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## THE SEC'S RULE 206(4)-8: TWO STEPS BACK AND ONE STEP FORWARD

*“Without a private right of action, the only true barometer for successful hedge fund regulation will be the transparency that it mandates.”*<sup>1</sup>

### I. INTRODUCTION

Over the last ten years, the landscape of the U.S. financial markets has changed drastically, and not necessarily for the better. The most predominant feature of this change is attributable to the massive growth of hedge funds.<sup>2</sup> Investors of all types are dumping their assets into hedge funds, attempting to capitalize on the potentially astronomical gains hedge funds offer.<sup>3</sup> As a result, hedge funds—under-regulated, risky, and all too available—are now controlling over \$1 trillion in assets.<sup>4</sup> The problem with hedge funds managing such a

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1. Randall Steinmeyer, Director, the Hedge Fund Association; Of Counsel, Murray, Frank & Sailer LLP; Formerly Partner: Coughlin Stoia Geller Rudman & Robbins LLP, Lerach Coughlin Stoia & Robbins LLP, Milberg Weiss LLP.

2. See *infra* Part II.B (discussing the recent growth of hedge funds).

3. See Melissa Antoszewski, *Las Vegas Style Investing: In the Absence of Regulation, Risky Hedge Fund Bets Can Win Big and Lose Even More*, 8 TRANSACTIONS TENN. J. BUS. L. 381, 381 (2007) (stating that the growth of hedge funds is fueled by investors “who hope to receive high returns”); Sargon Daniel, *Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles*, 2007 COLUM. BUS. L. REV. 247, 256-57 (discussing how investors came to expect very high returns after the stock market boom in the 1990s, and sought after those returns through hedge funds); Jessica Natali, *Trimming the Hedges Is a Difficult Task: The SEC's Attempt to Regulate Hedge Funds Falls Short of Expectations*, 15 U. MIAMI BUS. L. REV. 113, 114 (2006) (“With seemingly illustrious returns over the past several years, many government officials and agencies believe that hedge funds have positioned themselves as the paradigm of investment instrumentality.”).

4. Antoszewski, *supra* note 3, at 385 (“Total assets under management topped 1.2 trillion dollars in 2006 . . . .”); see *infra* Part II.C (discussing the SEC's concerns

large sum of money is the potentially devastating effect that their failure could have on U.S. financial markets and individual investors. Just one or two major hedge funds failing could have severe ramifications for the world's financial markets, and could force the U.S. economy into a recession.<sup>5</sup> Moreover, many large institutional investors—including pensions, universities, and charitable organizations—risk losing millions by investing in hedge funds.<sup>6</sup>

Notwithstanding the hedge fund industry's powerful influence over individual investors and financial markets the world over, most hedge funds avoid any kind of regulation by taking advantage of certain exemptions provided for by U.S. securities laws.<sup>7</sup> Consequently, in 2004, the Securities and Exchange Commission (SEC) adopted the Hedge Fund Rule, which would have closed a major exemption available to hedge funds and required registration of most hedge fund advisers under the Investment Advisers Act of 1940 (IAA).<sup>8</sup> However, shortly after this promising law was adopted, it was vacated by the United States Court of Appeals in the District of Columbia.<sup>9</sup> The court in *Goldstein v. SEC* held that the rule was arbitrary and unreasonable, and concluded that the SEC had failed to justify its adoption.<sup>10</sup> Following the rule's defeat in *Goldstein*,<sup>11</sup> it

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with the recent hedge fund growth).

5. See Daniel, *supra* note 3, at 296 (“The sheer amount of capital under management and the ability for those managers to stake positions that have potentially harsh effects on the national and global economies provide strong arguments for imposing regulation.”); see also *infra* Part II.C (discussing concerns regarding hedge fund growth, including its potential to disrupt the world's financial markets).

6. See *infra* Part II.C.3 (discussing generally that institutional investors are beginning to increase investments into hedge funds); see also *infra* note 97 and accompanying text (commenting on how a San Diego county pension plan recently lost approximately \$175 million due to the collapse of Amaranth Advisors, LLC).

7. See *infra* Part II.A (describing how hedge funds take advantage of various exemptions in the securities laws).

8. See *infra* Part III.C (providing a general overview of the Hedge Fund Rule).

9. See *infra* Part IV (discussing the D.C. Circuit's rejection of the Hedge Fund Rule).

10. See *Goldstein v. SEC*, 451 F.3d 873, 880-84 (D.C. Cir. 2006).

11. See BARRY P. BARBASH & ERIC C. GOLDSTEIN, *The SEC and Hedge Funds: A Continuing Regulatory Saga*, in PRACTISING LAW INST., CORPORATE LAW AND PRACTICE 237, 239 (2007) (stating that the D.C. Circuit's decision was a

appeared that the SEC was faced with two options for re-addressing its concerns regarding hedge funds: appeal the court's decision or rewrite the IAA hedge fund rule.<sup>12</sup> However, in late 2006, the Commission elected to pursue a third alternative: propose and adopt a new antifraud rule under Section 206(4) of the IAA.<sup>13</sup> Purportedly, the new rule is intended to clarify the SEC's authority to bring enforcement actions against hedge fund advisers for fraudulent activity towards any of the fund's individual investors.<sup>14</sup> Further, the rule broadens the definition of fraud to a negligence standard,<sup>15</sup> and holds even unregistered hedge fund advisers liable for fraudulent practices.<sup>16</sup>

The adoption of Rule 206(4)-8 is a step in the right direction towards hedge fund regulation. However, in adopting the new rule, the Commission fails to address many, if not most, of its concerns

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“stinging defeat for the SEC”).

12. See THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 21.2[3] (5th ed. 2005 & Supp. 2008) (stating that, at the time of the *Goldstein* decision, “[i]t was not [] clear whether the SEC [would] appeal the decision or rewrite the rule”).

13. See *id.* (“[I]n December 2006, the Commission proposed an antifraud rule aimed at hedge funds . . .”).

14. See *infra* Part V (providing a detailed overview of Rule 206(4)-8). See generally Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756 (Aug. 9, 2007) (describing and adopting Rule 206(4)-8).

15. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,759. The new rule effectively broadens fraud to a negligence standard by eliminating scienter as a prerequisite to finding fraud. *Id.* The “scienter” requirement is not discussed at length in this Comment. The Supreme Court has generally defined scienter as “a mental state embracing intent to deceive, manipulate, or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976). However, in some circumstances, the scienter standard requires less than the intent to deceive. See *id.* For example, recklessness may be considered sufficient to show scienter. *Id.* The requirements for showing scienter under Rule 10b-5 have not been clearly established, and are subject to some dispute. See Kurtis A. Kemper, Annotation, *What Constitutes Recklessness Sufficient to Show Necessary Element of Scienter in Civil Action for Damages Under § 10(b) of Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b)) and Rule 10b-5 of the Securities and Exchange Commission*, 49 A.L.R. FED. 392, § 2 (1980) (“[A] number of courts [have interpreted] *Ernst & Ernst* as leaving open the possibility that reckless conduct may satisfy the scienter requirement . . .”); see also *infra* Part V.F.

16. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,758.

regarding hedge funds—concerns the Commission previously raised when it adopted the now-vacated Hedge Fund Rule. The new rule may be a small, measured step towards the ultimate goal of regulation, but it falls short of the vacated Hedge Fund Rule's, if not the Commission's, ultimate goals of providing security in U.S. financial markets and protecting the individual investors within these markets from the potentially devastating impact that unregulated hedge funds can have. Primarily, the new antifraud rule fails to provide a mandate or an incentive for hedge funds to register under the IAA. As will be discussed, registration of all hedge funds is necessary before any specific rule or regulation can be enforced as a preventative measure. How can the SEC monitor and detect fraud over unregistered and, consequently, unknown advisers?<sup>17</sup> Moreover, registration alone, without the newly broadened definition of fraud, would, at a minimum, be a viable deterrent of fraud, which is the primary reason the Commission adopted the new antifraud rule in the first place.<sup>18</sup> Accordingly, the SEC should re-focus its regulatory efforts on providing transparency within the hedge fund industry by implementing rules that either mandate the registration of hedge fund advisers, or, at a minimum, create certain incentives for hedge fund advisers to register.

This Comment explores the SEC's recent endeavor to regulate the explosive hedge fund industry. In so doing, it explores the history and current state of the hedge fund industry, including the Commission's fears regarding systematic risk and investor protection. Further, this Comment examines the SEC's attempt at regulation through the Hedge Fund Rule, the *Goldstein* decision to vacate that rule, and the SEC's disparate, if not desperate, response in adopting Rule 206(4)-8. Part II begins with an overview of the hedge fund industry's massive growth during the last decade and explores growing concerns within the hedge fund industry. This includes a discussion of several of the

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17. As will be discussed, holding unregistered investment advisers liable under the new antifraud provision is ineffective. It is improbable that the Commission has any information about the activities and operations of unregistered advisers because they are not registered. Therefore, considering this lack of information, it would be difficult to detect any fraudulent activity. *See infra* Part VI.A.

18. *See infra* Part VI.C (discussing how registration alone would be the most viable solution to the SEC's concerns regarding both registered and unregistered hedge funds).

SEC's specific concerns, as well as a brief summary of the two largest hedge fund failures to date. Part III provides a history and overview of the IAA and gives an explanation of the vacated 2004 Hedge Fund Rule. Part IV summarizes the *Goldstein* opinion and the reasons the court ruled to vacate the Hedge Fund Rule. Part V deconstructs and explains the SEC's new Rule 206(4)-8, which was adopted in response to *Goldstein*. Part VI argues that the new rule does not satisfy the current need for hedge fund regulation because it fails to address several of the concerns the SEC used to justify its initial adoption of the Hedge Fund Rule. Additionally, Part VI proposes the idea that the registration of hedge funds is an optimal solution to the Commission's concerns with hedge fund regulation because registration provides transparency, a necessary element to the operation of healthy financial markets. Finally, Part VII concludes by suggesting that any new regulatory actions should be focused on increasing the transparency of the hedge fund industry through the registration of all hedge funds.

## II. THE RISE OF HEDGE FUNDS AND THE NEW CONCERNS REGARDING INVESTOR SAFETY AND MARKET SECURITY

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

A hedge fund is difficult, if not impossible, to precisely and exclusively define.<sup>19</sup> Further, hedge funds have not yet been defined in any securities laws.<sup>20</sup> Some have cynically described hedge funds as “‘shadowy’ investment vehicles that ‘escape’ regulation by ‘exploiting loopholes’ in federal securities laws . . . ,”<sup>21</sup> while others have broadly defined them as “‘any pooled investment vehicle that is privately organized, administered by professional investment

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19. Daniel, *supra* note 3, at 251. A hedge fund has no legal definition. *Id.* Even the SEC has trouble defining the term exactly, admitting that they have no precise definition. *Id.* Therefore, the only way to really define a hedge fund is by explaining the fund's characteristics. *Id.*

20. *Id.*; Antoszewski, *supra* note 3, at 382 (“Thus, there is no universal definition to describe the various types of hedge funds.”).

21. Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 979.

managers, and not widely available to the public.”<sup>22</sup> Whatever one’s chosen definition, hedge funds may be defined by several universal characteristics.<sup>23</sup> Hedge funds hold pools of securities and other assets with the ultimate goal of generating positive returns for the fund’s investors.<sup>24</sup> Most importantly, hedge funds avoid registration under several of the main securities acts, including the Securities Act of 1933,<sup>25</sup> the Investment Company Act of 1940,<sup>26</sup> and the Investment

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22. *Goldstein v. SEC*, 451 F.3d 873, 875 (D.C. Cir. 2006) (citing PRESIDENT’S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999), available at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf> [hereinafter WORKING GROUP]); see also Antoszewski, *supra* note 3, at 383 (describing the term “hedge fund” as “a catchall classification for a number of privately-managed pools of capital that are not registered . . .”). It should be noted that the “aura of secrecy and mystique” surrounding hedge funds may be seeded in the “rules of decades past [requiring these funds] not to advertise or publicly solicit investors . . .” *Hedge Funds’ Notoriety: Fact or Fiction?*, CHARTERED FIN. ANALYST, Feb. 2004, at 68-69.

23. Daniel, *supra* note 3, at 251 (stating that the easiest way to define a hedge fund is to explain its uniform characteristics).

