

The SEC's Ineffective Move toward Greater Regulation of Offshore Hedge Funds: The Failure of the Hedge Fund Registration Requirement

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NOTE

THE SEC'S INEFFECTIVE MOVE TOWARD GREATER REGULATION OF OFFSHORE HEDGE FUNDS: THE FAILURE OF THE HEDGE FUND REGISTRATION REQUIREMENT

Alison S. Fraser[†]

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INTRODUCTION

Despite having little knowledge about the internal structure and investment methods of hedge funds,¹ Americans have invested in these elusive funds at exponentially increasing rates in recent years.²

¹ See, e.g., Comment, Paul R. Davis, Attorney, Boston, Mass., on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172 (Nov. 7, 2004) [hereinafter Davis Comment], <http://www.sec.gov/rules/proposed/s73004/prdavis9213.htm> ("[T]he real reason for this [hysteria associated with hedge funds] is that they operate in cloaked environments, in stealth mode, unlike mutual funds or other comparable investment vehicles."); PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999) ("The term 'hedge fund' is commonly used to describe a variety of different types of investment vehicles that share some similar characteristics."); Marcia L. MacHarg, *Waking up to Hedge Funds: Is U.S. Regulation Really Taking a New Direction?*, in HEDGE FUNDS: RISKS AND REGULATION 55, 57 (Theodor Baums & Andreas Cahn eds., 2004) ("The term 'hedge fund' is frequently used in the United States to identify a broad range of private investment vehicles that actively trade a variety of securities and commodities through a multitude of investment strategies, with an almost unbounded range of risk and return objectives."); *Hedge Funds and the SEC: Still Free*, ECONOMIST, July 1, 2006, at 68 (quoting Senator Orrin Hatch as calling hedge funds the "Wild West" of America's financial system); Steven Rattner, *Don't Fence in Hedge Funds*, BUS. WK., Jan. 16, 2006, at 104 ("[T]he secret to understanding hedge funds is to first accept the irrelevance of the term 'hedge fund.'").

² No concrete figures exist as to the extent of U.S. investment in hedge funds. See, e.g., *Recent Developments in Hedge Funds, Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 108th Cong. 8 (2003) (statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_senate_hearings&docid=f:92703.wais.pdf (estimating that there are 5,700 hedge funds in the United States that manage approximately \$600 billion in total assets); PRESIDENT'S WORKING GROUP ON FIN. MKTS., *supra* note 1, at 1 (estimating that as of mid-1998, there were 2,500 to 3,500 hedge funds that managed "between \$200 billion and \$300 billion in capital, with approximately \$800 billion to \$1 trillion in total assets"); Brett Duval Fromson, *Hedge Funds Today: Fortunes Favor the Brave*, WALL ST. J., Nov. 22, 2005, at A14 (estimating that there are 8,000 hedge funds that manage approximately \$1 trillion in total assets); Jayesh Punater, *Registration Pro and Con*, SEC. INDUSTRY NEWS, Oct. 24, 2005, at 4 ("[H]edge funds . . . have been growing at an exponential rate, with assets under management now exceeding \$1 trillion. The SEC knew hedge funds were growing, but it had no reliable data indicating just how many funds there were and exactly how much money they were managing."); Andy Serwer, *Carlo's Way: This Zany Hedge Fund Manager Preaches Peace—and Wages War*, FORTUNE, Nov. 14, 2005, at 73 ("[T]here are more hedge funds than Taco Bells in the U.S." (quoting hedge fund manager J. Carlo Cannell)); Paul F. Roye, Dir. of Inv. Mgmt., Sec. & Exch. Comm'n, Keynote Address at the Tenth

Not only does U.S. law fail to define “hedge fund,”³ it also creates loopholes such that most hedge funds and their advisers do not need to register with a regulatory body such as the Securities and Exchange Commission (SEC).⁴ While hedge funds may occasionally fall under the regulatory authority of other agencies,⁵ hedge fund advisers and administrators strive to avoid disclosure and additional regulation. Avoiding disclosure and regulation reduces costs for investors and improves funds’ returns.⁶

Annual Advanced ALI-ABA Course of Study: Investment Management Regulation (Oct. 28, 2004) [hereinafter Roye Speech], <http://www.sec.gov/news/speech/spch102804pfr.htm> (“While no one knows for sure, it is estimated that in the last five years, hedge funds have grown by 260[%], with assets of approximately \$870 billion in approximately 7,000 funds. Some predict that hedge fund assets will soon reach one trillion dollars.”). Perhaps the recent fall of Amaranth Advisors LLC—the Connecticut-based hedge fund that managed \$9.2 billion before its “mammoth trading mistakes” caused the fund to lose approximately \$6 billion of its assets during 2006, forcing it to sell off its assets and ultimately close—will encourage closer examination of the industry. Ron Orol, *A Gathering Storm?*, DAILY DEAL, Oct. 2, 2006, available at 2006 WLNR 16942481; see also Allan Sloan, *One Hedge Fund’s Wilted Fortunes*, NEWSWEEK, Oct. 2, 2006, at 15 (“We at Newsweek don’t print obituaries before our subject has been officially declared dead. . . . But [Amaranth is] so deep in the hole that I can’t imagine it surviving.”).

³ See, e.g., *Goldstein v. SEC*, 451 F.3d 873, 874–75 (D.C. Cir. 2006) (“‘Hedge funds’ are notoriously difficult to define. The term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition.”); *Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 109th Cong. (2006) (statement of Randal K. Quarles, Under Secretary for Domestic Finance, Department of the Treasury) [hereinafter Quarles Statement], available at http://banking.senate.gov/_files/ACFB976.pdf (“Despite the fact that hedge funds are today the subject of everyday discussion in the financial press and among policymakers, there is no universally accepted definition of a hedge fund.”); PRESIDENT’S WORKING GROUP ON FIN. MKTS., *supra* note 1, at 1 (“The term ‘hedge fund’ . . . is not statutorily defined”); Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 976 (“In large part, hedge funds are defined by the extent to which the [SEC] . . . does not regulate them.”).

⁴ See Franklin R. Edwards, *The Regulation of Hedge Funds: Financial Stability and Investor Protection*, in HEDGE FUNDS: RISKS AND REGULATION, *supra* note 1, at 30, 35 (“[H]edge funds exist because they fill a gap created by the many laws and regulations that restrict the activities of other investment vehicles.” (emphasis added)). This Note will discuss registration of hedge fund advisers only with respect to U.S. federal law. Generally, states do not impose registration requirements on investment advisers. See, e.g., DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS § 2.2(5), at 19–20 (2005).

⁵ See *infra* Part III.

⁶ See *infra* notes 35, 210 and accompanying text.

The SEC⁷ and other U.S. regulatory bodies⁸ have noted the increased investment interest in hedge funds. As a result, the SEC considered increasing its regulatory presence in the hedge fund arena. Historically, hedge fund advisers have not been subject to the strict requirements of the Investment Advisers Act of 1940.⁹ This changed in 2004, when the SEC expanded its regulatory reach by creating a mandatory registration provision for many hedge fund advisers,¹⁰ which would subject hedge fund advisers to the registration requirements of the Investment Advisers Act. The new rule mandated registration with the SEC by February 1, 2006.¹¹ In enacting these provisions, the SEC emphasized the need to collect data to fill in informational gaps for U.S. investors interested in investing in hedge funds, to deter and detect fraud by hedge fund advisers,¹² to prevent unfit advisers from managing hedge funds, to adopt measures to protect hedge fund investors, and to limit the marketing of hedge funds to unsuitable investors.¹³ Even though nearly one thousand hedge funds registered with the SEC,¹⁴ more than one hundred subse-

⁷ See DIV. OF INV. MGMT., SEC. & EXCH. COMM'N, STAFF REPORT TO THE U.S. SECURITIES AND EXCHANGE COMMISSION: IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 9-10 (2003). Professor Troy Paredes has suggested that one of the SEC's motivations for the hedge fund registration requirement was that the SEC "did not want to get caught flat-footed and embarrassed again, as it had been by Enron, WorldCom, the mutual fund abuses, and securities analyst conflicts of interest." Paredes, *supra* note 3, at 975-76. Professor Paredes attributes the SEC's shift toward an "aggressive," "better to be safe than sorry" attitude to the precautionary principle of behavior. *Id.* at 1007. For a full description of the precautionary principle, see Julian Morris, *Defining the Precautionary Principle*, in *RETHINKING RISK AND THE PRECAUTIONARY PRINCIPLE I* (Julian Morris ed., 2000); Cass R. Sunstein, *Irreversible and Catastrophic*, 91 CORNELL L. REV. 841, 848-55 (2006).

⁸ See, e.g., PRESIDENT'S WORKING GROUP ON FIN. MKTS., AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL (2007), available at <http://www.ustreas.gov/press/releases/reports/principles.pdf> (calling for unified regulatory efforts among U.S. agencies).

⁹ 15 U.S.C. §§ 80b-1 to -21 (2000); see Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004); Thomas Lee Hazen, *Investment Advisers Act of 1940: Who Is Subject to the Advisers Act?*, in *LAW OF SECURITIES REGULATION* § 21.2 (5th ed. 2005); MacHarg, *supra* note 1, at 88 ("[T]he United States is one of the few countries that does not require hedge fund sponsors to register.").

¹⁰ See 17 C.F.R. §§ 275.203(b)(3)-1 to -2 (2006). Consumers can easily access the registration database. See Investment Adviser Public Disclosure, <http://www.adviserinfo.sec.gov> (last visited Mar. 10, 2007).

¹¹ See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,054.

¹² This is a general goal of the SEC. See, e.g., A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1085 (2005).

¹³ See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,054.

¹⁴ See, e.g., Kara Scannell, *Making Hedge Funds Less Secret*, WALL ST. J., Feb. 3, 2006, at C1.

quently deregistered¹⁵ following the District of Columbia Circuit's decision in *Goldstein v. SEC*,¹⁶ which invalidated the registration requirement.¹⁷

Although the registration requirement sought to increase the SEC's regulatory strength over hedge fund advisers as a whole, it did little to regulate offshore hedge funds and their advisers. Considering the SEC's reasons for enacting the amendments to the registration requirements of the Investment Advisers Act,¹⁸ this lack of oversight for offshore hedge funds contravenes the purposes of the amendments. By regulating onshore hedge funds with higher scrutiny than offshore funds, the SEC encouraged onshore advisers to move their funds offshore¹⁹ or to create parallel offshore fund structures and subsequently move invested capital to the offshore funds. Once advisers move funds offshore, the SEC will be unable to achieve its goals of detecting and deterring fraud and generally protecting hedge fund investors.

Therefore, regulation of offshore hedge funds is important to the safety and integrity of U.S. markets. By registering only onshore fund advisers, the SEC not only encouraged hedge fund advisers to move offshore, but it also gave small investors a false sense of security when investing in hedge funds, both onshore and offshore. New commercial products, which are available to all investors, evaluate hedge fund returns and could augment this misleading sense of security.²⁰

¹⁵ See, e.g., *Hedge Fund Advisers Flee SEC Register*, TIMES (U.K.), Sept. 28, 2006, at 47; *Hedge Funds Reject SEC Oversight After Court Annuls Disclosure Requirement*, BLOOMBERG.COM WORLDWIDE NEWS, Sept. 22, 2006, http://www.bloomberg.com/apps/news?pid=20601087&sid=aB_eIQxtgfAk&refer=Worldwide_news. But see, e.g., *Hedge Funds and the SEC: Still Free*, *supra* note 1 ("Many hedge funds are likely to stay registered, to reassure institutional investors.").

¹⁶ 451 F.3d 873 (D.C. Cir. 2006).

¹⁷ See *id.* at 883–84.

¹⁸ See *supra* notes 12–13 and accompanying text.

¹⁹ But see Alex R. McClean, Note, *The Extraterritorial Implications of the SEC's New Rule Change to Regulate Hedge Funds*, 38 CASE W. RES. J. INT'L L. 105, 107 (2006) ("Hedge funds . . . are not moving anywhere[,] . . . because market conditions, foreign regulators, and provisions of the new rule make moving offshore impractical."). However, in making this claim, McClean initially ignores the fact that even prior to registration, many U.S. hedge funds had already created parallel funds offshore. Later in his Note, McClean contradicts his earlier assumptions about the willingness of hedge fund managers to go offshore. See *id.* at 132 ("Hedge funds can change domiciles quickly and cheaply since they do not own any physical assets. The only asset that a hedge fund would have to transport would be its human capital."). For a discussion of some of the motivations for hedge fund managers to go offshore, see Mara Der Hovanesian, *For Hedge Funds, Some Sweet Deals*, BUS. WK., May 8, 2006, at 11.

²⁰ See, e.g., Anne Tergesen, *Sizing up a Hedge*, BUS. WK., Nov. 28, 2005, at 128 ("With hedge funds booming—and investors worried about getting burned—mutual fund tracker Morningstar and bond rater Moody's Investors Service plan to launch hedge fund research tools [in 2006] and make them available to individual investors."). The Web site www.hedgebay.com also lists more than 600 offshore hedge funds and allows the funds to take

This Note contends that the SEC's amended registration requirements were insufficient to address potential problems with offshore hedge funds. It also suggests that in enacting the amendments, the SEC did not address its own concerns raised during internal discussion of the amendments. In particular, the amendments did not address the loopholes that allow offshore fund advisers to operate largely unregulated. Part I provides background by explaining how offshore hedge funds have historically operated and by contrasting the SEC's treatment of onshore hedge funds with its treatment of offshore hedge funds. It also clarifies the changes that the amendments made to the existing hedge fund regulation regime and summarizes criticisms of the rule and its effects. Part II elaborates on the concerns that the SEC staff, financial institution insiders, and legal insiders raised during the rule-making process and shows how the SEC systematically rejected measures that would have empowered it to regulate offshore hedge fund advisers. Part II also discusses how the registration requirement would allow fraud to flourish in the offshore market, thus increasing the risk to U.S. investors and markets. Part III describes how other U.S. regulatory bodies, including the Internal Revenue Service (IRS), the U.S. Department of Labor as mandated by the Employee Retirement Income Security Act (ERISA), and the Commodity Futures Trading Commission (CFTC),²¹ have regulated offshore investments and advisers. Part IV suggests possible fixes for the SEC's registration regulation.

offers and bids from potential investors. See *Online Matchmaking: Trading Hedge Funds*, *ECONOMIST*, Aug. 6, 2005, at 59.

²¹ As a preliminary disclosure, the author interned at the CFTC's Division of Enforcement in the Eastern Region. The views expressed here are hers alone and do not reflect the views of the CFTC.

