3) (2000), and something else entirely when determining whether an investment adviser must register under the [Advisers] Act . . ." *Id.* at 882 (internal citations omitted).

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

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

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

<sup>187</sup> *Id.*

<sup>188</sup> Adopted Hedge Fund Rule, *supra* note 4, at 72069–70.

<sup>189</sup> *Goldstein*, 451 F.3d at 883.

reasons by the SEC supported a holding.<sup>190</sup> Looking at the entire picture, the D.C. Circuit held that the rule was arbitrary under a *Chevron* analysis, and it was, therefore invalid.<sup>191</sup>

#### V. THE SEC & HEDGE FUND REGULATION 2007: TAKE TWO

The Commission announced in early August 2006 that it did not intend to seek an en banc review of the decision and neither would it petition the U.S. Supreme Court for a writ of certiorari.<sup>192</sup> Chairman Cox stated that “since the appellate court’s decision was based on multiple grounds and was unanimous, further appeal would be futile and would simply delay and distract from our goal of advancing investor protection.”<sup>193</sup>

However, the court in *Goldstein* did not foreclose the broader purposes of regulation stating “more comprehensive regulation of hedge funds may be understandable.”<sup>194</sup> The court simply refused to allow the Commission to “accomplish its objective by a manipulation of meaning” via a special definition of client for just section 203(b)(3).<sup>195</sup>

Even before announcing the Commission’s decision to not appeal the *Goldstein* ruling, Chairman Cox presented two hedge fund related rule proposals in his July 2006 testimony to Congress.<sup>196</sup> First, he stated that the Commission was contemplating a new Advisers Act antifraud rule that would have the effect of “looking through” a hedge fund to its investors.<sup>197</sup> Second, the Chairman expressed concern that one of the primary benefits of the Hedge Fund Rule, the increase to \$1.5 million (from the pre-rule threshold of \$1 million) of net worth for accredited investor determination,

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<sup>190</sup> The SEC could not justify a mandatory adviser registration requirement for only investment companies with 99 or fewer investors but more than 14 in light its accepted interpretation of the Safe Harbor Rule. *Id.* at 883. Additionally, the SEC’s argument that hedge funds explosive growth over the last fifteen years did not justify counting clients individually because, the number of investors in a fund was not an accurate measure of the fund’s assets or activities. *Id.*

<sup>191</sup> *Id.* at 884.

<sup>192</sup> Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in *Phillip Goldstein, et al. v. SEC* (Aug. 7, 2006), <http://www.sec.gov/news/press/2006/2006-135.htm>.

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

<sup>194</sup> *Goldstein*, 451 F.3d at 882.

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

<sup>196</sup> *Regulation of Hedge Funds*, *supra* note 2.

<sup>197</sup> *Id.*

was thrown out with the *Goldstein* decision.<sup>198</sup> Chairman Cox also stressed that “notwithstanding the *Goldstein* decision, it is important to point out that hedge funds today remain subject to SEC regulations and enforcement under the antifraud, civil liability, and other provisions of the federal securities laws.”<sup>199</sup> His final point was that the Commission “will continue to vigorously enforce the federal securities laws against hedge funds and hedge fund advisers who violate those laws. Hedge funds are not, should not be, and will not be unregulated.”<sup>200</sup>

#### A. De-registration

Prior to the *Goldstein* ruling, thousands of hedge fund advisers filed registration papers with the SEC.<sup>201</sup> The funds sunk countless hours and large sums of money into setting up compliance systems.<sup>202</sup> The Commission also faced the “difficulty of reversing the effects of a regulation once it gets into the rulebooks.”<sup>203</sup> In August 2006, the Commission provided no-action relief to advisers required to register under the invalidated Hedge Fund Rule.<sup>204</sup> De-registration would be available to all hedge fund advisers who filed with the SEC by February 1, 2007.<sup>205</sup> Those fund advisers that remain registered would be subject to all provisions of the Advisers Act.<sup>206</sup> To encourage advisers to remain registered, the Commission extended certain exceptions available in the

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<sup>198</sup> *Id.*

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

<sup>201</sup> See Clair, *supra* note 139. It is worth noting that some advisers avoided registration by taking advantage of the two-year lockup. See *supra* note 112 and accompanying text. See also Remarks Before EDHEC Alternative Investment Days 2007 by SEC Commissioner Paul S. Atkins (Nov. 20, 2007) [hereinafter EDHEC Remarks], <http://www.sec.gov/news/speech/2007/spch112007psa.htm> (“Oddly, the rule allowed advisers to avoid registration by extending their lock-up periods beyond two years. Two years was deemed to be the magic line that distinguished advisers to hedge funds from advisers to other types of funds, such as venture capital or private equity funds.”).

<sup>202</sup> See Clair, *supra* note 139.

<sup>203</sup> Remarks Before the 9th Annual Alternative Investment Roundup by SEC Commissioner Paul S. Atkins (Jan. 29, 2007) [hereinafter Alternative Investment Roundup Remarks], <http://www.sec.gov/news/speech/2007/spch012907psa.htm>.

<sup>204</sup> No Action Letter sent to ABA (Aug. 10, 2006), <http://www.sec.gov/divisions/investment/noaction/aba081006.pdf>.

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

<sup>206</sup> *Id.*

defunct Hedge Fund Rule.<sup>207</sup> In the end approximately 350 advisers withdrew.<sup>208</sup>

*B. Increased Enforcement*

In July 2007, Chairman Cox announced the creation of a Hedge Fund Working Group (HFWG) inside the Enforcement Division.<sup>209</sup> One of the group's primary responsibilities is to "coordinate and enhance our efforts to combat hedge fund insider trading, including by working with other federal law enforcement agencies and self-regulatory organizations."<sup>210</sup>

One of HFWG's top enforcement priorities is to root out trading abuses by hedge funds.<sup>211</sup> Trading abuses, as defined by the SEC include insider trading, misuses of Private Investment in Public Equity transactions, and improper Regulation M short sales.<sup>212</sup> Recent insider trading cases dealt with a research analyst tipping hedge fund managers of upcoming brokerage transactions and two instances in which using hedge funds were used to mask trading based on insider tips between family members.<sup>213</sup> In these instances, parallel criminal charges were also brought.<sup>214</sup>

The overall number of SEC enforcement actions related to hedge funds is also on the rise. As early as 2005 (prior to the creation of the HFWG),

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<sup>207</sup> The exceptions for advisors choosing to remain registered included (1) ensuring that "substantive provisions of the [Advisers] Act do not apply to offshore advisers with respect to such advisers' dealings with offshore funds and other offshore clients[.]" (2) not requiring an adviser to a private fund "to maintain books and records . . . to support the performance of any private fund or other account for any period ended prior to February 10, 2005[.]" and (3) reviving certain performance-based compensation exemptions. *Id.*

<sup>208</sup> Alternative Investment Roundup Remarks, *supra* note 203.

<sup>209</sup> *The State of the Securities Markets: Before the U.S. Senate Committee on Banking, Housing and Urban Affairs*, 110th Cong. (July 31, 2007) [hereinafter *The State of the Securities Markets Testimony*] (statement of SEC Chairman Christopher Cox), available at <http://www.sec.gov/news/testimony/2007/ts073107cc.htm>.

<sup>210</sup> *Id.*

<sup>211</sup> *Id.* Stephen G. Stroup, SEC's Hedge Fund Working Group Actively Targets Trading Abuses 1 (June 2008), pdf available at <http://www.drinkerbiddle.com/publications/Detail.aspx?pub=1636>.

<sup>212</sup> *The State of the Securities Markets Testimony*, *supra* note 209. See also Stroup, *supra* note 211, at 1.

<sup>213</sup> *The State of the Securities Markets Testimony*, *supra* note 209. See also Stroup, *supra* note 211, at 1–2.

