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Too Much of a Good Thing: How Much Should Hedge Funds Be Required to Disclose?

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TOO MUCH OF A GOOD THING: HOW MUCH SHOULD HEDGE FUNDS BE REQUIRED TO DISCLOSE?

DANIEL ETLINGER*

I. Introduction 81
II. Construction and Application of 13(f) 84
  A. Legislative History of Rule 13(f) 84
  B. Construction of Rule 13(f) 86
III. The Hedge Fund Industry 91
  A. Definition 91
  B. Performance 94
  C. Structure 95
  D. Fees, Strategies and Leverage 98
IV. Trade Secret Argument 100
  A. First Prong – Possessing a Trade Secret 101
  B. Second Prong – Improper Appropriation of the Trade Secret 104
V. Analysis under a Regulatory Takings Argument 105
VI. Related Disclosure Proposals 109
VII. Conclusion 120

I. INTRODUCTION

Hedge funds are currently all the rage. Over the last seven years the hedge fund industry has averaged close to an eleven percent annual yield,[1] as compared to the Standard & Poor's (S & P) 3.30%.[2] 2007 was particularly impressive with the hedge fund industry yielding slightly over double the S & P's return.[3] Even in the current economic crisis hedge funds continue to outperform the S & P.[4] These large returns led Linda Thomsen, the Securities and Exchange Commission's

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[1] Patrick Hosking, *Hedge Fund Returns are 'Vastly Overstated'*, TIMES ONLINE, Feb. 26, 2006, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article735784.ece.

[2] *S&P 500,* STANDARD & POOR'S, Dec. 31, 2007, http://www2.standardandpoors.com/spf/pdf/index/SP_500_Factsheet.pdf.

[3] Svea Herbst-Bayliss, *Prominent Hedge Funds Nurse Heavy Losses in 2008,* REUTERS, Jan. 23, 2008, http://www.reuters.com/article/fundsFundsNews/idUSN23863620080123.

[4] Gregory Zuckerman & Jenny Strasburg, *For Many Hedge Funds, No Escape,* WALL ST. J., Jan. 2, 2009, at R7 (stating that through November 2008 hedge funds had lost 18% on average, whereas the S & P had lost nearly 38%). *See also* Jenny Strasburg, Gregory Zuckerman & Cassell Bryan-Low, *More Hedge Funds Expected to Succumb,* WALL ST. J., Nov. 22-23, 2008, at B2 (predicting hedge fund assets to fall by as much as 50% from their peak).

(SEC) Director of the Division of Enforcement, to comment that "[t]hese days, the money is in hedge funds, so the potential for abuse, the potential for securities law violations is there because there is so much money there."[5]

There is indeed a lot of money in hedge funds, with over $2 trillion in assets,[6] spread out over an estimated 10,000 hedge funds worldwide.[7] Due to relatively low entry costs, aggressive strategies, leveraging and fierce competition hedge funds are continually being created and disassembled, causing a fluid number in the market.[8] In fact, Credit Suisse predicts that as many as 30% of hedge funds will have to close due to the economy.[9] Although hardly new,[10] there is still no statutory definition for a hedge fund.[11] A common description is "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[12]

The controversies surrounding hedge funds have shaken public confidence and led to calls for increased regulation.[13] These proposals, ranging from more informative online brochures,[14] to hedge funds having to adopt Section 2(a)(41) of the Investment Company Act of 1940 (Investment Act) (affecting how hedge funds would value securities),[15] have not gone unopposed. According to Philip Goldstein, a co-founder of Bulldog Investors (Bulldog – although there are several funds under Goldstein, they will collectively be referred to as Bulldog), "[r]egulatory agencies all the time are doing things that are beyond their authority. In this country, that's a very scary thing, because they are not really accountable.

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[5] *Hedge Funds and Wall St. Are Warned to Be Vigilant on Misdeeds,* N.Y. TIMES, Nov. 14, 2006, *available at* http://www.nytimes.com/2006/11/14/business/14hedge.html.

[6] REPORT OF THE INVESTORS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, PRINCIPALS AND BEST PRACTICES FOR HEDGE FUND INVESTORS, 1 (Apr. 15, 2008), *available at* http://www.treasury.gov/press/releases/reports/investors'committeereportapril152008.pdf [hereinafter *Principals*].

[7] Houman Shadab, *The Challenge of Hedge Fund Regulation,* REGULATION, Spring 2007, at 38.

[8] SEC, STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, 63 n.218 (1999), http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter *Implications*] ("The President's Working Group on Financial Markets report estimated that, based on a sample of 397 hedge funds from 1994 to 1998, the survival rate was less than 60 percent."). *See also* Anthony Hanlon, Proposals for Reform of Hedge Fund Regulation, 11 (Apr. 24, 2002) (unpublished LL.M. written work requirement submission, Harvard Law School), *available at* http://www.law.harvard.edu/programs/pifs/pdfs/tony_hanlon.pdf (highlighting the median age of hedge funds in 2002 was only 5.3 years).

[9] Gregory Zuckerman & Cassell Bryan-Low, *More Pressure on Hedge Funds,* WALL ST. J., Oct. 17, 2008 at C3.

[10] REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT, 1 (Apr. 1999), http://www.ustreas.gov/press/releases/reports/hedgefund.pdf [hereinafter *Hedge Funds*] (identifying the first hedge fund as being created in 1949).

[11] *Id.*

[12] *Id.*

[13] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, 72056 n.27 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279) [hereinafter *Registration*] ("In a recent study, over fifty percent of respondents identified hedge funds as 'most likely to be at the center of an investment controversy' in the next five years.").

[14] Judith Burns, *SEC Dusts Off Online Plan For Brochures of Advisers,* WALL ST. J., Feb. 6, 2008, at A14.

[15] *Implications*, *supra* note 8, at 99.

You've got to sue them!"[16]

There have been two discrete rounds in the attempt to increase regulation of hedge funds that Goldstein has challenged. The first involves Rule 203(b)(3)-2 of the Investment Advisers Act of 1940 (Advisers Act), which provides hedge funds an exemption from registration if they have less than fifteen clients.[17] In February of 2006, the SEC modified the definition of client from an entire fund counting as one client to a 'look-through' attitude that counts each investor in the fund separately.[18] This change would require many hedge funds that were previously exempt to register with the SEC through the Advisers Act.[19]

After several comment letters on the subject, Goldstein finally took the SEC to court.[20] The SEC argued that the term "client" is not defined by the Advisers Act and thus is ambiguous. Accordingly, the SEC maintained that they could reasonably interpret the provision as applying to hedge funds.[21] The United States Court of Appeals for the District of Columbia agreed with Goldstein that the new definition runs counterintuitive to other sections of the Advisers Act and vacated the rule.[22] The SEC subsequently announced that it would not challenge the decision; the hedge funds essentially earned a temporary truce.[23]

That truce did not even last a year. Since 1975, Congress introduced legislation requiring investment managers with at least $100,000,000 to file reports, under Rule 13(f) of the Securities Exchange Act of 1934 (Exchange Act), that disclose certain security positions and their value.[24] In 2006, two of Goldstein's funds crossed this threshold and Goldstein filed a request for exemption from 13(f).[25] When that request was denied, Goldstein filed suit claiming Bulldog will be monetarily hurt by 13(f) since the public could duplicate his positions.[26] Essentially, Goldstein's suit advances two arguments. First, these reports would disclose trading strategies, and thus harm proprietary interests in the

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[16] Jonathan Shazar, *Philip Goldstein: The Man Behind Bulldog,* FINALTERNATIVES, Oct. 5, 2007, http://www.finalternatives.com/node/2595/.

[17] Dale Oesterle, *Regulating Hedge Funds,* 1 ENTREPREN. BUS. L.J. 1, 8-9 (2006).

[18] *Id.*

[19] *Id.*

[20] *See* Letter from Philip Goldstein, President, Bulldog Investors, to Jonathan Katz, Secretary, Securities and Exchange Commission (Sept. 25, 2004).

[21] Goldstein v. SEC, 451 F.3d 873, 878-84 (D.C. Cir. 2006) (relying on Chevron v. NRDC, Inc., 467 U.S. 837 (1984)).

[22] *Id.* (arguing the SEC's definition ran counterintuitive to other provisions of the Advisers Act, the definition could result in conflicts of interest and the SEC was advocating changing the definition in some instances but using the old definition in others).

[23] Christopher Cox, 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://www.sec.gov/news/press/2006-2006-135.htm.

[24] Securities Exchange Act of 1934, 15 U.S.C.S. § 78a.

[25] Karyn McCormack, *Do Hedge Funds Hold 'Trade Secrets'?,* BUSINESSWEEK, Sept. 12, 2006, http://www.businessweek.com/investor/content/sep2006/pi20060913_356291.htm; *see also* Telis Demos, *The Man Who Beat the SEC,* FORTUNE, Jun. 18, 2008, http://money.cnn.com/2008/06/06/magazines/fortune/ Man_who_beat_SEC_Demos.fortune/index.htm (reporting that Bulldog now has over $500 million in assets and has yielded a 15% return over its lifetime).

[26] Dane Hamilton, *Hedge Funds Take on SEC Over Disclosure Requirements,* CNBC, May 17, 2007, http://www.cnbc.com/id/18722751.

way that Coca-Cola's Coke formula is a protectable asset.[27] Second, the reports would disclose "unique intellectual property," and thus violate the Fifth Amendment's prohibition against taking private property without just compensation.[28]

This Article critically evaluates these arguments before ultimately concluding that 13Fs are critical to monitoring the security markets and informing investors. Part I reviews the construction and application of 13(f). This part will first discuss the legislative history and intent behind Rule 13(f) before discussing how Congress, courts and the SEC have constructed 13(f). Part II then provides a general overview of hedge funds and their peculiar position within the existing regulatory framework. Part III explores a trade secret argument to 13(f). Part IV examines a takings claim against application of 13(f). And finally, Part V looks at related disclosure proposals. Most proposals are not feasible in their current form due to costs or undue burdens on the hedge fund industry. However, two proposals that make a strong case are creating a private market intermediary and changing the requirements for accredited natural persons.

II. CONSTRUCTION AND APPLICATION OF 13(f)

A. Legislative History of Rule 13(f)

The Securities Act of 1933 (Securities Act) and the Exchange Act were enacted to regulate the securities markets through disclosure.[29] The Securities Act has two principal goals: 1) to protect investors through disclosure and 2) to outlaw fraud in the sale of securities.[30] The Exchange Act explicitly seeks to promote efficiency in the markets and to protect interstate commerce, national credit, federal taxing power and the banking system.[31] Taken together, these two acts add to the age-old adage of caveat emptor by "put[ting] the burden of telling the whole truth on the seller."[32]

In the 1960s, Congress became concerned about the growing influence of financial institutions on markets and considered amending the two acts.[33] In 1968, Congress commissioned the SEC to study the markets and the new trends.[34] Over the next three years the SEC utilized interviews, questionnaires, surveys and

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[27] *Id.*; *see also* Edward Pekarek, *Hogging the Hedge? "Bulldog's" 13F Theory May Not Be So Lucky,* 12 FORDHAM J. CORP. & FIN. L. 1079, 1138 n.224 (2007) ("If you are arguing is it could be worse because you could have to publish every trade, I agree, but that's like saying that Coca-Cola doesn't have to publish its entire formula, but just maybe like thirty percent of all the ingredients, and that is not so bad.") (quoting Philip Goldstein, President, Bulldog Investors, Morning Call: Hedge Funds Spill the Beans, CNBC (Dec. 12, 2006)).

[28] Hamilton, *supra* note 26.

[29] Securities Act of 1933, 15 U.S.C.A. §§ 77a, 78a.

[30] Edward N. Gadsby, *Historical Development of the S.E.C.-The Government View*, 28 GEO. WASH. L. REV. 6, 9 (1959).

[31] *Id.*

[32] H.R. REP. NO. 73-95, at 2 (1933) (quoting President Franklin D. Roosevelt).

[33] Thomas Lemke & Gerald Lins, *Disclosure of Equity Holdings by Institutional Investment Managers: An Analysis of Section 13(f) of the Securities Exchange Act of 1934*, 43 BUS. LAW. 93, 98 (1987).

[34] *Id.*

market portfolios to analyze various aspects of managers.[35] The SEC looked at the number of managers, their size, growth, value of assets, fees and other relevant information.[36]

In 1971, the SEC released their findings in its Institutional Study.[37] Among the findings, the Institutional Study showed that managers had shifted their portfolios to give a higher weight to equities.[38] In terms of negative or volatile swings in the market place, the Institutional Study found that "institutional trading overall has not impaired price stability in the markets."[39] However, the study did conclude there was a need for increased disclosure requirements.[40] In particular, the Institutional Study noted:

> The past and likely future growth of institutional investors in the equity markets makes the collection of timely information about institutional holdings and activity in securities essential for an agency responsible for the administration of the federal securities laws . . .
>
> The importance of a regularized, uniform, and comprehensive scheme of institutional reporting cannot be minimized in light of the demonstrated growth of institutional investment and its impact on the structure of the securities markets, corporate issuers and individual investors.[41]

Ultimately, based on their findings, the SEC formally recommended the Exchange Act be amended to include greater disclosure requirements.[42] Several proposals were drafted and introduced until in 1975 Congress settled on one and amended the Exchange Act to include Rule 13.[43]

Specifically, Rule 13(f) requires all investment managers (which can include hedge funds, banks, pension funds, non-profits and others) who hold certain types of publicly traded securities worth at least $100,000,000 to file a 13F report four times a year.[44] Individuals are exempt from this reporting due to privacy considerations.[45] In addition, the manager must utilize investment discretion over the accounts since the purpose is to record information on the activities and movements of the managers.[46]

For each security listed, the report must include the title, class, CUSIP number (an identification number that facilitates the trading and clearing of

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[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] Lemke, *supra* note 33, at 99.