I

BACKGROUND AND DESCRIPTION OF OFFSHORE HEDGE
FUND REGULATIONA. Structure of Offshore Hedge Funds and Previous SEC
Regulation

Offshore hedge funds with ties to the United States are usually established as corporations²² in the Cayman Islands,²³ the British Virgin Islands,²⁴ or Bermuda.²⁵ Traditionally, offshore hedge funds have attracted investment from U.S. tax-exempt entities, including foundations, endowments,²⁶ charitable trusts, and pension

²² See, e.g., DIV. OF INV. MGMT., *supra* note 7, at 9. Whereas offshore hedge funds are typically set up as corporations, onshore funds are normally set up as limited partnerships. See *id.* at 10. For a pictorial depiction of hedge fund structures for both onshore and offshore hedge funds, see HAMMER ET AL., *supra* note 4, §§ 4.3–4.4. These offshore hedge funds organized under non-U.S. law may only make a private offering to U.S. investors “if after the private offering the foreign fund’s securities are held by no more than 100 beneficial owners resident in the United States, or if all of the beneficial owners resident in the United States are ‘qualified purchasers’” PRESIDENT’S WORKING GROUP ON FIN. MKTS., *supra* note 1, at app. B n.3.

²³ See, e.g., SIMONE BORLA & DENIS MASETTI, HEDGE FUNDS: A RESOURCE FOR INVESTORS 75 (2003); COMPARATIVE JURISDICTION GUIDE: WHERE TO SET UP AND, PERHAPS, MANAGE A HEDGE FUND? 19–20 (Carol Bonnett & Sarah Barham eds., 2005); GORDON DE BROUWER, HEDGE FUNDS IN EMERGING MARKETS 12 (2001); Alan L. Kennard, *The Hedge Fund Versus the Mutual Fund*, 57 TAX LAW. 133, 158 (2003); James Eedes, *Cayman Islands: Offshore, on Target*, BANKER, July 1, 2006, at 106 (stating that the Cayman Islands’ regulator had more than 1700 hedge fund registrations in 2005 and that the regulator estimates that it currently regulates 80% of hedge funds worldwide); *Hedging and Betting*, INT’L MONEY MARKETING, Sept. 9, 2004, at 25; Neal Lomax, *Hedge Funds*, MONDAQ, June 12, 2006, available at 2006 WLNR 10049660 (stating that of the approximately 8,000 active funds that will be registered in the Cayman Islands by the end of 2006, approximately 95% will be hedge funds).

²⁴ See, e.g., BORLA & MASETTI, *supra* note 23, at 75; COMPARATIVE JURISDICTION GUIDE: WHERE TO SET UP AND, PERHAPS, MANAGE A HEDGE FUND?, *supra* note 23, at 11–12; DE BROUWER, *supra* note 23, at 12; Kennard, *supra* note 23, at 158; *Hedging and Betting*, *supra* note 23. But see, e.g., Jeremy Grant & Richard Lapper, *Boost for Offshore Regulation*, FIN. TIMES (U.K.), Feb. 12, 2007, at 5 (“Hundreds of hedge funds based in the US and Europe face tighter regulation as the British Virgin Islands prepares legislation that will require funds registered in the offshore financial centre to conduct regular audits and appoint whistleblowers to root out fraud.”).

²⁵ See, e.g., BORLA & MASETTI, *supra* note 23, at 75–76; COMPARATIVE JURISDICTION GUIDE: WHERE TO SET UP AND, PERHAPS, MANAGE A HEDGE FUND?, *supra* note 23, at 4–5; Kennard, *supra* note 23, at 158; *Hedging and Betting*, *supra* note 23; Angela MacKay, *Bermuda Looks to Tighten Fund Rules*, FIN. TIMES (U.K.), May 5, 2003, at 21; Mairi Mallon, *Bermuda—Changes Are Afoot—Relaxation of Bermuda’s Foreign Ownership Laws Is Boosting the Island’s Bank Sector*, BANKER, Dec. 1, 2004, at 93.

²⁶ See *Testimony Concerning the Regulation of Hedge Funds, Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs* (2006) (statement of SEC Chairman Christopher Cox) [hereinafter Cox Statement], available at <http://www.sec.gov/news/testimony/2006/ts072506cc.htm> (“Nearly two-thirds of endowments invest in hedge funds, and those that do allocate an average of 18% to them. Whether or not this sort of institutional investment directly impacts retail investors, it surely is increasing the potential impact that hedge funds might have on our capital markets.”).

funds.²⁷ Select private U.S. investors have also looked to offshore hedge funds because of the IRS's favorable tax treatment of these funds.²⁸ This changed somewhat when Congress enacted the Taxpayer Relief Act of 1997,²⁹ which "abolished the requirement that the principal office of a non-U.S. entity that trades for its own accounts must be outside the United States for that entity to avoid being treated as engaged in a U.S. trade or business."³⁰

²⁷ Some data indicate that investments of pensions in hedge funds increased from \$13 billion in 1997 to \$72 billion in 2004. See *Regulation of the Hedge Fund Industry: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 108th Cong. 27 (2004) (statement of Charles J. Gradante, Managing Principal, Hennessee Group LLC), available at http://banking.senate.gov/_files/gradante.pdf; see also *Protecting America's Pension Plans from Fraud: Will Your Savings Retire Before You Do?: Hearing Before the S. Comm. on Health, Education, Labor, and Pensions*, 109th Cong. 54 (2006) ("Pension plans and other investors are counting on the SEC to protect them."); Comment, S. Waters, Individual Investor, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172 (Sept. 16, 2004) [hereinafter Waters Comment], <http://www.sec.gov/rules/proposed/s73004/swaters9240.htm> ("The population most at risk for exploitation is senior citizens When this class of investors roll over their 401Ks and take their pensions, they may have just enough money to . . . become hedge fund targets. This population is vulnerable with no way to recover financially in old age from risky investments."); Div. of Inv. MGMT., *supra* note 7, at 10; Cynthia M. Fornelli, *Regulatory Risk for Hedge Funds*, in *MANAGING HEDGE FUND RISK: STRATEGIES AND INSIGHTS FROM INVESTORS, COUNTERPARTIES, HEDGE FUNDS AND REGULATORS* 359, 363–64 (Virginia Reynolds Parker ed., 2005); Helen Parry, *Hedge Funds, Hot Markets and the High Net Worth Investor: A Case for Greater Protection?*, 21 *NW. J. INT'L L. & BUS.* 703, 703 (2001) ("Hedge funds, so often booed and hissed by politicians and regulators, are now strutting their stuff in the limelight to the acclaim of pension funds, unit trusts and private investors." (quoting *Sprucing up Their Appearance*, MONEY OBSERVER, Sept. 19, 2000)); Carrie Johnson, *Appeals Judges Question SEC's Hedge Fund Rule*, WASH. POST, Dec. 10, 2005, at D1 ("Average investors and pension funds increasingly are investing in . . . [hedge] funds."); Joseph Nocera, *Offering up An Even Dozen Odds and Ends*, N.Y. TIMES, Dec. 24, 2005, at C1 ("Hedge fund managers need to understand that as they push to become a mainstream part of institutional investing—used not just by clever endowment managers but also by plain-vanilla pension funds—they need oversight. Otherwise, they will remain what they are today: the world's best-paying cottage industry."); Gregory Zuckerman, *Hedge Funds Grow Popular with Investors*, WALL ST. J., Jan. 3, 2006, at R12 ("[I]n 2005, . . . more institutional investors adopt[ed] the view that [hedge funds] can play an important role in a portfolio, providing returns that often don't correlate to the overall stock and bond markets. Pension plans and other institutional investors increased their allocations to hedge funds"). Recently, Congress has suggested its commitment to protect those who have invested pension funds in hedge funds. See, e.g., 152 CONG. REC. S11429, 11439–41 (daily ed. Dec. 7, 2006) (statement of Sen. Arlen Specter) (explaining the Criminal Misuse of Material Nonpublic Information and Investor Protection Act of 2006, which called for the registration of hedge funds, prescribed compliance expectations, and limited investments by pension funds); Ron Orol, *Dodd to Focus on Hedge Funds*, DAILY DEAL, Dec. 8, 2006, available at 2006 WLNR 21194614 ("I'm worried about pensioners, who are not sophisticated investors. . . . We bear a responsibility that there is transparency for that kind of investor." (quoting Senator Christopher Dodd, Chairman, Senate Banking Committee)).

²⁸ See HAMMER ET AL., *supra* note 4, § 4.4(1), at 98.

²⁹ Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 26 U.S.C.).

³⁰ HAMMER ET AL., *supra* note 4, § 4.4(1), at 98–99.

The Taxpayer Relief Act of 1997 thus extended the U.S. government's reach over offshore hedge funds, but offshore hedge funds nevertheless have remained popular with investors for other reasons. First, unlike their onshore counterparts, offshore hedge funds can keep the identities of their investors confidential from the U.S. government.³¹ Second, U.S. tax-exempt investors, including pension funds and charitable trusts, prefer offshore funds because they are organized as corporations and thus do not expose these investors to taxation. By contrast, investing in onshore hedge funds, which are typically structured as limited partnerships, exposes investors to taxation.³²

Previously, both onshore and offshore hedge fund advisers did not have to register with the SEC under the Investment Advisers Act of 1940³³ in the way that mutual fund advisers must register.³⁴ This disparity created a huge advantage for hedge fund advisers and their investors, because the registration obligations carry high costs.³⁵ For example, registered advisers must meet extensive reporting require-

³¹ See *id.* § 4.4(1)(i), at 99; THOMAS P. LEMKE ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 8:20, at 205 (2005) (“[T]he activities of many offshore fund managers and administrators are still conducted outside the U.S. for a number of reasons, such as . . . maintaining investors’ anonymity.”). Hammer notes, however, that the offshore fund “reserve[s] its rights to disclose each investor’s identity and information about the investor to cognizant U.S. or non-U.S. governmental authorities to the extent required under anti-money-laundering laws.” HAMMER ET AL., *supra* note 4, § 4.4(1)(i), at 99.

³² See DIV. OF INV. MGMT., *supra* note 7, at 9.

³³ See 15 U.S.C. § 80b-3(b)(3) (2000).

³⁴ See Hazen, *supra* note 9, § 21.2, at 790; Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

³⁵ See, e.g., Barry P. Barbash, *Ten Years After Unibanco: The Extraterritorial Reach of the U.S. Investment Advisers Act of 1940*, in INTERNATIONAL SECURITIES MARKETS 2002: ADDRESSING CROSS-BORDER LEGAL & BUSINESS CHALLENGES 335, 339 (2002) (“Compliance with the provisions of the Advisers Act is not an inconsiderable task; the Act imposes significant fiduciary duties, restrictions and responsibilities on entities that come within its definition of ‘investment adviser’ and that must be registered under the Act.”); Paredes, *supra* note 3, at 1006 (“The SEC paid relatively short shrift to the cost of regulating hedge funds.”). Even for unregistered funds, the need to keep administrative costs low is mounting as the number of hedge funds multiplies. This increasingly crowded field complicates the hunt for those winning investment strategies that have made hedge fund investments so desirable. See, e.g., *Regulating Hedge Funds: Thorns in the Foliage*, ECONOMIST, Apr. 1, 2006, at 6I (“New funds are set up almost every day: [A]cross the world there are now more than 8,000. More dollars are pursuing the same strategies, reducing returns for many.”). Some argue that further oversight will prevent the innovation necessary for even honest hedge funds to develop winning strategies. See, e.g., Rattner, *supra* note 1, at 104; Dale A. Oesterle, *Regulating Hedge Funds 2* (Ohio State Univ. Moritz Coll. of Law, Pub. Law & Legal Theory Working Paper Series No. 71, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913045 (“Tighten up hedge fund regulation and we threaten their competitive advantage.”).

ments and pay an associated annual fee.³⁶ They are also subject to surprise inspections by accountants³⁷ and by the SEC.³⁸ Moreover, registration as an investment adviser would obligate hedge fund managers to make the necessary periodic filings under the Securities Exchange Act of 1934.³⁹ Finally, registration imposes both a fiduciary duty⁴⁰ and a code of ethics⁴¹ on investment advisers.

To avoid registration, nearly all offshore hedge funds relied on the § 4(2) exemption of the Securities Act of 1933, which applies to firms that sell securities through a nonpublic offering to accredited investors.⁴² Accredited investors for the purposes of § 4(2) include: certain institutional investors, registered broker-dealers, ERISA and other employee benefit plans;⁴³ private business development companies;⁴⁴ tax-exempt organizations with assets over \$5 million;⁴⁵ certain individuals associated with the issuer of the private offering;⁴⁶ trusts with \$5 million in total assets and investment decisions that a sophisticated person made;⁴⁷ individual investors “whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000”;⁴⁸ and individual investors “who had an individual income in excess of \$200,000 in each of the two most re-

³⁶ See Investment Advisers Act of 1940 § 203A(d), 15 U.S.C. § 80b-3a(d) (2000); see also Giselle Abramovich, *Hedge Funds Gear up for Registration*, MONEY MGMT. EXECUTIVE, Nov. 28, 2005, at 1 (“[T]he hard part is complying with the recordkeeping requirements . . . [which] require[] that advisors maintain copies of their policies and procedures along with any revisions. They must also conduct an annual review of these policies and maintain all records documenting this review. And they must retain all of these records for five years.”); Zuckerman, *supra* note 27 (“The move [toward adviser registration] will force funds to upgrade their compliance and record-keeping efforts, which can create a burden, especially for smaller funds.”).

³⁷ See 17 C.F.R. §§ 275.206(4)-2, 279.8 (2006).

³⁸ See 15 U.S.C. § 80b-4.

³⁹ *Id.* § 78m.

⁴⁰ See, e.g., Eugene Bilotti, Securities Act Release No. 7490, Investment Advisers Act Release No. 1689, 1997 SEC LEXIS 2628 (Dec. 23, 1997); Alfred C. Rizzo, Investment Advisers Act Release No. 897, 1984 SEC LEXIS 2429 (Jan. 11, 1984); Kidder, Peabody & Co., Securities Act Release No. 8426, Investment Advisers Act Release No. 232, 43 S.E.C. 911 (Oct. 16, 1968); Securities Act Release No. 3043, Exchange Act Release No. 3653, Investment Advisers Act Release No. 40, 11 Fed. Reg. 10,997 (Feb. 5, 1945).

⁴¹ See 17 C.F.R. § 275.204-2; Investment Adviser Codes of Ethics, 17 C.F.R. § 275.204A-1 (2004); Investment Adviser Codes of Ethics, Investment Company Act Release No. 26492, Investment Advisers Act Release No. 2256, 69 Fed. Reg. 41,696 (July 9, 2004). Scholars, financial institutions, and government officials have suggested many forms of a code of conduct. See, e.g., DE BROUWER, *supra* note 23, at 210; Joseph C.K. Yam, *Capital Flows, Hedge Funds and Market Failure: A Hong Kong Perspective*, in CAPITAL FLOWS AND THE INTERNATIONAL FINANCIAL SYSTEM 164, 164-78 (David Gruen & Luke Gower eds., 1999).