<sup>214</sup> *The State of the Securities Markets Testimony*, *supra* note 209. See also Stroup, *supra* note 211, at 1–2.

the number of enforcement actions targeted at hedge funds stood at twenty-nine.<sup>215</sup> In 2007, the SEC brought twenty-one actions.<sup>216</sup> In contrast, ten were brought in 2002<sup>217</sup> and four were brought in 2001.<sup>218</sup>

Certainly, rooting out fraud of any type is an important task. It is often a difficult and time intensive one as well. Most fraudulent schemes are designed to evade the existing regulatory system and often are only discovered through tips<sup>219</sup> or when the schemes fail.<sup>220</sup> Another concern is that the Commission must spread resources across a number of regulatory and enforcement initiatives.<sup>221</sup>

### C. New Rules Proposed

In December 2006, the Commission proposed two new rules<sup>222</sup> first mentioned by Chairman Cox during his July remarks to Congress. These

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<sup>215</sup> Kara Scannell, *Moving the Market: Lawmaker Urges U.S. to Step up Hedge-Fund Probe*, WALL ST. J., June 29, 2006, at C3.

<sup>216</sup> Sidley Austin LLP, Highlights from “SEC Speaks” 2008 27 (Mar. 2008), pdf available at <http://www.sidley.com/clientupdates/Detail.aspx?news=3505>.

<sup>217</sup> Scannell, *supra* note 215.

<sup>218</sup> *Regulation of Hedge Funds*, *supra* note 2.

<sup>219</sup> “[T]he SEC relies heavily on investor tips in pointing us to wrongdoing by hedge fund advisors.” EDHEC Remarks, *supra* note 201.

<sup>220</sup> For instance, the hedge fund firm Bayou Management LLC failed in August 2005 amidst claims of fraud. Gretchen Morgenson, *What Really Happened at Bayou*, N.Y. TIMES, Sept. 17, 2005, at C1. In 1998, the fund managers created an accounting firm (chaired by one of the fund’s principals) that issued fake audit documents to investors. *Id.* The falsified records covered up mounting losses by the firm. *Id.* Not surprisingly, the scheme failed, but not before ensnaring many unsuspecting investors. *Id.* Investor losses were almost \$500 million. Paredes, *supra* note 29, at 985.

In February 2006, prosecutors discovered the principal of the hedge fund firm International Management Associates LLC provided “blatantly false” financial information to investors in order to cover up investment losses. Ian McDonald & Valerie Bauerlein, *Southern Discomfort: Troubles at Atlanta Hedge Fund Snare Doctors, Football Players*, WALL ST. J., Mar. 9, 2006, at A1. The fraud came to light when an internal accountant contacted one of the firm’s partners to report “the apparent falsification of investment returns.” *Id.* Investors lost \$150 million. *Money-Scam Figure Is Dead*, WALL ST. J., May 27, 2008, at C12.

<sup>221</sup> See Paredes, *supra* note 29, at 1007 n.124 (discussing in the context of examinations that “[r]egulating hedge funds, for example, may divert resources that could be better spent on, for example, mutual fund regulation”).

<sup>222</sup> See *supra* notes 12 & 13 and accompanying text.

proposals generated a significant amount of comments and, ultimately, only one of the rules has been enacted.

*1. Antifraud Rule*

The Commission proposed, and later adopted, rule 206(4)-8.<sup>223</sup> The text of the rule contains the following prohibitions for advisers to a pooled investment vehicle:

It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business . . . for any investment advisor to a pooled investment vehicle to:

(1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

(2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.<sup>224</sup>

The statutory authority cited for this rule derives from section 206(4) of the Advisers Act.<sup>225</sup> Section 206(4) states that it is unlawful for an adviser “to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall . . . by rules

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<sup>223</sup> The new rule was adopted as proposed on August 9, 2007. See Adopted Antifraud Rule, *supra* note 15, at 44756–57. The new rule went into effect on September 10, 2007. *Id.* at 44756.

<sup>224</sup> 17 C.F.R. § 275.206(4)-8 (2008). Commissioner Atkins summed up the general scope of the rule as “Thou shalt not rip off thy limiteds.” Remarks Before the Federal Reserve Bank of Chicago Seventh Annual Private Equity Conference by SEC Commissioner Paul S. Atkins (Aug. 2, 2007), <http://www.sec.gov/news/speech/2007/spch080207psa.htm>.

<sup>225</sup> Adopted Antifraud Rule, *supra* note 15, at 44757. Section 206(4), 15 U.S.C. § 80b-6(4) (2000), permits the SEC to create rules that prevent investment advisers from engaging “in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.” As such, this section gives broad rulemaking powers to the SEC to address a wide variety of statements and conduct on the part of investment advisers. The Commission noted the *Goldstein* decision limited its statutory authority to regulate hedge funds under section 203(b)(3), but not under 206(b)(4). Adopted Antifraud Rule, *supra* note 15, at 44756–57.

and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.”<sup>226</sup> The new rule covers unregistered advisers, like hedge fund advisers, who have not always been subject to the general antifraud provisions of the Advisers Act.<sup>227</sup> In addition, the new regulation applies to both actual and prospective investors (thus covering communications made to prospective investors).<sup>228</sup>

The rule 206(4)-8 comment period lasted through early March and it was adopted as proposed in August 2007.<sup>229</sup> Not surprisingly, commenters objected to the broad scope of the rule in a variety of contexts. First, the Commission rejected the claim that the rule should not apply to prospective investors, noting that the new rule is based on sections 206(1) and (2) of the Advisers Act.<sup>230</sup> Other comments posited that the SEC had only the authority to proscribe specific fraudulent conduct and, therefore, must identify what constituted violative acts.<sup>231</sup> This proposal was rejected because the Commission drew authorization from section 206(4) to draw the rule “to apply more broadly to deceptive conduct that may not involve statements.”<sup>232</sup>

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<sup>226</sup> 15 U.S.C. § 80b-6(4).

<sup>227</sup> Adopted Antifraud Rule, *supra* note 15, at 44757–58. In its proposing release the Commission acknowledged that rule 206(4)-8 is an exception to the general SEC practice of not applying section 206(4) to unregistered advisers in favor of state regulation under the NSMIA. 2007 Proposed Rules, *supra* note 12, at 402. The Commission stated that the general practice of delegation is still in effect, and that it believed the provision was written broadly enough to escape possible complaints that it banned specific practices. *Id.* Two commenters objected to this provision. Adopted Antifraud Rule, *supra* note 15, at 44758.

<sup>228</sup> Adopted Antifraud Rule, *supra* note 15, at 44757–58.

<sup>229</sup> *Id.* at 44757. The Commission received forty-five comments regarding Rule 206(4)-8, only eighteen of which endorsed the rule as it was proposed. *Id.*

<sup>230</sup> *Id.* at 44758–59. “False or misleading statements and other frauds by advisers are no less objectionable when made in an attempt to draw in new investors than when made to existing investors.” *Id.* at 44758.

<sup>231</sup> *Id.* at 44759. It is worth noting that the other rules in 17 C.F.R. § 275.206(4) (2008), prohibit specific fraudulent conduct in areas such as advertising (§ 275.206(4)-1), custody of funds (§ 275.206(4)-2), (§ 275.206(4)-3), financial and disciplinary information disclosures (§ 275.206(4)-4), proxy voting. (§ 275.206(4)-6), and compliance procedures (§ 275.206(4)-7).

