

TOO FAR OVER THE HEDGE: WHY THE SEC'S ATTEMPT TO FURTHER REGULATE HEDGE FUNDS HAD TO FAIL & WHAT, IF ANY, ALTERNATIVE SOLUTIONS SHOULD BE CONSIDERED

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INTRODUCTION

As individuals attempt to preserve and grow their wealth in a quite volatile economic environment, more have turned toward hedge funds as one of the components necessary to achieving their financial goals.¹ Further, over the last decade the amount of assets invested in hedge funds has outpaced other supposedly more conservative investment classes, such as mutual funds.²

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¹ See CHARLES J. GRADANTE, COMMENTS OF HENNESSEE GROUP LLC FOR THE U.S. SECURITIES AND EXCHANGE COMMISSION ROUNDTABLE ON HEDGE FUNDS 4-5 (2003), <http://www.sec.gov/spotlight/hedgefunds/hedge-gradante.pdf> (informing that according to Hennessee's research data, assets invested in hedge funds grew from \$20 billion in 1987 to \$35 billion in 1992 to \$50 billion in 1993, and from there, according to most reputable sources, reached almost \$600 billion as of January 2003); see also IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 1 n.2 (2003), <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter THE REPORT] (relating that at the SEC Roundtable on Hedge Funds, which helped the SEC write The Report, the consensus was that there is approximately \$600 billion currently invested in hedge funds as of 2003, but also pointing out that other estimates "vary greatly"). In keeping with this trend, from 2003 through the end of June 2006, assets invested in hedge funds doubled, growing from \$600 billion to approximately \$1.22 trillion. See *Q2 Sees Biggest Jump in New Hedge Fund Inflows Since 2003*, HEDGEWEEK.COM, June 28, 2007, http://www.hedgeweek.com/articles/pdf_page.jsp?content_id=29604 (registration required) (reporting on newly-released data compiled and analyzed by Hedge Fund Research, Inc.); see also Marcia L. MacHarg, *Waking Up to Hedge Funds: Is U.S. Regulation Really Taking a New Direction?*, in HEDGE FUNDS: RISKS AND REGULATIONS 55, 55 (Theodor Baums & Andreas Cahn eds., 2004) (describing the recent growth of the hedge fund sector as "stunning").

² See THE REPORT, *supra* note 1, at 1-2 & n.4 (pointing out that while the amount of assets invested in hedge funds grew by 1,084% from 1993 to 2003, other

Surprisingly, even with this growing popularity there is no unanimously agreed-upon definition of what is a “hedge fund.”³ Problematically, this lack of a definition extends to U.S. federal securities law as well.⁴ One common description of a hedge fund is that it is a “[sometimes] aggressively managed portfolio of investments that uses advanced investment strategies such as [but not limited to] leverage, long, short and derivative positions in both domestic and international markets with the goal of generating high returns.”⁵

This explosion in hedge fund assets piqued the interest⁶ of the U.S. Securities & Exchange Commission (“SEC”).⁷ The SEC’s desire to learn more about hedge funds prompted its staff to embark on a study of the sector and to hold a roundtable discussion on the state of hedge funds.⁸ The outgrowth of these endeavors was the belief of the SEC that it did not have adequate regulatory measures in place to properly monitor hedge funds in order to protect investors.⁹ This then led the SEC to propose amendments to the Investment Advisers Act of 1940 (“Advisers

asset groups did not experience the same success). For reference, The Report explains that from 1992 to 2002, mutual fund assets grew by 289%, insurance company assets grew by 110%, and commercial bank assets grew by 100%. *Id.*

³ *Id.* at 3. To demonstrate this lack of a definition, one panelist at the Roundtable gathered and submitted fourteen such definitions. See DAVID A. VAUGHAN, COMMENTS FOR THE U.S. SECURITIES AND EXCHANGE COMMISSION ROUNDTABLE ON HEDGE FUNDS (2003), <http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm>.

⁴ See, e.g., Franklin R. Edwards, *The Regulation of Hedge Funds: Financial Stability and Investor Protection*, in HEDGE FUNDS: RISKS AND REGULATIONS, *supra* note 1, at 30, 32.

⁵ Hedge Fund, Investopedia.com, http://www.investopedia.com/terms/h/hedge_fund.asp (last visited Sept. 19, 2007). The commentary in the definition states that “hedging is actually the practice of attempting to reduce risk, but . . . [t]he name is mostly historical Nowadays, hedge funds use dozens of different strategies, so it isn’t accurate to say that hedge funds just ‘hedge risk.’” *Id.*

⁶ See THE REPORT, *supra* note 1, at 1.

⁷ The SEC is the federal agency responsible for protecting investors, monitoring the securities markets, and enforcing federal regulations pertaining to them. See U.S. Sec. & Exch. Comm’n, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwedo.shtml> (last visited Sept. 19, 2007).

⁸ See generally THE REPORT, *supra* note 1 (referring throughout to the data presented by panelists at the Roundtable).

⁹ Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172 & 45,185 (proposed July 28, 2004) [hereinafter Proposed Rule] (“Our current regulatory program for hedge funds and hedge fund advisers is inadequate We have no oversight program that would provide us with the ability to deter or detect fraud . . .”).

Act”),¹⁰ which it felt would allow for sufficient monitoring of the sector.¹¹ In hand with the proposal, the SEC requested comments on the proposed amendments from the industry itself and from individual investors.¹²

The request for input was met with much commentary.¹³ Of the letters received,¹⁴ fifty-two percent were in opposition to the amendments, with only twenty-two percent of the letters actually supporting the implementation of the amendments.¹⁵ Even with the majority of the letters recommending the amendments be abandoned, the SEC plowed ahead, promulgating the Final Rule.¹⁶ The intended outcome was to require that most hedge fund managers, i.e., the fund’s investment adviser(s), be registered with the SEC by February 1, 2006.¹⁷ Perhaps most jarring was that the amendments were finalized not only over the dissent of the industry, but also over the dissent of two of the five SEC commissioners.¹⁸

¹⁰ 15 U.S.C. §§ 80b-1 to 80b-21 (2000).

¹¹ See generally Proposed Rule, *supra* note 9 (outlining each of the amendments and the reasons for each of them). The most important amendment proposed was changing the definition of “clients” in 15 U.S.C. § 80b-3(b)(3) to include any limited partners or passive investors in hedge funds. This would force the investment advisers of many hedge funds to register, as they would now fail to meet the exception to registration, which allows one to avoid registration only if he has fewer than fifteen “clients.” See *id.* at 45,182. For a complete discussion of the statutes, the amendments, and what they were designed to do, see *infra* Part I.

¹² See Proposed Rule, *supra* note 9, at 45,185 to 45,187 (asking for comments from readers after each of the proposed amendments is explained).

¹³ See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2,333, 84 SEC Docket 1032, pt. I.C (Dec. 2, 2004) (to be codified at 17 C.F.R. pts. 275 & 279), <http://www.sec.gov/rules/final/ia-2333.htm> [hereinafter Final Rule] (explaining the response the SEC received from its request for comments).

¹⁴ For complete access to all comments submitted, including those in favor of the amendments, those opposed to the amendments, and those that did not express an opinion as to that particular question, see Comments on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2,266, File No. S7-30-04, <http://www.sec.gov/rules/proposed/s73004.shtml>.

¹⁵ See Final Rule, *supra* note 13, pt. I.C. The SEC received 161 letters of comment from a variety of sources including hedge fund advisers, individual investors, law firms, and other investment advisers. Of the 161 letters received, forty-two of them did not support or disagree with the rule, thirty-six supported the rule, and eighty-three of the letters were in opposition to the rule. *Id.*

¹⁶ See *id.* pt. II.

¹⁷ *Id.* pt. III.

¹⁸ See Proposed Rule, *supra* note 9, at 45,197 (Cynthia A. Glassman & Paul S. Atkins, Commissioners, dissenting); see also Final Rule, *supra* note 13 (Cynthia A.

Although the amendments to the Advisers Act meant many hedge fund advisers now had to register with the SEC,¹⁹ the consequences of which were sure to be burdensome,²⁰ almost all of the advisers and their funds were unwilling to formally challenge the authority of the SEC to propose and adopt said amendments.²¹ One manager, Phillip Goldstein,²² was nevertheless determined to confront the SEC as to the legitimacy of the actions it had taken.²³ Mr. Goldstein filed suit against the SEC on December 9, 2005.²⁴ More surprising than the filing of the suit itself was that Mr. Goldstein and his investment firm came out victorious²⁵: The Court of Appeals ruled unanimously that the amendment pertaining to the definition of the term “client” for the sake of only one section of the Advisers Act was an

Glassman & Paul S. Atkins, Commissioners, dissenting) (reiterating their opposition to the proposed amendments).

¹⁹ See *Court Challenge Looms Over SEC Hedge Fund Proposal*, GLOBAL RISK REGULATOR, Oct. 2004, available at <http://www.globalriskregulator.com/archive/October2004-05.html> (explaining that if the amendments to the Advisers Act are adopted, “the SEC estimates that between 690 and 1,260 advisers will be required to register”). In the end, the SEC’s estimates were low, and more than 2,000 funds fell under the registration requirements that went into effect. See Liz Moyer, *Whither Hedge Funds?*, FORBES.COM, Aug. 4, 2006, http://www.forbes.com/business/2006/08/04/sec-hedge-funds-appeal-cx_lm_0804hedge.html.

²⁰ See, e.g., Nir Yarden, *Hedge Fund Manager Registration*, FORBES.COM, Dec. 28, 2005, http://www.forbes.com/2005/12/27/hedge-funds-commentary-cx_ny_1228_hedge_print.html (delving into the “significant” costs that registration would present to hedge fund advisers and the funds themselves).

²¹ Telephone Interview with Phillip Goldstein, Principal, Bulldog Investors; President, Opportunity Partners L.P.; and General Partner, Kimball & Winthrop, Inc., in Queens, N.Y. (Aug. 8, 2006) [hereinafter Goldstein Interview] (telling the author that he (Goldstein) tried to convince other hedge fund managers to join in his lawsuit against the SEC, but they all declined, perhaps out of fear of repercussions).