[39] *Id.* (quoting Institutional Investor Study Report, H.R. Doc. No. 92-64, at XXI (1971)) [hereinafter *Study Report*].

[40] *Id.*

[41] *Id.* (quoting *Study Report*, *supra* note 39, at X).

[42] *Id.*

[43] Lemke, *supra* note 33, at 99-100

[44] Securities and Exchange Commission Rule 13(f), 17 C.F.R. rule 13f-1 (referring to 13(f) as the Exchange Act rule, 13F denotes the actual form itself).

[45] *Id.*

[46] *Id.*

securities), number of shares and aggregate fair market value.[47] Fair market value indicates the value on the last trading day rounded to the nearest one thousand dollar.[48] Transactions of $500,000 or more require additional disclosures that include the nature of the transaction, per share price, dates of the transaction, dates of the settlement, the broker and the market(s) in which the transaction was effected.[49]

The main purpose of 13(f) is to gather and disseminate data about investment managers. Congress specifically intended 13(f) to be a means for promptly providing this information to the public.[50] A Senate report recommended 13(f) be used to promote informed investors, increase regulatory accountability and create an informational database for use in future reforms,[51] all of which in turn would generate greater market confidence, induce future investors and facilitate tracking of data.[52] The database also would allow a greater understanding of the security markets as well as their potential impact on banks, other markets and investors.[53]

Notably, the Exchange Act does not contain language forcing firms to disclose information about their future positions. Traditionally, the SEC has taken a conservative view on this issue due to the inherit speculative nature and potential to (unintentionally) mislead investors.[54] According to the United States Court of Appeals for the Third Circuit, "[o]rdinarily, the SEC and the courts discourage presentations of future earnings, appraised asset valuations and often hypothetical data in proxy materials."[55] Although the SEC has since relaxed their future disclosure rules somewhat they have never amended Rule 13(f) to require future disclosures.[56]

B. Construction of Rule 13(f)

The first source of guidance in the construction process is Congressional Reports. The 1968 Senate report (conducting the research which lead to the promotion of Rule 13(f)) praised Rule 13(f) as capable of informing investors, increasing regulatory accountability and creating an informational database that could be used in the debate for future reforms.[57] Acknowledging there might be some initial discomfort the report mentions:

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[47] *Id.*

[48] Lemke, *supra* note 33, at 110.

[49] 17 C.F.R. rule 13f-1.

[50] Confidential Treatment Filer, SEC No-Action Letter, 1998 SEC No-Act. LEXIS 643 (June 17, 1998) [hereinafter *Confidential Treatment Filer*].

[51] S. REP. NO. 94-75, at 78 (1975), *as reprinted in* 1975 U.S.C.C.A.N. 179, 256.

[52] *Id.*

[53] *Id.*; *see also Implications*, *supra* note 8, at 94 n.308.

[54] Kenneth Scott Fife, Comment, *Mandatory Disclosures of Soft Information in the Market for Corporate Control,* 35 EMORY L.J. 213, 215 (1986) (delineating general disclosure rules).

[55] *Id.* (quoting Kohn v. Am. Metal Climax, Inc., 458 F.2d 255, 265 (3d Cir. 1972), *overruled in part by* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976)).

[56] *Id.* at 217-18 (allowing forward-looking statements in certain scenarios as long as the statement "was (1) prepared with a reasonable basis and (2) disclosed in good faith.").

[57] S. REP. NO. 94-75, at 77-78 (1975), *as reprinted in* 1975 U.S.C.C.A.N. 179, 256.

> [w]hile expanding the reporting burden for certain institutional investment managers may result in some initial expense to some investment managers, it is nevertheless clear that it is now appropriate to begin to accumulate such a body of data to permit reasoned discussion and decision about the influence and impact of the large institutional investment managers on the securities markets.[58]

Furthermore, the report mentions that hampering a firm's competitive edge is not a reason behind enacting the amendment.[59] The report actually acknowledges "that generally it is in the public interest to grant confidential treatment to an ongoing investment strategy of an investment manager. Disclosure of such strategy would impede competition and could cause increased volatility in the market place."[60]

One month later a House Conference Report addressed the same issues.[61] A central message to the report is that "[t]he securities markets of the United States are indispensable to the growth and health of this country's and the world's economy."[62] The report continued, stating that to remain competitive the American markets must remain efficient and operate fairly.[63] Should the markets falter along these lines American markets will lose grounds to international financial centers (including growing international hedge fund centers include in Hong Kong, Singapore, UK and Germany).[64] To help assure the efficiency of these markets the House supported Rule 13(f).[65]

In 1983 a Report of the Staff of the SEC noted that "[a]lthough the Commission does not plan to make extensive use of information that could be gathered under Rule 13(f) *at the present time*, we do believe that disclosure of holdings of institutional managers is in the public interest for the reasons set forth in the Senate Report."[66] This suggests that in 1983 the SEC was still figuring out what exactly 13Fs can demonstrate and how best to utilize them.[67] More recently, in 1998, a Commission Notice acknowledged that "Congress also recognized that, in some instances, disclosure of certain types of information could have harmful effects, not only on an investment manager, but also on the investors whose assets are under its management."[68] This implies Congress' recognition that 13Fs at least have the potential to negatively impact the value of these portfolios.[69]

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[58] *Id.* at 85.

[59] *Id.* at 87.

[60] *Id*.

[61] H.R. REP. NO. 94-229, at 90-91 (1975), *as reprinted in* 1975 U.S.C.C.A.N. 321, 322.

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] Full Value Advisors, Application for Exemption from Rule 13f-1, File No. ------- , 14(Oct. 24, 2006) [hereinafter *Exemption*] (quoting Report of the Staff of the Securities and Exchange Commission on the Operation of Section 13(f) of the Securities Exchange Act of 1934 at 17 (Nov. 29, 1983)) (emphasis added).

[67] *Id.*

[68] *Id.* at 19 n. 14 (quoting Commission Notice: Re: Section 13(f) Confidential Treatment Requests (June 17, 1998)).

[69] *Id.*

The second sources to examine are cases. To prove a party is violating the Exchange Act, willfully or otherwise, it is not necessary to prove they had knowledge they were in fact violating it.[70] Section 21(b) of the Exchange Act allows the SEC to issue cease and desist orders to an institution in violation of any of the Exchange Act's rules.[71] This also enables the SEC to require a firm come into compliance in the future and to correspond with the SEC on their efforts.[72] Fraudulent claims also fall under Rule 10(b)-5 of the Exchange Act stating that no "manipulative or deceptive device[s]" in connection with securities may be used, otherwise the SEC has the right to act to protect the public interest.[73] Remedies available allow the SEC to investigate and to publish wrongdoings, judicial enforcement, sanctions, suspensions, and requiring compliance in the future.[74]

For managers that comply with the Advisers Act there are further provisions to examine.[75] Section 80b-3 gives the SEC authority to censure a firm, to limit a manager's activities and to suspend or revoke registration for certain violations.[76] The first of these violations is filing any false report with the SEC; including 13Fs.[77] The Act expands this idea to say that the SEC can bring an action for any act by a manager to defraud a client.[78] Section 80b-3e5 is even broader still, stating that the SEC can bring action for a violation of any provision of the Exchange Act.[79]

The SEC only has a budget of $888 million (.035% of the United States' total budget) and approximately 3,000 employees.[80] In 2006, the SEC lost 155 employees and their total cases dropped 9%.[81] Despite these obstacles, since Rule 13(f)'s enactment the SEC has exhibited an increased willingness to take formal actions.[82] These actions fall into three distinct categories. The first is a failure to report 13F forms altogether.[83] The second is filing 13F reports past when they are due (which has happened only once).[84] The third is filing fraudulent 13F forms.[85]

In *SEC v. Mogy*, a Rule 13(f) issuer failed to file its required report for a significant amount of time.[86] The court determined that the issuer had met all of

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[70] Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965).

[71] Securities Exchange Act of 1934, 15 U.S.C.S. § 21(b).

[72] *Id.*

[73] Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5.

[74] 15 U.S.C.S. § 78u.

[75] Investment Advisers Act of 1940, 15 U.S.C.S. § 80b-1.

[76] 15 U.S.C.S. § 80b-3e.

[77] 15 U.S.C.S. § 80b-3e1.

[78] 15 U.S.C.S. § 80b-3e6.

[79] 15 U.S.C.S. § 80b-3e5.

[80] Carl J. Nelson, Note, *Hedge Fund Regulation: A Proposal to Maintain Hedge Funds' Effectiveness Without SEC Regulation,* 2 BROOK. J. CORP., FIN. & COM. L. 221, 229-30 (2007).

[81] *Id.* at 230.

[82] S. REP. NO. 94-75, at 70-71(1975), *as reprinted in* 1975 U.S.C.C.A.N. 179, 248-49.

[83] 17 C.F.R. rule 13f-1. .

[84] *Id.*, *see e.g.,* Paramount Capital Group, Inc., Exchange Act Release No. 89,121 (June 27, 1989), *available at* http://sec.gov/news/digest/1989/dig062789.pdf (failing to file a timely 13F report caused Paramount to revise and then present policy modifications to prevent this from occurring again).

[85] *Id.*

[86] Joel R. Mogey Inv. Counsel, Inc., Exchange Act Release No. 44,268, 74 SEC Docket 2007 (May

the requirements but failed to file a report for six years and therefore imposed a civil penalty of $25,000, as well as an order to file 13F reports.[87] Similarly, in 2007, Quattro Global Capital, LLC was forced to comply with Rule 13(f) and pay substantial civil penalties of $100,000.[88] The increase in penalty was due to Quattro's inclusion of 13F forms in its compliance manual, reminders by outside auditors and prompting by the SEC during the period in which they failed to report.[89]

In *Cabot Money Management, Inc.*, a Cabot director repeatedly praised one stock (Presstek) as "the best stock we have ever uncovered in our lifetime of searching for super-growth stocks" in their investment advisory letters.[90] During this period Cabot met all of the Rule 13(f) requirements, but failed to file a 13F twice.[91] Also during this period Presstek's stock swung between $200 and $60.[92] Since Cabot failed to file 13Fs, and due to the severity in the swings of Presstek's stock, the court ordered Cabot to file 13Fs in the future and to pay a penalty of $12,500.[93]

There has been one case for filing false information in a 13F report.[94] *SEC v. Sacane* is a civil action in which a private plaintiff sued Durus Capital Management, LLC, for alleged damages sustained from material omissions and misrepresentations within its 13F.[95] The action was cogently based on a fraud-on-the-market theory,[96] but ultimately was dismissed for failure to plead a proper complaint.[97] After the case, United States Attorney Kevin O'Connor stated in a press release:

> "It is our hope that this prosecution will send a message to hedge fund operators that the federal government is watching . . . [T]he failure to obey securities laws, especially by making false statements in SEC filings on which investors rely, is a serious crime. Violators will be vigorously prosecuted."[98]

These cases indicate the SEC's willingness to monitor and to enforce

7, 2001).

[87] *Id.*

[88] Quattro Global Capital, LLC, Exchange Act Release No. 37,573, 62 SEC Docket 994 (Aug. 15, 1996).

[89] *Id.*

[90] Cabot Money Mgmt., Inc., Exchange Act Release No. 37,573, 62 SEC Docket 1562 (Aug. 15, 1996).

[91] *Id.*

[92] *Id.*

[93] *Id.*

[94] Sacane, Civil Action No. 2:05cv1575-SRU (2005).

[95] *Id.* at 23 (filing that Durus owned 5,283,248 shares of Aksys stock, when in fact they owned over 10,000,000 shares resulting in the deflation of Aksys' stock).

[96] *Id.* at 39 (stating that misrepresentations affect the price of securities on an open market and that investors rely on the price to make their decisions, established by Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

[97] *Id.* at 58-60.

[98] *Hedge Fund Officer Who Assisted in the Filing of False SEC Statements is Sentenced,* United States Attorney's Office District of Connecticut, Mar. 6, 2006, *available at* http://www.usdoj.gov/usao/ct/Press2006/20060306.html.

compliance with Rule 13(f). However, since its inception there have been only five cases to reach this stage, a relatively small amount compared to the SEC's overall caseload of defrauding clients.[99] There were three cases for failure to file, one for filing late and one for a fraudulent filing. This suggests that to a large extent firms are willing to comply with Rule 13(f)'s requirements.

