

ADMINISTRATIVE LAW REVIEW

Regulation of Hedge Fund Advisers: A Valid Exercise of Rulemaking Authority or the Promulgation of New Law?

Adam R. Bolter

Reprinted from
Administrative Law Review
Volume 57, Number 2, Spring 2005

Cite as
57 ADMIN. L. REV. 595 (2005).

The *Administrative Law Review* is a joint publication of the ABA Section of Administrative Law & Regulatory Practice and the Washington College of Law, American University. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or downloaded or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

NOTES & COMMENTS

REGULATION OF HEDGE FUND ADVISERS: A VALID EXERCISE OF RULEMAKING AUTHORITY OR THE PROMULGATION OF NEW LAW?

ADAM R. BOLTER*

TABLE OF CONTENTS

Introduction	596
I. An Overview of Hedge Funds	598
II. Agency Rulemaking Authority	600
A. APA Requirements and Judicial Review.....	600
B. The Advisers Act—Under Scrutiny	601
1. Background and the Promulgation of Rule 203(b)(3)-2	601
2. Reinterpretation of the Longstanding Meaning of a “Client”	602
3. The “Look Through” Provision	607
C. Congressional Intent Not to Regulate Private Offerings.....	610

* J.D. Candidate, 2006, Washington College of Law, American University; B.S., Accounting, The Pennsylvania State University, 1996. Managing Editor, *Administrative Law Review*, 2005-2006. This Comment is dedicated to my sister, Lisa, who has provided me with support and guidance throughout my professional career and most recently, in my pursuit of a law degree. I would like to give a special thanks to Wallace L. Duncan of the law firm Duncan, Weinberg, Genzer & Pembroke, P.C.—this Comment would not have been possible without your support. I would also like to thank the following: Marybeth Sorady of the law firm Katten Muchin Zavis Rosenman LLP, for her insightful critique; Monica Gonzalez for helping me with the basics of Administrative Law; Michelle Carhart for her support and valuable comments; my friends and the hard-working staff of the *Administrative Law Review*; and my parents, Guy and Ellen, for their never-ending love and support in all facets of my life. Any errors are, of course, my own.

596	<i>ADMINISTRATIVE LAW REVIEW</i>	[57:2
	1. The Securities Act of 1933 ('33 Act).....	610
	2. The Investment Company Act of 1940 ('40 Act).....	612
III.	Ramifications.....	614
	A. Direct Effects.....	614
	B. Indirect Effects.....	615
IV.	Alternative Recommendations.....	616
	A. Retailization of Hedge Funds.....	617
	B. The Information Gap.....	618
	Conclusion.....	620

INTRODUCTION

On September 29, 2003, the Securities and Exchange Commission (SEC or Commission) released its much anticipated staff report entitled "Implications of the Growth of Hedge Funds" (Staff Report).¹ According to current estimates, there are approximately 7,000 hedge funds operating in the United States, managing approximately \$870 billion in assets.² The Staff Report was a direct result of the SEC's increasing concerns about the rapidly growing, largely unregulated, hedge fund industry.³ On October 26, 2004, after a 60-day comment period on the proposed rule⁴ expired, the

1. See U.S. SECURITIES AND EXCHANGE COMMISSION, *IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS* vii (2003) [hereinafter *STAFF REPORT*] (answering the request of the Securities and Exchange Commission (SEC), this 134-page report summarizes a year-long study of 65 hedge fund advisers, both registered and unregistered, managing approximately 650 different funds and representing over \$160 billion in assets), at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> (last visited Mar. 23, 2005).

2. See Registration Under the Advisers Act of Certain Hedge Fund Advisers; Final Rule, 69 Fed. Reg. 72,055-56 (Dec. 10, 2004) (to be codified at 17 C.F.R. pt. 275 & 279) [hereinafter *Adopting Release*] (recognizing the tremendous growth in hedge funds and projecting assets over \$1 trillion by the end of 2004).

3. See *STAFF REPORT*, *supra* note 1, at 76-86 (describing several concerns resulting from rapid growth in the hedge fund industry, including: the inability to proactively detect fraud; the retailization of hedge funds; and conflicts of interest between managers and prime brokers). SEC Chairman William Donaldson recently reiterated his concern that hedge funds, with assets quickly approaching \$1 trillion dollars, have a significant impact on the operation of the U.S. securities markets. See *Testimony Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry Before the U.S. Senate Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (April 8, 2004) (statement of William H. Donaldson, Chairman, SEC) [hereinafter *Mutual Fund Hearings*] (asking the SEC staff to move forward with a rulemaking proposal that would enable the SEC to better detect and deter fraudulent conduct in the investment management industry), at <http://www.sec.gov/news/testimony/ts040804whd.htm> (last visited Mar. 23, 2005).

4. See Registration Under the Advisers Act of Certain Hedge Fund Advisers; Proposed Rule, 69 Fed. Reg. 45,172 (proposed July 28, 2004) [hereinafter *Proposing Release*] (proposing for comment a new rule and amendments which would require advisers to certain private investment pools to register with the SEC). During the public comment period, the SEC received 161 comments from advisers, investors, trade associations, and law firms. See *Adopting Release*, *supra* note 2, at 72,058-59 (noting that forty-two (26%) commenters expressed no opinion, thirty-six (22%) supported the proposal, and eighty-three (52%) commenters argued against the rule proposal). Despite the vast number of substantial comments received, the SEC denied numerous requests for an extension of time in order to adequately respond to the SEC's proposal. See *id.* at 72,090 & n.5 (dissenting from the

highly contested debate over hedge fund regulation resulted in an SEC vote of three to two in favor of requiring hedge fund managers to register as investment advisers under the Investment Advisers Act of 1940 (Advisers Act).⁵

The SEC adopted the Staff Report's primary recommendation to amend Rule 203(b)(3)-1 (the Safe Harbor Rule) under the Advisers Act, eliminating a safe harbor provision by requiring managers of "private funds" to count each investor in a hedge fund as a separate client.⁶ Because almost all hedge funds have more than 14 investors, the new client-counting rule will preclude most managers from relying on the "small adviser" exemption under the Advisers Act.⁷ This Comment argues that a reviewing court would be justified in finding this rule to be an unlawful extension of the SEC's rulemaking authority.⁸

Part I of this Comment provides an overview of the unique and historically private hedge fund industry. This section describes the difficulties encountered in defining a hedge fund and examines the key differences between hedge funds and the more widely recognized mutual fund. Part II of this Comment analyzes the SEC's rulemaking authority by considering the legislative intent behind § 203(b)(3) of the Advisers Act, the historical application of the "look through" provision, and the various exemptions by which hedge funds escape regulation under the securities

majority opinion, Commissioners Cynthia A. Glassman and Paul S. Atkins argue that a major shift in regulatory approach warranted a longer comment period; the Proposing Release appeared in the Federal Register on July 28, 2004 and the comment period closed on September 15, 2004). The dissenters also noted that the SEC failed to prepare a formal summary of the estimated 160 comment letters received, standard procedure for a rulemaking of such significance. *Id.*

5. See Adopting Release, *supra* note 2, at 72,054. The final vote in favor of regulation was made over a strong dissenting opinion from Commissioners Glassman and Atkins. See *id.* at 72,089; see also Paul Barr, *Greenspan Still Opposes Hedge Fund Managers Registration*, HEDGEWORLD DAILY NEWS, June 16, 2004 (restating comments made by Federal Reserve Chairman Alan Greenspan, in which Greenspan opposes requiring hedge fund managers to register as investment advisers, believing that hedge funds provide vital liquidity to the U.S. financial markets and should be left alone provided retail investors are not involved).

6. See STAFF REPORT, *supra* note 1, at 88-89 (shifting the emphasis away from counting each hedge fund as a client and more towards assessing whether an adviser is of sufficient size to warrant federal attention); see also Adopting Release, *supra* note 2, at 72,070. For a discussion of what constitutes a "private fund," see *infra* note 4 and accompanying text.

7. See *infra* notes 34-38 and accompanying text; see also Adopting Release, *supra* note 2, at 72,070.

8. Members of the investment community have similar concerns about the SEC's legal authority to promulgate this rule. See, e.g., Alistair Barr, *Hedge Fund Manager Sues SEC To Block New Rules*, CBS MARKETWATCH, Dec. 22, 2004 (suing the SEC over the new rules requiring advisers to hedge funds to register under the Advisers Act). Phillip Goldstein, portfolio manager of Opportunity Partners LP, alleges that the SEC is overstepping its authority by making new law, something that should be left to Congress; SEC general counsel has noted that the Commission will vigorously defend its position.

laws. This section concludes that while the SEC's statutory authority appears to provide broad rulemaking authority, a reviewing court would be justified in setting aside the rule. Part III examines the ramifications of this rule proposal, and Part IV concludes by recommending several regulatory alternatives that would address the SEC's concerns in a manner more consistent with the legislative history and spirit behind the securities laws.

I. AN OVERVIEW OF HEDGE FUNDS

A.W. Jones is credited with establishing the first hedge fund in 1949.⁹ Although there is no universal definition of a hedge fund¹⁰ despite the vast growth of the industry, the term "hedge fund" has been largely defined by what it is *not* and by the regulations to which they are *not* subject.¹¹ For instance, the Staff Report defines a hedge fund as an entity that holds a pool of securities, whose interests are *not* sold in a registered public offering and which is *not* registered as an investment company under the Investment Company Act of 1940 ('40 Act).¹²

The industry definitions that do exist generally recognize hedge funds as privately offered, largely unregulated, pooled investment vehicles, but there are several other characteristics common to most hedge funds.¹³ Notable attributes frequently associated with hedge funds include limiting availability to retail investors and charging incentive fees generally equal to

9. See Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 684 (2000) (describing the initial trading concept behind a hedge fund as investing in both long and short equities, thereby positioning the fund to generate positive returns regardless of market swings); see also *id.* at 684 n.18 (establishing that a hedge fund assumes a long position by buying and selling securities which it owns; the fund takes a short position by selling borrowed securities along in the hope that the securities' market value declines before the hedge fund has to buy it back).