²² A veteran manager in the hedge fund industry, Mr. Goldstein is a co-founder of Bulldog Investors, a group of hedge funds that use value-driven strategies to achieve absolute positive returns for its investors. He is also an outspoken advocate of hedge funds and is often sought for his opinions on issues of corporate governance. For a more complete biography of Mr. Goldstein and the funds’ strategies, see the Bulldog Investors website at <http://www.bulldoginvestors.com> (presently under construction).

²³ See Goldstein Interview, *supra* note 21 (explaining to the author that he felt someone had to stand up to the SEC, and how that someone was going to have to be him).

²⁴ *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

²⁵ See *id.* at 879–84 (going over the rationale behind ruling in favor of Mr. Goldstein).

“arbitrary rule” and must therefore be vacated.²⁶ The decision essentially meant that the rule no longer existed.²⁷

The court’s definitive statement spurred a flurry of activity. Within days of the ruling, the U.S. Senate Judiciary Committee held a hearing to analyze whether the best strategy would be to focus more on enforcing current laws applicable to hedge funds,²⁸ or if there really was a need for new legislation.²⁹ This was followed less than a month later by Chairman Cox of the SEC testifying before the U.S. Senate Committee on Banking, Housing, and Urban Affairs that he had directed the staff of the SEC to take a number of “emergency action[s]”³⁰ in light of the *Goldstein* decision. Even with this testimony, the SEC ultimately decided against appealing the case en banc to the Supreme Court.³¹ As these events unfolded, divergent voices trumpeted the necessity of the court’s decision, claiming that no further regulation was needed and that the Final Rule would have caused more harm than good.³²

²⁶ *Id.* at 884.

²⁷ See *The Goldstein Decision: So Now What?*, IM INSIGHT NEWS, June 23, 2006 (received via email from Phillip Goldstein; on file with author) [hereinafter *Goldstein Decision: So Now What?*] (quoting a legal expert as stating that when a rule is vacated, that means the rule is “[t]oast”).

²⁸ See, e.g., THE REPORT, *supra* note 1, at 21 (“Investment advisers that are exempt from registration nevertheless are subject to the antifraud provisions of the [Investment] Advisers Act [of 1940].”).

²⁹ See Liz Moyer, *Senate Weighs Hedge Fund Regulations*, FORBES.COM, June 28, 2006, http://www.forbes.com/business/2006/06/28/hedge-fund-hearings-cx_lm_0628hedge.html [hereinafter Moyer, *Senate Weighs Regulations*].

³⁰ See *Testimony Concerning the Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 109th Cong. (2006) (statement of Christopher Cox, Chairman, SEC), available at <http://www.sec.gov/news/testimony/2006/ts072506cc.htm> [hereinafter Cox Testimony]. Interestingly, many of the “emergency action[s]” that Chairman Cox mentioned had to do with undoing the effects that the *Goldstein* decision had on the Advisers Act, like to whom the adviser owes a fiduciary duty. *Id.*

³¹ See *S.E.C. Decides It Won’t Appeal on Hedge Funds*, N.Y. TIMES, Aug. 8, 2006, at C9. The decision not to appeal was a statement in and of itself, as many thought that the SEC would surely appeal their case to the United States Supreme Court. See, e.g., *Court of Appeals Strikes Down SEC Hedge Funds Registration Rule*, HEDGEWEEK.COM, June 26, 2006, http://www.hedgeweek.com/articles/detail.jsp?content_id=2701 (registration required) (writing, in a commentary on the *Goldstein* decision, how “the SEC will likely seek permission to appeal to the Supreme Court” (emphasis added)).

³² See, e.g., Perrie Weiner, *Putting the “Hedge” Back*, FORBES.COM, July 3, 2006, http://www.forbes.com/business/2006/06/30/hedge-funds-sec-comment-cx_pw_0703weiner.html (“The SEC’s hedge fund registration requirement was ill-conceived, did not serve to protect investors, and met a well-deserved fate . . .”).

Consequently, as the hedge fund industry continues to grow and assert its position in the portfolios of investors and world capital markets,³³ the laws and registration requirements pertaining to it are anything but settled. This regulatory uncertainty provides the backdrop to the issues that this Note attempts to address. This Note puts forth that the court's decision in *Goldstein*, which stifled the SEC's attempt to further regulate hedge funds, is a positive legal development for the hedge fund industry, the investing public, and the SEC itself. This Note, in fact, proposes that it was not just positive, but imperative, for the SEC to fail in its chosen course of action. This Note also stresses that while the hedge fund sector may require some form of change, the amendments the SEC proposed would not have alleviated the concerns they were meant to extinguish; therefore, any additional steps taken should be of a different variety than the amendments that ultimately failed when analyzed by the court.

Part I of this Note will give a more complete picture as to why hedge funds have historically been exempt from registration and the events that coalesced to bring forth the current confusion. Part II will present a deeper understanding as to why the SEC's failure to further regulate the hedge fund industry is a positive turn of events for all parties and how any other outcome would have only created more problems. Finally, Part III of this Note will present some possible alternative solutions to consider in contrast to SEC's failed solution, which can alleviate the fears of the SEC while still recognizing the needs of the industry and its investors as well.

I. THE STATUTORY EXEMPTIONS & HOW THE UNCERTAINTY DEVELOPED

Hedge funds have been utilized as an investment tool for over sixty years.³⁴ Over the last fifteen years, money has flowed into the sector in impressive amounts, leading the current level of assets invested in hedge funds to exceed \$1.2 trillion.³⁵ This

³³ See Cox Testimony, *supra* note 30 ("Although hedge funds represent just 5% of all U.S. assets under management, they account for about 30% of all U.S. equity trading volume.").

³⁴ See Edwards, *supra* note 4, at 30.

³⁵ See Philipp M. Hildebrand, Member, Governing Board, Swiss Nat'l Bank, Opening Address at the 59th Annual Conference of the CFA Institute: The Virtues of

success is due in large part to the fact that most funds and their advisers are exempt from registration and all of the demands and restrictions it encompasses. This Part will explain how hedge funds take advantage of these exemptions, how turmoil has recently unfolded due to the SEC's newfound discomfort with these exemptions, and how the agency's actions have only caused more confusion.

A. *The Exemptions Utilized by Hedge Funds*

There are four statutes that act as the cornerstones of the SEC's regulation and monitoring of the securities markets. These are the Investment Company Act of 1940 ("Company Act"), the Investment Advisers Act of 1940, the Securities Act of 1933 ("1933 Act"), and the Securities Exchange Act of 1934 ("1934 Act").³⁶ Most mainstream investment companies, such as mutual funds, must register under these Acts.³⁷ Registration, in turn, restricts what strategies may be used to obtain positive returns.³⁸ For perspective, consider that popular hedge fund strategies such as using leverage, employing short-selling tactics, investing in derivatives instruments, and concentrating a fund's assets completely in one or few investments are all highly regulated or disallowed completely by the SEC for investment companies required to register.³⁹

Within these Acts, there are key exemptions that the hedge fund industry utilizes in order to avoid registration, enabling them to pursue more freely their goal of absolute returns. The rationale most often offered to explain why certain investment structures, such as hedge funds, should be exempt from registration is that investments in hedge funds are made by "sophisticated" investors.⁴⁰ Sophisticated investors are those individuals or entities that have a certain level of assets, are

Flexible Financial Markets: A Central Banking Perspective (May 22, 2006), http://www.snb.ch/en/mmr/speeches/id/ref_20060522_pmh/source/ref_20060522_pmh.en.pdf.

³⁶ See Edwards, *supra* note 4, at 33.

³⁷ See Investment Company Institute, The Differences Between Mutual Funds and Hedge Funds, http://www.ici.org/funds/abt/faqs_hedge.html (last visited Sept. 17, 2007).

³⁸ See *id.* ("Virtually every aspect of a mutual fund's structure and operation is subject to strict regulation . . .").

³⁹ See MacHarg, *supra* note 1, at 61–65.

⁴⁰ See *id.* at 61.

familiar with the risks of the funds through investing experience, and usually have a previous relationship with the managers of the fund.⁴¹ These investors are viewed as being able to perform their own due diligence in order to decide for themselves if the potential financial rewards are worth the risk.⁴² As each statute and its exemptions are discussed, it is imperative to remember that while the exemptions allow funds to not register, the exemptions never free hedge funds from the multiple anti-fraud provisions written into the Acts, and funds and their managers are always responsible for operating their companies honestly.⁴³

1. The Investment Company Act of 1940

The first relevant statute is the Company Act.⁴⁴ It defines any company that is engaged in investing in other companies' securities as an "investment company," and requires it to register with the SEC.⁴⁵ Registration entails the initial disclosure of much information regarding many aspects of the company, and then further disclosures of information on a regular basis, such as the company's structure, investment strategies, and operations.⁴⁶ It also allows the SEC to perform on-site examinations.⁴⁷ Although hedge funds definitely invest in other companies' securities, they usually rely on two of the exemptions written into the Company Act in order to avoid having to register as an "investment company."⁴⁸

First, under section 3(c)(1), if a company (or fund) has no more than 100 investors and does not attempt to offer investment

⁴¹ *Id.*

⁴² *See, e.g.,* Edwards, *supra* note 4, at 35 (relating that the reason to treat the investors of hedge funds differently is "premised on the philosophy that wealthy (or 'qualified') investors should be free to make their own decisions unhindered by government regulation . . . and in return should have to bear the full consequences of their investment decisions—good or bad").

⁴³ *See, e.g.,* MacHarg, *supra* note 1, at 61–71 (noting the numerous anti-fraud provisions that hedge funds already must comply with that are found in these Acts, the Commodity Exchange Act, the Patriot Act, and various state statutes).

