AN OPPORTUNITY LOST: THE U.S. SECURITIES AND EXCHANGE COMMISSION'S NEW RULE REQUIRING REGISTRATION OF HEDGE FUND ADVISERS HAS AN ACHILLES HEEL - AND HEDGE FUNDS WILL TAKE ADVANTAGE

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I. Introduction

Hedge Funds. It seems that you cannot read a newspaper, magazine or financial website without taking notice of these stealthy investment mechanisms. Even with all the publicity that these funds receive, both positive and negative, does anyone really know much about them? Estimates show that, as of mid-2004, there were thirty-nine firms in the United States providing either on-shore or off-shore services to hedge funds that were managing around $1.2 trillion in assets.[1] Despite the availability of such estimates, the exact size of the hedge fund industry remains unknown, as neither the U.S. Securities and Exchange Commission ("SEC"), nor any other federal agency, collects data specifically related to hedge funds.[2] It is equally difficult to determine what hedge funds actually are. To the extent that they have been defined, hedge funds are known for their exclusive nature, limited availability only to institutional investors and investors of high net worth, and the sophisticated strategies that they employ, such as short selling, arbitrage and leverage.[3] Beyond that, however, investors are often unclear about what kind of holdings are in their hedge funds and are even less clear about the strategies which those funds' managers employ.

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[1] *See* Xenia P. Koylarz, *Hedge Funds Top $1 Trillion*, EAST BAY BUSINESS TIMES, Aug. 19, 2005, *available at* http://www.bizjournals.com/eastbay/stories/2005/08/22/story3.html.

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

[3] *See* Adam R. Bolter, Note & Comment, *Regulation of Hedge Fund Adviser: A Valid Exercise* of *Rulemaking Authority or the Promulgation of New Law?*, 57 ADMIN. L. REV. 595, 599 (2005).

What is clear, however, is that hedge fund managers have traditionally been able to structure their funds so as to take advantage of the exemptions from registration contained in the four major federal laws regulating the securities and investment industry: the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 ("the Advisers Act"). As a result of such structuring and the consequent covert nature of hedge funds, very little data regarding the funds is available to the SEC and other regulatory agencies. Moreover, there has been an increase in fraudulent activities by managers of those and other funds who have taken advantage of late trading and market timing. Consequently, the SEC has amended Rule 203(b)(3)-1 of the Advisers Act to require that most hedge fund managers register with the SEC, the first step in regulatory oversight of the booming hedge fund industry.[4]

The primary questions that this comment will address are whether the SEC's amendment will provide the oversight needed and whether that oversight will allow the hedge fund industry to continue to thrive. Part II reviews the history, structure, strategy and rise in popularity of hedge funds. Part III examines the recent controversies surrounding hedge funds and how they support the call for hedge fund regulation. This includes some of the more questionable tactics that hedge fund managers employ as well as the fallout from the Long Term Capital Management collapse. Part IV focuses on the SEC's study of hedge funds, its conclusions and consequent amendment of Rule 203(b)(3)-1 and whether that amendment will be successful in achieving the SEC's goals. In particular, Part IV will examine whether it will prevent the hedge fund industry from continuing to provide benefits to investors and the overall economy. In conclusion, Part V argues that the rule will ultimately fail to achieve its intended goal because of a poorly constructed exception that allows hedge fund managers to avoid registration.

II. An Overview of Hedge Funds

A. History

Unlike other information regarding hedge funds, the history of the industry is relatively well documented. The first known hedge

[4] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,054.

fund was formed in 1949 by Alfred Winslow Jones, an Australian investor.[5] Winslow's fund strategy was to find stocks that he felt were overvalued and sell them short, while simultaneously purchasing stocks he deemed undervalued and certain to rise.[6] With this strategy, Winslow was able to hedge against a decline in the market because he was able to profit from the short positions even during a bear market.[7] Only able to raise $100,000 between himself and his friends, Winslow's second strategy was to borrow additional monies, thereby leveraging the fund.[8] Using a combination of these strategies, Winslow's funds returned 325 percent from 1961 to 1966 and an astonishing 670 percent from 1956 to 1966.[9]

Hedge fund activity grew slowly but surely in the years following Winslow's innovation. However, by the beginning of the twenty-first century, hedge funds began growing at an exponential rate. There were an estimated 140 hedge funds in 1968, 300 funds in 1990 and, by 2001, the number had spiked dramatically to 6,000 funds.[10] Within two years, the number of funds had risen to between 6,000 and 7,000 with the total number of assets under hedge fund management eclipsing $650 billion.[11] It is now believed that the hedge fund industry accounts for more than $1 trillion in investment assets.[12]

B. Strategy

With the growth in number and size of hedge funds has come an expansion of the initial strategies used by Winslow, now encompassing a wider variety of investment techniques, not all of which include hedging.[13] The primary strategies can be broken

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[5] David Skeel, *Behind the Hedge*, LEGAL AFFAIRS, Nov.-Dec. 2005, *available at* http://www.legalaffairs.org/issues/November-December-2005/feature_skeel_novdec05.msp.

[6] *See* Joseph Hellrung, Note & Comment, *Emerging Issues in Banking Regulation: Hedge Fund Regulation: Investors are Knocking at the Door, But Can the SEC Clean House Before Everyone Rushes In?*, 9 N.C. BANKING INST. 317, 321 (2005).

[7] Skeel, *supra* note 5.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] Hellrung, *supra* note 6, at 321.

[12] *See Koylarz*, *supra* note 1.

