THE CHANGING LANDSCAPE OF HEDGE FUND REGULATION: CURRENT CONCERNS AND A PRINCIPLE-BASED APPROACH

Jennifer Ralph Oppold*

I. INTRODUCTION

Rapid growth in the international financial system has created unprecedented opportunity and complexity for investors, as well as challenges for capital markets regulators. The popularity of pooled investment vehicles such as hedge funds, private equity funds, and venture capital funds, has helped to fuel this growth. Industry expansion has in turn necessitated the reexamination of the appropriate capital markets regulatory structure. In particular, hedge fund regulation has been at the forefront of the debate because hedge funds deeply impact market liquidity and the potential for heightened systemic risk, due to the leverage they typically use. While mandatory registration is no longer a likely prospect in the near future, an examination of the current disclosure rules, in tandem with an analysis of the concerns raised by the growth of hedge funds, can build a better understanding of the correct regulatory approach moving forward.

This Article will provide an overview of the basics of the hedge fund industry, summarize the securities laws applicable to hedge funds, examine how disclosure requirements interact with the hedge fund industry, review common concerns with hedge funds, and assess the current regulatory approach to hedge funds both in the United States and abroad. Additionally, this paper will evaluate how changes to the current securities rules that affect hedge funds could impact the industry’s future.

II. HEDGE FUND OVERVIEW

The term “hedge fund” does not have a single accepted definition although it is generally understood to be an unregistered pooled investment vehicle that invests in a broad range of securities, with a fee structure that

typically compensates the fund advisor based upon a combination of assets under management and a percent of capital appreciation.\(^1\) The General Accounting Office differentiates hedge funds from other investment vehicles by citing the capability of hedge fund managers to: (1) invest in any type of asset in the market; (2) use many investment strategies at the same time; (3) switch investment strategies quickly; and (4) borrow money and/or otherwise use leverage without being subject to investment company leverage limits.\(^2\)

While not all funds will meet each of these criteria, depending on their particular investment mandate, the description helps differentiate a typical hedge fund from a vehicle such as a mutual fund, which is regulated and faces much tighter restrictions on its possible investments.\(^3\)

In general, a hedge involves taking a position in one security and an offsetting position in another security, such as buying a stock and a put on that stock at the same time, which will allow investors to benefit from upward movement of the stock, but will also give investors the right to sell the stock at a specified exercise price if it experiences a decline. Using derivative instruments to take hedged positions allows investors ideally to limit their downside risk while making a directional bet that a security will move up or down, or even simply experience volatility.\(^4\) Myriad strategies fall under the hedge fund designation. Hedge Fund Research, Inc. assembles one of the largest industry databases tracking nineteen separate strategies including, among others, event driven, distressed securities, convertible arbitrage.\(^5\)

\(^1\) See, e.g., STAFF OF THE COMMISSION'S DIVISION OF INVESTMENT MANAGEMENT AND OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION viii (2003) [hereinafter SEC 2003 STAFF REPORT] (explaining that other unregistered pooled investment vehicles include venture capital and private equity funds, which typically have different fee structures and rarely invest in public securities).


\(^4\) A straddle, which consists of buying both a put and a call around a given range on a security, is one of many ways that an investor could use derivatives to benefit from volatility regardless of the direction the market moves. A derivative instrument derives value from underlying assets such as stocks, bonds, commodities, real estate, etc. Examples of derivatives include puts, calls, futures, forwards, and swaps.

\(^5\) See Hedge Fund Research, Inc., HFR Industry Reports Asset Flows,
A. Hedge Fund Structure

Hedge funds in the United States are typically organized as limited partnerships or limited liability corporations (LLP or LLC) to obtain the benefits of limited liability.\(^6\) Hedge funds organized as limited partnerships may pass tax consequences directly along to investors, although this may expose investors to unrelated business taxable income.\(^7\) The hedge fund advisor who serves as the general partner in the LLP or LLC owes fiduciary duties to the limited partners.\(^8\) While there are approximately 10,000 hedge funds at this time, the industry is relatively concentrated, such that the 100 largest funds control about 65% of the industry's total assets.\(^9\)

Incorporation in a tax haven such as Bermuda, the Bahamas, or the Cayman Islands, is common to minimize taxes and benefit from a looser regulatory environment.\(^10\) Offshore incorporation particularly appeals to non-U.S. citizens and tax-exempt investors such as pension funds.\(^11\) Although estimates are inexact, observers believe that 43-80% of hedge funds are organized offshore,\(^12\) and that up to 62% of assets are managed in offshore funds.\(^13\) Many advisors oversee both funds that are organized in the United States and at least one fund that is organized offshore to meet

---

6. Jacob Preiserowicz, Note, The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?, 11 FORDHAM J. CORP. & FIN. L. 807, 812 (2006); see SCOTT, supra note 3, at 713 (stating that German, Japanese, and British funds commonly use other organizational structures, such as contract or unit trust forms).

7. See JOSEPH G. NICHOLAS, INVESTING IN HEDGE FUNDS 47 (rev. and updated ed., Bloomberg Press 2005) (explaining that the majority of tax-exempt investors are unwilling to accept unrelated business taxable income for tax reasons, and thus prefer offshore funds).


10. See SEC 2003 STAFF REPORT, supra note 1, at ix (discussing offshore hedge funds); see also Lartease Tiffith, Hedge Fund Regulation: What the FSA is Doing Right and Why the SEC Should Follow the FSA's Lead, 27 NW. J. INT'L L. & BUS. 497, 500 (2007) (also discussing offshore hedge funds).

11. Preiserowicz, supra note 6, at 812.

12. Tiffith, supra note 10, at 509 n. 76.

different investor preferences, although the investment strategy is often the same. The following chart, provided by Liang and Park based on 2005 data from the Lipper TASS hedge fund database, reveals that funds domiciled offshore have attracted by far the greatest share of assets.

TABLE 1: OFFSHORE DOMICILES ATTRACT THE LARGEST SHARE OF ASSETS.

<table>
<thead>
<tr>
<th>Hedge Fund Industry by Domicile Country</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

Due principally to regulatory reasons requiring minimum investments ranging from $100,000 to $5 million, hedge fund investors are primarily wealthy individuals and institutions. Historically, while the majority of investors have been wealthy individuals, a study by McKinsey & Company estimated that, for the first time in 2007, more than half of flows into hedge funds (52%) originated from institutions. The specific investor mix can vary widely. For instance, a European long-short equity fund with approximately $1.1 billion under management, which prefers to remain anonymous, had the following investor assortment in 2006.

14. See, e.g., SCOTT, supra note 3, at 723 (stating that one way to effectuate this legally is to use a master/feeder structure, in which the domestic and offshore funds buy shares in a Master Fund that invests the actual portfolio and enables the funds to have duplicate holdings and returns).
15. Liang & Park, supra note 13, at 38.
16. Id. (using data from the Lipper TASS database).
17. NICHOLAS, supra note 7, at 34.
TABLE 2: SAMPLE HEDGE FUND INVESTOR COMPOSITION

Sample Investor Composition

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>30%</td>
</tr>
<tr>
<td>Other Hedge Funds</td>
<td>30%</td>
</tr>
<tr>
<td>Corporate Insurance</td>
<td>11%</td>
</tr>
<tr>
<td>Employees-NHW Families</td>
<td>10%</td>
</tr>
<tr>
<td>Pensions</td>
<td>12%</td>
</tr>
<tr>
<td>Fund of funds</td>
<td>30%</td>
</tr>
</tbody>
</table>

Interestingly, almost one third of its investors were other hedge funds although they were not formally funds of funds themselves.

B. Fees and Returns

Fund advisors are commonly compensated by an annual management fee of 1-3% of assets under management plus a 10-30% share of the fund’s annual appreciation, which may or may not be measured above an index benchmark. Hedge fund fees for assets under management average 2.07%, excluding the performance incentive fee, while mutual funds, by comparison, average 1.43%. “Two and twenty” (2% of assets under management plus 20% of the fund’s profits) is the most common hedge fund fee structure and can compensate the fund advisor very attractively.

19. $1.1 billion long-short European equities fund quoted on condition of anonymity.
20. SEC 2003 STAFF REPORT, supra note 1, at ix.
21. SCOTT, supra note 3, at 736.
For instance, a $5 billion absolute return fund that earned 10% for the year and used a two and twenty fee structure would net the manager $200 million. Moreover, compensation can be far more than this; in their best years, investors such as Eddie Lampert of ESL, James Simons of Renaissance Technologies, and T. Boone Pickens of BP Capital each made over $1 billion. In 2006, the twenty-five highest-paid hedge fund investors earned $14 billion combined, and an advisor had to earn at least $240 million to even be considered on Alpha Magazine's top twenty-five hedge fund earners list. In comparison, the CEO of Goldman Sachs earned $54.3 million over the same period.

A fund of funds, which helps investors diversify by investing in a pool of hedge funds, typically also charges an asset-based fee and a performance fee. These fee are 1% of assets under management and 10% of profits, which result in a double layer of fees for investors as they still must pay the fees of the underlying funds. Funds of funds can still be attractive to investors, however, as they allow investors the benefits of diversification without the usual minimum investment requirement of $100,000 at multiple funds.

As with all investment vehicles, returns vary widely among hedge funds. In 2006, hedge funds on average had a 12.9% return, compared to 13.6% for the S&P 500. Results in 2007 were better, when the hedge fund industry averaged returns of 14.1% versus 5.5% for the S&P 500. Historically, hedge funds have average returns in line with the S&P 500, but with lower volatility. Typically, a fund selects a benchmark against which it measures its returns, and any return above the benchmark is known as "alpha."

Many funds follow an absolute return strategy that is designed to be

management and 44% of profits).

26. Mark Hulbert, *2 + 20, and Other Hedge Fund Math*, N.Y. TIMES, Mar. 4, 2007, § 3, at 4. For a simplified example, in a fund of funds worth $1 billion that appreciated 10% for the year, the underlying funds would earn $40 million if their fee structure was two and twenty, and the fund of funds would earn an additional $20 million, leaving the investor with an after-fee return of 4%.
30. This can include absolute return funds, which use a 0% benchmark.
independent from the S&P or other benchmarks, and which offers significant diversification benefits.\textsuperscript{31} Returns are measured after fees and are often boosted by the use of leverage; hedge funds typically may borrow 200\% or more of their assets under management.\textsuperscript{32} Leverage boosts a fund's return if the fund can borrow money at a cost lower than the rate of return that the fund can make on that money. As a simplified example, a fund with $1 billion of assets under management could borrow another $1 billion at 5\% interest. If the fund earned 10\%, its overall return to investors would be $200 million ($100 million/$10 billion) less $50 million in borrowing costs (5\% of $1 billion) for a before fee return on equity of approximately 15\% ($150 million/$1 billion). This return is substantially greater than the simple 10\% return on equity ($100 million/$1 billion) that the fund would have earned without the use of leverage.

The use of leverage gives hedge funds a much greater impact on the financial markets than the level of their assets under management would suggest. For instance, Long Term Capital Management (LTCM) had a debt-to-equity ratio of 25:1, giving the approximately $5 billion fund a $125 billion impact on the capital markets.\textsuperscript{33} The failure of highly-levered funds such as LTCM and Amaranth raised concerns about the potential for systemic market risk.\textsuperscript{34} The benefits and risks associated with the use of extensive leverage are further discussed in Part V.A below.