24. See DIV. OF INV. MGMT. ET AL., SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION, at ix (2003) [hereinafter STAFF REPORT]; Paredes, *supra* note 21, at 981-82 (describing hedge funds as investment vehicles that “maximize risk-adjusted returns for investors . . .”).

25. See Daniel, *supra* note 3, at 258 (discussing how hedge funds use a “private offering exemption” to avoid registration under The Securities Act of 1933). Hedge funds avoid registering their securities under the Act by only offering their services to accredited (pre-approved) investors and not to the general public. *Id.* at 258-59.

26. *Goldstein*, 451 F.3d at 875; STAFF REPORT, *supra* note 24, at viii. An exemption from the Investment Company Act allows hedge funds to participate in activities that would otherwise be restricted to investment companies, such as mutual funds, which must register under the Act. *Goldstein*, 451 F.3d at 875. These otherwise-restricted investing behaviors include trading on margin, engaging in short sales, and not having to gain shareholder approval to take on debt or invest in certain assets. *Id.* These otherwise-restricted investing behaviors are essential elements of a hedge fund’s operation. *Id.* Consequently, taking advantage of these exemptions affords hedge funds the flexibility and freedom to be very aggressive in their investment strategies because they do not have the same requirements and restrictions that registered funds have, such as diversification requirements and restrictions on leveraging (investing with borrowed money). See Daniel, *supra* note 3, at 252.

Advisers Act of 1940.<sup>27</sup> These funds avoid registration by flexibly operating within certain exemptions under each act.<sup>28</sup> Taking advantage of these exemptions allows hedge funds the freedom to employ investment techniques, such as excessive leveraging and short selling—techniques that are otherwise prohibited to registered companies and advisers.<sup>29</sup> Also, an unregistered hedge fund can seriously limit its disclosures by withholding information relating to its investment strategies from regulators and from the fund's investors.<sup>30</sup> The combination of unregulated investing activities, specifically over-leveraging, and the lack of transparency into hedge funds' positions and trading techniques caused several of the largest fund failures in history—failures that came close to substantially disturbing the world's financial markets.<sup>31</sup>

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27. *Goldstein*, 451 F.3d at 876. For information on the IAA, see *infra* Part III. Although hedge funds take advantage of all the mentioned exemptions, this Comment focuses primarily on the “private adviser exemption” of the IAA. See discussion *infra* Part III. The SEC first attempted to increase regulation by creating a new rule, the Hedge Fund Rule, which had the effect of re-defining the language of the “private adviser exemption” to encompass almost every hedge fund adviser. *Id.* However, their attempt failed in that the U.S. Court of Appeals, District of Columbia, vacated the rule. *Goldstein*, 451 F.3d at 884. The SEC's response was Rule 206(4)-8, which is explained and critiqued in Part V of this Comment.

28. *Natali*, *supra* note 3, at 116 (“Hedge fund advisers . . . have the flexibility to structure their securities offerings in ways that qualify [them] for exemption from all relevant federal securities laws.”); see also *Hedge Funds' Notoriety: Fact or Fiction?*, *supra* note 22, at 68 (discussing how the first hedge fund was formed as a private limited partnership because that was the only available legal vehicle under the restrictive federal securities laws).

29. *Natali*, *supra* note 3, at 116 (“[H]edge funds are not subject to the diversification requirements or borrowing and leverage restrictions with which other registered investment companies must comply.”); see *Daniel*, *supra* note 3, at 252 (“[H]edge funds are not limited by the restrictions on mutual funds, such as diversification requirements and the inability to short-sell.”). As far as a hedge fund's investment strategies are concerned, this Comment, concerned primarily with the new antifraud provision, only briefly delves into the use of extensive leveraging and short selling. However, hedge fund investing strategies can be very complex and may include “convertible arbitrage, emerging markets, long/short equity, event-driven, fixed income, global macro, managed futures, market neutral, and short biased.” *Paredes*, *supra* note 21, at 982.

30. See *Goldstein*, 451 F.3d at 875 (“[H]edge funds typically remain secretive about their positions and strategies, even to their own investors.”).

31. See discussion *infra* Part II.D (providing two examples of when major

*B. The Growth of Hedge Funds in the Last Decade*

The first hedge fund was created in 1949 by Alfred Winslow Jones, who concentrated primarily on hedging the fund's exposure to the market through investing practices based on long and short positions, as well as leveraging.<sup>32</sup> Since 1949, hedge funds have grown dramatically, especially in the last decade, and now comprise a significant portion of the financial services landscape.<sup>33</sup> However, precise numbers on exactly how fast hedge funds have grown or their current status in the securities markets are difficult to attain; the SEC has no way of monitoring many of these funds because they avoid registration by exploiting exemptions under the IAA.<sup>34</sup> Hedge funds have grown from only 1100 funds managing approximately \$50 billion in 1993<sup>35</sup> to over 7500 hedge funds managing approximately \$1.6 trillion in assets in 2007, the equivalent of 10% of the New York Stock Exchange's total value.<sup>36</sup> Further, hedge funds achieved a growth rate of 20% per year during this period, with individual funds more than quadrupling in size.<sup>37</sup> Estimates suggest that from 1999 to

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hedge funds have failed and the effects of their failure).

32. See STAFF REPORT, *supra* note 24, at 3; Daniel, *supra* note 3, at 253-54 (discussing the creation and growth of hedge funds); *Hedge Funds' Notoriety: Fact or Fiction?*, *supra* note 22, at 68 ("The first hedge fund . . . was a simple long-short fund, but it was revolutionary."). Although hedge funds have technically been in existence since 1949, this Comment focuses on their growth in the last decade or so, from approximately 1993 to 2006.

33. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004).

34. See *id.*

35. Paredes, *supra* note 21, at 982-83.

36. Kevin G. Hall & Robert A. Rankin, *Hedge Funds May Pose a Risk to U.S. Economy*, MCCLATCHY NEWSPAPERS, Aug. 8, 2007, available at <http://www.mcclatchydc.com/227/story/18766.html> ("Some 7,500 hedge funds controlled \$1.6 trillion in assets as of the end of June [2007]. That's equal to about 10 percent of the total value of the New York Stock Exchange.").

37. ISAAC RUIZ-CARUS ET AL., WHAT IS A HEDGE FUND?, § 1.3, <http://www.uiowa.edu/ifdebook/faq/Hedge.shtml> (last visited Feb. 17, 2007) (stating that the hedge fund industry is growing approximately 20% annually). The claim that hedge funds have more than quadrupled in size is based on simple arithmetic by the author, based on the average size of a hedge fund being approximately \$45.5 million (\$50 billion divided by 1100 funds) in 1993 and \$213.3 million (\$1.6 trillion divided by 7500 funds) in 2007. See *supra* notes 35-36 and accompanying text.

2004 alone, hedge funds grew approximately 260%.<sup>38</sup> Clearly, hedge funds, and their investment advisers, are becoming “significant players” in U.S. financial markets.<sup>39</sup> The industry’s massive growth and, consequently, the hedge fund’s ability to adversely impact the world’s financial markets, have not gone unnoticed by regulators.<sup>40</sup>

### *C. The SEC’s Growing Concerns Regarding Hedge Funds*

The rapid growth of hedge funds and their increasingly large share of the U.S. market’s managed assets have amplified the SEC’s apprehension towards investor safety and market stability.<sup>41</sup> Until recently, the SEC was not troubled with hedge funds taking advantage of exemptions provided for by securities laws because hedge funds were considered exclusive investment vehicles offered privately only to “sophisticated investors.”<sup>42</sup> Traditionally, the SEC did not consider investment vehicles with those characteristics dangerous to securities markets or to the average investor.<sup>43</sup> However, three recent trends have raised the SEC’s concern, including the growth of hedge funds within U.S. financial markets, increased fraudulent activity in an under-regulated industry, and the retailization of hedge funds.<sup>44</sup>

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38. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,055.

39. See *id.* at 72,056 (“[H]edge fund advisers have become significant participants in the securities markets, both as managers of assets and traders of securities.”).

40. See *infra* Part II.C.

41. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,055; Antoszewski, *supra* note 3, at 391 (“[R]isky bets by [hedge] fund managers have far-reaching implications for both investors and financial markets.”); Paredes, *supra* note 21, at 983.

42. See *Goldstein v. SEC*, 451 F.3d 873, 875 (D.C. Cir. 2006).

43. See *id.*

44. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,055; Antoszewski, *supra* note 3, at 391 (“[H]edge funds raise a number of important policy concerns, including the potential for fraud, retailization, and serious market disruptions.”).

### 1. *A Growing Share of the U.S. Markets and Systematic Risk*

First, and most importantly, the SEC is troubled by the rapid growth of hedge funds in recent years and the industry's increasing share of trading volume in U.S. markets.<sup>45</sup> This growth in trading volume has created apprehension among regulators due to increased systematic risk, that is, the hedge fund industry's growing capability to negatively impact the health of U.S. financial markets.<sup>46</sup> Currently, hedge funds have "enormous influence in the marketplace," accounting for approximately 30% of all equity trading in U.S. markets,<sup>47</sup> and nearly 50% of all trading in the world's major financial markets.<sup>48</sup> Also, hedge funds can hold significant portions of specific market segments, such that a fund's failure could seriously derail that segment.<sup>49</sup> The extent to which risky and over-leveraged hedge funds can affect the market is unknown,<sup>50</sup> but just a single collapse could be "devastating."<sup>51</sup> Furthermore, the threats that hedge funds pose go

45. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,055; *see also* Antoszewski, *supra* note 3, at 395 (discussing how the hedge fund industry's enormous influence and risky investment techniques expose financial markets to potentially huge losses).

46. *See* Paredes, *supra* note 21, at 983 ("The dramatic growth of the hedge fund industry has fueled concerns about so-called 'systematic risk,' which goes to the safety and soundness of financial markets."). Systematic risk is "the potential for a modest economic shock to induce substantial volatility in asset prices, significant reductions in corporate liquidity, potential bankruptcies and efficiency losses." *Id.* (citing Paul Kupiec & David Nickerson, *Assessing Systemic Risk Exposure from Banks and GSEs Under Alternative Approaches to Capital Regulation*, 48 J. REAL EST. FIN. & ECON. 123, 123 (2004)). Specifically, systematic risk becomes a concern "when leading financial institutions are exposed to highly leveraged hedge funds . . ." *Id.* at 999. Moreover, concern regarding systematic risk is amplified by the fact that hedge funds, their investors, and the institutions that finance hedge funds "focus on the private benefits and costs of the transactions, not the social cost of greater leverage or speculation in the financial system as a whole." *Id.*

47. Antoszewski, *supra* note 3, at 394-95.

48. Paredes, *supra* note 21, at 986. Furthermore, hedge funds "account for over 70% of daily activity in the convertibles market, the U.S. distressed debt market, and the U.S. exchange-traded fund market." *Id.*

49. Antoszewski, *supra* note 3, at 395.

50. *See* Hall & Rankin, *supra* note 36.

51. Antoszewski, *supra* note 3, at 395 ("Many analysts are concerned that these practices may cause widespread systematic losses to other firms, which will

beyond Wall Street. For instance, hedge funds have the potential to shake the economy by distressing large commercial banks.<sup>52</sup> These funds leverage their risky investments by borrowing, on margin, large amounts of money from these banks.<sup>53</sup> When hedge funds fail, the banking industry becomes vulnerable because banks are not able to collect on their loans.<sup>54</sup> Though it is unclear as to the extent, a large commercial bank's failure can have a significant adverse impact on the economy.<sup>55</sup>

## 2. *Fraudulent Activity*

Second, the SEC is alarmed with the growing number of fraud cases being brought against hedge fund advisers.<sup>56</sup> From 2000 to 2004, the SEC brought fifty-one fraud cases worth over \$1.1 billion.<sup>57</sup> The number of cases suggests that fraud by hedge fund advisers is a prevalent concern.<sup>58</sup> These fraudulent activities include: "misappropriation of assets; misrepresentation of portfolio performance; falsification of experience, credentials and past returns; misleading disclosure regarding claimed trading strategies; and improper valuation of assets."<sup>59</sup>

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disrupt global financial markets. . . . The consequences could be devastating, and the fall of a single hedge fund could bring about an economic catastrophe.").