[13] *See* David Harper, *Introduction to Hedge Funds – Part One*, Investopedia Advisor, November 26, 2003, available at http://www.investopedia.com/articles/03/112603.asp.

down into following three main categories, all of which can then be divided into respective subcategories:[14]

1. Arbitrage[15]

Convertible Arbitrage
Fixed Income Arbitrage
Capital Structure Arbitrage
Risk Arbitrage
Statistical Arbitrage

2. Event Driven[16]

Distressed securities
Merger Arbitrage

3. Directional/Tactical[17]

Long/Short (initial Winslow strategy)
Market Neutral
Dedicated Short

C. Structure

A better way to explain hedge funds, however, is not based upon their history or investment strategy, but by their unique structure which is designed to exclude the hedge fund from SEC regulation. By organizing as a limited liability company or limited partnership, hedge funds are able to take advantage of pass through taxation,[18] and avoid SEC regulation by organizing in a way that will take advantage of the exceptions to the four main federal securities laws.[19]

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[14] *Id.*
[15] *See* Riskglossay.com, Market Neutral Trading Strategy, http://www.riskglossary.com/link/market_neutral_strategy.htm (Last visited May 31, 2006) (providing specific examples of arbitrage strategy).
[16] *See* Harper *supra* note 13 (providing specific examples of event driven strategies).
[17] *Id.* (providing specific examples of directional/tactical strategies).
[18] *See* Jonathan H. Gastik, Note, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 595 (2001).
[19] William H. Donaldson, *Testimony Concerning Investor Protection Implications of Hedge Funds Before the House Financial Services Subcommittee on Capital*

1. Exclusion from Registration of the Investment Company Act of 1940

Hedge funds are able to avoid registration under the Investment Company Act of 1940 through the use of two of its exemptions.[20] Section 3(c)(1) exempts from registration investment companies that have 100 or fewer investors.[21] In addition, Congress added a second exclusion in 1996, under Section 3(c)(7), allowing investment companies to forego registration when fund investors are "qualified purchasers." Qualified purchasers include institutional investors and individuals with a net worth in excess of $5 million.[22] Section 3(c)(7) is the more attractive exemption for hedge funds because it places no limitation on the number of qualified investors permitted to partake in the fund.[23] However, a fund need only qualify for one exemption in order to avoid registration with the SEC.

2. Exclusion from the Securities Act of 1933

In order to avoid registration of shares under the Securities Act of 1933, hedge fund shares must be offered via private offering. The main exemption provision is Rule 506 of Regulation D, which allows a private placement exemption for securities which are only offered to "accredited investors," i.e., individuals with either $300,000 in combined annual income, $200,000 in individual annual income or $1,000,000 in net worth.[24] Also exempted are investor entities with over $5,000,000 in net assets.[25] To qualify for the exemption, hedge funds securities may not be offered for sale using general solicitation or advertising.[26]

Markets, Insurance and Government Sponsored Enterprises, May 22, 2003, http://www.sec.gov/news/testimony/052203tswhd.htm.
[20] *Id.*
[21] Investment Company Act of 1940, 15 U.S.C. §80a-3(c)(1) (2000).
[22] Investment Company Act of 1940, 15 U.S.C. §80a-3(c)(7) (2000).
[23] *Id.*
[24] 17 C.F.R. §230.502(c) (2005).
[25] *Id.*
[26] *Id.*

3. Exclusion from the Investment Adviser's Act of 1940

Under the Investment Adviser's Act of 1940, an adviser is "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities. . . ."[27] Any person deemed an investment adviser within the meaning of the Adviser's Act must register with the SEC.[28] As part of that registration, advisers must file a Form ADV with the SEC which requires advisers to disclose information regarding business practices and disciplinary history.[29] The registered adviser must also observe specific accounting standards and anti-fraud safeguards, and the adviser is subject to periodic examinations by the SEC.[30]

An investment adviser does not have to register, however, if he/she (1) has fewer than fifteen clients, (2) does not hold himself/herself out to the general public as an adviser, and (3) does not advise a registered investment company.[31] Moreover, pursuant to the small adviser exception, an adviser may treat corporations, partnerships and limited liability companies as single clients.[32] Therefore, hedge fund advisers traditionally have not had to register with the SEC because the hedge fund is considered one client.

4. Exclusion from the Securities Exchange Act of 1934

Under the Securities Exchange Act of 1934, all brokers and dealers of securities must register with the SEC.[33] Hedge fund managers classify themselves as "traders" of securities and are thus exempt from the registration requirements.[34] Furthermore, by limiting the number of participating equity holders to 499 or fewer, hedge funds are able to avoid the registration requirements of Section 12(g) and Rule 12g-1 of the Exchange Act. The requirements

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[27] Investment Advisers Act of 1940, 15 U.S.C. §80b-2(a)(11) (2000).
[28] Investment Advisers Act of 1940, 15 U.S.C. §80b-3(a) (2000).
[29] 17 C.F.R. §275.203-1 (2005).
[30] Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (2000).
[31] 15 U.S.C. § 80b-3(b).
[32] 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2005).
[33] Securities Exchange Act of 1934, 15 U.S.C. § 15a(1) (2000).
[34] *See* Hellrung, *supra* note 6, at 323.

demand registration of issuers who have 500 or more holders of record of a class of equity securities[35] and over $10 million in assets.[36]

5. Compensation Structure

Hedge funds also have a unique way of charging fees to their investors. Unlike mutual funds managers, who usually charge 1 percent of the money that they manage, hedge fund managers usually charge a fee of 20 percent of the fund's profits, in addition to the traditional 1 percent of funds under management.[37]

D. Rising Popularity

The hedge fund craze is a recent development, with the number of funds increasing 2,000 percent between 1990 and 2000.[38] What is behind this growth? The simple answer is that hedge funds are able to maneuver through the securities law landscape in order to avoid regulation. This allows fund managers to use a number of strategies that are unavailable to mutual fund managers, such as leverage, short selling and trading options and other derivatives. As a result, hedge funds have been able to offer high returns even when the market takes a turn for the worse – a claim that mutual funds cannot make.