<sup>232</sup> Adopted Antifraud Rule, *supra* note 15, at 44759. The Commission reasoned that identifying specific conduct would by definition exempt other possible activity not enumerated in the rule and “could provide a roadmap for those wishing to engage in fraudulent conduct.” *Id.*

Finally, commenters objected to the Commission's statement that it would not be required to show that advisers violating rule 206(4)-8 "acted with scienter."<sup>233</sup> The Commission, in the adopting release, stated that negligence was the acceptable standard.<sup>234</sup> The adopting release argued that section 206(4) reached conduct "that is negligently deceptive as well as conduct that is recklessly or deliberately deceptive."<sup>235</sup> To further support this concept the Commission quoted language from *SEC v. Steadman*,<sup>236</sup>—"scienter is not required under section 206(4)."<sup>237</sup> The Commission also relied on the *United States v. O'Hagan*<sup>238</sup> holding to support its belief that "use of a negligence standard also is appropriate as a method reasonably designed to prevent fraud."<sup>239</sup>

Commissioner Atkins concurred with adoption of the new rule, but disagreed "that a negligence standard is consistent with the Commission's authority under [s]ection 206(4)."<sup>240</sup> He noted that section 206(4) included the term "manipulative"—a term that the Supreme Court has taken to include "intentional or willful conduct designed to deceive or defraud investors."<sup>241</sup>

He further pointed out that the *Steadman* holding cited by the Commission was not as straightforward a supporting precedent as the adopting release made it appear. The underpinning of the *Steadman* no scienter requirement in section 206(4) came from a comparison of language in section 17(a)(3) not present in section 206(4).<sup>242</sup> The

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<sup>233</sup> *Id.* The Commission admitted that this was a deviation from similar rules such as 10b-5 under the Exchange Act. *Id.*

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

<sup>235</sup> *Id.*

<sup>236</sup> 967 F.2d 636 (D.C. Cir. 1992).

<sup>237</sup> Adopted Antifraud Rule, *supra* note 15, at 44759 (quoting *Steadman*, 967 F.2d at 647).

<sup>238</sup> 521 U.S. 642 (1997).

<sup>239</sup> Adopted Antifraud Rule, *supra* note 15, at 44759. The Commission looked to *O'Hagan* to establish that it had the authority to ban acts that are, per the *O'Hagan* holding, "not themselves fraudulent under the common law or § 10(b) if the prohibition is 'reasonably designed to prevent . . . acts and practices [that] are fraudulent.'" 521 U.S. at 673 (internal citations omitted).

<sup>240</sup> Adopted Antifraud Rule, *supra* note 15, at 44761.

<sup>241</sup> *Id.* at 44762 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)).

<sup>242</sup> The *Steadman* Court compared sections 17(a)(3) and 206(4) of the Advisers Act. *Steadman*, 967 F.2d at 647. Section 17(a)(3) stated that it was illegal "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." 15 U.S.C. § 77q(a)(3) (2000). Commissioner Atkins pointed

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Commissioner also offered that the history of section 206(4) showed that it derived from section 15(c)(2) of the Exchange Act, and that section 15(c)(2) also prohibited brokers or dealers from “engag[ing] in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation.”<sup>243</sup> The *Steadman* holding did not compare these two sections.<sup>244</sup>

Finally, Commissioner Atkins distinguished *O’Hagan* and *Steadman* from the current rule. The rules at issue in the cases were “narrowly targeted . . . [and] covered clearly-defined behavior.”<sup>245</sup> In contrast, rule 206(4)-8(a)(2) was so broad that it “essentially repeats the statutory prohibition.”<sup>246</sup> Therefore, Commissioner Atkins concluded that implementing the negligence standard was nothing more than rewriting the statute.<sup>247</sup>

## 2. Accredited Natural Person Proposal

In December 2006, the Commission also proposed two new rules under its 1933 Act authority, rules 216 and 509, that would create a new category of accredited investor called the “accredited natural person.”<sup>248</sup> The new category of investor would apply to offers and sales of securities issued by “private investment vehicles” to accredited investors under the 1933 Act.<sup>249</sup> The accredited natural person would have to meet the

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out that *Steadman’s* reliance on a formulation of section 17(a)(3) from *Aaron v. SEC*, 446 U.S. 680 (1980) was not dispositive because *Aaron* “placed considerable weight on the terms ‘operate’ or ‘would operate,’ neither of which appears in [s]ection 206(4).” Adopted Antifraud Rule, *supra* note 15, at 44762.

<sup>243</sup> Adopted Antifraud Rule, *supra* note 15, at 44762 (quoting 15 U.S.C. 78o(c)(2) (2000)).

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

<sup>245</sup> *Id.* at 44763.

<sup>246</sup> *Id.*

<sup>247</sup> *Id.* This is in contrast to the claim contained in adopting release that under *O’Hagan* negligence is a method “reasonably designed to prevent fraud.” *Id.* at 44759.

<sup>248</sup> See 2007 Proposed Rules, *supra* note 12, at 405. See *supra* Part II.C.1 for details regarding how the accredited investor status fits into the regulation of hedge funds under the 1933 Act. The term accredited natural person would mean any natural person who meets either the net worth or income test specified in 17 C.F.R. § 230.501(a) (2008) or 17 C.F.R. § 230.215 (2008), as applicable, and who owns at least \$2.5 million in investments individually or jointly with a spouse. 2007 Proposed Rules, *supra* note 12, at 405.

<sup>249</sup> The Commission noted that the proposed rule applies to only investment companies under section 3(c)(1). 2007 Proposed Rules, *supra* note 12, at 405. Existing rules and net

(continued)

existing accredited investor rules and, at the time of investment, own at least \$2.5 million in investments.<sup>250</sup> The \$2.5 million figure would index to inflation every five years from the date of the rules' adoption.<sup>251</sup> The Accredited Natural Person Proposal would not apply to existing accredited investors who do not meet the proposed accredited natural person rules.<sup>252</sup>

The Commission's rationale for the Accredited Natural Person Proposal centered on individual investor protection. First, the proposing release reiterated the long-held concerns that individual investors are neither privy to information related to the complex trading strategies of hedge funds nor might they understand the risks associated with investing in such funds.<sup>253</sup> Second, the Commission claimed adequate investor protections "may be lacking" under Investment Company Act section 3(c)(1).<sup>254</sup> The proposing release analogized the accredited natural person to the two-step approach employed for investment pools under section 3(c)(7).<sup>255</sup> Finally, the proposing release noted that 1.87% of U.S. households met the accredited investor rule when the rule was adopted in 1982.<sup>256</sup> This percentage increased to 8.74% by 2003.<sup>257</sup> By implementing the proposed rule, the Commission estimated 1.3% of households would qualify as natural accredited persons, which was "appropriate given the increasing complexity of financial products, in general, and hedge funds, in particular, over the last decade."<sup>258</sup>

The proposed rule generated over 600 comments.<sup>259</sup> The commenters touched on a variety of concerns some of which included (1) wealth not

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worth guidelines govern section 3(c)(7) companies such as venture capital funds which are exempted from the proposed rule. *Id.*

<sup>250</sup> *Id.*

<sup>251</sup> *Id.*

<sup>252</sup> *Id.* at 406. Therefore, these individual would still be eligible to continue investing in private investment pools. *Id.*

<sup>253</sup> *Id.* at 404.

<sup>254</sup> *Id.* at 404. Hedge funds may fall under either section 3(c)(1) or 3(c)(7) of the Investment Company Act. *See supra* Part II.C.3.

<sup>255</sup> 2007 Proposed Rules, *supra* note 12, at 404. The two-step approach requires that the natural person own at least \$5 million in investments at the time of investment, and in order for the investment company to take advantage of the Safe Harbor Provision, qualified investors must also be accredited investors. *Id.*

<sup>256</sup> *Id.* at 406.