⁴² See 15 U.S.C. § 77d(2).

⁴³ See 17 C.F.R. § 230.501(a)(1) (2006).

⁴⁴ See *id.* § 230.501(a)(2).

⁴⁵ See *id.* § 230.501(a)(3).

⁴⁶ See *id.* § 230.501(a)(4).

⁴⁷ See *id.* § 230.501(a)(7).

⁴⁸ *Id.* § 230.501(a)(5).

cent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year."⁴⁹ The common characteristic of each of these accredited investors is that they are either in a position to manage or possess a significant amount of money such that there is a presumption of financial sophistication.

The Investment Company Act of 1940 also contains two registration exemptions, §§ 3(c)(1)⁵⁰ and 3(c)(7).⁵¹ Generally, § 3(c)(1) excludes funds that are not making a public offering and that have no more than 100 beneficial owners of their securities.⁵² Determining who is a beneficial owner is a thorny issue,⁵³ but offshore funds benefit from this arrangement because they "need only count U.S. beneficial owners toward the 100-beneficial-owner threshold."⁵⁴ Furthermore, a corporate investor counts as a single beneficial owner.⁵⁵ Offshore funds take advantage of this counting method by organizing as corporations.⁵⁶ According to legislative history, Congress chose not to regulate these privately held companies with few investors because they "do not rise to the level of federal interest under the Investment Company Act."⁵⁷

⁴⁹ *Id.* § 230.501(a)(6).

⁵⁰ Investment Company Act of 1940 § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (2000).

⁵¹ *Id.* § 80a-3(c)(7).

⁵² *See id.* § 80a-3(c)(1).

⁵³ *See* Robert W. Helm & Kevin K. Babikian, *Creating, Managing And Distributing Offshore Investment Products: A Legal Perspective*, in NUTS & BOLTS OF FINANCIAL PRODUCTS 2006: UNDERSTANDING THE EVOLVING WORLD OF CAPITAL MARKET & INVESTMENT MANAGEMENT PRODUCTS 675, 705–09 (2006).

⁵⁴ LEMKE ET AL., *supra* note 31, § 8:16.

⁵⁵ *See* DIV. OF INV. MGMT., *supra* note 7, at 11. There is, however, an important exception to this rule:

If a corporate investor that is a registered investment company, or a company relying on Section 3(c)(1) or Section 3(c)(7), beneficially owns [10%] or more of the outstanding voting securities of the Section 3(c)(1) fund, the Section 3(c)(1) fund must "look-through" that corporate investor and count each of its investors as a beneficial owner of the Section 3(c)(1) fund for purposes of the 100-investor limitation. A hedge fund that relies on Section 3(c)(1) and that accepts investments from registered investment companies or entities relying on Section 3(c)(1) or Section 3(c)(7), therefore, must ensure that those investors do not acquire more than [10%] of the hedge fund's outstanding voting securities so that the hedge fund may continue to rely on Section 3(c)(1).

Id. at n.34.

⁵⁶ *See* 17 C.F.R. §§ 275.206(4)-2, 279.8 (2006); HAMMER ET AL., *supra* note 4, §§ 4.3, 4.4, at 91–110.

⁵⁷ DIV. OF INV. MGMT., *supra* note 7, at 11–12; *see Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency*, 76th Cong. 179 (1940) (statement of David Schenker, Chief Counsel, Securities and Exchange Commission).

Funds are likewise exempt from registration under § 3(c)(1) so long as they make offerings to accredited investors.⁵⁸ These investors, according to the Securities Act of 1933, include certain banks, registered investment companies, small business investment companies, ERISA plans,⁵⁹ and individual investors who are accredited “on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management.”⁶⁰ The Securities Act allows accredited investors to invest through private placements.⁶¹ Because the Securities Act does not consider characteristics other than an individual investor’s wealth, some commentators have suggested a broader standard because “the only way to assure adequate [investor] protection is to require hedge funds to make an assessment of the level of an investor’s sophistication and determine whether the investor’s ‘expertise’ is suitable for the investment in question.”⁶²

While § 3(c)(1) exempts hedge funds limited to accredited investors, § 3(c)(7) exempts funds that do not make public offerings and have only “qualified purchasers,” whose numbers can exceed 100.⁶³ Qualified purchasers include individual investors with investments worth at least \$5 million, family companies with investments worth at least \$5 million, certain trusts, and companies that own or manage

⁵⁸ See DIV. OF INV. MGMT., *supra* note 7, at 12. Even if the hedge funds can make offerings to accredited investors, they cannot engage in a general solicitation or general advertising of their shares. See *id.*

⁵⁹ See 15 U.S.C. § 77b(a)(15)(i) (2000).

⁶⁰ *Id.* § 77b(a)(15)(ii); see also *Recommendations by the President’s Working Group on Fin. Mkts.: Hearing Before the H. Comm. on Banking and Fin. Servs.*, 106th Cong. 69 (2000) (statement of George Crapple, Chairman, Managed Funds Association) (“[P]rivate offered investment funds such as hedge funds are offered to sophisticated investors whose ability to make informed investment decisions and to impose their own demands for information generally obviate federally-imposed disclosure requirements.”); 17 C.F.R. § 230.501(a)(5)–(6) (stating the asset requirements to be an accredited investor as “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000” or “[a]ny natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year”).

⁶¹ See DE BROUWER, *supra* note 23, at 13.

⁶² Edwards, *supra* note 4, at 44 (“Such a ‘suitability’ standard would shift the responsibility of limiting access to hedge fund investments to hedge funds and other marketers of these products, and would relieve investors of the responsibility of determining whether hedge fund investments are suitable for them.”). Many commentators have suggested that the SEC should pay little attention to investments that accredited investors make. See, e.g., Parry, *supra* note 27, at 718 (“Regulators generally do not spend sleepless nights worrying about the plight of millionaires who invest unsuccessfully in alternative markets such as hedge funds”); John Berlau, *Hedge Funds Today: Who Is Watching the Watchdog?*, WALL ST. J., Dec. 9, 2005, at A14 (“[T]here has been . . . a widespread consensus that [accredited] investors don’t need the additional protection of the registration process, and that it is essential for the capital markets that these entities be able to move quickly.”).

⁶³ Investment Company Act of 1940 § 3(c)(7), 15 U.S.C. § 80a-3(c)(7) (2000).

investments worth at least \$25 million.⁶⁴ In certain situations, “qualified institutional buyers”⁶⁵ and “knowledgeable employees”⁶⁶ can be qualified purchasers. Again, offshore funds that rely on the § 3(c)(7) exemption need only count U.S. investors as qualified purchasers.⁶⁷

Given that the definitions of accredited investor and qualified purchaser include only high-worth individuals, it is clear why the Investment Company Act of 1940 generally exempts hedge funds.⁶⁸ The federal government should not bear the responsibility for protecting high net-worth investors who are in a better financial position to assume risk in their investments.⁶⁹

Hedge fund advisers can also take advantage of a fourth exemption from registration: the Investment Adviser Act’s *de minimis* exemption, also called the “private adviser exemption.”⁷⁰ The *de minimis* exemption excuses from registration “any investment 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 [registered] investment company.”⁷¹ Legal organizations such as hedge funds count as only one client under the *de minimis* exemption,⁷² because “[i]n computing the number of clients, a limited partnership counts as only one client of the general partner or any other person acting as investment adviser to the partnership.”⁷³

B. SEC Registration Provisions for Hedge Fund Advisers

Following a 2004 three-to-two vote by the SEC Commissioners, many hedge fund advisers could no longer take advantage of the *de minimis* exemption.⁷⁴ By eliminating the *de minimis* exemption, the

⁶⁴ See *id.* § 80a-2(a)(51)(A).

⁶⁵ 17 C.F.R. § 270.2a51-1(g)(1).

⁶⁶ *Id.* § 270.3c-5.

⁶⁷ See LEMKE ET AL., *supra* note 31, § 8:16.

⁶⁸ See, e.g., DE BROUWER, *supra* note 23, at 14.

⁶⁹ See *id.* (“The rationale is clear—the law is involved to protect investors from exploitation, but very high-worth individuals who choose to invest in risky ventures [such as hedge funds] are well placed to make their own investment choices and defend their own interests.”); see also H.R. 2924—*The Hedge Fund Disclosure Act: Hearing Before the Subcomm. on Capital Mkts., Sec. and Gov’t Sponsored Enters. of the H. Comm. on Banking and Fin. Servs.*, 106th Cong. 1 (2000) (statement of Rep. Richard H. Baker, Chairman, Subcomm. on Capital Markets, Sec. and Gov’t Sponsored Enters. of the H. Comm. on Banking and Fin. Servs.) (“Because hedge fund investors are presumed to be capable of judging risk and bearing the losses that follow from a bad mistake, the failure of hedge funds has not been a public policy concern.”).

⁷⁰ LEMKE ET AL., *supra* note 31, at 2 (Supp. Jan. 2005).

⁷¹ 15 U.S.C. § 80b-3(b)(3) (2000).

⁷² See DIV. OF INV. MGMT., *supra* note 7, at 21.

⁷³ PRESIDENT’S WORKING GROUP ON FIN. MKTS., *supra* note 1, at B-3; see also 17 C.F.R. 275.203(b)(3)-1 (2006).

⁷⁴ See Hazen, *supra* note 9, § 21.2[3].

SEC required hedge fund advisers to employ a new method for counting their clients.⁷⁵ The new rule⁷⁶ adopted a look-through approach and “no longer count[ed] a [hedge] fund as one advisory client but rather look[ed] through to the fund’s investors as advisory clients.”⁷⁷ Nevertheless, the SEC adopted a completely different counting method for certain offshore advisers:⁷⁸ The SEC allowed those who “ha[d their] principal office and place of business outside the United States”—almost all offshore hedge funds—to treat their fund and not their investors as clients.⁷⁹

The registration regulations did not change the minimum level of assets that a hedge fund adviser must manage to mandate registration with the SEC.⁸⁰ This decision runs against the suggestions of

⁷⁵ See 17 C.F.R. § 275.203(b)(3)-2.

⁷⁶ The new rule does not literally apply to hedge funds. Rather, hedge funds fall under the definition of “private funds” and thus the registration requirements apply. See *id.* § 275.203(b)(3)-2(a); see also Waters Comment, *supra* note 27 (“Labeling hedge funds is critical. Today, identifying whether an investment is a hedge fund can be almost impossible for the individual investor.”).

⁷⁷ Hazen, *supra* note 9, § 21.2[3] (explaining the provisions of 17 C.F.R. § 275.203(b)(3)-2(c)); see also Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054, 72,065 (Dec. 10, 2004). This approach, according to many hedge fund attorneys, was contrary to prior readings of the Investment Advisers Act of 1940. See, e.g., Comment, Paul N. Roth, Partner, Schulte Roth & Zabel, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172 (Sept. 15, 2004) [hereinafter Schulte Roth & Zabel Comment], <http://www.sec.gov/rules/proposed/s73004/schulte091504.pdf> (“We believe that Rule 203(b)(3)-1 as currently written is consistent with Congressional intent, accurately reflects legislative history and represents sound policy—that an adviser’s client is the fund, not the investors in the fund.” (emphasis added)); Comment, Marianne K. Smythe, Louis R. Cohen & James E. Anderson, Partners, Wilmer Cutler Pickering Hale and Dorr, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172, at 1 (Sept. 8, 2004), <http://www.sec.gov/rules/proposed/s73004/wilmer090804.pdf> (“Counting clients by the ‘look through’ method the Commission now proposes is contrary to the text and the entire history of the Advisers Act.”).

⁷⁸ See, e.g., Carbon 360°, *The Operational “Do’s and Don’ts” of Hedge Fund Registration*, in IT’S THE RULE: THE NEW SEC ADVISER REGULATION FOR HEDGE FUNDS 88, 98 (2005), http://www.hedgeworld.com/download/sec_adviser_regulation.pdf.

⁷⁹ 17 C.F.R. § 275.203(b)(3)-2(c).

⁸⁰ See John P. Moriarty & Curtlan R. McNeily, Registration Under the Advisers Act for Hedge Fund Advisers, in 19A REGULATION OF FINANCIAL PLANNERS, § 3:51, at 3–137 (2006). The SEC in late 2006 considered raising the minimum asset level for individual investors. See, e.g., Jenny Anderson, *Barring the Hedge Fund Doors to Mere Millionaires*, N.Y. TIMES, at C9; Kathleen Pender, *Hedge Fund Investing Reforms Considered*, S.F. CHRON., Dec. 10, 2006, at F1. The current minimum asset levels have not changed since 1982. See Chris Clair, *SEC Proposes New Hedge Fund Rules*, HEDGEWORLD NEWS, Dec. 14, 2006, available at 2006 WLNR 21602815 (“[I]n 1982, when the accredited investor rules were implemented, roughly 1.87% of U.S. households would have qualified to invest in hedge funds. Currently because of inflation and rising U.S. personal wealth in general, about 8.5% of U.S. households meet the accredited investor standards.”).

many industry insiders.⁸¹ The SEC, however, contended that including the minimum asset level in federal regulation would violate state regulation, as forty-nine states already have statutory minimums for registered advisers.⁸² Moreover, when calculating a hedge fund's assets to determine whether registration is necessary, "[a]n adviser [has to] exclude proprietary assets invested in the fund, and need not include the value of assets attributable to non-U.S. investors."⁸³

According to some commentators, the registration requirement was part of the SEC's effort to increase regulation of offshore funds.⁸⁴ In a report that the SEC issued:

The SEC has chosen to limit . . . extraterritorial application . . . by providing that an offshore adviser to an offshore private fund may treat the fund . . . and not the investors . . . as its client for most purposes under the Act. The offshore adviser will register under the Act and keep certain books and records as required by SEC rules, and will remain subject to examinations by SEC staff. Other requirements, including the . . . compliance rule, custody rule, and proxy voting rule, would not apply to the registered offshore adviser. In addition, SEC staff is exploring ways to obtain and share information with foreign authorities with oversight of hedge fund advisers that may register with the SEC.⁸⁵

⁸¹ See Comment, Dixie L. Johnson, Chair, Comm. on Fed. Regulation of Sec.; Diane E. Ambler & Robert Todd Lang, Co-Chairs, Task Force on Hedge Fund Regulation, Section of Bus. Law, Am. Bar Ass'n, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172, at 7-8 (Sept. 28, 2004), <http://www.sec.gov/rules/proposed/s73004/aba092804.pdf>; Comment, Patricia A. Poglinco & Robert B. Van Grover, Partners, Seward & Kissel LLP, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172, at 7 (Sept. 15, 2004) [hereinafter Seward & Kissel Comment], <http://www.sec.gov/rules/proposed/s73004/poglinco091504.pdf> (suggesting that the SEC apply a \$100 million threshold to offshore advisers); Comment, David Wright, Director, European Commission, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172, at 4 (Sept. 15, 2004) [hereinafter Wright Comment], <http://www.sec.gov/rules/proposed/s73004/dwright091504.pdf>.