10. See Gibson, *supra* note 9, at 683 (explaining that the federal securities laws do not provide a statutory definition for a hedge fund); see also STAFF REPORT, *supra* note 1, at 3. Moreover, some of the SEC's concern over its inability to gather reliable information is attributable to the lack of an industry-wide definition. See *The Long and Short of Hedge Funds: Effects of Strategies For Managing Market Risk Before the Subcomm. on Capital Mkts., Ins., and Gov't. Sponsored Enterprises of the Comm. on Fin. Services*, 108th Cong. 63 (2003) (testimony of William H. Donaldson, Chairman of the SEC) (explaining that there are no precise figures available regarding the number, size, and assets of hedge funds).

11. See David A. Vaughan, Comments for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds, *Selected Definitions of "Hedge Fund,"* 2-3 (May 14-15, 2003) (providing various definitions of the term "hedge fund" including unregistered, private investment partnerships, for wealthy and sophisticated investors, generally using leverage to achieve their trading strategies), at <http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm> (last visited Mar. 23, 2005).

12. See STAFF REPORT, *supra* note 1, at 3 (recognizing that while hedge fund trading strategies historically focused on equities, today's hedge funds are considerably more diverse and include various other financial instruments, including fixed income, convertibles, currencies, futures, and options).

13. See Erik J. Greupner, *Hedge Funds Are Headed Down-Market: A Call For Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1559 (2003) (defining hedge funds as pooled investment vehicles typically organized as limited partnerships that utilize a variety of trading strategies in order to invest in a broad array of securities).

twenty percent of the fund's realized and unrealized capital gains.¹⁴ Hedge fund managers also use sophisticated trading strategies such as short selling (selling a borrowed security), arbitrage (simultaneously buying and selling a security in different markets to profit from pricing discrepancies), and leverage (magnifying the impact of trading decisions by investing with borrowed money).¹⁵

Hedge funds are often compared to mutual funds, which must be registered as investment companies. While hedge funds and mutual funds do share some similarities,¹⁶ the relatively risky and versatile trading strategies used by hedge funds, combined with their current lack of regulation, provide for some stark differences between the two. Hedge funds are not generally subject to the rules that govern registered investment companies such as mutual funds.¹⁷ In addition to being heavily regulated, mutual funds do not charge performance-based advisory fees, nor do they typically engage in the short-term investment strategies of hedge funds.¹⁸ The next section critically examines the SEC's amendment of the Safe Harbor Rule, which is arguably a first step in eliminating the differences described above.¹⁹

14. See Steven B. Boehm & Cynthia A. Reid, *Shedding Light on Hedge Funds*, BUS. LAW TODAY (American Bar Association), May/June 2004, at 53 (finding that traditional hedge funds, seeking to achieve an absolute positive return, engage in sophisticated and riskier trading strategies). The unusual fee structure of a hedge fund also includes an annual management fee ranging from 1-2% of the fund's net assets. *Id.* The incentive fee, also known as a performance fee, is generally assessed based upon a high watermark. See generally Greupner, *supra* note 13, at 1559 (stating that a high watermark requires a manager to recover prior losses before assessing performance fees based solely on current year profits). In most instances, any performance fee earned by an adviser is reinvested into the fund, thereby aligning the manager's interests with those of the client. *Id.*

15. See *Funds of Hedge Funds – Higher Costs and Risks for Higher Potential Returns*, NASD INVESTOR ALERT, August 23, 2002, at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_006028 (last visited Mar. 23, 2005) [hereinafter *Funds of Hedge Funds*] (describing other unique strategies used by hedge fund managers, such as concentrating positions in particular issuers or industries, investing in derivatives such as options and futures, and investing in private placements).

16. See, e.g., STAFF REPORT, *supra* note 1, at 5 (acknowledging that both entities may invest in similar types of securities and offer investors the opportunity to diversify their investments through professionally managed investment pools).

17. See *Funds of Hedge Funds*, *supra* note 15 (providing examples of regulations which only registered investment companies, such as mutual funds, must adhere to: (1) liquidity requirements, (2) redemption requirements, (3) disclosure requirements for fees, holdings, and performance, and (4) limitations on the use of leverage).

18. See *Report of the President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, App. A1-2 (1999), at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf> (last visited Mar. 23, 2005) (noting that while both hedge funds and mutual funds have the ability to quickly liquidate holdings, performance-based compensation and the use of arbitrage trading strategies make short-term trading more likely in the case of a hedge fund).

19. See SEC Open Meeting, *Registration under the Advisers Act of Certain Hedge Fund Advisers*, July 14, 2004, at <http://www.sec.gov/news/openmeetings.shtml> (audio file) (last visited Mar. 23, 2005) (statement of Commissioner Campos) (responding to criticism that this rule is simply the start of more hedge fund regulation to come, Commissioner

II. AGENCY RULEMAKING AUTHORITY

A. APA Requirements and Judicial Review

Under the Administrative Procedure Act (APA),²⁰ a reviewing court will set aside an agency's rulemaking as unlawful if found to be in excess of statutory authority.²¹ When an agency proposes or finalizes a rule, it must state the statutory authority it relies upon.²² In amending the Safe Harbor Rule, the SEC relied primarily upon § 211(a) of the Advisers Act.²³ Section 211(a) provides broad rulemaking authority to classify and prescribe different requirements for different classes of persons, and allows the SEC to issue, amend, and rescind rules as are necessary or appropriate.²⁴ Notwithstanding this expansive authority, a reviewing court will set aside an agency rule when it is found to frustrate the policy that Congress sought to implement.²⁵

In assessing legislative intent, a reviewing court must determine if Congress has directly addressed the issue, or if the statute is ambiguous as to the issue, whether the agency's action was based on an allowable reading.²⁶ The legislative history of § 203(b)(3) (Small Adviser Exemption) explicitly leaves unanswered the question as to whether advisers are entitled to the no "look through" provision in counting beneficial owners of entities other than business development companies (BDCs) as single "clients."²⁷ Moreover, there is no legislative history addressing the purpose behind the "15 client rule" within the Small Adviser Exemption.²⁸ Where Congress has explicitly left a gap for the agency to

Campos noted that the "slippery-slope" argument is omnipresent).

20. See 5 U.S.C. § 552 (2000) (describing many of the requirements that agencies must adhere to, including the publication of rules of procedure, substantive information regarding those rules, and all related amendments).

21. See 5 U.S.C. § 706(2)(c) (2000) (listing other conditions where an agency action will be set aside to include actions, findings, and conclusions which are found to be arbitrary and capricious).

22. See 5 U.S.C. § 553(b)(2) (2000) (requiring general notice be published in the Federal Register).

23. See Adopting Release, *supra* note 2, at 72,087 (providing §§ 202(a)(17), 203, 204, 205(e), 206(4), 206A, and 208(d) as further statutory authority).

24. 15 U.S.C. § 80b-11(a) (2000).

25. See *SEC v. Sloan*, 436 U.S. 103, 118 (1978) (reasoning that the courts are not obliged to act as rubber-stamps in approving agency rulemaking).

26. See *Chevron v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984) (stating that if congressional intent is clear, there is no further issue; the court, as well as the agency, must adhere to the expressed intent of Congress).

27. See H.R. Rep. No. 1341, 96th Cong. at 62 (1980).

28. See STAFF REPORT, *supra* note 1, at 89 & n.292 (suggesting that the *de minimis* exemption was enacted based upon Congress's view that investment advisers with a limited number of clients are presumably "private" and do not require SEC oversight). In the view of the SEC staff, Rule 203(b)(3)-2 would be consistent with the underlying purpose of § 203(b)(3), designed to exempt advisers whose business is so small that it fails to require federal regulation. *Id.*

fill, agency rules will be given controlling weight *unless* they are manifestly contrary to the statute.²⁹ Furthermore, a reviewing court will engage in a more scrutinizing analysis where an agency has departed from consistent and longstanding precedents or policies.³⁰

B. The Advisers Act—Under Scrutiny

1. Background and the Promulgation of Rule 203(b)(3)-2

The Advisers Act was designed to eliminate certain abuses in the securities industry.³¹ It defines an investment adviser as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities.”³² Individuals meeting the definition of an investment adviser are generally required to register with the SEC.³³ Most hedge fund managers avoid registration by relying on the exemption found under the Small Advisor Exemption.³⁴ This exemption excludes most managers who would ordinarily fall within the scope of an “investment adviser” but for the fact that they have advised fewer than 15 *clients* during the preceding 12 months.³⁵ The Safe Harbor

29. See *Chevron*, 467 U.S. at 843-44 (further recognizing that a reviewing court will set aside agency rulemaking where found to be arbitrary or capricious). Given the strong dissenting opinion of Commissioners Glassman and Atkins (questioning whether the SEC fully understands what the problem is they are trying to address), an argument could also be made that the SEC’s rulemaking is unlawfully capricious. See WILLKIE FARR & GALLAGHER LLP, COMMENT LETTER RE: RELEASE NO. IA-2266 (FILE NO. S7-30-04): REGISTRATION UNDER THE ADVISERS ACT OF CERTAIN HEDGE FUND ADVISERS 3-4 (September 13, 2004), at <http://www.sec.gov/rules/proposed/s73004/zeigler091304.pdf> (last visited Mar. 24, 2005) [hereinafter WILLKIE] (citing *City of Chicago v. Fed’l Power Comm’n*, 458 F.2d 731 (D.C. Cir. 1971), which held that “[a] regulation perfectly reasonable in the face of a given problem may be highly capricious if that problem does not exist”). An argument could also be made that the SEC has not shown a demonstrated need to protect hedge fund investors. *Id.*

30. See *Natural Res. Def. Council, Inc. v. SEC*, 606 F.2d 1031, 1050 n.23 (D.C. Cir. 1979) (finding a more exacting scrutiny appropriate in certain circumstances where the presumption of agency regularity has been rebuffed).

31. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-92 (1963) (noting that the Advisers Act is founded upon congressional intent to expose and eliminate all conflicts of interest that might influence an adviser to act in a manner inconsistent with the client’s best interests).

32. See 15 U.S.C. § 80b-2(a)(11) (2000) (excluding certain parties from the definition of an investment adviser, including lawyers and other professionals whose performance of such services is incidental, and broker-dealers who receive no special compensation and whose performance is solely incidental).

33. See 15 U.S.C. § 80b-3(b) (2000) (stating the circumstances under which an investment adviser need not register with the SEC). Registered investment advisers must periodically disclose information about the adviser’s business practices, maintain required books and records, and submit to periodic examinations by SEC staff. See STAFF REPORT, *supra* note 1, at 21.