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

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

<sup>259</sup> Adopted Antifraud Rule, *supra* note 15, at 44757 n.7.

being an accurate predictor of investor savvy; (2) the proposed rule unfairly favored investors based solely on wealth classifications; and (3) the SEC's time would be better spent rooting out fraud in the trading markets.<sup>260</sup> Commissioner Atkins pointed out that the rule, by way of shrinking the number of potential investors, might close out new hedge fund advisers "without much of a track record," and, thus, "may prove to be a barrier to entry."<sup>261</sup> In August 2007, the Commission admitted that many of the commenters "generally disfavored our proposal."<sup>262</sup> It also noted that no further action would be taken while the Commission solicited additional comments.<sup>263</sup>

## VI. HEDGE FUND INDUSTRY POST-*GOLDSTEIN*

Besides SEC activity, other events following the *Goldstein* case are relevant to the ongoing hedge fund regulation debate.

### A. *Bad Bets Sink Hedge Funds*

A 2006 report detailed the three main causes of hedge fund failure:

- *financial issues*, or losses stemming from unfavorable market moves;
- *operational issues*, such as errors in trade processing or mispricing complex, opaque financial instruments; and
- *fraud*, or misbehavior by fund management.<sup>264</sup>

The most common cause is most likely the first; although, in many cases when hedge funds fail they dissolve, return money to investors, and

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<sup>260</sup> Bethany McLean, *SEC Slammed Over Hedge Fund 'Wealth' Test*, FORTUNE, Feb. 11, 2007, available at <http://money.cnn.com/2007/02/11/magazines/fortune/sec.fortune/index.htm?postversion=2007021117>.

<sup>261</sup> Alternative Investment Roundup Remarks, *supra* note 203.

<sup>262</sup> Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. 45116, 45117 (proposed Aug. 10, 2007).

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

<sup>264</sup> Mark Jickling & Allison A. Raab, CRS Report for Congress: Hedge Fund Failures 3 (Dec. 2006) [hereinafter Hedge Fund Failure Report], available at [https://www.policyarchive.org/bitstream/handle/10207/3026/RL33746\\_20061204.pdf?sequence=1](https://www.policyarchive.org/bitstream/handle/10207/3026/RL33746_20061204.pdf?sequence=1). This report details domestic and international hedge fund failures in all three categories from 2000 to 2006. For a discussion of cases involving fraud see *supra* note 220.

nothing is publicly reported.<sup>265</sup> Losses due to “sudden or severe” market fluctuations are usually of the type that are reported in the media and receive government scrutiny.<sup>266</sup>

Long-Term Capital was the first documented large-scale failure of a hedge fund due to financial issues.<sup>267</sup> Yet one subsequent failure proved to be more costly, even if not as dangerous to the overall financial markets. In September 2006, a hedge fund operated by Amaranth Advisors lost over \$6 billion when natural gas prices “fell precipitously” due to larger-than-expected storage and forecasts of a mild hurricane and winter seasons.<sup>268</sup> Risk of a wider impact on financial markets was minimal due to the fund’s highly specialized trades that led to the loss<sup>269</sup> and because J.P. Morgan Chase & Co. and Citadel Investment Group took over a significant portion of Amaranth’s remaining commodity investments.<sup>270</sup>

In contrast, the subprime mortgage crisis that began in late 2006<sup>271</sup> claimed two large Bear Stearns hedge funds in June 2007<sup>272</sup> and touched

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<sup>265</sup> Hedge Fund Failure Report, *supra* note 264, at 3.

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

<sup>267</sup> *See supra* Part III.A.1.

<sup>268</sup> Ann Davis, Henry Sender & Gregory Zuckerman, *What Went Wrong at Amaranth*, WALL ST. J., Sept. 20, 2006, at C1. At its height Amaranth held assets worth \$9 billion. *Id.* The initial \$5 billion loss unfolded amid one week of market volatility. Ann Davis, *Private Money: The New Financial Order-Blue Flameout: How Giant Bets on Natural Gas Sank Brash Hedge-Fund Trader*, WALL ST. J., Sept. 19, 2006, at A1. Mother Rock, an energy trading hedge fund, also collapsed due to volatility in the natural gas market in the summer of 2006, losing \$230 million. *See* Hedge Fund Failure Report, *supra* note 264, at 5.

<sup>269</sup> Phil Izzo, *Moving the Market: Economists See Hedge-Fun Risks*, WALL ST. J., Sept. 20, 2006, at C3.

<sup>270</sup> Ann Davis, Henry Sender & Gregory Zuckerman, *Hedge-Fund Hardball: Amid Amaranth’s Crisis, Other Players Profited*, WALL ST. J., Jan. 30, 2007, at A1. J.P. Morgan was Amaranth’s clearing broker, meaning that J.P. Morgan executed trades and backed Amaranth’s obligations. *Id.* Serving in this capacity J.P. Morgan held a large sum of Amaranth’s cash as collateral to cover margin calls. *Id.* The bank used this collateral as a bargaining chip in order to obtain portions of Amaranth’s portfolio. *Id.* J.P. Morgan netted \$725 million when it sold off the assets in the portfolio. *Id.*

<sup>271</sup> David Henry & Matthew Goldstein, *The Bear Flu: How It Spread*, BUSINESSWEEK.COM, Dec. 19, 2007, [http://www.businessweek.com/magazine/content/07\\_53/b4065000402886.htm](http://www.businessweek.com/magazine/content/07_53/b4065000402886.htm).

<sup>272</sup> Kate Kelly & Serena Ng, *Bear Stearns Bails Out Fund With Big Loan*, WALL ST. J., June 23, 2007, at A1. The subprime mortgage market “caters to borrowers with weak credit,” and had been in trouble as loan delinquencies rose sharply in late 2006 and early 2007. *Id.*; *see also* Henry & Goldstein, *supra* note 271.

off concerns in the finance markets. Both funds invested heavily in the lightly-traded market of collateralized debt obligations (CDOs) backed by subprime mortgage assets.<sup>273</sup> The original fund soared with forty months without a loss and total returns approached 50%.<sup>274</sup> This led to a second fund startup.<sup>275</sup> The funds bought CDOs in a “voracious” manner driving down yields and forcing the funds to borrow large sums of cash to buy even more in an effort to produce the expected high returns.<sup>276</sup> However, when the subprime mortgage market began to unravel, the funds’ losses mounted throughout the first half of 2007.<sup>277</sup> By mid-June the funds’ creditors, among them large banking houses such as Barclays PLC, Goldman Sachs Group Inc., J.P. Morgan Chase & Co., and Merrill Lynch & Co., intervened in order to head off a collapse in subprime mortgage

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<sup>273</sup> Kelly & Ng, *supra* note 272. The CDOs at issue were pioneered by Bear Stearns as a “product to attract money-market funds—a new class of investor—to the mortgage market.” Henry & Goldstein, *supra* note 271. These CDOs paid higher interest rates than the usual short-term debt held by money market funds and were often guaranteed by the banks that purchased and held them. *Id.* Bear Stearns churned the money from the sale of CDOs into purchasing more mortgage-backed securities. *Id.* Not surprisingly, other investment firms and banks started up copycat operations funneling over \$100 million into the subprime mortgage market. *Id.* The overall effect of this investment vehicle was a “flood of fresh money made it even cheaper and easier for buyers to get mortgages. That, in turn, drove up home prices, holding off defaults and foreclosures.” *Id.*

<sup>274</sup> Kelly & Ng, *supra* note 272.

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

<sup>276</sup> Matthew Goldstein & David Henry, *Bear Stearns’ Bad Bet*, BUSINESSWEEK.COM, Oct. 11, 2007, [http://www.businessweek.com/bwdaily/dnflash/content/oct2007/db20071011\\_175964.htm](http://www.businessweek.com/bwdaily/dnflash/content/oct2007/db20071011_175964.htm). At one point the funds’ borrowing led to “\$60 worth of securities for every \$1 of investors’ money.” *Id.*

<sup>277</sup> Kelly & Ng, *supra* note 272.

