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Carl J. Nelson

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HEDGE FUND REGULATION: A PROPOSAL TO MAINTAIN HEDGE FUNDS' EFFECTIVENESS WITHOUT SEC REGULATION

I. INTRODUCTION

American hedge funds hold \$1.7 trillion in assets.¹ In 2002, this figure was a far-more paltry \$560 billion.² In the same period, annual gross domestic product (GDP) rose from \$10.05 trillion to \$11.3 trillion.³ As a percentage of GDP, hedge fund assets under management have increased from 5.6% to 15% in the past four years.⁴

This growth mirrored an improving economy after the stock market slump from the end of 2000 to 2002,⁵ and far exceeds the growth of mutual funds or the equity markets as a whole.⁶ Funds that invest in other hedge funds to spread risk, called funds of funds,⁷ have increased hedge fund accessibility for those who do not meet the investment thresholds traditional hedge funds usually require.⁸ Funds of funds also add liquidity for investors who are unable or unwilling to lock up substantial assets based on the terms required by each underlying fund.⁹

The burgeoning hedge fund industry brought with it several high-profile fund collapses. These collapses have resulted from risky investment strategies, questionable standards of ethical trading and extreme leveraging of assets.¹⁰ The effect of these collapses and the perceived growing threat of a hedge fund industry accounting for an increasingly large share of the economy led the Securities and Exchange Commission (SEC) to draft and

1. Ambrose Evans-Pritchard, *SEC and FBI Bare Teeth at Hedge Funds*, DAILY TELEGRAPH, Sept. 27, 2006, at 1.

2. Donna Rosato, *Investing: Hedge Funds for All? Well, Not Quite*, N.Y. TIMES, Apr. 14, 2002, § 3, at 36.

3. BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COMMERCE, CURRENT-DOLLAR AND "REAL" GROSS DOMESTIC PRODUCT (2006), available at <http://www.bea.gov/national/xls/gdplev.xls> [hereinafter U.S. GDP].

4. GDP dollar amounts are in real terms and reflect U.S. dollars in 2000.

5. NAT'L BUREAU OF ECON. RESEARCH, BUS. CYCLE DATING COMM., THE NBER'S BUSINESS-CYCLE DATING PROCEDURE 1-2 (2003), available at <http://www.nber.org/cycles/recessions.pdf>.

6. See *infra* Part III.

7. See *infra* Part III.B.

8. Hedge funds typically have a minimum investment of \$1,000,000. INV. CO. INST., THE DIFFERENCES BETWEEN MUTUAL FUNDS AND HEDGE FUNDS (2005), available at http://www.ici.org/funds/abt/faqs_hedge.html [hereinafter ICI].

9. On top of existing hedge fund fees, see *infra* Part III.B, funds of funds charge an additional 1% management fee and, possibly, a performance fee of up to 5% on return over a certain benchmark. James Altucher, *Beware a Fund of Funds Relying on Gimmickry*, FIN. TIMES, Nov. 14, 2006, at 12.

10. See *infra* Part III.

implement rules to regulate U.S. hedge fund managers.¹¹ However, a recent decision, *Goldstein v. SEC*,¹² challenged the method the SEC used to require hedge funds to register with the SEC.¹³ The U.S. Court of Appeals for the D.C. Circuit vacated the rule requiring hedge funds to register with the SEC.¹⁴ Though this “hedge fund rule” did not accomplish hedge fund regulation, the debate continues: some suggest that legislative action may be the next step to solve the perceived threat of unregulated hedge funds, while others argue no further action to regulate hedge funds is necessary.¹⁵

This note argues that further hedge fund regulation is unnecessary and could actually negatively affect markets. First, this note concludes that increased regulation will not prevent system-wide market failure, and in fact, may abridge the abilities of hedge funds to deliver proven benefits to the economy.¹⁶ Second, the SEC should not regulate hedge fund managers because the agency does not have the resources to effectively do so, and hedge fund investors can adequately protect themselves since they are generally sophisticated investors; the SEC can more effectively protect investors by focusing on investors who are more vulnerable to market risk and who are less able to protect themselves.¹⁷ Third, SEC regulation may reduce hedge funds’ effectiveness and growth, and because hedge funds have added value to financial markets, unnecessary burdens on hedge funds should be avoided.¹⁸ Finally, this note proposes two preferable alternatives to increased hedge fund regulation, which address regulators’ concerns over providing investor protection and market stability, while allowing hedge funds to operate freely: the prevention of excessive leverage by counterparties and limiting hedge funds’ eligible investor pool.¹⁹ This note concludes that, in the current environment, increased hedge fund regulation should not be implemented because the potential benefits do not outweigh the costs and potential detrimental effect that regulation will have on the market.

11. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279) [hereinafter Hedge Fund Rule].

12. *Goldstein v. S.E.C.*, 451 F.3d 873 (D.C. Cir. 2006).

13. Rule 203(b)(3)-2 “requires investment advisers to count each owner of a ‘private fund’ towards the threshold of 14 clients for purposes of determining the availability of the private adviser exemption of . . . the [Adviser’s] Act.” 17 C.F.R. § 275.203(b)(3)-2.

14. *Goldstein*, 451 F.3d at 884.

15. See, e.g., Daniel K. Liffmann, *Registration of Hedge Fund Advisers Under the Investment Advisers Act*, 38 LOY. L.A. L. REV. 2147, 2149 (2005) (arguing that “registration [is] the proper method of dealing with . . . risks posed by the hedge fund industry”); *Hedge Funds and Independent Analysts: How Independent Are Their Relationship?: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 20–22 (2006) (statement of Joseph McLaughlin, Partner, Sidley Austin LLP, Managed Funds Association).

16. See *infra* Part III.A.

17. See *infra* Part III.B.

18. See *infra* Part IV.

19. See *infra* Part V.

II. THE HEDGE FUND INDUSTRY AND REGULATION

The term “hedge fund” is not a technical term, nor is it legally defined.²⁰ The term was coined in a *Fortune* magazine article by Carol Loomis about Alfred Winslow Jones, another journalist for *Fortune*, who developed the idea in 1949.²¹ Jones had written an article called “Fashions in Forecasting” that suggested covering long positions with short positions to hedge bets and offset shifts in the economy.²² One definition of a hedge fund is “any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.”²³

Hedge funds have some distinction from their more voluminous relative, mutual funds; hedge funds are often organized as limited partnerships, while mutual funds are often organized as corporations.²⁴ Mutual funds generally operate on a relative return-basis, while hedge funds attempt to operate distinct from any benchmark, operating on an absolute-return basis.²⁵

Mutual funds are regulated under the Investment Company Act of 1940 (Company Act)²⁶ and the Investment Advisers Act of 1940 (Advisers Act).²⁷ Hedge funds have been able to avoid registration under both of these acts. To avoid registration under the Company Act, hedge funds use two exemptions. First, the Company Act defines the term “Investment Company” as “[a company that] holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.”²⁸ The statute excludes “any issuer whose outstanding securities . . . are beneficially owned by *not more than one hundred persons* and which is not making and does not presently propose to make a public offering of its securities.”²⁹ And second, hedge funds are exempt from Company Act regulation by only offering securities to “accredited

20. Goldstein v. S.E.C., 451 F.3d 873, 874–75 (D.C. Cir. 2006).

21. Carol J. Loomis, *The Jones Nobody Keeps Up With*, FORTUNE, 237, 237 (Apr. 1966).

22. David Skeel, *In the Untamed World of Hedge Funds, Rigged Deals and Manipulated Markets Help*, 2005-DEC LEGAL AFF. 28, 30 (2005).

23. REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999) [hereinafter WORKING GROUP REPORT].

24. See SEC DIV. OF INV. MGMT., REPORT ON MUTUAL FUND FEES AND EXPENSES (2000), available at <http://www.sec.gov/news/studies/feestudy.htm>; IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 9 (2003) [hereinafter STAFF REPORT]. A mutual fund is an open-end company, which is “a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer.” 15 U.S.C. § 80a-5 (2000). A hedge fund, however, is a closed-end company, which is “any management company other than an open-end company.” *Id.*

25. STAFF REPORT, *supra* note 24, at 33.

26. See Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (2000).

27. See Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2000).

28. § 80a-3(a)(1)(A).

29. § 80a-3 (emphasis added).

investors,” those who meet certain financial thresholds.³⁰ Thus, a hedge fund can escape the Company Act classification of a mutual fund as long as it has fewer than one-hundred beneficial owners, does not offer its securities publicly and accepts only accredited investors.³¹ The Company Act also has a slightly more general exemption for funds that are not publicly offered and in which only “qualified purchasers” invest.³²

Hedge funds have also traditionally avoided registration under the Advisers Act, which requires registration of “investment advisers”³³ in connection with their business as “investment advisers.”³⁴ However, this section excludes “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.”³⁵

Thus, by limiting the beneficial owners to one hundred, limiting the number of clients to fourteen and by refraining from offering to the public, hedge funds could traditionally avoid registration under both the Company Act and the Advisers Act. However, the term “client” in the Advisers Act was ambiguous; the statute did not determine whether an investment adviser’s client was the hedge fund itself or also included the investors in the hedge fund who are limited partners.³⁶ And so, the applicability of the hedge fund exemption under the Advisers Act was unclear.

In 2004, the SEC adopted a regulation defining the term “client” in its “hedge fund rule.”³⁷ The regulation required that “for purposes of [the Advisers Act, hedge fund advisers] must count as clients the shareholders, limited partners, members, or beneficiaries . . . of a private fund.”³⁸ Thus, although hedge funds with fewer than one hundred beneficial owners could

30. See *infra* Part III.B.

31. It is crucial that hedge funds avoid classification under the Company Act because this legislation, which regulates mutual funds, would drastically limit certain hedge fund activity such as short selling and leveraged trading. See *infra* Part IV.A; see also STAFF REPORT, *supra* note 24, at 11–12.

32. See STAFF REPORT, *supra* note 24, at 12–13. Qualified purchasers can be, *inter alia*, individuals or companies that have more than \$5,000,000 in investments. 15 U.S.C. § 80a-2(51)(A) (2000).

33. 15 U.S.C. § 80b-2(a)(11) (2000).

“Investment adviser” means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

Id.

34. 15 U.S.C. § 80b-3 (2000) (emphasis added).

35. § 80b-3(b)(3) (emphasis added).

36. See *id.*

37. 17 C.F.R. § 275.203(b)(3)-2(a) (2004).

38. *Id.*

avoid registration under the Company Act, the hedge fund rule required managers of funds with more than fifteen investors to register with the SEC because the rule included investors as the clients of the investment adviser.³⁹

Registration under the Adviser's Act would require that hedge funds register with the SEC, maintain certain business records, deliver disclosure statements to clients, and would impose a duty to fully disclose any material conflicts the adviser has with its clients.⁴⁰ Further, the rule would prohibit, with some exception,⁴¹ a registered investment advisor from charging performance-based fees,⁴² which are an integral part of a hedge fund manager's compensation.⁴³

In 2005, an investment advisor, Philip Goldstein, challenged the SEC's regulation of hedge funds by its new definition of the term "client" in the U.S. Court of Appeals for the District of Columbia.⁴⁴ Goldstein, a hedge fund adviser,⁴⁵ challenged the rule that required him to register with the SEC.⁴⁶ The court sustained Goldstein's challenge, holding that since an investment adviser's fiduciary duties are to the fund, not the investors, the latter should not be considered clients.⁴⁷ Further, the Advisers Act defines an advisor as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."⁴⁸ Hedge fund managers do not advise investors directly, but rather advise the fund, which holds assets of the investors.⁴⁹ The court concluded investors cannot be included in the count of an investment adviser's clients.⁵⁰ The SEC did not appeal the decision⁵¹ and no

39. The adviser is the manager of the hedge fund, who is the general partner of the limited partnership. James Altucher, *No Place to Hide in an Age of Transparency*, FIN. TIMES, Nov. 7, 2006, at 11. ("A hedge fund is often structured as a partnership in which the manager is the general partner and the investors are limited partners.")

40. Hedge Fund Rule, *supra* note 11.

41. Heightened financial requirements, investors with \$750,000 invested with the adviser or with a net worth of \$1.5 million, would exempt this prohibition. STAFF REPORT, *supra* note 24, at xii.

42. Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 696-97 (2000).

43. STAFF REPORT, *supra* note 24, at 61.

44. *Goldstein v. S.E.C.*, 451 F.3d 873, 874 (D.C. Cir. 2006).

45. Lynn Hume, *SEC Won't Appeal Court's Hedge Fund Decision*, THE BOND BUYER, Aug. 8, 2006, at 44. Goldstein is at Opportunity Partners LP. *Id.*

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

47. *Id.*

48. 15 U.S.C. § 80b-2(a)(11) (2000).

49. *Goldstein*, 451 F.3d at 879-80.

50. *Id.* at 884.

51. Hume, *supra* note 45, at 44.

further action has been taken.⁵² It remains to be seen whether further legislative action will be initiated to accomplish SEC regulation of hedge funds. But risks associated with an unregulated hedge fund market do not seem to justify further regulator action.