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

35. See *id.* (identifying the requirements for the Small Advisor Exemption: (1) the adviser must have no more than 14 clients; (2) must not hold itself out generally to the

Rule provides that, for purposes of determining who constitutes a client under § 203(b), investment advisers may count a “legal organization,” such as a corporation or partnership, as a single client.³⁶ It also states that the manager of a legal organization need not “look through” to the beneficial owners of the organization in counting “clients” so long as advice is provided to the entity itself and is not based upon the investment objectives of the individual investors.³⁷ Because the vast majority of hedge fund managers do not have to “look through” the funds they manage and count each individual shareholder as a client, they currently avoid registration under the Advisers Act.³⁸

Despite this exemption, three of the five SEC Commissioners voted to amend the Safe Harbor Rule by adopting Rule 203(b)(3)-2 (Hedge Fund Rule), eliminating the availability of the safe harbor for “private funds.”³⁹ The Hedge Fund Rule requires that for purposes of the Small Adviser Exemption, each beneficial owner of a “private fund” will count as a single client.⁴⁰ The SEC defines a “private fund” as one that (1) would be subject to regulation under the '40 Act but for the exceptions provided under § 3(c)(1) or § 3(c)(7); (2) permits investors to redeem their interests within two years of purchase; and (3) offers its interests based on the ability of the investment adviser.⁴¹

2. Reinterpretation of the Longstanding Meaning of a “Client”

The term “client” is not explicitly defined anywhere within the Advisers Act.⁴² Since 1940 and the inception of the Small Adviser Exemption, both the SEC and Congress have consistently treated a legal organization receiving advice from an investment adviser as a single client, declining to

public as an adviser; and (3) cannot act as an investment adviser to a registered investment company or business development company). The Staff Report’s “look through” recommendation will likely require the majority of hedge fund advisers to register under the Adviser’s Act. See STAFF REPORT, *supra* note 1, at 90 n.293.

36. See 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2003) (allowing corporations, general and limited partnerships, and limited liability companies to be counted as single clients).

37. *Id.*

38. See Boehm & Reid, *supra* note 14, at 54 (noting that because a hedge fund only counts as one client, regardless of the number of owners it has, the adviser would only have to register if it provides investment advice to more than 13 other funds).

39. Adopting Release, *supra* note 2, at 72,075.

40. *Id.* at 72,073.

41. See *id.* at 72,073-5 (designing the first prong of the “private fund” definition in order to capture investment advisers to pooled investment vehicles, while excluding advisers to most non-investment related business organizations, such as banks). The redemption provision was designed to include most hedge fund advisers, while excluding advisers to private equity and venture capital funds that normally require long-term capital commitments. *Id.* See the textual discussion at *infra* Section II (C)(2) for more information regarding the § 3(c)(1) and § 3(c)(7) exemptions.

42. See Adopting Release, *supra* note 2, at 72,069 (believing that there is no one clear meaning of the term “client”).

“look through” the entity and count individual shareholders as clients.⁴³ The plain meaning of a “client” was reiterated by the SEC itself, when it adopted the initial Safe Harbor Rule, providing that a general partner to an investment limited partnership need not “look through” and count each limited partner as a “client” as long as advice was given based on the investment objectives of the limited partnership, rather than the individual investors.⁴⁴ As recently as 1997, the SEC reaffirmed the plain language meaning of a “client” when it broadened the Safe Harbor Rule to its current form, allowing an adviser to count as a single client *any* legal organization that receives investment advice based on its investment objectives and not the particularized objectives of its shareholders or beneficiaries.⁴⁵ The SEC’s response to critics of its recent reinterpretation is that its authority is not undermined by changing its position from a prior interpretation.⁴⁶ However, while a reviewing court certainly allows for changed circumstances to support an agency’s reinterpretation,⁴⁷ it should not allow an agency to redefine a term central to the meaning of the Advisers Act. This is especially true where both congressional and agency actions seem to indicate otherwise.

The Hedge Fund Rule requires that each shareholder or beneficiary of a “private fund” (as defined, to include all hedge funds) be considered a separate client in counting towards the “15 client rule” within the Small

43. See WILMER CUTLER PICKERING HALE AND DORR LLP, COMMENT LETTER RE: INVESTMENT ADVISERS ACT RELEASE NO. 2266 (FILE NO. S7-30-04): REGISTRATION UNDER THE INVESTMENT ADVISERS ACT OF CERTAIN HEDGE FUND ADVISERS 1-2 (Sept. 8, 2004) [hereinafter WILMER] (providing that the adviser does not advise beneficial owners individually), at <http://www.sec.gov/rules/proposed/s73004/wilmer090804.pdf> (last visited Mar. 24, 2005); see also 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2003).

44. See WILMER, *supra* note 43, at 7 n.23 (citing *Definition of ‘Client’ of Investment Advisor for Certain Purposes Relating to Limited Partnerships*, SEC Rel. No. IA-983 (July 12, 1985)). The initial Safe Harbor Rule appears to have been created in response to uncertainty regarding whether a general partner providing investment advice to a partnership was advising the partnership or the limited partners individually. See Adopting Release, *supra* note 2, at 72,067 n.157 (citing *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977), where the Court initially characterized the individual limited partners as the “clients” of the general partner, but later withdrew this characterization from the final opinion; this created doubt as to whether the partnership, or each of the partners, should constitute a single client). Regardless of the intent behind the Safe Harbor Rule, the fact remains that the SEC consistently treated the term “client” to represent a person or organization that receives particularized investment advice. See WILMER, *supra* note 43, at 8 n.27 (noting several SEC no-action letters applying the “distinct-advice” test in determining who qualifies as a “client”).

45. WILMER, *supra* note 43, at 7; see also 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2003).

46. See Adopting Release, *supra* note 2, at 72,069 n.173 (allowing agencies clear authority to change a prior position in light of changed circumstances (citing *Am. Trucking Ass’n., Inc. v. Atchison, Topeka & Santa Fe Ry Co.*, 387 U.S. 397, 416 (1967))). The SEC cites the vast growth of hedge funds as changed circumstances warranting its change in interpretation. *Id.*

47. *Id.*

Adviser Exemption.⁴⁸ As used in the Advisers Act and understood by Congress, the term “client” refers to an individual or organization that receives direct advice from an investment adviser, not to passive investors in the legal organization.⁴⁹ Moreover, the plain meaning of the term “client” generally refers to “a person or company for whom a lawyer, accountant, advertising agency, etc. is acting[.]”⁵⁰ Not only does the plain language of the term conflict with the SEC’s reinterpretation in the Hedge Fund Rule, but judicial interpretation and the legislative intent behind the Advisers Act affirm the longstanding interpretation that a “client” is a party who receives particularized advice.

In *SEC v. Lowe*, the Supreme Court discussed the importance of the fiduciary relationship between an adviser and client, emphasizing that the Advisers Act was created to govern situations where individualized advice is given specific to a client’s particular needs.⁵¹ The effect of *Lowe* was reiterated in *SEC v. Park*,⁵² despite the Court’s finding that unlike in *Lowe*, the defendant’s internet website did not fall within the “publisher’s exclusion” to the definition of an investment adviser.⁵³

48. See Adopting Release, *supra* note 2, at 72,088 (defining Rule 203(b)(3)-2: Methods for Counting Clients in Certain Private Funds).

49. See WILMER, *supra* note 43, at 4-5 (emphasizing that the 1939 Commission report entitled *Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services*, H.R. DOC. NO. 477, 76th Cong., 2d Sess. (1939) treated investment advisers as those professionals who provide particularized services to a client); see also MANAGED FUNDS ASSOCIATION, COMMENT LETTER RE: REGISTRATION UNDER THE ADVISERS ACT OF CERTAIN HEDGE FUND ADVISERS 1 (October 12, 2004), at <http://www.sec.gov/rules/proposed/s73004/jggaine101204.pdf> (last visited Feb. 22, 2005) (noting that Chairman Donaldson was asked by Senator Corzine to describe the Commission’s legal authority in promulgating this rule).

50. See WILMER, *supra* note 43, at 4 (noting *Black’s Law Dictionary* as defining a client as “a person or entity that employs a professional for advice or help in that professional’s line of work.”). *But see* Adopting Release, *supra* note 2, at 72,069 n.172 (citing Webster’s Unabridged Dictionary (2nd ed. 1934), which defines a “client” as “[one] [who] submits his cause to his management[.]” as support that dictionary definitions are inconclusive).

51. See *SEC v. Lowe*, 472 U.S. 181, 208 (1985) (holding that a publisher of a securities newsletter was not an investment adviser under the Advisers Act because his “publications do not fit within the central purpose of the [Advisers] Act [since] they do not offer individualized advice attuned to any specific portfolio or to any client’s particular needs”); see also WILMER, *supra* note 43, at 5 (describing a House Report on the Advisers Act that emphasized the importance of the personalized services of the investment adviser to its client). In response to this argument, the SEC notes that *Lowe* involved a different issue and different statutory provision. See Adopting Release, *supra* note 2, at 72,069 n.174 (emphasizing that the issue at bar involved the meaning of the “publisher’s exclusion” from the definition of an investment adviser under § 202(a)(11)(D)). For an argument that the Advisers Act was not designed solely to govern situations where particularized advice is given, consider Rule 204-3 of the Advisers Act (Brochure Rule), generally requiring that registered advisers provide each advisory client with a written disclosure statement. See 17 C.F.R. § 275.204-3 (2003) (exempting contracts for *impersonalized advisory services* from the general requirement).

52. 99 F. Supp. 2d 889 (N.D. Ill. 2000).