Funds may also have a lockup period during which investors agree to keep their money committed to the fund and not withdraw it. Customarily, private equity and venture capital funds use multi-year lockups because these funds' private investments typically remain illiquid until the companies are sold. Hedge funds occasionally use one or two-year lockups as well, as they allow the fund to focus on longer-term investments rather than being concerned about a draw down if it has a bad quarter, which, in turn, could force the fund to sell investments at an inopportune time. Research of the TASS hedge fund database shows that out of approximately 2000 funds, 31\% had lockups of some duration.\textsuperscript{35} Several researchers have found a positive relationship between a lockup provision and aggregate fund returns. Aragon found that funds with lockups have returns 4-7\% higher than funds without lockups.\textsuperscript{36} One interpretation of

\begin{itemize}
\item \textsuperscript{31} Verret, supra note 8, at 804.
\item \textsuperscript{32} Tiffith, supra note 10, at 501.
\item \textsuperscript{33} Id.
\item \textsuperscript{34} Steel Remarks, supra note 9, at 4 (defining systemic risk as the risk that one financial firm's failure could severely impact the financial system, and, at an extreme, "trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected").
\item \textsuperscript{35} See Liang & Park, supra note 13, at 30 (featuring a table of funds with a lockup of some duration).
\item \textsuperscript{36} Id. at 4 (citing George Aragon, Share Restriction and Asset Pricing: Evidence from
this finding is that a lockup functions as an illiquidity premium, where investors demand higher returns as compensation for increased illiquidity.37

C. Industry Growth

Hedge funds have grown rapidly from approximately 400 funds in 1992 to approximately 10,000 funds in 2007, and play a major role in injecting liquidity into the market place.38 As of March 2007, global hedge fund assets were estimated at $2.079 trillion, as compared to $186 billion in 1995.39 While other investment vehicles such as mutual funds account for a greater share of assets under management, (e.g., mutual funds had $17.8 trillion under management as of 2005), hedge funds have a disproportionately large impact on the capital markets due to their active trading strategies.40 In 2006, one estimate claimed that hedge funds accounted for up to 50% of daily trading volume in some asset classes.41 This rapid growth places hedge funds in the spotlight not only in the United States, but also internationally. German Chancellor Angela Merkel recently included hedge fund regulation as one of the key issues on the G8 agenda during its June 2007 summit meeting.42

the Hedge Fund Industry, 83 J. FIN. ECON. 33 (2007)). Liang and Park’s research suggests that offshore investors may actually receive a greater illiquidity premium for a lockup, along with tax advantages. Id.

37. Id. at 5.


40. See SCOTT, supra note 3, at 712 (defining international financial transactions and discussing the relationship between mutual funds and hedge funds).

41. Steel Remarks, supra note 9.

42. Spalter, supra note 38.
Table 3: Growth in the Number of Hedge Funds\textsuperscript{43}

\begin{center}
\textbf{Hedge Fund Industry Experienced Rapid Growth}
\end{center}

\begin{center}
\begin{tabular}{|c|c|c|c|c|c|c|c|c|c|}
\hline
\hline
Number of Funds & 7000 & 8000 & 9000 & 10000 & 11000 & 12000 & 13000 & 14000 & 15000 & 16000 & 17000 & 18000 & 19000 & 20000 & 21000 \\
\hline
\end{tabular}
\end{center}

\textbf{D. Financial Market Impact: Benefits and Concerns}

Hedge funds provide substantial benefits such as greater market liquidity, improved market efficiency, more accurate pricing, enhanced risk management, and wider portfolio diversification.\textsuperscript{44} They account for 40-50\% of all equity trades globally; they increase liquidity and deepen the markets.\textsuperscript{45} Beyond the “vital role” in “materially enhancing market liquidity” that hedge funds play, and the fact that they serve as “a crucial ingredient in the price discovery process,” hedge funds also boost the general economy by providing jobs and by aiding the expansion of existing businesses.\textsuperscript{46} For instance, prime brokers, who provide hedge funds with services such as trade consolidation, custody, financing, stock lending, and back office technology, earned $7.5 billion in revenues in 2005.\textsuperscript{47}

Attributes of hedge funds that trouble policy makers include the high levels of leverage that many funds use, the lack of transparency into their holdings, the frequently short period of ownership, the separation of voting from stock ownership enabled by derivates, the potential for market manipulation, and the use of soft dollars. The short track records of many hedge funds exacerbate several of these concerns; in 2006, the average

\begin{flushright}
\begin{itemize}
\item 43. Tran \textit{supra} note 29, at 46; Paredes \textit{infra} note 167, at 982; Preiserowicz \textit{supra} note 6, at 820; Spalter \textit{supra} note 38.
\item 44. See, e.g., SEC STAFF REPORT, \textit{supra} note 1, at viii (presenting the wide range of tangible benefits that hedge funds provide).
\item 45. Verret, \textit{supra} note 8, at 804.
\item 46. Steel Remarks, \textit{supra} note 9.
\item 47. See SCOTT, \textit{supra} note 3, at 737 (discussing the influential role of U.S. securities markets and analyzing the national GDP).
\end{itemize}
\end{flushright}
hedge fund life span was 5.3 years, making it difficult to analyze long term risks and trends.\textsuperscript{48} Furthermore, there are concerns regarding funds’ power to derail politically sensitive deals, as was seen in the strong reaction to The Children’s Investment Trust (TCI) and Atticus Capital’s successful activism against Deutsche Börse’s proposed bid for the London Stock Exchange. In the aftermath of the failed deal, Rolf Breuer, the outgoing Chairman of the Frankfurt stock exchange, accused TCI and other funds of “ripping into the heart of the German economy” and proposed new laws to limit hedge fund activity.\textsuperscript{49} Similarly, the German Vice Chancellor described hedge funds as “locusts” after the collapse of the merger.\textsuperscript{50}

Critics are not only politically driven; they also include well-known investors such as Warren Buffett, who describes the derivatives business as “fraught with danger” and a “strange world” where the “imagination” of traders comes into play when establishing valuations of long contracts.\textsuperscript{51} Buffett hoped that his public statements about Berkshire Hathaway’s problems with its acquisition of General RE’s derivatives business would “prove instructive for managers, auditors, and regulators . . . . [W]e are a canary in this business coal mine and should sing a song of warning as we expire.”\textsuperscript{52}

III. SECURITIES REGULATIONS IN RELATION TO HEDGE FUNDS

Historically, securities regulation was the province of state governments’ blue sky laws until concern with securities fraud preceding and during the Great Depression led Congress to pass the Securities Act of 1933.\textsuperscript{53} This Act was followed by the Exchange Act of 1934, the Investment Company Act, and Investment Advisor Act of 1940, as well as other federal security regulations. While state blue sky laws continue to exist and may be relevant to intra-state offerings, for the most part they have been superseded by federal securities regulation.\textsuperscript{54} The following is a

\textsuperscript{48} Duff McDonald, \textit{The Running of the Hedgehogs}, N.Y. MAG., Apr. 2007, at 44.  
\textsuperscript{49} Julia Kollewe & Damian Reece, \textit{Hedge Funds Accused of “Ripping Heart Out of German Economy”}, INDEPENDENT, May 11, 2005, at 52.  
\textsuperscript{50} Id.  
\textsuperscript{52} Id. at 11.  
\textsuperscript{53} The name blue sky laws was coined by Judge McKenna in \textit{Hall v. Geiger-Jones Co.}, where he referred to promoters who tried to sell nothing more substantial than “so many feet of blue sky.” 242 U.S. 539, 550 (1917).  
\textsuperscript{54} Congress amended section 18 of the Securities Act in 1996 such that most state blue sky laws are preempted. \textit{E.g.}, \textit{JAMES COX ET AL., SECURITIES REGULATIONS} 390 (5th ed. 2005) (outlining limits of state regulation). Intra-state offerings, which are covered by
summary of the portions of securities regulations most relevant to the hedge fund industry.

A. The Securities Act of 1933

The Securities Act primarily focuses on initial public offerings and was motivated by a desire to ensure, as Franklin D. Roosevelt said, that "every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element . . . be concealed from the buying public." In general, the Act requires issuers to register a security with the SEC before it is offered to the public, unless the security is otherwise exempt. The term "security" is widely defined in section 2(a)(1) of the Act to include investment contracts, which are in turn defined as investments in a common enterprise where the investor expects profits solely from the efforts of others. Given the encompassing definition of investment contracts, investments in hedge funds clearly would be considered securities and thus need to be registered if the funds do not fall under a registration exemption. Because registration is an expensive process that requires detailed disclosure, funds are structured specifically to ensure that they fall into an exemption.

Currently, hedge funds can avoid the Securities Act's registration and prospectus requirements by using the private offering exemption in section 4(2), which is based on the belief that the sophisticated investor has less need for protection from disclosure than the average investor. To qualify for the registration exemption provided by section 4(2), hedge funds must abide by the limits of Rule 506, which provides a safe harbor for compliance with section 4(2) as long as an offering has thirty-five or fewer purchasers and is not publicly advertised. The limits of Rule 506 are

---

section 3(a)(11) of the 1933 Act and the safe harbor of Rule 147, receive an exemption from registration as long as the issuing company does business within a state and sells the offering only to investors within that state. These offerings are still subject to state law, however, as section 3(a)(11) and Rule 147 exempt the offering only from federal registration requirements.


57. Registration costs start around $200,000-$500,000 and can be even more for large offerings. Joseph Castelluccio, Sarbanes-Oxley and Small Businesses: Section 404 and the Case for a Small Business Exception, 71 Brook. L. Rev. 429, 445 (2005).

58. See, e.g., Liffman, supra note 55, at 2155 (arguing that experienced investors are more insulated from harm than less experienced investors).

59. Rule 506 is part of Regulation D, and provides that issuers who meet the conditions
actually less restrictive than they may appear, as an offering can also be sold to an unlimited amount of accredited investors who do not count towards the thirty-five purchaser limit. The wide definition of accredited investor covers all institutional investors, as well as wealthy individuals.

Specifically, Rule 501(a) defines accredited investors as various large financial institutions and individuals with an income of over $200,000 (over $300,000 for a married couple) or net worth of over $1 million. There are concerns, however, that a growing number of people with $1 million in net worth are not actually sophisticated investors with a high risk tolerance, particularly when individuals are able to include their home equity as part of their net worth. To meet these concerns, the SEC has proposed a new category of “accredited investors” to include natural persons who own at least $2.5 million in investable assets. Home equity is not considered an investable asset, and thus could no longer be counted towards meeting the net worth requirement.

The only drawback to this wide dispensation from the registration requirements is that hedge funds must also comply with the prohibition on advertising in Rule 502(c), which mandates restrictions such as using password-protection to prevent casual, unsophisticated investors from stumbling across hedge fund websites. Despite these restrictions, the section 4(2) exemption allows hedge funds to escape onerous registration requirements while still serving the anti-fraud purpose of the Securities Act, as section 4(2) exemptions do not exempt offerings from the anti-fraud

of the rule will not be deemed to be involved with a public offering under section 4(2) of the Securities Act. Unlike Rules 504 and 505, Rule 506 does not establish a dollar limit on the offering. But, 506(b)(2)(i) requires less than thirty-five purchasers, and with purchasers who are non-accredited investors, 506(b)(2)(ii) requires either that issuers reasonably believe such purchasers are sophisticated (having “such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment”), or that such purchasers be represented by a purchaser representative who has such knowledge. 17 C.F.R. § 230.506 (2007).


62. The SEC warned in a 1995 release that placing private offering materials on the web for public access “would not be consistent with the prohibition against general solicitation or advertising [in Rule 502(c)].” COX ET AL., supra note 54, at 307 (citing Securities Act Release No. 33-7233, 60 Fed. Reg. 53,458 (Oct. 6, 1995)). The Commission subsequently disciplined CGI Capital for failing to restrict access to its webpage to sophisticated investors and for allowing investors to purchase securities online without first determining whether they were sophisticated or accredited investors. See SCOTT, supra note 3, at 740-41 (mentioning the password requirement for online securities purchases).
protections of section 12 and section 17.