Furthermore, hedge funds are considered beneficial to the economy because the "liquidity hedge funds provide to the marketplace in the form of risk capital creates more stable and efficient markets and reduces systemic risk."[39] In other words, hedge funds absorb risk in markets "by serving as ready counterparties to those wishing to hedge risk, even when markets are volatile." Moreover, "their active trading and research contribute to greater pricing efficiencies in our financial markets."[40]

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[35] 15 U.S.C. § 78l(g)(1)(B).
[36] 17 C.F.R. § 240.12g-1 (2005).
[37] Skeel, *supra* note 5.
[38] Skeel, *supra* note 5.
[39] *Regulation of the Hedge Fund Industry: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affiars*, 108th Cong. 1 (2004) (statement of Adam C. Cooper, Chairman, Managed Funds Association), *available at* http://banking.senate.gov/_files/ACF3D.pdf.
[40] *Id.*

However, these reasons alone cannot explain the rapid growth of hedge funds over the last several years, because such funds have been available for over fifty years. Rather, the real catalyst behind the recent rise in hedge fund popularity is an increase in the supply of funds available to investors – a direct result of the National Securities Market Improvement Act of 1996. That Act added the aforementioned Section 3(7) of the Investment Company Act, which provides that a fund can have an unlimited amount of "qualified investors" without triggering registration requirements under that act.[41] This new exemption dramatically opened up the ability for hedge fund managers and opportunistic money managers to attract more investors to more funds. Consequently, these managers also increased the amount of money received in fees and compensation.[42] Considering the fact that the performance of most mutual funds perennially trails the S&P 500,[43] it is clear why hedge funds have become such hot commodities over the past ten years.

III. The Case for Hedge Fund Regulation

With the rise in popularity of hedge funds, the expectations of current and potential investors have increased.[44] Those expectations have driven hedge fund managers to take greater risks in order to maintain high levels of returns. Their risk-taking has often resulted in the overuse of leverage and the employment of questionable tactics, some of which have been illegal. Consequently, as illustrated below, hedge funds have been involved in some of the less favorable news headlines over the past few years, causing the financial community and the SEC to open their eyes to the unique problems that hedge funds can cause to those funds' investors as well as to the economy. Those problems can be divided into three categories based upon which parties they negatively affect, namely: (1) direct investors in hedge funds; (2) indirect investors in hedge funds, and; (3) non-investor market participants.

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[41] *See* Riskglossary.com, Hedge Fund, http://www.riskglossary.com/link/hedge_fund.htm (last visited Apr. 3, 2006).

[42] *Id.*

[43] *See* Justin Fox, *Fear of a Black Box*, FORTUNE, Nov. 14, 2005, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2005/11/14/8360677/index.htm.

[44] Skeel, *supra* note 5.

A. How Hedge Funds Can Negatively Affect Direct Investors in Hedge Funds - Fraud

Though an unfortunate fact, it is a reality that some hedge fund managers are simply more concerned with lining their own pockets than in generating above-market returns for their investors. In 2004, Bayou Management, LLC of Stamford, Connecticut was accused of converting hundreds of millions of investor dollars, while at the same time falsely reporting significant profit margins for those same investors.[45]

Of course, the example of Bayou Management was not an isolated case. Conrad Seghers, a founder of the hedge fund Integral Investment Management, received over $43 million from the Art Institute of Chicago to invest in funds which he promised would return profits at a rate of 1 to 2 percent per month.[46] Instead, he invested the money in a friend's internet startup company, and promptly lost $20 million.[47] In another recent case, the West Palm Beach based KL Group Hedge Fund shut down operations amidst reports that it had fraudulently reported inflated earnings of 70 and 40 percent over the past two years, when the company was actually losing money.[48]

These cases are merely representative of the increase in reported hedge fund fraud. In the past five years, the SEC has brought fifty-one fraud actions against hedge funds.[49] While this is not necessarily a large amount, it is certainly a large enough number to garner the SEC's attention, resulting first in a 2002 study of the hedge fund industry, and finally, in the promulgation of a new rule designed to bring hedge funds partially within the SEC's oversight.[50]

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[45] Skeel, *supra* note 5.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *See* Registration under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 2.

B. How Hedge Funds Can Negatively Affect Indirect Investors in Hedge Funds

1. Funds of Hedge Funds

One area in which the SEC has expressed concern regarding the effect of hedge funds on indirect investors is the use of funds of hedge funds (FOHF).[51] As of the date of the SEC's new rule requiring registration of hedge fund advisers, there were fifty-two registered FOHFs that offered their shares publicly.[52] While those funds have traditionally sold shares only to accredited investors, there is no rule preventing them from doing otherwise.[53] Furthermore, those funds represent "approximately twenty percent of hedge fund capital, and are the fastest growing source of capital for hedge funds."[54] Consequently, there is a growing concern that hedge funds will become more accessible to the general public through the use of these indirect investment mechanisms.