⁴⁴ 15 U.S.C. §§ 80a-1 to 80a-52 (2000).

⁴⁵ *Id.*

⁴⁶ Securities Industry & Financial Markets Association Primer on Securities—Investment Company Act of 1940, http://www.sifma.org/legislative/invstmt_comp_act_of_1940.html [hereinafter Primer] (last visited Sept. 17, 2007).

⁴⁷ Phillip R. Mack, *Recent Trends in the Mutual Fund Industry*, FED. RES. BULL., Nov. 1993, available at http://findarticles.com/p/articles/mi_m4126/is_n11_v79/ai_14714669.

⁴⁸ THE REPORT, *supra* note 1, at 11–12.

opportunities in the fund to the general public, registration with the SEC is not required.⁴⁹ The second exemption used by hedge funds is section 3(c)(7),⁵⁰ which allows companies that have “qualified purchasers”⁵¹ as their only investors, the choice to not register.⁵² Meeting these exemptions, together with the exemptions of the other Acts, allows hedge funds to avoid registration.

2. The Investment Advisers Act of 1940

The Advisers Act was passed in tandem with the Company Act and was meant to be enforced alongside it.⁵³ As the Company Act requires registration of investment companies and demands strict disclosure guidelines of them, the Advisers Act serves the same purpose for the registration of investment advisers.⁵⁴ The Advisers Act 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.”⁵⁵ Although hedge fund managers meet the definition of “investment adviser,”⁵⁶ as with the Company Act, most hedge funds and their managers design their funds to fall within an exemption expressed in section 203(b)(3) of the Advisers Act. This exemption does not require registration if the

⁴⁹ 15 U.S.C. § 80a-3(c)(1) (2000). Subsection (c) deals with “further exemptions” from what will be considered an investment company and lists as the first such exemption: “Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.” *Id.*

⁵⁰ *Id.* § 80a-3(c)(7) (exempting “[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities”); *see also* THE REPORT, *supra* note 1, at 12.

⁵¹ *See* THE REPORT, *supra* note 1, at 12 n.37 (citing section 2(a)(51) of the Investment Company Act of 1940 defining a “qualified purchaser” as, among other things, any person or family-owned business in possession of at least \$5 million in investments).

⁵² *See* 15 U.S.C. § 80a-3(c)(7).

⁵³ *See Primer, supra* note 46.

⁵⁴ *See id.* (listing some of the rules that the Advisers Act includes, such as disclosing “[r]ecord-keeping; [s]ubstantive content of advisory contracts; [a]dvertising; [c]ustody of client funds and assets; and [p]roxy voting”).

⁵⁵ 15 U.S.C. § 80b-2(a)(11) (emphasis added).

⁵⁶ THE REPORT, *supra* note 1, at 20.

adviser has had fewer than fifteen clients in the past twelve months, does not represent himself to the investing public as an investment adviser, and does not advise a registered investment company.⁵⁷

The exemption in the Advisers Act goes on to state that for the sake of meeting the exemption, investors, limited partners, and shareholders in the investment company do not count as clients of an investment advisor.⁵⁸ The reason for this rule is that from the time the Act was originally passed, the word "client" has specifically meant a person or entity receiving *direct* investment advice from an investment advisor.⁵⁹ Therefore, as applied to hedge fund advisers, each of the hedge funds they manage count as one "client" because that is the only entity that is actually receiving *direct* investment advice. The adviser is making decisions for the sole benefit of the fund and not taking into account the interests or concerns of any individual investor or shareholder.⁶⁰ The effect of this is that a hedge fund adviser will not have to register under the Advisers Act unless he manages fifteen or more hedge funds.⁶¹ Along with the Company Act, this exemption greatly benefits the hedge funds and their managers in allowing them to more completely attempt to achieve their funds' financial goals free from unnecessary disclosures, trading restrictions, or time constraints.

⁵⁷ 15 U.S.C. § 80b-3(b)(3). There are other factors that may allow an adviser to succeed in gaining the exemption, but these are not used as often and are beyond the scope of this Note. Notice the interactivity of the Company Act with the Advisers Act—both adviser and his or her fund must be exempt under each Act in order for the hedge fund to avoid registering with the SEC.

⁵⁸ *Id.* This clarification of the term "client" reads in full:

For purposes of determining the number of clients of an investment adviser under this paragraph, *no shareholder, partner, or beneficial owner* of a business development company, as defined in this subchapter, shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner

Id. (emphasis added).

⁵⁹ See *Lowe v. SEC*, 472 U.S. 181, 207–08 (1985).

⁶⁰ See MacHarg, *supra* note 1, at 66:

Under Rule 203(b)(3)-1 promulgated by the SEC, a limited partnership (such as a hedge fund) generally is a single client of any general partner or other person acting as an investment adviser to the partnership. An adviser may count a limited partnership as a single client as long as the adviser provides advice based on the partnership's investment objectives, and not the individual objectives of the limited partners.

⁶¹ See THE REPORT, *supra* note 1, at 21.

3. The Securities Act of 1933

The 1933 Act⁶² requires that any public offering of a security be preceded by a “full and fair disclosure” of what exactly the security is and by whom exactly it is being offered.⁶³ The goal is to protect the average investor and allow him access to important information as he decides whether to invest.⁶⁴ Like with the other Acts, hedge funds can be excused from this Act’s registration requirement if designed to fall within its two exemptions. The first exemption is usually referred to as the “private offering” exemption⁶⁵ and exempts “transactions by an issuer not involving any public offering.”⁶⁶ This means that hedge funds are exempt from any initial filing responsibility as long as the fund is not offered to the broad investing public.⁶⁷ The Supreme Court in *SEC v. Ralston Purina Co.*⁶⁸ explained the reasoning of the exemption, stating that “private offerings” are those made to informed, experienced investors. Investors such as these have demonstrated the ability to make their own investment decisions after performing their own research, and who thus do not need the extra regulatory protections.⁶⁹

The second exemption under this Act requires that the fund meets the criteria set forth in Rule 506 under Regulation D⁷⁰ of the 1933 Act.⁷¹ This provision provides that as long as a fund has not made solicitations to the public regarding the offering and has involved only “accredited investors” or no more than thirty-five “unaccredited investors,” it is considered a “private offering” and no registration is necessary.⁷² The term “accredited investor” means any person or couple with a net worth of at least

⁶² Securities Act of 1933, 15 U.S.C. §§ 77a–aa.

⁶³ THE REPORT, *supra* note 1, at 13.

⁶⁴ See MacHarg, *supra* note 1, at 63.

⁶⁵ THE REPORT, *supra* note 1, at 14.

⁶⁶ 15 U.S.C. § 77d(2).

⁶⁷ See THE REPORT, *supra* note 1, at 14.

⁶⁸ 346 U.S. 119 (1953).

⁶⁹ See *id.* at 125–27; see also THE REPORT, *supra* note 1, at 14.

⁷⁰ See MacHarg, *supra* note 1, at 64 (informing that Regulation D was adopted by the SEC in 1982). It is worth noting that hedge funds were already on the SEC’s radar in 1982, but when the SEC promulgated Regulation D, it made sure to reiterate that limited partners and shareholders of companies were still not considered “clients.” See Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,251 & 11,251 to 11,259 (Mar. 16, 1982).

⁷¹ See THE REPORT, *supra* note 1, at 14.

⁷² 17 C.F.R. § 230.506 (2007); see also MacHarg, *supra* note 1, at 63.

\$1 million, or an income the last two years of at least \$200,000—\$300,000 for couples—with the reasonable expectation that it will continue. It also includes any company, partnership, bank, trust, or pension or employee benefit plan with at least \$5 million in assets.⁷³ This exemption works nicely for hedge funds, as the ideal investor will normally fit this description.

4. The Securities Exchange Act of 1934

Lastly, the 1934 Act⁷⁴ picks up the regulatory baton where the 1933 Act leaves off, focusing on perpetual registration requirements demanded once a security has begun trading on the open market.⁷⁵ The 1934 Act demands that any issuer of a publicly traded security be registered with the SEC.⁷⁶ The purpose of the statute is to regulate the securities markets, make pertinent information accessible to buyers and sellers, protect investors and markets from fraud and manipulation, and offer remedies if fraud does take place.⁷⁷ The 1934 Act provides that only issuers of publicly offered securities having at least 500 investors are required to register with the SEC.⁷⁸ In order to avoid registration, then, hedge funds must only ensure that the number of investors in the fund does not exceed 499.⁷⁹ This exemption, along with the exemptions in the other three Acts, allows hedge funds who so choose to dodge registration requirements, thereby gaining more flexibility in their strategies and expenses.

B. *The Concerns of the SEC and the Solutions It Sought*

1. Framing the Concerns

The SEC's most recent hedge fund study, *Implications of the Growth of Hedge Funds* ("The Report"),⁸⁰ was requested due to the unprecedented growth that the hedge fund sector had experienced. The SEC wanted to understand why the sector was

⁷³ 17 C.F.R. § 230.501; *see also* THE REPORT, *supra* note 1, at 15.

⁷⁴ Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–ll (2000).

⁷⁵ *See* MacHarg, *supra* note 1, at 64.

⁷⁶ *See id.* at 64–65.

⁷⁷ *See id.* (citing L. LOSS, SECURITIES REGULATION 84 (1951)).

⁷⁸ 15 U.S.C. § 781(g) (2000 & Supp. IV 2005); *see also* MacHarg, *supra* note 1, at 64–65 (going over this Act's exemptions in more detail).

⁷⁹ *See* MacHarg, *supra* note 1, at 65.