III. HEDGE FUND RISKS

A. SYSTEMIC RISK:⁵³ AN UNREGULATED HEDGE FUND INDUSTRY DOES NOT THREATEN THE ECONOMY

1. Relevance in the Financial Markets

As hedge funds grow in number and in market share, their significance as a part of the economy also grows. While hedge funds hold far fewer assets than mutual funds,⁵⁴ they have nonetheless proven to play a significant role in the nation's economy.⁵⁵ One reason for this is the extreme leverage many hedge funds use to enhance returns.⁵⁶ A fund leverages its assets by borrowing capital to invest, expecting that the return on the borrowed capital is greater than the interest paid to borrow it.⁵⁷ Since a leveraged fund trades with assets it does not own outright, adverse movements in the underlying fund could have widespread economic implications capable of affecting the entire economy.⁵⁸ The downfall of Long-Term Capital Management (LTCM), a hedge fund, highlighted and practically defined this risk.⁵⁹ However, the after-effects of LTCM also revealed the industry's ability, through market discipline, to regulate itself.

52. *Id.* ("Securities and Exchange Commission Chairman Christopher Cox announced yesterday that the SEC will not appeal a federal appeals court's decision to strike down its rule requiring hedge fund advisers to register with the commission as investment advisers.")

53. As defined in a United States General Accounting Office Report, "[s]ystemic risk is generally defined as the risk that a disruption (at a firm, in a market segment, to a settlement system, etc.) could cause widespread difficulties at other firms, in other market segments, or in the financial system as a whole." U.S. GEN. ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL REQUESTERS, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK 2 (1999) [hereinafter GAO REPORT].

54. In August 2006, mutual funds held \$9.59 trillion of the nation's economy. INV. CO. INST., TRENDS IN MUTUAL FUND INVESTING SEPTEMBER 2006 (2006), available at http://www.ici.org/stats/mf/arctrends/trends_09_06.html. At the end of 2002, mutual funds held \$6.4 trillion in assets, INV. CO. INST., TRENDS IN MUTUAL FUND INVESTING JANUARY 2003 (2003), available at http://www.ici.org/stats/mf/arctrends/trends_01_03.html, an increase of about 50% in four years. Thus, as a percentage of GDP, mutual fund assets increased from 64% to 85% from 2002 to 2006. U.S. GDP, *supra* note 3.

55. See Diana B. Henriques and Joseph Kahn, *Back from the Brink: Lessons of a Long, Hot Summer*, N.Y. TIMES, Dec. 6, 1998, at C3.

56. Daniel K. Liffmann, *Registration of Hedge Fund Advisers Under the Investment Advisers Act*, 38 LOY. L.A. L. REV. 2147, 2168 (2005).

57. See STAFF REPORT, *supra* note 24, at 37 (2003).

58. See, e.g., Henriques, *supra* note 55.

59. See generally Henriques, *supra* note 55.

2. Hedge Fund Failures: Long-Term Capital and Amaranth Advisors

The near-collapse of LTCM in 1998 demonstrated the risk an unregulated hedge fund market posed to the economy. LTCM leveraged its assets 25 times.⁶⁰ Thus, of the fund's total portfolio value, \$5 billion was from investors, while the remaining \$120 billion was borrowed to enhance returns on equity.⁶¹ Several factors threatened the collapse of LTCM, including, significantly, a Russian threat to withhold payment of credit obligations and a devaluation of the ruble.⁶² This threat sent a wave of panic through worldwide debt markets, including countries on which LTCM had wagered substantial leveraged capital.⁶³ LTCM lost hundreds of millions of dollars on junk bond exposure and on mortgage pools.⁶⁴ Further, although LTCM was primarily invested in fixed income securities, it held \$6.5 billion in equity, and was hit again by declining stock prices.⁶⁵

The combination of events seriously compromised LTCM's ability to repay the investors who had lent it \$120 billion with which to trade. Its borrowing contracts provided that upon default, all of the other lenders could also call their loans to LTCM.⁶⁶ In the end, the Federal Reserve brokered a deal with investment banks to essentially buy out the fund and prevent a financial disaster.⁶⁷

The damage was done. A report issued by the Government Accounting Office after LTCM's bailout stated that the "LTCM crisis prompted strong reactions from virtually all large firms that were counterparties of hedge funds and an increased sense of awareness regarding risk management policies and procedures."⁶⁸ The report also noted that accounting firm Arthur Andersen LLP⁶⁹ conducted a study which highlighted three specific changes that occurred because of the collapse of LTCM: first, "[t]he number of banks and securities and futures firms doing business with hedge funds has decreased, and the business is substantially more concentrated among the largest, globally active firms;"⁷⁰ second, "[t]hese firms have focused on their risk management activities, including obtaining more complete information through required data reports and on-site visits;

60. *Id.*

61. *Id.*

62. WORKING GROUP REPORT, *supra* note 23, at 12.

63. Henriques, *supra* note 55.

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. GAO REPORT, *supra* note 53, at 13.

69. Arthur Andersen is now defunct for reasons unrelated to this issue. David G. Savage, *High Court Says it Wasn't Proved that Defunct Accounting Giant Arthur Andersen Intended to Commit a Crime in the Enron Scandal*, L.A. TIMES, June 1, 2005, at A1.

70. GAO REPORT, *supra* note 53, at 14.

tightening credit terms and increasing margin requirements; and improving risk models and recognizing the risks of unanticipated market events;⁷¹ and third, “hedge funds have become more forthcoming with meaningful data and information ensuring greater transparency to their activities.”⁷² These changes illustrate the industry’s concern for poorly managed hedge funds.

However, these changes also indicate that the LTCM crisis benefited the market: first, since fewer banks are willing to work with hedge funds, it will be more difficult for hedge funds to acquire dangerous levels of leveraged capital; second, implementing internal and external controls is a safeguard that puts the onus on investors, counterparties and the hedge fund itself; and third, the increased transparency of hedge funds provides the informational access to hedge funds that SEC registration would attempt to provide.⁷³ As opposed to increased SEC regulation, which may now only occur through legislation, the market is already able to quickly create incentives for hedge funds to adopt their own regulation. These built-in market controls protect investors and the economy. SEC regulation would be redundant if the market can already effectively regulate itself.

Amaranth Advisors (Amaranth) was another hedge fund that recently collapsed, lending some support to proponents of hedge fund regulation; however, the minimal impact Amaranth’s collapse had on the markets further demonstrates that hedge fund regulation is unnecessary.⁷⁴ Amaranth invested heavily in derivatives linked to future energy prices.⁷⁵ Energy prices began to fall in September 2006, instigated by better-than-expected weather,⁷⁶ and the fund started hemorrhaging assets.⁷⁷ Unable to liquidate its positions fast enough, Amaranth lost \$6.5 billion in two weeks.⁷⁸ Unlike LTCM, however, the repercussions of Amaranth’s downfall were limited primarily to its investors.⁷⁹ The derivative positions of the \$9 billion fund were sold to other investors and the rest was returned to Amaranth’s investors.⁸⁰ This collapse, however, did not threaten the economy at large.⁸¹

71. *Id.*

72. *Id.*

73. Hedge Fund Rule, *supra* note 11, at 72,061.

74. For a general discussion on the political regulatory effects stemming from Amaranth’s collapse, see Avital Louria Hahn, *The SEC’s Last Shot at Hedge Fund Regulation*, INVESTMENT DEALERS’ DIGEST, Oct. 23, 2006.