2. Institutional Investors

After watching investment banker David Swensen put a large portion of Yale University's $15.2 billion endowment into various hedge funds and earn large returns, other universities soon followed suit.[55] Of course, university endowment funds were not alone in rushing towards this high return investment vehicle.[56] Public and private pension plans, charitable organizations and trusts have all begun to seek the high returns that hedge funds can offer.[57] In fact, the SEC believes that institutional investing in hedge funds may increase by as much as $300 billion over the next four years.[58] These trends have signified to the SEC that the risks and rewards of hedge funds are now starting to trickle down to non-sophisticated, indirect investors whose pension benefits and other investments are now

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[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] Skeel, *supra* note 5.
[56] *See* Registration under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 2.
[57] *Id.*
[58] *Id.*

subject to the vagaries of the hedge fund industry. These trends have added to the case for hedge fund regulation.

C. How Hedge Funds Can Negatively Affect Non-Investor Market Participants

1. The Fall of Long Term Capital Management

Long-Term Capital Management ("LTCM") was a hedge fund created in 1994 by former Salomon Brothers bond trader John Meriwether.[59] LTCM employed a complex strategy in which it would take advantage of fixed income arbitrage deals in U.S., Japanese, and European sovereign bonds.[60] LTCM believed that the value of long term bonds issued on different dates would eventually become identical and that this could be turned into a profit situation as the difference in the value of the bonds narrowed.[61] However, because the differences in value were small, the fund needed to take highly leveraged positions in order to make any substantial profit.[62] By 1998, LTCM had equity investments of $4.72 billion and borrowed over $131 billion,[63] with another $1.25 trillion in off-balance sheet derivative positions.[64]

The downfall of LTCM began in June of 1998, when net returns fell 10 percent.[65] By August of that year, the Russian government defaulted on their sovereign debt and investors responded by selling Japanese and European bonds in order to purchase U.S. treasuries.[66] As LTCM's strategy was based on the value of similar bonds converging, this development caused LTCM to lose over $1.85 billion in capital as the prices of the bonds diverged.[67] Further aggravating the damage to LTCM was a "flight

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[59] *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED, 7 & 39 (2000).
[60] *Id.* at 54 & 110.
[61] *Id.* at 27-28.
[62] *Id.*
[63] *Id.* at 120 (calculating leverage amount from the "28 to 1" leverage figure provided by author).
[64] *Id.* at 200.
[65] *Id.* at 136.
[66] *Id.* at 144-45.
[67] *Id.* at 147-50.

to liquidity",[68] causing LTCM to eventually lose over $4 billion dollars.[69] This necessitated a bailout in the amount of $3.625 billion by the Federal Reserve Bank of New York.[70] The bailout was prompted by fears that there would be a chain reaction as LTCM liquidated its securities to cover debt, causing the prices of those securities to drop and forcing those companies to liquidate their own debt, thereby causing a viscous cycle and a large scale economic collapse.[71]

The fall of LTCM illustrates the increased role that hedge funds play in the world economy and, perhaps more importantly, why some degree of regulation of those funds is necessary. When a fund reaches the sheer size of LTCM, it creates systematic economic risks to the rest of the financial world, endangering even those market participants that are not part of the fund.[72] It is this kind of large scale macro-risk that has propelled the SEC into action, a point that is lost on those who claim that the "sophisticated" investors in hedge funds do not require the same level of regulatory protection as those who invest in mutual funds. The movement towards regulation is not only a reaction to the collapse of LTCM alone, but is also a response to other similar incidents involving hedge funds over the past few years.

2. Market Timing and Late Trading

The LTCM incident could be attributed simply to bad luck and overuse of leverage. After all, LTCM could not know that the Russian economy would collapse and default on its bonds. Though LTCM may have engaged in overly risky and imprudent behavior, its collapse and the ensuing damage was not directly tied to any unethical or illegal behavior. The same cannot be said for other hedge funds, such as Canary Capital Partners, that were using their financial power to engage in illegal practices such as late trading, and unethical behavior such as market timing.[73]

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[68] *See* Gouda Abdel-Khalek, *Bad Policies or Systemic Dysfunction? The Perils of Financial Globalization: A South View* 12 (USC CLEO Research Paper, Paper No. C03-18), *available at* http://ssrn.com/abstract=434741.
[69] *See* LOWENSTEIN, supra note 59, at 147 & 210.
[70] *Id.* at 207.
[71] *Id.* at 194-95.
[72] *See* Gastik, *supra* note 18, at 623.
[73] *See* Skeel, *supra* note 5.

Market timing occurs when fund traders buy and sell stakes in mutual funds based on stale information.[74] Essentially, market timers are able to purchase shares of a mutual fund before that fund has had the ability to account for the positive changes in value of the stocks of its portfolio companies.[75] The next day, when the value of the mutual fund increases, the market timers are able to realize a gain that ordinary investors could not.[76] While this practice is legal, it is frowned upon and is often not allowed by mutual fund managers. However, the sheer volume of available investment capital that hedge funds can provide has apparently influenced mutual fund managers to allow the practice to its "preferred customers," such as with Canary Capital Partners.[77] In most circumstances where hedge funds were allowed to partake in market timing, the hedge fund manager promised to make a large investment in the mutual fund, thereby increasing the amount of fees to which the mutual fund adviser would be entitled.[78]

Late trading, however, is illegal. Nonetheless, hedge funds have typically been permitted to engage in the activity by unscrupulous mutual fund managers.[79] In this scenario, late traders buy or sell mutual fund shares after the close of American markets at 4:00 P.M.[80] This allows traders to turn a profit based upon information that is not reflected in the days share price and will not be so reflected until the next trading day.[81]