⁸⁰ *See* THE REPORT, *supra* note 1.

growing as fast as it was and to analyze whether investors were protected enough as this growth continued.⁸¹ The SEC was quite candid about believing they did not have nearly enough information on hedge funds—even on a simple level. The goal of the study was to shed light on, among other things, how hedge funds operate, the risks involved, the ability of funds or managers to defraud investors, and their impact on financial markets.⁸²

The SEC's first concern in its Report was the recent unparalleled growth seen in the hedge fund sector.⁸³ This development made the potential effects of hedge funds on the markets that much more substantial, worrying the SEC considerably.⁸⁴ Tied to this, the SEC was fearful that the growth would lead to a surge in hedge fund fraud perpetrated by the funds and their managers that would severely affect investors.⁸⁵ The Proposed Rule listed several variations used to lure investors,⁸⁶ including how certain hedge funds had overstated their past success, overstated or misstated the returns for current investors—causing them to stay invested when in fact they were being charged substantial undisclosed fees—and misappropriated their investors' assets in other ways.⁸⁷ With new methods of hedge fund fraud still being uncovered,⁸⁸ the SEC implied in its report that more “transparency”⁸⁹ was absolutely required.

⁸¹ See *id.* at 1–2.

⁸² See, e.g., *id.* at 2, 76–79 (listing all of the concerns the SEC voiced in The Report).

⁸³ See, e.g., Proposed Rule, *supra* note 9, at 45,174 to 45,175 (explaining that from 1993 through 2003, hedge funds assets rose “fifteenfold” and the number of funds increased “fivefold”); see also *supra* note 2 and accompanying text.

⁸⁴ See Proposed Rule, *supra* note 9, at 45,174 to 45,176.

⁸⁵ See *id.* at 45,175 to 45,176 (stating how the growth has been correlated with a “troubling” increase in the number of hedge fund fraud “enforcement” cases the SEC had recently brought).

⁸⁶ See *id.*

⁸⁷ See *id.*

⁸⁸ See *id.* (detailing some of the innovative types of fraud, including conspiring with mutual fund managers during the mutual fund market-timing scandals).

⁸⁹ Edwards, *supra* note 4, at 42–43 (presenting several types of “transparency” that have been suggested of hedge funds, including looking through to the fund's holdings on a periodic basis, or having more “transparency” regarding the amount of risk associated with a fund's portfolio).

Another concern highlighted by the SEC regarded the so-called “retailization” of the hedge fund sector.⁹⁰ “Retailization” refers to the recent trend of the “wrong type” of investor gaining the ability to invest in hedge funds through certain channels.⁹¹ Specifically, the SEC was anxious that investors such as pension funds, university endowments, foundations, and “unsophisticated” investors were placing their assets in these funds without a full understanding of the risk to which they would be exposed.⁹² Unsophisticated, or “retail,”⁹³ investors are also investing more in this sector due to the development of registered “funds of hedge funds” (“FOFH”s). These FOFHs can be offered to the investing public because they are registered, even though the underlying hedge funds they invest in may not be registered. This can lead to inexperienced investors committing significant assets to these funds, perhaps without appreciating the true potential for losses.⁹⁴ All of these concerns elucidated by the SEC caused the agency to take action.

2. The Solution Sought by the SEC

The SEC, in response to the Report, presented its solution, entitled “Registration Under the Advisers Act of Certain Hedge Fund Advisers; Proposed Rule” (“Proposed Rule”). The Proposed Rule reflected the SEC’s determination to amend certain aspects of the Advisers Act.⁹⁵ The SEC summarized the goals it had in mind with the rule-change: “The rule and rule amendments are designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission’s ability to protect our nation’s securities markets.”⁹⁶ The SEC’s commissioner majority decided to adopt the Final Rule,⁹⁷

⁹⁰ Proposed Rule, *supra* note 9, at 45,176 to 45,177.

⁹¹ *See id.*

⁹² *See id.* (“Hedge funds are thus today being purchased by entities that are not traditional hedge fund investors.”).

⁹³ *See* Edwards, *supra* note 4, at 36 (explaining that less wealthy investors are referred to as “retail” investors).

⁹⁴ *See, e.g.*, Proposed Rule, *supra* note 9, at 45,176. In addition to these worries, there have been others mentioned as well, including abusive short-selling practices by funds and the sometimes exorbitant fees which are charged. *See, e.g.*, Cox Testimony, *supra* note 30.

⁹⁵ *See generally* Proposed Rule, *supra* note 9.

⁹⁶ Final Rule, *supra* note 16.

⁹⁷ *See id.* pt. II.A–D (proposing what it felt were necessary amendments to the Advisers Act and the reasoning behind the changes).

notwithstanding a dissent by two of the five SEC commissioners, Cynthia A. Glassman and Paul S. Atkins,⁹⁸ and the significant amount of commentary received after the initial Proposed Rule was presented.⁹⁹

The most important amendment implemented was to change the wording of section 203(b)(3) of the Advisers Act.¹⁰⁰ Under its original wording, as long as other necessary criteria were met, if an adviser had less than fifteen clients in the past twelve months, that adviser was excused from registering with the SEC.¹⁰¹ Just as importantly, the same subsection goes on to immediately state that “no shareholder, partner, or beneficial owner of a business development company . . . shall be deemed a client.”¹⁰² Because hedge fund investors fall squarely within this description as to what is a “non-client,” only the fund itself is considered a client and, in turn, only an adviser managing more than fourteen *funds* must still register with the SEC. The amendment was administered to combat this reality.

The SEC determined that section 203(b)(3) would now include a “look-through” component which would require a “private fund,” when counting “clients” in order to meet the exemption, to look through the hedge fund itself and count as clients of the fund the number of owners and investors that are invested in the fund.¹⁰³ An adviser of a domestic fund that had more than fourteen *investors* in the previous twelve months would have to register with the SEC, as long as the fund had at

⁹⁸ See Proposed Rule, *supra* note 9, at 45,197 to 45,200. In brief, Commissioners Glassman and Atkins felt that more alternative solutions should be considered before this rule-making was undertaken, that the majority’s stated concerns for the rule did not hold up under “scrutiny,” and that the new registration requirements would divert the already limited resources of the SEC. See Final Rule, *supra* note 13 (Cynthia A. Glassman & Paul S. Atkins, Commissioners, dissenting).

⁹⁹ See *supra* notes 13–17 and accompanying text (discussing the breakdown of the comments received).

¹⁰⁰ 15 U.S.C. § 80b-3(b)(3) (2000); see Final Rule, *supra* note 13, pt. II.C (relaying how this exemption was originally revisited in 1980 and again in 1985, and was meant to exempt entities, in the opinion of the SEC, that did not include private investment pools such as hedge funds, and why therefore the amendments were necessary and appropriate).

¹⁰¹ See 15 U.S.C. § 80b-3(b)(3).

¹⁰² *Id.*

¹⁰³ See Final Rule, *supra* note 13, pt. II.D (“Rule 203(b)(3)-2”) (discussing how to use the look-through provision).

least \$25 million in assets.¹⁰⁴ This meant many hedge funds would now fall under the auspices of mandatory registration.

In amending section 203(b)(3) of the Advisers Act, the SEC limited the “look-through” provision to ensure that only those entities which would meet the definition of what it called a “private fund”¹⁰⁵ would be compelled to register. The SEC further stated that a “private fund” would be defined as any investment entity that possessed each of three characteristics “shared by virtually all hedge funds, and that differentiate hedge funds from other pooled investment vehicles.”¹⁰⁶ The first characteristic asked whether the fund would have had to register with the SEC as an “investment company” under the Company Act,¹⁰⁷ *but for* the exceptions that the Company Act provides.¹⁰⁸

The second characteristic involved the various “lockup period” provisions normally used by hedge funds.¹⁰⁹ A lockup provision is one of several “liquidity provisions” that a fund may employ, which puts restrictions on how and when an investor can retrieve his assets from the investment vehicle.¹¹⁰ Lockup provisions state that for a certain period of time after *initially* investing in the hedge fund, the investor may not withdraw his monetary investment.¹¹¹ The SEC determined that almost always, these initial “lockup periods,” when dealing with hedge funds, are less than two years in length.¹¹² Therefore, the SEC stated that if an investment pool has a “lockup period” and it is less than two years long, it would meet the second of the three characteristics needed to be defined as a “private fund.”¹¹³

¹⁰⁴ *See id.*

¹⁰⁵ *See id.*

¹⁰⁶ *Id.* pt. II.E (“Definition of ‘Private Fund’”).

¹⁰⁷ *See id.* The Final Rule expressly states that this would not affect most clients that are “business organizations, including insurance companies, broker-dealers, and banks, but [that it would be] required to look through many types of pooled investment vehicles investing in securities, including hedge funds.” *Id.*

¹⁰⁸ For a reminder of the Company Act exceptions, see *supra* notes 44–52 and accompanying text.

¹⁰⁹ Final Rule, *supra* note 13, pt. II.E.2 (“Redemption Within Two Years”).

¹¹⁰ *See* David Harper, *Introduction to Hedge Funds—Part One*, INVESTOPEDIA.COM, Nov. 26, 2003, <http://www.investopedia.com/articles/03/112603.asp> (“Liquidity provisions vary, but invested funds may be difficult to withdraw ‘at-will.’”).

¹¹¹ *See id.*

¹¹² *See* Final Rule, *supra* note 13, pt. II.E.2 (“Redemption Within Two Years”).

¹¹³ *See id.* Ironically, singling out this characteristic backfired. When the Final Rule went into effect, many hedge funds just increased their initial “lockup periods”

The last characteristic necessary to make an investment pool a “private fund” regards the actual skills of the adviser of the fund and what he holds himself out to be.¹¹⁴ This means that the fund will only be recognized as having this characteristic if the fund attempts to gain and invest assets by informing potential investors of the adviser’s skills, ability, or expertise.¹¹⁵ Thus, between the amendment to section 203(b)(3) and the announcement of what the term “private fund” would refer to, the SEC had effectively constructed a law that would specifically require managers of hedge funds—but not the managers of many other investment pools—to register with the SEC.¹¹⁶

C. How the “Solution” Has Led to Uncertainty

1. Mr. Goldstein Goes to Washington

Even with all of the commotion surrounding the Final Rule,¹¹⁷ no manager or fund was willing to challenge the authority of the SEC¹¹⁸ or the constitutionality of changing the definition of “client”—a term that had been clearly and universally understood for more than half a century to mean one who receives *direct* investment advice. No one was willing, that is, except for one—Phillip Goldstein.¹¹⁹

Phillip Goldstein has managed his own “value-driven” hedge fund since 1993.¹²⁰ He is also a “widely-quoted expert on value investing and corporate governance.”¹²¹ He was determined to challenge what he believed was a rule based on “myths” the SEC used to support its position.¹²² After a lengthy trial and to the

to two years or longer, thereby allowing their funds to remain exempt from registration. Weiner, *supra* note 32.