75. Jonathan Davis, *Amaranth: How to Lose \$6 Billion in a Fortnight*, THE SPECTATOR, Oct. 28, 2006.

76. There were fewer hurricanes than predicted that year, which kept energy prices lower than they would have been after a severe hurricane season. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*; see also Hahn, *supra* note 74 (noting that “Amaranth’s loss was relatively well contained”).

80. Davis, *supra* note 75.

81. See Hahn, *supra* note 74.

Both LTCM and Amaranth demonstrate the potential threat that hedge funds pose to the U.S. economy. However, neither example demonstrates the need for hedge fund regulation because neither potential threat came to fruition; both cases were solved without any serious harm to the economy.⁸² Federal Reserve chairman, Ben Bernanke, recently expressed skepticism about giving regulators more oversight, indicating that allowing hedge funds and trading partners to manage risk in the sector made “economic sense.”⁸³ History shows that the market can most effectively regulate hedge funds; efforts to regulate hedge funds to avoid systemic risk are not currently justified.

The systemic risk posed by hedge funds has the broadest relevance, but the SEC is also tasked with protecting investors, including hedge fund investors.⁸⁴ Investor protection does not justify increased hedge fund regulation because hedge fund investors are a small, elite segment of the investing public.⁸⁵ Further, an inquiry must be made as to whether the SEC is financially and tactically able to handle the diverse and complex hedge fund industry.

B. INVESTOR RISK: REGULATION OF HEDGE FUNDS IS NOT A JUSTIFIABLE SEC EXPENSE

1. The SEC is Not Equipped to Regulate Hedge Funds.

Regulating hedge funds would require the SEC to devote an unknown, but potentially substantial, amount of additional time and money to monitor the growing industry. There are approximately 8,000 hedge funds currently operating in the U.S. and the number appears to be growing.⁸⁶ The SEC has a relatively small budget of \$888 million,⁸⁷ which is 0.036% of the U.S. 2005 fiscal year budget outlays of \$2.5 trillion.⁸⁸ The 3,100-employee agency has limited resources to fulfill its mission “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”⁸⁹ The SEC already appears stretched too thin, even without a

82. Henriques, *supra* note 55; Davis, *supra* note 75.

83. Jeremy Grant, *Rethink in the U.S. on Hedge Fund Rules*, FIN. TIMES, Oct. 16, 2006, at 21.

84. The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, *available at* <http://www.sec.gov/about/whatwedo.shtml> [hereinafter The Investor’s Advocate] (“The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”).

85. *See infra* note 97.

86. *See, e.g.*, Kit R. Roane, *Hedging Their Debts*, U.S. NEWS & WORLD REPORT, Apr. 10, 2006, at 38.

87. Frequently Requested FOIA Document: SEC Budget History vs. Actual Expenses, <http://www.sec.gov/foia/docs/budgetact.htm> (last visited Nov. 24, 2006).

88. OFFICE OF MGMT. & BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 2007 (2006), *available at* <http://www.gpoaccess.gov/usbudget/fy07/pdf/budget/tables.pdf>.

89. The Investor’s Advocate, *supra* note 84.

commitment to implement increased hedge fund regulation.⁹⁰ In 2006 the SEC lost 155 employees and, as a result, the amount of enforcement cases brought by the agency dropped by 9%.⁹¹ Further, the SEC had a budget shortfall and so had to institute a hiring freeze.⁹² The SEC's strained capacity seems incapable of adjusting to the increased work-load hedge fund regulation would create, especially when it is unclear that the additional strain would enable the SEC to fulfill its mission to protect investors and financial markets.

In order to be able to fulfill its mission, the SEC's small budget allotment must be efficiently spent; the crucial question is, whether devoting more resources to regulate the self-regulated hedge fund industry would be worthwhile. Of 3,100 SEC employees, only 495 are responsible for 8,000 mutual funds owned by 91 million investors.⁹³ A 1996 Senate report noted that "the number of registered [mutual fund] investment advisers has increased by over 500% since 1980, far outstripping the growth in the Commission's examination resources."⁹⁴ As a result, smaller investment advisers are now examined, on average, once every 44 years—amounting to virtually no regulation at all.⁹⁵ The thinly stretched SEC may not be able to handle an additional 8,000 hedge funds. With its budget shortfall, it seems unlikely that the SEC is currently able to realistically initiate a taskforce to monitor the huge hedge fund industry.

Whether the SEC's budget would be effective in preventing an economic collapse by regulating hedge funds is, at best, speculative. It is not worth implementing a regulatory system that will burden hedge fund investors both through SEC fees, and the cost of registration, which would be paid by investors through diminished returns.⁹⁶ Protecting hedge fund investors is not a sufficient goal to justify this burden.

2. Protection of Sophisticated Investors is Unnecessary

SEC regulation over hedge funds is unnecessary for the protection of hedge fund investors because hedge funds are made up of investors meeting stringent financial requirements and who are presumed to be more investment-savvy individuals. Hedge fund investors are institutions and

90. See, e.g., Carrie Johnson, *Staff Reduced Because of Budget Crunch*, WASH. POST, Nov. 3, 2006, at D03.

91. *Id.*

92. *Id.*

93. *Fiscal 2005 Appropriations Request for the U.S. Securities and Exchange Commission: Hearing Before the Subcomm. on Commerce, Justice, State, and the Judiciary of the H. Comm. on Appropriations*, 108th Cong. (2004) (statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission), available at <http://www.sec.gov/news/testimony/ts033104whd.htm>.

94. S. Rep. No. 104-293, at 3 (1996).

95. *Id.*

96. WORKING GROUP REPORT, *supra* note 23, at B-1.

accredited investors, the latter of which must have a net worth of over \$1,000,000 or have, in each of the last two years, earned more than \$200,000.⁹⁷ Surely wealthy investors are no less deserving of the benefits of government regulation, in general, but hedge funds in particular have developed with very little regulation, and these investors have still knowingly partaken in their success.

Also, funds of funds—investment companies that diversify risk by buying shares in other hedge funds⁹⁸ — comprise a large segment of hedge fund assets.⁹⁹ Funds of funds generally register with the SEC because their investors are not accredited investors and because they generally have over 25 investors.¹⁰⁰ Thus, because a large amount of capital in funds of funds is already registered, regulating the underlying funds would be redundant regulation. The burden of additional regulation on the hedge fund industry could be substantial.¹⁰¹ The burden would likely limit the effectiveness of hedge funds and would not likely achieve putative goals, namely preventing malfeasance among hedge funds.