The third, and last, source that is of help is SEC Opinion Letters and Releases. The SEC has also spent considerable time clarifying Rule 13(f) issues.[100] One of these issues is how managers can exempt out of Rule 13(f).[101] The SEC has expressed its concerns that "many Form 13F filers have concluded that confidential treatment of information contained on Form 13F will be granted automatically upon a superficial showing of need. Such a conclusion is erroneous."[102] The SEC instead has identified four major categories for confidentiality: 1) information that would identify securities held by a natural person, 2) revealing a strategy, 3) open risk arbitrage positions and 4) block positioning.[103]

These four categories are similar in that they all require a showing of a specific, rather than general, strategy, as well as resulting harm in disclosure. These are just two of the steps the SEC looks for.[104] Typically, exemptions are issued only if a manger demonstrates 1) a justification for the time period sought, 2) a specific investment strategy, 3) the strategy is ongoing, 4) disclosure would reveal the strategy and 5) demonstrable harm from disclosure.[105]

A second issue the SEC has spent time clarifying is issuers now filing 13F forms online via the SEC's Electronic Data Gathering, Analysis and Retrieval system (EDGAR).[106] This change follows the legislative intent to have a rapid dissemination of the information.[107] Consistent with rule changes, the SEC solicited comments from individuals, companies and industry representatives affected by the change.[108] Their names were not released, but six individuals suggested submitting 13F forms more frequently[109] and the industry representative

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[99] *Registration*, *supra* note 13, at 72,056 (during the period from 1999 to 2004 the SEC brought fifty-one cases against hedge fund managers for defrauded investors).

[100] *Division of Investment Management: Frequently Asked Questions about Form 13F,* U.S. Securities and Exchange Commission, May 2005, *available at* http://www.sec.gov/divisions/investments/13ffaq.htm [hereinafter *Frequently Asked Questions*].

[101] *Confidential Treatment Filer*, *supra* note 50, at 1-2.

[102] *Id.*

[103] *Id.*; *see also* Quarterly Filings, INVESTOR VILLAGE (2008), http://www.investorvillage.com/smbd.asp?mb=3532&mn=14262&pt=msg&mid=4055080 (defining open risk arbitrage as a risk arbitrage position that will still exist when 13Fs are released which will effectively close the opportunity); *see also Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO,* U.S. Securities and Exchange Commission, July 2007, Question 4.7, *available at* http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm (defining block positioning as holding a group of stocks together that need to be sold rapidly under certain circumstances).

[104] *Id.* at 3-4.

[105] *Id.*

[106] Rulemaking for EDGAR System, Exchange Act Release No. 40,934, Investment Company Act Release No. 23,640, 68 SEC Docket 2814 (Jan. 12, 1999).

[107] *Id*. at 2.

[108] *Id.*

[109] *Id.* at *5* (stressing one commenter actually suggests filing the form within five days at the end of every month).

stated the current time period remained appropriate.[110] The SEC also encouraged comments addressing whether electronic filing of 13Fs would have an adverse effect upon competition, but did not receive any letters on this point.[111] These letters suggests the industry as a whole accepted the Rule 13(f) requirements.[112]

III. THE HEDGE FUND INDUSTRY

A. Definition

Although hedge funds avoid statutory definition they can be identified by meeting several key features. The first is that they are investment managers not marketed to the general public.[113] Second, investors are limited to high net worth individuals and institutions.[114] Third, hedge funds are not registered as an investment company under the Investment Act or similar regulations.[115] Fourth, a hedge fund's assets are managed by an investment manager whose gains in part rely on the performance of the portfolio.[116] And fifth, there is typically a lock-in period which restricts investor redemption rights.[117]

Breaking down these five points will illuminate the nature of hedge funds further. First, they are not marketed to the general public (largely in part since they are only offered to sophisticated investors).[118] Under the Securities Act Regulation D Rule 506 hedge funds are prohibited from making general solicitations or general advertising.[119] However, an important exemption to the rule allows hedge funds to market themselves to institutional investors, accredited investors or natural persons with a net worth over $1,000,000.[120] They do so primarily by sending out targeted material and by cooperating with financial advisers who make recommendations to sophisticated investors where they should invest. A hedge fund will stress to this segment a high rate of return, steady performance, unique strategies and other strengths they possess to gain their business.[121]

The second premise, only sophisticated investors can invest, is the lynchpin behind hedge funds. In theory, sophisticated investors understand investment risks and therefore are well equipped to deal with the aggressive, less disclosed

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[110] *Id.*

[111] *Rulemaking for EDGAR System*, *supra* note 106, at 6-7.

[112] *Id. at 3, 7.*

[113] *Principals*, *supra* note 6, at 8.

[114] *Id.*

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] *See* Svea Herbst-Bayliss, *Hedge Funds Press for Rights to Advertise,* REUTERS, May 6, 2008, *http://uk.reuters.com/article/ousiv/idUKN0230134620080506* (noting that Phillip Goldstein is contemplating a lawsuit for the right to publicly advertise limited information).

[119] Oesterle, *supra* note 17, at 3.

[120] *Id.* at 3-4 (by targeting this segment of the market a hedge fund can employ any strategy available to a traditional manager).

[121] *Id.* at 3.

strategies hedge funds employ. By limiting themselves to only sophisticated investors this allows hedge funds to exempt out of many regulations, their third premise.

The third characteristic of hedge funds is that they are exempt from many registration requirements.[122] Hedge funds are exempt from many of the reporting obligations of the Securities Act and the Exchange Act.[123] Furthermore, hedge funds are exempt from the registration requirements of the Investment Act and the Advisers Act.[124] Despite this, many hedge funds will voluntarily register with an agency.[125] In 2006, roughly 86% of hedge funds had voluntarily registered with some regulatory agency.[126] Hedge funds voluntarily register for several reasons, including a need to establish legitimacy, to attract capital from certain markets (by giving assurances to investors) and to establish a rapport with regulatory bodies.[127]

The essence of a hedge fund is the same as any investment manager. They monitor markets and trends and make educated predictions on where best to invest money.[128] These investments yield returns with which the hedge funds, in part, make their profits off of.[129] To effectuate their trades hedge funds interact with a number of different partners.[130] Counterparties, including banks and broker-dealers, take the other side of a hedge fund position.[131] Broker-dealers and future broker-dealers help consolidate and clear trades for the hedge fund.[132]

Lastly, since hedge funds can employ long term strategies that require a minimal amount of capital in the pool to work, they employ lock-in strategies.[133] A typical lock-in period is from one to three years,[134] and varies in how severe an investor's redemption rights are (only a few restrict an investor from pulling out any money from the fund, most restrict the amount to a low percentage).[135] Hedge funds often buckle under when their lock-in periods are not sufficient and panic strikes their investors.[136] Some hedge funds are pushing back and installing longer "lock-in" periods.[137] Due to the 2008 credit crunch, along with tighter lending policies and heavy losses from mortgage securities, hedge funds are seeking longer

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[122] *Id.*

[123] *Id.*

[124] Oesterle, *supra* note 17, at 3.

[125] Shadab, *supra* note 7, at 36.

[126] *Id.*

[127] *Implications, supra* note 8, at 22 n.76.

[128] Oesterle, *supra* note 17, at 3.

[129] *Id.*

[130] Shadab, *supra* note 7, at 38.

[131] *Id.*

[132] *Id.*

[133] Dr. Philipp M. Hildebrand, Member of the Governing Board, Swiss National Bank, Developments in the Hedge Fund Industry, Address at the Swiss Finance Conference (Feb. 04, 2005), *available at* http://www.bis.org/review/r050216d.pdf.

[134] *Id.*

[135] *Id.*

[136] *Id.*

[137] Sarfraz Thind, *Bigger Becomes Better as Small Managers Struggle,* E. FINANCIALNEWS, May 26, 2008, http://www.efinancialnews.com/assetmanagement/index/content/2350759402.

lock-ins to stabilize their funds.[138]

To better understand the definition of hedge funds still one might compare them to other pooled investment vehicles, the first of which are registered investment companies. Registered investment companies have a number of similarities to hedge funds that causes investors to mistakenly take them for one.[139] Both engage in holding and investing pools of securities through a professional asset manager, who can follow similar investment strategies and investment vehicles.[140]

However, registered investment companies register under the Investment Act, the Securities Act and the Advisers Act and are subject to their disclosure and reporting requirements.[141] These differences manifest into greater transparency, public solicitation, and eventual acceptance of unsophisticated investors, governing board of directors and other structural changes.[142] Registration also affects the company operationally and can limit their choice of strategies, issues with leveraging and investment vehicles.[143]

A second comparison can be made to private equity funds. Private equity funds, like hedge funds, are a type of unregistered investment strategy.[144] Since they are unregistered they cannot solicit to the general population and generally attract high net worth individuals and institutions.[145] In addition, private equity funds follow the legal formula for incorporation as a limited liability company (LLC) or limited partnership (LP) and utilize the master-feeder structure like hedge funds do.[146]

But, however, private equity funds differ from hedge funds in several material ways. Private equity funds investors agree to invest their capital over the life of the fund at staggered intervals.[147] These intervals are not necessarily predetermined and can be induced by "capital calls" on the part of the fund.[148] Redemption rights also differ. Typically the fund is established with long-term goals and redemption before its contractual conclusion can be difficult.[149]

One last assessment can be made with venture capital funds. Venture capital funds have similar elements to hedge funds that mirror private equity funds' commonalities.[150] Venture capital funds are unregistered, structurally similar, attract similar investors and have mandatory capital contributions over a staggered

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[138] *Id.*
[139] *Implications, supra* note 8, at 5.
[140] *Id.*
[141] *Id.* at 5-6.
[142] *Id.* at 6.
[143] *Id.*
[144] *Implications, supra* note 8, at 7.
[145] *Id.*
[146] *Id.*
[147] *Id.*
[148] *Id.*
[149] *Implications, supra* note 8, at 8.
[150] *Id.*

period.[151] An additional similarity is that they will often have a controlling influence (such as sitting on the board of directors) over the companies they invest in.[152]

In contrast, venture capital funds almost exclusively look to invest in companies who are in their start-up or infant stages.[153] Venture capital funds also seek to liquidate their positions as soon as they make a suitable profit on their investment.[154] Hedge funds, on the other hand, may hold onto these positions long afterwards based on their portfolio needs (such as making sure they have at least one highly liquid position).[155]

B. Performance

Although hedge funds command roughly $2 trillion in assets this is still a relatively small amount compared to other sectors of the financial market.[156] Heading into the new millennium "commercial banks had $4.1 trillion in total assets; mutual funds had assets of approximately $5 trillion; private pension funds had $4.3 trillion; state and local retirement funds had $2.3 trillion; and insurance companies had assets of $3.7 trillion."[157]

Despite holding nearly $2 trillion in assets as a whole there are very few top players. Only "3% of funds manage more than $500 million, 15% of funds manage $100-$500 million, and roughly 38% manage each category of $5-25 million and $25-100 million."[158] Former Federal Reserve Chairman Alan Greenspan has speculated that consolidation in the hedge fund industry will occur to create firms that can compete at the top levels.[159]

Hedge funds' assets, as a percentage of GDP, haves jumped from 5.6% to 15% from 2003 to 2007.[160] The ascension of hedge funds is due to a variety of reasons. For one, hedge funds have earned a reputation for producing outstanding years with sustained above-average returns (yielding about 8% above the S & P over the last seven years).[161] A second reason is that hedge funds utilize greater diversification than traditional managers to provide portfolios that can survive any type of political/economic climate.[162] There have been some attempts to quantify how successful hedge funds have been by looking at the risk and returns of hedge funds based on samples, but the results are still speculative.[163]

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151 *Id.*

152 *Id.*

153 *Id.*

154 *Implications, supra* note 8, at 8

155 *Id.*

156 *Hedge Funds, supra* note 10, at 1.

157 *Id.* at 1-2.

158 Jay Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II,* 32 DJCL 1, 6 (2007).

159 *Id.*

160 Nelson, *supra* note 80, at 221.

161 *See supra* notes 1-4 and accompanying text.

162 *Implications*, *supra* note 8, at viii (lending to their name as hedge funds since they effectively "hedge" their bets against down turning markets).

163 *See, e.g.,* Roger Ibbotson & Peng Chen, *The A,B,Cs of Hedge Funds: Alphas, Betas, and Costs,*

Due to their strong performance and growth, hedge funds can significantly influence the market. Hedge funds can enhance liquidity, reallocate financial risk and lead to innovation, all of which promotes efficiency and evolution.[164] Patrick Parkinson, Deputy Director of the Division of Research and Statistics of the Federal Reserve Board, stated in 2006:

> In various capital markets, hedge funds are increasingly consequential as providers of liquidity and absorbers of risk. For example, a study of the markets in U.S. dollar interest rate options indicated that participants viewed hedge funds as a significant stabilizing force. In particular, when the options and other fixed income markets were under stress in the summer of 2003, the willingness of hedge funds to sell options following a spike in the options prices helped restore market liquidity and limit losses to derivatives dealers and investors in fixed-rate mortgages and mortgage-backed securities. Hedge funds reportedly are significant buyers of the riskier equity and subordinated tranches of collateralized debt obligations (CDOs) and of asset-backed securities, including securities backed by nonconforming residential mortgages.[165]

However, hedge funds also have the potential to disrupt markets.[166] Due to their excessive leverage and aggressive strategies hedge funds can exacerbate conditions and increase the volatility and uncertainty in markets.[167] Whether hedge funds are viewed in a positive or negative light, it is consistently held that they have a significant impact on the markets.[168]

C. Structure

Hedge funds usually incorporate as a limited partnership (LP) or limited liability corporation (LLC), maintaining both onshore and offshore presences (for legal and tax purposes).[169] Typically, the onshore and offshore accounts follow

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Yale ICF Working Paper No. 06-10, (Sept. 2006); *see also* Burton Malkiel & Atanu Saha, *Hedge Funds: Risk and Return*, 61 FIN. ANALYSTS J. 6. (2005).

[164] *Hedge Funds, supra* note 10, at 2.