¹¹⁴ See Final Rule, *supra* note 13, pt. II.E.3 (“Advisory Skills, Ability, or Expertise”).

¹¹⁵ See *id.*

¹¹⁶ There were also additional amendments made to various sections of the Advisers Act related to this principle of hedge fund manager registration, which are beyond the scope of this Note. See Final Rule, *supra* note 13, pt. II.F–K.

¹¹⁷ See, e.g., *supra* notes 12–15 and accompanying text (relating the number of comment letters received by the SEC, including eighty-three letters in opposition).

¹¹⁸ See Goldstein Interview, *supra* note 21.

¹¹⁹ *Id.*

¹²⁰ Bulldog Investors, <http://www.bulldoginvestors.com> (last visited Sept. 16, 2007).

¹²¹ *Id.*

¹²² See Phillip Goldstein, Remarks at the Hedge Funds Best Practices 2005 Conference: Why We Are Suing the SEC (Feb. 28, 2005) (on file with author).

astonishment of many,¹²³ Mr. Goldstein was handed a favorable, unanimous decision: the rule would be vacated on the grounds that it was completely “arbitrary.”¹²⁴

Although there are many reasons why the Final Rule should not have been passed,¹²⁵ Mr. Goldstein focused his lawsuit on a purely legal argument—that the Commission was incorrect in its interpretation of section 203(b)(3) of the Advisers Act.¹²⁶ In his opinion, Judge Randolph pointed out that this was precisely one of the issues that the two dissenting commissioners of the SEC originally mentioned when the amendment was proposed.¹²⁷ That dissent had fallen on deaf ears, with the SEC believing that because the Advisers Act did not specifically define the word “client,” its meaning was ambiguous.¹²⁸ This ambiguity gave the SEC, as a federal regulatory agency, the authority to interpret the word as it felt appropriate.¹²⁹ The Court, however, was quick to point out that “[t]he lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous.”¹³⁰ Further, it should be remembered that “‘words of the statute should be read in context, the statute’s place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account’ to determine whether Congress has foreclosed the agency’s interpretation.”¹³¹

The court then applied this rule of law to the word and surrounding statute at issue.¹³² This enabled the court to see if the SEC’s definition of the word “client” was reasonable.¹³³ In so

¹²³ See, e.g., Becky Yerak, *Hedge Funds Win in Court: Appeals Panel Strikes Down SEC Rule Try*, CHI. TRIB., June 24, 2006, at B1 (quoting Michael Gray, an attorney at Schwartz Cooper who advises hedge funds, as saying, “I’m blown away by the court’s decision”).

¹²⁴ See *Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006).

¹²⁵ See *infra* Part II for a discussion of those reasons.

¹²⁶ *Goldstein*, 451 F.3d at 878.

¹²⁷ *Id.*; see also Proposed Rule, *supra* note 9, at 45,199 n.35 (Cynthia A. Glassman & Paul S. Atkins, Commissioners, dissenting) (disagreeing with the Commissioner majority, explaining that section 203(b)(3) of the Advisers Act is not in conflict with the rest of the Advisers Act and that “client” has been understood to mean receiving direct advice).

¹²⁸ See *Goldstein*, 451 F.3d at 878.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.* (quoting *PDK Labs. Inc. v. DEA*, 362 F.3d 786, 796 (D.C. Cir. 2004)).

¹³² *Id.* at 878–84.

¹³³ See *id.* at 880–84.

doing, the court made several notable points. First, the court discussed how in 1980, Congress amended section 203(b)(3) of the Advisers Act to include language that made clear that no partner, shareholder, or beneficial owner of a business development company should be considered a client for the purposes of the Act.¹³⁴ Further, the court pointed to how the SEC added a “safe harbor” provision to the Advisers Act.¹³⁵ This “safe harbor” allowed advisers to count certain limited partnerships as single clients without looking through to the investors.¹³⁶ The motivation was to “provide ‘greater certainty’ about the meaning of the term [client].”¹³⁷ Perhaps most importantly, the *Goldstein* decision reminded that in proposing the safe harbor provision, the SEC wrote that “when ‘an adviser to an investment pool manages the assets of the pool [as if the assets belonged to one group, and not to individual investors], . . . it appears appropriate to view the pool—rather than each participant—as a client of the adviser.’”¹³⁸ It is clear then, that even the SEC has agreed that investors in a hedge fund should not be considered clients of the adviser when the adviser is managing the assets solely in order to achieve the goals of the fund itself.

This was a concept, Judge Randolph pointed out, which had been discussed and confirmed in *Lowe v. SEC*.¹³⁹ There, the Supreme Court determined that although the petitioners were not registered with the SEC under the Advisers Act, they must still be permitted to write and publish investment newsletters.¹⁴⁰ The argument turned on the nature of the petitioners’ relationship with the readers of the newsletter, and if a relationship was found to exist, whether it was an “advisory

¹³⁴ *See id.* at 878.

¹³⁵ *See id.* at 879 n.5.

¹³⁶ *Id.* (citing Definition of “Client” of Investment Adviser for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Release No. 956, 50 Fed. Reg. 8740, 8740–41 (proposed Mar. 5, 1985)).

¹³⁷ *Id.*

¹³⁸ *Id.* at 880.

¹³⁹ 472 U.S. 181 (1985). Poignantly, this is a case that Mr. Goldstein had sent directly to the SEC in a comment letter in an attempt to convince it to not pass the adviser registration amendment. Letter from Phillip Goldstein, President, Opportunity Partners L.P.; and Gen. Partner, Kimball & Winthrop, Inc., to Jonathan G. Katz, Sec’y, SEC (Sept. 25, 2004), available at <http://www.sec.gov/rules/proposed/s73004/pgoldstein092504.pdf>.

¹⁴⁰ *See Lowe*, 472 U.S. at 203–11.

relationship.”¹⁴¹ Which type of relationship exists “depend[s] largely on the character of the advice rendered.”¹⁴² In practice, “[p]ersons engaged in the investment advisory profession ‘provide personalized advice attuned to a client’s concerns.’”¹⁴³ The advice has to be given to a specific client in order to achieve their unique financial goals for the relationship to be considered an “advisory relationship.” The Supreme Court in *Lowe* recognized that because the advice was not structured to satisfy the needs of any one reader, the petitioners’ activities did not fall within the coverage of the Advisers Act.¹⁴⁴ The *Goldstein* decision shared the same sentiment regarding the relationship that hedge fund advisers have with the investors of the fund, and how the relationship is not a “direct” one: “This type of direct relationship exists between the adviser and the fund [itself], but not between the adviser and the investors in the fund.”¹⁴⁵

As one final declaration, Judge Randolph also made clear that the SEC’s interpretation of the term “client” fell “outside the bounds of reasonableness.”¹⁴⁶ The “reasonableness” of a particular interpretation is dependent on how it “fit[s]” with the language of the statute, if the rest of the statute is still coherent and if it parallels the purpose of the statute in question.¹⁴⁷ The SEC’s fought-for interpretation, according to the court, “comes close to violating the plain language of the statute. At best it is counterintuitive to characterize the investors in a hedge fund as the ‘clients’ of the adviser.”¹⁴⁸ It is “counterintuitive,” the court explained, because if an investor is a “client” of the fund, the investor is owed certain fiduciary duties that are owed to all clients.¹⁴⁹ These fiduciary duties may, in certain cases, come into conflict with fiduciary duties that the adviser has to another of his clients—the fund itself.¹⁵⁰ The potential “conflicts of

¹⁴¹ *See id.* at 207–208, 210.

¹⁴² *Goldstein*, 451 F.3d at 880 (discussing what the Court in *Lowe* had held).

¹⁴³ *Id.* (quoting *Lowe*, 472 U.S. at 208).

¹⁴⁴ *See Lowe*, 472 U.S. at 210–11 (“We therefore conclude that petitioners’ publications fall within the statutory exclusion . . . and that none of the petitioners is an ‘investment adviser’ as defined in the Act.”).

¹⁴⁵ *Goldstein*, 451 F.3d at 880.

¹⁴⁶ *Id.* at 880–81.

¹⁴⁷ *See id.* at 881 (citing *Abbott Labs. v. Young*, 920 F.2d 984, 988 (D.C. Cir. 1990)).

¹⁴⁸ *Id.* (citing *Am. Bar Ass’n v. FTC*, 430 F.3d 457, 471 (D.C. Cir. 2005)).

¹⁴⁹ *See id.* at 881–82.

¹⁵⁰ *See id.* at 880 (giving as an example of a potential conflict of interest a hedge

interest” that would arise if this investors-as-clients scenario was correct illuminates why the SEC’s interpretation of the word “client” was “unreasonable.”¹⁵¹ As one commentator put it, “the [Final Rule] carved out an exception from the exceptions [of the Advisers Act and t]he court found that the SEC did not justify this exception.”¹⁵²

2. The Hearings, the Testimony, the Uncertainty

Phillip Goldstein’s victory was not a total surprise to him,¹⁵³ but it caught many people completely off-guard¹⁵⁴ and added to what was already a controversial topic.¹⁵⁵ The summer which followed was filled with voices from both sides, some stating that more steps need to be taken to reign in hedge funds,¹⁵⁶ and others lauding the decision as a step in the right direction—mainly, to not require hedge funds to register.¹⁵⁷ The debate centered, and continues to center, on what is the best course of action: Should the government focus on better enforcement of the numerous anti-fraud laws that already apply to hedge funds and their managers, or should Congress enact new laws to alleviate the SEC’s fears and allow it to accomplish its stated mission more freely?¹⁵⁸

fund about to go bankrupt, and how the correct advice to give to the fund itself—i.e., the adviser’s client—would be to take all possible action to “remain solvent,” but how the correct advice that the adviser should give to the investors of the fund—i.e., the individuals that the SEC would like to refer to as the adviser’s “clients”—would be to sell their share of the fund immediately, which conflicts with a fund’s goal of “remaining solvent”).