Recently, New York Attorney General Elliot Spitzer has begun to crack down on hedge funds like Canary Capital Partners for their role in market timing and late trading.[82] While the actions of these hedge frauds are not detrimental to their own investors, the practices of market timing and late trading are the practical

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[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] *Id.* (The SEC claimed that one mutual fund adviser, Fred Alger Management, had developed a specific formula to determine exactly how much a hedge fund would have to invest in the mutual fund in order to take part in a proportionate amount of market timing).
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*; *See also* Complaint, State v. Canary Capital Partners, (N.Y. Sup. Ct. Sept. 3, 2003), *available at* http://news.findlaw.com/nytimes/docs/nys/nyscanary90303cmp.pdf.

equivalent of stealing from mutual fund investors, who are not afforded the same opportunities for quick profits as the hedge funds.[83] It is estimated that market timing alone costs mutual fund investors $4.9 billion annually.[84]

3. Vote Buying

The efforts of A.G. Spitzer and the New York State Attorney General's Office have succeeded in bringing to light the questionable collusive practices between mutual funds and hedge funds. Those actions, however, may be just the beginning. Private parties and shareholders of portfolio companies are bringing their own actions against hedge funds for practices they believe are detrimental to those companies. Representative of those actions is the litigation brought by Carl Icahn.[85]

Icahn's lawsuit was initiated in order to foil the vote buying scheme of the Perry Corporation, a hedge fund that is run by former Goldman Sachs investment banker Richard Perry.[86] In late 2004, Perry purchased 26.6 million shares (9 percent) in Mylan Laboratories, a drug company in which Icahn was a majority shareholder.[87] At the time, Mylan had an outstanding $4 billion dollar offer for King Pharmaceuticals, a competitor of Mylan's.[88] Perry also owned seven million shares of King stock, and he stood to make over $28 million for his King shares if the Mylan deal went through.[89] Thus, Perry purchased the stake in Mylan in order to vote his shares in favor of the King deal and later sell the Mylan shares for the exact same price at which he bought them.[90]

Of course, Perry was unconcerned about whether the deal was good or bad for Mylan or its shareholders.[91] Rather, he was

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[83] *See* Skeel, *supra* note 5 ("Long-term investors are hurt because they must share their gains with the in-and-out market timers and late traders and because mutual funds must keep a substantial portion of their holding in cash to handle the timers' and traders' frequent withdrawals.").
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] *Id.*
[90] *Id.* (When Perry purchased the Mylan shares, he also entered into a forward contract to sell the shares at the same price at which he bought them).
[91] *Id.*

solely out for a profit which, despite the unethical taint of the vote buy, was not illegal. Although Perry's scheme was eventually halted by the Icahn litigation,[92] the lesson learned from the attempt is clear; hedge funds can legally earn billions of dollars at the expense of shareholders through vote buying. Like the LTCM fallout and the market timing and late trading practices, vote buying is just another example of the potential damage that hedge funds can cause, not to their investors, but to the overall economy and the entities that are the lifeblood of that economy.

4. Note Hoarding and Bankruptcy Voting

In addition to the strategies discussed above, hedge funds also use their financial wherewithal to engage in two other tactics that again, while not illegal, can cause irreparable damage to both the economy generally and the companies targeted by the hedge funds' strategies.

a) Note Hoarding

In May 2005, Chicago based hedge fund Citadel Investment Group bought and held an estimated $8 billion in 10-year U.S. treasury notes, which represented half of such notes readily available on the market.[93] This created problems for people who were in the business of purchasing futures contracts, as those investors were unable to fulfill those future obligations to sell U.S. treasury notes without paying over-market prices to Citadel. This destroyed any possibility of those futures dealers profiting from their transactions.[94] Citadel, meanwhile, made quite a handsome profit at the expense of the futures markets, all while being completely within the letter of the law.

b) Bankruptcy Voting

In a combination of vote buying and note hoarding, hedge funds will often purchase large portions of a certain class of a bankrupt company's debt.[95] This allows the hedge fund to control the

[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] *Id.*

class's vote in bankruptcy reorganization in order to liquidate the assets of the company, despite being counter to the company's best interests.[96] Once again, the sheer buying power of the hedge fund allows it to profit in a legal manner at the expense of the interests of the company which it is using to turn the profit.

5. Naked Shorting

The idea behind short selling stocks is a simple one based on the assumption that certain stocks are overvalued and the market will eventually push the price down to its actual worth.[97] A trader will borrow stocks from a broker and enter into a transaction with a purchaser to sell the stock at the current market price.[98] Simultaneously, the dealer will enter into another transaction to buy back the stock if it drops to a certain price.[99] If the stock falls to the target price, the trader buys it back, returns it to the broker, and pockets the profits.[100]

Short selling is a perfectly legal strategy relied upon by hedge funds in order to help hedge their portfolios. What is not legal in most circumstances, however, is the practice of naked short selling.[101] In a "naked" short sale, "the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period."[102] If a hedge fund were to engage in legal short selling on one hand, and illegal naked short selling on the other hand, the fund could increase the probability that it would cover its short position, and thus turn a profit.

The dangers of naked short selling may be the reason behind the continued slide of Overstock.com's stock.[103] In fact, Overstock CEO Patrick Byrne is so convinced that hedge funds are destroying the share price of his company, that he has initiated a lawsuit against

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[96] *Id.*
[97] *See* SEC Division of Market Regulation, *Key Points About Regulation SHO, April 11, 2005, http://www.sec.gov/spotlight/keyregshoissues.htm.*
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] Bethany McLean, *Phantom Menace*, FORTUNE, Nov. 14, 2005, available at http://money.cnn.com/magazines/fortune/fortune_archive/2005/11/14/8360711/index.htm.