B. The Exchange Act of 1934

While the Securities Act of 1933 primarily concerned initial public offerings, the Exchange Act of 1934 focused on the regulation of the secondary securities market. Congressional intent in passing the Exchange Act was to reduce fraud and protect investors by increasing the disclosure and distribution of material information. While hedge funds are exempt from many of the restrictions of the Exchange Act because they fall outside of the technical definitions of a broker and dealer, they are subject to a subset of the ongoing reporting requirements.

In particular, hedge funds are subject to the beneficial ownership rules in section 13(d) and section 13(g) of the Exchange Act, which require a public filing when any person acquires beneficial ownership of 5% of a company’s stock. Under Rule 13d-3’s definition, beneficial ownership includes the power to direct the voting or disposition of any equity securities, which typically includes hedge fund positions, even if the fund does not have economic exposure due to offsetting derivatives. If a fund builds a large position such that it has beneficial ownership of 10% or more of a company’s stock, then the fund is subject also to the reporting requirements of section 16(a), as well as the limits on short swing profits in section 16(b). The beneficial ownership provisions are discussed in further detail in Part IV.C.

Additionally, section 13(f) of the Exchange Act requires funds that manage over $100 million in equity securities to disclose their positions on a quarterly basis. Although rarely approved by the SEC, confidentiality

63. See, e.g., Basic Inc. v. Levinson, 485 U.S. 224, 258 (1998) (discussing the development of congressional policy to facilitate investor reliance on market integrity).


65. 17 C.F.R. § 240.13d (2007); 15 U.S.C. § 78m (2000 & Supp. IV 2004); see also Tiffith, supra note 10, at 511 (discussing beneficial ownership rules in sections 13(d) and 13(g) of the Exchange Act).

66. For the purposes of section 13(d) and section 13(g) of the Exchange Act, “a beneficial owner of a security includes any person who, directly or indirectly . . . has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) Investment power which includes the power to dispose, or to direct the disposition of, such security”). 17 C.F.R. § 240.13d-3.

exceptions to section 13(f) are a solution to fund managers' concerns with competitiveness and are discussed further in Part IV.B. Finally, section 10(b)(5)'s prohibition of insider trading applies to hedge funds, as has been seen in the recent SEC investigation of Pequot, and is discussed further below in Part IV.A.

C. The Investment Company Act of 1940

The Investment Company Act of 1940 regulates investment companies and requires their registration with the SEC. An "investment company" is broadly defined as an issuer that "holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities," which would typically include hedge funds. Nonetheless, hedge funds can usually avoid the restrictions of the Investment Company Act by using exemptions found in section 3(c)(1) or section 3(c)(7) of the Act. The exemption in section 3(c)(1) applies as long as an offering is not public and is made to fewer than 100 investors. Alternately, the exemption in section 3(c)(7) applies to an unlimited number of accredited investors as long as they have over $5 million in investable assets and the offering is not public. The definition of "qualified purchaser" differs in the two exemptions: section 3(c)(1) uses the Regulation D definition of $1 million in assets, while section 3(c)(7) requires an individual to have a net worth of greater than $5 million, or to invest greater than $25 million for others, to be an accredited investor under that exemption. If the fund is advised by a registered advisor under the Investment Advisors Act, the minimum asset requirement under section 3(c)(1) actually rises to $1.5 million, and the SEC is considering a further increase to $2.5 million in investable assets. While hedge funds must shape the limits on their clientele differently depending on which exemption they choose, they typically can find an exemption from the restrictions and registration requirement of the Investment Company Act.

68. Tiffith supra note 10, at 512.
70. "Any issuer whose outstanding securities . . . are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities" is not considered an investment company. Investment Company Act § 3(c)(1), 15 U.S.C. § 80a-3 (2000 & Supp. IV 2004).
73. See SCOTT, supra note 3, at 738-39 (describing the Investment Advisors Act and SEC considerations to raise minimum asset requirements).
If hedge funds, like mutual funds, were defined as investment companies, it would be extremely problematic for their typical strategies. Section 18(f) of the Investment Company Act restricts leverage to 33% of assets, limits investments in illiquid securities, and sets diversification requirements that would fundamentally make the operation of a hedge fund, as they are currently construed, impossible.\footnote{74} Such rigid rules would wipe out many of the varied categories of hedge fund strategies listed above, which in turn would reduce investors' ability to diversify their portfolios.

D. The Investment Advisor Act of 1940

The Investment Advisor Act was passed in 1940 with the goal of reducing abusive practices by requiring investment advisors with more than fifteen clients and greater than $30 million in assets to register with the SEC, maintain certain records, and make ongoing disclosure statements on Form ADV.\footnote{75} Form ADV requires investment advisors to disclose owners, prior securities convictions and injunctions, and an annual balance sheet among other things, and to distribute a brochure on business operations to prospective clients.\footnote{76} Recently, this Act served as the vehicle for the SEC's mandatory registration efforts, which changed the definition of "client" under the Act to force more hedge fund advisors to register.

The Act contained a broad private investor exemption in section 203(b)(3), which allows advisors to avoid registration if they have fifteen or fewer clients. Until 2006, section 203(b) defined "client" as a legal entity, such as a limited partnership that shares the same investment objective, and allowed managers to count each fund that they managed as one "client."\footnote{77} Thus, managers could advise up to fourteen funds before they were considered investment advisors under the Act. The SEC attempted to close this loophole for hedge fund advisors by amending Rule 203(b)(3)-1 and creating Rule 203(b)(3)-2, effective in February 2006, which together required advisors to "look through" the legal structure of their funds and "count each shareholder, limited partner, member, or beneficiary of a private fund as a client."\footnote{78} If a fund had more than fourteen U.S. clients, it had to register regardless of whether the fund was incorporated offshore.\footnote{79} Applying the look-through provision to funds in

\footnote{75. Joseph Hellrung, Hedge Fund Regulation: Investors are Knocking at the Door, But Can the SEC Clean House Before Everyone Rushes In?, 9 N.C. BANKING INST. 317, 326 (2005).}
\footnote{76. See SCOTT, supra note 3, at 749.}
\footnote{77. Bevilacqua, supra note 64, at 269; Tiffith, supra note 10, at 514.}
\footnote{78. Bevilacqua, supra note 64, at 270.}
\footnote{79. Liffmann, supra note 55, at 2179.}
the revised rule, regardless of whether they were incorporated offshore or in the United States, helped to prevent funds from reincorporating offshore to avoid registering as an investment advisor.\(^80\) The only exception was offshore funds managed by offshore managers, which did not have to register.\(^81\) Interestingly, the amended rule specifically excluded private equity fund advisors by excluding any fund with a lockup period of longer than two years.\(^82\) Hedge funds advisors also could avoid registering as investment advisors if they have a two year lockup, although this is rare and unpopular with investors.

For hedge funds then considered to be investment advisors, the main effects of the rule change were that such funds had to file and report basic information on Form ADV, and were "generally prohibited from charging performance fees unless investors have $750,000 invested with the advis[o]r or have a net worth of $1.5 million."\(^83\) In turn, this prohibition led most funds to raise their minimum investment levels, a result congruent with the SEC's desire to protect unsophisticated investors. As further discussed in the review of the policy behind the push for mandatory registration, found in Part VI.A below, the Goldstein court rejected the amended Rule 203(b)(3) in 2006, and hedge funds are no longer required to register.

Notwithstanding the Goldstein decision, hedge funds remain subject to the antifraud provisions of the Investment Advisor Act, which prohibit funds from making material omissions or misrepresentations to investors, regardless of their registration status. In December 2006, the SEC proposed including all pooled investment vehicles under the antifraud provisions of the Investment Advisors Act, regardless of whether the pooled vehicle would otherwise be exempt under section 3(c)(1) or section 3(c)(7) of the Investment Company Act.\(^84\) If passed as proposed, the SEC's rule further clarifies that hedge funds are considered investment companies for purposes of the antifraud provisions, and retain liability for making "false or misleading statements" or "defraud[ing] investors or prospective investors."\(^85\)

Hedge fund managers who disregard the anti-fraud provisions of the

\(^{80}\) See id. (discussing the lack of incentive to move offshore if a hedge fund advises more than fourteen clients).


\(^{82}\) See id. (discussing impact of amendment). Private equity and venture capital funds typically have a lockup for several years, if not for the life of the fund, due to the illiquidity of their investments.

\(^{83}\) Tiffith, supra note 10, at 516.

\(^{84}\) SEC Press Release, supra note 60.

\(^{85}\) Id.
securities acts clearly are not immune from enforcement. Daniel Marino, the former CFO of Bayou Management, was sentenced to twenty years in prison in January 2008 after he pled guilty to defrauding investors of more than $400 million. Along with the CEO, Marino misled investors as to Bayou's assets under management and performance, two critical factors in attracting new investors.

IV. DETAILS ON THE DISCLOSURE STANDARDS APPLICABLE TO HEDGE FUNDS

The principle regulations that apply to hedge funds at this time are the beneficial ownership reporting mandates of the Exchange Act, of which section 13(f) requires quarterly reports if a fund manages more than $100 million in equity securities, and the various antifraud provisions in section 12 and section 17 of the Securities Act. Disclosure requirements particularly trouble hedge funds, many of which emphasize secrecy within their investment process to create a competitive advantage. The primary concern is that immediate disclosure of positions allows imitators to piggyback on the work of the better funds. This lowers the first mover's returns if it is unable to complete building its position before the quarter end, at which time the fund will need to disclose its position.

The following are the specific disclosure requirements that most hedge funds face, along with a discussion of whether the application of securities laws in this context serves the original goals of these laws.

A. Disclose or Abstain: Insider Trading

Insider trading rules naturally apply to hedge funds, as well as other investors, and have led to several investigations of hedge funds by the SEC. The basic rule is that any investor in possession of material, nonpublic information must either disclose that information to the public or abstain from trading based on it. One of the most prominent recent SEC insider trading investigation of a hedge fund involves Pequot Capital Management. The focus of the investigation was a $44 million investment that Pequot made in Heller Financial in July 2001, just before Heller was acquired by GE Capital. John Mack, who has since been named the head of Morgan

87. Id.
Stanley, was suspected of having passed insider information to Arthur Samberg, Pequot’s founder. The SEC investigator in charge of the case, Gary Aguirre, testified before Congress that he was told he could not interview Mr. Mack due to his political power and was soon after fired from the SEC, despite having received a recent merit pay increase. Congress later questioned the way in which Aguirre was fired and requested that the SEC reopen the Pequot investigation. While the case received extensive public scrutiny and raised important issues regarding the overlap of politics with regulatory investigations, it did not raise unique or novel regulatory issues.

B. Ongoing Disclosure of Investment Positions

The most common disclosure requirement stems from section 13(f) of the Exchange Act, which requires institutional money managers who exercise discretion over greater than $100 million of exchange traded or over the counter quoted equity securities to disclose their aggregate positions quarterly in Form 13F filings. The filing must be made within forty-five days of the end of the quarter. Form 13F applies to only long positions; there is no requirement to publicly report short positions, securities that are not publicly traded, or OTC derivatives.

The rationale behind section 13(f) is that fund position disclosures will “fill an information gap” and “increase investor confidence” in the U.S. securities markets. The SEC may exempt any institutional investors from these provisions under section 13(f)(2). Additionally, Rule 24b-2 of the Exchange Act authorizes the SEC to delay or prevent disclosure otherwise required by section 13 when necessary or appropriate in the public interest or for the protection of investors. In reality, there is little deviance from

90. Id.
92. See Exchange Act § 13(f), 17 C.F.R. § 240.13(f)(1) (listing report requirements for each equity security held on the last day of the reporting period to include issuer name, title, class, CUSIP number, number of shares or principal amount, and aggregate fair market value of each such security).
the disclosure standard because the SEC approves both of these exceptions extremely infrequently.