The quick collapse of the . . . fund[s] conjures memories of Long-Term Capital Management, the multibillion-dollar fund that blew up in 1998. In both cases, the damage helped ignite a worldwide credit crunch that prompted intervention by central bankers. But there’s an important difference: LTCM, run by some of the sharpest minds in finance, was built to do well in rising and sinking markets alike. It failed because its impossibly complex trading strategies went haywire. The Bear funds cratered because their managers never came up with a Plan B to survive a downturn. [The Bear managers were] more like a day trader chasing tech stocks in the late 1990s than the Nobel laureates at LTCM.

*Bear Stearns’ Bad Bet*, *supra* note 276.

bond prices.<sup>278</sup> After a series of negotiations, Bear Stearns loaned \$3.2 billion to bailout one of the funds.<sup>279</sup>

The fallout from this episode was widespread. An ongoing federal insider trading investigation of the funds' top managers at Bear Stearns was opened.<sup>280</sup> Bear Stearns' reputation among Wall Street companies and investors was damaged.<sup>281</sup> As the mortgage crisis continued the investment bank's overall financial position was also battered heavily.<sup>282</sup> In March 2008, J.P. Morgan bought Bear Stearns in a deal initiated by Treasury Secretary Henry Paulson.<sup>283</sup> The federal government, concerned that already mounting economic worries would be made worse by the failure of the company, "threw its rule book out the window" in order to make the sale a reality.<sup>284</sup>

#### B. Hedge Fund Registration Act

Senator Charles Grassley, concerned with hedge fund transparency, twice introduced legislation during 2007 that would revive a form of hedge

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<sup>278</sup> Kelly & Ng, *supra* note 272. The banks held significant stakes in the funds. Merrill was owed \$850 million and J.P. Morgan over \$500 million. *Id.* Other banks, such as Citigroup and Bank of America ended up taking over \$10 billion in write-offs later in 2007 due in part to their own investments in mortgage-backed CDOs. Henry & Goldstein, *supra* note 271.

<sup>279</sup> Kelly & Ng, *supra* note 272.

<sup>280</sup> Matthew Goldstein & David Henry, *Probe of Insider Trading at Bear Stearns*, BUSINESSWEEK.COM, Dec. 17, 2007, [http://www.businessweek.com/bwdaily/dnflash/content/dec2007/db20071217\\_019781.htm](http://www.businessweek.com/bwdaily/dnflash/content/dec2007/db20071217_019781.htm).

<sup>281</sup> Matthew Goldstein, *Bear Stearns' Big Bailout*, BUSINESSWEEK.COM, Mar. 14, 2008, [http://www.businessweek.com/bwdaily/dnflash/content/mar2008/db20080314\\_993131.htm](http://www.businessweek.com/bwdaily/dnflash/content/mar2008/db20080314_993131.htm).

<sup>282</sup> *Id.* (noting that the firm saw "its bread-and-butter work in underwriting and trading mortgage-backed securities dry up").

<sup>283</sup> Robin Sidel, Greg Ip, Michael M. Phillips & Kate Kelly, *The Week That Shook Wall Street: Inside the Demise of Bear Stearns*, WALL ST. J. Mar. 18, 2008, at A1.

<sup>284</sup> *Id.* The Federal Reserve, for the first time ever, promised direct loans to investment banks (barred by federal law absent invoking an exception not used since the 1930s). *Id.* The federal government also assumed \$30 billion in Bear Stearns securities. *Id.*

Fellow Wall Street firms also had a stake in preventing a Bear Stearns collapse. *See Bear Stearns' Big Bailout, supra* note 281, (noting that "[i]t would have been highly risky for other Wall Street firms if Bear Stearns had been allowed to go under because Bear is tightly interconnected with them as both a borrower and a lender").

fund adviser registration.<sup>285</sup> Senator Grassley's bill, the Hedge Fund Registration Act of 2007,<sup>286</sup> would amend the current Advisers Act registration exemptions<sup>287</sup> so that an adviser must register with the SEC unless the adviser (1) manages \$50 million or less of assets; (2) has fewer than fifteen clients; (3) manages the assets of fewer than fifteen investors, regardless of whether the investors make use of the advisers' services directly or through a pooled investment vehicle like a hedge fund; and (4) does not hold herself out to the public as an investment adviser.<sup>288</sup> Senator Grassley first proposed the bill in March 2007 as an amendment to S.4, the 9/11 homeland security legislation, and then again in May 2007, in stand alone form.<sup>289</sup> It has yet to be enacted.

### C. 2/20 Compensation Tax Loophole

Hedge fund advisers derive compensation from both management and performance fees.<sup>290</sup> The management fee is normally taxed as ordinary income.<sup>291</sup> The performance fee, better known as the carried interest, is treated as investment income in a partnership arrangement.<sup>292</sup> The tax benefits of this distinction are significant because capital gains are taxed at a rate much lower than the top ordinary income tax bracket.<sup>293</sup> Closing this loophole for partners in private equity and hedge funds was seen as a potential new revenue stream.<sup>294</sup>

Congressional opposition was initially limited to Republicans.<sup>295</sup> However, private equity and hedge fund lobbyists mobilized to build

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<sup>285</sup> Press Release, Sen. Grassley Introduces the Hedge Fund Registration Act of 2007-05-15 (May 15, 2007) [hereinafter Grassley Press Release], available at [http://grassley.senate.gov/news/Article.cfm?customel\\_dataPageID\\_1502=11641](http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=11641).

<sup>286</sup> Hedge Fund Registration Act of 2007, S.1402 110th Cong. (2007).

<sup>287</sup> 15 U.S.C. 80b-3(b)(3) (2000). See also *supra* Part II.C.4.

<sup>288</sup> S.1402 § 2.

<sup>289</sup> See Grassley Press Release, *supra* note 285.

<sup>290</sup> See *supra* note 33 and accompanying text.

<sup>291</sup> Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 9-10 (2008).

<sup>292</sup> *Id.* at 14.

<sup>293</sup> *Id.* Capital gains are taxed at a rate of 15%. I.R.C. § 1(h)(1)(C) (West 2008). The top ordinary income bracket is 35%. I.R.C. § 1(a)-(e).

<sup>294</sup> Sarah Lueck & Kara Scannell, *Funds' Profits Tax Democrats*, WALL ST. J., July 12, 2007, at A2. Legislation to close the loophole was introduced in both houses of Congress. See H.R. 2834, 110th Cong. (2007); S. 1624, 110th Cong. (2007).

<sup>295</sup> Brody Mullins & Sarah Lueck, *Democrats Lose Zeal for Raising Hedge-Fund Tax*, WALL ST. J., July 31, 2007, at A1.

opposition to the proposal among Democrats. Industry lobbyists argued that re-characterizing the carried interest as ordinary income would result in higher management fees passed along to investors and a corresponding drop in returns.<sup>296</sup> Another concern was that higher taxes would drive new investment activity offshore.<sup>297</sup> In addition, private equity trade groups also held sway with lawmakers because of past campaign donations.<sup>298</sup> By November 2007, the tax proposal was considered unlikely to pass because of insufficient support in the Democrat-controlled Senate.<sup>299</sup>

#### *D. PWG Groups Propose Best Practices*

Defining best practices is considered key to implementing a more market-driven regulatory scheme for hedge funds.<sup>300</sup> In February 2007, the PWG issued a high-level principles and guidelines agreement focusing on private pools of capital.<sup>301</sup> The agreement was between the PWG and principal regulatory agencies charged with oversight of private pools of capital.<sup>302</sup> It covered investor protection principles<sup>303</sup> and systemic risk principles.<sup>304</sup> The formulation of these principles became part of Secretary Paulson's capital markets competitiveness program "to maintain our capital markets' leadership . . . [and to encourage] a modern regulatory structure complemented by market leaders embracing best practices."<sup>305</sup>

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<sup>296</sup> *Id.*

<sup>297</sup> *Id.*

<sup>298</sup> *Id.* One trade group contributed \$3.4 million during the 2006 campaign season; 69% went to Democrat candidates. *Id.*

<sup>299</sup> Sarah Lueck, *Politics & Economics: 'Carried Interest' Tax Unlikely to Rise in '07*, WALL ST. J., Nov. 6, 2007, at A8.