[165] Oesterle, *supra* note 17, at 5 (quoting Testimony of Patrick M. Parkinson, Before the Subcommittee on Securities and Investment, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, May 16, 2006, *available at* http://www.federalreserve.gov/boarddocs/testimony/2006/20060516/default.htm); *see also* Oesterle, *supra* note 17, at 5 ("Timothy F. Geithner, President and Chief Executive Office of the Federal Reserve Bank of New York notes the positive role played by hedge funds: 'Hedge funds play a valuable arbitrage role in reducing or eliminating mispricing in financial markets. They are an important source of liquidity, both in periods of calm and stress. They add depth and breadth to our capital markets. By taking risks that would otherwise have remained on the balance sheets of other financial institutions, they provide an importance source of risk transfer and diversification.'" (quoting Timothy Geithner, *Remarks at the Institute of International Bankers Luncheon in New York City*, Oct. 18, 2005, *available at* http://www.ny.frb.org/newsevents/speeches/2005/gei051018.html)).

[166] *Hedge Funds*, *supra* note 10, at 2*; see also* ROGER LOWENSTEIN, WHEN GENIUS FAILED (Random House Trade Paperbacks 2000) (documenting in detail the potential impact Long-Term's collapse would have on the markets).

[167] *Hedge Funds, supra* note 10, at 2.

[168] *Id.*

[169] *Id.* at 1*; see also* Stephanie Baum, *US Presidential Election May Spur Hedge Fund Regulations,* E. FINANCIAL NEWS, Jun. 17, 2008, http://www.efinancialnews.com/usedition/content/2450966225/22855/44D73MzcyODQxOjM2MDk3MDoxNzY2Nw%3D%3D (noting that last year the House of Representatives approved a bill to increase the taxes that hedge funds would have to pay. The bill was

similar strategies, securities and advisers and are both offered to clients.[170] Usually this operates on a master-feeder structure that trades through a single entity to accommodate both taxable and tax exempt (such as pension funds or charitable trusts) investors.[171] The following chart summarizes much of the information about performance, structure and other key statistics:

Characteristics	**Mean**	**Median**	**Mode**
Fund Size	$87 million	$22 million	$10 million
Fund Age	5.9 years	5.3 years	5.0 years
Minimum investment required	$695,000	$250,000	$250,000
Number of Entry Dates	34	12	12
Number of Exit Dates	28	4	4
Management Fee	1.7%	1.0%	1.0%
Performance Allocation (“Fee”)	15.9%	20.0%	20.0%
Manager’s Experience			
In Securities Industry	17 years	15 years	10 years
In Portfolio Management	11 years	10 years	10 years
Percent Responding “Yes”			
Manager is a U.S. registered investment advisor			45%

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ultimately shot down in the Senate. However, with the upcoming election and possible changes in the makeup of Congress and the White House the issue could be renewed. Should the bill be reintroduced and higher taxes are passed hedge funds may yet again change their incorporation strategy to best adapt to these changes).

[170] *Implications, supra* note 8, at ix.

[171] *Id.* at 9-10.

Fund has hurdle rate	17%
Fund has high water mark	75%
Fund has audited financial statements or audited performance	98%
Manager has $500,000 or own money in fund	75%
Fund can handle "hot issues"	53%
Fund is diversified	57%
Fund can short sell	84%
Fund can use leverage	72%
Fund uses derivatives for hedging only, or none	71%[172]

This survey exposes some shocking results. The first is the relative inexperience of the field. A fund's age of roughly six years pales in comparison to other major financial institutions that have been around sometimes as old as 100 years.[173] Though a manager's experience is slightly greater, this still is relatively short when contrasted to top executives at traditional investment managers who have several decades under their belt.[174]

A second surprise is that the minimal investment required by hedge funds is well above the statutory benchmark.[175] One reason this number is so high is that some hedge funds set the minimum high because they only cater to institutions, pension funds and endowments that invest hundreds of millions at a time.[176] The rationale is that there are now fewer clients to handle and therefore the ability to negotiate, keep in touch and cater to each client is improved.[177]

The management and performance fees, entry dates and exit dates all fit with the common descriptions and definitions advanced by the government.[178] The fund size also complies with earlier reports, including Greenspan's recognition that there are very few players at the top.[179]

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[172] Neal Epstein, Neil Brown, Darlene DeRemer, Joseph Hershberger & Donald Putnam, *Institutional or Institutionalized – Are Hedge Funds Crazy?* PUTNAM LOVELL NBF 30 (Dec. 2002) [hereinafter *Institutional or Institutionalized*].

[173] *Id*.

[174] *Id*.

[175] *Id*.

[176] *Id*.

[177] *Institutional or Institutionalized, supra* note 172.

[178] *Id.*

[179] *Id*.

The "Yes/No" portion of the survey also indicates some unusual phenomenon. The most surprising is that only 57% are diversified, when the cornerstone to hedge fund investment strategies is to diversify and therefore survive in all climates.[180] A second revelation is that three out of every four managers have significant amounts of their money in their own funds.[181] This is an example of putting all of one's eggs in one basket. Should the unthinkable happen and a fund goes under not only does the manager lose his/her source of revenue but also much of their personal income.

A new structure in the hedge fund world is fund of funds.[182] Fund of funds pool capital and then invest in a package of hedge funds.[183] Some regulators are concerned that this option will circumvent investor qualifications for hedge funds and open up to the general public.[184] Fund of funds have grown in popularity since they are seen as a way to quickly and efficiently diversify an investor's risk across hedge funds.[185] The fee structure for this scenario is similar to traditional hedge fund fees, with both performance and fixed components.

D. Fees, Strategies and Leverage

A typical fee hedge funds extract for their services is to take one to two percent as a management fee (a fixed fee) and roughly twenty percent of the fund's profits as well (a performance fee).[186] Hedge funds will invest in a variety of instruments, including over-the-counter instruments (particularly derivatives) or markets involving foreign exchange, short positions, futures, equity and income to earn these fees.[187] Hedge funds also employ a vast array of sophisticated strategies (i.e. currencies, derivatives and short positions) to gain value for their funds and justify the fees.[188]

Strategies are often lumped into four different groups: 1) Market Neutral Group, 2) Long/Short Equity Group, 3) Directional Trading Group, and the 4) Specialty Strategies Group. Market Neutral strategies typically invest in an opportunity unique to one sub-set of securities while maintaining broad exposure (and therefore hedging risks) against wider securities.[189]

Common strategies in this group include Equity Market Neutral opportunities where a manager invests in short and long security positions to encompass gains and losses in the market.[190] A second type is Distressed

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[180] *Id*.
[181] *Id*.
[182] Oesterle, *supra* note 17, at 4.
[183] *Id.*
[184] *Id.*
[185] *Id.*
[186] *Id.* at 3.
[187] *Hedge Funds, supra* note 10, at 3.
[188] Oesterle, *supra* note 17, at 4.
[189] *Equity Market Neutral,* HEDGE FUND CONSISTENCY INDEX, http://www.hedgefundindex.com/d_equitymn.asp.
[190] *Hedge Fund Strategy Definitions,* GREENWICH ALTERNATIVE INVESTMENTS, 2008, http://www.greenwichai.com/GenPages/gvhfindex42.aspx?vNode=8&vChild=2 [hereinafter *Strategy]*.

Securities, where managers invest in companies having financial difficulties and stand to make money should they successfully reorganize.[191] A third type is Special Situations where a firm may long or short a stock due to a unique occasion (such as an acquisition or merger).[192] Three other highly utilized methods include:

> Statistical Arbitrage – The manager uses quantitative criteria to choose a long portfolio of temporarily undervalued stocks and a rough equal-sized short portfolio of temporarily overvalued stocks. Trades tend to be short-term and the overall portfolio is usually neutral in terms of various risk characteristics (beta, sector exposure, etc.). 'Pairs trading' is a common form of statistical arbitrage. . .
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> Event-Driven – The manager focuses investment activities on significant catalyst-type events, such as spin-offs, mergers and acquisition, bankruptcy reorganizations, recapitalizations and share buybacks. Some managers who employ Event-Drive trading strategies may shift the majority weighting between Merger Arbitrage and Distressed Securities, while others may take a broader scope. Typical trades and instruments used may include long and short common and preferred stocks, debt securities, options and credit default swaps. Leverage may be employed by some managers. . .
>
> Merger arbitrage – The manager will take positions in companies undergoing "special situations," for example, when on firm is to be acquired by another, or is preparing for a reorganization or spin-off. A frequent trade is "long the acquiree, short the acquirer."[193]

The Long/Short Equity Group primarily relies on long and short exposures in the market. Aggressive growth strategies target companies whose earnings per share are expected to take off (due to price momentum or other factors).[194] Short selling is the exact opposite as a manager targets stocks he/she feels are overvalued and therefore eventually their value will fall.[195]

Directional Trading Groups look at general trends and predicted future of the environment. Futures are where a hedge fund agrees to buy/sell a stock for a given price in the future, trying to capitalize on the predicted movement of the stock.[196] Macro strategies invest in global trends and predict asset classes as a whole (for instance a hedge fund may predict the U.S. dollar will fall).[197] One last strategy is:

> Market Timing – The manager attempts to predict the short-term movements of various markets (or market segments) and, based on those predictions, moves capital from one segment to another in order to capture market gains and avoid market losses. While a variety of investment categories may be used, the most typical ones are various mutual funds and money market funds. Market timing managers focusing on these mutual funds are sometimes referred to as mutual fund

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[191] *Id.*
[192] *Id.*
[193] *Id.*
[194] *Id.*
[195] *Strategy, supra* note 190.
[196] *Id.*
[197] *Id.*

switchers.[198]

The last group is the Specialty Strategies Group, which acts as a catch-all that includes special, diverse strategies.[199] Emerging Markets invest in developing economies that have huge potential (such as Brazil or India).[200] And Income strategies look at current income vehicles like bonds to gain quicker returns.[201]

To magnify their strategies, hedge funds often utilize various levels of leveraging (borrowing money to amplify positions).[202] Traditional managers are limited by the Investment Act which can dictate how they gain leverage (i.e. open-ended investment companies can only leverage through bank loans) and also by how much a manager can leverage.[203] Hedge funds are not subject to these constraints and thus can obtain higher degrees of leverage from a wider range of sources, which increases the returns as well as risks of a hedge fund.[204]

IV. TRADE SECRET ARGUMENT

Hedge funds such as Two Sigma Investments and Bulldog have advanced trade secret arguments against Rule 13(f). Much like hedge funds, trade secrets resist definition.[205] For instance, the Restatement (First) of Torts (Restatement) has struggled to define the term but ultimately published its definition of a trade secret as:

> [A]ny formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be a formula for a chemical compound, a process of manufacturing, treating or preserving materials, a pattern for a machine or other device, or a list of customers.[206]

The Uniform Trade Secrets Act (UTSA) which, while acknowledging that a precise definition is difficult, added to the concept the idea that a trade secret is subject to reasonable constraints to keep it secret.[207] A typical two prong test courts use is "[first prong - the plaintiff] possessed a trade secret and [second prong] that the defendant used that trade secret in breach of an agreement, a

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[198] *Id.*

[199] *Id.*

[200] *Strategy, supra* note 190.

[201] *Id.*

[202] Shadab, *supra* note 7, at 40 ("A 2005 interview-based study by the financial adviser TABB Group estimated that half of all funds have a 3:1 leverage ratio while only three percent have a ratio of 7:1 or more.").

[203] *Implications, supra* note 8, at 38.

[204] *Id.* (mentioning creditors and counterparties alike may impose market restrictions on leverage).

[205] *See, e.g.*, Lear Siegler, Inc. v. Ark-Ell Springs, Inc., 569 F.2d 286, 288 (5th Cir. 1978) ("The term 'trade secret' is one of the most elusive and difficult concepts in the law to define.").

[206] RESTATEMENT (FIRST) OF TORTS § 757 cmt. a (1939).

[207] JERRY COHEN & ALAN GUTTERMAN, TRADE SECRETS PROTECTION AND EXPLOITATION 8-9 (BNA Books 1998) (stating three major reasons why a national conference was called on this subject, they were: 1) businesses rely heavily on trade secrets; 2) many states did not have a good body of work on the subject; and 3) although the Restatement had touched on the subject there was a still a fair amount of confusion on the subject). *See id.* at 9 (noting that by 1996 forty states and the District of Columbia had enacted trade secret laws based on the UTSA).

confidential agreement, or duty, or as a result of discovery by improper means."[208] Although there are no hard and fast rules for establishing the first prong, at the very least, the claimant must show they were actively trying to prevent the release of their information.[209] In an SEC comment letter to the UTSA, they advise that some standard examples are advising employees that there is a trade secret, limiting knowledge of the trade secret to a need to know basis and limiting plant access.[210]

Justifications for trade secret protection fall into three categories.[211] Economically, trade secrets provide remedies and protections additional to conventional tort laws and thus may inspire innovation.[212] Philosophically, it's accepted that one person should not unjustly benefit from acquiring a trade secret through some improper means (such as breach of confidence).[213] The third, and weakest, argument is a populist one – the vast majority of states support protection and this perpetuates protection.[214]

A. First Prong – Possessing a Trade Secret

Hedge fund interests arguably constitute "property" that is protected by trade secret law and the Fifth Amendment.[215] Again there is no set test to determine a trade secret exists but the Restatement identified six key factors:

> (1) The extent to which the information is known outside of his business;
> (2) The extent to which it is known by employees and others involved in his business;
> (3) The extent of measures taken by him to guard the secrecy of the information;
> (4) The value of the information to him and to his competitors;
> (5) The amount of effort or money expended by him in developing the information;
> (6) The ease or difficulty with which the information could be properly acquired or duplicated by others.[216]

Andrew Beckerman-Rodau, an intellectual property professor, examined in further detail "reasonable efforts" to establish and protect a trade secret.[217] He concluded that a manager must show they expended substantial resources, including financial and man-power.[218] Other relevant economic considerations are the extent of adequate protections, compliance with industry standards, communication to and restriction thereof concerning employees, and non-

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[208] Hudson Hotels Corp. v. Choice Hotels Int'l, 995 F.2d 1173, 1176 (2d Cir. 1993).