52. See Hall & Rankin, *supra* note 36 (discussing how hedge funds not only adversely affect Wall Street when they fail, but also other industries, including the banking sector).

53. See *id.* ("Much of what [hedge funds] own was bought with money they borrowed from big banks, sometimes up to 80 percent of their holdings.").

54. *Id.*

55. *Id.* ("If the banks are in trouble, so is the economy. But nobody knows how much trouble.").

56. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056 (Dec. 10, 2004).

57. *Id.* ("In the last 5 years, the Commission has brought 51 cases in which we have asserted that hedge fund advisers have defrauded hedge fund investors . . . in amounts our staff estimates to exceed \$1.1 billion."). However, the SEC release fails to provide any comparative figure for assertions of fraudulent activity prior to the year 2000. See *id.*

58. See *id.*; Antoszewski, *supra* note 3, at 391-93.

59. STAFF REPORT, *supra* note 24, at 73-74; Antoszewski, *supra* note 3, at 391.

Although the most prevalent type of fraud is an investment adviser defrauding the fund's own investors, there is a mounting concern over the alarming rate at which hedge fund advisers have been defrauding other financial entities in the markets.<sup>60</sup> Specifically, hedge funds are linked to late trading and market timing scandals which result in their earning money at the expense of mutual fund investors.<sup>61</sup> Although this type of fraud may ultimately increase the value of the hedge fund and thereby benefit the hedge fund's investors, the negative impact it has on other unrelated market participants, including mutual fund investors, is what concerns the SEC.<sup>62</sup> In 2004 alone, an estimated 400 hedge funds and eighty-seven hedge fund advisers were involved in this type of fraud, a statistic the SEC finds disturbing.<sup>63</sup> The SEC's concern is rooted in its responsibility to find, punish and deter deceitful investment tactics aimed at defrauding any investor, regardless of whether the investor is a hedge fund investor or an unrelated market participant negatively affected by a hedge fund's activities.<sup>64</sup>

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60. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,056-57 (“[W]e now too frequently see instances in which hedge funds have been used to defraud other markets participants. . . . [T]he frequency with which hedge funds and their advisers appear in these cases and continue to turn up in the investigations is alarming.”); Antoszewski, *supra* note 3, at 392.

61. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,056-57 (“Many of our enforcement cases involved hedge fund advisers that sought to exploit mutual fund investors for their funds’ and their own gain. Some . . . entered into arrangements with mutual fund advisers under which the mutual fund advisers waived restrictions on market timing in return for receipt of the hedge fund advisers’ ‘sticky assets,’ i.e., placement of other assets of other funds managed by the mutual fund adviser. Other hedge fund advisers sought ways to avoid detection by mutual fund personnel by conspiring with intermediaries to conceal the identity of their hedge funds.”); Antoszewski, *supra* note 3, at 392.

62. The SEC’s concern over fraud by an investment adviser extends to all investors, not just those in the adviser’s fund. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72056-57.

63. *Id.*; Antoszewski, *supra* note 3, at 392.

64. *See* Paredes, *supra* note 21, at 1005 (“[F]ederal securities regulation is primarily oriented toward investor protection in the sense of remedying information asymmetries and rooting out fraud. The SEC, at both the commissioner and staff levels, has long characterized itself as the investors’ protector . . .”).

### 3. Retailization

Finally, the SEC is concerned with the “retailization”<sup>65</sup> of hedge funds.<sup>66</sup> Retailization results in smaller, namely institutional, investors gaining access to risky hedge fund investing.<sup>67</sup> This access to hedge funds is fueled by three developments. First, although opposing arguments may suggest otherwise,<sup>68</sup> hedge funds have become more available to the average investor who is usually unfamiliar with the fund’s riskier investment behaviors.<sup>69</sup> Second, the growth of “funds of hedge funds” is increasing the accessibility of hedge fund investing.<sup>70</sup>

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65. Hedge fund “retailization” can be defined as “the increasing availability of [hedge funds] and how and to whom they are available.” *Testimony Concerning Investor Protection Implications of Hedge Funds: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs* (2003) (statement of William H. Donaldson, Chairman, SEC), available at <http://edgar.sec.gov/news/testimony/041003tswhd.htm>.

66. See *Goldstein v. SEC*, 451 F.3d 873, 877 (D.C. Cir. 2006).

67. See *id.*; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,057-58.

68. See Antoszewski, *supra* note 3, at 393-94 (“[H]edge fund managers continue to argue that they do not intend to solicit ‘retail investors’ because such investors are not suited for the inherent risks of hedge funds . . . .”); see also Paredes, *supra* note 21, at 990 (“Although some evidence shows a modest ‘retailization’ of the hedge fund industry, the vast bulk of hedge fund investors can protect themselves, at least insofar as the federal securities laws understand investor self-protection.”).

69. See Antoszewski, *supra* note 3, at 393 (stating that the decrease in minimum investment requirements of hedge funds has increased the ability of less “sophisticated” investors to enter the market). Access to hedge funds has traditionally been limited to “high net worth individuals and families.” STAFF REPORT, *supra* note 24, at 43. Recently, hedge funds have been decreasing their minimum requirements, allowing them to “attract individuals who meet the monetary requirement, but who do ‘not possess the understanding or market power’ to make an informed investment decision.” Antoszewski, *supra* note 3, at 393 (citing STAFF REPORT, *supra* note 24, at 81).

70. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,057 (“[T]he development of ‘funds of hedge funds’ has made hedge funds more broadly available to investors. . . . Funds of hedge funds today represent approximately twenty percent of hedge fund capital, and are the fastest growing source of capital for hedge funds today.”). “Funds of hedge funds” are “pooled funds that allocate their capital among several hedge funds, usually in the neighborhood of 15 to 25 different hedge funds. Unlike the underlying hedge funds, these vehicles are often registered with the SEC and promoted to individual

Third, and most importantly, there have been an increasing number of hedge fund investments by institutional investors who have traditionally not invested in hedge funds.<sup>71</sup> When an institutional investor, such as a pension fund, invests in a hedge fund, it exposes the institution and, consequently, the institution's millions of beneficiaries to the inherent dangers and risks associated with hedge funds—risks these types of investors and their beneficiaries may not otherwise knowingly take.<sup>72</sup> However, some critics argue that these institutional investors have sophisticated investment managers who are able to recognize the risks of hedge fund investing.<sup>73</sup> However, this argument fails to take into account that even the most experienced investment manager is unable to make informed investment decisions with the severe lack of transparency in this unregulated industry.<sup>74</sup>

#### *D. Examples of When Hedge Funds Fail*

##### *1. Long Term Capital Management*

The SEC's concerns regarding hedge funds' potential to systematically disrupt U.S. financial markets were realized with the failure of Long-Term Capital Management (LTCM).<sup>75</sup> LTCM was a hedge fund that managed more than \$125 billion in 1998.<sup>76</sup> LTCM

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investors.” David Harper, *Introduction to Hedge Funds—Part Two*, <http://www.investopedia.com/articles/03/121003.asp> (last visited Feb. 19, 2008).

71. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,058. These institutional investors include pension funds, universities, charitable organizations, endowments, and foundations. *Id.*

72. *See id.* (“Losses resulting from hedge fund investing and hedge fund frauds may affect the entities’ ability to satisfy their obligations to their beneficiaries or pursue other intended purposes.”).

73. *See, e.g.,* Natali, *supra* note 3, at 127-28 (stating that, despite the SEC’s concerns, “the SEC fails to take into consideration the experience and financial sophistication of the investment managers employed by institutional investors”).

74. Paredes, *supra* note 21, at 992 (“[E]ven sophisticated investors may not be able to protect their own interests if they do not have the information they need or want about the issuer or cannot feasibly understand it.”).

75. Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006). *See generally* WORKING GROUP, *supra* note 22, at 10-21 (discussing the failure of LTCM and the effects that it had on financial markets).

76. WORKING GROUP, *supra* note 22, at 12.

used extremely complex investment strategies<sup>77</sup> to achieve nearly 40% returns for investors.<sup>78</sup> The most dangerous of these investment strategies was LTCM's derivatives positions which totaled approximately \$1.5 trillion, including complicated derivatives products in Russian debt.<sup>79</sup> At the end of 1998, Russia suddenly defaulted on that debt,<sup>80</sup> and LTCM became instantly liable for its \$1.5 trillion in positions.<sup>81</sup> Due to LTCM's major leveraging strategies and derivative positions, the fund could not even come marginally close to covering this figure.<sup>82</sup> In addition to the Russian default, LTCM experienced other major financial downturns.<sup>83</sup> Consequently, major market participants became concerned with LTCM's imminent failure.<sup>84</sup> Specifically, "major banks and other creditors who enabled LTCM to build up its leveraged positions were concerned about the effect of a default on their operations."<sup>85</sup> Ultimately, the banks that were intertwined with LTCM, together with the Federal Reserve Bank of New York, financially bailed LTCM out.<sup>86</sup> Despite the help,

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77. Antoszewski, *supra* note 3, at 407 ("LTCM used a variety of trading strategies including 'shorted' Treasury bond futures and high yielding 'mortgage-backed or corporate debt securities.' LTCM held large positions in various markets and was extensively leveraged . . . expos[ing] the fund to major market risks." (citing *Hedge Fund Gets Help*, CNN MONEY.COM, Sept. 23, 1998, <http://money.cnn.com/1998/09/23/investing/longterm>)). See Paredes, *supra* note 21, at 985 (stating that "LTCM was extremely leveraged").

78. Antoszewski, *supra* note 3, at 407 (stating that LTCM was once considered the "dream team" because of its success).

79. Daniel, *supra* note 3, at 267. These positions were "all legally taken and supported by major financial institutions." *Id.*

80. *Id.*; Paredes, *supra* note 21, at 987 (stating that Russia unexpectedly "devalued the ruble and declared a debt moratorium in 1998").

81. Daniel, *supra* note 3, at 267.

82. *Id.*; see also Antoszewski, *supra* note 3, at 407 ("LTCM could not continue to meet its cash flow obligations to creditors because of its size and the leverage involved.").

83. See Antoszewski, *supra* note 3, at 407 ("In 1998, the fund began experiencing devastating financial hardships, with a loss of over fifty percent of its equity."); Daniel, *supra* note 3, at 267.

84. Antoszewski, *supra* note 3, at 407 ("Market participants became concerned about the possibility that LTCM would collapse . . ."); see also Daniel, *supra* note 3, at 267 (stating that the U.S. government investigated LTCM's default).

85. Antoszewski, *supra* note 3, at 407.

86. *Goldstein v. SEC*, 451 F.3d 873, 877 (D.C. Cir. 2006) ("[T]he Federal

LTCM's investors were severely harmed.<sup>87</sup> However, had the government and the associated banks not acted, LTCM would have failed, and the damage would have extended beyond LTCM's investors; there would have been severe ramifications felt throughout the world's capital markets.<sup>88</sup>

## 2. *Amaranth Advisors*

The failure of Amaranth Advisors, LLC (Amaranth) was the largest fund failure in history.<sup>89</sup> During the first week of September 2006, Amaranth lost close to \$5 billion due to a highly leveraged investment strategy.<sup>90</sup> Amaranth's strategy included using large bank loans and lines of credit to fund futures positions in natural gas, an extremely risky and unpredictable commodity.<sup>91</sup> The natural gas market was cooperative with Amaranth's investment techniques during the first half of 2006, but suddenly shifted in September.<sup>92</sup>

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Reserve Bank of New York personally intervened to engineer a bailout of the fund in order to avoid a national financial crisis.”). See Antoszewski, *supra* note 3, at 407-08 (discussing the agreement whereby the banks involved and the Federal Reserve Bank of New York invested \$3.6 billion into LTCM in exchange for a 90% equity position in the fund).

87. Antoszewski, *supra* note 3, at 408.

88. See Goldstein, 451 F.3d at 877 (stating that the bailout of LTCM was to avoid a national financial crisis); Antoszewski, *supra* note 3, at 408 (“LTCM avoided a major world financial crisis largely due to the assistance of other financial institutions.”); Daniel, *supra* note 3, at 267 (“[T]he default of LTCM . . . could have derailed the entire world’s financial markets . . .”).