Rocker Partners, a well known hedge fund. Byrne's suit alleges that Rocker has, among other things, engaged in the practice of naked short selling the stock of Overstock, which has resulted in a continued decline of that stock's prices, despite the company's positive earnings.[104] While some may consider Byrne to be overzealous in his position, there are many others who claim that naked short selling by hedge funds is rampant and will continue to ruin companies and their shareholders.[105]

IV. The SEC Throws Its Hat Into the Ring

In 2002, the SEC requested that its staff investigate the activities of hedge funds and their advisers.[106] In connection with the study, the SEC held a Hedge Fund Roundtable in the spring of 2003, where various hedge fund industry participants attended to make their views heard.[107] In September 2003, the staff released its final report, entitled "Implications of the Growth of Hedge Funds."[108] This report reflected the issues and concerns discussed in the previous section of this note, and provided recommendations on how the SEC might adequately address those concerns. With the information and recommendations from the Hedge Fund Roundtable and the SEC Staff Report in hand, on December 10, 2004, by a majority vote of three to two, the SEC issued its solution in the form of a new rule to the Adviser's Act. This rule would, subject to exceptions, amend Section 275.203(b)(3)-1 to require hedge fund advisers to register with the SEC.[109]

A. The Mechanics of the New Rule

The primary function of new Rule 203(b)(3)-2 is to count each owner of a "private fund" towards the 15-client test of the

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[104] *Id.*
[105] *Id.* (noting that naked shorting has gained national attention in part due to the website, National Coalition Against Naked Shorting (www.ncans.net), as well as through the efforts of Attorney John O'Quinn, a Texas litigator who has launched over two dozen "naked short selling" lawsuits against numerous Wall Street firms).
[106] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 2.
[107] *Id.*
[108] *See* Securities and Exchange Commission, Implications of the Growth of Hedge Funds (Staff Edition, September 2003) (hereinafter SEC Staff Report).
[109] *Id.*

private exemption to the Advisers Act.[110] Therefore, where hedge fund managers were once able to count the hedge fund as a single client to avoid registration, the SEC will now "look through" the entity that is the hedge fund and count each individual investor in the fund for the purposes of the Advisers Act.[111]

In order to be considered a "private fund" and be required to register with the SEC, the fund must be exempted by definition from the Investment Company Act of 1940 and the fund must permit its investors to redeem their interests within two years.[112] Consequently, hedge fund managers who prohibit their investors from cashing out their interests within two years of participating ensure that their funds do not fall under the new SEC registration requirement. The SEC believes that its new registration rules will accomplish five primary goals.[113] First, hedge fund registration requirements will provide statistics for the SEC to gauge the number, size and structure of hedge funds currently in existence.[114] Second, the SEC may now conduct periodic examinations of hedge funds that may detect fraud before it occurs. If nothing else, the SEC's new oversight will create a regulated environment that promotes due diligence and deters potential wrongdoing.[115] Third, the rule will help identify unqualified hedge fund managers who may be using the funds' lack of transparency to commit fraud, or mask their incompetence.[116] Fourth, the rule will require hedge funds to adopt internal controls to minimize the risk of fraud and avoid conflicts of interest.[117] Finally, the rule would limit the retailization of hedge funds, because the Advisers Act does not allow a hedge fund adviser to charge investors performance fees unless the investors have at least $1.5 million of net worth.[118] Encouraging hedge fund advisers to tailor their marketing to high net worth

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[110] *SEC Issues Final Rule on Registration of Investment Advisers to Hedge Funds*, INV. MGMT. ALERT (Holland & Knight), Dec. 9, 2004, *available at* http://www.hklaw.com/Publications/Newsletters.asp?IssueID=522.
[111] *Id.*
[112] *Id.*
[113] *See* Hellrung, *supra* note 6, at 334.
[114] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 2; *See also See* Hellrung, *supra* note 6, at 334.
[115] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 2.
[116] *Id.*
[117] *Id.*
[118] *Id.*

individuals ensures that those who invest in hedge funds are capable of weathering hedge funds' potentially negative volatility, such as that suffered by LTCM.

B. The Positive Aspects of the New Rule

As stated above, hedge funds have the potential to negatively affect (1) direct investors in hedge funds, (2) indirect investors in hedge funds, and (3) non-investing market participants. Besides the positive impact on investors who directly participate in hedge funds, the SEC's new rule should also benefit those who indirectly invest in hedge funds, and minimize the wider market risk posed by hedge funds.

1. The Rule's Impact on Direct Investors

The greatest threat to investors who directly participate in hedge funds is fraud perpetrated by hedge fund managers. As demonstrated by the Bayou Management, Integral Investment Management and the KL Group cases, hedge funds' investment strategies and lack of transparency allow the funds' managers to defraud investors of large sums of money. This is difficult to pinpoint because they are under only a limited duty of disclosure to their investors. By requiring hedge fund advisers to register under the Advisers Act, the SEC has provided a mechanism to combat fraud. SEC examiners may uncover fraudulent activity through routine investigations, and may serve to deter fraud in the first place. Furthermore, hedge funds' registration records will allow more information to be shared with the investing public, enabling potential investors to better compare different funds, and to make better-informed investment decisions.