Mutual funds, which are substantially similar in form to hedge funds,¹⁰² are currently regulated by the SEC.¹⁰³ Under the Company Act, mutual funds must provide information such as the extent to which the fund intends to engage in specific activities, a recital of all investments and their general policies.¹⁰⁴ Investors who seek the presumed protection of SEC regulation can invest in any of the 8,000 registered mutual funds. Hedge funds have been exempted from this registration, and so have been vehicles for those who seek greater absolute returns in exchange for greater risk. Investor

97. 17 C.F.R. § 230.501(a)(5)–(6) (2004). There are 2.7 million individuals in North America who meet the \$1 million net assets threshold. Press Release, Capgemini, World Wealth Report 2005 Discloses that Number of “Millionaires” Grows by Over 7% to 8.3 Million Worldwide (June 9, 2005), available at http://www.us.capgemini.com/industries/ind_pressrelease.asp?IndID=4&ID=489. The United States population is just over 300 million. CIA: The World Factbook, <https://www.cia.gov/library/publications/the-world-factbook/geos/us.html>. High net-worth individuals, therefore, account for just under 1% of all Americans.

98. STAFF REPORT, *supra* note 24, at 99.

99. *Id.* at 44 n.154 (“FOHFs represented approximately 27 percent of hedge fund assets, compared to 20 percent the year before.”).

100. MANAGED FUNDS ASS’N, THE SEC’S REGISTRATION PROPOSAL: THE PUBLIC COMMENTARY—A SUMMARY 2 (2004) [hereinafter MFA PROPOSAL]; STAFF REPORT, *supra* note 24, at 67–69.

101. Matthew A. Chambers and Alexandra Poe, *Regulatory Oversight of Hedge Fund Advisers*, 1517 PRAC. LAW INST. 467, 471–77. A recent Practising Law Institute publication suggests that the registration requirements would be substantial. Among the types of regulation suggested are 1) compliance programs where hedge funds would create and execute procedures to comply with SEC rules; 2) the adoption of codes of ethics; 3) portfolio management procedures and valuation procedures; 4) record-keeping requirements; 5) compulsory communications with investors and 6) increased vigilance of short-selling. *Id.*

102. *See supra* Part II.

103. *Id.*

104. 15 U.S.C. § 80a-8(a)–(b) (2000).

appetite for hedge funds has not abated¹⁰⁵ and unregulated hedge funds should continue to be an investment option for qualified investors.

3. Hedge Fund Regulation Will Not Effectively Prevent Malfeasance

Preventing illegal activity is not a justifiable end to be obtained by further hedge fund regulation. SEC regulation may simplify the process of uncovering illegal activity, but registration would not change the legal guidelines trading firms must already follow; hedge funds would still be subject to anti-fraud restrictions.¹⁰⁶ For example, the hedge fund manager's fiduciary duty to the investors requires that managers fully disclose to their clients all matters regarding the fund's business practices, fees and conflicts of interest.¹⁰⁷

From 1999 to 2004, before the SEC implemented increased regulation, the SEC brought 51 cases against hedge funds or their managers alleging that they defrauded investors.¹⁰⁸ Further, 400 funds (5% of all funds currently operating) have been investigated by the SEC in some form.¹⁰⁹ These non-regulatory controls have thus proven effective in uncovering and taking action against misconduct. If the current scheme has worked to prevent misconduct and has allowed hedge funds to operate unhindered by regulation, there is little need to spend the time and money to implement new, more burdensome regulation.

Further, hedge funds may more effectively self-regulate than other investments that cater to large segments of the public. Each hedge fund investor who has over \$1 million invested¹¹⁰ likely has more bargaining power (through the threat of redemption, which lowers the hedge fund's assets) than the average mutual fund investor, who may have far less invested with the mutual fund manager. Fewer and more influential investors will be a constant centripetal force on potential deviant hedge fund activity. Investors may also control hedge fund managers by requiring that the fund register with the SEC.¹¹¹ Funds of funds executives have stated

105. See *supra* Part I.

106. See MFA PROPOSAL, *supra* note 100.

107. WORKING GROUP REPORT, *supra* note 23, at B-15 (citing Section 204 of the Investment Advisers Act [15 USC 80b-4]).

108. Hedge Fund Rule, *supra* note 11, at 72,056.

109. *Id.* at 72,057.

110. The minimum investment of most hedge funds is usually \$1 to 2 million. *Investor Protection and the Regulation of Hedge Funds Advisers: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (2004) (testimony of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission), available at <http://edgar.sec.gov/news/testimony/ts071504whd.htm>.

111. A requirement by a hedge fund investor could come in one of two ways: 1) an investor, more likely an influential one, could explicitly require that a hedge fund manager register with the SEC or; 2) an investor could require registration by its actions by choosing as an investment a fund that takes the initiative to register with the SEC.

that they declined investing with Amaranth¹¹² because of its lack of disclosure.¹¹³ Thus, since the market will, in some instances, provide incentives for hedge funds to register, compulsory SEC regulation imposes an unnecessary requirement on the hedge fund industry. Aside from the potential ineffectiveness of hedge fund regulation, legislation that could alter the shape of hedge funds and their place in the market could actually be detrimental to the current system.

IV. CONCERNS ABOUT FURTHER REGULATION

A. INCREASED REGULATION WILL MAKE HEDGE FUNDS A LESS-ATTRACTIVE INVESTMENT OPTION

1. Problems with Further Legislation

Currently, hedge funds do not have to register under either the Company Act or the Advisers Act.¹¹⁴ The SEC attempted to regulate hedge funds through the Advisers Act.¹¹⁵ However, it was unsuccessful in implementing regulation because *Goldstein* invalidated the SEC's interpretation of the term "client."¹¹⁶ Since the SEC is concerned with the hedge fund's activities and not the manager per se, the route for implementing hedge fund regulation would logically be the Investment Company Act, not the Investment Adviser's Act.¹¹⁷ However, because the regulation required under the Company Act is more stringent than under the Advisers Act,¹¹⁸ regulation under the Company Act could over-regulate. Alan Greenspan, former chairman of the Federal Reserve, warned about the potential that Congress would take the opportunity to expand hedge fund regulation beyond the purported registration requirements imposed prior to *Goldstein*: "Should registration fail to achieve the intended objectives, pressure may well become irresistible to expand the SEC's regulatory reach from hedge fund advisers to hedge funds themselves."¹¹⁹

112. See *infra* Part III for a brief discussion about Amaranth.

113. Henny Sender & Gregory Zuckerman, *Moving the Market—Tracking the Numbers / Street Sleuth: Amaranth Natural-Gas Losses May Have Far-Reaching Effect—Investors in Other Markets Could Feel Spreading Chill of 1 Week's \$5 Billion Drop*, WALL ST. J., Sept. 19, 2006, at C3.