⁸² See Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633, 62 Fed. Reg. 28,112, 28,119-20 (May 22, 1997).

⁸³ Moriarty & McNeily, *supra* note 80, § 3:51, at 3-138; see Sec. & Exch. Comm'n, Form ADV: Instructions for Part 1A, <http://www.sec.gov/about/forms/formadv-instructions.pdf>.

⁸⁴ See Hazen, *supra* note 9, § 21.2[3]; Press Release, Sec. & Exch. Comm'n, SEC Proposes Securities Offering Reform, Requires Registration of Hedge Fund Investment Advisers (Oct. 27, 2004), <http://www.sec.gov/news/press/2004-150.htm>. The hedge fund adviser registration requirement will trigger more state law involvement in hedge fund regulation because the states have jurisdiction over many advisers. See, e.g., *New Rules for Hedge Fund Advisers May Prompt SEC to Seek Help from States*, 36 SEC. REG. & L. REP. (BNA) 1986 (Nov. 8, 2004).

⁸⁵ Office of Int'l Affairs, *Office of International Affairs Outline*, in 2 THE SEC SPEAKS IN 2005, at 683, 691-92 (Annette L. Nazareth & Paul F. Roye eds., 2005); see LEMKE ET AL., *supra* note 31, at 2 (Supp. Jan. 2005).

Essentially, the SEC's Office of International Affairs allowed several obvious loopholes for offshore funds and their advisers. The Office of International Affairs explained that it was "exploring ways to obtain and share information with foreign authorities"⁸⁶ rather than providing actual regulatory guidance to offshore funds and their advisers.

C. Criticisms of the Hedge Fund Adviser Registration Rule

Despite the SEC's assertion that the registration provisions of the Investment Advisers Act would strengthen regulation of offshore hedge funds, letters that industry leaders sent to the SEC during the rule-making stage suggested that these provisions would be insufficient to regulate offshore funds and advisers.⁸⁷ For example, one industry leader said that mandatory registration would encourage some hedge fund advisers to relocate offshore, which would defeat the effectiveness of the regulations.⁸⁸ Similarly, former Federal Reserve Board Chairman Alan Greenspan commented that "[a]ny direct U.S. regulations restricting [the hedge funds'] flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. . . . If the funds move abroad, our oversight will diminish."⁸⁹ The movement of funds overseas and the resulting loss of U.S. jurisdiction contravene the SEC's goal of protecting investors from unfit advisers and potential fraud.

The implications of registration create additional concerns. First, depending on their fund's structure, some hedge fund managers, particularly managers of previously unregistered and smaller funds, might find the registration requirements difficult to meet.⁹⁰ Second, with registration comes implied fiduciary duties and the SEC's mandatory disclosure and filing requirements.⁹¹ Additionally, the SEC likely lacks adequate resources to deal with the periodic filings,

⁸⁶ Office of Int'l Affairs, *supra* note 85, at 692.

⁸⁷ See, e.g., Letter from John G. Gain, President, Managed Funds Ass'n, to The Honorable William H. Donaldson, Chairman, Sec. & Exch. Comm'n (Nov. 21, 2003), available at 1422 PLI/Corp 777 (Westlaw).

⁸⁸ See *id.*

⁸⁹ *Id.*

⁹⁰ See, e.g., Seward & Kissel Comment, *supra* note 81 ("[W]e believe that the required registration of private fund advisers . . . will likely cause many smaller advisers to close."); Christopher Faille, *The Cost of Compliance, in IT'S THE RULE: THE NEW SEC ADVISER REGULATION FOR HEDGE FUNDS*, *supra* note 78, at 30, 30 ("What this rule is going to do . . . is make it virtually impossible to take . . . \$50 million or . . . \$75 million and start a hedge fund. The costs associated with this are a huge hurdle."). For an example of a rule that would affect hedge fund managers once they register, see Maintenance of the Indicia of Ownership of Plan Assets Outside the Jurisdiction of the District Courts of the United States, 29 C.F.R. § 2550.404b-1(a)(2) (2006).

⁹¹ See Hazen, *supra* note 9, § 21.3[1].

while few hedge funds likely have the infrastructure in place to meet the necessary reporting requirements.⁹²

Immediately prior to the effective date of the registration regulation, members of the hedge fund and mutual fund industries, attorneys who specialize in hedge fund regulation, worldwide regulators, and academics formally challenged the regulation. One hedge fund manager, Phillip Goldstein, took the SEC to federal court to challenge the registration regulation,⁹³ alleging that the SEC exceeded its authority in adopting the rule,⁹⁴ that the rule was “not a reasonable interpretation of the [Investment] Advisers Act,”⁹⁵ and that the rule was “arbitrary and capricious.”⁹⁶ Initially, legal commentators speculated that Goldstein’s arguments would not hold any weight in court⁹⁷ because they believed that “[i]f the SEC wants oversight in a particular jurisdiction, they’re going to get it.”⁹⁸

Nevertheless, the D.C. Circuit invalidated the registration requirement.⁹⁹ Circuit Judge Arthur Raymond Randolph examined the ambiguous meaning of the term “client” in the Investment Advisers Act¹⁰⁰ and discussed the duties that arise in an adviser-client context, including a fiduciary duty and a duty of loyalty.¹⁰¹ Judge Randolph held that the SEC had “not adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter.”¹⁰² The D.C. Circuit was so emphatic in its rejection of the registration requirement that days after the invalidation, SEC Chairman Christopher Cox issued a statement declaring that the SEC would not seek en banc review.¹⁰³

⁹² See James M. Amend, *CCOs Wrestle over Reporting to the SEC: Also Worry What to Do When Management Resists Change*, MONEY MGMT. EXECUTIVE, Jan. 30, 2006, available at 2006 WLNR 1640541.

⁹³ Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006); see Walter Hamilton, *Suit Tests SEC Rule on Hedge Funds*, L.A. TIMES, Jan. 2, 2006, at C1; Siobhan Hughes, *Moving the Market: Hedge Fund Sues to Block Registry of Advisers by SEC*, WALL ST. J., Dec. 23, 2004, at C3.

⁹⁴ See Brief of Petitioners at 26, Goldstein v. SEC, No. 04-1434 (D.C. Cir. June 23, 2005) [hereinafter Brief of Petitioners].

⁹⁵ *Id.* at 35.

⁹⁶ *Id.* at 47.

⁹⁷ See, e.g., Jeff Benjamin, *Suit over Hedge Fund Registration on, But Industry Isn't Holding Its Breath*, INV. NEWS, Oct. 17, 2005, at 3 (“[T]here are many in the hedge fund industry who are not pinning their hopes on a victory for [the adviser] To some, the lawsuit is little more than a desperate attempt at finding a loophole.”).

⁹⁸ *Id.* (quoting Jeff Joseph, Managing Director, Alternative Investments, Rydex Global Advisors, Inc.).

⁹⁹ Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006).

¹⁰⁰ See *id.* at 878–84 (“The client of a laundry occupies a very different position than the client of a lawyer.”).

¹⁰¹ See *id.* at 879–80 (discussing *Lowe v. SEC*, 472 U.S. 181 (1985)).

¹⁰² *Id.* at 882.

¹⁰³ See S.E.C. *Decides It Won't Appeal on Hedge Funds*, N.Y. TIMES, Aug. 8, 2006, at C9 (“[F]urther appeal would be futile and would simply delay and distract from our goal of advancing investor protection.” (quoting SEC Chairman Christopher Cox)); Press Re-

II

THE SEC'S INACTION IN RESPONSE TO CONCERNS FROM MUTUAL FUND AND LEGAL INSIDERS DURING THE RULE-MAKING PROCESS AND POSSIBLE EFFECTS OF IGNORING REGISTRATION OF OFFSHORE HEDGE FUNDS

A. SEC Inaction

According to a 1999 statement from the President's Working Group on Financial Markets,¹⁰⁴ "requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity."¹⁰⁵ Despite this statement, the SEC conducted a comment period after drafting the Proposed Rule,¹⁰⁶ taking comments from both its staff¹⁰⁷ and the public.¹⁰⁸ Some commentators argued that the comment period was insufficient "to solicit *meaningful* input on this important proposal"¹⁰⁹ and indi-

lease, Sec. & Exch. Comm'n, Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in *Philip Goldstein, et al. v. SEC* (Aug. 7, 2006), <http://sec.gov/news/press/2006/2006-135.htm>.

¹⁰⁴ The President's Working Group on Financial Markets is a group comprised of leading members of the Department of the Treasury, Board of Governors of the Federal Reserve System, the SEC, and the CFTC. See Exec. Order No. 12,631, 53 Fed. Reg. 9,421 (Mar. 18, 1988).

¹⁰⁵ PRESIDENT'S WORKING GROUP ON FIN. MKTS., *supra* note 1, at B-16 (emphasis added); see also Comment, Sheila C. Bair, Dean's Professor of Fin. Regulatory Policy, Univ. of Massachusetts-Amherst, Former Assistant Sec'y for Fin. Insts., U.S. Dep't of the Treasury, Former Comm'r and Acting Chairman, Commodity Futures Trading Comm'n, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Adviser Act Release No. 2266, 69 Fed. Reg. 45,172, at 3 (Sept. 15, 2004) [hereinafter Bair Comment], <http://www.sec.gov/rules/proposed/s73004/scbair091504.pdf> ("Given the fact that hedge funds do not account for a disproportionate share of fraud cases, it would seem that market discipline is by and large working. SEC registration could weaken that discipline.").

¹⁰⁶ See, e.g., Comment, Managed Funds Ass'n, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172, at 1 (Oct. 18, 2004) [hereinafter MFA Comment], <http://www.sec.gov/rules/proposed/s73004/mfa101804.pdf> ("The SEC received 156 letters as of October 13th, 124 of which were either for or against the proposal. The overwhelming number of the 124 comment letters that took a position *opposed* the SEC Proposal" (citation omitted)).

¹⁰⁷ See, e.g., DIV. OF INV. MGMT., *supra* note 7.

¹⁰⁸ See, e.g., MFA Comment, *supra* note 106, at 1 ("Those who oppose this proposal include not only major hedge fund groups, industry participants, the leading trade association representing this industry and top legal professionals and law firms who represent hedge fund managers, but also major business groups such as the U.S. Chamber of Commerce.").

¹⁰⁹ Comment, George J. Mazin & David A. Vaughan, Dechert LLP, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172 (Aug. 24, 2004) (emphasis added), <http://www.sec.gov/rules/proposed/s73004/mazin082404.pdf>. SEC Commissioner Paul Atkins, an opponent of the registration requirement, was particularly outspoken in the months after the SEC adopted the requirement about the SEC's ineffective approach in doing so. See, e.g., James M. Amend, *Hedge Funds Suffer High Anxiety as Registration Nears*, MONEY MGMT.

cated that the “limitation of the comment period . . . was obviously designed to reduce comment on the proposed rule.”¹¹⁰

In adopting the final rule, the SEC ignored important suggestions,¹¹¹ both internal and external. Namely, the SEC did not specify the types of disclosures it would mandate for registered fund advisers,¹¹² require “Board Adopted Valuation Procedures,”¹¹³ identify and encourage industry “Best Practices,”¹¹⁴ or develop programs for investor education.¹¹⁵

B. Likely Creation of Parallel Funds Offshore to Avoid Registration Requirements and Movement of U.S. Investors' Funds to Offshore Havens

Because of the ambiguity regarding how the registration requirements pertained to offshore hedge funds,¹¹⁶ onshore hedge funds could still create “two parallel funds, one fund for non-qualified investors which is subject to the 100 holder limit, and a second fund solely for qualified investors which can admit an unlimited number of quali-

EXECUTIVE, Dec. 12, 2005, at 7 (“In a recent speech deriding what he called an ‘undisciplined approach’ to rulemaking at the SEC, Commissioner Paul Atkins said, ‘We are discovering that the benefits of registration might fall short of our expectations, since [the registration form] will not yield the type of information that would be needed for meaningful oversight.’”); Mark Hendrickson, *Commissioner Atkins Says Hedge Fund Rules Stretch SEC Too Thin*, SEC WK., Oct. 10, 2005, at 7 (“[SEC Commissioner Paul] Atkins . . . criticized the agency for not listening to other regulators at the time the hedge fund rule was adopted.”); Jaime Levy Pessin & Phyllis Plitch, *SEC’s Atkins: Hedge-Fund Rule Yields Little Info So Far*, DOW JONES NEWS SERVICE, Nov. 9, 2005 (“‘Now our own staff is saying, duh, we’re not getting the information we need.’” (quoting Commissioner Atkins in a speech at a Securities Industry Association conference on November 9, 2005)).

¹¹⁰ Brief of Petitioners, *supra* note 94, at 52.

¹¹¹ See, e.g., MFA Comment, *supra* note 106, at 1 (“[M]any commentators provided alternatives to the SEC Proposal that, to our knowledge, the Commission has yet to consider.”); Comment, Richard M. Whiting, Executive Dir. & Gen. Counsel, Fin. Servs. Roundtable, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172, at 3 (Sept. 15, 2004) [hereinafter Fin. Servs. Roundtable Comment], <http://www.sec.gov/rules/proposed/s73004/rmwhiting091504.pdf> (“[T]here are other, less intrusive methods to achieve the goals identified by the Commission.”).

¹¹² See DIV. OF INV. MGMT., *supra* note 7, at x, 96–97.

¹¹³ *Id.* at 99.

¹¹⁴ *Id.* at x, 101.