[209] COHEN, *supra* note 207, at 15.

[210] *Id.* at 12.

[211] Michael Risch, *Why Do We Have Trade Secrets?*, 11 MARQ. L. REV. 1, 26 (2007).

[212] *Id.* at 37.

[213] COHEN, *supra* note 207, at 15.

[214] Risch, *supra* note 211, at 35.

[215] *Exemption*, *supra* note 66, at 5.

[216] RESTATEMENT, *supra* note 206, at § 757 cmt. b.

[217] Andrew Beckerman-Rodau, *Trade Secrets – The New Risks to Trade Secrets Posted by Computerization,* 28 RUTGERS COMPUTER. & TECH. L. J. 227, 238-39 (2002).

[218] *Id.* at 240.

disclosure documentation when it is necessary to divulge the information to third-parties.[219] Professor Beckerman-Rodau next raised ascertainable factors such as the amount of time and money necessary to reverse-engineer the secret, third-parties' unsuccessful attempts at duplication as well as third-party willingness to pay for the information.[220]

In *Ruckelshaus v. Monsanto*, the Supreme Court addressed mandatory data about pesticides that were submitted to the Environmental Protection Agency and then ultimately published.[221] The Court held the information is in fact protected by trade secret law, first recognizing that various intangible interests can be seen as property under the Fifth Amendment.[222] The Court reasoned that due to the fact that the data requires extensive financial resources to ascertain (typically five to fifteen million dollars annually), a lengthy period of time to develop (usually fourteen to twenty-two years), thousands of screened pesticides before endorsing one and the security measures in place to guard the information that it was in fact a trade secret.[223]

Goldstein's exemption relied heavily on the *Ruckelshaus* case.[224] Goldstein uses the case to support his strategies are considered property, the disclosures are mandatory and he claims there are no reciprocal benefits for his firm.[225] However, Goldstein fails to provide the amount of man hours, resources and finances employed to protect his information.[226] These are all steps that are advertised in the Restatement and important to the *Ruckelshaus* Court.

There has, on the other hand, been a history of Goldstein and Bulldog revealing the very same privileged information they now desperately seek to protect.[227] There are three major instances that hinder his argument: a publication to a court, a letter and a failure to secure information about a private offering.[228] To the court, it might now appears that Goldstein utilizes the information when it is in his favor but now feels that information would hamper his competitive edge.[229]

The first is during a lawsuit between Goldstein and Lincoln National Convertible Securities Fund, Inc. the facts included stated that "Goldstein provided investment advice and money management services to family, friends and four clients."[230] All of these funds had varying investment objectives and different

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[219] *Id.* at 240-41.

[220] *Id.* at 241-43.

[221] Ruckelshaus v. Monsanto Co., 467 U.S. 986, 991-93 (1984)

[222] *Id.* at 987.

[223] *Id.* at 998 (focusing on the Tucker Act providing adequate avenues for compensation; the Court ultimately concluded the claimants did not have all the necessary elements to win their case).

[224] *Exemption*, *supra* note 66, at 5.

[225] *Id.*

[226] *Id.*

[227] Pekarek, *supra* note 27, at 1157.

[228] *Id.*

[229] *Id.*

[230] Goldstein v. Lincoln Nat'l Convertible Sec. Fund, 140 F. Supp.2d 424, 435 (E.D. Pa. 2001) (claiming Lincoln breached their fiduciary duty when the defendants held an election for directors without enough advance notice given to shareholders. The court ultimately found in part for the plaintiffs (finding that the defendant omitted material information) and in part for the defendants

degrees of control, but they did allow Goldstein discretionary trading privileges.[231] Through the testimony of Goldstein's family, friends and clients, many of whom were Bulldog investors, it became clear to the court that Goldstein discussed at length strategies and implementing procedures.[232] A key issue is that many of these are discussions about strategy with the investors that occurred before the trades were actually executed and protected.[233] There are no obvious studies on the information hedge fund managers informally give, however, if a future case is brought this would, again, be an issue to examine.

The second occurrence was in September 2006, less than a month before Goldstein filed the exemption request.[234] In a Conference Call with Millennium Media Consulting Money Manager Series Goldstein "revealed aspects of his hedge fund investment strategies for generating 'alpha.'"[235] HedgeCo, an online informational portal on hedge funds, defines alpha as the value a hedge fund produces by comparing the manager's performance against a risk-free investment (like a United States Treasury Bill).[236] Therefore, revealing the firm's alpha strategies is tantamount to Goldstein revealing the firm's overall investment strategies.[237] Managers often publicly speak about their hedge fund, differentiating it from others often by discussing their strategies at a broad level (for instance six other managers spoke at the same event Goldstein did).

The third instance involves a complaint lodged against Goldstein.[238] The Secretary of the Commonwealth Securities Division for Massachusetts brought the claim alleging several wrongdoings.[239] Although Goldstein was ultimately found not guilty of these charges they do cast the shadow of doubt on his situation. Among these were violations of the Massachusetts Uniform Securities Act for having improper security controls on their website.[240] Prospective clients can access the website only by agreeing to a superficial disclaimer, and can then view the private offerings.[241] Again, hedge funds need to carefully monitor what information is displayed on their websites to avoid a claim of general solicitation.

These offerings can reveal substantial information about the firm's investing philosophies and strategies.[242] Not only did Bulldog passively allow this

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(finding that the plaintiff submitted insufficient evidence of a joint transaction)).

[231] *Id.*

[232] *Id.*

[233] *Id.*

[234] Pekarek, *supra* note 27, at 1158.

[235] *Id.*

[236] Hedge Fund Glossary, HEDGECO, http://www.hedgeco.net/hedgeducation/hedge-fund-glossary/.

[237] Pekarek, *supra* note 27, at 1158.

[238] Complaint, Mass. v. Bulldog Investors, No. E-07-0002 (Mass. 2007) *available at* http://www.sec.state.ma.us/sct/sctpdf/bulldogcomplaint.pdf [hereinafter *Complaint*].

[239] *Id.* at 1.

[240] *Id.* at 2-3 (adhering to the court's wishes Bulldog has taken down their old website, however, an archived version can be seen at http://web.archive.org/web/20060116131029/http://www.bulldoginvestors.com).

[241] *Id.*

[242] *Id.* at 9.

information to come out, but the complaint also alleges that Bulldog sent e-mail investment solicitations to at least one Massachusetts resident which included investment strategies, investment examples, performance analyses and asset information among other firm information.[243] Goldstein has publicly and repeatedly dismissed these charges and promoted First Amendment rights as his defense.[244]

B. Second Prong – Improper Appropriation of the Trade Secret

The second prong requires proof that disclosure of the information to be protected information would unfairly benefit or advantage a competitor.[245] 13F forms arguably enable investors to reverse-engineer hedge fund investments. For instance, David Ross, a Vice President for an economics consulting firm, argues that looking at sequential filings can let an investor adequately determine the net amount of shares bought or sold of a particular stock during a quarter.[246] Furthermore an investor could deduce the number of shares currently being held by the company.[247] Although investors may have some difficulty in precisely replicating a hedge fund's strategy a 13F could enable one to determine the fund's weights for various sectors, new holdings, the level of its strategic aggressiveness, timing of purchases and sales and other critical decisions.[248]

The SEC will argue that the information contained in 13F forms will provide at best snippets of a firm's strategy, rather than a complete guide.[249] For one, not all securities must be reported.[250] Only those that are publically traded, such as those on the New York Mercantile Exchange, are included.[251] Many positions like short stocks (whether on short equity, future or option positions) are not reported.[252] Shares of open-ended investment companies (like mutual funds), shares less than 10,000 in number and less than $200,000 in value, shares that

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[243] *Complaint, supra* note 238, at 8-9.

[244] *See, e.g.,* Jeff Benjamin, *Hedge Fund Activist Taunts SEC* ,INVESTMENT NEWS Mar. 3, 2008, *available at* http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080303/REG/800282892/1009/INIssueAlert01; *see also Goldstein Set to Sue SEC Over Marketing Ban,* FINALTERNATIVES, Mar. 3, 2008, http://www.finalternatives.com/node/3704; *see also* Jay Fitzgerald, *Bulldog Hedge Fund Manager Barks: 'Galvin is a Bully'!, BOSTON HERALD,* at *24;* Feb. 15, 2007, *also available at* http://pqasb.pqarchiver.com/bostonherald/access/1216846871.html?dids=1216846871:1216846871&FMT=ABS&FMTS=ABS:FT&type=current&date=Feb+15%2C+2007&author=JAY+FITZGERALD&pub=Boston+Herald&edition=&startpage=24&desc=Bulldog+hedge+fund+manager+barks%3A+Galvin+%60is+a+bully%27!.

[245] *Exemption, supra* note 66, at 7.

[246] David Ross, *Do Conflicts Between Class Members Vitiate Class Action Securities Fraud Suits?*, 70 ST. JOHN'S L. REV. 209, 230-31 (1996). *See also id.* at n.101 ("For example, if institution XYZ held 10,000 shares at the end of quarter one and 20,000 shares at the end of quarter two, then institution XYZ had net purchases of 10,000 shares during quarter two.").

[247] *Id. See also* David Edwards, *Reverse Engineer Your Mutual Fund,* THE STREET.COM, May 06, 2002, *available at* http://www.thestreet.com/funds/mutualfundmondaydedwards/10020715.html (writing on how to reverse-engineer a mutual fund Edwards advises matching prospectus materials, online reports, and online financial information (like 13Fs) to gain a perspective).

[248] *Id.*

[249] Securities Exchange Act of 1934, 15 U.S.C. § 78a.

[250] *Id.*

[251] *Id.*

[252] *Id.*

appear only on foreign exchanges and put or call options that the firm itself writes all do not need to be included.[253]

The first issue with 13Fs is their content, the second are their timing.[254] By the time these reports are made available to the public the information is forty-five days old.[255] Many hedge fund strategies move quickly and by the time the reports are published their opportunities are over. For example, Event Driven, Merger and Market Timing strategies are all very sensitive to current market conditions and may be outdated by the time 13Fs are published.

The last argument the SEC will advance is the manager's ability to seek an exemption from 13(f). Rule 13(f)(3) provides the SEC with the power to grant confidential treatment on a case by case basis.[256] Therefore when a manager meets these requirements (most importantly a specific strategy and resulting harm) the SEC will cooperate with the firm in protecting that strategy.[257] These three responses will most likely be enough for the SEC.

V. ANALYSIS UNDER A REGULATORY TAKINGS ARGUMENT

The concept of a takings argument has a rich and complicated history. The basis for a takings action is grounded in the Fifth Amendment which states "nor shall private property be taken for public use, without just compensation."[258] Much of the following casework focuses on real property. At the heart of *Berman v. Parker*, a seminal case before the Supreme Court, a Redevelopment Act authorized the government to seize blighted property in an attempt to stimulate growth.[259] One shopkeeper argued that his affected land was commercial, not residential, and would be redeveloped under private management thus violating his rights.[260] The Court upheld the statute and gave broad deference to the Legislature's use of eminent domain.[261] This broad understanding has been upheld through many cases.[262]

For over 100 years, courts have recognized instances where government regulations are to such a high degree that they are in essence a government taking, even if physical property is not seized.[263] An important decision in *Kelo v. City of*

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[253] *Frequently Asked Questions, supra* note 100, at Questions 39-43.

[254] *Id.*

[255] *Id.*

[256] *Confidential Treatment Filer, supra* note 50, at 2.

[257] *Id.*

[258] U.S. CONST. amend. V.

[259] Berman v. Parker, 348 U.S. 26, 29-30 (1954).

[260] *Id.* at 31.

[261] *Id.* at 35-36.

[262] *See, e.g.*, Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 244-45 (1984). *See also* Poletown Neighborhood Council v. City of Detroit, 304 N.W.2d 455, 459 (Mich. 1981), *overruled by* Rowland v. Washtenaw County Rd. Comm'n, 477 Mich. 197 (Mich. 2007).

[263] Ann Wooster, Annotation, *What Constitutes Taking of Property Requiring Compensation Under Takings Clause of Fifth Amendment to United States Constitution—Supreme Court Cases,* 10 A.L.R. Fed. 2d 231 (2006).

New London reaffirmed a broad understanding for regulatory takings.[264] The Court reviewed a development plan that needed to seize property from several shopkeepers to complete the project.[265] Although their property was not blighted, the Court once again gave great deference to the city's determination.[266] One year after the *Kelo* decision, President Bush issued an Executive Order stating that regulatory takings are necessary to preserve the general interest and not just advancing the economic interest of private parties.[267]

To fully analyze a regulatory takings argument the scenario must be assessed through five phases: 1) threshold questions, 2) is this a *per se* taking, 3) is there linkage, 4) a balancing test and 5) is this taking for public use. It is through this lens that Goldstein's argument will be discussed.