Nonetheless, critics of the registration rules, including SEC Commissioners Cynthia Glassman and Paul Atkins, claim that, of the fifty-one fraud cases brought against hedge funds in the past five years, registration would only have prevented a minority of the cases.[119] These critics were not convinced that the threat of examination will prevent fraud, especially because the SEC does not

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[119] *Id.*; *see also* Mark J. Astarita, *Regulation of Hedge Fund Managers: Bureaucracy Without Benefit*, *available at* http://www.seclaw.com/docs/NewHedgeFundAdvisorRule.htm.

have the resources to examine a significant number of hedge funds simultaneously.[120]

However, these critics are missing the bigger picture. While it is true that hedge fund registration is not a cure-all for combating fraud, it is a step in the right direction. There is no single rule or regulation that can prevent fraud in any industry. Rather, there must be a combination measures: proactive, deterrent, and enforcement.

For example, if one were to apply the logic of the dissenters and critics of the rule to the U.S. system of taxation, there would be no purpose of initiating an IRS tax audit. There are likely thousands of citizens who cheat on their taxes, whether intentionally or unintentionally. Of those citizens, only a very small percentage is caught by the IRS. Does that mean that we should get rid of the IRS tax audit? Of course not. While there may not be exact numbers to illustrate the value of such a procedure, the mere threat of an audit (and resulting penalties) are enough to deter more taxpayers from skirting the rules than if there was no threat of an audit at all. Likewise, once the hedge fund industry adapts to the new SEC regulations, a culture of compliance will take hold, and the number of frauds committed by hedge funds managers will decrease.. It will follow that requiring hedge funds to register with the SEC will help protect the funds' direct investors.

2. The Rule's Impact on Indirect Investors

As a result of the new rule, those who indirectly invest in hedge funds, either through pension funds or funds of hedge funds, will also have an added layer of protection. Currently, FOHF's and institutional funds are regulated by the SEC under both the Advisers Act and the Investment Company Act.[121] Likewise, pension funds are regulated by the Department of Labor.[122] With the new hedge fund registrations rules, investors in these funds are protected against fraud by the hedge funds' themselves.

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[120] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 2.

[121] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 2.

[122] *See* Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001, et seq.

3. The Rule's Impact on Non-Hedge Fund Investing Market Participants

The impact of hedge funds on non-investor market participants may be the best reason to regulate hedge funds. Granted, protecting the market place from the residual impact of failed hedge funds, or hedge funds scandal, may be difficult. However, the near fallout caused by the LCTM collapse, and the negative impact on mutual fund investors as a result of late trading and market timing, have taught us that hedge fund failures are not isolated incidents..

One method to limit hedge funds' potential damage to the greater marketplace is to require hedge funds to register as investment companies under the Investment Company Act. This would subject hedge funds to limitations on short selling and leverage,[123] and it would subject hedge funds to greater oversight by the SEC.[124] Theoretically, this greater oversight would allow the SEC to prevent LTCM-like problems by limiting the use of leverage as well as preventing vote buying, naked short selling, market timing and late trading.[125]

Yet, despite the apparent benefits of regulating the hedge funds under the Investment Company Act, the harm that it would cause the hedge fund industry would far outweigh these benefits. By limiting the use of leverage and the ability to short sell, the SEC would effectively be turning hedge funds into run-of-the-mill mutual funds. This would take away the benefits that hedge funds offer to the economy. Hedge funds offer investors an alternative to protect themselves against in market downturns. As a product of their size and investment strategies, hedge funds also help create markets and liquidity for high risk investment products. Fortunately, the SEC did not choose to require hedge fund registration under the Investment Company Act and instead decided to use the less stringent Advisers Act. In so doing, the SEC preserved positive role that hedge funds play in the economy.

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[123] *See* SEC Staff Report, *supra* note 108.

[124] *See* Astarita, *supra* note 119.

[125] Note, however, that the SEC was not able to proactively stop mutual funds, which are regulated under the Investment Company Act, from manipulating the after-hours market by late trading and market timing. It is unclear how greater SEC oversight of hedge funds would prevent hedge funds from committing these same questionable practices.

The question that remains, however, is how the SEC's new rule under that Investment Advisers Act will prevent abuses that may have detrimental effects on market participants who do not invest in hedge funds themselves. Likely, the best answer is that registration of hedge fund managers will allow the SEC access to more information about hedge funds, thereby giving it the tools to discover, analyze, and remedy actions by hedge funds on an ad hoc basis. For instance, evidence of naked short trading and late trading may push the SEC to be more diligent in enforcing the rules that the agency itself has designed to counter these activities. A determination that there is a significant amount of market timing and/or vote buying could lead the Commission to promulgate rules aimed at preventing that behavior. The SEC could also share its information with other agencies that might better be able to regulate the specific actors involved. For example, the Federal Reserve and the Central Banks may be the best agents to regulate leverage requirements currently used by hedge funds by exercising greater oversight on risk management operations of major world banks.[126] In cases of note hoarding, the SEC could share its information with the U.S. Treasury and various self-regulatory agencies, which could then place limits on the total amount of notes that one entity can hold at any one time.

Thus, though the new rule will not directly prevent some of the enumerated harms that hedge funds could inflict on the marketplace, the SEC correctly avoided over-regulating the industry, which may have eradicated hedge funds altogether. Furthermore, it is very likely that the information gained from the registration and regulation process under the Advisers Act could help monitor and discourage the overuse of leverage as well as other questionable tactics and strategies that may be harmful to market participants who do not invest in hedge funds at all.