¹¹⁵ See *id.* at x, 103. Investor education is not a point that should have been lost on the SEC, particularly following a false news release the agency placed on the Internet, advertising the fictitious hedge fund Guaranteed Returns Diversified Inc. (Symbol GRDI, pronounced “Greedy”). See Joseph Hellrung, *Hedge Fund Regulation: Investors Are Knocking at the Door, But Can the SEC Clean House Before Everyone Rushes In?*, 9 N.C. BANKING INST. 317, 317 (2005). The funds advertised on the hedge fund’s Web site included one that claimed to have generated returns of 148% since 2000 and another that claimed to have consistent returns of up to 99%. See *id.* “Despite the outrageous claims by [the fund], the site received over 80,000 hits in a ten month period.” *Id.*

¹¹⁶ See *supra* Part I.B.

fied purchasers.”¹¹⁷ The adviser therefore could continue to avoid registration. This structure took advantage of the preexisting loophole that foreign investors do not count toward the hundred-person limitation.¹¹⁸ In practice, however, some funds found such a drastic alteration in fund structure too inconvenient and opted to register.¹¹⁹

C. Increased Risk of Fraud

Simply put, “[f]raud is bad.”¹²⁰ One of the SEC’s goals in enacting the registration regulation was to prevent fraud, and some commentators believed that the hedge fund registration requirement would force hedge funds “to become a lot more open as SEC regulators increase their surveillance over the financial markets in an effort to protect investors.”¹²¹ Other commentators have noted that “[t]he

¹¹⁷ Joel Scharfstein & Brian Kniesly, *Section 7704 and Publicly (or Non Publicly) Traded Partnerships*, in 10 TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2005, at 275, 288 (2005); see also *Recommendations by the President’s Working Group on Financial Markets: Hearing Before the H. Comm. on Banking and Fin. Servs.*, 106th Cong. 9 (2000) (statement of Hon. Richard H. Baker, Chairman, Subcomm. on Capital Markets, Securities and Government Sponsored Enterprises of the House Comm. on Banking and Financial Services) (“I do not support regulating hedge funds directly. I do not want to take any action that would result in the relocation of this industry to an unregulated offshore domicile.”); *H.R. 2924—The Hedge Fund Disclosure Act: Hearings Before the Subcomm. on Capital Mkts., Secs. and Gov’t Sponsored Enters. of the H. Comm. on Banking and Fin. Servs.*, 106th Cong. 5 (2000) (statement of Rep. Patrick J. Toomey) (“[This move toward regulation] will be detrimental to American financial institutions, in part by encouraging hedge fund activity to just take place offshore, beyond the reach of American regulators.”); Fin. Servs. Roundtable Comment, *supra* note 111, at 2 (“[A]dditional regulation of hedge fund advisers could lead them to relocate offshore.”); PRESIDENT’S WORKING GROUP ON FIN. MKTS., *supra* note 1, at 42, 43 (“It is possible . . . that directly regulating these institutions could drive some of them offshore, which could make regulation less effective. . . . The increase in cross-border financial flows . . . highlights the importance of an appropriate financial regulatory structure.”); Julie Dalla-Costa, *Guarding Against Hedge Fund Fraud*, EUROMONEY (U.K.), Nov. 2004, at 58 (describing how hedge fund adviser Charles L. Harris admitted to moving funds offshore).

¹¹⁸ See Scharfstein & Kniesly, *supra* note 117, at 288.

¹¹⁹ See *id.*

¹²⁰ Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 824 (2006).

¹²¹ Jack O’Hara, *Hedge Funds Likely to Receive Additional Scrutiny*, LEGAL INTELLIGENCER, June 14, 2005, at 5; see, e.g., Alexander M. Ineichen, *On Myths, Bubbles and New Paradigms in the Hedge Fund Industry*, in HEDGE FUNDS: RISKS AND REGULATION, *supra* note 1, at 3, 3 (“Hedge fund managers have different incentives than Wall Street talking heads where self-promotion is a key to success. If you have a trading strategy or investment process with superior risk/reward trade-off in absolute return space, why do you want to tell it to the world for free . . . ?”); Nocera, *supra* note 27 (“Hedge fund managers fear that the [SEC] isn’t sophisticated enough to understand their complex trading strategies Secrecy is the Achilles’ heel of the hedge fund industry. It’s scary that nobody knows what hedge funds are doing”); see also Davis Comment, *supra* note 1 (“The potential for abuse for investors in hedge funds, as well as to the general public who invests in securities contemporaneously, is enormous.”); Gary Duncan, *Hedge Funds—Weapons of Mass Financial Destruction*, TIMES (U.K.), Oct. 25, 2004, at 22 (“[T]he burgeoning operations of hedge funds [are] operations that may now pose a threat greater than Saddam Hussein and his elusive

growth in hedge funds has . . . been accompanied by troubling growth in the number of . . . hedge fund enforcement cases.”¹²² The number of hedge fund enforcement cases will most likely grow, and ineffective SEC regulation has led some lawmakers to investigate alternative ways to rein in hedge funds.¹²³

weapons of mass destruction.”). *But see H.R. 2924—The Hedge Fund Disclosure Act: Hearings Before the Subcomm. on Capital Mkts., Secs. and Gov’t Sponsored Enters. of the H. Comm. on Banking and Fin. Servs.*, 106th Cong. 4 (2000) (statement of Rep. Patrick J. Toomey) (“Requiring hedge funds to disclose the risks that they are taking reveals the nature of their business strategy in a way that would be comparable to requiring Mrs. Field to reveal the recipe and the baking instructions of her cookies.”); MFA Comment, *supra* note 106, at 2 (“Although the SEC claims that its proposal is not aimed to govern the activities of the funds themselves, this new regime will hurt hedge fund investors and capital markets by impeding entrepreneurial efforts that characterize the industry’s diversity and innovation.”); Seward & Kissel Comment, *supra* note 81, at 2 (“[W]e believe that the required registration of private fund advisers would have a substantial chilling effect on the industry”); Fromson, *supra* note 2 (“Instead of demonizing hedge funds, we should be applauding them.”); Hamilton, *supra* note 93 (“[T]he rule would do nothing to combat fraud but would raise investor costs and sap some of the nimbleness that has made hedge funds successful. They are a big part of what’s keeping the economy growing and you don’t want to hobble that” (internal quotations omitted)); Hendrickson, *supra* note 109, at 7 (“[SEC Commissioner Paul] Atkins said the hedge fund industry’s current approach toward developing sound practice guidelines would do far more than SEC registration to enable investors ‘to sleep at night.’ He said development of the sound practice guidelines belies the notion that unregistered hedge fund advisers ‘operate largely in the shadows, with little oversight.’”); Punater, *supra* note 2, at 4 (“The more time spent on compliance and dealing with regulatory issues, the less time spent on their core activities. Regulation . . . does not guarantee a level of performance; it will only increase management’s involvement in non-investment-related activities, potentially leading to lagging performance and then to the very issue of mitigating risk with which regulators are concerned.”). Even bloggers have noticed the recent fraud scandals within the alternative investment arena. *See, e.g.*, Greg Newton, *It’s Time to Pull for Phil*, NAKEDSHORTS, http://nakedshorts.typepad.com/nakedshorts/2005/10/its_time_to_pul.html (Oct. 30, 2005) (“Refco chief accounts receivable officer Phil Bennett apparently can’t find . . . six people to cosign his \$50 million bond I must admit that my original reaction was: ‘Tough. You can have John Gotti’s old space at The Tombs where you can hang out while Sandy Maggio makes like Sammy The Bull.’”).

¹²² Roye Speech, *supra* note 2 (“In the last five years, the Commission has brought 51 cases involving hedge fund fraud, resulting in losses of more than \$1.1 billion. These cases are more than [10%] of cases against investment advisers over the same period.”); *see* William P. Barrett, *Hedgehogs*, FORBES, Nov. 14, 2005, at 46 (“Regulatory claims of fraud by hedge fund managers seem all the rage”); *see, e.g.*, *Britney Hit by Hedge Fund Scandal*, ACCOUNTANCY, June 1, 2003, at 77 (“A hedge fund scandal in the British Virgin Islands has claimed Britney Spears and former Sotheby’s chairman Alfred Taubman as victims. They were among the investors who lost money when the . . . fund collapsed.”); Nancy R. Mandell, *Hedge Funds Beware: Ready Or Not, Here Comes Regulation*, SEC. WK., Sept. 19, 2005 (“The increasing number of hedge funds means increasing pressure on them to perform, which . . . can only lead to fraud.” (quoting SEC Commissioner Roel C. Campos)); Janet Novack, *Offshore Mystery*, FORBES, Oct. 17, 2005, at 58; Emily Thornton, *Call It ‘Grounds for Suspicion’*, BUS. WK., Oct. 31, 2005, at 9 (“The [SEC] has accused an Ohio stockbroker in federal court with collecting millions of dollars for a bogus hedge fund—and then pouring some of that money into his coffee shop.”).

¹²³ *See, e.g.*, *Hedge Funds and Independent Analysts: How Independent Are Their Relationships?: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 369 (2006) (statement of Sen. Arlen Specter, Chairman, Senate Comm. on the Judiciary), available at 2006 WLNR 11262786 (stating that if the SEC is unable to find ways to regulate fraudulent hedge funds,

There is an industry-wide concern that the registration requirement would give the public a false sense of security about investing in hedge funds.¹²⁴ As the number of American millionaires who qualify as accredited investors and sophisticated investors increases, these new millionaires will likely jump into hedge fund investment.¹²⁵ New tools on the market will aid these investors in making their investments.¹²⁶ For instance, investors today have access to online informa-

then criminal authorities will have to play a larger role in regulation). Even after the invalidation of the registration requirement regulation, Congress and other lawmakers did not stop trying to find ways to regulate hedge funds. *See, e.g.*, Cox Statement, *supra* note 26, at 3 (“Hedge funds are not, should not be, and will not be unregulated. The challenge for the SEC and the President’s Working Group going forward is, rather, to what extent to add new regulations, particularly in light of the recent Court of Appeals ruling.”); Carol E. Curtis, *Turf Wars over Hedge Funds*, SEC. INDUSTRY NEWS, Aug. 21, 2006, at 8, available at 2006 WLNR 14457108 (detailing the increased regulatory discussion by the Treasury Department, Congress, and the SEC); *Hedge Funds and the SEC*, ECONOMIST, July 1, 2006, at 22 (“Christopher Cox, the head of the SEC, has said that the agency will ‘re-evaluate’ its options.”); Ron Orol, *SEC to Restore Hedge-Fund Law*, DAILY DEAL, July 26, 2006, available at 2006 WLNR 12861876 (“We are moving as quickly as we can to, if not to put Humpty Dumpty back together again, to erect something sturdier that will accomplish the same objectives,” [SEC Chairman Christopher] Cox told lawmakers at a Senate Banking Committee hearing on the hedge fund industry.”). *But see, e.g.*, Josh Mecham, *Senate Witnesses Say No More Regulation Needed*, MONDAQ, May 22, 2006, available at 2006 WLNR 8775157. One member of the House even went so far as to introduce a bill that would have the same effect as the SEC’s registration requirement regulation but with Congress’s lawmaking power behind it. *See Frank Introduces Hedge Fund Bill*, EUROMONEY, July 3, 2006, at 2, available at 2006 WLNR 13260460. Retail customers, calling hedge funds “regulatory black hole[s],” have also demanded increased oversight. Michael Peltz, *Not in My Backyard*, INSTITUTIONAL INVESTOR, Aug. 1, 2006, at 36–38 (quoting testimony of Connecticut Attorney General Richard Blumenthal before the Senate Judiciary Committee on June 28, 2006).

¹²⁴ *See, e.g.*, Bair Comment, *supra* note 105, at 1–2 (“[I]t is far from clear whether requiring hedge fund advisers to register with the SEC will help or inadvertently harm investors by creating unrealistic expectations . . . perhaps emboldening investors who otherwise would not invest in such funds to do so, out of the belief that the SEC will protect them.”); Parry, *supra* note 27, at 719 (“The relatively new rich are particularly ripe targets for unscrupulous . . . hedge fund advisers and managers.”). The public generally finds out about certain funds through word of mouth because the law historically has not permitted hedge funds to solicit funds from the public. *See, e.g.*, Davis Comment, *supra* note 1 (“Hedge funds relatively new to the public now are starting to reach the mainstream media.”); DE BROUWER, *supra* note 23, at 13; DIV. OF INV. MGMT., *supra* note 7, at ix–x, 16; PRESIDENT’S WORKING GROUP ON FIN. MKTS., *supra* note 1, at 3.

¹²⁵ *See, e.g.*, O’Hara, *supra* note 121, at 5; Parry, *supra* note 27, at 719 (“Unlike the traditional . . . target for an investment scam . . . ‘Aunt Agatha’—a term redolent with images of elderly upper class spinsters, replete with inherited wealth but with no husband to look after it—the new rich of today are more likely to be entertainers, sports stars or those who have amassed wealth in the dot.com sector, and they may have practically no knowledge of or experience of any significance with financial markets or investing.”). For definitions of accredited and sophisticated investors, see *supra* text accompanying notes 50–67.

¹²⁶ *See, e.g.*, BORLA & MASETTI, *supra* note 23, at 79 (“Within the world of hedge funds . . . , we are seeing the emergence of a series of associations, web sites, organi[z]ations and speciali[z]ed organi[z]ations whose objective is to provide information, research, reports, databases and organi[z]e conferences and events.”).

tion tools¹²⁷ and can investigate hedge funds on their own—for a cost—by hiring detective agencies that specialize in hedge fund investigation.¹²⁸

These investigative tools may give the average U.S. investor a false sense of security, thus exposing an increasing number of American households to fraud.¹²⁹ Currently, not only is it difficult for the average investor to garner information about hedge funds (short of hiring one of the private agencies),¹³⁰ but hedge funds are also inherently riskier than the typical investment vehicles in which the average U.S. investors currently entrust their money. However, despite the recent mutual fund scandals,¹³¹ a great deal of curiosity surrounds hedge fund investment.¹³² Thus, the SEC needs to be diligent in providing measures to protect investors who may be accredited or qualified¹³³ by definition but perhaps are not so in actuality.¹³⁴

III

HOW OTHER U.S. REGULATORY BODIES HAVE DEALT WITH THE OFFSHORE PROBLEM

A. Internal Revenue Service

Historically, offshore hedge funds were an investment haven because of U.S. tax law's favorable treatment.¹³⁵ As long as the offshore fund is deemed not to be "engaged in a U.S. trade or business," the

¹²⁷ See, e.g., Tergesen, *supra* note 20.

¹²⁸ See, e.g., Jane J. Kim, *Digging for Hedge Fund Dirt*, WALL ST. J., Aug. 8, 2005, at C1; Anne Tergesen, *Hedge Fund Sleuths*, BUS. WK., Nov. 21, 2005, at 142 ("[The investigative firms'] fees range from \$1,000 to \$30,000, depending on the number of funds or managers involved. . . . If a manager has spent time overseas, they'll investigate there.").

¹²⁹ See, e.g., Hellrung, *supra* note 115, at 329; Erik J. Greupner, Note, *Hedge Funds Are Headed Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1573-78 (2003); Lori Pizzani, *Registered Hedge Funds Gain in Popularity*, INVESTMENT MGMT. WKLY., May 3, 2004, at 7. But see, e.g., Helm & Babikian, *supra* note 53, at 796-97; Jeff Benjamin, *Hedge Funds May Gain New Fans: Registration Makes Them More Palatable to Financial Advisers*, INVESTMENT NEWS, Nov. 1, 2004, at 1 ("[The] decision by the [SEC] to require the majority of hedge fund managers to register as investment advisers could have the unintended consequence of creating a seal of approval for the \$870 billion hedge fund industry."). Because the new regulations will give the guise that investment in U.S. funds will have improved antifraud measures, larger funds' investments will likely move offshore, away from the SEC's arm of regulation, thus increasing the risk of fraud.