Historically, the SEC has not made section 13(f) a major focus of its enforcement actions; SEC Chairman Cox and Randall Thomas found that there were no enforcement actions for noncompliance with section 13(f) from 1968, when the disclosure was mandated, to 2005.97 Nevertheless, section 13(f) is one of the more contentious disclosure requirements because secrecy is often critical to building a position in a security that a fund considers to be misvalued. As discussed in the next Part, Warren Buffett demonstrated to the SEC that disclosures by Berkshire Hathaway create temporary market spikes that hamper his investment program. While the trade secret argument (also discussed below) is weaker than Buffett's followership concern, both demonstrate that managers have realistic concerns with respect to section 13(f). Thus far, the SEC has done little to address these concerns, although a possible solution would be for the SEC to delay disclosure for some slightly longer period, e.g., sixty to seventy-five days rather than forty-five days; this would likely still serve the purpose of informing the public and alleviating managers' concerns about disclosing an investment thesis before they can fully stake out their position.

C. "Followership" and Trade Secret Concerns Regarding the Disclosure Requirements

A primary problem with the disclosure requirements of section 13(f) of the Exchange Act is that the quarterly filings can be a competitive disadvantage when a fund is in the process of building a position. As mentioned above, Rule 24b-2 of the Exchange Act authorizes the SEC to delay or prevent disclosure otherwise authorized by section 13(f), but the SEC will generally keep a disclosure confidential only if revealing it would expose an advisor's ongoing investment strategy, open risk arbitrage positions, or block positioning strategies.98 In practice, the test is whether the fund can demonstrate that disclosure "would be likely to cause substantial harm to [the fund’s] competitive position."99 The

99. In the Matter of Berkshire Hathaway Inc., Order Affirming the Determination of the
confidentiality exception within securities law is itself derived from one of nine exceptions to the Freedom of Information Act, which would otherwise require all information filed with the SEC to be made available to the public.\(^\text{100}\) The exemption most commonly used in securities law covers “trade secrets and commercial or financial information obtained from a person and privileged or confidential.”\(^\text{101}\) Applicants must meet several substantive requirements in their application, which cannot be overly broad, should set forth an analysis for the exemption, and must specify the duration of the requested confidentiality period.\(^\text{102}\)

Berkshire Hathaway made such a confidentiality request in February 2000 and August 2003. In its 2003 petition, Berkshire argued that “other market participants would on learning of Berkshire’s interest join in acquiring the stock, causing a material increase in the price of the stock, thus making pursuit of the acquisition program more costly.”\(^\text{103}\) Berkshire also provided the SEC with a list of cases in which disclosure of a position had been followed by increased prices in those securities.\(^\text{104}\) Both times, the SEC declined Berkshire’s confidentiality request because it did not demonstrate “the likelihood of substantial competitive harm” to the extent required by the Exchange Act.\(^\text{105}\) In its 2003 decision, the SEC recognized that the disclosures had “[on] a number of occasions . . . resulted in temporary spikes in the market,” but was concerned that approving a grant of confidentiality on those specific grounds would result in “a virtual per se justification for confidentiality for Berkshire.”\(^\text{106}\) The SEC appeared willing to examine specific cases if further information about the expected duration of the acquisition program, historic prices, and average daily trading volumes could be provided.\(^\text{107}\) On the whole, the wording of the release implies that the SEC would be more inclined to approve delayed disclosure of section 13(f) filings if it was provided with full details and reassured that the acquisition program would be completed relatively promptly.\(^\text{108}\)

Phillip Goldstein, the hedge fund manager who successfully challenged the revised Rule 203(b) mandating hedge fund registration, also

\(^{100}\) SEC Legal Bulletin No. 1, supra note 98.

\(^{101}\) Id.

\(^{102}\) Id.

\(^{103}\) Id.

\(^{104}\) Id.

\(^{105}\) Id.

\(^{106}\) Id.

\(^{107}\) Id.

\(^{108}\) Berkshire requested a confidentiality period of one year, which the Commission may have likely viewed as unnecessarily long. Id.
filed an application to exempt his fund from filing Form 13F on trade secret grounds in September 2006. He analogized his Bulldog Fund's holdings to Coca Cola's confidential formula, and contended that section 13(f) "constitutes a taking of the fund's property without just compensation in violation of the Fifth Amendment to the Constitution." Interestingly, Goldstein argued that section 13(f) may actually reduce investor protection by inducing false over-confidence in the market and making investors less likely to conduct full due diligence reviews before investing. Few people in the industry, however, agree with him. One commentator who manages several billion dollars in a fund of funds commented that "the 13F is a very valuable tool for us to fulfill fiduciary duties to our clients . . . . [It] allows us to monitor the holdings of our external managers and ensure that their monthly reports accurately reconcile with SEC filings." As Goldstein recognized, the SEC is extremely unlikely to provide a blanket exemption from Form 13F for his fund.

While the SEC is unlikely to agree to delayed disclosure for a year, as Berkshire Hathaway requested, or to exempt a fund from section 13(f) requirements altogether, greater use of the Rule 24b-2 confidentiality exception for brief periods of time would help allay fund managers' concerns without undermining the purpose of making the holdings public, i.e., filling the information gap and building public confidence in the market. As it is, Form 13F filings are meant to represent a manager's holdings rather than to reflect the fund's current positions given the existing forty-five-day delay, as many funds turn over their holdings within forty-five days. Lengthening that time period slightly, upon a request to complete a specific acquisition program, to a period such as sixty to seventy-five days, (which is the time span allowed to file 10-K's), should not make the filings less representative or serve to undermine investor confidence.

D. Disclosures of Beneficial Ownership Positions

The Williams Act, which is part of the Exchange Act of 1934, requires preliminary reports if a significant stake of equity securities is acquired to give other shareholders advanced notification of a possible takeover. As mentioned in the record of congressional debates on amendments to

109. See Do Hedge Funds Hold 'Trade Secrets', supra note 95 (quoting Phillip Goldstein).
110. Id.
111. Id.
112. Id. (including reader comment of Ben S. to http://www.businessweek.com/investor/content/sep2006/pi20060913_356291.htm?chan=search (Sept. 14, 2006)).
113. Id.
sections 13 and 14, the goal of this portion of the securities acts is to ensure that investors receive "timely, adequate, or sufficient information with respect to accumulation of securities in the market and with respect to conduct involved in tender offers." The primary provision is section 13(d) of the Exchange Act, which requires any party that becomes a 5% beneficial owner of a registered class of equity securities to file a Schedule 13D report within ten days of reaching the 5% threshold. The party must also provide a copy of the report to the issuer and to the relevant exchanges upon which the security trades. A group may be deemed to act as a single person and qualify for the 5% threshold if its members act together for purposes of "acquiring, holding, or disposing of securities."

In addition, the Williams Act requires 5% beneficial owners who acquire an additional 2% within a twelve-month period to file an updated report with the SEC within ten days of such additional purchases. In either case, Schedule 13D contains the information that a purchaser must disclose once it reaches the 5% threshold, which includes information about the purchaser, the source, the amount of consideration used in the purchase, whether the purpose is to acquire control or make other major changes, the number of shares the purchaser owns, and information about any contracts the purchaser has that relate to the issuer or security. Five-percent holders do not need to make a new section 13(d) filing as long as their additional purchases within a twelve-month time frame remain under 2%.

If an owner does not intend to propose a change in control of the issuer, section 13(g) of the Exchange Act, which requires less disclosure, can be used in place of section 13(d). In essence, section 13(g) requires the disclosure of the name and description of the shares owned, the nature of such interest, and whether any person has a right to receive the proceeds from their sale. While this is a less detailed disclosure than section 13(d) requires, it still includes basic information regarding the size of the holding that most hedge funds would prefer to keep confidential until they have

116. Id.
117. Id. § 78m(d)(3).
118. See, e.g., GAF Corp. v. Milstein, 453 F.2d 709 (2d Cir. 1971) (noting that the 5% threshold under section 13(d) of the Exchange Act applies separately to each registered equity class, so a fund may pass the threshold if it owns 5% of a firm's convertible debentures, although they would not convert into 5% of the firm's common stock).
finished building a position in the stock.

If the investor fails to make the appropriate section 13(d) filing upon reaching the 5% threshold, the target company has a private right of action against the buyer. The key concern of a target is most often a tender offer, which is not the outcome sought by most hedge funds, but can be an issue for activist funds. If a tender offer is launched, there are specific reporting requirements under section 14 that will not be discussed in detail here, as generally few funds seek controlling ownership positions. The convergence of the private equity and hedge fund industries may lead more funds to seek control positions, but this Article focuses on the appropriate regulatory regime for funds that do not seek such control.

Under section 16(a) of the Exchange Act, as an investment firm's holdings grow in size, it must report when it reaches a 10% beneficial ownership threshold. A short term holder will want to avoid 10% beneficial ownership, because the holder would then need to surrender any short swing trade profits to the corporation under section 16(b). Short selling is also prohibited for 10% beneficial owners. The end result of the restrictions in section 16 is that funds rarely buy more than 9.9% ownership to retain investment flexibility.

At this point, it is necessary to distinguish activist hedge funds, which seek control of a company or changes in management or strategy, from purely investment-oriented hedge funds, which believe that a company is undervalued or overvalued, but do not actively try to change the market's valuation. In January 2007, Paul Kingsley estimated that there were approximately 100 activist funds, with an estimated $50 billion in assets under their control. Prominent examples of activist investors include Chris Hohn's The Children's Investment Trust and Atticus Capital, which engaged in a public battle to prevent the acquisition of LSE by Deutsche Borse. Appropriately, section 13 requirements cover these activist funds because they trigger the traditional concern to notify management when a party interested in making fundamental changes in the business acquires a large stake of securities. As a side note, section 13(d)'s 5% level actually may be too high, as a smaller shareholder in an extremely large company with a diversified shareholder base can exert some control with an even

122. See Exchange Act § 16(b), 15 U.S.C. § 78p(b) (2000 & Supp. IV 2004) (stating that a beneficial owner must be a 10% holder at the time of both purchase and sale to be covered by the short swing trading restrictions).
smaller stake. For instance, Carl Icahn attempted to exercise substantial control over Time Warner despite owning only a 3% stake in the company.\textsuperscript{126}

The majority of hedge funds, however, are not activists, and it is inappropriate to apply the same disclosure standard when the primary purpose of warning of a potential tender offer is no longer valid. The section 13(g) standard requires funds to make disclosures regarding their ownership stake, regardless of their activist/non-activist position, and despite the fact that doing so can limit their ability to finish building a position in the stock. Extending the window for filing section 13(g) reports would allay some of the investor concerns with followership while still making the information publicly available within a reasonable time frame.

Currently section 13(d), (g), (f), and section 16 disclosures do not provide all the information that critics want. Outstanding issues further discussed below include funds’ leverage ratios and “empty voting” through the use of derivatives, neither of which can be tracked through current disclosure requirements.