89. Antoszewski, *supra* note 3, at 410.

90. *Id.* at 409 (stating that Amaranth’s \$9 billion in assets fell to \$4.5 billion); see also Roger Ferguson & David Laster, *Hedge Funds and Systemic Risk*, 10 BANQUE DE FR. FIN. STABILITY REV. (SPECIAL ISSUE) 45, 51 (2007), available at [http://www.banque-france.fr/gb/publications/telechar/rsf/2007/etud5\\_0407.pdf](http://www.banque-france.fr/gb/publications/telechar/rsf/2007/etud5_0407.pdf) (“Amaranth, a highly regarded USD 9 billion multi-strategy fund, recently lost 65% of its assets in less than two weeks. The fund lost 35% of its value during the week of 11 September 2006 . . .”).

91. See Ferguson & Laster, *supra* note 90, at 51 (Amaranth “employ[ed] a highly leveraged natural gas spread strategy”); Antoszewski, *supra* note 3, at 408 (describing Amaranth’s financial positions as “risky bets in natural gas”).

92. See Antoszewski, *supra* note 3, at 409 (stating that the fund was up approximately \$2 billion for the year by April 2006, but “[b]y September 2006, . . . the market quickly changed and gas prices fell drastically”).

Amaranth's investments in the commodity were so large and concentrated that, when the market adversely shifted, it was unable to get out of its positions.<sup>93</sup> Ultimately, Amaranth lost approximately 65% of its net asset value (NAV) in less than two weeks.<sup>94</sup> Despite the severity of the fund's collapse, a large, systemic failure in the markets was prevented with the help of J.P. Morgan Chase & Co. and Citadel Investment Group, LLC, who quickly and efficiently bought out Amaranth's positions at a discount.<sup>95</sup> Moreover, Fortress Investment Group LLC helped ease any market disruptions by allowing Amaranth to sell off \$3 billion in assets before Amaranth's clients could assert their outstanding claims.<sup>96</sup> Although a major market disruption was avoided with the help of J.P. Morgan, Citadel, and Fortress, the thousands of unaware beneficiaries whose institutional investors had invested in Amaranth—including beneficiaries of 3M Company's pension fund and the San Diego County Employees Retirement Association pension—suffered losses.<sup>97</sup> Ultimately, “Amaranth has raised increased concerns regarding the trading practices of funds and

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93. *Id.* See Ferguson & Laster, *supra* note 90, at 51 (“Amaranth tried unsuccessfully to sell its positions . . .”).

94. Ferguson & Laster, *supra* note 90, at 51; Antoszewski, *supra* note 3, at 409.

95. Ferguson & Laster, *supra* note 90, at 51 (“[Amaranth] sold its positions to JP Morgan Chase and Citadel Investment Group at a USD 1.4 billion discount from the prior day's market-to-market values.”); *see also* Antoszewski, *supra* note 3, at 409-10 (commenting that the J.P. Morgan/Citadel buyout “eased concerns about broad market turmoil and ‘ripple effects’ from the hedge fund's failure”); Edward Pekarek, *Pruning the Hedge: Who Is a “Client” and Whom Does an Adviser Advise?*, 12 FORDHAM J. CORP. & FIN. L. 913, 962 (2007) (commenting on how the “market barely blinked” after the failure of Amaranth because of the help provided by J.P. Morgan and other institutions).

96. *See* Antoszewski, *supra* note 3, at 410.

97. *Id.* Furthermore, the San Diego pension filed a class action lawsuit against Amaranth to recover its losses from the fund's collapse. *See* Alistair Barr, *Amaranth Tries to Have Pension Fund Suit Dismissed*, MARKETWATCH, June 7, 2007, available at <http://www.marketwatch.com/news/story/amaranth-files-motion-dismiss-pension/story.aspx?guid=%7B6D743FA9-5FAA-4B06-94C5-95E4A4C76F95%7D> (discussing the San Diego County Employees Retirement Association's lawsuit against Amaranth and its officers to recover losses from its \$175 million investment).

the need for regulation to ensure that a similar incident does not happen in the future.”<sup>98</sup>

The massive failures of LTCM and Amaranth certainly increased regulators’ concerns over a hedge fund’s potential to have a serious, adverse impact on investor safety and market stability. Although a major financial crisis was avoided when several major financial institutions bailed LTCM and Amaranth out of their dismal situations, the funds’ effects on individual investors is obvious and disturbing, with investors losing millions due to the failures. However, it is impossible to determine the degree of devastation these massive hedge fund failures would have had on the world’s financial markets had they not been averted.

### III. REGULATION OF HEDGE FUNDS THROUGH THE INVESTMENT ADVISERS ACT OF 1940 AND THE “HEDGE FUND RULE”

#### *A. History of the Investment Advisers Act of 1940*

The IAA was one of a series of acts enacted by Congress in response to the stock market crash of 1929.<sup>99</sup> Specifically, these acts were created to address the corruption and misuses in the securities markets which led to the crash.<sup>100</sup> Prior to the crash, Congress’

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98. Antoszewski, *supra* note 3, at 410.

99. Allan E. Korpela, Annotation, *Construction and Effect of Investment Advisers Act of 1940, as Amended (15 U.S.C.A. § 80b-1-80b-21)*, 5 A.L.R. FED. 246, § 2[a] (1970). The stock market crash of 1929 was one of the worst financial crises in U.S. history and ushered in the Great Depression—the worst economic recession in U.S. history. See Daniel, *supra* note 3, at 276-77 (“In a matter of three days, the 1929 stock market crash erased over \$14 billion of stock capitalization; the total market capitalization eventually dropped from \$90 billion to \$16 billion. To put this into perspective, between 1929 and 1933, national personal income went from just under \$90 billion to just over \$40 billion.”). Essentially, the U.S. national income fell approximately 15% in just a few days. *Id.* at 277. The crash was caused by a few primary factors, including speculation, outstanding trading volume, short-selling, and lax margin requirements. *Id.* Although there are some differences, one can see the eerie similarities between the financial landscape preceding the stock market crash of 1929 and the current landscape of hedge funds. See generally *id.* at 274-96 (comparing the events leading to the stock market crash of 1929 to the current concerns regarding hedge funds and concluding that hedge fund conditions differ slightly).

100. See Korpela, *supra* note 99, § 2[a].

primary view towards the securities markets was one of caveat emptor.<sup>101</sup> However, the crash, and the abuses leading to it, resulted in Congress adopting a radically different philosophy—one of “full disclosure”—evidenced by the creation of the IAA.<sup>102</sup> The IAA was passed in reaction to a comprehensive study and report by the SEC concerning, among other things, the post-depression demand for unbiased investment advice, as well as the subsequent rise in professional investment advisers.<sup>103</sup> The report indicated that certain problematic issues were developing with these professional investment advisers.<sup>104</sup> These new concerns included “protect[ing] the public against malpractice by persons paid for advising others concerning investment in securities,” and “conflicts of interest between investment advisers and their clients, resulting in subconscious as well as conscious impediments to objectivity.”<sup>105</sup> Principally, the IAA was designed “to protect the public against malpractice by persons paid for advising others concerning investment in securities.”<sup>106</sup>

### *B. Function of the IAA*

Generally, the IAA gives the SEC authority to regulate investment advisers.<sup>107</sup> The IAA requires non-exempt investment advisers to register with the SEC and implements certain disclosure and

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101. *Id.* “Caveat emptor” is Latin for: “let the buyer beware.” BLACK’S LAW DICTIONARY 236, 1708 (8th ed. 2004). It is a legal maxim that purchasers buy at their own risk. *Id.* In the context of financial investments, caveat emptor describes the notion that the individual investor should be responsible for avoiding fraud or scams. *See* Investopedia.com, Caveat Emptor, <http://www.investopedia.com/terms/c/caveatemptor.asp> (last visited Feb. 24, 2008).

102. Korpela, *supra* note 99, § 2[a].

103. *See* Korpela, *supra* note 99, § 2[a]; Paul F. Roye, Director, Div. of Inv. Mgmt., SEC, Remarks Before the Investment Counsel Association of America, Atlanta (Apr. 6, 2000), available at <http://www.sec.gov/news/speech/spch361.htm>.

104. *See* Korpela, *supra* note 99, § 2[a].

105. *Id.*

106. *Id.*

107. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,054 (Dec. 10, 2004) (requiring advisers to register with the SEC).

regulatory requirements for those advisers.<sup>108</sup> These requirements include: anti-fraud provisions, guidelines for marketing and communications activities, requisite disclosure of financials and disciplinary measures, mandatory recordkeeping practices, and guidelines for an adviser's personal securities-related dealings.<sup>109</sup> Registration provides the SEC with a reliable source of data—data that is critical in detecting and deterring fraudulent activity.<sup>110</sup>

The IAA has specific language defining who, exactly, is an “investment adviser” for the purposes of the Act.<sup>111</sup> However, falling within the definition of an “investment adviser” does not necessarily require automatic registration with the SEC.<sup>112</sup> Among the various exemptions provided in the IAA is the “private adviser exemption,” which allows investment advisers to avoid registration if they are an adviser “who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts [as] an investment adviser to any investment company registered under [the Act].”<sup>113</sup> Moreover, advisers may consider each hedge fund, trust, or corporation they manage as one client for the purposes of the “private

108. *Id.*; GERALD T. LINS ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 3:45 (2007).

109. *See* LINS ET AL., *supra* note 108, § 3:16. Despite these requirements, there is no private right of action by individual investors in a hedge fund against the investment adviser. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,760 (Aug. 9, 2007) (“[Rule 206(4)-8] does not create a private right of action.”).

110. *See* Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (“By keeping a census of advisers, the Commission can better respond to, initiate, and take remedial action on complaints against fraudulent advisers.”).

111. The IAA defines an “investment adviser” as:

[A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . .

Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2006).

112. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,054 (stating that many advisers use the private adviser exemption to avoid registration with the SEC).

113. 15 U.S.C. § 80b-3(b)(3) (2006).

adviser exemption.”<sup>114</sup> Essentially, this enabled hedge fund advisers to “manage large amounts of client assets and, indirectly, have a large number of clients,” even though they were unregistered.<sup>115</sup> As will be discussed, the dramatic growth of private pooled investment vehicles, primarily hedge funds, combined with the increasing number of investment advisers who have avoided SEC registration by structuring their funds to take advantage of exemptions like the “private adviser exemption,” has prompted increased regulation by the SEC.<sup>116</sup>

*C. The IAA as an Avenue for Hedge Fund Regulation:  
“The Hedge Fund Rule”*

*1. Summary of the Rule*

In 1999, in response to the failure of LTCM, the President’s Working Group on Financial Markets submitted a report to Congress recommending changes in hedge fund regulation and disclosure.<sup>117</sup> In 2003, following the Working Group’s report, the SEC staff investigated hedge funds and their advisers, and held a “Hedge Fund Roundtable” in connection with the investigation.<sup>118</sup> Subsequently, in September 2003, the SEC produced its own report focusing on the issues and concerns with the growth of hedge funds and the activities of hedge fund advisers.<sup>119</sup> In response to the investigation, the

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114. *See id.*; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,054-55 (stating that, for the purposes of the private adviser exemption, the IAA “permitted advisers to count each partnership, trust or corporation as a single client . . .”).

115. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,055.

116. *See id.* at 72,054-56; *see also* Paredes, *supra* note 21, at 976-77.

117. *See generally* WORKING GROUP, *supra* note 22.

118. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,055. Prior to requesting the investigation, the SEC was very generally addressing its concerns with hedge funds. *See id.* The SEC requested that its staff “develop information . . . and advise [it on] whether [it] should exercise greater regulatory authority over the hedge fund industry.” *Id.* The “Hedge Fund Roundtable” was intended to develop in greater depth the proposals regarding hedge funds, and included many participants in the hedge fund industry. *See id.*

119. *See generally* STAFF REPORT, *supra* note 24 (outlining the SEC staff’s findings, identifying concerns, and recommending regulatory measures to improve

roundtable, and the report, the SEC proposed and adopted the 2004 Hedge Fund Rule.<sup>120</sup> Most significantly, the rule changed how investment advisers to private funds must count clients: “For the purposes of [the private adviser exemption] of the [IAA], [advisers] must count as clients the shareholders, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an “owner”) of a private fund . . . .”<sup>121</sup> Essentially, the new rule “require[d] hedge fund advisers to count each investor in a hedge fund, rather than only the hedge fund itself, as a client for the purposes of the private adviser exemption.”<sup>122</sup>

## 2. Implications of the Rule

As mentioned, prior to the Hedge Fund Rule, investment advisers of hedge funds could rely on the private adviser exemption by counting each fund as a single client.<sup>123</sup> The Hedge Fund Rule eliminated that option for investment advisers by requiring them to “look through the fund to count each investor in the fund as a single client for purposes of the registration requirement under the Advisers Act.”<sup>124</sup> Therefore, any investment adviser managing a fund that had more than fifteen investors was now required to register under the IAA.<sup>125</sup> The major implication of the rule was that “almost every

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regulation and oversight of the hedge fund industry); *see also* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,055 (discussing the staff report and stating the report confirmed and developed the SEC’s concerns regarding the hedge fund industry).