<sup>300</sup> Paredes, *supra* note 29, at 1028–34 (discussing the benefits and risks of identifying and encouraging best practices).

<sup>301</sup> Press Release, U.S. Dep't of the Treasury, President's Working Group Releases Common Approach to Private Pools of Capital Guidance on Hedge Fund Issues—Focuses on Systemic Risk, Investor Protection (Feb. 22, 2007), <http://www.treas.gov/press/releases/hp272.htm>.

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

<sup>303</sup> Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital (Feb. 2007), *available at* [http://www.treasury.gov/press/releases/reports/hp272\\_principles.pdf](http://www.treasury.gov/press/releases/reports/hp272_principles.pdf).

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

<sup>305</sup> Press Release, U.S. Dep't of the Treasury, Paulson Announces Next Steps to Bolster U.S. Markets' Global Competitiveness (June 27, 2007), <http://www.treas.gov/press/releases/hp476.htm>.

Two committees were created to formulate and release best practices to the public.<sup>306</sup> The Asset Managers' Committee, comprised of both government officials and private sector asset managers, set its sights on hedge fund manager best practices.<sup>307</sup> The Investors' Committee included investors drawn from pension funds, labor organizations, charitable organizations, and investment consultants.<sup>308</sup> Its initial focus was on best practices for investment in hedge funds.<sup>309</sup> Both committees issued draft proposals on April 15, 2008.<sup>310</sup>

*1. The Asset Managers' Committee Report (AMC Report)*

The AMC Report seeks to "raise[] the bar" in terms of solidifying industry practices while permitting managers the necessary "flexibility to continue to innovate and grow."<sup>311</sup> The committee focused its efforts on five "key areas where best practices would most effectively promote investor protection and reduce systemic risk" including: (1) disclosure; (2) valuation; (3) risk management; (4) trading and business operations; and (5) compliance, conflicts, and business practices.<sup>312</sup> Hedge fund managers should develop disclosure practices that provide investors "with information to allow them to make an investment decision and to monitor [the fund] over time."<sup>313</sup> This includes developing "GAAP-compliant financial statements," releasing regular quantitative and qualitative

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<sup>306</sup> Press Release, U.S. Dep't of the Treasury, PWG Announces Private Sector Groups to Address Market Issues for Private Pools of Capital (Sept. 25, 2007), <http://www.ustreas.gov/press/releases/hp575.htm>.

<sup>307</sup> Press Release, President's Working Group on Financial Markets Asset Managers' Committee Mission Statement (Sept. 25, 2007), <http://www.ustreas.gov/press/releases/reports/AssetMgrsCommMission09252007.pdf>.

<sup>308</sup> Press Release, President's Working Group on Financial Markets Investors' Committee Mission Statement (Sept. 25, 2007), <http://www.ustreas.gov/press/releases/reports/InvestorsCommMission09252007.pdf>.

<sup>309</sup> *Id.*

<sup>310</sup> Press Release, U.S. Dep't of the Treasury, President's Working Group on Financial Markets Investors' Committee Mission Statement (Apr. 15, 2008), <http://www.treas.gov/press/releases/hp927.htm>.

<sup>311</sup> Best Practices for the Hedge Fund Industry: Report of the Asset Managers' Committee to the President's Working Group on Financial Markets iii (Apr. 15, 2008) [hereinafter PWG AMC Report], available at <http://www.ustreas.gov/press/releases/reports/amcreportapril152008.pdf>.

<sup>312</sup> *Id.*

<sup>313</sup> *Id.* at v.

performance reports to investors, and reaching agreements with counterparties on the types of information to be disclosed.<sup>314</sup>

The AMC Report recommends all hedge funds adopt policies that document valuation and set “appropriate controls for segregation of responsibilities between portfolio managers and those responsible for valuations.”<sup>315</sup> In the committee’s view, an independent valuation assessment through a committee or third-party firm reduces conflicts of interest in determining prices of private investments and setting manager compensation.<sup>316</sup>

Also of note are the AMC Report recommendations regarding risk management. Hedge funds to need to implement processes to identify and measure risks including liquidity, leverage, market, counterparty credit, and operational.<sup>317</sup> In addition, portions of this risk profile should be disclosed to investors with the caveat that confidential information must be withheld.<sup>318</sup>

In the last two areas, the report touches on the need to establish personnel responsible for operations who are supported by “adequate resources.”<sup>319</sup> Firms should also establish compliance procedures such as “a written code of ethics and a written compliance manual.”<sup>320</sup> In addition to the written policies, a firm should appoint a compliance officer responsible for reviewing ongoing efforts.<sup>321</sup>

## 2. *The Investor’s Committee Report (IC Report)*

The IC Report contains a Fiduciary’s Guide and an Investor’s Guide. The Fiduciary’s Guide presents topical questions fiduciaries should ask when assessing “the appropriateness of a hedge fund program.”<sup>322</sup> The report encourages fiduciaries to determine how hedge fund investing will integrate into the organization’s overall investment portfolio, meet the organization’s liquidity needs, and remain consistent with the organization’s known risk tolerance.<sup>323</sup> Interestingly, fiduciaries should

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<sup>314</sup> *Id.*

<sup>315</sup> *Id.* at vi.

<sup>316</sup> *Id.*

<sup>317</sup> *Id.* at viii.

<sup>318</sup> *Id.*

<sup>319</sup> *Id.* at ix.

<sup>320</sup> *Id.*

<sup>321</sup> *Id.*

<sup>322</sup> PWG IC Report, *supra* note 33, at 6.

<sup>323</sup> *Id.*

also consider if the organization is “comfortable that the hedge funds in . . . [its] portfolio are good capital market citizens and are not engaged in objectionable practices.”<sup>324</sup> The guide also offers a list of five areas in which fiduciaries should “develop explicit policies that define the key features and objectives of the hedge fund program”<sup>325</sup>:

- (1) What is the strategic purpose of investing in hedge funds? What role will hedge funds play in the total investment portfolio?
- (2) Is the hedge fund program consistent with the applicable investment beliefs, objectives, and risk profile of the investment program?
- (3) What are the performance and risk objectives of the hedge fund investment program?
- (4) Who will manage the hedge fund investment program and what responsibilities will they have?
- (5) What investment guidelines will apply to the range of funds and strategies that can be utilized, the number of funds to be targeted, and the risk and return targets for those funds?<sup>326</sup>

The Fiduciary’s Guide serves two other important purposes. First, it stresses “particular care” must be exercised when conducting hedge fund due diligence because of “the complex investment strategies [hedge funds] employ,” the risks of using leverage, and because of the relative newness (and lack of sophistication) of many hedge fund firms.<sup>327</sup> Second, it is a much-needed educational tool because the guide defines what generally constitutes a hedge fund, compares hedge funds to other “traditional products” (such as mutual funds), and outlines fee structures.<sup>328</sup>

The Investor’s Guide contains a “comprehensive list of the best practices and principles applicable to hedge fund investors in a wide array

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<sup>324</sup> *Id.* at 7.

<sup>325</sup> *Id.* at 12.

<sup>326</sup> *Id.*

<sup>327</sup> *Id.* As a general matter “[h]edge fund managers can vary significantly in their levels of sophistication,” and, startup funds and their managers may not have sophisticated “operations and risk management practices.” *Id.* at 10.