53. See *id.* at 893-96 (arguing the merits of a motion to dismiss, defendant reiterates that *Lowe* established that an adviser must be providing particularized investment advice to its clients in order to fall within the purview of the Advisers Act; the SEC contends that

Looking at congressional intent, both the language of the Advisers Act and subsequent amendments advance the argument that the term “client” refers to a person or organization that receives personalized investment advice. As originally drafted, § 203(b)(2) exempted from registration any adviser “whose only clients are *investment companies and insurance companies*.”⁵⁴ In 1970, Congress responded to the SEC’s recommendation that advisers to *registered investment companies* be required to register under the Advisers Act; Congress elected to enact this change in philosophy⁵⁵ by amending the Small Adviser Exemption, thereby specifically denying the “fewer than 15” exemption to advisers of companies registered under the ‘40 Act.⁵⁶ In fact, this amendment demonstrates that the Small Adviser Exemption was not designed to count each individual investor as a “client” because if that were true, there would be no need to specifically deny the exemption to advisers of registered funds.⁵⁷

The legislative record associated with the 1970 amendments shares remarkable similarities to the rationale given by the SEC for its Hedge Fund Rule, including explosive growth and increased public investment (retailization).⁵⁸ Neither Congress nor the SEC considered redefining the longstanding definition of a “client” in order to accomplish their objective.⁵⁹ In fact, the SEC sought congressional action to require registration of advisers to *registered investment companies*, but elected not

Lowe simply applied the statutory definition found at 15 U.S.C. § 80b-2(a)(11) and then looked to the “publisher’s exclusion” to conclude that *Lowe*’s activities were not governed by the Advisers Act). In denying the motion to dismiss, the Court found that “the correct understanding of what constitutes an ‘investment adviser’ is somewhere in between those advanced by the parties.” *See id.* at 894-95 (finding it unclear whether the defendant provided the type of personalized investment advice intended to be governed by the Advisers Act).

54. *See* WILMER, *supra* note 43, at 6 (citing Investment Advisers Act of 1940 § 203(b)(2), 54 Stat. 847).

55. *See id.* (citing *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 97-2339, at 344-45 (1966)).

56. *See id.* (amending § 203(b)(2) at the same time by removing the words “investment companies and”).

57. *See* WILLKIE, *supra* note 29, at 2 (noting that the “look through” provision would have already required registration since every registered fund would undoubtedly have 15 or more “clients”).

58. *See* SCHULTE ROTH & ZABEL LLP, COMMENT LETTER RE: PROPOSING RELEASE: REGISTRATION UNDER THE ADVISERS ACT OF CERTAIN HEDGE FUND ADVISERS 3 (Sept. 15, 2004), at <http://www.sec.gov/rules/proposed/s73004/schulte091504.pdf> (last visited Mar. 24, 2005) [hereinafter SCHULTE] (recognizing that similar to the changed circumstances now surrounding hedge funds, the 1970 Congressional Record indicated that the proposed amendment was a result of the fact that Congress could not have foreseen the tremendous growth in mutual funds or the increased amounts of advisory fees at stake).

59. *See* WILMER, *supra* note 43, at 6; *see also* *White Paper on Registration of Hedge Fund Advisers Under the Investment Advisers Act of 1940*, (Managed Funds Association) 11, July 7, 2003 [hereinafter Managed Funds Association], at <http://www.sec.gov/spotlight/hedgefunds/hedge-mfa2.htm> (last visited Mar. 24, 2005).

to do so with respect to its recent policy belief that advisers to *unregistered* funds (such as hedge funds) should now be required to register under the Advisers Act.⁶⁰ Such agency rulemaking should be set aside as unlawful because, similar to the 1970 amendment (properly passed by Congress), it is more appropriately characterized as the promulgation of new law.⁶¹

The circumstances surrounding the Hedge Fund Rule are analogous to the SEC's promulgation of Rule 3b-9 under the Securities Exchange Act of 1934 ('34 Act), which had the effect of revoking a statutory exemption for banks from broker-dealer registration.⁶² Similar to the numerous amendments to the Small Adviser Exemption, Congress amended the '34 Act on several occasions with full knowledge of the increasing growth of brokerage activities by banks; yet, Congress did not elect to specifically address this problem or revoke the statutory exemption.⁶³ Upon challenge, a reviewing court set aside the SEC's rule as an unlawful extension of its regulatory powers.⁶⁴ Rule 3b-9 was set aside notwithstanding express statutory authority to define terms used in the '34 Act.⁶⁵ Interestingly, of the six major securities laws governed by the SEC, the Advisers Act is the only statute that does not specifically authorize the right to define "accounting, technical and trade terms" as used in their respective Acts.⁶⁶ This is especially troubling when considering that the term at issue (a "client") is vital to the spirit of the Advisers Act and is now being reinterpreted in a manner inconsistent with plain language and legislative history.⁶⁷

As described above, congressional mandate demonstrates that the historical understanding of a "client" is a person or organization that receives particularized investment advice. Moreover, the SEC has recognized and furthered this understanding through its own rulemaking.

60. Managed Funds Association, *supra* note 59, at 11.

61. *See* Manhattan Gen. Equip. Co. v. Comm'r of Internal Revenue, 297 U.S. 129, 134 (1936) (emphasizing that the power of an agency to administer a federal statute by way of rules and regulations is not the power to make law, but the power to further the will of Congress, as expressed by statute).

62. WILLKIE, *supra* note 29, at 3.

63. *Id.*

64. *See id.* at 3 (citing *American Bankers Assoc. v. SEC*, 804 F.2d 739 (D.C. Cir. 1986), the Court reasoned that the SEC's rulemaking was "tantamount to one of the regulatory players unilaterally changing the rules of the game").

65. *See id.* (providing statutory support in rule 3(b) of the '34 Act "to define technical, trade, accounting, and other terms").

66. *See id.* (noting that this omission should not be taken for granted and was not likely an oversight). As an example, see the definitional authority provided in § 19(a) of the '33 Act, and § 38(a) of the '40 Act. *Id.* *But see* Adopting Release, *supra* note 2, at 72,069 n.173 (responding, the SEC notes that the absence of a specific grant of authority to define terms, as found in the other securities statutes, does not limit its authority because it has inherent authority to interpret ambiguous language found within the Small Adviser Exemption).

67. WILLKIE, *supra* note 29, at 3-4.

Despite the vast growth and impact hedge funds now play in our financial markets, it is questionable whether the SEC has the authority to reverse sixty-four years of precedent and act to effectively create new law without congressional approval. More generally, the Commission's rule creates a further inconsistency with respect to the Advisers Act provision which states that an adviser cannot make or recommend investments unsuitable for its clients.⁶⁸ The SEC has never mandated that an adviser "look through" the fund to determine what investments may or may not be suitable for each investor.⁶⁹ The SEC has not only reinterpreted the longstanding meaning of a "client," but has departed from consistent policy in its use of the "look through" provision.

3. The "Look Through" Provision

The SEC contends that its authority to determine whether an exemption applies should not be limited to a rigid assessment of whether the adviser provided advice to a legal organization or, for that matter, an individual.⁷⁰ Rather, the SEC states that surrounding circumstances, in appropriate situations, might require the use of the "look through" provision.⁷¹ The SEC further argues that its creation of the Safe Harbor Rule implicitly

68. See CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, COMMENT LETTER RE: PROPOSED RULE TO REQUIRE REGISTRATION OF CERTAIN HEDGE FUND ADVISERS UNDER THE INVESTMENT ADVISERS ACT OF 1940, 12 (Sept. 15, 2004), at <http://www.sec.gov/rules/proposed/s73004/dhirschmann091504.pdf> (last visited Mar. 24, 2005) (emphasizing that under the SEC's reinterpretation, the term "client" will have one meaning for determining whether advisers must register and another for different purposes).

69. *Id.*; see also *The Committee on Private Investment Funds of the Association of the Bar of The City of New York*, 7 n.25 (Dec. 8, 2003), at <http://www.abcnyc.org/pdf/report/58851715.pdf> (last visited Mar. 24, 2005) (expressing concern that a "look through" provision might require an adviser to consider the diverse objectives of each investor, inconsistent with the purpose behind pooled investment vehicles that provide for diversification of risk).

70. See Adopting Release, *supra* note 2, at 72,067 n.157 (supporting its position, the SEC notes several circumstances in which prior to its adoption of the Safe Harbor Rule, no-action letters were issued that essentially required advisers to "look through" legal entities in counting clients). In response to an inquiry as to whether 20 people, organized into a limited partnership, would constitute 20 clients or one client with respect to the Safe Harbor Rule, the SEC responded that it would most likely "look through" the partnership and count each person as a "client." Ruth Levine, SEC No-Action Letter, Lexis 2719 (Dec. 15, 1976). However, when taken in light of other examples of the historical use of the "look through" provision, this determination appears to reflect the SEC's concern that the adviser was actively considering ways in which registration could be avoided. *But see* Adopting Release, *supra* note 2, at 72,097 n.98 (prohibiting a person from indirectly doing that which is unlawful to do directly, § 208(d) of the Advisers Act requires "look through" to an entity's investors in counting clients where the entity is merely a shell created in order to avoid registration). On the contrary, the SEC's Hedge Fund Rule targets advisers to hedge funds that simply take advantage of the statutory § 3(c)(1) and § 3(c)(7) exemptions; these funds and their advisers have not been implicated in the kinds of prohibited activities that § 208(d) governs. *Id.*

71. See Adopting Release, *supra* note 2, at 72,067-68 (finding the "look through" provision in this case to be consistent with the broad purposes of the Advisers Act and Safe Harbor Rule, and noting that the Act's objectives might be undermined if an adviser with more than 15 clients could simply form a limited partnership in order to evade registration).

proves that an adviser might have been required to “look through” an entity and count each shareholder as a “client.”⁷² Despite the SEC’s arguments, a reviewing court should not give deference to an agency’s rulemaking where its actions depart from longstanding policy.⁷³ Both Congress and the SEC have consistently used the “look through” provision to prevent circumvention of a statute’s purpose, not to effectively create new law.

As an example, the SEC promulgated Rule 205-3(b) which requires that advisers “look through” to the beneficial owners of § 3(c)(1) funds⁷⁴, thereby ensuring that performance-based fees are assessed only against qualified⁷⁵ clients.⁷⁶ This is similar to the “look through” provision in Rule 501(e)(2) of the Securities Act of 1933 ('33 Act). Rule 501(e)(2) provides that in calculating the number of unaccredited purchasers allowed under Rule 506,⁷⁷ a corporation or partnership will generally be counted as one purchaser, unless the entity was formed for the purpose of investing in such securities.⁷⁸ Moreover, the purpose of the “look through” provision can also be seen in § 3(c)(1)(A) of the '40 Act (enacted by Congress),⁷⁹ and subsequent amendment to that provision by the SEC.⁸⁰

In the Hedge Fund Rule, the SEC supports its rulemaking and use of the “look through” provision on the belief that a growing number of advisers are taking advantage of the Small Adviser Exemption, thereby circumventing the purpose of the rule.⁸¹ However, the SEC has provided

72. See *id.* at 72,068 (making a similar argument that the 1980 amendment establishing a no “look through” requirement for Business Development Companies implies that a “look through” was certainly possible at that time).