¹⁵¹ See *id.* at 881–84.

¹⁵² See Mark J. Astarita, *Court Strikes New Hedge Fund Rule*, SEC LAW.COM, June 24, 2006, <http://www.seclaw.com/docs/HedgeFundRuleStricken062406.htm> [hereinafter Astarita, *Court Strikes Rule*].

¹⁵³ See, e.g., E-mail from Phillip Goldstein, Principal, Bulldog Investors, to author (Nov. 2, 2006, 19:25 EST) (on file with author) (“Basically, the only way we could have lost [was] if the court ignored the merits and deferred completely to the SEC.”).

¹⁵⁴ See, e.g., Yerak, *supra* note 123; see also *supra* text accompanying note 123.

¹⁵⁵ Astarita, *Court Strikes Rule*, *supra* note 152.

¹⁵⁶ See, e.g., Jacob H. Zamansky, *Two Rights Equal One Wrong*, FORBES.COM, June 28, 2006, http://www.forbes.com/columnists/2006/06/28/hedge-fund-hearings-commentary-cx_jz_0628zamansky.html (writing that although the *Goldstein* decision was legally correct, it highlights the fact that more regulation is needed).

¹⁵⁷ See, e.g., Weiner, *supra* note 32 (announcing that the *Goldstein* decision was correct, necessary, and beneficial).

¹⁵⁸ Liz Moyer, *Senate Weighs Regulations*, *supra* note 29.

Of those disappointed with the ruling, some of the most vocal voices came from the Senate, where hearings were held on the issue of hedge fund regulation in the days following the decision.¹⁵⁹ For instance, Senator Orrin Hatch (R-Utah) felt that the legislature has to recreate securities law to make it more applicable to hedge funds and stricter regarding the activities of hedge funds.¹⁶⁰ Perhaps as a symbol of the utter uncertainty surrounding current hedge fund regulation, the Legislature could not even finalize who had jurisdiction over hedge funds.¹⁶¹

Among the other voices, that of the SEC was the loudest. Immediately following the decision, the SEC stated that it would reconsider its approach to hedge fund regulation and activity, more seriously weigh alternatives to what it proposed, and consider whether to appeal the decision.¹⁶² Christopher Cox, chairman of the SEC, then testified in front of the Senate Banking Committee. Interestingly, he made sure to state at the outset that what he was about to say was only his own opinion and did not necessarily reflect the sentiments of his fellow commissioners.¹⁶³ This seemingly insignificant statement underscores the complete unsettledness of current hedge fund regulation and how no one really knows what the conclusion will be. After giving that caveat, Chairman Cox stressed that the SEC still retained the same concerns regarding hedge funds¹⁶⁴ that had initially moved it to propose and promulgate the Final Rule. He also made recommendations that the financial criteria an investor must meet before being eligible to invest in hedge

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* (describing hedge funds, in a negative light, as the "Wild West of [the] financial markets," and arguing why they need more regulation).

¹⁶¹ Liz Moyer, *Hedge Hogs*, FORBES.COM, June 28, 2006, http://www.forbes.com/business/2006/06/28/hedgefund-senate-regulations-cx_lm_0628hedge.html ("Already a turf war is brewing. The Judiciary Committee is clashing with colleagues on the U.S. Senate Banking Committee, who claim that hedge funds . . . are their exclusive jurisdiction.").

¹⁶² See Timothy Spangler, *Comment: US Court Decision on Hedge Fund Manager Supervision*, HEDGEWEEK.COM, June 30, 2006, http://www.hedgeweek.com/articles/print_page.jsp?content_id=27223 (registration required) (explaining the rationale behind the court's decision and what the SEC planned to do next); see also Yerak, *supra* note 123 (quoting Chairman Cox, who said that the decision "requires that going forward we re-evaluate the agency's approach to hedge fund activity").

¹⁶³ Cox Testimony, *supra* note 30 ("I should emphasize at the outset . . . that my testimony today reflects my views . . . and does not represent the position of the five-member Commission. The views I am expressing this morning are solely my own.").

¹⁶⁴ *Id.*; see also *supra* Part I.B.1 (explaining the fears and concerns of the SEC).

funds be raised in order to prevent “unsophisticated” investors from having access to hedge funds.¹⁶⁵ In addition, he reminded Congress that it could pass legislation if it saw fit, and explained how the SEC would lean more on related agencies and associations in understanding and monitoring hedge funds.¹⁶⁶ In sum, the Chairman’s testimony made clear that, according to him, the correct balance to strike regarding hedge fund regulation has not yet been realized, and if it had, the Commission had not yet given it enough analysis.

All of these dire opinions were contrasted by many applauding the decision and expressing why it was positive for everyone involved. Some reiterated that two of the five commissioners had dissented from the Final Rule from the beginning.¹⁶⁷ Many also announced the decision as necessary because the Final Rule did not actually serve to protect investors and they felt that the Final Rule “met a well-deserved fate” with the *Goldstein* decision.¹⁶⁸

As the debate continued in the months following the ruling, Chairman Cox announced that his agency would not pursue appealing the *Goldstein* decision.¹⁶⁹ Because the ruling was “based on several grounds and was unanimous,” Chairman Cox explained that “further appeal would be futile.”¹⁷⁰ This was yet another twist in the current saga that is hedge fund regulation. Ultimately, the questions regarding hedge fund registration and regulation remained and a new, broad question was presented: Was the SEC’s failure to further regulate hedge funds through the use of the Final Rule a positive or negative development for the industry and its investors? Part II of this Note proposes that it was a completely positive development for all parties involved for several reasons, and explains how any other outcome would have only produced more problems.

¹⁶⁵ See Cox Testimony, *supra* note 30 (proposing that the definition of an “accredited investor” be changed to demanding a net worth of \$1.5 million for an individual to be eligible, up from the current, lower threshold, which only requires a net worth of \$1 million to be eligible).

¹⁶⁶ *Id.*

¹⁶⁷ See, e.g., Mark J. Astarita, *Registration of Hedge Fund Managers: Bureaucracy Without Benefit*, SEC LAW.COM, <http://www.seclaw.com/docs/NewHedgeFundAdvisorRule.htm> [hereinafter Astarita, *Registration of Managers*].

¹⁶⁸ See, e.g., Weiner, *supra* note 32.

¹⁶⁹ *S.E.C. Decides It Won't Appeal on Hedge Funds*, N.Y. TIMES, Aug. 8, 2006, at C9.

¹⁷⁰ *Id.*

II. WHY THE SEC'S FAILURE WAS IMPERATIVE TO PROTECT THE BEST INTERESTS OF THE INVESTORS, THE ADVISERS, AND THE SEC ITSELF

The *Goldstein* court's striking down of the Final Rule was a positive and necessary event because it will benefit all investors, hedge fund advisers, the funds themselves, and even the SEC. The court explained the ruling on concrete legal grounds and seemed to reprimand the SEC for their chosen course of action. This Part of the Note will go beyond the court's discussion. It will examine the shortcomings of the rule from many different angles, which will illuminate how the rejection of the rule is safer and more productive for investors and advisers alike. Finally, this Part will demonstrate how the failure of the SEC to further regulate hedge funds efficiently or lawfully highlights some serious flaws in the methodology, rule construction, and general practices used by the agency. This recognition of the SEC's shortcomings may spur positive action to correct the inefficiencies.

A. *The SEC's Reasons for the Final Rule Were Not Reasonable*

The SEC's reasons for the Final Rule appear to be nothing more than pretext,¹⁷¹ which is the first reason that it was positive and necessary for the amendments to be vacated—it would not have made sense to allow it to live on, with investors still not truly protected. The first reason that the SEC gave for the registration demands was that it did not have basic data on hedge funds and did not know how they worked or to what extent they utilized particular strategies.¹⁷² The reality though, is that the SEC has access to the statistics of approximately 1,250 hedge funds.¹⁷³ If the SEC yearns to understand hedge funds, that is quite a significant sample into which it may delve.¹⁷⁴

¹⁷¹ See Final Rule, *supra* note 13 (Cynthia A. Glassman & Paul S. Atkins, Commissioners, dissenting) ("The pretext for the rule does not withstand scrutiny."); see also Astarita, *Registration of Managers*, *supra* note 167 ("[T]he justifications [for the new requirements] do not support the concept of registration.").

¹⁷² See *supra* notes 80–82 and accompanying text.

¹⁷³ See Cox Testimony, *supra* note 30 (referencing how many funds were already registered with the SEC before the Final Rule was passed). Over 1,250 funds were registered. *Id.*

¹⁷⁴ See Comment Letter from Phillip Goldstein, President, Opportunity Partners L.P., and Gen. Partner, Kimball & Winthrop, Inc., Regarding Investment Advisers Act Release No. 2266 (Sept. 10, 2004), <http://www.sec.gov/rules/proposed/s73004/>

The SEC also stated that the Final Rule was necessary to curb the growing number of fraud cases involving hedge funds and their advisers.¹⁷⁵ The SEC pointed to absolute numbers of cases,¹⁷⁶ rather than an increase in the *ratio* of cases of hedge fund fraud, to prove its point. Even the SEC admitted that there was *no* increase in the *ratio* of fraud cases involving hedge funds even as the sector exploded.¹⁷⁷ It is a normal reality that as something grows, and there is more of it, there will always be more instances of that “thing” not performing as intended or not living up to its user’s expectations. The key is that as long as *the ratio* of unexpected performances does not increase, it is irrelevant that the technical number of instances does increase—it is to be expected.