\textbf{E. Open Issues Regarding Disclosure}

One unresolved question is the disclosure of certain arrangements that hedge funds occasionally use, including side letters and side pockets. A side letter grants the specified investor preferential terms if a designated event occurs, such as when a fund manager leaves, while a side pocket sets different liquidity provisions for a certain segment of a hedge fund.\textsuperscript{127} Investor approval is not always obtained before instituting one of these arrangements. For instance, Scion Value Fund did not obtain investor approval before it created a mandatory side pocket for its investments in mortgage derivatives in November 2006.\textsuperscript{128} While creating the side pocket protected the fund from having to unwind its investment at the wrong time, which ultimately paid off when the subprime market collapsed in early 2007, some investors were furious that they were not given the choice to exit the fund.\textsuperscript{129}

Investors may also be concerned that side pockets, while reasonably used to separate out illiquid investments, may instead be used as a repository for losing trades.\textsuperscript{130} A recent survey of in-house counsel at

\textsuperscript{127} See SCOTT, supra note 3, at 742 (establishing the difference between side letter and side pocket).
\textsuperscript{129} \textit{Id}.
\textsuperscript{130} Chidem Kurdas, \textit{Headline Risk Tops Pension Concerns: Survey}, HEDGEWORLD DAILY NEWS (HedgeWorld News, White Plains, N.Y.), Apr. 9, 2007 (citing industry
investment management firms revealed that they believe the use of both side letters and side pockets is declining, along with the use of soft dollars, as funds focus on increasing transparency to investors.\textsuperscript{131} The SEC is also investigating the use of side pockets, as are regulators in Hong Kong and the International Organization of Securities Commissions.\textsuperscript{132} SEC intervention probably is unnecessary in this area, however, as market discipline will likely lead to clauses in funds' investment mandates that ban the use of such arrangements if investors feel they are being abused.

F. \textit{Public Policy Behind the Disclosure Standards}

The push to regulate hedge funds is largely consistent with the policies that have historically motivated securities legislation.\textsuperscript{133} Two traditional policy goals—protecting investors and reducing fraud—were also behind the drive for mandatory registration. Nevertheless, many of the concerns with fraud are currently addressed, as hedge funds are not exempt from the anti-fraud provisions of the securities acts. Often considered one of the most powerful anti-fraud provisions, section 12 of the Securities Act already applies to hedge funds if they make false or misleading statements, as do section 17(a) and the anti-fraud provisions of the Investment Advisor Act.

Historical concerns that promote ownership disclosure are most relevant to activist hedge funds. The distinction between an activist and non-activist hedge fund is that the former encourages companies to make strategic changes, while the latter invests passively. The primary purpose of the Williams Act disclosure requirements in sections 13 and 16 was "to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information regarding the qualifications and intentions of the offering party."\textsuperscript{134} These concerns, which are appropriate in a tender offer situation and thus ought to apply to activist hedge funds, do not apply when control is not an end goal. The SEC recognizes this to some extent and allows funds to file a Form 13G rather than a Form 13D when funds reach a 5% beneficial ownership threshold and do not intend to suggest changes in the company.

The most relevant outstanding policy concern for hedge funds is investor protection, particularly with the growing involvement of retail investors. This is further discussed in the upcoming Part, but the SEC has

\begin{footnotes}
\item[132] Id.
\item[133] See, e.g., Liffmann, \textit{supra} note 55 (recounting history of hedge funds).
\end{footnotes}
not presently found a coherent response. Although it has proposed raising the accredited investor standard, this may be difficult to sustain as other countries concurrently lower their investment requirements for retail investors in hedge funds. Regulatory convergence, particularly with the FSA in the U.K., makes it likely that the SEC may reconsider raising the standard, and may actually lower it in the long run. Instead, a more effective approach to investor protection would be for the SEC to focus on vigorous enforcement of the current fraud rules, which make material misrepresentations and omissions to investors illegal. These existing tools, if used effectively, will appropriately penalize fraudulent funds without increasing the regulatory burden on the hedge fund industry as a whole.

V. REGULATORY CONCERNS WITH HEDGE FUNDS

The following Part discusses issues that remain at the forefront of critics' minds, such as leverage, empty voting, retailization, market manipulation, soft dollars, and short term investing. Most of these issues are not limited to hedge funds; many apply to other private pools of capital, including private equity or mutual funds.

A. Leverage

Hedge funds' customary use of leverage raises concerns that the funds' unregulated status could allow them to "potentially wreak havoc on the world financial markets," principally through large losses that could force them to quickly liquidate their positions.\(^\text{135}\) These losses can be exacerbated in highly leveraged funds, as was seen in the failure of Long Term Capital Management (LTCM) in 1999 and more recently with the rapid losses that Amaranth Advisors experienced in the fall of 2006.\(^\text{136}\) A fund's increased vulnerability to a reversal in turn increases systemic risk to the market place and leads to concerns that the failure of one or two large firms could trigger a chain reaction.

Derivatives are one of the primary leverage methods funds use, as puts and calls can be bought for a fraction of the underlying value of the security, but enable a fund to capture the gain if the security moves in the expected direction. While this helps boost returns if the market moves in line with the investment thesis, it can expose the firm to enormous downside losses if the market moves contrary to the bet, as happened to...


Amaranth Advisors. Amaranth invested principally in energy futures, and when the market moved against its positions in September 2006, Amaranth lost approximately $6.5 billion. Similarly, LTCM’s rapid losses came relatively close to fulfilling many critics’ prophesy that leveraging would lead to a potential systematic collapse of the financial system, which was why the federal government encouraged banks to invest in LTCM, shoring it up such that it could liquidate its positions in an orderly manner rather than in a fire sale. The use of leverage did not surprise LTCM’s investors. LTCM disclosed to investors that it planned to make “extensive use of borrowed funds” and consistently maintained leverage of twenty-one times their equity or greater. If highly-levered funds start to experience large losses with increased frequency, investors will likely begin to pay more attention to leverage levels, acting as a market check.

A natural check on the leverage of a hedge fund is the internal risk management systems of its counterparties, who stand to lose large sums of money if the fund cannot fulfill its side of a derivatives contract. LTCM’s counterparties would have lost $300-500 million each and $3-5 billion collectively if LTCM had failed. As LTCM’s trades moved against its predictions, its counterparties insisted on marking-to-market the positions and demanded extra collateral from LTCM, which in turn made the traders at LTCM feel that “their counterparties [were] easing them into a death spiral.” In its review of LTCM’s collapse, the General Accounting Office found that the “banks and securities and futures firms that were its creditors and counterparties failed to enforce their own risk management standards.” The report concluded that “lapses in market discipline” created the potential for systemic risk, but also noted the response where the potential losses posed by LTCM “prompted strong reactions from virtually all large firms that were counterparties of hedge funds and an increased sense of awareness regarding risk management policies.”

Risk management improved post-LTCM, bringing down leverage and thus market liquidity. Dunbar estimates that liquidity in certain markets

---

138. The panic resulting from the widespread fear that LTCM would be forced to liquidate its positions led people to avoid the markets, such that “now . . . there was no market, as all the high-yield investors stayed at home. It was the same in the mortgage bond market.” Bill McDonough, the President of the Federal Reserve Bank of New York, became increasingly involved in negotiations with the investment banks throughout September and October of 1999. See DUNBAR, supra note 136, at 217.  
139. GAO REPORT ON LTCM, supra note 2, at 41.  
140. Id. at 12.  
141. DUNBAR, supra note 136, at 213.  
142. GAO REPORT ON LTCM, supra note 2, at 2.  
143. Id. at 10, 13.
dropped by over 90%.

Eventually leverage levels rebounded, but experiences such as LTCM and Amaranth remind counterparties of the need for solid risk management systems, as they will pay the cost if there is a large scale liquidation event. In May 2007, a New York Federal Reserve economist suggested that “[r]ecent high correlations among hedge fund returns could suggest concentrations of risk comparable to those preceding the hedge fund crisis of 1998,” making it clear that leverage is still a significant regulatory concern. On the whole, however, while there is the potential moral hazard that banks will grant hedge funds unreasonably high leverage if they believe the Federal Reserve will bail them out, hedge funds’ potential counterparty risk should be a sufficient check on leverage.

A more recent pullback on leverage came in the fall of 2007, as a decline in the value of subprime mortgages led to volatile markets and a decline in the amount banks were willing to lend to hedge funds. Margin calls and the impact of leverage led to several hedge fund failures in late 2007 and early 2008, but these losses occurred without causing a systemic collapse or creating the need for federal intervention.

Additionally, investment consultants who serve pensions and high net worth families have incentives as fiduciaries to not risk a negligence lawsuit by recommending a highly levered-fund. One consultant, Rocaton Investment Advisors, was sued by the San Diego County Employees Retirement Association (SDCERA) for recommending Amaranth and eventually settled the claim for $2.75 million. While this is only a fraction of the $105 million that SDCERA lost, it is a sufficiently stiff penalty to make consultants take leverage levels into account when recommending funds. The combination of increased investor awareness of leverage risks, improved counterparty risk management systems, and rising litigation risks for investment consultants should result in sufficient discipline to keep leverage in check without the need for more rigid formal regulations, such as the rules for mutual funds in the Investment Company Act of 1940.
B. The Separation of Voting Rights and Economic Ownership

Corporate law is largely based on the premise that voting power is proportional to economic ownership, and that the coupling of shares and votes creates a market for corporate control. There are some exceptions, such as when different classes of stock have different voting rights and values. The difference in voting rights, however, is public information, and shareholders who buy a class of shares with limited rights are fully informed that they are purchasing economic ownership that does not include a voice in its corporate governance. The growth in derivatives has undermined this distinction and enabled investors to buy or sell voting power—essentially corporate control—separately from economic ownership. The basic method is to buy an equity stake in the corporation in question and sell an offsetting amount of stock short, such that the voting rights are retained, but not the economic interest in the stock. Hu and Black describe the decoupling of economic ownership and voting rights, which is principally done through the use of derivates, as “empty voting.”

Empty voting is most likely to become an issue when a proposed merger or acquisition is under consideration and funds can attempt to influence the outcome of a merger arbitrage opportunity. There are two principal concerns with empty voting. First, it can allow negative economic ownership and thus permit an investor to vote in ways that

---

150. Hu & Black, supra note 93, at 814.
151. See, e.g., Stroh v. Blackhawk Holdings, 272 N.E.2d 1 (lll. 1971) (legitimizing classification schemes that give one class greater control over the corporation, such as where a private corporation that goes public often reserves voting power for one class of shares, of which it preserves ownership, and then sells a Class B or other class that has either minimal or no voting power).
152. Vote buying is not illegal per se; Delaware uses a three-part test from Schreiber v. Carney to evaluate vote buying, which looks at whether the purpose was to defraud or disenfranchise nonparticipating shareholders and examines the fairness of the underlying transaction. 447 A.2d 17 (Del. Ch. 1982). See Jonathan J. Katz, Note, Barbarians at the Ballot Box: The Use of Hedging to Acquire Low Cost Corporate Influence and its Effect on Shareholder Apathy, 28 CARDOZO L. REV. 1483, 1511-13 (2006) (discussing Schreiber’s departure from a per se rule, toward a fact-sensitive approach to vote-buying cases). Shareholder disenfranchisement is a weak argument against practices such as Perry’s, as shareholders explicitly give their consent to stock lending and receive interest in return. Id. at 1514.
153. See id. at 1503 (describing Perry Corp.’s strategy).
154. Hu & Black, supra note 93, at 815.
155. See Katz, supra note 152, at 1486-87 (explaining a hedging technique to garner voting influence in a pending transaction).
actually reduce the firm's value, to benefit from a drop in its share price.\textsuperscript{156} While board members owe fiduciary duties to the firm, shareholders generally do not owe fiduciary duties to each other.\textsuperscript{157} Second, vote buying is often secretive, as securities rules seldom require its disclosure.\textsuperscript{158} This means that other shareholders may be unaware of divergent incentives that could motivate a voting decision, particularly in sensitive cases such as those that consider an acquisition or a vote on a proposed leveraged buyout.