73. *Natural Res. Def. Council, Inc. v. SEC*, 606 F.2d 1031, 1050 (D.C. Cir. 1979).

74. See *infra* note 104 and accompanying text.

75. See 17 C.F.R. § 275.205-3(a), (d)(1) (2003) (defining a “qualified client” under Rule 205-3(d)(1) to include a natural person having at least \$750,000 under management of the adviser, or a net worth in excess of \$1.5 million).

76. See 17 C.F.R. § 275.205-3(b) (2003); see also 15 U.S.C. § 80b-5(a)(1) (2000) (generally prohibiting registered investment advisers from entering into performance-based fee agreements).

77. See 17 C.F.R. § 230.506 (2003) (exempting limited offers and sales without regard to the dollar amount of the offering and providing a safe harbor for certain transactions).

78. See 17 C.F.R. § 230.501(e)(2) (2003) (including a “look through” to each beneficial owner of the entity if it was formed for the specific purpose of investing in the securities offered and is not an “accredited investor”).

79. See 15 U.S.C. § 80a-3(c)(1)(A) (2000) (defining beneficial ownership by a company to count as one person, unless such company owns 10% or more of the voting securities of the issuer, in which case each holder of the company’s securities will be deemed a beneficial owner).

80. See *Private Investment Companies*, 61 Fed. Reg. 68,100, 68,101-02 (1996) (amending § 3(c)(1)(A) to exclude operating companies (i.e., a non-investment company) that invest in § 3(c)(1) funds because such companies do not raise concerns that the “look through” provision was intended to address—namely, ensuring that the investor is not merely a conduit created to allow a § 3(c)(1) fund with more than 100 investors).

81. See Adopting Release, *supra* note 2, at 72,054 (implying that rather than managing client money directly, investment advisers create limited partnerships through which clients invest in order to avoid registration).

little factual predicate for the conclusion that the Safe Harbor Rule now functions as a pervasive loophole that must be closed.⁸² The dissenting opinion notes that when the Safe Harbor Rule was proposed, the SEC explained that the rule's availability was limited to situations where the general partner advises the partnership based on the fund's investment objectives, not those of its partners.⁸³ Therefore, it appears that the Safe Harbor Rule was itself established to prevent circumvention, not solely to exempt from registration those advisers whose business is so limited that it does not raise federal interest.⁸⁴

In addition, the SEC notes that an adviser managing 15 clients and \$100 million in combined assets can simply move them into a single hedge fund and then withdraw its registration from the Advisers Act.⁸⁵ The SEC cites one case, arguably not even analogous to the issue at hand, in support of its determination that it is acting appropriately in closing off a pervasive loophole in the regulatory scheme of the Advisers Act.⁸⁶ Despite the fact that many hedge fund advisers seek out legal advice to assist in minimizing the costs and regulatory burdens of registration, the SEC is most likely targeting "private funds" as a result of negative publicity surrounding recent mutual fund timing scandals.⁸⁷ Without a sound factual predicate for concluding that the Small Adviser Exemption is now being exploited, the use of the "look through" provision functions more like a mechanism to create new law, rather than a legitimate means of enforcing the rule's primary objective.⁸⁸

82. See Proposing Release, *supra* note 4, at 45,199 (dissenting from the majority's opinion that Rule 203(b)(3)-1 is a loophole allowing advisers to manage the assets of more than 14 clients while remaining unregistered).

83. See *id.* at 45,199 n.35 (noting that contrary to the SEC's current position, this rule was established in order to prevent a general partner from using the partnership to do what it could not do directly itself).

84. *Id.*; see also Adopting Release, *supra* note 2, at 72,069 (finding the Small Adviser Exemption to reflect congressional intent that there is no federal interest in regulating advisers to family members or friends). However, the SEC's characterization is based upon a single example given by a Commission lawyer during the 1940 Senate Hearings, never designed to be a comprehensive statement of the reach of the Advisers Act. See Goldstein v. SEC, Complaint Case Number 1: 04CV02216, 21 (Dec. 21, 2004) (rationalizing that the expansion of the § 3(c)(7) exemption for "qualified" investors demonstrates congressional intent to provide an exemption to certain private funds regardless of asset size or the number of individual holders).

85. See Adopting Release, *supra* note 2, at 72,069 (describing that after such a shift, what remains is the loss of regulatory protection for investors, with a continued reliance on the skills and expertise of the adviser).

86. See *id.* at 72,069 n.177 (citing *SEC v. Gary Smith*, 1995 Lexis 22352 (S.D. Mich. 1995), where an investment adviser persuaded a client to reorganize its trust accounts in order to avoid regulation).

87. See *infra* note 150 (suggesting that the heightened desire for hedge fund regulation is not the result of a change in circumstances now allowing more hedge fund advisers to take advantage of a registration loophole).

88. See Goldstein, Complaint Case Number 1: 04CV02216 at 2 (compounding this problem is the fact that the Commission's rulemaking has not been "supported by a

C. Congressional Intent Not to Regulate Private Offerings

In this case, a reviewing court will need to address the question of whether Congress ever intended to regulate private offerings to sophisticated investors.⁸⁹ In fact, this question was specifically addressed by Commissioners Glassman and Atkins in their dissenting opinion from the Proposed Rule, citing several exemptions within the securities laws historically relied upon by hedge funds in avoiding regulation: § 4(2) of the '33 Act, Regulation D, and §§ 3(c)(1) and 3(c)(7) of the '40 Act.⁹⁰ An analysis of the exemptions contained within the securities laws provides further support in concluding that Congress never intended for private investment pools to require federal regulation, especially when offered solely to sophisticated investors.⁹¹

1. The Securities Act of 1933 ('33 Act)

The Hedge Fund Rule seeks to eliminate many of the exemptions that most hedge funds have historically relied upon in avoiding registration. For example, the '33 Act, designed to protect investors by promoting full disclosure, requires that companies provide investors with significant information concerning securities being offered for public sale.⁹² While § 5

reasoned explanation establishing a rational connection between the facts and the regulatory choices made").

89. See *Regulation of the Hedge Fund Industry Before the U.S. Senate Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (2004) [hereinafter *Hedge Fund Hearing*], at <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=122> (last visited on Feb. 25, 2004) (statement of Senator John E. Sununu) (questioning Chairman Donaldson on the basic policy issue of whether the investment industry should ever allow an unregulated investment pool if catered to the wealthy); see also *id.* (testimony of William H. Donaldson) (responding "yes," provided that non-wealthy investors on the other side of the transaction are not affected). However, the complex nature of most hedge fund transactions would make it difficult to operate in this "isolated environment" under which Chairman Donaldson would allow for unregulated investment pools designed for the wealthy.

90. See Proposing Release, *supra* note 4, at 45,200 (requesting comments on whether the SEC's Proposing Release conflicts with the fundamental notion that sophisticated investors do not warrant Commission oversight).

91. See AMERICAN BAR ASSOCIATION SECTION ON BUSINESS LAW, COMMENT LETTER RE: REGISTRATION UNDER THE ADVISERS ACT OF CERTAIN HEDGE FUND ADVISERS 24 (Sept. 28, 2004) [hereinafter PROPOSING RELEASE], at <http://www.sec.gov/rules/proposed/s73004/aba092804.pdf> (last visited Feb. 24, 2005) (agreeing that registration of advisers would conflict with traditional securities law beliefs that sophisticated investors do not warrant Commission oversight).

92. See U.S. Securities and Exchange Commission, *The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity, Laws That Govern the Securities Industries*, *14, at <http://www.sec.gov/about/whatwedo.shtml> (last visited Feb. 24, 2005) (describing the registration process as the primary means of accomplishing these objectives). Generally, securities sold in the U.S. must be registered, which requires certain disclosures about the company's management, a description of the security to be offered, and financial statements certified by independent accountants. *Id.* Congress enacted the '33 Act as a result of the stock market crash of 1929 and resulting economic depression. See James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L.

of the '33 Act generally prohibits the offer and sale of securities prior to the filing of a registration statement,⁹³ hedge funds typically take advantage of § 4(2), commonly referred to as the private offering exemption.⁹⁴ Although § 4(2) exempts from registration those issuer transactions not involving a public offering,⁹⁵ ambiguity surrounding what constitutes a public offering prompted the SEC's promulgation of a safe harbor provision in Rule 506 of Regulation D.⁹⁶ Under Rule 506, an issuance will not be deemed a public offering (and will consequently satisfy the requirements under § 4(2)) where made to an unlimited number of accredited investors,⁹⁷ but such offerings are restricted to no greater than 35 non-accredited purchasers.⁹⁸ Because hedge funds generally solicit only accredited investors, Rule 506 enables most hedge funds to safely rely upon the exemption in § 4(2) of the '33 Act.⁹⁹ The private offering exemption, combined with the SEC's safe harbor provision, illustrates legislative intent to exempt non-public offerings focused towards sophisticated investors.¹⁰⁰

REV. 29, 30-34 (1959-60) (drafting what would eventually become the '33 Act to provide full and fair disclosure of securities offered to the public).

93. 15 U.S.C. § 77e(c) (2000).

94. See 15 U.S.C. § 77d(2) (2000) (exempting transactions not involving a public offering). Section 4(2) was enacted to apply to offerings involving a limited number of individuals, where the public interest was not an issue. See Gibson, *supra* note 9, at 689.

95. 15 U.S.C. § 77d(2) (2000).