The first phase addresses threshold questions. The first, and easiest, of the threshold questions is whether or not there is some form of government action. In Goldstein's case the answer is definitively yes, the SEC requires hedge funds to file 13F forms with their agency. These forms are then published on the SEC's website at their EDGAR database for the public to view.

Next, the court must determine if the claimed loss is a property right. For purposes of a takings argument, property has been defined as "denot[ing] the group of rights inherent in the citizen's relation to the physical thing, as the right to possess, use and dispose of it."[268] Courts later relaxed this definition to encompass non-physical items as well as recognizing that when "regulation goes too far it will be recognized as a taking."[269]

Presumably, the case would be heard in a New York court since Bulldog is incorporated there. New York, traditionally, has a more lenient interpretation of what is property than other courts and therefore Goldstein should have enough evidence to satisfy this prong.[270] One of the most famous New York intellectual property cases held that a license was property even though it did not have an exact market value.[271] Therefore, if the case is heard in New York Goldstein has a better chance for getting past the first prong. Ultimately, the court will probably acknowledge Goldstein's investment strategies as constituting a property right.

The second phase of the analysis is to ask if the claimed loss is a *per se* taking. If the loss is in fact a *per se* taking then there is no need to conduct a balancing test. However, courts have been very restrictive in assigning *per se* status and have carved out only three main categories, the first being a complete

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[264] Kelo v. City of New London, 545 U.S. 469, 489-90 (2005). *See also* Dana Berliner, *Opening the Floodgates; Eminent Domain Abuse in a Post-Kelo World*, Institute for Justice *available at http://castlecoalition.org/pdf/publications/floodgates-report-low.pdf* (June 2006) ("Since Kelo's decision more than 5,783 properties have been threatened or condemned by local governments.").

[265] *Id.* at 472-74.

[266] *Id.* at 482-83.

[267] Exec. Order No. 13406 (2006).

[268] U.S. v. Gen. Motors Corp., 323 U.S. 373, 377-78, (1945) (upheld in Pruneyard Shopping Center v. Robins, 447 U.S. 74 (1980)).

[269] Pa. Coal Co. v. Mahon, 260 U.S. 393, 415 (1922).

[270] *See* O'Brien v. O'Brien, 66 N.Y.2d 576, 590 (Ct. App. 1985).

[271] *Id.*

loss of economic viability.[272] This is not the case for Goldstein since Bulldog is still maintaining healthy profits.

The second category is for permanent physical occupation by the government.[273] Since there is no permanent physical invasion as interpreted by the courts (such as taking an inheritance or moving soil), Goldstein will not prevail here. The third is for core rights.[274] This is the hardest area to convince the courts because they have really only accepted the rights to devise/alienate land and the right to sell as core rights.[275] Therefore, this case will most likely not fall under a *per se* taking.

The third analysis is linkage. To evaluate linkage the Court in *Dolan v. City of Tigard* settled on a nexus test.[276] This is a rough proportionality test which asks if there is a nexus between the goal of the program and what the government is actually doing.[277] Assuming the analysis moves past threshold and *per se* questions this is one of the two main thrusts for Goldstein's takings clause argument. Goldstein asserts this notion clearly in his request for an exemption stating:

> The legislative history of 13(f) indicates that its primary purpose was to fill an information gap about the activities of institutional investment managers that would enable the Commission to diverse regulatory initiatives. However, the Commission has never used the data in 13F filings for that purpose. Therefore, despite Congress' intent in 1975 when it adopted 13(f), there has been no actual connection between the disclosure scheme of 13(f)(1) and any regulatory use of the resultant data disclosures.[278]

Furthermore, Goldstein's exemption claims that no investor can gain market confidence from these forms.[279] Indeed, Goldstein says that increasing investor confidence is not necessarily a rational goal to begin with.[280] The exemption ends on the note that, "the suggestion that 13F filings are routinely used for any legitimate purpose is disingenuous."[281]

The SEC will most likely counter with two arguments: 1) 13F forms have in fact been used as their intended informational database; and 2) 13F forms have been used to increase market confidence. Regarding databases as late as 2004, the SEC has commented "neither we nor any other government agency has any reliable data on even the number of hedge funds or the amount of their assets. We

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[272] *See* Pa. Cent. Transp. Co. v. City of New York, 438 U.S. 104, 127-28 (1978), *see also* Palazzolo v. Rhode Island, 533 U.S. 606, 607 (2001).

[273] Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419, 427 (1982).

[274] Babbitt v. Youpee, 519 U.S. 234, 242 (1997).

[275] *Id.*

[276] Dolan v. City of Tigard, 512 U.S. 374, 386 (1994).

[277] *Id.*

[278] *Exemption, supra* note 66, at 3 (emphasis added).

[279] *Id.* at 14.

[280] *Id.* at 3. *See also* Alex J. Pollack, *The Government Should Not try to Promote "Investor Confidence",* American Enterprises Institute for Public Policy Research, Apr. 2005, *available at* http://www.aei.org/docLib/20050331_AprilFSOnewg.pdf.

[281] *Exemption, supra* note 66, at 15.

must rely on third-party surveys and reports, which often conflict and may be unreliable."[282] However, the EDGAR database and 13F forms help provide "information that is reliable, current, and complete" in one database.[283] These databases are used by agencies for a variety of purposes. For instance, the SEC couples 13Fs with other guidelines such as questions potential investors should ask to help create more competent investors.[284]

The SEC has a much stronger stance demonstrating that these forms have been used to increase market confidence, mainly by assisting in the due diligence process. Hedge funds, like all investment managers, have had their share of controversies, which has led to increasing standards for due diligence.[285] According to a Deutsche Bank survey, over 60% of institutional investors will take between two and six months to complete due diligence on a hedge fund.[286] Many of them will hire a private investigator to assist and advise them in this process.[287] Advisers will continue to look at these 13F forms for two main reasons.[288] The first is to match 13F forms filed with the SEC to the reports the hedge fund gives the investor to verify that the hedge fund is not trying to deceive either the investor or the SEC.[289] Secondly, the adviser will look at the 13F forms to make sure the hedge fund is pursuing the strategy that the investor and the hedge fund agreed upon.[290]

A report by the President's Working Group on Financial Markets (Working Group) notes that not only do individuals and investors utilize these disclosure tools, but other institutions do as well.[291] Many banks for instance will look at 13Fs to help determine their exposure risk and leverage concerns for hedge funds.[292] 13Fs remain invaluable since there is still a division within the industry and many hedge funds resist providing meaningful information to counterparties.[293] Although there can be some expense associated with these disclosures to other institutions, they can also be associated with differentiating a hedge fund, which can lead to raising capital and gaining favorable terms.[294] Ultimately, the SEC should have sufficient evidence to support that there is in fact linkage.

The court will next balance the interests of the hedge fund managers and

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[282] *Registration, supra* note 13, at 72061.

[283] *Id.*

[284] *Implications, supra* note 8, at 103.

[285] *Id.* at 59. *See also Registration*, *supra* 13, at 72057-58 (especially since a growing number of pension funds, endowments, etc. are entering the market which have higher standards before investing).

[286] *Implications, supra* note 8, at 59.

[287] *Id.*

[288] *Id.* at 49.

[289] *Id.*

[290] *Id.* *See also* U.S. Commodity Futures Comm'n v. Amaranth Advisors, LLC, 2007 U.S. Dist. LEXIS 80978 (S.D.N.Y Nov. 1, 2007).

[291] *Hedge Fund, supra* note 10, at 34.

[292] *Id.*

[293] COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE 45 (2005), *available at* http://www.isda.org/educat/pdf/CRMPGII_7-22-05_FINAL_v6_wcover.pdf.

[294] Shadad, *supra* note 7, at 41.

those of the government in the fourth analysis. There are several considerations that could push this issue in favor of the SEC. First, since rule 13(f) applies to many different hedge funds, the burden of this rule is spread across a large group, as opposed to resting predominantly on the shoulders of Bulldog alone.[295] Secondly, the courts will take into account just how much the property is actually diminished in value.[296] Goldstein has yet to provide a specific number and at this time the decrease in value seems to be insubstantial.

A third consideration is whether the property owner who is losing property is also benefiting. If he or she is also benefiting the court will be less likely to consider the actions a taking.[297] In this case the SEC will argue that increased market confidence will benefit all hedge funds, including Bulldog, by bringing in more investors. Lastly, the precedent of over thirty years has been to allow 13F forms. There has been an increased reliance on these forms, and this is not the situation where a new rule is now proposing to take away private property. Taken as a whole these factors seem to weigh in the SEC's favor.

The last consideration is whether the taking is for public use. As noted, courts have taken a broad understanding of public use and thus the SEC should have no problems satisfying this criterion. The Court in *Berman v. Parker* notes that "[t]he concept of the public welfare is broad and inclusive. The values it represents are spiritual as well as physical, aesthetic as well as monetary."[298] As long as the exercise in control is rationally related to "a conceivable public purpose" and the other prongs are satisfied, the government can go ahead and take the property.[299]

The government should be able to satisfy this requirement pretty easily, stating that increasing investor awareness, promoting market efficiency and strengthening market confidence are all for public use. 13(f) protects investors from fraud and ensures greater stability in the markets. If, however, for some reason the court does not find there is a public use, the court could justify striking down the 13F forms.

VI. RELATED DISCLOSURE PROPOSALS

As noted earlier, the public has several qualms about the hedge fund industry. Many feel that hedge funds use their power in unison, controlling the market to their will.[300] Tangential to this is the fact that hedge funds often utilize short positions, which can serve to put negative pressure on a firm's stock.[301] There has also been a long string of hedge funds collapsing, such as Long Term

[295] *See e.g.* Dolan v. City of Tigard, 512 U.S. 374, 384 (1994) (holding that forcing a shop owner to dedicate land to a public pathway in exchange for expansion rights was a regulatory taking).

[296] *See e.g.* Pa. Coal Co. v. Mahon, 260 U.S. 393, 413 (1922) (holding that a takings analysis must include attention to how much diminution in value there was).

[297] *Id.*

[298] Berman v. Parker, 348 U.S. 26, 33 (1954).

[299] Haw. Hous. Auth. v. Midkiff, 467 U.S. 229, 241 (1984).

[300] Oesterle, *supra* note 17, at 9.

[301] *Id.* at 10.

Capital Management (losing nearly $4.6 billion in 1998),[302] and Amaranth Advisors (losing $5 billion in 2006).[303] There are also the scandals and fraudulent actions, such as KL Group admitting to a $194 million scam.[304]

These factors, taken together, have led many to fear and distrust the hedge fund industry. One of the most widely supported methods for remedying this situation is increased disclosure practices. In recent years there has been a surge in the United States calling for tighter regulations, including some increased disclosure requirements.[305] President Barack Obama's nominee to lead the SEC vowed to increase enforcement and vigilance, particularly with hedge funds.[306] This sentiment is being seen around the world as nations vow to step up their hedge fund regulations.[307]

This note will run through several of the most important proposals examining their merits, ultimately arguing that any future increases in disclosure should be handled very carefully. There are several considerations to examine when looking at these proposals. The first, and arguably the most important, is whether the proposal will hamper a firm's competitive advantage. There is a fine balance between protecting investors and intrusion into the market place. When a regulation intrudes too far into a firm's ability to compete it runs counter to the will of the Securities and Exchange Acts, as well as the general notion of a capitalist market. There is the added threat of driving investors to foreign hedge funds.

The second set of considerations is the costs of implementation. The Working Group noted in their 1999 report that direct regulations of the hedge fund industry come at a great price.[308] There are issues of the increased costs for hedge funds to comply (including possible registration fees), as well as the burden on the SEC and other agencies of enforcing these new regulations.[309] Part of what makes 13(f) so effective is that it neither hampers hedge funds nor imposes large costs on them.[310] The next set of proposals will be evaluated looking at the same considerations. Many of these proposals, such as the hard-to-value assets

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[302] LOWENSTEIN, *supra* note 166 (documenting the entire Long Term saga in great detail).

[303] Alistair Barr, *San Diego Pension Fund Sues Amaranth,* MARKET WATCH, Mar. 30, 2007, http://www.marketwatch.com/news/story/san-diego-pension-fund-sues/story.aspx?guid=%7B816AD0AD-C6BB-400E-8D63-14B7863C3B3C%7D.

[304] *Hedge Funds Admit to $194 Million Scam,* U.S. ATTORNEY GENERAL'S OFFICE: SOUTHERN DISTRICT OF FLORIDA, July 20, 2007, http://www.usdoj.gov/usao/fls/PressReleases/070720-01.html.

[305] *See, e.g.,* Jenny Strasburg, *Hedge Funds on Hot Seat,* WALL ST. J., Nov. 10, 2008 at C2 (discussing how several of the industry's top managers appeared before Congress to address their role in the financial collapse and new regulations. One hedge fund law firm commented "Large hedge funds are expecting increased regulation…").

[306] Kara Scannell, *Schapiro Pledges Vigilance as SEC Chief,* WALL ST. J., Jan. 16, 2009, at C3.