Related to this was the SEC’s belief that the Final Rule was necessary to give investors added protection due to an alleged dearth of hedge fund-applicable regulation.¹⁷⁸ This is curious, as there is already much federal regulation in place that applies to hedge fund managers. As the commissioner majority stated, even though exempt advisers do not have to file paperwork with the SEC, the advisers “must nonetheless comply with the [Advisers] Act’s antifraud provisions.”¹⁷⁹ In the Advisers Act, section 206 outlaws various types of fraud—that targeting clients and that which is characterized as any practice that is “fraudulent, deceptive, or manipulative.”¹⁸⁰ Further, the funds are subject to the anti-fraud provisions of the 1934 Act.¹⁸¹

There are yet other anti-fraud laws that always apply to hedge funds and their managers. In the 1933 Act, hedge funds are completely covered under section 17(q)(a), which involves protecting against funds selling any securities through

pgoldstein091004.pdf (pointing out that the SEC should begin its data-gathering process with those funds that are already registered).

¹⁷⁵ See *supra* notes 85–89 and accompanying text (explaining the SEC’s fear of fraud and the various forms that it may take).

¹⁷⁶ See Proposed Rule, *supra* note 9, at 45,197 to 45,198 (pointing to the number of cases as forty-six).

¹⁷⁷ See, e.g., THE REPORT, *supra* note 1, at 73 (“There is no evidence indicating that hedge funds or their advisers engage disproportionately [as compared to other investment sectors] in fraudulent activity.”).

¹⁷⁸ See *supra* Part I.B.2.

¹⁷⁹ See Proposed Rule, *supra* note 9, at 45,173.

¹⁸⁰ 15 U.S.C. § 80b-6(1) to (4) (2000).

¹⁸¹ See Proposed Rule, *supra* note 9, at 45,173 n.12 (citing 17 C.F.R. § 240.10b-5 (2007)).

misleading or fraudulent information.¹⁸² Also, there is the USA Patriot Act, related to money laundering statutes, which demands registration of a hedge fund if it meets basic requirements, such as having an initial “lockup period” of less than two years and over \$1 million in assets “at the end of the most recent calendar quarter.”¹⁸³ Therefore, there is a sincere question as to what this new regulation would have added in addition to what is already in place. Essentially, it demonstrates an unfortunate lack of focus by the SEC.

The last main concern that the SEC expressed, the “retailization” of hedge funds, involved a fear that as the hedge fund industry grows in popularity, more “unsophisticated” investors will continue gaining access to these aggressive investments, without even being aware of it in some cases, such as where a pension fund invests on behalf of its participants.¹⁸⁴ This concern, though, is also overblown. Pension fund investing in hedge funds actually totaled just one percent of all pension fund assets at the time of the Proposed Rule.¹⁸⁵ Moreover, pension funds may not need this extra guidance from the SEC, as these funds are managed by professional money managers who are fiduciaries to the funds in addition to falling under the supervision of the Department of Labor.¹⁸⁶ This all demonstrates that the SEC’s defense of the rule was based on pretextual grounds. Therefore, because there was no justifiable reason for the particular amendments imposed, it is positive for all involved that the amendments were vacated.

B. The Final Rule Was Born of Faulty Construction

Even if the Final Rule had been upheld by the Court, the Final Rule would not have produced the SEC’s intended results because it was constructed in such a way that would have prevented it from serving its stated purpose of requiring

¹⁸² 15 U.S.C. § 77q(a) (2000).

¹⁸³ See MacHarg, *supra* note 1, at 69. Investors are protected in even more ways as well. For instance, states generally have their own anti-fraud provisions. See Joseph C. Long, *A Hedge Fund Primer*, Order No. 6855, 1503 PLI/Corp. 233, 248 (2005). Separately, any hedge fund investing in commodities must register with the CFTC under the Commodities Exchange Act and currently, many hedge funds are registered with the CFTC for this reason. See THE REPORT, *supra* note 1, at 23.

¹⁸⁴ See *supra* notes 90–94 and accompanying text.

¹⁸⁵ See Proposed Rule, *supra* note 9, at 45,198.

¹⁸⁶ *Id.*

registration and protecting investors. Recall that under the Final Rule, any investment pool which possessed three key characteristics would be considered a “private fund” and would then be compelled to register with the SEC. Recall also that the SEC designed it so that only hedge funds, for the most part, would meet all three characteristics. In essence, the “private fund designation” rule created a de facto registration requirement for hedge funds to allow the SEC to monitor them more fully.¹⁸⁷ Shockingly, though, due to its poor design, the SEC left a gaping loophole in the Final Rule that would have potentially allowed most—if not all—hedge funds to remain exempt from registration.

The second of the three characteristics needed to be a “private fund” is that the fund must have an initial “lockup period,” relating to new assets invested, of less than two years.¹⁸⁸ What the SEC did not plan for was that many hedge funds would simply lengthen their initial “lockup periods” to two years in order to remain exempt.¹⁸⁹ This would allow hedge funds to remain exempt even under the Final Rule because the funds would not meet the second prong of the “private fund” criteria and therefore would not have to register. This was a wide chasm of a loophole, an enormous oversight, since it would have prevented the Final Rule from serving its stated purpose of requiring hedge funds to register with the SEC in order to help the SEC learn about and monitor the industry.¹⁹⁰ In fact, before the Final Rule went into effect, many hedge funds had already extended their “lockup periods” to meet the exemption, or informed their investors that they intended to do so.¹⁹¹ The

¹⁸⁷ See *supra* notes 105–06 and accompanying text.

¹⁸⁸ See *supra* notes 109–13 and accompanying text.

¹⁸⁹ See Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule—Some Big Firms Change Lockups, Stop Accepting New Investments to Take Advantage of Loopholes*, WALL ST. J., Nov. 10, 2005, at C1.

¹⁹⁰ See *id.* (“These [hedge funds] have adopted measures to take advantage of a loophole provided by the [SEC]—potentially undercutting the SEC’s efforts to uncover fraud and get a better understanding of the growing business.”).

¹⁹¹ See *id.* (stating that many funds, including some of the largest, took steps to lengthen their “lockup periods” in reaction to the SEC’s demands); see also Weiner, *supra* note 32 (writing that many funds had already lengthened their “lockup periods” to two years and “[m]any investors, knowing full well that agreeing to such a lockup would result in their funds *not* being subject to SEC registration, nevertheless agreed”). For instance, Kingdon, a twenty-two-year-old hedge fund with over \$4.5 billion under management, decided that it would not register by the deadline because the fund would instead take advantage of this hole left unplugged

ruling was therefore both positive and necessary. Since the Final Rule was written so poorly, it would not have achieved the goals intended and may have actually led to less investor autonomy due to the longer "lockup periods."

Other rule construction issues similarly would have prevented the rule from impeding the very fraud that it set out to stifle. The SEC attempted to demonstrate the need for the Final Rule by stating what fraud had occurred in specific cases.¹⁹² What the majority failed to mention is that "[r]egistration [that the Final Rule would have demanded] would not have prevented the violations in the enforcement cases cited by [them]."¹⁹³ This came on the heels of the dissenting commissioners' comments in the Proposed Rule, where they stated:

The 46 cases [of fraud] suggest that the typical "hedge fund" fraud is perpetrated by an adviser that is *too small to be registered with the Commission, was registered already with the Commission, or evaded registration requirements*. Mandatory hedge fund adviser registration would not add to the Commission's ability to combat these types of fraud.¹⁹⁴

The fact that several of the enforcement cases were brought against hedge funds that were already registered reinforces the point that the Final Rule, as written, was without worth because it would have failed to do what the SEC intended. Therefore, the rejection of the Final Rule was beneficial because it will enable the SEC to learn from its rule-construction mistakes in order to fashion rules in the future that are truly useful in protecting investors, instead of creating rules that give a false sense of security.

C. *The SEC's Shortcomings in Enforcing Regulations*

Even if the new registration requirements had actually added vital enforcement mechanisms which could not be easily manipulated, unfortunately, it would not have allowed the SEC to prevent more fraud. The SEC is ill-equipped to take on the additional task of intense monitoring of hedge funds due to its

in the Final Rule. See Zuckerman & McDonald, *supra* note 189.

¹⁹² Proposed Rule, *supra* note 9, at 45,175.

¹⁹³ Final Rule, *supra* note 13 (Cynthia A. Glassman & Paul S. Atkins, Commissioners, dissenting) ("Registration Would Not Have Prevented the Violations in the Enforcement Cases Cited by the Majority").

¹⁹⁴ Proposed Rule, *supra* note 9, at 45,197 to 45,198 (emphasis added).

currently diminutive level of funding.¹⁹⁵ At the time of the Final Rule, the SEC did not have the resources to monitor newly registered hedge fund advisers; it did not even have the resources to monitor the hedge funds that had registered voluntarily before the SEC instituted its requirement.¹⁹⁶ The dissenting commissioners queried whether the SEC, with such limited resources, should have been spending what resources it had on hedge funds, which are utilized by less than one million “sophisticated” investors and institutions, instead of focusing the resources on “other, more traditional, areas”—i.e., mutual funds and equities—which are utilized and depended on by over ninety million investors.¹⁹⁷ The query, of course, was rhetorical—the SEC should be focusing not on hedge funds, but on those sectors that dominate the focus of the vast majority of investors. The Court’s rejection of the Final Rule will potentially allow the SEC to refocus its spotlight on these more popular investment sectors.