96. See STAFF REPORT, *supra* note 1, at 14 (discussing how the "public offering" language in § 4(2) has evolved over time based on judicial interpretation and the promulgation of Rule 506 as a means of lessening the uncertainty surrounding what constitutes a "public offering"); see also 17 C.F.R. § 230.506 (2003) (providing specific conditions which if satisfied, shall be deemed to be transactions not involving a "public offering" within the meaning of § 4(2)). In *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), the Court held that the private offering exemption does not turn on a purely numerical calculation, but instead upon the knowledge of the offeree and the need for protections afforded through registration. *Id.* at 125-27 (recognizing that while there is no reason why the SEC cannot use some sort of numerical test in deciding when to investigate an exemption claim, there is no justification for the use of a determinative quantity limit without regard to investor sophistication). Interestingly, the Hedge Fund Rule requires all hedge fund advisers to register based on a numerical calculation, without regard to congressional intent or judicial interpretation suggesting that private offerings focus on investor sophistication.

97. For purposes of Rule 506 in Regulation D, an accredited investor generally includes natural persons with an individual or joint net worth of \$1 million or individual income in excess of \$200,000 (\$300,000 if joint) in each of the two most recent years. See 17 C.F.R. § 230.501(a)(5)-(6) (describing two of the categories of offerees and purchasers who qualify as accredited purchasers); see also 17 C.F.R. § 230.215 (defining an accredited investor).

98. See 17 C.F.R. § 230.506(b)(2) (2003) (placing no limit on the dollar amount of securities that an issuer can offer under Rule 506). Hedge funds relying on Rule 506 cannot engage in general solicitation or advertising. See 17 C.F.R. § 230.502(c) (2003) (describing several forms of public solicitation which issuers of securities under Regulation D are precluded from utilizing).

99. 17 C.F.R. § 230.506(b)(2).

100. See PROPOSING RELEASE, *supra* note 91, at *24 (arguing that while the majority believes that all investors, regardless of wealth, deserve the protection of the Advisers Act, the dissent notes that wealthy investors might not want or need such protection).

2. *The Investment Company Act of 1940 ('40 Act)*

Congress enacted the '40 Act to prevent self-dealing on the part of those managing investment companies and to protect investors from possible abuses.¹⁰¹ The '40 Act defines an investment company as any issuer which is engaged primarily in the business of investing or trading in securities, and generally requires registration.¹⁰² However, hedge funds typically rely on two statutory exclusions from the definition of an investment company.¹⁰³ Section 3(c)(1) exempts any issuer whose outstanding securities are beneficially owned by not more than 100 persons.¹⁰⁴ Section 3(c)(7) excludes from the definition of an investment company any issuer whose securities are owned exclusively by "qualified purchasers"¹⁰⁵ and who does not propose a public offering of such securities.¹⁰⁶ These exemptions, similar to § 4(2) of the '33 Act,¹⁰⁷ provide evidence of congressional intent to allow certain "private offerings," especially those including only wealthy investors, to operate in an unregulated environment.¹⁰⁸ The Hedge Fund Rule, on the other hand, seemingly contradicts congressional intent by specifically requiring advisers to funds relying on §§ 3(c)(1) and 3(c)(7) to register under the Advisers Act.¹⁰⁹

Moreover, the § 3(c)(7) exemption was created as part of the National Securities Markets Improvement Act (NSMIA),¹¹⁰ which confirms the traditional belief that financially sophisticated investors do not require the protections of the '40 Act.¹¹¹ This legislation casts further doubt on the

101. See, e.g., *United States v. Brashier*, 548 F.2d 1315, 1320-21 (9th Cir. 1976) (describing the '40 Act as the result of an SEC study of investment companies which documented significant problems with insider self-dealing and inappropriate use of investment companies).

102. See 15 U.S.C. § 80a-3(a)(1)(a) (2000); see also 15 U.S.C. § 80a-7 (prohibiting certain transactions by unregistered investment companies).

103. See STAFF REPORT, *supra* note 1, at 11-13 (describing the § 3(c)(1) and § 3(c)(7) exemptions).

104. See 15 U.S.C. § 80a-3(c)(1) (2000) (requiring that in addition to the beneficial owner limitation, the issuer does not make, or propose to make, a public offering of its securities).

105. See 15 U.S.C. § 80a-2(a)(51)(A) (2000) (defining a "qualified purchaser" to include: (1) a natural person or family-owned company owning at least \$5 million in investments, (2) certain trusts, and (3) any other person that owns and invests on a discretionary basis at least \$25 million in investments).

106. See 15 U.S.C. § 80a-3(c)(7) (2000).

107. See *supra* note 94 and accompanying text.

108. See *Hedge Fund Hearing*, *supra* note 89, at 2 (statement of Adam C. Cooper, Chairman, Managed Funds Association) (recognizing that the current regulatory framework reflects long-standing congressional intent to focus government resources on investors who require protection).

109. See Proposing Release, *supra* note 4, at 45,195 (requiring under § (d)(1)(i) that a "private fund" is one ordinarily meeting the definition of an investment company, but for its reliance on § 3(c)(1) or § 3(c)(7)).

110. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (amending the Investment Company Act of 1940 to provide more efficient regulation and better protect investors).

111. See WILMER, *supra* note 43, at 8-9 & n.30 (recognizing that while § 3(c)(7)

consistency of the SEC's rulemaking, where the Commission is attempting to reverse congressional intent on its own accord, despite its knowledge of the implications embedded within § 3(c)(7).¹¹² The SEC responds by stating that commenters failed to offer support for concluding that the recent addition of § 3(c)(7) provides evidence that Congress intended hedge fund advisers be left unregulated by the *Advisers Act* as well as the '40 Act.¹¹³ However, the § 3(c)(7) exemption was recommended by the SEC itself and enacted by Congress while fully aware of the client-counting rule and growth of private investment companies.¹¹⁴ In addition, while each major securities law serves separate and distinct purposes, it is difficult to reconcile why resources should be conserved with respect to hedge funds and regulation under both the '33 Act and '40 Act, but not with respect to the *Advisers Act*.¹¹⁵ This concern is compounded by serious questions regarding the sufficiency of available resources and ability of the SEC to perform adequate inspections geared at discovering misconduct.¹¹⁶ Nevertheless, the SEC believes that despite thinning

essentially eliminates the investor limitation found in § 3(c)(1), hedge funds normally limit participation to less than 500 investors in order to avoid the registration requirements under § 12(g)(1) of the Securities Exchange Act of 1934); *see also* SCHULTE, *supra* note 58, at 7 (reiterating that the federal securities laws exist to protect retail investors, and emphasizing that the Staff Report found no evidence of direct retailization). Responding to the SEC's argument that increasing investments by institutional investors (e.g., pension plans) are indirectly exposing retail investors, one commenter emphasized that these institutions are not only sophisticated, but employ knowledgeable advisers already subject to regulation. *See id.* at 7-8 (noting fiduciary requirements under ERISA, as well as the Internal Revenue Code and Comptroller of the Currency).

112. *See* CHAMBER OF COMMERCE, *supra* note 68, at 12 (emphasizing that the 1996 addition of § 3(c)(7) expanded the number of private funds (hedge funds) and their advisers that could avoid regulation under the '40 Act and *Advisers Act*, respectively).

113. *See* Adopting Release, *supra* note 2, at 72,066 (further arguing that because NSMIA amended § 205 of the *Advisers Act* to exempt § 3(c)(7) funds from restrictions on performance fees, this demonstrates that Congress might have expected some § 3(c)(7) funds to be advised by registered advisers). However, it is certainly possible that advisers to § 3(c)(7) funds might voluntarily elect to register under the *Advisers Act*, while continuing to take advantage of the exemption from the stricter requirements of the '40 Act.

114. *Id.*; *see also* WILKIE, *supra* note 29, at 3 (contrasting the SEC's current endeavor with an analogous situation less than 10 years ago in which Congress declined to take action).

115. *See* Adopting Release, *supra* note 2, at 72,066 (reiterating that *Lowe* recognized a distinction in the protections required for sophisticated investors within the meaning of the '33 Act, but the majority notes that the *Advisers Act* does not). The majority notes that the Small Adviser Exemption was not designed to exempt advisers to sophisticated clients, but rather reflects the ideology that there is no federal interest in regulating advisers having only a small number of "clients." *Id.* at 72,054. *But see* Managed Funds Association, *supra* note 59, at 5-6 (recognizing that the '33 Act, and ensuing federal securities laws, have consistently carved out private offering exemptions under the belief that the sale of securities to a limited group of sophisticated investors does not warrant federal attention). Moreover, the Supreme Court has noted that interdependence between various sections of the securities laws is a factor to consider in interpreting congressional intent. *See SEC v. Nat'l Securities, Inc.*, 393 U.S. 453, 466 (1969) (recognizing, however, that the same words can take on different meanings in different sections of the securities laws).

116. *See* Adopting Release, *supra* note 2, at 72,093 (noting that the SEC's lack of

resources, risk assessment tools will be used to improve efficiency and enable it to focus resources on the areas of greatest risk.¹¹⁷

III. RAMIFICATIONS

Notwithstanding the searching inquiry required when an agency acts contrary to legislative history and its own historical policies, a reviewing court will require clear statutory authority or a congressional mandate when implementation of the rule has a devastating impact.¹¹⁸ This section examines some of the more severe ramifications likely to result from the Hedge Fund Rule.

A. Direct Effects

The Hedge Fund Rule requires most hedge fund managers to comply with the provisions of the Advisers Act.¹¹⁹ One of the most direct implications of registration under the Advisers Act is to significantly restrict access to hedge funds by increasing the financial requirements of investors into the fund.¹²⁰ The effect of this regulation is undesirable if the SEC believes that investing in hedge funds is appropriate for most investors, so long as there is adequate disclosure and regulation.¹²¹

resources is a matter of public record and that such deficiencies will substantially weaken any deterrence effect provided by the Commission's examination authority). Moreover, Alan Greenspan, Chairman of the Federal Reserve Board, stated "[my] problem with the SEC's current initiative is that [it] cannot accomplish what it seeks to accomplish. Fraud and market manipulation will be very difficult to detect from the information provided by registration under the 1940 Act." *See id.* at 72,090 n.10; *see also id.* at 72,093 (suggesting that because of the broad market implications, such regulation would be better addressed by members of the President's Working Group on Financial Markets, many of which have expressed concern with the proposal). The dissent has also questioned the wisdom in diverting scarce resources away from 90 million mutual fund investors in order to protect the estimated 200,000 sophisticated investors in hedge funds. *Id.* at 72,094.

117. *See id.* at 72,082-83 (seeking additional funding from Congress if necessary).