One important limit on the extent of empty voting is section 16(c) of the Exchange Act, which prohibits short selling by any entity that owns more than 10\% of any class of a corporation's stock. As short selling is an essential ingredient in the empty voting strategy, section 16(c) effectively limits a hedge fund to acquiring 10\% of the vote.\textsuperscript{159}

One of the best public examples of empty voting was provided by Perry Capital, which acquired a 9.9\% stake in Mylan Laboratories when it made a bid to take over King Pharmaceuticals, and then eliminated its economic exposure to Mylan through swaps and short transactions.\textsuperscript{160} Perry planned to use its voting power to swing the vote for the merger, against the wishes of Carl Icahn, who was Mylan's second-largest shareholder with 9.8\% of the stock.\textsuperscript{161} Note that both Perry and Icahn remained under a 10\% ownership threshold for different reasons: Perry did not want to invoke the section 16(c) prohibition against short selling for 10\% beneficial owners, and Icahn did not want to invoke the section 16(b) prohibition against short-swing profits for 10\% owners. King Pharmaceutical ultimately withdrew from the deal, but the main contention is that Perry failed to disclose in its 13D filing that it was not taking an economic interest in the company. The SEC served a Wells Notice on Perry Capital in January 2006 and is currently investigating the trading techniques used in the deal.\textsuperscript{162} Vote purchasing is not per se illegal, but its behavior could be considered a market manipulation and a violation of the spirit of the disclosure requirements of section 13(d) of the Exchange Act.

Critics suggest that the SEC should declare this type of morphable ownership to be void, despite the apparent legality of its underlying

\begin{itemize}
\item \textsuperscript{156} Hu & Black, \textit{supra} note 93, at 815.
\item \textsuperscript{157} Shareholders with majority control are more likely to owe fiduciary duties to other shareholders, however, given their controlling position.
\item \textsuperscript{158} See Hu & Black, \textit{supra} note 93, at 818 (discussing legal disclosure gaps).
\item \textsuperscript{159} Katz, \textit{supra} note 152, at 1507.
\item \textsuperscript{160} See, e.g., Andrew Sorkin, \textit{S.E.C. Plans to Accuse Hedge Fund of Violations}, \textit{N.Y. Times}, Jan. 11, 2006, at C3 (discussing how Perry's maneuver to become Mylan's largest shareholder ensured Mylan could approve the deal that Icahn, Mylan's next-biggest shareholder, wanted to block).
\item \textsuperscript{161} \textit{Id.}; see Katz, \textit{supra} note 152, at 1503 (explaining Perry's strategy to neutralize Icahn's substantial opposition, increase the chance of merger, and secure potential profits).
\item \textsuperscript{162} Sorkin, \textit{SEC Plans to Accuse Hedge Fund of Violations, supra} note 160.
\end{itemize}
methods, on the grounds that it allows the voting process to be "hijacked" by hedge funds with "distorted voting incentives." Jonathan J. Katz, the author of a note on this subject, specifically suggests that the practice of empty voting will undermine the value of control premiums and foster economic loss, which will exacerbate shareholder voting apathy by leading to "lost confidence in the notion of a corporate democracy."

In the U.K., hedge funds voluntarily are moving away from empty voting and have proposed adopting a self-regulated standard that forbids funds from borrowing stock solely to make use of their voting rights.

Despite legitimate concerns, a ban on "empty voting" is overly broad and unnecessary. First, a party with true control, as in majority ownership, retains the power to decide the outcome of a shareholder vote. Katz erroneously refers to Carl Icahn's position in Mylan as an example of thwarting the control premium and fails to note that Icahn did not have control over the corporation with 9.8% of its stock and did not pay a control premium for his stake. Icahn's failed plans for Mylan had nothing to do with the value of control premiums, as he had no reasonable expectation to earn such a premium. Second, the increase in institutional shareholders has already undermined the will to vote among individual shareholders, who correctly conclude that their votes will have little effect on the outcome. For any party willing to take a large position to influence the outcome of a vote, the possibility of buying votes, as Perry did, is an equally viable option and makes the vote no less of a corporate democracy. Methods change over time, but Perry and other hedge funds do not have a monopoly over the ability to acquire voting influence. While a reasonable policy for the SEC would be to enforce disclosure of a fund's individual voting and economic stakes in Form 13D filings, it would make little sense for the SEC to arbitrarily declare this use of derivatives, which is open to any party, to be void.

C. Hedge Funds as Retail Investments

One of the SEC's key concerns with hedge funds is their "retailization," as average "retail" investors have increasingly demanded access to hedge funds along with sophisticated accredited investors. Both pension funds and funds of funds enable average investors to at least

163. Katz, supra note 152, at 1487.
164. Id. at 1516.
166. See Preiserowicz, supra note 6, at 840 ("If hedge funds will be "for the masses," then the SEC feels it has an obligation to regulate the industry.")
indirectly invest in hedge funds, although these individuals would likely not meet the definition of an accredited investor or the funds’ minimum investment level requirements on their own. As hedge funds become more widely used investment vehicles, the SEC’s mandate to protect individual investors becomes increasingly relevant. Former Federal Reserve Board Chairman Alan Greenspan has commented that “should hedge funds accept capital from retail investors they should be under the same regulations as mutual funds.” Applying the Investment Company Act to hedge funds as well as mutual funds, however, would fundamentally change the hedge fund industry, given the Act’s diversification requirements, limits on short selling, and leverage limits. This would be a drastic, overly-broad response to the problem.

One way the SEC has dealt with retailization concerns is its attempt to tighten the definition of accredited investor, as mentioned above. Nonetheless, wealth may not necessarily be a proxy for sophistication and access to information, particularly for individual investors. Moreover, even wealthy individuals who would meet the SEC’s standards for accredited investors do not necessarily feel that they have all the information they need to invest in hedge funds. In a recent poll by U.S. Trust, three out of four wealthy investors said that “hedge funds are difficult to investigate” and “it is difficult to find a good fund.” While the SEC’s concern with “retailization” reflects Congress’ mandate of investor protection as part of the Securities Act, equitable concerns also limit wealthy investors’ right to these returns. To protest the SEC’s proposal to raise the accredited investor standard, one irate investor wrote, “I believe that limiting any type of investment based on how much money a person owns is unfair and discriminatory . . . . The amount of money a person has to lose should not be used as a measure of that person’s sophistication as an investor.” While this goes against the grain of the securities’ laws paternalistic concern with investor protection, it is a valid concern, and individual investors arguably have better access to information and risk measures with modern technology than ever before.

Most recently, several pooled investment vehicles conducted initial

public offerings (IPO’s) such that retail investors could directly invest in them without meeting the minimum investment standards that would otherwise be required. For instance, Fortress Investment Group, which has $9.4 billion in hedge fund assets as well as private equity investments, conducted an IPO in February 2007 and raised $634 million. On the one hand, these securities are registered and thus require the firms to divulge substantially more information to potential investors than they otherwise would release. Fortress will also have a board with a majority of independent directors to oversee it, as required by NYSE listing rules.

On the other hand, concerns remain about the appropriateness of riskier investments for financially unsophisticated retail investors. Some commentators have attempted to allay these concerns by describing the Fortress shares as more akin to an equity investment, without the risks or rewards of a typical hedge fund investment, because the shares are in the management company rather than the underlying investment vehicles. However, the success of the management company remains entirely dependent on the vicissitudes of the underlying fund, as the performance fees they earn depend on a combination of assets under management and performance, as described in Part II.B above. Blackstone Group, a private equity fund, raised $4.13 billion in an IPO in June 2007. Similarly, investors hold shares in the management company rather than in the underlying funds. While Blackstone is a private equity fund, its IPO reflects a trend that is likely to increase general public access to these previously unattainable funds within the near future.

Internationally, the approach to retail investors varies. Singapore and Hong Kong allow all investors to access hedge funds and set much lower minimum investment requirements. Hedge funds are also open to almost all investors in Germany, although they are subject to portfolio restrictions and risk diversification requirements more stringent than those applied in the United States. The rationales behind the policies vary; Germany hoped to “kick start their financial markets by making hedge funds more accessible,” while some countries simply think it is inequitable to restrict the potential high rewards of hedge fund investment to the wealthy, despite

---

175. SCOTT, supra note 3, at 739.
176. Id. at 741.
the potential risk. The Financial Services Authority (FSA), which is the U.K.'s regulatory body, has also widely debated "retailization," but announced in March 2007 that it intends to allow retail investors to invest in hedge funds.

Given the convergence between the SEC's and the FSA's regulatory approaches, greater access for retail investors is likely to emerge in the United States too. On the whole, the SEC appears to be fighting a losing battle against "retailization" by raising the accredited investor standard when retail investors can indirectly access the same companies, either through funds of funds or through public offerings of funds such as Fortress and Blackstone. A better approach may be to focus on the availability of information to retail investors and to ensure that potential investors receive full disclosure, which could help them understand what risk adjusted returns mean.

D. Market Manipulation

Several allegations charge hedge funds with shorting stocks and then manipulating the market by convincing ostensibly independent security analysts to write negative reports. Cases include Biovail Corp. Securities Litigation and Overstock.com v. Gradient and David Rocker, a short seller. In Biovail, the central allegation was that S.A.C. committed fraud by using a "short and distort" strategy, in effect ghostwriting research reports published by Gradient Research Analytics. Similar claims were made against Gradient and Rocker in Overstock.com's suit. Patrick Byrne, Overstock.com's CEO, accused hedge funds, journalists, and regulators of acting together "under the direction of an unidentified 'Sith Lord'" in an October 2005 conference call. More specifically, Byrne contended that 10 major brokerage U.S. brokerages deliberately attempted to drive down Overstock.com's price. Despite Overstock.com's charges, the SEC closed its investigation of Gradient Analytics without taking action, which

177. Id.
178. See id. at 752 (noting that Regulation D is a safe harbor provision for all transactions that meet the requirements of Rule 506 of the Securities Act of 1933).
180. See Brooke A. Masters, 2 Firms Claim Conspiracy in Analyst Reports, WASH. POST, Apr. 26, 2006, at D1 (describing "short and distort" strategy); Leonard Zehr, Short Sellers Had Knives Out for Drug, Biovail Charges: Lawsuit Alleges Funds Targeted Cardizem, GLOBE & MAIL, Mar. 20, 2006, at B3 (discussing Biovail claims).
182. Id.
suggests that the allegations have no solid grounding in securities law. Nevertheless, the judge has thus far refused to dismiss Overstock.com’s lawsuit as frivolous.

These lawsuits illustrate that litigation risk can have a prohibitive effect on shorting. This is unfortunate, as shorting serves the valuable purpose of allowing investors to directionally hedge their positions, as well as revealing market sentiment about a stock and tipping off regulators to potential fraud. If litigation fears drove most short sellers out of the market, the market as a whole would be negatively impacted, as the short ratio on a stock is a valuable indicator of market sentiment. Additionally, the suits raised free speech concerns, as they effectively penalized short sellers for discussing their often legitimate concerns in regards to a company. Critics of both Biovail and Overstock.com legitimately believed the companies were overvalued; for instance, Overstock had never been profitable and was experiencing declining revenue.

Typically, short selling does not concern CEO’s if the underlying concerns are false, because they realize that an efficient market will correctly price a security over time, as it otherwise creates arbitrage opportunities. The efficient market hypothesis suggests that the market can effectively sort through a vast array of information, which may include misinformed viewpoints that could encompass purposefully misleading reports, to arrive at the true price of securities. Finally, the lawsuits also exhibit a selective bias, as they do not target distortion of stock prices through promotion by analysts overall, but rather only those who “short and distort.” In the eyes of the SEC, upside distortion can be just as serious of a crime, as was seen in the events that led up to the Global Research Analyst Settlement in 2003-2004.