120. Pekarek, *supra* note 95, at 925 (discussing how, after the SEC reviewed the findings from the 2003 staff report, it “adopted a revised investment adviser registration Rule”). *See generally* Hedge Fund Rule, 17 C.F.R. § 275.203(b)(3)-2 (2004), *vacated*, Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006) (requiring specific methods for counting clients in hedge funds).

121. 17 C.F.R. § 275.203(b)(3)-2(a).

122. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,058.

123. *See Goldstein*, 451 F.3d at 876 (stating that, prior to the Hedge Fund Rule, “the Commission had interpreted [the private adviser exemption] to refer to the partnership or entity itself as the adviser’s ‘client.’”).

124. Paredes, *supra* note 21, at 988.

125. *Goldstein*, 451 F.3d at 877 (“The rule had the effect of requiring most hedge fund advisers to register by February 1, 2006.”).

hedge fund adviser in America would no longer be exempt and would be potentially subject to the registration requirements, based on the [r]ule's more inclusive new definition of 'client.'"<sup>126</sup>

### 3. Initial Opposition to the Hedge Fund Rule and the SEC's Response

The Hedge Fund Rule was one of the most controversial regulatory schemes in recent history.<sup>127</sup> Various comment letters opposing the new Hedge Fund Rule were presented in the SEC's release. Their main arguments were twofold. First, if investment advisers were required to register, they would be unwilling to engage in the complicated investment strategies available to unregistered investment advisers.<sup>128</sup> Second, the burdens and costs of registering with the SEC "would make [hedge funds] less competitive, and would impose barriers to entry preventing new hedge fund advisers from starting their own hedge funds."<sup>129</sup> Although the requirements of the IAA certainly impose more of a burden on investment advisers, "[t]he IAA does not impose a detailed regulatory regime."<sup>130</sup> In response to those opposing the Hedge Fund Rule, the SEC presented several arguments as to why the registration of hedge fund advisers would not "impose undue burdens on them or interfere significantly with their operations."<sup>131</sup> The SEC argued that the success of registered investment advisers demonstrates that registration and the extra requirements that follow would not prevent advisers from using

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126. Pekarek, *supra* note 95, at 926.

127. *Id.* at 932 ("The [Hedge Fund] Rule ignited one of the more widely reported regulatory conflicts in recent market history, and included publication of both Commissioner Atkins's and Glassman's dissents."); *see also* Paredes, *supra* note 21, at 989 (discussing the criticisms of the Hedge Fund Rule, including: "(1) it [would] drive hedge funds offshore; (2) its cost of compliance [would] erect entry barriers that keep new funds from launching; and (3) it [would] chill hedge fund managers form undertaking at least some new and innovative investment strategies . . ."); Antoszewski, *supra* note 3, at 404 ("[The Hedge Fund Rule] quickly came under attack by hedge fund advisers, trade associations, and other critics who were concerned about compliance costs and inefficiencies.").

128. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,060 (Dec. 10, 2004).

129. *Id.* at 72,063.

130. *Id.* at 72,054.

131. *Id.* at 72,059.

complicated and inventive investing techniques.<sup>132</sup> Specifically, the SEC presented a study suggesting that the performance of registered and unregistered hedge fund advisers is relatively similar, and that “[f]ive of the ten largest (and presumably most successful) hedge fund advisers [were then] registered . . . under the Advisers Act.”<sup>133</sup> Further, although “[m]ore than 8,500 advisory firms that collectively manage[d] over \$23 trillion . . . [were] registered under the Advisers Act[,]” they remained competitive in the financial markets and were able to employ successful investing techniques.<sup>134</sup>

#### 4. *Why the Hedge Fund Rule is Necessary*

The SEC presented various reasons, still applicable today, why the safety of U.S. financial markets and investors requires registration of hedge fund advisers. First, the SEC needs “reliable, current, and complete” data to facilitate analysis by SEC staff.<sup>135</sup> Second, although the SEC does not have an “effective program that would provide [it] with the ability to deter or detect fraud by unregistered hedge fund advisers[.]”<sup>136</sup> registration under the IAA would enable the SEC to conduct examinations which could detect fraud and provide a deterrent against it.<sup>137</sup> Third, registration would enable a screening process through which the SEC could keep “fraudsters, scam artists and others” from entering the hedge fund industry and engaging in fraudulent activities.<sup>138</sup> Finally, the SEC argued that adoption of “compliance controls” and “compliance officers” would help detect violations of the securities laws and potential conflicts of interest.<sup>139</sup>

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132. *See id.* at 72,060 (stating that arguments suggesting registration would hinder advisers from engaging in their previous investment strategies are “refuted by the experience of registered hedge fund advisers” who have experienced success despite registration).

133. *Id.*

134. *Id.*

135. *Id.* at 72,061.

136. *Id.* at 72,059.

137. *See id.* at 72,061.

138. *Id.* at 72,063. The SEC was, and still is, concerned that such persons find hedge funds appealing due to the lax registration requirements and their potential to defraud investors. *See id.*

The Commission acknowledged that it does not have the resources to constantly regulate every investment adviser at all times and that compliance officers would “serve as the front line” in detecting these dangers.<sup>140</sup>

On December 10, 2004, the SEC officially adopted the Hedge Fund Rule, and many previously unregistered advisers were instantly required to register by February 1, 2006.<sup>141</sup> However, the Hedge Fund Rule never took full effect. Within months of its adoption, the rule's legality was challenged by an investment adviser in the Court of Appeals for the District of Columbia.<sup>142</sup>

#### IV. *GOLDSTEIN v. SEC*: A DEFEAT FOR THE SEC

##### A. *Summary of the Case*

Shortly after its adoption, Phillip Goldstein, Kimball & Winthrop, and Opportunity Partners L.P. (Goldstein) challenged the Hedge Fund Rule in the D.C. Circuit Court.<sup>143</sup> Phillip Goldstein co-owned Kimball & Winthrop, an investment advisory firm that was the general partner and adviser of Opportunity Partners L.P., a hedge fund.<sup>144</sup> Specifically, Goldstein “challenge[d] the regulation's equation of ‘client’ with ‘investor,’” or, in other words, the “look-through” provision of the Hedge Fund Rule.<sup>145</sup> Goldstein's main argument was that, in adopting the Hedge Fund Rule, the SEC misconstrued the “private adviser exemption” of the IAA.<sup>146</sup> The petition for review was argued on December 9, 2005, and was decided on June 23,

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139. *Id.*; see also Antoszewski, *supra* note 3, at 403 (“[R]egistration would require hedge funds to adopt compliance programs and submit to routine examinations.”).

140. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,063.

141. See *id.* at 72,054.

142. See generally *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

143. *Goldstein*, 451 F.3d at 874.

144. *Id.*

145. *Id.*; see also Paredes, *supra* note 21, at 988 (stating that the rule required the adviser to “look through the fund to count each investor . . . as a single client for purposes of the registration requirement”).

146. *Goldstein*, 451 F.3d at 878.

2006.<sup>147</sup> The court concluded that the Hedge Fund Rule was “arbitrary,” and that the SEC failed to show “how the relationship between hedge fund investors and advisors justifies treating the former as clients of the latter.”<sup>148</sup> Accordingly, the court vacated and remanded the Hedge Fund Rule.<sup>149</sup>

*B. The Definition of “Client”: Ambiguity and the SEC’s  
Authority to Define the Term*

The court began by discussing the procedural background leading up to the adoption of the Hedge Fund Rule and generally summarized the rule.<sup>150</sup> The court then addressed the SEC’s first argument that, because the IAA does not define “client,” the statute is “ambiguous as to a method for counting clients.”<sup>151</sup> The court rejected this argument and declared that there is no rule of law which states that a statutory term is ambiguous if it lacks a specific statutory definition.<sup>152</sup> The court reasoned that, in the same manner that defined statutory terms are not automatically unambiguous, undefined statutory terms are not automatically ambiguous.<sup>153</sup> Further, the court held that Congress has “scarcely” authorized an agency to choose one of the many possible definitions of an unclear statutory term.<sup>154</sup> Finally, the court held that the “‘words of the statute should be read in context, the statute’s place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account’ to determine whether the Congress has foreclosed the agency’s interpretation.”<sup>155</sup>

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147. *Id.* at 873.

148. *Id.* at 882, 884.

149. *Id.* at 884.

150. *See id.* at 877.

151. *Id.* at 878.

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.* (citing *PDK Labs. Inc. v. DEA*, 362 F.3d 786, 796 (D.C. Cir. 2004)).

*C. The Definition of "Client": A Legislative Interpretation*

Next, the court discussed the term "client" and whether Congress intended to include investors, shareholders, limited partners, members, and beneficiaries of hedge funds within the meaning of term.<sup>156</sup> The court acknowledged an amendment to the IAA in 1980 that added the following language: "For purposes of determining the number of clients of an investment adviser . . . no shareholder, partner, or beneficial owner of a business development company . . . shall be deemed to be a client of such investment adviser . . . ."<sup>157</sup> The court stated that this amendment "could be seen as Congress's acknowledgement that 'client' is ambiguous in the context of § 203(b)(3)."<sup>158</sup> However, the court also acknowledged a 1970 amendment in which Congress appeared to take the view that investment company entities are the clients of advisers, and not the entities' shareholders.<sup>159</sup> Moreover, the court looked to another section of the IAA defining "investment adviser" as "any person who, for compensation, engages in the business of advising others, either *directly* . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."<sup>160</sup> The court noted that the investment adviser does not *directly* advise the shareholders or limited partners of the fund, but rather advises the fund itself.<sup>161</sup> The court referred to the investors as "completely passive," and concluded that if the investment adviser is not advising each investor, then it follows that each investor cannot be a "client" of the adviser.<sup>162</sup>

*D. The Definition of "Client": The Requirement of an Adviser-Client Relationship*

The court confirmed that the SEC has traditionally held the court's view of the adviser-client relationship, and that the SEC stated

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156. *See id.* at 878.

157. *Id.*

158. *Id.* at 879.

159. *Id.*

160. *Id.* at 879 (citing 15 U.S.C. § 80b-2(a)(11)).

161. *See id.* at 879-80.

162. *Id.* at 880.

in a 1997 release that an adviser provides clients with “individualized advice,” and that an adviser “need not consider the individual needs of the company’s shareholders when making investment decisions.”<sup>163</sup> Also, the court recognized a 1985 release from which the SEC promulgated a rule stating that, for purposes of the private adviser exemption, a client “is the limited partnership [and] not the individual partners,” and that an adviser should regard the entire investment pool, and not the individuals, as the “client.”<sup>164</sup> Finally, the court established that even the Supreme Court had “embraced a similar conception of the adviser-client relationship,”<sup>165</sup> envisioning the adviser as providing his or her client with “personalized advice attuned to a client’s concerns.”<sup>166</sup> The court concluded that a fiduciary relationship exists between the investment adviser and the fund, but not between the adviser and the fund’s investors.<sup>167</sup> Therefore, the court held that the SEC’s interpretation that each investor within a fund is the adviser’s “client” “falls outside the bounds of reasonableness.”<sup>168</sup>

*E. The Definition of “Client”: Practical Reasons for  
Not Considering All Investors “Clients”*

Thereafter, the court addressed the practical reasons for not considering each individual investor a client. First, the court referred to section 206 of the IAA, which prohibits any registered or unregistered investment adviser from “engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”<sup>169</sup> The court reasoned that if an investment adviser were to owe this fiduciary duty to both the individual investor and the fund, then the adviser would certainly be

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163. *Id.* (construing Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15,098, 15102 (Mar. 31, 1997)).