114. See *supra* Part II.

115. *Id.*

116. *Goldstein v. S.E.C.*, 451 F.3d 873, 884 (D.C. Cir. 2006).

117. The Company Act indicates that activities under its purview are investing, reinvesting, and trading in securities. 15 U.S.C. § 80a-1(a) (2000). Meanwhile, activities associated with investment advisers are contemplated by the Advisers Act to be the advice, counsel, publications, writings, analyses, and reports [of the advisers], 15 U.S.C. 80b-1(1) (2000).

118. See § 80a-8(b); *cf.* § 80b-3(c)(1)–(2).

119. *Federal Reserve's Second Monetary Policy Report for 2004: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 43 (2004) (response to a written question of Senator Crapo from Alan Greenspan).

The court in *Goldstein* further warned that the sort of regulation with which mutual funds must comply does not comport with many hedge fund strategies: “[Mutual funds] are . . . foreclosed from trading on margin or engaging in short sales, and must secure shareholder approval to take on significant debt or invest in certain types of assets, such as real estate or commodities. These transactions are all core elements of most hedge funds’ trading strategies.”¹²⁰

The cost of enacting new legislation and the cost of implementing regulatory changes if legislation is enacted are both unclear. These costs would fall on hedge funds to pay SEC fees and to implement registration systems, both adding to the already high fees hedge fund investors pay.¹²¹ This could ultimately affect the desirability of hedge funds because their fee structure would yield a lower return to hedge fund investors.¹²²

Regulated hedge funds would be subject to more limitations than those that are not. For example, increased regulation may consist of limits on management fees, such as are imposed upon mutual funds.¹²³ This may dissuade talented hedge fund managers from starting hedge funds if the incentive of lucrative fees is diminished by excessive regulation. Further, because managers are beholden to their investors to make prudent and fair investing decisions, managers who oppose duplicative SEC oversight could move the hedge fund offshore to avoid the oversight of the SEC. Dana Johnson, senior vice president and chief economist at Comerica Bank, recently warned in a *Wall Street Journal* article that some hedge funds would be pushed “offshore if we tried to regulate with a heavy hand. . . . [It is b]etter to have them onshore with light regulation.”¹²⁴

2. Benefits of Hedge Funds’ Distinctness from Mutual Funds

Hedge funds have delivered numerous benefits to the global financial markets. Hedge funds invest in new and often undercapitalized markets.¹²⁵ This enhances liquidity in less traditional markets. Hedge funds also often purchase derivatives¹²⁶ and take short positions,¹²⁷ which increases

120. *Goldstein*, 451 F.3d at 875 (citation omitted).

121. Hedge funds typically charge 1-5% of assets under management in management fees and an additional performance fee, based on returns, that can range from 10-40%. David Reilly, *Moving the Market—Tracking the Numbers / Street Sleuth: Breaking the Trend to Higher Fees — Will Hedge-Fund Industry Follow U.K. Firm as It Cuts What It Charges Clients?*, WALL ST. J., Feb. 22, 2005, at C3.

122. WORKING GROUP REPORT, *supra* note 23, at B-1.

123. *See id.* at 3.

124. Phil Izzo, *Moving the Market: Economists See Hedge-Fund Risks—Survey Indicates Concerns About a Lack of Oversight, Use of Borrowed Money*, WALL ST. J., Oct. 13, 2006, at C3.

125. STAFF REPORT, *supra* note 24, at 4–5.

126. A derivative is “[a] financial instrument whose characteristics and value depend upon the characteristics and value of an underlier, typically a commodity, bond, equity or currency.” Investorwords.com, <http://www.investorwords.com/1421/derivative.html> (last visited Dec. 21, 2006).

reliability to market prices and may limit irrational security appreciation.¹²⁸ As Joseph McLaughlin, a partner at Sidley Austin, LLP, testified before the Senate Judiciary Committee:

Hedge funds enhance market liquidity and contribute to pricing efficiency and market stability. Hedge funds also foster financial innovation and risk sophistication among the market participants with which they deal. . . . [H]edge funds' ability to deliver these benefits to the financial marketplace depends in large measure on their ability to engage in short sales and related activities.¹²⁹

The putative benefits of hedge fund regulation do not justify a new scheme of regulation of an industry that, at its core, has been distinguished from other investments by its *lack* of regulation. Hedge funds have provided value to financial markets. Removing attributes that distinguish hedge funds and mutual funds may eliminate an environment where wealthy investors have allowed managers to invest in new and risky markets.¹³⁰ Talented managers may be dissuaded from starting funds, or from personally investing in the funds they manage.¹³¹ Investors may find new vehicles in which to invest that are more distinct from mutual funds. Dressing hedge funds up as mutual funds by imposing strict regulation will hinder investing innovation and will reduce the benefits hedge funds have provided to the economy.

Hedge funds are a concept defined by what they are not.¹³² As the SEC tightens its regulatory hold on hedge funds, a major distinction between hedge funds and mutual funds begins to vanish. Wealthy investors who formerly favored hedge funds over mutual funds for the unique opportunity of a cutting-edge investment will find new ways to distinguish themselves from ordinary investors.

With regulation foreseeably driving away wealthy investors, areas of the market in which hedge funds invest may become undercapitalized. Hedge funds invest in a wide array of securities and take varying positions. For example, hedge funds invest in the second-lien loan market and in corporate bankruptcies.¹³³ Hedge funds have also increasingly been a major

127. Taking a short position means “[b]orrowing a security (or commodity futures contract) from a broker and selling it, with the understanding that it must later be bought back (hopefully at a lower price) and returned to the broker.” Investorwords.com, http://www.investorwords.com/4556/sell_a_stock_short.html (last visited Dec. 21, 2006).

128. STAFF REPORT, *supra* note 24, at 4.

129. *Hedge Funds and Independent Analysts: How Independent Are Their Relationship?: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. (2006) (testimony of Joseph McLaughlin, Partner, Sidley Austin LLP, Managed Funds Association).

130. See STAFF REPORT, *supra* note 24, at 4.

131. See WORKING GROUP REPORT, *supra* note 23, at A-1.

132. See *supra* Part II.

133. Jenny Anderson, *As Lenders, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, at A1.

creditor to numerous markets from retail to technology to the automotive sectors, providing much-needed capital and reducing lending costs.¹³⁴ Markets that might otherwise go unfunded are capitalized by hedge funds willing to take risk in these markets for the potential upside benefit. Further, hedge funds often hedge their portfolios by trading both long and short positions.¹³⁵ Increased hedge fund regulation could disrupt trade strategies and encourage a precipitous flow of capital out of hedge funds and out of the markets they support.