¹³⁰ See *supra* notes 127-128 and accompanying text.

¹³¹ See Rory B. O'Halloran, Comment, *An Overview and Analysis of Recent Interest in Increased Hedge Fund Regulation*, 79 TUL. L. REV. 461, 489-90 (2004).

¹³² See *supra* note 2.

¹³³ For definitions of accredited and sophisticated investors, see *supra* text accompanying notes 50-67.

¹³⁴ See *supra* note 122.

¹³⁵ See Helm & Babikian, *supra* note 53, at 773-75. Little has been done to legislate for the movement of funds offshore to avoid U.S. taxes. See, e.g., C. Bryan Cloyd et al., *Firm Valuation Effects of the Expatriation of U.S. Corporations to Tax-Haven Countries*, J. AM. TAX'N ASS'N, Jan. 1, 2003, available at 2003 WLNR 5773157; Amy Hamilton, *REPO Act Targets Inver-*

IRS will impose only a withholding tax on certain income.¹³⁶ Because of this loophole, hedge fund advisers strive to ensure that they are not “engaged in a U.S. trade or business.”¹³⁷ Arguably, this loophole protects U.S. investors from offshore hedge fund solicitation. Yet, even though hedge funds cannot advertise to the public, they seem undeterred from finding U.S. investors because U.S. investors are a hotbed of assets.¹³⁸

Although the Taxpayer Relief Act of 1997 eliminated some of the previous favorable treatment toward offshore entities,¹³⁹ the IRS still affords offshore hedge funds multiple loopholes. For instance, fund investors bear a great tax burden if the fund is deemed to be a “foreign corporation” with U.S. investors owning “more than 50[%] of . . . the total combined voting power of all classes of stock of [the offshore hedge fund] entitled to vote, or the total value of the stock of such [offshore fund].”¹⁴⁰ The IRS would consider the fund a “controlled foreign corporation”¹⁴¹ (CFC) and would tax its U.S. investors at an unfavorable rate.¹⁴² Offshore hedge funds can generally avoid CFC status by organizing as a noncorporation, such as a limited liability partnership, such that the fund “is less likely to be considered a CFC.”¹⁴³

Offshore funds are also careful to ensure that they do not fall under the U.S. Treasury Department’s rules for “passive foreign investment companies” (PFICs).¹⁴⁴ Under these rules, the IRS taxes certain distributions from PFICs to U.S. investors at the highest possible rate for individuals and subjects these distributions to a deferred inter-

sions; *Are Offshore Hedge Funds Next?*, 95 TAX NOTES 287 (2002); Robert Willens, *The Bermuda Angle*, DAILY DEAL, Apr. 17, 2002, available at 2002 WLNR 3532666.

¹³⁶ I.R.C. § 881(a) (2000).

¹³⁷ *Id.*

¹³⁸ Offshore funds can make public offerings to U.S. investors only pursuant to an SEC order because § 7(d) of the Investment Company Act prohibits any company organized outside the United States from using the U.S. mails or facilities of interstate commerce in connection with a public offering of its securities. See Investment Company Act of 1940 § 7(d), 15 U.S.C. § 80a-7(d). Private offerings may be made under the limitations of § 3(c)(1). See *supra* text accompanying notes 52–62.

¹³⁹ See *supra* notes 29–32 and accompanying text.

¹⁴⁰ I.R.C. § 957.

¹⁴¹ *Id.*

¹⁴² See *id.* § 951; see also LEMKE ET AL., *supra* note 31, § 8:21 (explaining that the consequences could include “acceleration of certain taxable income and conversion of certain capital gains into ordinary income”).

¹⁴³ LEMKE ET AL., *supra* note 31, § 8:21.

¹⁴⁴ I.R.C. § 1297 (“[T]he term ‘passive foreign investment company’ means any foreign corporation if . . . 75[%] or more of the gross income of such corporation for the taxable year is passive income, or . . . the average percentage of assets (as determined in accordance with subsection(e)) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50[%].”).

est tax charge.¹⁴⁵ Generally, this high tax would offset most of the benefits that the U.S. investor would otherwise have.¹⁴⁶ However, a loophole exists to avoid some of this unfavorable tax treatment.¹⁴⁷

B. U.S. Department of Labor, ERISA, and Pension Fund Investment Offshore

With an increasing number of pension plans, endowments, and charities investing in hedge funds, the activities of hedge funds play a larger role in the lives of small, individual investors.¹⁴⁸ Pension plans have a fiduciary relationship to their beneficiaries, so when pension plans invest in hedge funds, these plan fiduciaries arguably expose their beneficiaries to greater risks with their retirement income.¹⁴⁹ Potential losses stemming from risky hedge fund investments question the pension plan's ability to satisfy its requirements as a fiduciary to the beneficiaries of the plan.¹⁵⁰

ERISA, the legislation with the greatest impact on pension plans, together with its regulations, limits the entities that are qualified to hold "plan assets" in offshore funds.¹⁵¹ ERISA places limitations on plan fiduciaries,¹⁵² establishes a standard of conduct,¹⁵³ makes guidelines for complying with the "prudent conduct" standard,¹⁵⁴ prohibits certain transactions,¹⁵⁵ creates a bonding requirement,¹⁵⁶ and explains the proper custody of plan assets.¹⁵⁷ The custody of assets pro-

¹⁴⁵ See *id.* § 1291.

¹⁴⁶ See LEMKE ET AL., *supra* note 31, § 8:22.

¹⁴⁷ See I.R.C. §§ 1293, 1295 (qualified electing fund provisions).

¹⁴⁸ See O'Hara, *supra* note 121, at 5; see also Riva D. Atlas & Mary Williams Walsh, *Pension Officers Putting Billions into Hedge Funds*, N.Y. TIMES, Nov. 27, 2005, at 1 ("Faced with growing numbers of retirees, pension plans are pouring billions into hedge funds, the secretive and lightly regulated investment partnerships that once managed money only for wealthy investors.").

¹⁴⁹ See Roye Speech, *supra* note 2.

¹⁵⁰ See *id.*

¹⁵¹ See Employee Retirement Income Security Act of 1974 § 404(b), 29 U.S.C. § 1104(h) (2000); 29 C.F.R. § 2550.404b-1 (2006).

¹⁵² Section 404(a)(1) of ERISA sets forth the basic responsibilities and expectations of an ERISA plan fiduciary. See 29 U.S.C. § 1104(a)(1)(A) ("exclusive benefit" rule); *id.* § 1104(a)(1)(B) ("prudence" rule); *id.* § 1104(a)(1)(C) ("diversification" rule "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so"); *id.* § 1104(a)(1)(D) (requiring action by fiduciaries in accordance with plan documents and the other provisions of ERISA).

¹⁵³ See *supra* note 152.

¹⁵⁴ See 29 U.S.C. § 1104(a)(1)(B).

¹⁵⁵ See *id.* § 1106. There are some exemptions to the prohibited transactions. See *id.* § 1108.

¹⁵⁶ See *id.* § 1112.

¹⁵⁷ See *id.* § 1104(b)-(c).

vision specifically states that ERISA assets cannot be held outside the jurisdiction of U.S. district courts unless certain conditions are met.¹⁵⁸

Hedge funds that specifically and intentionally target investment by pension plans are structured in such a way as not to be subject to ERISA and its regulations¹⁵⁹ because of the fiduciary responsibilities placed on ERISA plan fiduciaries. For example, a hedge fund adviser can be deemed an ERISA plan fiduciary if the adviser takes compensation for his or her investments, renders advice about the ERISA plan assets, and either has control over some plan assets or renders advice pursuant to an agreement.¹⁶⁰ One important inquiry is to determine whether hedge fund assets are plan assets: If 25% or more of the hedge fund's assets are plan assets, the hedge fund adviser is deemed an ERISA plan fiduciary.¹⁶¹

Some funds face a tradeoff between accepting regulation under ERISA and attracting investors to their hedge fund.¹⁶² On the one hand, accepting ERISA plan funds entails the expense of the fiduciary duty.¹⁶³ On the other hand, because pension funds can bring in large amounts of assets,¹⁶⁴ some fund advisers are willing to accept the fiduciary duty that comes with managing ERISA funds.¹⁶⁵ Typically, before a pension plan invests in a hedge fund, the ERISA fiduciary "will require assurances from the hedge fund adviser that it will not be liable under ERISA for any misconduct on the part of the hedge fund adviser in managing the plan assets."¹⁶⁶ Hedge fund advisers can ordinarily protect ERISA plan fiduciaries from liability for such misconduct if the hedge fund adviser registers with the SEC as an investment adviser.¹⁶⁷

¹⁵⁸ See *id.* § 1104(b); Maintenance of the Indicia of Ownership of Plan Assets Outside the Jurisdiction of the District Courts of the United States, 29 C.F.R. § 2550.404b-1 (2006).

¹⁵⁹ See LEMKE ET AL., *supra* note 31, § 4:52.

¹⁶⁰ See 29 U.S.C. § 1002(21)(A).

¹⁶¹ See 29 C.F.R. § 2510.3-101; see also Bronislaw E. Grala et al., *Summary of ERISA Issues for Hedge Fund Managers Considering Exceeding the 25% Threshold on Benefit Plan Investors*, in PENSION PLAN INVESTMENTS 2005: CONFRONTING TODAY'S ISSUES 329, 329 (2005) ("Once benefit plan investors cross the 25% threshold, the hedge fund manager will be subject to fiduciary standards and prohibited transaction rules of ERISA."); Steve Zwick, *2006: Hedge Funds Get Regulated*, FUTURES, Dec. 1, 2005, at 60 ("[A]ny fund manager who gets more than 25% of his money from pensions is subject to the same fiduciary responsibilities as pension funds themselves under . . . ERISA . . . which is administered by neither the SEC nor the CFTC, but by the Department of Labor.")

¹⁶² See DIV. OF INV. MGMT., *supra* note 7, at 28.

¹⁶³ See *supra* text accompanying notes 151-158.

¹⁶⁴ See DIV. OF INV. MGMT., *supra* note 7, at 96-97.

¹⁶⁵ See *id.* at 28.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*; see Employee Retirement Income Security Act of 1974 § 405(d), 29 U.S.C. § 1105(d) (2000); *id.* § 1102(38).

C. Commodity Futures Trading Commission and Pooled Assets Offshore

Although the Commodity Exchange Act,¹⁶⁸ like all other federal securities legislation, does not define the term hedge fund, the CFTC has had some success in requiring the registration of hedge fund advisers.¹⁶⁹ However, CFTC insiders recognize that the CFTC's regulatory methods concerning offshore investment are imperfect.¹⁷⁰ For instance, if the hedge fund trades futures contracts or commodity options, the hedge fund adviser must register with the CFTC as a commodity pool operator¹⁷¹ or a commodity trading adviser¹⁷² unless an exemption is available.¹⁷³ Once the hedge fund adviser registers with the CFTC, he or she becomes subject to the Commodity Exchange Act's antifraud provisions¹⁷⁴ and extensive disclosure requirements.¹⁷⁵

However, the Commodity Exchange Act still allows for loopholes in the registration of offshore hedge fund advisers.¹⁷⁶ For example, hedge funds regulated by other federal or state law—most offshore hedge funds—can take advantage of Commodity Exchange Act Rule 4.5, which is intended to avoid double registration.¹⁷⁷ Another exemption exists for commodity pool operators that register with the National Futures Association before beginning to operate the pool: The operators may claim a specific exemption from all disclosures and reporting requirements of registered commodity pool operators as well as many recordkeeping requirements.¹⁷⁸

The Commodity Exchange Act rules include many exemptions that offshore advisers can use. For instance, the CFTC rules exempt offshore funds from registration when the adviser receives no compensation¹⁷⁹ and when there are limited investments and investors in

¹⁶⁸ Commodity Exchange Act §§ 1–27, 7 U.S.C. §§ 1–27 (2000).

¹⁶⁹ See, e.g., HAMMER ET AL., *supra* note 4, § 2.9; Ernest E. Badway, *Hedge Funds Under Fire: Is There Body Armor Out There?*, METROPOLITAN CORP. COUNS., June 2005, at 33.

¹⁷⁰ See *To Consider the Reauthorization of the Commodity Futures Trading Commission: Hearing Before the S. Comm. on Agric., Nutrition and Forestry*, 109th Cong. 3 (2005) (statement of Sharon Brown-Hruska, Chairman, Commodity Futures Trading Commission) (“Congress may wish to review whether the CFTC has clear and adequate authority to police retail fraud, particularly in the foreign exchange area.”).

¹⁷¹ See 7 U.S.C. § 1a(5).

¹⁷² See *id.* § 1a(6).

¹⁷³ See, e.g., 17 C.F.R. §§ 4.5, 4.7(a)(2)(viii)(A), 4.14 (2006).

¹⁷⁴ See 7 U.S.C. § 4b(a)(i).

¹⁷⁵ See 17 C.F.R. pt. 4; see also DE BROUWER, *supra* note 23, at 15 (“The [Commodity Exchange] Act requires funds to be registered, to report information about risks, historical performance, fees, business background, and conflicts of interest to the . . . CFTC . . . and maintain records for possible inspection by the CFTC and . . . Department of Justice.”).

¹⁷⁶ See, e.g., 17 C.F.R. §§ 4.13(a)(3)–(4) (exemptions from registration as a commodity pool operator), 4.14(a)(8) (exemptions from registration as a commodity trading adviser).

¹⁷⁷ See *id.* § 4.5.

¹⁷⁸ See *id.*; Div. OF INV. MGMT., *supra* note 7, at 25.

¹⁷⁹ See 17 C.F.R. § 4.13(a).

the pool.¹⁸⁰ In addition, two recently adopted Commodity Exchange Act rules allow hedge fund advisers to qualify for exemptions from commodity pool operator and commodity trading adviser registration.¹⁸¹ First, if a commodity pool operator operates a pool under a registration statement, sells only to certain high net-worth investors, and limits its commodity futures activities, then the operator may be exempt.¹⁸² Second, commodity pool operators that operate pools that advertise and sell to only certain high net-worth investors may also be exempt.¹⁸³ Additionally, the Commodity Exchange Act and its corresponding regulations contain a *de minimis* exemption that is similar to the SEC's *de minimis* exemption.¹⁸⁴ Generally, because of the similarities between the Commodity Exchange Act exemptions and the Investment Advisers Act exemptions, "hedge fund advisers that are exempt from registration as an investment adviser also are usually exempt from registration as a [commodity trading adviser]."¹⁸⁵

IV

WHETHER AND HOW THE SEC SHOULD ALTER ITS HEDGE FUND REGULATORY REGIME

A. The SEC's Inability to Regulate Hedge Funds Effectively

Notably, during the recent shift to increase the SEC's regulation of hedge funds, there have been no moves to eliminate the investment vehicle entirely. In fact, some commentators have noted a *need* for hedge funds in the marketplace.¹⁸⁶ With the average investor's interest in hedge funds increasing,¹⁸⁷ market overseers have expressed a desire to protect unsophisticated investors from potential fraud.¹⁸⁸ However, the SEC's efforts seem shortsighted and ignore the concerns of government officials from other regulatory agencies as well as

¹⁸⁰ See *id.*

¹⁸¹ See PRESIDENT'S WORKING GROUP ON FIN. MKTS., *supra* note 1, at C-3.