Anti-short sellers have turned to tools beyond lawsuits in their efforts to increase disclosure of short selling and to halt the practice. Patrick Byrne, the CEO of Overstock.com, lobbied the Utah State Legislature to

---

184. See Joe Nocera, *Revisiting Overstock.com and Utah*, N.Y. TIMES, Mar. 10, 2007, at C1 (discussing Overstock.com’s rapid drop in stock value, and noting “most shorts have gone underground because they don’t want to be sued”).
186. See, e.g., COX ET AL., supra note 54, at 106 (discussing the market’s power to sift through large quantities of information).
187. New York State Attorney General Elliot Spitzer led an investigation of conflicts of interest in Wall Street research, resulting in a $1.4 billion settlement that involved ten banks and federal regulators, and became known as the Global Research Settlement. See, e.g., Christopher O’Leary, *Cracks in the Chinese Wall: Four Years After the SEC Settlement, is Street Research Withering in the Shadows*, INV. DEALERS’ DIGEST, Mar. 5, 2007, at 19 (reviewing the general pitfalls of upside distortion).
make naked short selling illegal, briefly resulting in a law that would have allowed companies to find out who was shorting them and to file suit on technical “failure to deliver” terms.\textsuperscript{188} The state legislature repealed this law within months, after the Securities Industry Association lobbied with SEC support and made it clear that regulating short sellers is within the purview of the federal, not the state, government.\textsuperscript{189} Lobbying probably will not lead the government to outlaw short selling, given the clear results of the case, the support of the SEC, and the value of shorting as an indicator of market sentiment.

Exchanges have rules that aim to prevent shorting from turning into a wave of speculation against a company, such as by allowing short sales “only when the last recorded change in the stock price is positive.”\textsuperscript{190} The SEC is concerned with connections between short sales and market manipulation and believes that the “general purpose of the short sale rule is to prevent manipulative sales of a security for the purpose of accelerating a decline in the price of such security.”\textsuperscript{191} Of course, investors can still build a substantial short position simply by waiting for an uptick in the price and then placing their order, but rules such as this help to prevent shorting from exacerbating a fast fall in stock prices. After NASDAQ’s approval as an exchange on January 13, 2006, the SEC agreed to suspend temporarily the application of the price test to securities traded on the NASDAQ in order to “avoid unnecessarily burdening the markets” and to “evaluate the overall effectiveness and necessity of such restrictions.”\textsuperscript{192} It appears that the trend is moving away from restrictions such as the uptick rule as shorting becomes a more standard, quotidian practice. On the whole, this makes sense because formalistic rules such as the uptick rule are relatively easy to work around, but add significantly to the regulatory burden on exchanges.

\textsuperscript{188} Nocera, supra note 184. Customarily a short seller borrows stock before it sells them to others, and then purchases shares to cover the ones it borrowed. Naked short selling involves selling stock that the investor has not borrowed or bought, which can lead to large losses if the market moves against the seller. See, e.g., Zvi BODIE ET AL., INVESTMENTS 92, 713 (2005) (reviewing the covered call position, which Bodie defines as the purchase of a share of stock with a simultaneous sale of a call on that stock).

\textsuperscript{189} Nocera, supra note 184.

\textsuperscript{190} BODIE ET AL., supra note 188, at 92; see also Regulation of the Short Sale Price Test and Rule 10a-1(a), Exchange Act Release No. 34-55970, 17 C.F.R. pts. 240, 242 (July 3, 2007) (amending short sale price test under Exchange Act to foster a more consistent regulatory environment).


\textsuperscript{192} Id. at *2.
E. Soft Dollars

The expression "soft dollars" refers to the practice of paying brokers higher commissions than would otherwise be justified in exchange for services such as research or a Bloomberg terminal. This is not a breach of the fund advisors' fiduciary duties, as section 28(e) of the Securities Exchange Act protects advisors who pay higher commissions than would otherwise be charged, as long as they determine "in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided." Nonetheless, the practice is troubling because it can overcharge clients for both commissions and research or other services. The SEC estimates the cost of soft fees at approximately $1 billion. This is the cost to the securities industry as a whole, not just to hedge funds.

The movement towards unbundling requires brokers to break out the cost of the trade versus other services provided. The SEC issued guidance in June 2006 to recommend that buy side firms consolidate their trading with brokers who offer the best execution and pay a separate commission to third-party research providers. A managing director from Credit Suisse commented that "[u]nbundling seems to be the right thing to do as a fiduciary at this point." Fidelity, for one, has followed that advice and now has separate agreements for trade execution and research. A concern with the unbundling approach is that it will exacerbate the decline in quantity and quality of research, which appears to have been negatively impacted by the Global Research Settlement.

F. Short Termism

On the whole, hedge funds are viewed as short term investors, which can make them unpopular with companies and countries that want stable, long term shareholders or investors. Companies often raise concerns with

---

193. See, e.g., SEC, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (1998), http://www.sec.gov/news/studies/softdolr.htm. Soft dollars also typically include entertainment expenses that brokers incur, such as taking fund managers out to professional sports games or expensive dinners, to retain or gain their trading business.
195. See Scott, supra note 3, at 731.
196. See Ivy Schmerken, Buy Side Seeks Unbundling; Finds New Ways to Manage Sell Side Relationships, WALL ST. & TECH., Mar. 1, 2007 (explaining the buy side's struggle with attaining adequate research from brokers and boutiques).
197. Id.
198. See O'Leary, supra note 187 (discussing Fidelity's approach to attaining research).
199. See id. (detailing other problems with acquiring quality research).
activist hedge funds, because such funds focus on a short term rise in stock prices and do not consider long term value creation.\textsuperscript{200} One study indicated that hedge fund activism may help the target company’s operating performance in the long run, rather than hurt it; Brave et al., found that on average target companies experienced a 7% increase in stock price during the four weeks around the announcement that a hedge fund acquired a 5% stake, that the stock kept pace with the market for the next year, and that the stock’s operating performance improved over the next two years.\textsuperscript{201} While this data reflects the short term jump that hedge fund investors may have been looking for, it also indicates that their activism does not appear to have hurt the company.

On a national level, regulators worry that short term investors worsen periods of reduced confidence when they quickly withdraw their money without first considering whether the fundamentals of the market remain sound. One of the primary drawbacks of heightened liquidity is that financial inflows can become outflows just as quickly. The former Prime Minister of Malaysia, Mahathir Mohamad, blamed “hedge funds, and in particular George Soros, for destabilizing exchange rates and playing a major role in causing the Asian financial crisis.”\textsuperscript{202} Although studies show that funds made substantial withdrawals preceding and during the crisis, Mohamad’s criticism oversimplifies the problem because it ignores other important events, such as the refusal of foreign banks to roll over short term loans to Asian banks during the crisis.\textsuperscript{203} While hedge funds were only one factor in the Asian financial crisis, they are still seen as the source of higher volatility in the Asian equity markets.\textsuperscript{204} Funds are injecting greater liquidity into these markets, as reflected by the fact that the trading volume in Asian interest rate derivatives has tripled and the amount of

\textsuperscript{200} E.g., Richard Parsons, CEO of Time Warner, Address at the Mergers and Acquisition class at Harvard Law School (Oct. 18, 2006) (on file with author) (opining that Carl Icahn’s public protest against the company’s strategic plan was actually an effort to create an event where he could benefit from event driven investing, and that Icahn was not interested in building sustainable long term earnings).

\textsuperscript{201} See Alon Brav et al., Hedge Fund Activism, Corporate Governance, and Firm Performance (Sept. 22, 2006) http://www.fdic.gov/bank/analytical/cfr/2006/oct/hedge_fund.pdf (explaining how hedge fund activism generates statistically significant abnormal returns); see also Mark Hulbert, A Good Word for Hedge Fund Activism, N.Y. TIMES, Feb. 18, 2006, at C6 (arguing that hedge funds may not actually represent sound investment opportunities).

\textsuperscript{202} SCOTT, supra note 3, at 745.


\textsuperscript{204} See, e.g., Heather Timmons, Hedge Funds, the Usual Suspects, Blamed for Volatility in Asia, N.Y. TIMES, Mar. 15, 2007, at C9 (discussing the problems with investors who blame hedge funds for the recent volatility in Asia).
credit derivatives has doubled since last year, and heightened volatility is likely part of the price, particularly when there is overall uncertainty with the market direction.\textsuperscript{205}

VI. REGULATORY REFORM EFFORTS

A general sense that investors need more access to information regarding hedge funds drove the mandatory registration effort in the United States and underlies many of the ongoing concerns with hedge funds both in the United States and internationally. Below is an overview of mandatory registration efforts, a description of the United States' more recent regulatory approach, and a brief overview of the international regulatory approach.

A. Movement Towards Hedge Fund Registration

In the United States, one of the most widely debated regulatory issues has been whether the SEC may require hedge funds to register with the Commission. The SEC became concerned that hedge funds were not being scrutinized adequately as their growth picked up in the late 1990's and in early 2000. Specifically, the SEC was concerned about fraud, conflicts of interest, and the retailization of hedge funds through funds of funds.\textsuperscript{206} Recent scandals that implicated hedge funds included late-trading and market-timing schemes. Due to hedge funds' wide exemptions from registration and other regulation, the SEC had limited data about the funds and their impact on the market economy. The SEC's 2003 Staff Report stated that it "has no reliable data on the number of hedge funds in existence or the amount of hedge fund assets under management."\textsuperscript{207} These concerns led the SEC to issue new rules in October 2004, which became effective in February 2006, that narrowed the definition of "client" in Rule 203(b)(1-2) of the Investment Advisor Act (IAA) such that a look-through could be used to count the actual number of clients and required hedge funds to register with the agency.\textsuperscript{208} As mentioned in Part III.D above, investment vehicles with lockup periods of two years or longer were specifically excluded from the registration requirements, which effectively

\textsuperscript{205} Id.

\textsuperscript{206} See Hellrung, supra note 75, at 334 (outlining SEC trepidation with the threat of hedge fund retailization). Funds of funds are often open to smaller investors because they have lower minimum purchases, raising concerns that smaller investors are not truly sophisticated investors who can evaluate the risks involved. Id. at 331-33.

\textsuperscript{207} SEC 2003 STAFF REPORT, supra note 1, at 1 n.2.

\textsuperscript{208} See Bevilacqua, supra note 64, at 268 (reviewing the requirement that all investment advisors with a certain level of assets must register with the SEC).
excluded most private equity and venture capital firms.\textsuperscript{209} Such lockups, however, are largely unpopular with hedge fund investors, and so the proposed rules required the vast majority of hedge funds to register.