[307] John McKinnon, *Rethinking Capitalism's Contours,* WALL. ST. J., Oct. 20, 2008, at A4 (writing on an international summit between world powers discussing, among other things, hedge fund regulation. French President Nicolas Sarkozy stated "Hedge funds cannot continue operating as they have in the past; tax havens, neither; financial institutions that are under no supervisory control – this is no longer acceptable, this is no longer possible."). *See also* Cassell Bryan-Low, *U.K. Parliament Grills Hedge-Fund Heads,* WALL ST. J., Jan. 28, 2009, at C3.

[308] *Hedge Funds, supra* note 10, at 42.

[309] *Id.*

[310] *Rulemaking for EDGAR System*, *supra* note 106, at 6.

recommendation, fail these criteria. Others, most notably the private market intermediary and accredited natural person, fit well within the framework.

The first proposal is online brochures. In 2003, a Staff Report to the SEC encouraged greater disclosure in the form of a brochure.[311] The brochure would be designed for both investors and prospective investors alike.[312] Contained in the brochure would be important information on how the hedge fund operates, including: how they value securities, risk management procedures, what lock-in periods the firm has, and other valuable information.[313] The plan was not initiated, however, and put on the backburner.

In February of 2008 the SEC revisited their plan for brochures.[314] Currently advisers may offer online brochures to state regulators, but are not required to submit them to the SEC or other federal agencies.[315] A move to online brochures is expected to "reduce compliance costs and yield savings on printing and mailing."[316] At this point it is too early to accurately determine if the plan will move forward since there are many crucial issues in the precise details of the plan.[317]

This proposal should not have any adverse affect on hedge funds and, aside from an initial switching cost, should not be too burdensome. The information contained in the brochure can be found in a number of places already, and thus does not erode any additional competitive edge. The Staff Report admits that much of the information is the same as found in a firm's offering memorandum (OM) or private placement memorandum (PPM).[318] These documents are provided by hedge funds to prospective clients and provide a fair amount of detail about the firm. However, some, like Duane Thompson, managing director at the Financial Planning Association, feel that OMs and PPMs are too thick and intimidating.[319] The brochure would provide information in a much more user-friendly and intuitive format.

Much of the information is also contained in a firm's Form ADV. Generally hedge funds with over $25 million in assets under management will file ADVs with the SEC.[320] Part One of the Form provides basic information about the hedge fund, such as headquarters, number of employees and so forth.[321] Part One is filed and can be recovered electronically.[322] Part Two provides more insight into the hedge fund's practices, such as fees, strategies and so forth.[323] Part Two is not

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[311] *Implications, supra* note 8, at 97.
[312] *Id.*
[313] *Id.* at 98.
[314] Burns, *supra* note 14, at A14.
[315] *Id.*
[316] *Id.*
[317] *Id.*
[318] *Implications, supra* note 8, at 98.
[319] Burns, *supra* note 14, at A14.
[320] SEC, *Form ADV,* (2006), *available at* http://www.sec.gov/answers/formadv.htm.
[321] *Id.*
[322] *Id.*
[323] *Id. See also* Jenny Anderson, *A Modest Proposal to Prevent Hedge Fund Fraud,* N.Y. TIMES,

required to be filed electronically.[324] The 2003 Staff Report also acknowledges some overlaps with the Form ADV, but again insists there would be additional benefits to an online database.[325]

The move to online brochures is more of an extension of existing policies than a revolutionary change. Much of the information contained in the brochure can already be found in an OM, PPM or Form ADV. The advantage would be to create a database with easier access for investors, where they can quickly compare important criteria between hedge funds. This move should not impair any hedge funds and aside from initial set-up costs the plan might actually save money over time. In general, this proposal seems acceptable, but does not seem to make any real strides towards addressing the faults in the current regulatory scheme.

A second recommendation concerns how hard-to-value assets. The Hedge Fund Working Group (HFWG) is a group of hedge fund managers from the United Kingdom (UK).[326] In June of 2007, the HFWG set out to study in depth the hedge fund industry and presented their findings in a Final Report in January of 2008.[327] Based on their findings they recommended several proposals moving forward, including several increases in disclosure.[328]

One of their proposals is that hedge funds should include more information on hard-to-value assets.[329] The HFWG writes:

> A hedge fund manager should, in cases where, in its view, the fund has material exposure to hard-to-value assets, ensure that any disclosure in its own marketing materials relating to the fund's performance is accompanied by a reference to any factors which may be material to the robustness of the performance calculation. A hedge fund manager should also do what it reasonably can to enable and encourage the fund governing body to include similar references in the fund's offering documents where they include details of the fund's performance.[330]
>
> Such factors might, amongst others, include: the percentage of the portfolio invested in what the manager considers being hard-to-value assets; the method used in valuing assets which the manager considers to be hard-to-value; and the use of side pockets.[331]
>
> - the percentage of the portfolio invested in what the manager considers to be hard-to-value assets;

Oct. 7, 2005, at C6, *available at* http://www.nytimes.com/2005/10/07/business/07insider.html?_r=1&adxnnl=1&oref=slogin&adxnnlx=1218219447-9aTEBdqeTZGD8tRczhqgoQ (calling for additional changes in Form ADVs, such as the name of the auditing accountant, to help prevent hedge fund fraud. These proposals help illustrate the precise information that should be included in a Form ADV is also currently being debated.).

[324] *Id.*

[325] *Implications, supra* note 8, at 98.

[326] THE HEDGE FUND WORKING GROUP, HEDGE FUND STANDARDS: FINAL REPORT 4 (Jan. 2008), *available at* http://www.pellin.co.uk/HFWG/Final-Report.pdf [hereinafter *THE HEDGE FUND WORKING GROUP]*.

[327] *Id.*

[328] *Id.* at 40-45.

[329] *Id.* at 44.

[330] *Id.*

[331] *THE HEDGE FUND WORKING GROUP, supra* note 326.

- the method used in valuing assets which the manager considers to be hard-to-value; and

- the use of side pockets.[332]

The theory behind this recommendation is that hard-to-value assets in particular pose a huge risk for investors.[333] Their value can swing dramatically and thus investors may not be fully aware of their risk.[334] Even sophisticated and savvy investors may not fully appreciate their risk without knowing some of the basics to the hedge fund's operations on hard-to-value assets. That being said, providing a percentage of the portfolio in hard-to-value assets, the first of the HFWG's recommendations, will prove difficult to provide and may unduly scare aware investors. Providing investors with all of their hard-to-value methods, the second recommendation might handcuff hedge funds in the future and limit their competitive edge. Rather, it might be beneficial for hedge funds to offer a few examples of their methods in the OM or PPM to give investors an idea.

The third recommendation deals with side pockets. Side pockets are "similar to a single-asset private equity fund."[335] Hard-to-value (or sometimes illiquid) assets are often designated for a side pocket to provide greater flexibility to the hedge fund.[336] Once the asset is in the side pocket new clients will not share in it, existing clients may redeem the value once it is finally liquidated.[337] Fees are similar with a management and incentive fee, but the terms of the side pocket are looser.[338] There may be no date for liquidation, and fewer limitations on the size and nature to the side pocket.[339] Adding additional information on the use of side pockets in the OM and PPM will give investors greater insight for the future, but ultimately is not necessary. Side pockets are largely negotiated on a one-on-one basis and therefore the investors will be fully informed of the conditions upon entering into the side pocket agreement.

There are several important issues to note about this proposal. The first is that the HFWG is UK- based and has no direct influence in the United States. However, the UK is an important financial center for hedge funds and US regulators look closely at their practices.[340] Assets under European hedge funds grew 80% from 2003 to 2005, investors view the United States' markets as more regulated and controlled (largely due to the Sarbanes-Oxley Act) and the euro helping European investors are just some of the reasons for the UK's recent

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[332] *Id.*

[333] *Id.*

[334] *Id.*

[335] Stephanie Breslow & Paul Gutman, *Hedge Fund Investment in Private Equity,* ALTASSETS, Feb. 11, 2005, http://www.altassets.com/features/arc/2005/nz7645.php.

[336] *Id.*

[337] *Id.*

[338] *Id.*

[339] *Id.*

[340] Heather Timmons, *New York Isn't the World's Undisputed Financial Capital,* N.Y. TIMES, Oct. 27, 2006 at C1.

surge.[341] The United States will certainly keep an eye on if these regulations are put in place and their effect.

A second issue is that the HFWG is not the formal UK regulatory body. They are a group of self appointed managers who undertook this project on their own.[342] Critics argue that the HFWG is a non-independent board that has an obvious interest in how hedge fund regulation proceeds.[343] These critics feel that investors' priorities were not sufficiently represented and that while the Final Report is a solid start, much work needs to be included.[344] Interested parties in the United States, like the SEC, surely recognize that the HFWG is not independent and will view their proposals through this lens. Due to the excessive scope and costs associated with this project it would benefit the SEC to wait and see how this regulation plays out in the UK first before moving ahead with their own initiative. However, in its current form the proposal seems to place too great a burden on hedge funds and will hamper their competitive edge.

The HFWG's Final Report has an even bolder proposal for the future of hedge fund disclosure, and that is industry disclosures. The proposal is to create an easily navigable database on industry characteristics made available to the public.[345] The information would include statistics like the number of hedge funds in existence, assets under management, definitions (of strategies, industry terms like side pockets and similar issues), typical fee structures and other useful information to investors. HFWG Chairman Sir Andrew Large said: "The initiative had come about because the industry's largest firms recognize there is a deficit in accurate and comprehensive information about the hedge fund industry, and that they should rectify it. Improvement is needed in two areas: publicly available generic data about the sector; and information about individual firms."[346]

The first obstacle to this proposal is that hedge funds can not advertise and solicit the general population.[347] Sir Large advocates that if the information is purely factual in nature and not used as a solicitation the project could go forward.[348] Even information as seemingly harmless as assets under management could be viewed as a selling point if easily compared to assets under management by other types of investment managers (such as mutual funds). Additionally, typical strategies that are available to hedge funds exclusively may be seen as an advantage and therefore a selling point.

The second obstacle is the cost associated with maintaining accurate information.[349] Statistics, such as the number of hedge funds and assets under management, will constantly be changing and surveying the markets could be

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341 *Id.*

342 Hedge Fund Working Group – "doing what you reasonably can", http://castlehall.typepad.com/risk_without_reward/2008/01/hedge-fund-work.html (Jan. 22, 2008).

343 *Id.*

344 *Id.*

345 William Hutchings, *Hedge Funds to Improve Public Disclosures,* E. FINANCIAL NEWS, Jan. 23, 2008, http://www.efinancialnews.com/homepage/content/2449621990.

346 *Id.*

347 Oesterle, *supra* note 17, at 3.

348 Hutchings, *supra* note 345.

349 *Registration, supra* note 13, at 72061.

costly. Determining how often to update the information is another issue that has direct implications for the costs of the project.

In its current state this proposal seems unlikely to gain traction in the United States anytime soon. One adaptation would be to move forward with the project, but only make the information available to sophisticated investors who qualify to invest with hedge funds. The industry characteristics can be provided to investors, along with the hedge fund's OM or PPM, to give the investor a better feel about the industry as a whole. This might serve as one last warning to investors who technically qualify to invest with hedge funds but who still lack the sophistication to truly appreciate the risks associated with doing so.

Another proposal that has been advanced is the creation of a new regulatory body.[350] This proposal can manifest itself in one of two forms, the first of which is a self regulation organization. A pure market discipline theory, or self regulation, argues that banks and securities firms have incentives, including shareholder pressure, to limit their risk to hedge funds.[351] Avoiding excessive risk will force banks to limit their exposure to hedge funds, or in other words, hedge funds' leveraging will be capped.[352] However, this theory often breaks down since in good times banks are more generous with their loan processes to obtain even greater returns.[353]

Self regulation is sometimes augmented by introducing a self regulation organization (SRO), such as the Federal Reserve.[354] The SEC could help assist in the creation of the SRO and what its powers would be.[355] SROs usually keep up with industry needs and trends fairly well and can be more sensitive to compliance costs than a pure regulatory body.[356] SROs internalize the costs for regulation and therefore have a natural incentive not to over-regulate the industry since they are the ones to who balance the costs and benefits.[357]

A SRO would have the benefit of industry support, natural incentives not to over-regulate, fair fee schedules, and the ability to maintain a pure market feel to the industry.[358] A SRO would help prevent some of the fraudulent activities and blow-ups that have plagued the industry. However, establishing the boundaries for the SRO might prove difficult. How much hedge funds would be required to disclose to the SRO, and how that information would be protected, would need to be addressed from the start. This method has promise but is currently not being supported by any major agencies or big players in the industry and for the moment does not appear to be seriously considered. A more likely solution will be in the

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[350] *Hedge Funds, supra* note 10, at 430.

[351] *Id.*

[352] *Id.*

[353] *Id.*

[354] Posting of A Self Regulation Proposal for the Hedge Fund Industry to The Harvard Law School Corporate Governance Blog, http://blogs.law.harvard.edu/corpgov/2008/01/24/a-self-regulation-proposal-for-the-hedge-fund-industry/ (Jan. 24, 2008, 11:02 EST).

[355] *Id.*

[356] *Id.*

[357] *Id.*

[358] *Id.*

second form of a new regulatory body, that is, a private market intermediary.