¹⁸² See 17 C.F.R. § 4.13(a)(3).

¹⁸³ See *id.* § 4.13(a)(4).

¹⁸⁴ See 7 U.S.C. § 6m(1) (2000) (providing exemption from registration for commodity trading advisers with fifteen or fewer clients); 17 C.F.R. § 4.14(a)(10).

¹⁸⁵ DIV. OF INV. MGMT., *supra* note 7, at 25; see 17 C.F.R. §§ 4.14(a)(4)–(5).

¹⁸⁶ See, e.g., Quarles Statement, *supra* note 3; *Federal Reserve's First Monetary Policy Report for 2004: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 108th Cong. 37 (2004) (testimony of Alan Greenspan, Chairman, Federal Reserve Board), *quoted in* Fin. Servs. Roundtable Comment, *supra* note 111, at 1–2 (“[Hedge funds] have been very helpful to liquidity and hence the international flexibility of our financial system.”); Justin Fox, *Fear of a Black Box*, *FORTUNE*, Nov. 14, 2005, at 174 (“[H]edge funds appear to deliver better returns—and returns that don’t just follow the ups and downs of the stock market—than the heavily regulated, transparent, largely blowup-free mutual fund industry.”).

¹⁸⁷ See *supra* note 2 and accompanying text.

¹⁸⁸ See *supra* Part II.C.

hedge fund and mutual fund insiders, investors, academics, and attorneys who specialize in the regulation of financial institutions.¹⁸⁹

For instance, the SEC staff did not consider whether the SEC has the means to effectively enforce the registration regulation.¹⁹⁰ Like many Americans, many SEC employees do not understand the workings and investment strategies of hedge funds.¹⁹¹ Had the court in

¹⁸⁹ See *supra* Part II.A.

¹⁹⁰ See Comment, W. Nieves, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Adviser Act Release No. 2266, (Oct. 26, 2004), <http://www.sec.gov/rules/proposed/s73004/wnieves102604.htm>; PRESIDENT'S WORKING GROUP ON FIN. MKTS., *supra* note 1, at 42 ("[D]irect regulation of hedge funds could present formidable challenges in terms of cost and effectiveness."); see also Bair Comment, *supra* note 105, at 4 ("I would hate to see that luster tarnished a few years from now by a hedge fund scandal because a well-intentioned SEC prematurely decided to take responsibility for an industry it did not have sufficient resources to oversee."); MFA Comment, *supra* note 106, at 2 ("[T]he SEC has only 495 employees responsible for examining 8,000 mutual funds with about 91 million investors, managing \$7 trillion. The SEC has not made clear that the agency would have the needed expertise to monitor thousands more hedge fund advisers."); Comment, Joseph H. Omansky, President, Sky Fund LLC, SkyRank System of Hedge Fund Ratings, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. 2266 (Sept. 24, 2004), <http://www.sec.gov/rules/proposed/s73004/jhomansky1880.htm> ("The SEC alone cannot reduce fraud through the registration of hedge funds . . ."); Schulte Roth & Zabel Comment, *supra* note 77, at 9 ("[T]he average tenure of the inspection staff currently is approximately 1.9 years. . . . The turnover rate among examiners, combined with length of the Commission's inspection cycle, makes the likelihood of uncovering fraud even less likely."); Amend, *supra* note 109, at 7 ("[SEC Commissioner Paul Atkins] doesn't think the SEC has enough manpower to adequately police hedge funds."); Vineeta Anand, *SEC Requests Industry Group Help in Training*, INVESTMENT NEWS, Oct. 24, 2005, at 32 ("The [SEC] has asked the hedge fund industry to help train SEC staff to inspect the estimated 1,260 hedge fund investment advisers expected to register by February [2006]."); Susan L. Barreto, *SEC Not Prepared for the Registration Flood?*, HEDGEWORLD NEWS, Sept. 29, 2005 ("How adequately [is the SEC] defending investors if they too are overwhelmed?" (quoting Brian Shapiro, president of Carbon360, a research and advisory firm that works with hedge fund managers)); Hendrickson, *supra* note 109, at 7 ("In a blistering September 29 speech before the Managed Funds Association, [SEC Commissioner Paul] Atkins . . . said . . . , '[W]e have neither the resources nor the expertise to oversee all the potential new registrants The precious time and attention of our examination staff is being diverted to advisers that manage the money of a relatively tiny number of sophisticated investors [Y]ou have to wonder if the SEC is doing the right thing.')."); Don Noone, Letter to the Editor, *No SEC Cops Walking the Hedge Fund Beat*, WALL ST. J., Dec. 7, 2005, at A19 ("There are no cops on the hedge fund beat; frauds are only coming to light because defrauded investors are talking out and the media is listening. . . . The SEC's regulation of hedge funds is a square-pegged solution praying it finds a square-holed problem."). Likewise, one could argue that money that the SEC would have to divert to the hedge fund regulatory scheme could be better spent elsewhere in its regulatory fiefdom. See Paredes, *supra* note 3, at 989.

¹⁹¹ Part of what makes hedge funds so profitable is their secret and unique investment methods, so it is only logical that the average SEC employee would not understand them. See, e.g., Anand, *supra* note 190, at 32 ("The SEC's office of compliance inspections and examinations has called upon members of the Washington-based Managed Funds Association, which represents the hedge fund industry, to speak at training sessions the SEC has begun to hold for its staff in preparation for when [the] new rule kicks in"); Joe Hutnyan, *New Hedge Fund Rule Poses Unique Challenges for SEC*, SEC. WK., Sept. 26, 2005, at 10 ("The new system is going to be a huge learning curve for SEC staff." (quotations omitted)).

Goldstein not invalidated the registration regulations, the SEC would have faced great costs in educating its staff to examine and process the information gleaned from registration.¹⁹² Until the SEC has the resources necessary to survey the hedge fund market and to enforce actions against violative hedge fund advisers,¹⁹³ fund registration will strain the SEC's existing resources. Therefore, the registration requirements would be less effective at preventing and detecting fraud, two goals that the SEC stated explicitly when it enacted the registration requirement.¹⁹⁴

In establishing the registration regulations, the SEC also did not consider whether it has jurisdiction to create such a rule and to change its regulatory regime by redefining "client."¹⁹⁵ Even prior to the *Goldstein* decision, some commentators argued that the SEC had exceeded its powers by using a "look-through" provision¹⁹⁶ to define client.¹⁹⁷ The SEC's power to make rules is not an express grant for the agency to remake law by redefining such an essential term, for example.¹⁹⁸ Instead, the SEC has the power to carry out the will of

¹⁹² See, e.g., Comment, Nora M. Jordan et al., Davis Polk & Wardwell, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, File No. S7-30-04, at 3 (Sept. 15, 2004) [hereinafter Davis Polk & Wardwell Comment], <http://www.sec.gov/rules/proposed/s73004/nora091504.pdf> ("We believe that the Commission underestimates the costs and market effects of registration and incorrectly infers that registration imposes only minimal burdens on advisers.").

¹⁹³ See *supra* note 190.

¹⁹⁴ See *supra* text accompanying notes 12–13.

¹⁹⁵ See *supra* notes 75–79 and accompanying text.

¹⁹⁶ 15 U.S.C. § 80b-3(b)(3) (2000); 17 C.F.R. § 275.203(b)(3)(1)–(2) (2006); see Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054, 72,067 (Dec. 10, 2004) ("[Rule 203(b)(3)(2)] requires an advisor to 'look through' a hedge fund to determine whether it is eligible for the private advisor exemption . . .").

¹⁹⁷ See, e.g., MFA Comment, *supra* note 106, at 2; see also Comment, Marco V. Masotti, Chair, Comm. on Private Inv. Funds, Ass'n of the Bar of the City of New York, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, File No. S7-30-04, at 1–2 (Sept. 15, 2004) [hereinafter Ass'n of the Bar of the City of New York Comment], <http://www.sec.gov/rules/proposed/s73004/mvmassotti091504.pdf> ("[W]e are concerned with . . . the statutory authority of the Commission to count clients using the 'look-through' method as provided in the . . . Rule."). According to the Committee on Private Investment Funds of the Association of the Bar of the City of New York, it is unclear how the look-through provision would affect offshore advisers of offshore funds. See Ass'n of the Bar of the City of New York Comment, *supra*, at 5 ("The 'look-through' requirement in the . . . Rule becomes even more problematic in the context of an offshore adviser to an offshore fund where the adviser would only be required to count U.S. investors. The . . . Rule is unclear on whether the same 'look-through' requirement would apply."). A comment letter from the law firm Davis Polk & Wardwell echoes the Association's concerns. See Davis Polk & Wardwell Comment, *supra* note 192, at 3, 10 ("We suggest various technical clarifications to the . . . Rule, including clarifications of . . . the extraterritorial reach of the . . . Rule. . . . We are concerned that this lack of guidance will create significant ambiguity in the . . . Rule and its application.").

¹⁹⁸ See MFA Comment, *supra* note 106, at 2.

Congress, as expressed by statute, to adopt regulations to effect congressional will.¹⁹⁹ Since Congress adopted the Investment Advisers Act, it clearly did not account for a look-through provision by the SEC for counting clients, as the *Goldstein* court observed.²⁰⁰ Thus, at the very least, the SEC should have allowed for additional comments during the official comment period and should have paid closer attention to its own authority in promulgating a registration requirement.

By allowing the current ambiguities regarding offshore hedge funds and offshore advisers to stand, the SEC has created additional problems. An SEC official has even acknowledged that by early 2005, 70% of the hedge fund market consisted of offshore hedge funds.²⁰¹ Obviously, this is only an estimate because the SEC staff was unable to develop reliable figures in making its recommendation.²⁰² However, leaving the regulation as enacted continues to confuse advisers who oversee perhaps billions of dollars offshore. Furthermore, if there are so many funds domiciled offshore, the registration requirement is inherently inefficient because it allows loopholes for offshore advisers who accept investment funds from U.S. investors.²⁰³

Determining where to draw the line on regulation is difficult. On the one hand, the SEC should keep hedge fund investment largely unregulated and allow investors to continue reaping the benefits of the funds' risky investment strategies without forcing the average American taxpayer to pay to protect wealthy, sophisticated investors from their inherently risky investment decisions.²⁰⁴ On the other hand, now that more unsophisticated investors are aware of the great

¹⁹⁹ See 15 U.S.C. §§ 77s(a), 78w(a).

²⁰⁰ See *Goldstein v. SEC*, 451 F.3d 873, 878–79, 883 (D.C. Cir. 2006); see also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213–14 (1976), quoted in MFA Comment, *supra* note 106, at 2.

²⁰¹ See Matt Piotrowski, *SEC Regulation Concerns Hedge Funds*, OIL DAILY, Apr. 12, 2005.

²⁰² See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054, 72,055 (Dec. 10, 2004) (“It is difficult to estimate precisely the size of the hedge fund industry . . .”).

²⁰³ See Wright Comment, *supra* note 81, at 1–2 (asking for clarification of the proposed rule as to offshore funds).

²⁰⁴ See, e.g., Comment, Max Rottersman, President, Fund Forensics, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, File No. S7-30-04 (Sept. 15, 2004) [hereinafter Fund Forensics Comment], <http://www.sec.gov/rules/proposed/s73004/mrottersman5801.htm> (“Perhaps cold-hearted, but modestly wealthy people who lose their money in un-regulated hedge funds have only themselves to blame. If a hedge fund commits fraud the American taxpayer should not foot the bill through the S.E.C.”); Paredes, *supra* note 3, at 990 (“[T]he SEC has deferred to such well-heeled investors to protect themselves through market discipline.”); Robert C. Pozen, *Hedge Funds Today: To Regulate or Not?*, WALL ST. J., June 20, 2005, at A14 (“Should the SEC establish regulatory safeguards to protect investors in hedge funds that underperform? No. These investors are almost all wealthy individuals and institutions who should be able to protect themselves . . . absent fraud for which they already have legal claims . . .”).

opportunities offered by hedge funds, these investors will likely seek to invest without truly knowing the associated risks.²⁰⁵ The question comes down to how the SEC or Congress should strike a balance between these two scenarios.

While requiring hedge fund advisers to register with the SEC and to undergo periodic SEC examinations would seem to benefit investors,²⁰⁶ registration comes with enormous costs.²⁰⁷ Currently, many unregistered hedge funds do not have the infrastructure necessary to meet the SEC's disclosure requirements.²⁰⁸ When it hastily required hedge fund advisers to register with the SEC by February 1, 2006, the SEC forced some hedge funds to develop ad hoc reporting mechanisms that will likely need future correction.²⁰⁹ For funds without strong existing compliance or reporting mechanisms, the need to quickly establish such programs will come at a high cost to the hedge fund's investors.²¹⁰ This high cost could mean the end of small hedge funds. Furthermore, once hedge funds have their reporting mechanisms in place, U.S. taxpayers—many of whom do not meet the minimum requirements to invest in a hedge fund—will pay an enormous amount of money to cover the additional SEC employees necessary to process all of the disclosures and periodic filings.

²⁰⁵ Unsophisticated investors have been able to gain access to hedge funds through funds of hedge funds, see Leslie Rahl & Stephen Rahl, *Institutionalization of Hedge Funds: How Can Hedge Funds Be Tamed Without Breaking Their Spirit or Negatively Impairing Their Performance?*, in HEDGE FUND STRATEGIES: A GLOBAL OUTLOOK 69, 69–70 (Brian R. Bruce ed., 2002), as well as the new publicly traded hedge funds, see Barbara Kiviat, *Hello, Hedge Funds*, TIME, Dec. 4, 2006, at 62, and Merrill Lynch's and Goldman Sachs's new index-based products that offer hedge fund exposure, see *Hedge Funds: Attack of the Clones*, BUS. WK. ONLINE, Dec. 4, 2006, http://www.businessweek.com/investor/content/dec2006/pi20061204_627321.htm?campaign_id=Rss_topStories.

²⁰⁶ See DIV. OF INV. MGMT., *supra* note 7, at xi.