<sup>328</sup> *Id.* at 9–10.

of circumstances.”<sup>329</sup> The Investor’s Committee also counsels that “[i]nvestors should decide which best practices are appropriate for their hedge fund investment program and for the individual funds under consideration.”<sup>330</sup> The guide offers recommendations in seven areas: “due diligence process; risk management; legal and regulatory considerations; valuation; fees and expenses; reporting; and taxation.”<sup>331</sup> An effective due diligence process includes the investor asking “probing questions into the material aspects of a hedge fund’s business and operations.”<sup>332</sup> The investor’s risk management process requires parallel efforts—the investor must be able to manage her own risk and evaluate the “risk management framework employed by a hedge fund manager.”<sup>333</sup> Investors must also be familiar with the broad categories of risk in order to “evaluate each component of risk in a hedge fund investment and determine their willingness to accept the related risks.”<sup>334</sup>

Legal and regulatory best practices involve the investor first understanding that most hedge funds are not subject to the same reporting and registration requirements as other investment companies.<sup>335</sup> Therefore, most hedge fund investors do not enjoy the built-in protections of registration that “address conflicts of interest, limit their debt, comply with strict rules in determining the fair value of their assets, permit shareholder voting on key issues, ensure that management fees are reasonable, and provide regular disclosures to investors and reports to the SEC.”<sup>336</sup> Investors should understand the financial reporting requirements of the jurisdiction under which the fund is organized,<sup>337</sup> examine the fund’s governing documents “with an eye to determining whether their interests

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<sup>329</sup> *Id.* at 16.

<sup>330</sup> *Id.*

<sup>331</sup> *Id.* at 16–17.

<sup>332</sup> *Id.* at 17. The suggested areas of inquiry include process (selection of markets and instruments), performance (fund and manager histories), fund personnel, risk management, third parties (who are they and how are they selected and evaluated), fund legal structure, and the fund’s domicile. *Id.* at 17–19.

<sup>333</sup> *Id.* at 22.

<sup>334</sup> *Id.* at 25. The broad categories include market risks (e.g., equity, interest rate, currency, credit, volatility, and liquidity) and additional risks such as counterparty and asset/liability matching. *Id.* at 25–27.

<sup>335</sup> *Id.* at 37.

<sup>336</sup> *Id.*

<sup>337</sup> *Id.* at 38.

are adequately protected,”<sup>338</sup> inquire if the fund manager is an ERISA fiduciary (for the investor’s ongoing compliance),<sup>339</sup> and not “substitute regulatory oversight for their own due diligence in any circumstances.”<sup>340</sup>

Best practices for valuation of hedge fund assets center upon funds establishing valuation policies which “identify the securities and instruments that the fund is expected to hold and the valuation source for each.”<sup>341</sup> Investors should inspect these documents and familiarize themselves with the fund’s valuation internal governance process.<sup>342</sup> Finally, independent valuations of the fund’s portfolio are useful if conducted on a regular basis, usually one year, and more frequently if the fund holds “significant assets for which there is not a liquid market.”<sup>343</sup>

When assessing fees and expenses, investors, prior to investing, need to decide what percentage of return they are willing to pay in fees and actively “negotiate fees and performance targets.”<sup>344</sup> Obtaining sufficient reporting in the face of the fund protecting proprietary details requires investors to identify “critical” information needed to assess the “essential risks and rewards of the investment.”<sup>345</sup> Finally, the simplest guidance for investors is in the area of tax disclosures: (1) hedge funds should “explain all tax considerations that may impact a hedge fund’s returns;”<sup>346</sup> and (2) “[i]nvestors should seek the advice of competent tax advisors.”<sup>347</sup>

## VII. LESSONS LEARNED?

So, to recap, the SEC has through its rule making authority proposed two waves of regulation. Strong criticism met all of the rule proposals. The first wave, the Hedge Fund Rule, was narrowly adopted and subsequently thrown out by the United States Court of Appeals for the District of Columbia. The second wave consisted of the adopted antifraud regulation and the proposed accredited investor rule which received such strong criticism that it has yet to be adopted. The SEC, after losing in

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<sup>338</sup> *Id.* at 40.

<sup>339</sup> *Id.* at 41–42.

<sup>340</sup> *Id.* at 42. Regulatory oversight would result from the fund manager’s voluntary registration with the SEC or CFTC. *Id.*

<sup>341</sup> *Id.* at 44.

<sup>342</sup> *Id.* at 45.

<sup>343</sup> *Id.* at 48.

<sup>344</sup> *Id.* at 49.

<sup>345</sup> *Id.* at 51.

<sup>346</sup> *Id.* at 55.

<sup>347</sup> *Id.* at 56.

*Goldstein*, had to unwind the effects of the Hedge Fund Rule by offering de-registration. In the meantime, the Commission stepped up hedge fund enforcement activity through the HFWG. And, finally, it also pursued market-based reforms by participating and signing off on the PWG best practices proposal.

Commissioner Atkins observed that the SEC could learn six distinct lessons from the *Goldstein* decision. “First, the SEC should thoroughly consider why it needs to regulate, before regulating. Second, the SEC should consider whether a proposed regulatory approach will work to meet that need.”<sup>348</sup> Third, the Commission should determine all of the direct and indirect costs of regulation and decide if the “benefits of a particular regulatory approach outweigh” these costs.<sup>349</sup> Fourth, does the SEC have the necessary regulatory authority to implement the desired regulation?<sup>350</sup> Fifth, the Commission must “work better with other regulators.”<sup>351</sup> Finally, the effects of regulations are difficult to unwind and reverse once adopted.<sup>352</sup>

*A. Does the Antifraud Rule Show the Commission Learned any Lessons?*

While one might characterize the Commission’s diverging approaches to hedge fund regulation pre and post-*Goldstein* as schizophrenic, perhaps a better view is of a partial lesson learned—the SEC finally recognizes that the best way to root out hedge fund fraud is to actually prosecute it. After all, the Commission in adopting the Hedge Fund Rule was concerned about the rising cases of hedge fund fraud.<sup>353</sup> The adopted Antifraud Rule,<sup>354</sup> while overly broad in one respect, certainly shows the SEC tailored a regulation to meet the worthwhile goal of reducing fraudulent activity. Establishing the HFWG is evidence that the Commission understands that it must set aside resources solely for the purpose of hedge fund enforcement actions. In addition, the Commission continues to work with federal prosecutors to bring parallel criminal prosecutions in recent hedge fund insider trading cases.

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<sup>348</sup> Alternative Investment Roundup Remarks, *supra* note 203.

<sup>349</sup> *Id.*

<sup>350</sup> *Id.*

<sup>351</sup> *Id.*

<sup>352</sup> *Id.* For a discussion of the steps the SEC took to reverse the effects of the Hedge Fund Rule see *supra* Part V.A.

<sup>353</sup> See *supra* note 119 and accompanying text.

<sup>354</sup> See *supra* Part V.C.1.

There remains an open question of whether or not adopting the negligence standard is within the Commission's authority.<sup>355</sup> Yet even with this concern the regulation still passed unanimously.<sup>356</sup> A commentator best summed up the effect of the Commission's activities by stating that the "[n]ew enforcement proceedings and regulatory rules have removed much of the significance of registration and leave all hedge funds subject to potential legal exposure."<sup>357</sup>

*B. Accredited Natural Person Proposal: Is There Still a Lesson to be Learned?*

The voluminous (and generally) negative comments regarding the Accredited Natural Person Proposal<sup>358</sup> are strong indicators that the SEC still has yet to learn the second *Goldstein* lesson when it comes to protecting the unsophisticated investor.<sup>359</sup> It is not a surprise that the SEC proposed the rule—it tracks recommended alternatives offered by both the dissenting Commissioners and commenters to the Hedge Fund Rule as well as Chairman Cox in his July 2006 post-*Goldstein* congressional testimony.<sup>360</sup> However, it is unlikely that the proposed rule will fully protect the individual investor. The SEC acknowledged during the Hedge Fund Rule adoption debate that the increased retailization of hedge funds included the indirect exposure of investors' monies due to institutional investments.<sup>361</sup> The inherent flaw in the proposed two-step approach<sup>362</sup> is that institutions will still be permitted continue pouring capital into section 3(c)(1) private investment pools. Shrinking the number of potential individual investors does nothing to protect what is, more than likely, a larger group of investors whose dollars are invested on their behalf by pension funds.