By making hedge funds indistinguishable from mutual funds, regulation could also have a deleterious effect on hedge fund managers' participation in their funds. While hedge fund managers are notoriously well paid, with top earners earning \$1 billion or more in a year,¹³⁶ they also invest substantial assets of their own in the funds they manage,¹³⁷ which may induce investor confidence in their vested managers. When hedge fund managers are invested in their own fund, they are naturally less likely to engage in dubious or even fraudulent trading. Overly burdensome regulation could have two primary effects: 1) managers may refrain from starting hedge funds; or 2) managers may refrain from investing in their own fund. Increased legislation, therefore, could negatively impact the role of the autonomous hedge fund manager and hamper hedge fund growth in the U.S.

Further, while the American hedge fund industry is currently the biggest in the world, hedge fund activity in Hong Kong and London has grown rapidly.¹³⁸ While London and Hong Kong have smaller hedge fund

In this market, if a borrower defaults, the primary lender gets repaid before the secondary lender; in exchange for shouldering this risk, that second-lien lender earns a higher interest rate from the borrower. . . . Hedge funds have also grown prominent in corporate bankruptcies, where they can make a cheap bet on a company's recovery by buying its debt.

Id.

134. Roane, *supra* note 86, at 38.

135. See STAFF REPORT, *supra* note 24, at 33–34. By taking short positions hedge funds sell a security loaned to it and then have to buy it back later to cover that loan. The short seller, hopes for a depreciation in market value so it can buy the security back at a lower price, pocketing the difference. Short Sales, <http://www.sec.gov/answers/shortsale.htm> (last visited Nov. 26, 2006).

A short sale is generally the sale of a stock you do not own. Investors who sell short believe the price of the stock will fall. If the price drops, you can buy the stock at the lower price and make a profit. If the price of the stock rises and you buy it back later at the higher price, you will incur a loss.

Id.

136. Adam Shell, *\$363M Is Average Pay for Top Hedge Fund Managers*, USA TODAY, May 26, 2006, at 1B.

137. See WORKING GROUP REPORT, *supra* note 23, at A-1.

138. See Heather Timmons, *New York Isn't the World's Undisputed Financial Capital*, N.Y. TIMES, Oct. 27, 2006, at C1; Stephen Schurr, *Hedge Funds: London Wins Prize for Nurturing Fast-rising Star*, FIN. TIMES, Mar. 26, 2006.

markets than the U.S., both economies (and others, like Singapore and Australia) compete for economic freedom; Hong Kong and Singapore are considered more economically free by the Index of Economic Freedom and the U.K. ranks number six, behind the U.S. at number four.¹³⁹ Further, Hong Kong, U.K., Ireland, Luxembourg, Estonia, The Netherlands, Belgium and Germany are all considered more free specifically in terms of “investment freedom” than the U.S.¹⁴⁰ The Index of Economic Freedom is a publication by the Heritage Foundation and the *Wall Street Journal* that ranks countries’ economic freedom using several criteria, including the amount of governmental regulation.¹⁴¹ The report notes in its methodology that “[h]eavy bank regulation reduces opportunities and restricts economic freedom.”¹⁴² Already lagging in its ability to foster investment freedom, increased hedge fund regulation in the U.S. could create a less desirable environment in which to foster hedge fund growth, driving hedge funds abroad. Illustrative of this effect is a recent SEC decision to deregulate certain Sarbanes-Oxley requirements by loosening auditing requirements and making foreign companies’ withdrawals from American markets easier.¹⁴³ The SEC deregulated for fear that its regulatory reach would hamper investment in the U.S.¹⁴⁴ Similarly, overregulation of hedge funds could negatively impact the desirability of the U.S. market.

The SEC has claimed regulation would have minimal effects on hedge funds,¹⁴⁵ but because its attempt to work around the existing bars to hedge fund registration was invalidated,¹⁴⁶ the next step is likely legislation. Congress could take the opportunity, for simplicity’s sake, to revamp existing laws to include hedge funds within the same realm of mutual fund regulation. Increased regulatory oversight would likely be a result of further legislative action, which would negatively affect the hedge fund industry and could result in instability in financial markets.

V. PROPOSALS TO LIMIT HEDGE FUND RISK

1. PREVENT EXCESSIVE LEVERAGE THROUGH HEDGE FUND COUNTERPARTIES

One problem that seems to be common among the financial risks associated with hedge funds is excess leverage. An un-leveraged hedge

139. TIM KANE ET AL., THE 2007 INDEX OF ECONOMIC FREEDOM 9 (2007), available at <http://www.heritage.org/research/features/index/downloads/Index2007.pdf>.

140. *Id.*

141. *Id.* at 40–50.

142. *Id.* at 47.

143. Stephen Labaton, *S.E.C. Eases Regulations On Business*, N.Y. TIMES, Dec. 14, 2006, at C1.

144. *Id.*

145. Hedge Fund Rule, *supra* note 11, at 72,054.

146. *Goldstein v. S.E.C.*, 451 F.3d 873 (D.C. Cir. 2006).

fund poses a risk only to investors, who can lose their invested capital. An un-leveraged hedge fund may not be practical for many funds, though, because leveraging can be an effective way to capitalize on interest-rate arbitrage. However, the more a fund is leveraged, the more volatile the risk becomes.¹⁴⁷ Excessive leverage is a problem not only to hedge fund investors, but to banks as well, since the banks risk losing the credit they have extended if a hedge fund cannot pay.

In response to the LTCM collapse in 1999, Patrick Parkinson, Associate Director of Division of Research and Statistics at the Federal Reserve testified before Congress that the

primary responsibility for addressing the weaknesses in risk management practices that were evident in the LTCM episode rests with the private financial institutions—a relatively small number of U.S. and foreign banks and broker-dealers, most of which were LTCM’s counterparties. . . . [P]rudential supervisors and regulators have a responsibility to help to ensure that the processes that banks and securities firms utilize to manage risk are commensurate with the size and complexity of their portfolios and responsive to changes in financial market conditions.¹⁴⁸

Similarly, a joint report by the Department of the Treasury, The Board of Governors of the Federal Reserve, the SEC and the Commodities Futures Trading Commission indicated that the most effective way to contain excess leverage was not by regulating hedge funds, but through the discipline of hedge fund counterparties, such as the banks who lend hedge funds capital with which to invest.¹⁴⁹ Significantly, the report goes on to note that while these disciplinary controls will not always be effective (for example in the case of LTCM), “the failures and losses that have occurred have been small relative to the benefits of a market economy.”¹⁵⁰

147. For example, hedge fund A is leveraged five times, \$100 million in invested capital and \$400 million borrowed at 5% annualized interest. Hedge fund B is leveraged twenty-five times, \$100 million in invested capital and \$2.4 billion borrowed at 5% interest. At the end of one year, hedge fund A will owe its creditor \$420 million. On a \$500 million investment, hedge fund A would have to lose over 16% in one year to default on the loans. (A 16% loss on \$500 million brings the value to \$420 million, the amount borrowed owed to the creditor. This scenario assumes that all of the investors would lose every penny. While this outcome is undesirable, it only directly affects the individual investors, so for the purposes of this example will be considered irrelevant.) On the other hand, hedge fund B has less cushion for failure. At the end of the year, hedge fund B will owe its creditor \$2.52 billion. On an investment of \$2.5 billion, hedge fund B has to earn at least 0.8% on the portfolio just to service the debt, assuming that all investors are completely wiped out. To service the debt and to allow the investors to break even on their investments, the fund would have to return 4.8% of its portfolio value.