²⁰⁷ See, e.g., Schulte Roth & Zabel Comment, *supra* note 77, at 11 (“We are concerned that the Commission underestimates the full extent of these costs.”); DE BROUWER, *supra* note 23, at 212 (“The cost to regulators—and ultimately the tax-payer—could include an increase in staff at domestic and international institutions to process, analy[z]e and disseminate the information, and costs of publication of the results.”); Emmett Ryan, *A Roadmap to SEC Registration for Hedge Fund Invest Advisers*, in IT'S THE RULE: THE NEW SEC ADVISER REGULATION FOR HEDGE FUNDS, *supra* note 78, at 107, 111 (“While the SEC registration process is not difficult, keeping up with compliance regulations is a Herculean . . . task for many investment advisers to hedge funds.”).

²⁰⁸ See, e.g., Faille, *supra* note 90, at 30–31 (discussing how the regulations create a “huge hurdle” to smaller hedge funds).

²⁰⁹ See, e.g., Netage Solutions, *The Risks of Selecting an Investor Relations and Compliance Management System*, in IT'S THE RULE, THE NEW SEC ADVISER REGULATION FOR HEDGE FUNDS, *supra* note 78, at 101, 101 (“Choosing an investor relations and compliance management system is not . . . easy, because a host of risks often get unnoticed. Either out of lack of experience or because of the pressure to choose a solution quickly, hedge funds can end up with a ticking time bomb if they do not anticipate the . . . risks.”).

²¹⁰ See, e.g., Davis Polk & Wardwell Comment, *supra* note 192, at 12 (“Our view is that such costs are substantial and increasing and will in some form be passed on to, and affect returns realized by, hedge fund investors.”).

B. Possible Fixes for the SEC Registration Regulation

In fixing the registration requirement, the SEC must consider certain limitations it faces as a federal agency. As this Note has stated, the majority of SEC employees do not specialize in hedge funds.²¹¹ In addition, hedge fund enforcement would overstretch the SEC's limited resources.²¹² Therefore, it is important that the SEC fix the registration requirement in a way that the agency can easily implement without a substantial financial commitment. Arguably, this discussion is moot, because hedge funds cannot advertise and thus average investors who meet the statutory requirements would likely not learn of hedge fund investment opportunities. However, this argument does not hold weight in the age of the Internet, when any investor with Internet access can find information on hedge funds on Morningstar and Moody's.²¹³ While registration does increase the necessary investment level and investor net-worth levels, it does so only slightly.²¹⁴ The SEC should thus reevaluate how it defines "accredited," "sophisticated," and "qualified" such that the annual income and net-worth figures would increase with inflation, for example, rather than rely on static, outdated figures.²¹⁵

1. Redefine "Accredited Investor" and "Qualified Purchaser"

To improve the registration requirement, the SEC could look to the ideas and history behind hedge fund investment. Hedge fund advisers intended to attract wealthy, sophisticated investors who could absorb the losses from a poor investment.²¹⁶ The SEC should create new standards for "accredited investor" and "qualified purchaser"²¹⁷

²¹¹ See *supra* note 191 and accompanying text.

²¹² See *supra* note 190–192 and accompanying text.

²¹³ See, e.g., *supra* note 20.

²¹⁴ See, e.g., DIV. OF INV. MGMT., *supra* note 7, at xii ("[R]egistration of hedge fund advisers under the Advisers Act would effectively increase the minimum investment requirement for direct investments in certain hedge funds because registered advisers are generally prohibited from charging performance fees unless investors have \$750,000 invested with the adviser or have a net worth of \$1.5 million.").

²¹⁵ See, e.g., Fund Forensics Comment, *supra* note 204 ("[T]he minimums need to keep up with market valuations. The acid test . . . should be, what amount of money would a citizen need to hire a team of lawyers and accountants to monitor and defend their interests in the hedge fund? Or, put another way, what level of wealth is insufficient to protect an investor from an unscrupulous hedge fund?").

²¹⁶ See Paredes, *supra* note 3, at 980–84 (discussing the high-risk nature of hedge funds).

²¹⁷ See, e.g., Cox Statement, *supra* note 26 ("I am concerned that the current definition, which is decades old, is not only out of date, but wholly inadequate to protect unsophisticated investors from the complex risks of investment in most hedge funds."); MFA Comment, *supra* note 106, at 3 ("Accredited investor standards . . . should be raised so that the monetary thresholds reflect the inflation in wealth and incomes since 1982 or by imposing a similar enhanced accredited investor standard under the Advisers Act for hedge fund investors."). Until the SEC adopts higher standards for individual investors, many industry

because the Commission has not updated the specified wealth amounts since 1982. At that time, a much smaller percentage of the American public had the wealth necessary to be deemed an accredited investor or a qualified purchaser.²¹⁸ As the number of millionaires who will meet the SEC's statutory requirements for hedge fund investment despite having little education in hedge fund investment or general investment increases,²¹⁹ the likelihood of fraud on the market increases as well, which could in turn discourage investment in the securities markets.²²⁰

Currently, the SEC is accepting comments on a proposed rule to redefine "accredited investor."²²¹ The new definition would, among other things, raise the minimum asset level of accredited investors, whom the new rule labels "accredited natural persons."²²² An accredited natural person would still need a net worth of at least \$1 million but would also have to possess \$2.5 million in "investments," which will be adjusted every five years for inflation.²²³ From the comments received thus far, it appears that the accredited natural person standard could follow the path of the *Goldstein* litigation, as several commentators have already referred to the new minimum investment level of accredited natural persons as "arbitrary."²²⁴

2. Encourage Voluntary Disclosure

One way to ease into a new regulatory regime might be to encourage voluntary disclosure. Indeed, one of the SEC's general goals is to improve the dissemination of information to investors through

insiders believe that hedge fund investing is best kept out of the hands of unsophisticated investors. See, e.g., Rattner, *supra* note 1. Since the D.C. Circuit invalidated the registration requirement regulation in *Goldstein*, SEC Chairman Christopher Cox has suggested that he would like to increase the net-worth level requirements for individuals who seek to invest in hedge funds. See Orol, *supra* note 2.

²¹⁸ See, e.g., Daniel P. Collins, *SEC's 'Solution in Search of a Problem'?*, *FUTURES*, Dec. 2003, at 60.

²¹⁹ See, e.g., *Britney Hit by Hedge Fund Scandal*, *supra* note 122.

²²⁰ *Cf. Schlanger v. Four-Phase Sys. Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982) ("[I]t is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?").

²²¹ See *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Securities Act Release No. 8766, Investment Advisers Act Release No. 2576, 72 Fed. Reg. 400 (proposed Jan. 4, 2007). The proposed redefinition is in conjunction with a revised antifraud standard. See *id.*

²²² *Id.* at 400 n.6, 405-07.

²²³ *Id.* at 414 (proposing to amend 17 C.F.R. § 230.215 and add 17 C.F.R. § 230.216).

²²⁴ E.g., Comment, M. Kelley Price, Vice President, Price Meadows Inc., on Proposed Rule: *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Securities Act Release No. 8766, Investment Advisers Act Release No. 2576, 72 Fed. Reg. 400 (proposed Jan. 4, 2007), <http://www.sec.gov/comments/s7-25-06/kprice8949.pdf>.

disclosures.²²⁵ By not instituting a system of voluntary disclosure before promulgating the mandatory registration requirement, the SEC has ignored a potential solution to the information-asymmetry problem with hedge funds. While hedge funds are eager to get new, wealthy investors, many investors are reluctant to make the minimum investment and pay the exorbitant management fees without knowing more about the funds. By voluntarily disclosing information, funds could reap tremendous benefits from investors whom the voluntary disclosures wooed. Furthermore, the SEC staff itself has suggested the need for disclosure to hedge fund investors.²²⁶ By starting with a voluntary disclosure system, those funds that are ready to make disclosures to investors may profit because of their openness. This profit could encourage nonreporting funds to implement reporting systems.

3. *Educate Investors*

Underlying the desire for disclosure is a related need for investor education. U.S. investors are largely uneducated in the investment techniques of hedge funds and generally do not fully understand the risks associated with such investments.²²⁷ Furthermore, the statutory language does not provide a definition of “hedge fund.”²²⁸ While investor education would come at a great cost to both the SEC and hedge funds, having knowledgeable investors would presumably help the SEC meet its goal of deterring fraud. Mandatory disclosures will do little to deter fraud unless it is paired with investor education, because investors would not know how to treat the disclosed information. Further, investor education would help those statutorily deemed “sophisticated investors” to make better investment decisions within the hedge fund world.

²²⁵ Interestingly, a recent study has shown that hedge funds that registered in anticipation of the February 2006 deadline historically had better past performance, more assets, and higher quality than those funds that did not register. See Stephen Brown et al., *Optimal Disclosure and Operational Risk: Evidence from Hedge Fund Registration* 33–34 (Yale Sch. of Mgmt., Int'l Ctr. for Fin., Working Paper No. 06-15, 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=918461. The study ultimately concluded that economically, registration achieved some of its goals, *see id.* at 33, because there was “evidence that the information in the form has the potential to add value to the investor decision-making process,” *id.* at 4.

²²⁶ See DIV. OF INV. MGMT., *supra* note 7, at xi (“The [SEC] staff further recommends that the [SEC] consider amending its rules to require that registered hedge fund advisers file with the [SEC], and deliver to investors, a disclosure statement specifically designed for hedge fund investors.”).

²²⁷ See *supra* text accompanying note 1.

²²⁸ See *supra* text accompanying note 3.

4. *Rely on Existing Regulatory Mechanisms*

Arguably, the current enforcement mechanism is sufficient and no further regulation of hedge funds is necessary. For instance, in enacting the registration regulation, the SEC sought to prevent and deter fraud. However, further regulation is not the answer; looking at the recent hedge fund scandals, each hedge fund adviser had broken the law.²²⁹ If existing criminal statutes can protect investors from the behavior that the SEC is trying to prevent, there is no need to change the regulatory regime and to create more rules that will be not only expensive for the funds to implement—a cost likely passed down to investors—but also difficult for the SEC to enforce given its already stretched resources.

Further, expanding the regulatory regime may discourage innovation and competition in U.S. markets.²³⁰ When the Department of Treasury asks the SEC to loosen its restrictive reign, this is a sign that the SEC has gone too far. Granted, investors have called for stricter regulations on investment companies since scandals such as mutual fund market timing, Enron, and Amaranth rocked newspaper headlines. On the other hand, investors would likewise call for the SEC to loosen the regulatory regime if draconian regulations resulted in a lack of innovation and prevented the investors from turning a profit. While the SEC's current model of hedge fund regulation is clearly imperfect, the other regulatory agencies have had enough success in achieving the SEC's goals. Thus, the SEC should not try to make any dramatic changes to the current regulatory regime.

CONCLUSION

Rather than institute onerous registration requirements that leave open loopholes for potentially 70% of the hedge fund market,²³¹ the SEC should rethink its definitions of "accredited" and

²²⁹ See, e.g., Ben Heath & Julie Fishman-Lapin, *Funds Face Further Regulation*, *ADVOCATE* (Ct.), Oct. 27, 2006, available at 2006 WLNR 18650451 ("I am no apologist for fraud . . . but we have a lot of statutes that restrict fraud on federal and state levels." (quoting Paul Roth, founding partner of Manhattan-based Schulte Roth & Zabel, a law firm representing about 1,500 hedge, private equity, and offshore funds)).

²³⁰ See, e.g., *Are Securities Rules Hurting U.S. Markets?*, *DEALBOOK*, Nov. 30, 2006, <http://dealbook.blogs.nytimes.com/2006/11/30/panel-to-urge-rewriting-sec-rules-to-aid-companies> ("An independent committee formed with the endorsement of Treasury Secretary Henry M. Paulson Jr. called for a sweeping overhaul of securities regulations, citing concerns that American markets are losing their competitiveness.")

²³¹ See, e.g., Anand, *supra* note 190, at 32 ("Hedge fund advisers may circumvent the registration requirements if they agree to lock up investors' money for at least two years."); Hamilton, *supra* note 93 ("[S]ome fund managers are going out of their way to avoid the agency. Funds must be registered if they allow investors to redeem their holdings within two years. Therefore, many funds' lock-ups have been extended to two years instead of one 'This is not heavy-handed regulation.'"); Hendrickson, *supra* note 109, at 7

“qualified,” should encourage voluntary disclosure from hedge fund advisers, and should develop educational programs for potential investors. The recently invalidated registration requirement overlooked offshore hedge funds and their advisers, leaving a loophole for the vast majority of U.S. assets currently invested in hedge funds. While the IRS and CFTC provide loopholes similar to those in the registration requirement, perhaps the SEC should consider the costs and benefits of enacting provisions such as the ones in ERISA, which would imply a fiduciary duty for hedge fund advisers. Even though this proposal would help the SEC rein in offshore hedge fund advisers, it is not a necessary fix. State authorities would be the appropriate bodies to create such duties, and hedge funds are already subject to antifraud provisions that the fiduciary duty would imply.

In the end, commentators may be correct that the average U.S. investor should stick to stocks, bonds, and mutual funds. But as long as there is hype around hedge funds, there is a need, at the very least, to educate investors.

(noting that SEC Commissioner Paul Atkins believes that “rules requiring hedge funds to register with the SEC . . . hav[e] little effect on finding fraudsters, but stretch[] the agency’s examination staff perilously thin”); David Hoffman, *One on One with Ron Baron of Baron Capital Group Inc.*, INVESTMENT NEWS, Dec. 19, 2005, at 69 (“I think lawyers for private institutions are highly paid and will, in most instances, be able to navigate the rules that the government puts forth. If people don’t want to be regulated, they won’t be.”); Chidem Kurdas, *Use of Registration Loophole Seen as Risky*, HEDGEWORLD NEWS, Nov. 17, 2005 (“[T]he assets already managed don’t have to be locked up; only new money is subject to the lock-up provision. So what if the manager does not take any new money? By the logic of the rule as written, there has been an inference that such managers would also be exempt.”); Janet Lewis, *New Twists Emerge in Registration Saga*, INVESTMENT DEALERS DIGEST, Nov. 21, 2005, at 9 (“[H]edge fund advisers looking to avoid registration with the [SEC] by extending their funds’ lockup periods will be able to do so regardless of the wishes of their investors, according to lawyers and consultants in the field.”); Nocera, *supra* note 27 (“The new rule . . . includes a ridiculously big loophole, exempting any hedge fund that locks up investors’ money for two years or more.”); Zuckerman, *supra* note 27 (“Some big-name hedge funds have imposed restrictions on when investors can withdraw money, among other steps, which permits them to opt out of registering.”); Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule—Some Big Firms Change Lockups, Stop Accepting New Investments to Take Advantage of Loopholes*, WALL ST. J., Nov. 10, 2005, at C1 (“A large number of major hedge-fund firms won’t be registering with the [SEC] despite new rules aimed at forcing most hedge-fund advisers to sign up by early next year.”).