118. *See SEC v. Sloan*, 436 U.S. 103, 105-112 (1978) (holding that the SEC was not statutorily authorized in continually suspending trading in a corporate stock, despite its reliance on public interest grounds and the protection of investors).

119. *See Adopting Release*, *supra* note 2, at 72,054 (noting that advisers now required to register must do so by February 1, 2006).

120. *See* 17 C.F.R. § 275.205-3(a) (2004) (exempting registered investment advisers from the general compensation prohibition of Rule 205(a)(1), provided that the client entering the contract is "qualified"). A "qualified client" is defined to include a natural person or company having a minimum of \$750,000 under management or a minimum net worth of \$1.5 million at the time the contract is entered into. *See* 17 C.F.R. § 275.205-3(d)(1) (2004). *But cf.* 17 C.F.R. § 230.501(a)(5)-(6) (2004) (describing lower financial minimums than those required under the "qualified purchaser" standard). Because investment advisers will likely seek to continue charging performance-based fees, the effect of registration will be to raise the financial eligibility standards.

121. *See* Steven M. Felsenstein & Joel S. Telpner, *For Hedge Funds, One Less Risk To Hedge – For Now*, GT ALERT, Oct. 2003, 2-3, available at <http://www.gtlaw.com/pub/alerts/2003/felsensteins.10.pdf> (last visited Feb. 22, 2005) (recognizing that advisers desiring to maintain their performance fee structure must now restrict access to more financially secure individuals, and that the SEC might have to make some provision for

Registration under the Advisers Act also mandates that the adviser file form ADV, which includes certain public disclosures and allows the SEC to periodically examine an adviser's books and records.¹²² While most investors look favorably upon increased disclosure, the effects of across-the-board registration might cripple smaller hedge funds that do not have the resources to comply with the registration process.¹²³

B. Indirect Effects

Federal Reserve Chairman, Alan Greenspan, has been a consistent opponent of broad hedge fund regulation, citing his concern that inhibiting unregulated market participants (such as hedge funds) from taking risks can have a damaging impact on the overall financial system.¹²⁴ Moreover,

performance compensation if the SEC plans to allow hedge fund investing under a more regulated environment). *But cf. id.* at 3 (acknowledging that if the SEC believes that investing in hedge funds is inappropriate for most investors, the effect of this rule change is consistent with their conclusion).

122. See 15 U.S.C. § 80b-3(c) (2000) (requiring that an adviser registering under the Advisers Act file a registration form with the SEC containing information about the adviser, the nature of the business, and certain financial information); see also 17 C.F.R. § 275.203-1(a) (2003) (denoting Form ADV as the proper registration form). See generally 17 C.F.R. § 275.204-2 (2003) (detailing the types of books and records which registered advisers must maintain and have available for periodic SEC examinations). Investment Advisers are also subject to the anti-fraud provisions of the Adviser Act. See 15 U.S.C. § 80b-6 (2000) (noting that this provision applies to all managers meeting the definition of an investment adviser, regardless of whether an adviser is exempt from registration).

123. See John Hintze, *SEC May Choose 'Registration Lite,'* SECURITIES INDUSTRY NEWS, June 21, 2004 (quoting Linda Munn, co-founder of Hedgepros consulting firm, as stating that registration under the Advisers Act is a very onerous process that often requires a full-time staff person, which many smaller hedge funds cannot afford); see also Proposing Release, *supra* note 4, at 45,189 & n.185 (estimating the initial filing fee and annual registration fee for a "small" fund to be \$800 and \$400, respectively; required compliance infrastructure for new advisers would approximate \$20,000 in professional fees and \$25,000 in internal costs). Moreover, the majority attempts to shift the burden of cost-benefit analysis to the commenters and does not provide a realistic estimate of direct costs. See Adopting Release, *supra* note 2, at 72,094 (noting that the majority easily accepted anecdotal evidence from those commenters in support of the rulemaking, but dismissed similar evidence from those opposed). The majority's cost-benefit analysis also fails to address the opportunity costs associated with the rulemaking. See Goldstein, Complaint Case Number 1: 04CV02216, at 19 (recognizing that hedge fund activities will likely be affected by the manager's diversion of time and effort away from the investment advisory function).

124. See Paul Barr, *Greenspan Still Opposes Hedge Fund Manager Registration,* HEDGEWORLD NEWS, June 16, 2004 (identifying Greenspan's belief that hedge fund managers should not be required to register with the SEC); see also *Private-Sector Refinancing of the Large Hedge Fund, Long-Term Capital Management Before the Comm. On Banking and Financial Services*, 105th Cong. 6 (1998) (statement of Chairman Alan Greenspan) (suggesting the possibility that direct U.S. regulation of hedge funds would encourage aggressive funds to relocate to a less restrictive jurisdiction). There is little dispute that hedge funds provide numerous market benefits and play an important role in maintaining an efficient financial market. See generally STAFF REPORT, *supra* note 1, at 4 (describing many of the benefits provided by hedge funds, including the use of short-term trading strategies designed to exploit mispricings of securities, serving as ready counterparties for numerous hedging transactions, and acting as a risk management tool by providing valuable portfolio diversification); see also Managed Funds Association, *supra*

requiring registration of hedge fund managers would be an enormous expansion of regulatory authority, requiring the diversion of SEC resources away from the protection of retail investors, refocused upon a privileged class historically deemed capable of protecting itself.¹²⁵ Hedge fund advisers might also be discouraged from engaging in complex trading strategies that cannot be easily explained to Commission examiners.¹²⁶ Beyond this seemingly inappropriate shift in focus, forced registration of managers combined with inadequate SEC resources might create a false stamp of approval in the eyes of investors and the securities markets.¹²⁷

IV. ALTERNATIVE RECOMMENDATIONS

Part of the difficulty surrounding hedge fund regulation stems from the fact that the SEC is attempting to address too many concerns by way of one seemingly simple amendment.¹²⁸ Arguably, the tremendous growth in hedge funds has heightened the level of concern to the point where some form of regulation is warranted. However, if the SEC's mission is to

note 59, at 9-10 (suggesting that an across-the-board registration requirement could impair an adviser's ability to implement the innovative investment strategies which have helped to improve overall market efficiency). *But see Hedge Fund Hearing, supra* note 89, at 6 (statement of William H. Donaldson) (emphasizing that the provisions of the Advisers Act are moderate, having no impact on trading strategies or the types of investments a hedge fund manager may make).

125. *See* Managed Funds Association, *supra* note 59, at 9 (concluding that NSMIA, which established a bifurcated system of federal and state jurisdiction over investment advisers, was at least in part a result of the realization that SEC resources were insufficient to effectively regulate registered investment advisers).

126. *See* Adopting Release, *supra* note 2, at 72,095 (stating similar concerns, one commenter explained that there is little doubt that advisers would rather abandon a risky but lawful strategy, rather than face the controversy associated with obtaining Commission "approval").

127. *See id.* (asserting that beyond resource constraints, it would be difficult to limit the impact of registration solely to hedge funds because of the fact that hedge funds are more often defined by what they are not). Despite concern from venture capital and private equity funds, it appears as though fund managers that lock up investors' money for a minimum of two years will not be subject to the Hedge Fund Rule. *See* Chidem Kurdas, *Hedge Fund Regulation: Why Is Private Equity Exempt?*, HEDGEWORLD'S INSIDE EDGE, June 15, 2004 (questioning whether providing a free pass to a fund that has a two year lock-up will encourage hedge funds to follow suit in order to avoid registration).

128. *See* Chidem Kurdas, *Hedge Fund Regulation: A Potential Mismatch of Rules, Goals and Authority*, HEDGEWORLD'S INSIDE EDGE, June 7, 2004 (questioning whether the purpose of SEC information gathering is to protect investors from fraud or to protect the integrity of the capital markets); *see also* Boehm & Reid, *supra* note 14, at 54-55 (describing many of the SEC's concerns, including: the inability to proactively fight fraud, the valuation of a hedge fund's portfolio, the increase in hedge fund availability to people with less financial sophistication, concerns over inappropriate general solicitation, and a general concern about lack of disclosure); Adopting Release, *supra* note 2, at 72,091 (finding the majority opinion's reliance on hedge fund growth, increasing fraud, and broad exposure to be insufficient grounds for such broad rulemaking).

protect all investors, regardless of their sophistication,¹²⁹ such a change is best left for Congress.

A. Retailization of Hedge Funds

One of the SEC Staff Report's primary objectives was to investigate whether less sophisticated investors are gaining access to hedge funds.¹³⁰ More specifically, the SEC is concerned about the lower minimum investments generally available in "funds of hedge funds" (FOHF).¹³¹ Another area of major concern noted in the Staff Report was the indirect exposure of individual investors through growing institutional investments by pension plans.¹³²

The Hedge Fund Rule seems to avoid one of the most obvious alternatives to broadly requiring all hedge fund managers to register as investment advisers. If the SEC is concerned that hedge funds are becoming available to less sophisticated investors, it should consider amending Rule 501's definition of an "accredited investor."¹³³ In response,

129. See *Hedge Fund Hearing*, *supra* note 89, at 5 (statement of William H. Donaldson) (responding to criticism that hedge fund investors do not require SEC oversight, Chairman Donaldson emphasized the SEC's mission as protecting *all* investors, large and small).

130. See STAFF REPORT, *supra* note 1, at 80-83 (focusing the investigation on three areas: direct investment, the use of registered funds of hedge funds, and indirect investment through pension plans). The Staff Report noted that despite the economic boom of the 1990s and an increase in the number of investors who have surpassed the "accredited investor" standard, there was no indication of substantial numbers of retail investors directly investing in hedge funds. See *id.* at 80-81 (realizing that most hedge fund managers have no interest in selling their product to retail investors and prefer the freedom that comes with privately offering to accredited or qualified purchasers).

131. See Boehm & Reid, *supra* note 14, at 54 (defining a fund of hedge funds (FOHF) as an investment company that invests almost exclusively in approximately 15 to 20 other hedge funds and is designed to allow investors, not otherwise able to meet the high minimum investment requirements, to pool their assets in order to gain access to these funds). Although registered FOHFs currently have investment minimums set between \$25,000 and \$1 million, there are no specific requirements that these funds continue to do so. *Id.*; see also STAFF REPORT, *supra* note 1, at 81 (reasoning that the SEC's concerns about registered FOHFs are no different than its concerns over hedge funds generally, but heightened by the possibility that the retail public might gain access to these funds in the future).