V. Why the New Rule Will Ultimately Fail

Even though it now has the opportunity to control questionable or overtly risky investment strategies used by hedge funds managers, the SEC undermined its own efforts by providing a loophole in the new regulations. This loophole allows certain hedge

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[126] Philipp M. Hildebrand, *Developments in the Hedge Fund Industry*, Speech by Dr. Philipp M. Hildebrand at the Swiss Finance Conference 2005, (Feb. 4, 2005), *available at* http://www.bis.org/review/r050216d.pdf.

funds to escape the new registration requirements altogether. As mentioned previously, hedge funds that prohibit their investors from liquidating their shares within two years of buying into the fund are not required to register with the SEC. The SEC's rationale for providing this exception was to create an escape hatch to benefit private equity and venture capitalists, which typically make long-term investments and have been involved with very few SEC enforcement actions.[127] Unfortunately, by creating that exception, the SEC has ensured that its first step in regulating the hedge funds industry has no teeth.

As the deadline for registration approaches, a large number of hedge funds are now taking advantage of the loophole by locking up their funds for two years.[128] Spurred by worry about (1) the costs ($500,000.00) associated with registration, (2) the time required of hedge fund managers and traders to comply with SEC examinations, and (3) the probability that the SEC will be very diligent with examinations during the incipiency of the rule, some of the largest hedge funds are looking to avoid registration.[129]

At the time this article was written, over 5,000 of the approximately 8,000 hedge funds thought to be in existence remain unregistered.[130] Among these unregistered funds are some of the largest hedge funds, such as SAC Capital Management LLC, Kingdon Capital Management LLC, Citadel Investment Group PLC, Eton Park Capital Management LLP, Lone Pine Capital and Greenlight Capital.[131] Furthermore, there has been a minimal overall increase in hedge fund registration this year, despite the fact that the effective date of the rule is fast approaching.[132] While this may simply be caused by hedge funds waiting until the last possible minute before registering, it is equally plausible that many hedge funds are restructuring to avoid the registration requirements.[133] Despite the reassurance from SEC insiders that it will reevaluate the

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[127] *See* Emily Thornton, *Hedge Funds Find an Escape Hatch*, BUSINESS WEEK, Dec. 27, 2005, *available at* http://www.businessweek.com/magazine/content/04_52/b3914039_mz011.htm.

[128] *See* Gregory Zuckerman and Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, WALL ST. J., Nov. 10, 2005, at C1.

[129] *Id.*

[130] *Id.*

[131] *Id.*

[132] *Id.* (currently there are 100 new registrations per month, compared to 80 per month last year).

[133] *Id.*

situation in February,[134] it is unlikely that the SEC will be able to amend the rule if it proves to be ineffective. In addition to the stiff opposition to the new rule by Commissioners Atkins and Glassman, William Donaldson, one of the Commissioners in favor of the rule, has been replaced by Christopher Cox, who is said to be against increased hedge fund regulation despite signing the rule into effect.[135] Consequently, it is unlikely that the SEC will be closing the rule's loophole in the near future.

Perhaps the most unfortunate part of the SEC's failure is the fact that the two year lockup period was not specifically designed for hedge funds, but rather was created to exempt private equities, venture capital firms, and real estate fund managers from the registration requirements.[136] The exemption was not constructed narrowly enough, however, and it has now provided hedge fund managers with an escape route. The SEC should have required all managers of private funds that prohibit redemption within two years to file a short form registration statement. This statement would not be nearly as onerous a requirement as Form ADV and would merely require disclosure of investment purpose, strategy and marketing plan of the fund. If the purpose of the fund is for private equity, venture capital or real estate funds, then the manager could take advantage of the two-year lockup exemption. If, however, the disclosure revealed that the purpose of the fund was not for one of those enumerated purposes, the manager would have to register under the Advisers Act, regardless of whether or not investors could redeem within two years. This would prevent the SEC's loophole from swallowing its new rule without putting too much of a burden on the type of funds that it meant to exclude from registration. Unfortunately, for the reasons stated in the previous paragraph, it is unlikely that the SEC would want to, or succeed in, amending the new rule. As such, hedge funds will continue to evade meaningful regulation.

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[134] *Id.* (Robert Plaze, Associate Director of the SEC's Management Division stated "We're aware that some hedge fund advisers are planning to extend their lockup period and we'll evaluate the situation when we have a better picture of the situation in February.")

[135] *See* Stephen Bainbridge, *This Hedge Bet is No Winner*, *available at* http://www.techcentralstation.com/092605C.html.

[136] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, *supra* note 2.

VI. Conclusion

Hedge funds are a valuable part of the global economy and financial landscape. They provide liquidity and markets for products that would otherwise not have them. They also provide an investment mechanism that can provide returns regardless of market conditions because of the very nature and strategy of those funds. Yet, despite these benefits, there are negative aspects to these stealth funds. Their overall size, speculative strategy, secretive nature and freedom from regulation create problems for investors and non-investors alike.

Nevertheless, the SEC seemed to be on the right track with its attempt at regulation. It chose to regulate hedge fund managers with the less stringent Advisers Act, and avoided rendering the hedge fund industry impotent as a result of the stricter regulations of the Investment Company Act. Yet, just when it appeared that the SEC was moving to the right direction, the Commission included a loophole in the new rule that essentially transformed the "rule" into an optional "recommendation." Consequently, hedge fund managers will continue to take advantage of the exception and a good number of existing hedge funds will likely choose to lock up their funds rather than register with the Commission. Unless the SEC modifies this registration exception, it will represent another lost opportunity to regulate the hedge funds industry.