164. *Id.*

165. *Id.*

166. *Id.* (citing *Lowe v. SEC*, 472 U.S. 181, 208 (1985)).

167. *Id.* (“This type of direct relationship exists between an adviser and the fund, but not between the adviser and the investors in the fund.”).

168. *Id.* at 880-81.

169. *Id.* at 881 (citing 15 U.S.C. § 80b-6(2)).

presented with conflicts of interest.<sup>170</sup> Thus, the court concluded that a client cannot be both the investor and the fund.<sup>171</sup>

Further, the court noted that the relationship between investment advisers and individual investors had not changed since the implementation of the “private adviser exemption.”<sup>172</sup> Therefore, although some of the reasons the SEC gave in favor of creating the Hedge Fund Rule may have been valid, they were not adequately justified by any change in the relationship between investment advisers and investors.<sup>173</sup> The court concluded that, if the SEC intended for there to be an adviser-client relationship between investment advisers and the investors, then “the Commission should have identified those characteristics and tailored its rule accordingly.”<sup>174</sup> Regardless, the court seemed to suggest that the unclear meaning of the term “client” and the method of counting clients for the private adviser exemption are issues that should have been left to Congress, not the Commission, which lacks the authority to interpret the term “client.”<sup>175</sup>

#### *F. The Court's Conclusion*

The Court of Appeals for the D.C. Circuit acknowledged that the SEC's desire for more comprehensive hedge fund regulation is reasonable, but stated that “[t]he Commission may not accomplish its objective by a manipulation of [the] meaning [of ‘client’].”<sup>176</sup> The court ruled that the SEC's Hedge Fund Rule was arbitrary and unreasonable, and, therefore, vacated and remanded the rule.<sup>177</sup> As a result, more than 1000 investment advisers who had registered with

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170. *Id.*

171. *See id.* at 881.

172. *See id.* at 882 (stating that the relationship between the fund advisers and the investors has not changed “over the years”).

173. *Id.* at 882.

174. *Id.* at 883.

175. *See id.* at 883-84.

176. *Id.* at 882.

177. *Id.* at 881, 884.

the SEC in accordance with the Hedge Fund Rule were able to de-register if they so chose.<sup>178</sup>

## V. RULE 206(4)-8: A RESPONSE TO *GOLDSTEIN*

### A. Adoption of Rule 206(4)-8

The SEC's defeat in *Goldstein* left the future of hedge fund regulation uncertain, and it was unclear how the Commission would respond.<sup>179</sup> However, the SEC clearly intended to act.<sup>180</sup> Shortly after the *Goldstein* decision, Commissioner Cox stated that the SEC's regulatory scheme concerning hedge funds was insufficient and that the Commission needed to act quickly to address the defects left by the decision.<sup>181</sup> It appeared as though the SEC would either appeal the court's decision or rewrite the Hedge Fund Rule.<sup>182</sup> However, the Commission chose neither route and opted to abandon its push for hedge fund registration altogether.<sup>183</sup> Instead, in 2007, the SEC adopted a new antifraud rule, Rule 206(4)-8.<sup>184</sup> The rule "prohibits

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178. See LINS ET AL., *supra* note 108, § 3:4.50; Antoszewski, *supra* note 3, at 404, 406 (stating that over 1000 advisers had registered between April 2005 and April 2006, and that, as of October 2006, 101 advisers had already de-registered).

179. See HAZEN, *supra* note 12, § 21.2[3]; Nathan J. Greene, *SEC Proposes Rules Prohibiting Fraud by Investment Advisers and Creating a New Category of Accredited Investor*, 26 BANKING & FIN. SERVICES POL'Y REP. 1, 1 (2007) (discussing how the *Goldstein* decision "raised questions regarding an investment adviser's obligations to investors in pooled investment vehicles").

180. See Daniel, *supra* note 3, at 296.

181. *Id.* at 296-97.

182. HAZEN, *supra* note 12, § 21.2[3].

183. *Id.* ("The SEC's response to Goldstein was to abandon [its] attempt to require registration under the [IAA].").

184. BARBASH & GOLDSTEIN, *supra* note 11, at 240. Rule 206(4)-8(a) states:

It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser to a pooled investment vehicle to:

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

(2) Otherwise engage in any act, practice, or course of business that is

[registered and unregistered] advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles.”<sup>185</sup>

The SEC proposed the rule in order to clarify the antifraud provisions in the IAA.<sup>186</sup> Specifically, the SEC felt that the language in *Goldstein* questioned the Commission's authority to enforce the antifraud provisions of the IAA.<sup>187</sup> Prior to the adoption of the new rule, section 206 of the IAA stated that registered and unregistered investment advisers were prohibited from “engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”<sup>188</sup> As discussed above, *Goldstein* established that the “client” of an investment adviser is the fund itself and not the investors in the fund.<sup>189</sup> Consequently, it became unclear whether or not the SEC could bring enforcement actions against an adviser for defrauding the individual investors of a hedge fund—investors who are not considered clients of the

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fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

Pooled Investment Vehicles, 17 C.F.R. § 275.206(4)-8(a) (2007). The SEC is authorized by Congress in section 206(4) of the IAA “to adopt rules and regulations that ‘define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.’” Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,757 (Aug. 9, 2007) (citing 15 U.S.C. 80b-6(4)).

185. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,756. *See generally* BARBASH & GOLDSTEIN, *supra* note 11, at 240-44 (discussing the provisions of Rule 206(4)-8).

186. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,756.

187. *See id.*; BARBASH & GOLDSTEIN, *supra* note 11, at 240 (“Proposed Rule 206(4)-8 . . . appears to be a response to a statement made by the Court in *Goldstein* regarding the nature of the fiduciary duty of a hedge fund manager. In its decision, the Court concluded . . . that an investment adviser . . . has a fiduciary obligation only to the investment vehicle and not to the vehicle's investors.”).

188. 15 U.S.C. § 80b-6(2) (2006).

189. *Goldstein v. SEC*, 451 F.3d 873, 880 (D.C. Cir. 2006); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,756.

adviser.<sup>190</sup> Rule 206(4)-8 avoids this dilemma by prohibiting fraud against “investors” or “prospective investors.”<sup>191</sup>

### *B. Scope of the New Rule*

Rule 206(4)-8 is larger in scope than other antifraud laws because of its broad definition of “fraud,” the rule’s extension of liability to unregistered investment advisers, and its language designed to protect individual investors. The SEC, against the opinions of some commentators, purposefully defined “fraud” broadly.<sup>192</sup> Consistent with this, Rule 206(4)-8 broadly prohibits an adviser from making any false material statements or omissions and from employing business practices that are “fraudulent, deceptive, or manipulative.”<sup>193</sup> The Commission’s arguments as to the reasonableness of adopting such broad language are twofold. First, the Commission asserts that Congress gave it the authority to adopt antifraud rules that are both general and flexible.<sup>194</sup> Second, the Commission reasons that “fraudulent, deceptive, or manipulative” conduct is easily-identifiable because what constitutes such conduct is well-established within the securities laws.<sup>195</sup> Additionally, the new antifraud rule extends liability to both registered and unregistered investment advisers.<sup>196</sup> The SEC constructed the new rule to include unregistered advisers because of the large number of fraud cases involving them, and

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190. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,756 (“As a result, it was unclear whether the Commission could continue to rely on sections 206(1) and (2) of the [IAA] to bring enforcement actions in certain cases where investors in a pool are defrauded by an investment adviser to that pool.”). As will be discussed, Rule 206(4)-8 does not create any private right to action. *Id.* at 44,760.

191. *Id.* at 44,757 (“The rule clarifies that an adviser’s duty to refrain from fraudulent conduct . . . extends to the relationship with ultimate investors . . . .”); Greene, *supra* note 179, at 2 (“Rule 206(4)-8 would apply to both current and prospective investors in the pooled investment vehicle.”).

192. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,757.

193. 17 C.F.R. § 275.206(4)-8(a) (2007).

194. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,757.

195. *Id.*

196. *Id.* at 44,758.

because the SEC believed it is critical to continue to act against fraudulent advisers regardless of whether they are registered.<sup>197</sup> Finally, the SEC structured Rule 206(4)-8 to protect investors and prospective investors alike, rather than just the pooled investment vehicles.<sup>198</sup>

### *C. Pooled Investment Vehicles*

The Commission used a new term, “pooled investment vehicle,” in adopting rule 206(4)-8.<sup>199</sup> A “pooled investment vehicle” is “any investment company defined in section 3(a) of the Investment Company Act [15 U.S.C. § 80a-3(a)] and any privately offered pooled investment vehicle that is excluded from the definition of investment company by reason of either section 3(c)(1) or 3(c)(7) of the [Act].”<sup>200</sup> Thus, even companies relying on the Investment Company Act’s (ICA’s) 3(c)(1) and 3(c)(7) exclusions, which include hedge funds, are considered pooled investment vehicles and are therefore implicated under the broad antifraud provisions.<sup>201</sup> As with the IAA, hedge funds rely on exclusions under the ICA to avoid registration under that

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197. *Id.*

198. *See id.* at 44,757. The SEC broadened the new rule to include “potential investors” for the same reasons that Congress included “potential clients” within the scope of sections 206(1) and 206(2) of the IAA. *See id.*

199. *See id.* at 44,758.

200. *Id.* Subsection 3(a) of the Investment Company Act states:

(1) When used in this subchapter, “investment company” means any issuer which—

(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

15 U.S.C. § 80a-3(a)(1) (2006).

201. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,758.

Act.<sup>202</sup> Section 3(c)(1) provides an exclusion for companies whose outstanding securities are owned by 100 people or fewer and whose issuer does not plan on making a public offering of its securities.<sup>203</sup> Section 3(c)(7) excludes from registration “investment companies that do not make a public offering and whose securities are owned exclusively by qualified purchasers.”<sup>204</sup> The Commission’s employment of the term “pooled investment vehicles” extends the breadth of Rule 206(4)-8 to cover funds relying on both the exemptions of the ICA and those of the IAA, including hedge funds, private equity funds, and venture capital funds.<sup>205</sup>

#### *D. False or Misleading Statements, or Omissions*

Rule 206(4)-8 prohibits investment advisers from making “any untrue statement of a material fact or [omitting] to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in a pooled investment vehicle.”<sup>206</sup> This requirement resembles provisions in other SEC antifraud laws; consequently, it is possible that some fraudulent statements may violate Rule 206(4)-8 in addition to other antifraud provisions.<sup>207</sup> Also, Rule 206(4)-8 covers more instances of fraud than other antifraud regulation, such as rule 10b-5 of the Securities and Exchange Act of 1934, in that it includes “statements to investors in the pool regardless of whether the pool is offering, selling, or

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202. Daniel, *supra* note 3, at 262 (discussing the exclusions that hedge funds rely on to avoid registration under the ICA and how avoiding registration permits hedge funds to partake in activities otherwise prohibited by the Act).

203. 15 U.S.C. § 80a-3(c)(1); Daniel, *supra* note 3, at 262.

204. Daniel, *supra* note 3, at 262; 15 U.S.C. § 80a-3(c)(7)(A).

205. See generally Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756 (Aug. 9, 2007) (using the term “pooled investment vehicles” throughout).

206. 17 C.F.R. § 275.206(4)-8(a)(1); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,758-59.

207. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,759 (“The provision is very similar to those in many of our antifraud laws and rules that, depending upon the circumstances, may also be applicable to the same investor communications.”).

redeeming securities.”<sup>208</sup> According to the SEC, the new rule prohibits “materially false or misleading statements regarding investment strategies . . . , the experience and credentials of the adviser . . . , the risks associated with . . . the pool, the performance of the pool or other funds advised by the adviser, the valuation of the pool . . . , and practices the adviser follows . . . .”<sup>209</sup>

### *E. Fraudulent, Deceptive, or Manipulative*

Under Rule 206(4)-8, investment advisers are prohibited from “engag[ing] in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.”<sup>210</sup> The broad language of this provision is derived from section 206(4) of the IAA.<sup>211</sup> The language of Rule 206(4)-8 prohibits any fraudulent action, as opposed to the more narrow provisions in other antifraud laws which limit liability only to fraudulent statements.<sup>212</sup> The SEC used this language so that the rule would be broader than the existing antifraud provisions and protect against fraudulent conduct as well as fraudulent communications.<sup>213</sup> Further, the Commission declined to specify what conduct is considered “fraudulent,” opting instead to maintain the rule’s broad construction in an effort to provide greater protection to pooled investment vehicles’ investors.<sup>214</sup>

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208. *Id.*; cf. 17 C.F.R. § 240.10b-5 (2007) (stating that it is unlawful “[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security”).

209. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,759.

210. 17 C.F.R. § 275.206(4)-8(a)(2).

211. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,759.

212. *See id.* (“[T]he wording of this provision . . . is designed to apply more broadly to deceptive conduct that may not involve statements.”).

213. *See id.* (“[S]ection 206(4) itself specifically authorizes us to adopt rules defining and prescribing . . . [conduct], and does not explicitly refer to communications . . .”).

214. *See id.*

### *F. No Scierter Requirement*

Unlike other antifraud provisions found in the securities laws, the Commission does not need to demonstrate that an adviser acted with scierter in order to violate Rule 206(4)-8.<sup>215</sup> Commentators voiced concern over the lack of a scierter requirement, arguing that a negligence standard would expand “fraud” beyond its original meaning.<sup>216</sup> Also, some commentators went so far as to say that the lack of a scierter requirement would reduce communications between hedge fund advisers and investors, thereby diminishing the transparency of the fund’s investment activities and increasing the likelihood that investors would make uninformed investment decisions.<sup>217</sup> The Commission responded with precedent authorizing it

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215. *See id.* For a brief explanation on “scierter,” see *supra* note 15.

216. *See, e.g.*, E-mail from David A. Vaughan & George J. Mazin, Partners at Dechert LLP, to Nancy M. Morris, Secretary, SEC (Mar. 9, 2007), in *SEC Proposed Rules; 17 CFR Parts 230 and 275, Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Dec. 27, 2006*, in PRACTICING LAW INST., CORPORATE LAW AND PRACTICE 145, 148 (2007) [hereinafter SEC PROPOSED RULES] (“Without [scierter], we believe that the proposed rule would have the effect of creating both uncertainty on the part of hedge fund advisers as well as the possibility of strict liability under Rule 206(4)-8 for innocent or minor violations . . . .”); Letter from Patricia A. Poglinco & Robert B. Van Grover, Attorneys at Seward & Kissel LLP, to Nancy M. Morris, Secretary, SEC (Mar. 8, 2007), in SEC PROPOSED RULES, *supra*, at 93, 99 (“Under the Proposed Rule, the Commission would theoretically be able to take enforcement action against an adviser who, for example, made an unintended typographical error in a routine email to an investor.”); E-mail from Ricardo W. Davidovich et al., Attorneys at Tannenbaum Helpert Syracuse & Hirschtritt LLP, to Jonathan G. Katz, Secretary, SEC (Mar. 1, 2007), in SEC PROPOSED RULES, *supra*, at 83, 84 (commenting that, although investment advisers should be held accountable for not using “reasonable care,” to hold investment advisers “accountable for inadvertent errors, including items that looking back over time may appear erroneous, even if thought in good faith to be true when published, appears quite unfair and seems to us to be a burden that is virtually impossible to meet”). *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, 72 Fed. Reg. at 44,759.

217. *See* E-mail from David A. Vaughan & George J. Mazin, Partners at Dechert LLP, to Nancy M. Morris, Secretary, SEC (Mar. 9, 2007), in SEC PROPOSED RULES, *supra* note 216, at 145, 148 (“As a consequence [of not having a scierter requirement], hedge fund advisers may choose to provide more limited information to investors . . . . This, in turn, would result in diminishing an investor’s understanding of and ability to evaluate potential investments and . . . discourage meaningful, candid and informative discourse between fund advisors and

to set forth prohibitions reasonably designed to prevent fraudulent practices.<sup>218</sup> Correspondingly, the SEC concluded that it has the authority to broaden liability for fraud beyond the scienter requirement because Rule 206(4)-8 is “reasonably designed to prevent fraud.”<sup>219</sup> Furthermore, the SEC reasoned that hedge fund advisers should not be concerned with the rule’s lack of a scienter requirement because the rule does not create or modify any fiduciary duty that is not already required by other sources of law.<sup>220</sup>

### G. No Private Right to Action

The Commission clearly established that Rule 206(4)-8 “does not create a private right of action.”<sup>221</sup> Specifically, the SEC stated, “Rule 206(4)-8 does not create under the Advisers Act a fiduciary duty to investors or prospective investors in a pooled investment vehicle not

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investors.”).

218. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,759 (construing *United States v. O’Hagan*, 521 U.S. 642, 673 (1997)). Specifically, the SEC opined that it is not restricted to the section 10(b) requirement of scienter. *See id.* at 44,759-60.

219. *Id.* at 44,759. The SEC further stated that, “by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception.” *Id.*

220. *Id.* at 44,760 (“Rule 206(4)-8 does not create . . . a fiduciary duty . . . not otherwise imposed by law. Nor does the rule alter any duty or obligation an adviser has under the Advisers Act, any other federal law or regulation, or any state law or regulation . . . . In most cases, the conduct that the rule prohibits is already prohibited by federal securities statutes, other federal statutes . . . , as well as state law.”).

221. *Id.* Even prior to the adoption of Rule 206(4)-8, the Supreme Court held that, generally, individual investors do not have standing to bring civil actions against investment advisers under the IAA. *See Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 23 (1979) (“[T]he Act confers no other private causes of action, legal or equitable.”); *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080, 1095 (S.D.N.Y. 1977), *aff’d*, 636 F.2d 1201 (2d Cir. 1980). The Act specifically limits who can bring a private cause of action against an adviser to that adviser’s clients or potential clients, and the *Goldstein* court made it clear that individual investors in a fund are not the considered “clients” of the adviser. *Goldstein v. SEC*, 451 F.3d 873, 880 (D.C. Cir. 2006). However, it should be noted that, in some situations, an investor may have “an implied right of rescission under section 215 of the Act, which provides that contracts in violation of the Act are void.” HAZEN, *supra* note 12, § 21.4[2].

otherwise imposed by law. Nor does the rule alter any duty or obligation an adviser has under the Advisers Act . . . .”<sup>222</sup> Therefore, only the SEC, and not the investors, can bring criminal and civil actions against an investment adviser who violates the antifraud provisions of the IAA.<sup>223</sup>

## VI. THE IMPLICATIONS OF RULE 206(4)-8: TWO STEPS BACK AND ONE STEP FORWARD

### *A. Two Steps Back: Rule 206(4)-8 Is an Ineffectual Response to Goldstein*

#### *1. Rule 206(4)-8 Fails to Fully Address the SEC’s Concerns Regarding Hedge Funds*

The SEC’s adoption of Rule 206(4)-8 is a weak response to the *Goldstein* decision when considering the concerns the SEC presented with its 2004 adoption of the Hedge Fund Rule.<sup>224</sup> Specifically, Rule 206(4)-8 only partially addresses one of the SEC’s three major concerns—fraudulent activity.<sup>225</sup> The new rule contains no provisions that would provide the Commission with a way to monitor unregistered hedge fund advisers or illuminate who is investing in hedge funds. In addition to fraudulent activity, the new rule does not provide the SEC with any way to examine the investment techniques that hedge fund advisers are employing—techniques that often require excessive amounts of leverage and risk, possibly resulting in failure even where no fraudulent activity is involved. For example, LTCM and Amaranth were two of the largest fund failures in history, yet their respective collapses were the result of over-leveraging, not fraud.<sup>226</sup>

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222. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,760.

223. See *id.* at 44,757 (“[T]he Commission may bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in those pooled investment vehicles.”).

224. The SEC’s reasoning behind adopting the 2004 Hedge Fund Rule is discussed earlier in this Comment. See *supra* Part III.C.

225. See *supra* Part II.C.2.

226. History shows that over-leveraging, and not fraud, was responsible for the largest hedge fund failures the U.S. has seen. See *supra* Part II.D. Randall

However, both failures resulted in significant hardships for investors and almost had a devastating impact on U.S. financial markets.<sup>227</sup>

## 2. *Detecting Fraud Without Disclosure*

The new rule may confirm and broaden the SEC's ability to bring actions against fraudulent activity, but fails to provide any provision that might increase the detection of fraud. In 2004, the SEC stated that it does "not have an effective program that would provide [it] with the ability to deter or detect fraud by unregistered hedge fund advisers" because the Commission lacks "basic information about hedge fund advisers and the hedge fund industry."<sup>228</sup> Rule 206(4)-8's broad definition of fraud may certainly give the SEC authority to bring actions for many kinds of fraudulent activity,<sup>229</sup> but does not improve the SEC's ability to gather information in order to detect fraud. Furthermore, the SEC was troubled that it had to "rely almost entirely on enforcement actions brought after fraud has occurred and investor assets are gone."<sup>230</sup>

Rule 206(4)-8 fails to address this concern as well because the rule does not increase the Commission's ability to collect relevant and current information on the industry.<sup>231</sup> As a result, the SEC will

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Steinmeyer, Director at the Washington D.C.-based Hedge Fund Association, considers excessive leveraging dangerous because "it increases the chances of [hedge funds] blowing themselves up." Gregory Bresiger, *Some Are Wary of Leverage*, TRADERS MAGAZINE, Mar. 2007, available at <http://www.tradersmagazine.com/issues/20070315/2746-1.html>. Steinmeyer believes that, "[f]or the undisciplined hedge fund, this is like giving the drug addict more access to drugs." *Id.*

227. *See supra* Part II.D.

228. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,059 (Dec. 10, 2004).

229. The SEC broadened its ability to bring actions against fraudulent advisers by using vague wording to define what constitutes "fraudulent." *See supra* Part V.B. The Commission also extended its authority to include unregistered advisers. *See supra* Part V.B.

230. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,059.

231. Rule 206(4)-8 merely enlarges the scope of what types of activities may be considered fraudulent and augments who can be held liable for fraudulent activity. *See supra* Part V. The Rule fails, however, to implement any new registration requirement, or any other method for collecting direct and current

continue to lack the ability to conduct examinations of hedge fund advisers, a critical element of investor protection.<sup>232</sup> Ultimately, the SEC's adoption of the new rule does not change the fact that, in most situations involving a Rule 206(4)-8 violation, an enforcement action will be brought only after fraud is reported to the Commission—and fraud will probably only be reported after an institutional or individual investor has been defrauded and the damage has been done. Intuitively, it makes more sense for the Commission to first find a method for illuminating the activities of hedge funds, and then for it to broaden the definition of fraud so as to eliminate the malfeasance that it has detected through that method. However, in adopting the new rule, the SEC remains reactive; the Commission may have increased its authority to reprimand advisers for fraud after-the-fact, but it fails to prevent fraud, and its associated losses, from occurring in the first place.

### 3. *No Private Right of Action*

As mentioned, the new anti-fraud rule fails to provide individual investors with any private right of action.<sup>233</sup> Although the SEC asserts that it is concerned with protecting investors,<sup>234</sup> it fails to provide individual investors with any explicit civil remedy by which they can recover losses resulting from their investment advisers' fraudulent activity. Rule 206(4)-8 does not change the reality that only the Commission has the authority, civilly and criminally, to bring any enforcement actions against fraudulent investment advisers.<sup>235</sup> Therefore, as long as deceitful investment advisers can evade detection by the SEC, they will avoid liability for their actions.

However, if individual investors had standing to bring actions against investment advisers, there would be greater detection and

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information on the hedge fund industry. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,059.

232. *Id.* at 72,059, 72,061 (stating that investment adviser examinations are “a key part of [the Commission's] investment protection program”).

233. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,760 (Aug. 9, 2007).

234. *See supra* Part III.C.

235. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,757.

deterrence against fraudulent activity. First, the addition of private individuals and institutions monitoring fraudulent behavior would dramatically improve the detection of fraud. With a private right of action, private organizations, such as law firms, would have an incentive to monitor the activities of investment advisers. Under some circumstances, these private legal institutions may have more resources than the Commission, and therefore may be better suited to detect fraud than the SEC. Consequently, those investment advisers who would otherwise avoid detection by the SEC alone would more likely be exposed through a combination of SEC and private monitoring. Second, investment advisers participating in deceptive practices would more likely be deterred from defrauding investors if they knew that they were being monitored by private institutions in addition to the SEC, and that both could bring an action against them. The knowledge that any investor, institutional or otherwise, law firm, or fund could bring legal actions against investment advisers would greatly discourage advisers from engaging in fraudulent practices. Unfortunately, similar to the SEC's enforcement of the new antifraud rule, the lack of transparency in the hedge fund industry would likely render it difficult for even private institutions to detect fraud among unregistered advisers.