148. *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management: Hearing Before the H. Comm. on Banking and Financial Services*, 106th Cong. (1999) (testimony of Patrick M. Parkinson, Associate Director, Division of Research and Statistics), available at <http://www.federalreserve.gov/BoardDocs/testimony/1999/19990506.htm>.

149. WORKING GROUP REPORT, *supra* note 23, at 34. Counterparties are banks and other entities with which hedge funds trade and borrow. *Id.* at 6.

150. *Id.* at 26.

Kurt Schacht, Managing Director of Chartered Financial Analyst Institute noted that “greater disclosure by regulated counterparty entities . . . will reveal any serious imbalances in a market” and that U.K. authorities are also looking at ways to prevent systemic risk by more closely regulating the counterparties who they already regulate.¹⁵¹ Of the parties who contribute to excessive leverage, banks and other counterparties, which are already regulated, seem to be the most efficient party to monitor.

2. INCREASE REQUIREMENTS FOR HEDGE FUND INVESTORS

A possible alternative to further regulation under the federal securities laws is to update the requirement one must meet to be an accredited investor. Currently accredited investors include those that earn over \$200,000 a year or have over \$1 million in net worth.¹⁵² These numbers were formulated over twenty years ago and are outdated.¹⁵³ The number of people meeting this threshold has increased significantly because of inflation.¹⁵⁴ Thus, those eligible to invest in hedge funds are more in number and less wealthy than those of twenty years ago in real terms. Hedge funds can be successful in an unregulated market when their investors are sophisticated enough to be an effective counterpart to the hedge fund manager. Sophisticated investors require less assistance from the SEC to protect their investments. Further, wealthy investors may be more willing to risk their investment for non-market-correlative returns. This allows for more complex or cutting-edge investments, which, as noted above, adds liquidity to the market.

The definition of an accredited investor should be raised, at least to reflect inflation over the last twenty years. This will limit the number of people who are able to invest in an unregulated hedge fund market and will also keep the hedge fund industry nimble and efficient.

VI. CONCLUSION

Hedge funds have become omnipresent across equity and bond markets, have become active in less-traditional derivative and arbitrage strategies, and have invested in retail, automotive and even the entertainment

151. *The Role of Hedge Funds in Our Capital Markets: Hearing Before the S. Subcomm. on Securities and Investment*, 109th Cong. (2006) (statement of Kurt Schacht, Executive Director, CFA Center for Financial Market Integrity).

152. See *supra* note 97.

153. *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing Before the H. Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises*, 108th Cong. (2003) (statement of The Hon. William H. Donaldson, Chairman, U.S. Securities and Exchange Commission) (“The monetary amounts used to determine accredited investor status essentially have remained the same since 1982.”).

154. *Id.* (“[M]ore investors meet this standard, despite recent economic downturns.”).

industry.¹⁵⁵ Hedge funds have enjoyed incredible growth, especially at the end of the twentieth century and the beginning of the twenty-first.¹⁵⁶ With well over \$1 trillion floating through the industry, the odds of financial risk would seem naturally to increase. Indeed, hedge funds have shown some potential to harm the economy and individual investors, but whether there is an appropriate way to stem these risks has not been proven.

Most hedge funds have avoided regulation under the federal securities laws. As the hedge fund industry has grown in size and in potential risk to the economy, the SEC has become increasingly concerned that it should act to prevent serious harm. It promulgated its hedge fund rule designed to bring hedge funds under its regulatory reach even though it seemed clear that the authorizing statute did not authorize it to take this measure.

The U.S. Court of Appeals invalidated the SEC's faulty hedge fund rule.¹⁵⁷ With no further action since, a likely next step is legislation, should Congress decide hedge fund regulation is necessary. There are two problems that further legislation which implements hedge fund regulation could pose. One, this legislation could over-regulate and hinder hedge funds' growth and effectiveness. Over-regulation would be detrimental to the economy because it would deprive the economy of the benefits hedge funds have provided through their aggressive and innovative trading strategies. Two, the legislation could be interminably time-consuming and expensive, yet still prove to be ineffective.

Hedge fund investors are limited to those who are presumed to be sophisticated investors. Sophisticated investors are more able to protect their investments from errant hedge fund managers and also have the power to control managers through the threat of redemptions of large amounts of capital from the fund. Further, hedge funds are already subject to anti-fraud regulations. Enforcement against hedge funds has proved workable in the current self-regulated environment.

The benefits of increased regulation are dubious and over-regulation could hinder hedge funds' ability to add value to the economy. The costs associated with implementation and execution of an unknown regulatory environment is not justified.

Excessive hedge fund leverage can magnify losses to extreme levels. The counterparty banks that lend hedge funds money should be restrained from making excessive and potentially dangerous loans. Further, hedge funds have operated in a mostly unregulated market because they have only

155. For example, unnamed hedge funds apparently negotiated recently with actor Tom Cruise and his business partner Paula Wagner, to invest upwards of \$100 million after the outspoken Scientologist actor was fired from Viacom's movie studio, Paramount Pictures. Merissa Marr & Kate Kelly, *For Hedge Funds, Backing Cruise Could Prove to Be a Risky Business*, WALL ST. J., Aug. 24, 2006, at A1.

156. See *supra* Part I.

157. *Goldstein v. S.E.C.*, 451 F.3d 873, 873 (D.C. Cir. 2006).

accepted institutional and wealthy investors. This ensures that the investors are sophisticated enough to handle an unregulated investment, and also that hedge fund investors will have enough influence to effectively monitor hedge fund managers. Hopefully, this will prevent malfeasance. The financial requirements of investors eligible to invest in hedge funds should thus be strengthened to reflect inflation over the last twenty years.

Since the current hedge fund regulatory scheme has worked successfully and has benefited the economy, it should be untouched. Private hedge funds should be able to interact with their private investors without regulatory interference. To encourage innovation and effectiveness, the hedge fund industry should not currently be regulated by the SEC.

*Carl J. Nelson**

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