132. See STAFF REPORT, *supra* note 1, at 82 (recognizing the increasing frequency of institutional investments by pension plans, universities, endowments, and other charitable organizations). Despite the fact that these institutions typically qualify as "accredited investors," participants without financial sophistication may be indirectly placing their retirement monies at risk within an unregulated industry. *Id.*; see also Neil Weinberg & Bernard Condon, *The Sleaziest Show On Earth*, FORBES, May 24, 2004, at *1, available at http://www.forbes.com/forbes/2004/0524/110_print.html (last visited Feb. 24, 2005) (estimating that U.S. pension funds plan to invest another \$250 billion into hedge funds in the coming years, 20 times their current exposure).

133. See *White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds*, (Managed Funds Association) 20, July 7, 2003, at <http://www.sec.gov/spotlight/hedgefunds/hedge-mfa2.htm> (last visited Feb. 22, 2005) (suggesting that the SEC could increase the financial eligibility standards of natural persons by making an inflationary adjustment, increasing the \$1 million net worth requirement to \$2 million, and the \$200,000 individual income threshold to \$400,000). The SEC could also consider

the majority notes that raising the accredited investor standard would fail to address the Commission's broader concerns regarding indirect exposure by the retail public.¹³⁴ With respect to the FOHF concern, the SEC could reasonably impose the revised accredited investor standard to these pooled entities, in conjunction with the "look through" provision.¹³⁵ Moreover, the concern regarding institutional investors does not fall under the purview of the SEC.¹³⁶ Adjusting the "accredited investor" standard would also be more consistent with the statutory requirements which made hedge funds an investment strategy for the wealthy and sophisticated.¹³⁷ Another alternative that would better protect retail investors would be to require all hedge funds or FOHFs that manage retail or retirement assets to register under the Advisers Act.¹³⁸ Once the SEC has taken steps to ensure that hedge funds remain in the hands of sophisticated investors, it must also be able to monitor the activities of such a rapidly growing industry.

B. The Information Gap

Chairman Donaldson notes that the SEC's responsibility is to police the securities markets and protect investors, and to that end, obtain important information about hedge funds and their managers.¹³⁹ The lack of information regarding hedge funds stems partly from the manager's ability to structure their operations so as to take advantage of the registration exemptions scattered throughout the securities laws.¹⁴⁰ There is little doubt

amending Rules 505 and 506 to disallow all non-accredited investors. *Id.* The increased eligibility standards would continue the original philosophy behind these private investment pools, never intended for investors who cannot afford to bear the risk. *See Hedge Fund Hearing, supra* note 89, at *3 (statement of James Chanos, President, Kynikos Associates, LP) (supporting a decision to raise the minimum investment requirements).

134. *See* Adopting Release, *supra* note 2, at 72,064 (describing the SEC's broader concerns to include increasing numbers of beneficiaries in pension plans and investments through other intermediaries).

135. *See Private Investment Companies, supra* note 80, at 68,102 (announcing the purpose of the "look through" provision as a mechanism designed to prevent the use of an entity (such as a FOHF) as a conduit for avoiding the purpose of a statute).

136. *See* Kurdas, *supra* note 128 (agreeing with the valid concerns raised by Chairman Donaldson, but recognizing that unless oversight authority is delegated to the SEC, the responsibility to protect retirement benefits resides with the Department of Labor).

137. *See Hedge Fund Hearing, supra* note 89, at *1 (statement of Senator Richard Shelby) (agreeing that it is essential that ordinary investors not obtain access to unregulated investment vehicles).

138. *See id.* at *8 (statement of Charles J. Gradante, Managing Principal, The Hennessee Group LLC) (suggesting other alternatives such as expanding current mutual fund regulations to allow retail investors greater access to hedge fund trading strategies, and requiring all hedge fund interests be sold by Series 7 registered representatives which require investor suitability under Rule 405).

139. *See Mutual Fund Hearings, supra* note 3, at *12 (statement of Chairman William H. Donaldson) (desiring basic information about hedge funds such as how many managers are deploying assets under management, how they handle conflicts of interest, how they value investments, and what impact their activities have on the financial markets).

140. *See* Brian J.M. Sano, Public Comment to the Staff's Report, "Implications on the

that a fundamental problem within the hedge fund industry is the lack of disclosure.¹⁴¹

As an alternative to the Hedge Fund Rule, the SEC could use its rulemaking authority to require that hedge fund managers file a notice of the exemptions relied upon in avoiding registration under the securities laws.¹⁴² This notification could be structured to include as little or as much information as the SEC deems appropriate. Included in the notification could be the legal structure of the fund, the fund's management, the minimum fund investment requirements, the investment policy, and the nature of the investors.¹⁴³ Similarly, hedge fund managers could be required to file notice with the SEC, disclosing its reliance on the Small Adviser Exemption.¹⁴⁴ Moreover, the current regulatory framework suggests that proactive indirect monitoring would be a less intrusive means in obtaining the desired information on hedge funds.¹⁴⁵ The majority

Growth of Hedge Funds," Alternatives to the Increased Regulation of Hedge Funds, 1 n.4 (May 21, 2004), at <http://www.sec.gov/rules/other/4-476/4476-90.pdf> (last visited Feb. 24, 2005) (expressing the SEC's concern that this has led to an "information gap" preventing the SEC and investors from obtaining basic information such as how many funds are out there, who manages them, and what their power is as an institutional investor).

141. See Whitney Tilson, *Sensible Hedge Fund Regulation*, THE MOTLEY FOOL.COM, Apr. 11, 2003 (on file with author) (suggesting that hedge funds should be required to disclose, at least once a year: use of leverage, the fund's concentration of positions, a breakdown of the portfolio by industry and market capitalization, and explanations for any significant management-valued securities).

142. See Sano, *supra* note 140, at 11 & n.39 (recognizing that the Commodities Futures Trading Commission (CFTC) and National Futures Association (NFA) already require similar filings under the Commodity Exchange Act); see also Adopting Release, *supra* note 2, at 72,091 (summarizing numerous comments suggesting that advisers relying on the § 3(c)(1) or § 3(c)(7) exemptions be required to file and annually update information statements with the Commission).

143. See Sano, *supra* note 140, at 12-14 (proposing a new SEC "Form HF" which could require disclosure of which exemption from the '40 Act the manager is relying upon, i.e., § 3(c)(1) or § 3(c)(7), as well as other items of interest, such as the fund's marketing strategy, the fund's prime brokers, and its use of leverage).

144. See *id.* at 18-20 (proposing a new "Form ADV-X" which would require managers to disclose numerous facts, including: whether the adviser has a personal stake in the fund, whether the manager advises any mutual funds, and the manager's experience and history); see also *Hedge Fund Hearing*, *supra* note 89, at *4 (statement of James Chanos) (requiring advisers exempt under § 203(b)(3) to certify certain information including: minimum investor qualifications that meet or exceed current accredited investor levels, assets under management, custody of fund assets in an identified broker-dealer, annual audits and delivery of financial statements to investors, and quarterly unaudited financial reports to investors).

145. See *Hedge Fund Hearing*, *supra* note 89, at *6-7 (statement of Charles J. Gradante) (suggesting that the current regulation of prime brokers, investment banks, commercial banks, accounting firms, and fund administrators provides adequate information on hedge funds if properly coordinated). Acknowledging that such information is not located in one convenient place, the dissent suggests that the SEC could have worked with other regulators to improve information sharing. See Adopting Release, *supra* note 2, at 72,090 n.6 (noting that the Commodities Futures Trading Commission (CFTC) and National Futures Association (NFA) both made such offers; the SEC might have further sought to expand upon the Department of Treasury's proposed form, aimed at obtaining information from unregistered advisers as part of its anti-money laundering program).

dismissed these alternatives because such suggestions fail to provide the SEC with examination authority.¹⁴⁶ However, the complicated nature of hedge fund transactions provides serious doubt as to whether the SEC's concerns can be adequately resolved through inspection authority.¹⁴⁷ The alternatives described above certainly seem to address the SEC's primary concerns regarding the hedge fund industry. More importantly, these alternatives provide an approach more consistent with that expressed by Congress, as well as the regulatory scheme already in place.¹⁴⁸

CONCLUSION

When the District of Columbia Court of Appeals addresses this issue,¹⁴⁹ the SEC's rulemaking should face a scrutinizing analysis. While some form of increased oversight is certainly justified, amending the Safe Harbor Rule likely requires formal congressional legislation because it creates a new regulatory regime.¹⁵⁰ The SEC's Hedge Fund Rule should be set aside by a reviewing court because it attempts to close a questionable loophole by reversing not only its own historical policies, but also by specifically targeting exempted funds that Congress has allowed to remain unregulated for the last sixty years. Under these circumstances, the ordinary deference given by a reviewing court to an administrative agency's rulemaking should be replaced by a more scrutinizing review. Absent congressional action, the SEC and other governmental agencies would have unfettered power to avoid the democratic lawmaking process.

146. See Adopting Release, *supra* note 2, at 72,091.

147. See *id.* at 72,092-93 (emphasizing that in response to the majority's claim that hedge funds played a role in the recent market timing scandals, the SEC's inspection authority over mutual funds failed to uncover the illegal conduct). The dissent also reiterates that the SEC already has subpoena power to investigate potential abuses in the hedge fund industry. See *id.* (using the subpoena power to gather information summarized in the Staff Report).

148. See Sano, *supra* note 140, at 11 n.39 (recognizing that the SEC already requires issuers, including most hedge funds, to file notice of reliance on the private offering exemptions in the '33 Act on Form D). The Patriot Act also includes provisions requiring unregistered investment funds, such as hedge funds, to file notices of exemption. *Id.*

149. See Goldstein, Complaint Case Number 1: 04CV02216, 21 (alleging in its pending lawsuit that the Commission's Hedge Fund Rule exceeds their agency rulemaking authority).

150. See SEC Open Meeting, *supra* note 19 (statement of Commissioner Atkins) (suggesting that the decision to move forward on hedge fund regulation is not necessarily a result of changed circumstances so much as it is an overreaction to recent scandals in the mutual fund industry).