Opposition to the proposed Rule 203(b) remained strong throughout the subsequent comment period, with 73\% of the letters that the SEC received opposing registration.\textsuperscript{210} In part, the cost of compliance drove this opposition, as many funds would need to hire a compliance officer to provide the necessary information for Form ADV.\textsuperscript{211} Nonetheless, the rules went into effect following the SEC’s rare 3-2 split vote in February 2006, indicating the breadth of the dissenting view.\textsuperscript{212} Off-shore funds had to register as well if they had more than fourteen U.S. investors, limiting the funds’ ability to escape regulation by moving offshore.\textsuperscript{213}

The rule was subsequently overturned in \textit{Goldstein v. SEC}, on the grounds that the definition of “client” was irregularly construed to mean different things in different parts of the IAA, making the rule arbitrary.\textsuperscript{214} The court looked to Congress’ intent in passing the IAA, as well as the definition of “client” in other securities regulations, before deciding that the SEC’s revised interpretation of “client” in section 203 was inconsistent both with the IAA and other securities regulations.\textsuperscript{215} Prior to the \textit{Goldstein} decision, 2,500 hedge funds had filed with the SEC as of February 2006.\textsuperscript{216} The SEC did not appeal that decision, and instead is focusing on protecting investors by raising the net worth requirements for accredited investors who invest in hedge funds.\textsuperscript{217} Additionally, the President’s Working Group (PWG) on Financial Markets, which is chaired currently by Treasury Secretary Henry M. Paulson, recently announced that it believes a principles-based approach to self-regulation, rather than further federal regulation such as a registration requirement, is the appropriate response to recent hedge fund growth.\textsuperscript{218}

\begin{itemize}
\item \textsuperscript{209} Hellrung, \textit{supra} note 75, at 337.
\item \textsuperscript{210} Liffmann, \textit{supra} note 55, at 2148.
\item \textsuperscript{211} Verret, \textit{supra} note 8, at 807.
\item \textsuperscript{212} \textit{Id.}; Paredes, \textit{supra} note 167, at 976.
\item \textsuperscript{213} Preiserowicz, \textit{supra} note 6, at 842.
\item \textsuperscript{214} 451 F.3d 873, 879 (D.C. Cir. 2006).
\item \textsuperscript{215} \textit{Id.} at 879.
\end{itemize}
B. Current Regulatory Approach in the United States

Although Congress could mandate hedge fund registration legislatively, such legislation appears politically unlikely at this time.\(^{219}\) This lack of political will probably was one of the reasons behind the SEC’s decision to not appeal \textit{Goldstein}.\(^{220}\) Additionally, SEC Chairman William H. Donaldson, who was one of the driving forces behind the Hedge Fund Registration Rule, has since been replaced as chairman by Christopher Cox, who prefers a consensus approach to regulation and is unlikely to push through a 3-2 vote at the SEC.\(^{221}\)

The PWG on Capital Markets issued a report in February 2007 that focused primarily on self-regulation through market discipline, and on using regulatory policies to limit direct investment in private pools of capital to sophisticated individuals instead of pursuing a mandatory registration approach.\(^{222}\) The PWG identified the avoidance of systemic risk and investor protection as two of its central goals, and put forth principles directed at four groups of industry participants: regulators and supervisors, counterparties and creditors, private pools of capital, and pool investors and fiduciaries.\(^{223}\) The EU quickly applauded the PWG’s “light touch” approach, and the EU Internal Markets Commissioner commented that he believed “the current regulatory structure is working well” and that a “well-developed set of checks and balances” are in place.\(^{224}\) Nevertheless, not all share this view: Connecticut’s Attorney General voiced concerns that the PWG’s principles-based approach is “vague” and “unenforceable.”\(^{225}\) Although a bright line rule would be simpler to enforce, the PWG’s suggested approach makes more sense than the rules-based approach that the SEC previously pursued given the complexity of issues such as leverage and retail investor access and the ease with which financial instruments can now be structured to largely evade bright line rules.

\(^{219}\) Senator Grassley has been attempting to introduce an amendment to the Investment Advisors Act to redefine “client” in line with the SEC’s original rule, but thus far he has received little support. Liz Moyer, \textit{Grassley Goes After Hedge Funds (Again)} (May 15, 2007), http://www.forbes.com/2007/05/15/hedge-fund-sec-biz-wall-cx_lm_0516grassley.html.


\(^{223}\) Steel Remarks, \textit{supra} note 9.


\(^{225}\) \textit{Id.}
C. International Regulatory Approach

The principles-based approach that U.S. regulatory authorities most recently presented is intentionally similar to the regulatory approach taken by the Financial Services Authority (FSA) in the U.K., reflecting a desire to maintain similar regulatory philosophies and to avoid regulatory forum shopping.\textsuperscript{226} The U.K. is actually moving towards voluntary self-regulation by hedge funds, which may foretell a similar move for the United States, as the Chairman of the PWG mentioned that “[t]he U.S. Treasury has two advisory groups examining the issue and has been in frequent contact with representatives of the U.K. group throughout their efforts.”\textsuperscript{227} Concern with the competitiveness of U.S. capital markets and a desire to avoid forum shopping for more lenient regulatory environments are reasons to closely consider other countries’ approaches to the same issues that the SEC currently faces. A recent report on the U.S. capital markets raised significant concerns with the competitiveness of the market looking forward, which it based in part on the regulatory environment.\textsuperscript{228} These concerns particularly apply to hedge funds, which have no physical need to be based in any one country. The SEC can reach funds that allow U.S. investors, but these investors could lose out in the long run if, at an extreme, funds closed themselves off to U.S. investors to avoid SEC regulation.

Many countries share concerns similar to those of U.S. regulators. Canadian authorities proposed mandatory registration for hedge funds within that country in February 2007, although no final decision has been made.\textsuperscript{229} Central bankers and finance ministers from the G7 countries are calling for greater disclosures “of strategies and the amount of risk being taken.”\textsuperscript{230} Their main concern is that investors and counterparties need “accurate and relevant information” for “market discipline to work effectively.”\textsuperscript{231} At the urging of German Chancellor Angela Merkel, the G8 placed hedge funds prominently on their agenda in 2007, where participants recognized that hedge funds have “contributed significantly to the efficiency of the financial system,” but called for “the need to be vigilant . . . [g]iven the strong growth of the hedge fund industry and the

\begin{itemize}
\item \textsuperscript{226} Steel Remarks, supra note 9.
\item \textsuperscript{227} Bryan-Low, supra note 165.
\item \textsuperscript{228} COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT (2006), http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.
\item \textsuperscript{229} E.g., Carrie Johnson, Call for More Oversight of Hedge Funds is Rejected, WASH. POST, Feb. 23, 2007, at D1 (describing the Canadian proposal).
\item \textsuperscript{231} Id.
\end{itemize}
increasing complexity of the instruments they trade...”

The leaders of the G8 agreed to adopt the recommendations from the Financial Stability Forum’s Report on Highly Leveraged Institutions and to continue to study the issue.

One of the unique problems regulators face in Muslim countries is the challenge of developing derivative contracts that are Shariah-compliant. The Shariah, which is the foundation of Islamic law, forbids variable interest rate payments, a key component of the Black-Scholes option pricing model. Due to this prohibition, the Saudi Arabian stock exchange, known as the Tadawul, currently does not allow short selling. Nevertheless, it is likely that Muslim financial institutions will develop a way to structure financial products that will both be Shariah-compliant and allow the use of derivatives within the next few years. Islamic financial institutions have found alternate structures for other instruments that typically use a variable interest rate, such as mortgages, so this possibility does not seem farfetched.

Internationally, the most common shared concern is with systemic risk rather than individual investor protection. Countries take different approaches to the level of paternalism that is appropriate in securities regulation. As mentioned above, the approach to retail investors vis-à-vis hedge funds varies widely internationally, ranging from free access in Hong Kong, to access with greater protective measures in Germany, to restricted access in the United States. Systemic risk and fears that the international nature of finance today could lead quickly to the contagion of multiple capital markets if one were to be affected by a fund collapse, explain why G8 countries have placed hedge funds prominently on their annual agenda. While Amaranth’s failure did not create systemic contagion, the failure of a larger fund or of a series of funds could push regulators towards tighter regulation. The German Finance Minister

233. Id.
234. Interest payments are considered usury (riba) under Islamic law and are thus forbidden. See, e.g., Muslim-Investor.com, Prohibited Business Activity, http://muslim-investor.com/mi/prohibited.phtml (last visited Apr. 5, 2008) (describing various prohibitions under Islamic law).
235. See, e.g., Simon Benninga & Zvi Wiener, Binomial Option Pricing, the Black-Scholes Option Pricing Formula, and Exotic Options, 6 MATHEMATICA IN EDUC. & RES. 1 (1997), http://finance.wharton.upenn.edu/~benninga/mma/MiER64.pdf (discussing the use of the Black-Scholes model to price options).
237. See, e.g., Assif Shameen, Islamic Banks: A Novelty No Longer, BUSINESS WEEK, Aug. 8, 2005, http://www.businessweek.com/magazine/content/05_32/b3946141_mz035.htm (chronicling various efforts by financial institutions to comply with Islamic law).
recently warned that “the repetition of a big crisis like Long Term Capital Management could provoke the outright regulation that funds want to avoid.”

VII. SUMMARY

Overall, the PWG’s approach to principles-based regulation of hedge funds appears to be a practical move. Hedge fund regulation is a sensitive matter, for hedge fund growth has fueled both growth and liquidity in the securities markets while simultaneously increasing the potential for systemic risk. Although this paper discusses a potential approach to each of the issues raised above, the following is a brief review of recommended regulatory measures.

For many of the relevant issues, and leverage in particular, market discipline should be sufficient to keep hedge funds in line. As mentioned, the combination of improved counterparty risk measures, increased investor awareness of risk following widely covered losses at funds such as LTCM and Amaranth, and increased litigation risk for investment consultants, should discourage funds from taking on too much leverage. At the same time, the SEC should ensure that hedge funds, especially funds of funds, fully disclose the extent of their leverage and the risk entailed to potential investors.

Legitimate concerns remain with retail investors’ increasing participation in hedge funds, given that such investors may be less financially sophisticated than the average hedge fund investor in the past. Currently, the anti-fraud rules of the various securities acts protect retail investors, and vigorous enforcement should help limit cases of actual fraud or material misrepresentation. A broader question remains, however, about the sufficiency of hedge fund disclosure to potential investors, particularly in regards to the potential risk involved. Current regulations, such as section 13(f) of the Exchange Act, do not directly address this, because non-equity holdings do not need to be disclosed and simply knowing a fund’s holdings will not necessarily help an individual investor assess the risk involved. The SEC’s current move to tighten the accredited investor standard is in line with its mandate to protect investors, but increasingly at odds with the international approach, and the reality of increasing indirect access to hedge funds through funds of funds and the initial public offerings of managers such as Fortress.

From the fund managers’ point of view, investment disclosure is the largest area of concern, particularly given the type of copycat followership

Berkshire Hathaway experienced. In regards to the portfolio disclosures required by section 13(f), increasing the issuance of confidentiality requests, even for relatively brief time periods, should help alleviate manager concerns. In addition, the SEC should give greater thought to the distinction it draws between activist and non-activist funds based on the differing regulatory concerns raised.

Morphable ownership is a concern to the extent that other market participants are not aware of the lack of economic ownership, and the possibly divergent incentives that may result. The SEC should ensure that funds disclose their economic ownership position as well as their voting control in Form 13D filings. Beyond that, the possibility of vote buying through the use of derivatives is open to anyone and should not be of particular concern. This is particularly true as the restrictions under section 16 of the Exchange Act mean that virtually no fund will acquire greater than a 9.9% stake in a company, and as such its voting—morphable or otherwise—is unlikely to be determinative.

The current regulatory structure adequately addresses short selling and soft dollars. The SEC should prosecute actual market manipulation, but should be wary of defensive executives who use lawsuits to attempt to prop up their stock, as appears to be the case with Overstock.com. Empirical evidence currently does not support other issues, such as the criticism of hedge funds as harmful short term investors. If countries such as Malaysia have specific concerns with currency outflows, they may chose to impose capital controls, as Malaysia did in the Asian financial crisis, but they will likely have to pay the price of reduced liquidity and foreign investment in the long term.

Overall, the current antifraud securities regulations, combined with market forces exerted by counterparties, investors, and investment consultants, appear largely sufficient to serve the purpose of investor protection. Systemic risk remains somewhat of an unknown risk, but Amaranth’s recent $6.5 billion loss suggests that the international financial system can absorb significant losses without triggering the collapse of other players. Increased international coordination by securities regulators and government leaders, such as efforts at the G8 summit, should help lead to internationally consistent regulation and reduce funds’ ability to escape existing regulation through regulatory forum shopping. In turn, this coherence should further diminish the likelihood of a possible systemic collapse due to hedge fund losses.

A principles-based approach will facilitate international cooperation by ensuring that regulators are focused on the same overarching issues rather than just the technical application of national rules. The application of national rules can lead to a patchwork of regulations internationally, while shared principles are more likely to lead to a congruent approach.
Bright line rules can also be easier to evade given the flexibility of financial instruments today, leading to behavior that is superficially within the letter of the law but violates the spirit of it. Neither rules nor principle-based regulations will prevent outright fraud, and neither is mutually exclusive, but a focus on principles will improve the coherence of international regulation while still allowing flexibility to take into account the different structures and strategies of hedge funds and other pooled investment vehicles.