The second version of a new regulatory body to examine is a "private market intermediary."[359] This has the unique feature of increased disclosure to a private party, rather than the public at large.[360] Under this plan a singular or select few private rating agencies would receive increased information about the hedge funds, such as more details about their leverage and risk.[361] For this plan to move forward there would have to be assurances on the safety of the firm's propriety data, but the government has made similar agreements in the past.[362]

This will in effect create industry standards which the intermediary will monitor.[363] Hedge funds will need to be certified by meeting minimal standards and operational practices.[364] In order to receive future investors the firm will need to maintain its certification, otherwise it will lose substantial business.[365] Proponents of this solution do not feel that it is a stand alone solution since the influence of institutional investors is not limitless.[366]

This plan offers several significant advantages to all interested parties. This would definitely ease concerns for investors, such as pension plans, who will now take comfort in minimal standards and increased oversight.[367] Secure hedge funds will most likely already meet the standards and may welcome the change as a chance to block out future competitors. They might also benefit by increased investor confidence which would translate into new investors to entering the market. The SEC and other regulatory agencies will also benefit. Hedge funds will finally be regulated bringing greater security and stability to the markets, but the SEC will not have to deal with the direct costs of the oversight.

However, there are a number of drawbacks and weaknesses to this approach. There are several issues surrounding the establishment of the intermediary. Hedge funds will not back this proposal without feeling secure that their propriety information can not be leaked or will be shared with other government agencies. Small hedge funds are particularly likely to resist since the costs will impact them more and getting certified might prove more difficult. There is also the issue of agreeing on industry standards. Firms already disagree on effective (and responsible) levels of leverage, investment strategies, general disclosure requirements, fees and other operational considerations. Furthermore, the considerations large, established firms will agree on can drastically differ from those of smaller firms just starting up. Investors, for that matter, also differ on what are acceptable standards.[368] A further drawback is that potential conflict of interests could arise with the intermediary serving both investor and hedge fund

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[359] Verret, *supra* note 158, at 833.

[360] *Id.*

[361] *Id.*

[362] *Id.*

[363] Harvey Westbrook Jr., *Hedge Fund Industry Structure and Regulatory Alternatives,* Q-GROUP, Sept. 08, 2003, at 24-25, http://www.q-group.org/archives_folder/pdf/Westbrook.pdf.

[364] *Id.* at 9.

[365] *Id.* at 25.

[366] Varret, *supra* note 158, at 834.

[367] Westbrook, *supra* note 363, at 25.

[368] *Id.* at 26.

interests.[369]

Another consideration for this proposal is where will funding will come from.[370] One answer would be for hedge funds to pay a registration fee; however, this will likely deter hedge fund support. The intermediary could receive funding from the federal government but that means that the taxpayers would bear the burden and that could prove difficult. Investors could pay a modest fee when they access the intermediary's information but that alone probably would not be sufficient. The most likely answer is a combination of the different fees to spread the cost around.

This proposal has a lot of merit behind it, although there are substantial hurdles to overcome. The concerns with hedge funds, such as overleveraging and fraudulent accounting practices, would be addressed with greater oversight. At the same time a firm's competitive advantage is not severely hampered since the information is not shared with the public or other hedge funds. This plan does not appear to be ready for action anytime soon, though. First, hedge funds must agree with the standards which could get drawn out. The issues of funding the program, information security and other operational considerations also threaten this program. All the factors taken together weigh favorably for this policy to move forward.

A fifth proposal centers on commodity pool operator filings. Commodity Pool Operators (CPO) are organizations or individuals who pools funds into commodity options or commodity futures.[371] CPOs register with the Commodity Futures Trading Commission (CFTC) and as such have to submit annual filings.[372] These filings include risk and performance disclosures under Title 17 of the Commodity and Securities Exchanges §4.[373] Many hedge funds meet these requirements and do in fact register and report to the CFTC.[374]

The Working Group recommended several changes for hedge funds that are also registered CPOs in their 1999 report.[375] The first suggestion is that these reports are filed quarterly instead of annually, allowing the information to reach investors quicker than the current process.[376] In addition, the scope of these reports should include more information on market risk "without requiring the disclosure of proprietary information on strategies or positions."[377] Lastly, individual financial reports should also be published.[378]

This suggestion has several complications that dim its chances. The first is that not all hedge funds are CPOs and therefore do not register with the CFTC.

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[369] Varret, *supra* note 158, at 835.

[370] *Id.* at 834.

[371] *Commodity Pool Operator,* NATIONAL FUTURES ASSOCIATION, 2009, http://www.nfa.futures.org/registration/cpo.asp [hereinafter *CPO*].

[372] *Id.*

[373] Commodity Futures Trading Commission, 17 C.F.R §4 (2005).

[374] *CPO, supra* note 371.

[375] *Hedge Funds, supra* note 10, at 32.

[376] *Id.*

[377] *Id.*

[378] *Id.* at 33.

The Working Group makes note of this point and suggests that Congress enact legislation mirroring the CFTC's regulations.[379] Getting the legislation off the ground and having it match the CFTC's in order to avoid unfairly burdening one group of hedge funds (i.e. those that are CPOs or those that are not) will take time and may even prove impossible.

The second complication is that many CPOs opt out of the disclosure requirements of the CFTC.[380] A CPO needs to satisfy two conditions to do so. First, the CPO must not be subject to any statutory disqualifications under Rules §8(a)(2) and §8(a)(3).[381] This means that the CPO must be free from fraud, material investigations, penalties and the like. Second, the CPO must meet all of §4.7's requirements.[382] The quickest, and most efficient way, to do this is having the client sign a §4.7 waiver, which enables the CPO to treat the client like a Qualified Eligible Person.[383] The CPO must still file the annual report, but does not need to file as much information.[384]

If the CFTC pushed filing from an annual schedule to quarterly, it would receive opposition, not only from hedge fund managers, but from all CPOs. A similar sentiment surrounds expanding the scope of disclosure requirements since this risks revealing propriety information. Even if these changes are approved, not all hedge funds are CPOs and many that are opt out of significant portions of the disclosure process. All these factors taken together mar this proposal's chances.

A sixth proposal concerns how material exposures to highly leveraged companies are disclosed. The Working Group made another disclosure proposal in their 1999 report; however, it was for public companies and not hedge funds.[385] The Working Group offers that public companies, including both financial and non-financial firms, should "publicly disclose a summary of direct material exposures to significantly leveraged financial institutions."[386] Leveraged financial institutions could include hedge funds, banks, finance companies and others.[387] The rationale behind this move is to add greater weight to private market discipline and cause public companies to pay closer attention to their risk lest running the risk of enraging their shareholders.[388]

Currently, neither the SEC nor the generally accepted accounting principals specifically call for such a measure.[389] The information conveyed should include their exposures and to whom, how they are measured and their diversification. The Working Group suggests this information could be contained in a document publicly filed with the SEC, such as Form 10-K and Form 10-Q.[390]

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[379] *Id.*
[380] *CPO, supra* ,note 371.
[381] 17 C.F.R §8 (2005).
[382] 17 C.F.R §4.7 (2005).
[383] *Id.*
[384] *Id.*
[385] *Hedge Funds,* supra note 10, at 33.
[386] *Id.*
[387] *Id.*
[388] *Id.*
[389] *Id.*
[390] *Hedge Funds, supra* note 10, at 33.

This proposal has been mulled over by authorities following the collapse of LTCM in 1999.[391] Following the collapse, Patrick Parkinson, Associate Director of Division of Research and Statistics at the Federal Reserve, testified that:

> 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.[392]

This proposal has several advantages that makes it attractive. First, the costs associated with this idea are minimal since this information is readily available to public companies already. Second, this should not hamper competitive edges too much since banks and other public companies already make it known to shareholders that they do in fact invest in hedge funds, but do not necessarily disclose full amounts. This recommendation has minimal intrusion into the market place and could make large strides in restoring investor confidence.

One last disclosure proposal concerns investor requirements. Currently there are minimal requirements investors must meet in order to pool their money into a hedge fund. These standards have not been revamped for over twenty years now and many regulators feel they are outdated. By elevating the standards, even fewer people will be allowed to receive a hedge fund's PPM or OM and other materials. By extension, this means that even fewer people will receive the disclosure statements from hedge funds. Increasing the standards to include fewer people will limit the number of potential investors, which is a huge downside for hedge funds. The regulation will, however, mean that only the most sophisticated investors will receive the information and should know how to employ it most effectively. There have been several variations of this proposal put forth.

The first variation deals with accredited investors. The current standard is people who earn $200,000 a year or who hold over $1 million in net worth.[393] Since this standard was first introduced over twenty years ago the number of people who meet these criteria has increased significantly.[394] However, some meet this benchmark due to inflation and not a true increase in wealth.[395] Raising the bar would ensure that only sophisticated investors are involved which allows hedge funds to take on their risky investments without overregulation.[396]

This regulation will most likely include a grandfather clause for those who are current investors but would not meet the new standards. Therefore, this regulation will do little to comfort these investors. A second complication is that

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[391] Nelson, *supra* note 80, at 238.

[392] *Id.*

[393] *Id.* at 239.

[394] *Id.*

[395] *Id.*

[396] *Id.*

the SEC and other regulatory bodies will not benefit much from this new change. There is no increase in the amount of data available to the agencies for them to make decisions.

The second variation looks at accredited natural persons. At the end of 2006, the SEC set in motion a proposal to create a new class of investor, the accredited natural person, who would be allowed to invest in hedge funds.[397] This definition would supersede that of the accredited investor and therefore replace it.[398] The new proposal states that a person must have at least $2.5 million (adjusted every five years for inflation) to meet the minimal requirements.[399] The exact number of investors who will now fail to meet the requirements has not yet been studied.

The difference between the two recommendations is essentially how high the bar should be raised. Of the two measures the SEC's accredited natural person criteria has the essential benefit of including measures for the future. This proposal takes into account inflation and provides a periodic check to increase the standards. Although this proposal will not solve many of the problems with in the regulatory scheme, it does seem necessary. By restricting some of the clients, the hedge fund industry may benefit from less litigation since only the most sophisticated investors remain.

VII. CONCLUSION

Hedge funds are a large and important player in America's financial landscape. Due to the recent surge in the number and influence of hedge funds the financial sector has experienced some growing pains. Specifically, regulatory bodies such as the SEC are still figuring out the right balance between a healthy environment for hedge funds and protecting investors.

For over thirty years, the SEC has relied on 13Fs to help strike this balance. However, a recent challenge to their validity by hedge fund manager Goldstein could throw this balance off. Goldstein makes two distinct claims: 1) that the information contained on the form falls under trade secret protection, and 2) the SEC's actions amount to a regulatory taking.

Most likely Bulldog will not prevail on a trade secret argument. Because there are three specific instances where Bulldog reveals this information, they are not the most ideal plaintiff to advance this argument. This will actually be problematic for most firms since many firms divulge certain aspects of their strategies to attract potential customers and retain current ones.

The courts will not view the incomplete, and sometimes outdated, information on a 13F as sufficient enough to satisfy the second prong of harm. Two Sigma, a fellow hedge fund, made a similar argument similar to Bulldog's in 2005 which was shot down since they could not prove specific ways to reverse engineer from 13F forms.[400] Since 13F has been around for over thirty years, firms should be able to prove specific instances where they were harmed. Until

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[397] Verret, *supra* note 158, at 14.

[398] *Id.*

[399] *Id.*

[400] In re Two Sigma Investments, LLC, Exchange Act, Release No. 52135 (2005).

they can actually point to such instances, 13Fs will remain in play for their information gathering uses and due diligence.

The second argument is a takings argument, which will be quite difficult for hedge funds to prove. Firms need to look no further than the first analysis, threshold questions, to encounter problems. Hedge funds need to convince courts that their strategies are in fact "property" as intended by the Fifth Amendment.[401] The fact that there is no market value to the strategies could be a problem, but ultimately courts should be receptive to this argument but not to the point where it would be classified as a *per se* case.[402]

Courts will have a tougher time resolving the policy issues since there is no precise rubric. Courts will have to weigh the balance between hedge funds' competitiveness and investors' knowledge. Since there is an extensive history of protecting investors, and eliminating fraud is crucial to healthy markets, the courts will most likely side with the investors.

There are several important distinctions between this and Goldstein's first lawsuit, which he won. Since the 2006 case, several hedge funds have collapsed and committed fraudulent actions which have raised concerns in Congress. A second distinction is that Goldstein's case will be subject to stricter scrutiny since he is now challenging Congressional legislation as opposed to an agency's interpretation and courts give broader deference to Congressional acts.

One last difference is that the first case was based on a change in a rule that had only existed for a short time; whereas Goldstein's new case is based on 13(f), which has been applied to case law for over thirty years. 13(f) has functioned in an acceptable manner as a whole; therefore, to be overturned would require a more persuasive argument than the one Goldstein and Two Sigma have advanced to be overturned. Thus, for the foreseeable future it would appear 13Fs are secure.

Beyond 13(f), there are a number of new disclosure proposals in the pipeline. Their promulgation comes from a variety of sources including the SEC, Working Group, foreign regulatory agencies and some even from the hedge fund industry itself. Each of these proposals weighs intrusions into the hedge fund environment and the associated costs. These factors are weighed against the added security to investors and markets, as well as the ability for agencies to more effectively do their jobs.

Currently, none of these proposals seems ready for implementation outside of a few years due to the intense battle of the details to follow any of them. However, several of the recommendations have great merit and can serve to benefit both investors and the hedge fund industry. Therefore, it is very likely that in the coming years a version of several of these ideas will be put into place. In the end, it seems that new regulations are only a matter of time.

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[401] *See supra* notes 275-278and accompanying text.

[402] *See supra* notes 279-282 and accompanying text.