*B. One Step Forward: Although It Falls Short of the Hedge Fund Rule, Rule 206(4)-8 Is a Step Towards Increased Investor and Market Safety*

Despite falling short of the 2004 Hedge Fund Rule, Rule 206(4)-8 may increase investor safety to some extent. Most importantly, the rule confirms the SEC's authority to bring antifraud actions against investment advisers who defraud individual investors or potential investors, a capacity that was questioned by the *Goldstein* court.<sup>236</sup> It is essential that the Commission have unquestioned authority to act against fraudulent activity. If its authority were unclear, it would only provide greater ability for deceitful advisers to defend their actions.

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236. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,756-57 (discussing how the *Goldstein* opinion left some uncertainty regarding the SEC's authority to bring enforcement actions against fraudulent investment advisers, but how the new rule clarifies the uncertainty surrounding the SEC's authority).

Additionally, the new rule's broad definition of fraud provides the SEC with a more flexible interpretation of what types of activities may be considered fraudulent.<sup>237</sup> Although antifraud provisions existed within securities laws prior to the new rule, they were fairly narrow in scope.<sup>238</sup> For example, prior to Rule 206(4)-8, the SEC could only bring actions for fraudulent adviser communications and disclosures.<sup>239</sup> The new rule authorizes the Commission to bring actions for a much broader variety of fraud.<sup>240</sup> Moreover, under the new rule, the SEC's ability to bring enforcement actions for fraudulent activity is no longer limited by a scienter requirement, effectively expanding fraud to include negligent activity.<sup>241</sup> An adviser can no longer argue that he or she did not have the required state of mind to defraud because it is enough that the adviser perpetuated an activity that is fraudulent in nature.<sup>242</sup> Finally, the rule applies to all investors and potential investors, and to advisers of all pooled investment vehicles, registered or unregistered.<sup>243</sup>

In summary, Rule 206(4)-8 gives the SEC broad enforcement authority against almost any type of fraud, by any investment adviser, perpetrated against any level of investor. The Commission's new and

237. See *supra* Part V.B (discussing the scope of Rule 206(4)-8).

238. Although the language of Rule 206(4)-8 is similar to that of Rule 10b-5 of the Securities Exchange Act, it differs in that Rule 206(4)-8 does not require a specific statement or disclosure by an investment adviser. See Greene, *supra* note 179, at 2 (commenting that Rule 206(4)-8 is broader than Rule 10b-5, and that "the proposed rule will not be limited to statements or other disclosure and will apply to any fraudulent, deceptive, or manipulative conduct").

239. The language in the antifraud provisions of the IAA prior to the adoption of Rule 206(4)-8 limited the activities in which fraud could be found to the "use of the mails or any means or instrumentality of interstate commerce, directly or indirectly." See 15 U.S.C. § 80b-6 (2006). The new rule eliminates this confine. See *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, 72 Fed. Reg. at 44,757.

240. *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, 72 Fed. Reg. at 44,757 (stating that the Commission has defined "fraud" more broadly than some commentators would have liked, and that its purpose for doing so was to "prohibit all fraud on investors in pools managed by investment advisers"); Greene, *supra* note 179, at 2.

241. See *supra* Part V.F.

242. See *supra* Part V.F.

243. See *supra* Part V.B-C.

improved definition of fraud is certainly a step in the right direction towards hedge fund regulation. However, many of the enforcement benefits that the new rule brings are hamstrung by the SEC's remaining inability to detect fraudulent activity within the hedge fund industry. Thus, the SEC must consider proposing a rule that would offer the type of transparency that the now-vacated Hedge Fund Rule once provided.

*C. Revisiting the SEC's Concerns: The Next Step*

It is highly likely that the Commission is not finished addressing hedge fund regulation. It is possible that the adoption of Rule 206(4)-8 was the first, measured step in a series of steps towards increased hedge fund regulation and disclosure. Nonetheless, the SEC's next step should center on transparency within the hedge fund industry. Transparency would protect investors, both within hedge funds and within the markets generally, for two main reasons. First, it would allow the SEC to more efficiently monitor the activities of hedge fund investment advisers. As the Alliance for Investment Transparency (AIT) so eloquently stated, "[t]he lack of transparency with respect to the market activities of hedge funds exacerbates the risk to the financial markets because regulators and others charged with overseeing those markets are left in the dark . . . ; leaving regulators unable to see a potential crisis on the horizon."<sup>244</sup> Illuminating the activities of hedge funds would allow the Commission to be proactive; the SEC could see a potential crisis in advance and work to prevent it. Second, transparency would allow individual and institutional investors to make more informed investment decisions. As Randall Steinmeyer declares, "[h]edge fund regulation will work if it accomplishes increased transparency, increased performance background information, and adequate disclosure."<sup>245</sup> He further states that such transparency and disclosure would legitimize hedge fund

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244. Statement of the Alliance for Inv. Transparency to House Fin. Servs. Comm. Hearing on "Hedge Funds and Systemic Risk: Perspectives of the President's Working Group on Financial Markets" (July 11, 2007), at 1, *available at* <http://www.investmenttransparency.org/documents/AIT.Statement.House.Hearing.071107.pdf> [hereinafter Statement of the AIT].

245. *Hedge Funds' Notoriety: Fact or Fiction?*, *supra* note 22, at 68.

investing in the minds of investors.<sup>246</sup> Clearly, the Commission should refocus its efforts on hedge fund regulation by concentrating on increasing transparency within the industry through mandated hedge fund registration.

Some have suggested that increased regulation should be achieved by limiting the leverage that a fund can employ,<sup>247</sup> or by limiting the types of investors that can invest in a given fund.<sup>248</sup> However, without the ability to examine hedge funds, it would be extremely difficult, if not impossible, to enforce any specific regulation until after a violation of that regulation has occurred. The SEC's ability to monitor the hedge fund industry is the critical element in preemptively enforcing any regulation, and the most obvious and accessible way to increase the Commission's ability to monitor hedge funds is through mandatory registration.<sup>249</sup>

Disclosure within the hedge fund industry is exactly what the Hedge Fund Rule was designed to achieve. As discussed, one of the reasons that the SEC sought to mandate registration under the Hedge Fund Rule was that it lacks information on the hedge fund industry, "and [therefore] must rely on third-party data that often conflict and may be unreliable."<sup>250</sup> Consequently, the SEC adopted the Hedge Fund Rule and its compulsory registration because they allow the Commission to examine the conduct of hedge fund advisers.<sup>251</sup> Such examinations "permit [the SEC] to identify compliance problems at an early stage, identify practices that may be harmful to investors, and

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246. *Id.* at 69.

247. *See, e.g.,* Daniel, *supra* note 3, at 298-99 (arguing that one solution to the hedge fund problem would be for the government to limit the leverage that funds employ through either stricter margin requirements or through direct limitations).

248. *See, e.g.,* Natali, *supra* note 3, at 131 (discussing how the SEC could "limit the types of investors permitted to invest in hedge funds," including restricting certain institutional investors' ability to invest in unregistered hedge funds); Daniel, *supra* note 3, at 307-08 (commenting that the SEC could limit pension funds and other institutional investors from investing, even to a certain percentage, in hedge funds).

249. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,059 (Dec. 10, 2004).

250. *Id.* at 72,059, 72,061.

251. *Id.* at 72,061 ("Registration under the Advisers Act enables us to conduct examinations of the hedge fund adviser.").

provide a deterrent to unlawful conduct.”<sup>252</sup> The registration of all hedge funds is necessary if the Commission is going to succeed in proactively regulating the hedge fund industry.

Moreover, registration of hedge funds alone—without any other specific regulations as to how funds may invest, or who can invest in funds—may be enough to prevent systemic loss. Hedge funds can be beneficial to U.S. markets; their flexible and unfettered trading activities provide the “smooth operation of financial markets and the accuracy of securities prices, upon which investor confidence and the integrity of securities markets depend.”<sup>253</sup> Additionally, “[t]he U.S. Federal Reserve, SEC, and IMF have all recognized the reality that hedge fund trading activity often improves financial market pricing efficiency and, in many instances, serves to increase liquidity.”<sup>254</sup> Hence, any regulation that restricts the types of activities in which hedge funds can engage or that limits who can invest in these funds may hinder the hedge fund industry, thereby causing U.S. financial markets to forego the benefits of hedge fund trading. However, a registration-alone approach to regulation would both deter misconduct and enable the Commission to identify and prevent misconduct before it can adversely impact the market. Further, a registration-alone approach would not inhibit a hedge fund adviser’s ability to employ the funds’ legitimate but distinctive trading strategies.<sup>255</sup> Although registration would have some minimal requirements,<sup>256</sup> it would only hamper an investment adviser’s activities if those activities are prohibited. If an adviser is legitimately conducting his or her operations, there should be minimal opposition to registration.

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252. *Id.*

253. Paredes, *supra* note 21, at 1003.

254. Pekarek, *supra* note 95, at 958.

255. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72059 (“[R]equiring hedge fund advisers to register . . . will [not] impose undue burdens on them or interfere significantly with their operations.”).

256. These requirements may consist of certain obligations that come with registration under the IAA, including guidelines for marketing and communications activities, requisite disclosure of financials and disciplinary measures, mandatory recordkeeping practices, and guidelines for an adviser’s personal securities related dealings, among other things. *See supra* note 109 and accompanying text. For more information on the specific requirements of the IAA, *see generally* LINS ET AL., *supra* note 108, at ch. 3.

Therefore, the Commission's next step should be towards implementing mandatory registration of all hedge fund advisers under the IAA. The SEC's first attempt at preventing hedge funds from taking advantage of the IAA exemptions that enabled them to remain unregistered failed when the *Goldstein* court vacated the Hedge Fund Rule.<sup>257</sup> However, this must not be the end of hedge fund registration. Currently, there has been little progress in addressing hedge fund registration and transparency.<sup>258</sup> Congress has introduced bills requiring registration, but they are having trouble reaching the Senate floor.<sup>259</sup> Thus, the Commission must find an alternate means for requiring registration, whether through implementation of some administrative rule, or by extensively lobbying the Legislature to take action.

## VII. CONCLUSION

The primary purpose of this Comment is to provide an overview of the current state of affairs concerning hedge fund regulation. Additionally, this Comment promotes the idea that the registration of hedge fund advisers will provide the necessary transparency into the hedge fund industry. A lucid hedge fund industry is the first step towards alleviating the SEC's concerns over the systemic risks and risks to investors posed by hedge funds. "[E]nhancing transparency in the markets and disclosures by all market participants will produce a more efficient market that is both fairer and less prone to instability or dislocation. Transparency in the financial markets is one of the bedrock principles that...is essential to the integrity of the markets."<sup>260</sup> Regrettably, the SEC's response to *Goldstein*, Rule 206(4)-8, fails to provide any disclosure into the hedge fund industry. Furthermore,

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257. See *supra* Parts III.C, IV (discussing the rationale behind the adoption of the Hedge Fund Rule and the reasons that the *Goldstein* court vacated the rule).

258. See HAZEN, *supra* note 12, § 21.2[1] ("The SEC's response to *Goldstein* was to abandon [its] attempt to require registration under the [IAA].").

259. See Pekarek, *supra* note 95, at 959-60 (discussing how a recent hedge fund registration bill was unable to get past the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises).

260. Statement of the AIT, *supra* note 244, at 2.

SEC's current focus on the implementation of specific regulations, as evidenced by the adoption of Rule 206(4)-8, will not likely provide any transparency into the industry. In fact, specific restrictions will likely cripple the industry and may hurt U.S. markets by preventing advisers from employing the investment techniques that distinguish hedge funds from other investment vehicles, techniques that provide certain benefits to financial markets.<sup>261</sup> Therefore, the SEC should refocus on a registration-based approach towards regulation. Registration will provide transparency to the hedge fund industry and illuminate any misconduct therein while minimally affecting an adviser's ability to employ innovative and unique investing activities that benefit U.S. markets.

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261. See *supra* notes 25, 53-55 and accompanying text.

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