*C. All Parties Should Consider Adopting Best Practices*

The Commission doggedly pursued adoption of the Hedge Fund Rule over strenuous objections.<sup>363</sup> If there is a lesson to be learned it is that the

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<sup>355</sup> See *supra* note 240.

<sup>356</sup> Commissioner Atkins concurred in the rule's adoption. See *supra* note 240.

<sup>357</sup> Stroup, *supra* note 211, at 5.

<sup>358</sup> See *supra* notes 259–63 and accompanying text.

<sup>359</sup> See *supra* note 348 and accompanying text.

<sup>360</sup> See *supra* notes 131, 134 & 198 and accompanying text.

<sup>361</sup> See *supra* notes 117 & 118 and accompanying text.

<sup>362</sup> See *supra* notes 250, 251 & 255 and accompanying text.

<sup>363</sup> See *supra* Part III.B.

SEC should just as strenuously promote the best practices it sanctioned in the AMC and IC Reports. It should do so through all possible avenues including speeches, congressional testimony, and when offering guidance (without, of course, mandating adoption of best practices).<sup>364</sup>

Too often best practices are ignored as a viable means of market-based oversight in favor of other options such as hedge fund certification and establishing a self-regulatory organization. All parties—hedge fund managers, investors, and regulators—have a stake in successful industry-wide adoption of best practices. For instance, best practices by themselves may not sway hedge fund managers to act more responsibly, but they, as one commentator notes, “can provide investors concrete guidance that facilitates market discipline.”<sup>365</sup> Further, the SEC attached its name to the proposals. Encouraging adoption of best practices gives all parties extra confidence that the Commission is serious about instilling market discipline.

*D. Revive Mandatory Registration: Back to the Future?*

For those who support mandatory registration of hedge fund managers the last two years have certainly been a disappointment. There has been little political appetite on the part of Congress to take any action that may directly or indirectly effect hedge funds. This is in part because the fund industry has an effective lobby, and, in part, because external events have not created the kind of political groundswell that may prod either new legislation or SEC regulatory actions. With an upcoming election, perhaps new political appointees will view hedge fund regulation differently. If, for instance, Democrats, who already control both houses of Congress, also capture the White House in 2008 they may, along with a host of new political appointees, push for regulatory reform involving hedge funds in 2009.

Regardless of who controls the political branches of government, there is likely to be public outcry for action as the overall economy continues to weaken. Simply put, the economic has deteriorated significantly since the Hedge Fund Rule was struck down in the summer of 2006. As of this

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<sup>364</sup> Paredes, *supra* note 29, at 1033 (“[F]or such a restrained best-practices technique to serve its purpose, it is imperative that the failure of securities market participants to comport with the SEC’s recommendations would not in and of itself constitute a violation of the federal securities laws. Otherwise, best practices back door into new mandates.”).

<sup>365</sup> *Id.* at 1031.

writing, credit markets continue to tighten.<sup>366</sup> The ongoing subprime mortgage issues claimed one venerable investment firm, Bear Stearns, and the federal government-sponsored enterprises charged with stabilizing the mortgage market are also reeling.<sup>367</sup> These events led Federal Reserve Chairman Ben Bernanke to conclude that “[t]he enormous losses and write-downs taken at financial institutions around the world since August [2007], as well as the run on Bear Stearns, show that, in this episode, neither market discipline nor regulatory oversight succeeded.”<sup>368</sup> And while the Chairman’s comments speak to wider economic concerns, hedge funds have been at, or near, the center of many of the key events during this crisis.

Before we race to revive hedge fund registration or other non-market based regulatory initiatives, a small dose of reality might be helpful. First, despite hedge funds becoming an ongoing lightning rod of criticism following the failure of Long-Term Capital, no evidence has emerged suggesting widespread fraud inside the industry. Second, in addition to Long-Term Capital, only the collapse of the Bear Stearns funds has registered a significant impact in the financial markets.<sup>369</sup> Also important is that there have been no major hedge fund collapses in the wake of the Bear Stearns problems in the summer of 2007.<sup>370</sup> The clear majority of hedge funds rise and fall on their own merits, and usually without garnering headlines or leading to wider turmoil in the financial markets. If the Hedge Fund Rule episode teaches nothing else, it should be that regulating as the first response to a real (or perceived) crisis is almost certain to miss the target and result in unintended costs to all parties.

However, to be fair, there are serious questions that should be asked by investors and regulators about the use and risks associated with CDOs

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<sup>366</sup> Damian Paletta & Sudeep Reddy, *Bernanke Moves to Extend Powers as Credit Woes Linger*, WALL ST. J., July 9, 2008, at A1.

<sup>367</sup> Jon Hilsenrath, *Markets Police Themselves Poorly, but Regulation Has Its Flaws*, WALL ST. J., July 21, 2008, at A2; *see also* Paletta & Reddy, *supra* note 366.

<sup>368</sup> *See* Hilsenrath, *supra* note 367. Perhaps most troubling are the following conclusions drawn from Chairman Bernanke’s comments—“Policy makers need to fix a broken financial system with policy levers they know are damaged, too. The pendulum between market forces and regulation has no reassuring place to swing, though in the short-run, it is surely swinging toward regulation.” *Id.*

<sup>369</sup> *See supra* notes 273 & 278 and accompanying text.

<sup>370</sup> *See supra* notes 271–84 and accompanying text.

backed by subprime mortgage assets.<sup>371</sup> First, what process was used to determine the value of CDOs, and how often was the process run?<sup>372</sup> Second, what kind of disclosures were made, and assuming disclosure of some type, did any of the documents alert the investor to the nature of the funds' holdings and risk?<sup>373</sup> Investors also deserve answers regarding counterparty activities in this affair. Many banks provided significant credit lines that permitted hedge funds to purchase ever increasing numbers of CDOs.<sup>374</sup> Regulators, of course, will be interested in the behind-the-scenes activities of the fund managers compared to their public statements. Some of these concerns can be addressed through the existing Antifraud Rule and enhanced enforcement activity described in this Note. In addition, the best practices proposals would guide investors to ask many of the same types of questions listed above prior to investing in any hedge funds.

### VIII. CONCLUSION

At the end of this ten-year process of studies, rule proposals, debates, and court challenges, there is an unshakeable sense that the business of regulating hedge funds has returned to where it began in 1998. The SEC paid a high price to obtain the registration of hedge fund managers in 2006. The Commission's subsequent regulations, enforcement efforts, and best practices formulations show that it learned some lessons from the *Goldstein* experience. Yet the Commission's greatest test stands before it as it copes with the fallout from a weakening economy. Will it return to policies favoring aggressive regulation or continue the enforcement and market-based reforms already underway?

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<sup>371</sup> See Hilsenrath, *supra* note 367 (noting that "hedge funds did play an important role in fueling the credit boom that preceded the current crunch—by funding and trading many of the complex debt instruments that have quickly unwound"). See also *supra* note 273 and accompanying text.

<sup>372</sup> Kelly & Ng, *supra* note 272 (explaining that CDOs do not share Treasury bonds characteristics of being "widely traded" and having "values that can be easily tracked").

<sup>373</sup> While exact numbers are not available, it is widely known that the two funds invested a significant portion of their assets in CDOs. *Id.*

<sup>374</sup> See *supra* notes 276 & 278 and accompanying text.