Two case studies further demonstrate the SEC’s lack of enforcement or monitoring prowess.¹⁹⁸ The first case, involving WorldCom, Inc., caused financial devastation to millions of investors, with shareholder losses approximated to be as high as \$200 billion.¹⁹⁹ WorldCom’s stock was publicly traded on a major exchange, which required it to be registered under all applicable securities statutes. The SEC, though, could not prevent the fraud. A similar inability to protect investors was seen in the recent mutual fund late-trading scandals. Even though every

¹⁹⁵ See Yerak, *supra* note 123 (“It was clear that the SEC lacked the manpower to do much in the way of enforcement” (quoting Stuart Feffer, Managing Director of the Investment Management Practice, BearingPoint, Inc.)). Dissenting Commissioners Glassman and Atkins expressed this sentiment bluntly: “[T]he Commission lacks the resources necessary to conduct frequent, comprehensive hedge fund adviser examinations, and our lack of resources is a matter of public record.” Final Rule, *supra* note 13.

¹⁹⁶ Final Rule, *supra* note 13 (Cynthia A. Glassman & Paul S. Atkins, Commissioners, dissenting) (“[New registration requirements] seem[] unwise so soon after we made the case that we did not have enough staff to oversee the existing pool of registered advisers and funds.”).

¹⁹⁷ See Proposed Rule, *supra* note 9, at 45,199.

¹⁹⁸ See, e.g., Christopher Byron, *Bring in the FBI—The SEC Isn’t Fit to Be the Beat Cop of Wall Street*, N.Y. POST, Sept. 5, 2006, at 37 (“[T]he SEC’s stature as an arm of federal law enforcement [is not] enhanced by its at times almost comical image on Wall Street as a lethargic bureaucracy filled with numskulls who can’t get out of their own way.”).

¹⁹⁹ Barnaby J. Feder, *WorldCom Agrees to Pay \$750 Million in S.E.C. Suit*, N.Y. TIMES, July 8, 2003, at C6.

mutual fund and its managers were registered with the SEC,²⁰⁰ the SEC did not discover *any* of the illicit activity due to parties being registered or due to any monitoring on the part of the SEC.²⁰¹ The fraud was only discovered when whistleblowers came forward to state commissioners.²⁰²

The result has been the same specifically regarding the defrauding of hedge fund investors. Kirk Wright, who was a principal owner of International Management Associates (“IMA”) and International Management Associates Advisory Group (“IMAAG”), which each operated a series of hedge funds, was charged with defrauding his investors of between \$150 and \$180 million.²⁰³ Wright’s funds were registered with the SEC and with several states when the fraud took place.²⁰⁴ The SEC, though, never detected that anything was amiss until it was too late.

Potential fraudsters are just not worried enough about the SEC because of its inability to detect fraud in most cases. Perhaps that is because “the commission’s lack of power gives it a bark that only seems to scare those who obey the law already.”²⁰⁵ Therefore, the *Goldstein* decision was positive because it shines a light on the deficiencies of current SEC enforcement policies and illustrates how the SEC must amend its own agency before it amends the laws related to hedge fund regulation.

²⁰⁰ See Proposed Rule, *supra* note 9, at 45,198.

²⁰¹ See Astarita, *Registration of Managers*, *supra* note 167 (describing the SEC’s explanation that new registration is necessary due to the mutual fund scandals as a “joke” because registration had nothing to do with any of the activity being uncovered).

²⁰² See *id.*

²⁰³ See Press Release, Dep’t of Justice, Investment Manager Charged in Collapse of \$180 Million Hedge Funds (Mar. 29, 2006), <http://www.usdoj.gov/usao/gan/press/2006/03-29-06c.pdf>.

²⁰⁴ See Complaint for Injunctive Relief at 5–6, *SEC v. Wright*, No. 1 06–CV–0438 (N.D. Ga. Feb. 27, 2006), available at www.sec.gov/litigation/complaints/compl9581.pdf (noting the number of states in which Wright’s funds, of which he was the owner and manager, had been registered); see also Goldstein Interview, *supra* note 21 (noting that Wright was registered with the SEC and that it did not help prevent the fraud, and noting that it will not help the investors get back any of their lost money in the future).

²⁰⁵ Byron, *supra* note 198.

D. Public Policy Reasons

1. The Fear of Overregulation

There is always a fear of overregulation; that is, regulation that is not necessary or goes too far. Indeed, this has been one of the main criticisms of the Final Rule from the beginning.²⁰⁶ Overregulation, and all of the varied costs it entails, can act as an impetus for investment companies to move their operations outside of the U.S., or to decide not to do business here in the first place.²⁰⁷ This presents a real public policy concern because of the economic benefits achieved by the U.S. broad markets due to this activity, and because of the tax revenue the national government would lose due to funds leaving.²⁰⁸ In fact, former Federal Reserve Chairman Alan Greenspan pointed out that if hedge funds feel stifled by the regulatory environment in the U.S., they may simply move their funds off-shore in order to more easily obtain the performance returns their clients desire.²⁰⁹

This fear of overregulation is of particular concern while discussing the SEC. The SEC has a history of overstepping its authority and the bounds of necessity in promulgating rules.²¹⁰ The Final Rule was one example, as the *Goldstein* court confirmed. Another example was the “mutual fund governance proposal” that the SEC presented in response to the mutual fund market-timing scandals.²¹¹ Most recently, the Commission was

²⁰⁶ See Proposed Rule, *supra* note 9, at 45,199 to 45,200 (reiterating that the Hedge Fund Registration rule may not have been needed, and that the Commission should have looked at alternative solutions and the voluminous information it had access to before taking any drastic measures); see also Weiner, *supra* note 32 (describing the SEC’s registration demands as “unnecessary”).

²⁰⁷ See John Churchill, *NYSE Chief John Thain Attacks “Excessive” Regulation*, REGISTEREDREP.COM, June 20, 2006, <http://www.registeredrep.com/news/NYSE-regulation-conference/index.html> (noting that twenty-three of the twenty-five largest initial public offerings of equities in 2005 took place outside the U.S., and that the capital raised for the offerings also came from outside the U.S.).

²⁰⁸ See Telephone Interview with Perrie M. Weiner, Partner and Int’l Co-Chair, Sec. Litig. Group, DLA Piper, in Queens, N.Y. (Aug. 23, 2006) [hereinafter Weiner Interview] (telling the author how funds will look to move outside the U.S.).

²⁰⁹ See Weiner, *supra* note 32 (commenting that “[a]n off-shore exodus will hardly result in more transparency” to allow the SEC to monitor the funds).

²¹⁰ See Weiner Interview, *supra* note 208 (“[The] SEC has [a] history of pushing inappropriate laws and losing out.”).

²¹¹ See Cynthia Glassman, Comm’r, SEC, Address to National Economists Club: Observations of an Economist Commissioner on Leaving the SEC (July 6, 2006), <http://www.sec.gov/news/speech/2006/spch070606cag.htm> (reiterating that this was

ordered to “do the empirical homework it should have done in the first place” if it wanted to continue its attempt in passing the mutual fund governance requirements.²¹²

Thus, while there will always be a fear of overregulation, the fear is particularly well-placed when speaking about the activity of the SEC. It is therefore positive that this demonstration of overzealous regulation on the part of the SEC was squashed by the *Goldstein* court. This will allow the SEC to analyze what went wrong and how to prevent a similar promulgating fiasco in the future.

2. Preventing a False Sense of Safety

In demanding hedge fund advisers to register, the SEC risked doing more social harm than good in that certain investors would invest without a true recognition as to the risks involved.²¹³ This concern has already been touched upon in this Note. Investors may incorrectly assume that hedge funds are now less risky or more protected from fraud due to SEC oversight. These mistaken investors may potentially invest when they are not mentally or financially prepared for what hedge fund investing actually entails. Former U.S. Treasury secretary John Snow, who also favors limited regulation of hedge funds, recently expressed this concern.²¹⁴ He explained that if the SEC assures the public that there will be “increased scrutiny” and then they cannot deliver, it would create “a real risk of moral hazard that implies, ‘Don’t worry. Now the government is watching over you and there aren’t any problems.’”²¹⁵ This false sense of security is not something that should be encouraged, but that is what the Final Rule would have done.

another instance of the SEC going too far in its rule promulgations).

²¹² *Id.*

²¹³ There are many risks that investors take when choosing to invest in hedge funds. See Yarden, *supra* note 20 (listing ever-present risks that both hedge fund managers and investors must keep in mind, including markets that are suddenly “illiquid, complex derivatives instruments react[ing] in ways that a hedge fund manager doesn’t anticipate, pricing models . . . prov[ing] faulty, leverage magnif[ying] losses and supposed market-neutral trading strategies drift[ing] with the market. These are all factors that can have dramatic negative consequences for a hedge fund’s portfolio value”).

²¹⁴ See Kevin Carmichael, *Bloomberg Funds Marketplace—In New Role, Snow Urges “Lighter” Regulatory Touch*, INT’L HERALD TRIB., Nov. 1, 2006, at 18.

²¹⁵ *Id.*

The Commission majority addressed this concern of “moral hazard.”²¹⁶ The commissioners in the majority disagreed on the grounds that using this reasoning, there should not be regulation of any investments for fear that investors will be lulled into a false sense of comfort.²¹⁷ Generally speaking, this is a valid response, and that is why there is so much important regulation in the securities markets. Regarding hedge funds specifically though, this argument does not ring true. The Final Rule would not have provided the protection that it intended to provide due to its poor design and because with a lack of funding, the SEC would not have been able to follow through with the exceptionally greater examinations and enforcements for which it had planned.²¹⁸ Therefore, in this unique situation, a sense of security on the part of investors would require a much greater leap of faith in the SEC’s ability as compared to other investment classes. That, in turn, would lead to much greater chances of loss and shock for unprepared or misinformed investors. The dissenting commissioners also believed this to be a real concern, unlike the majority. They wrote in their dissent to the Proposed Rule, “[i]f we fail devote adequate resources [to hedge fund monitoring] we are providing a false sense of security by suggesting to the marketplace that, through registration, we have bathed hedge funds in ‘sunlight.’”²¹⁹ Therefore, due to the potential social harm that may have been caused through a false sense of protection, it was crucial that the Final Rule was thrown out.

III. SEVERAL ALTERNATIVE SOLUTIONS TO CONSIDER

This Note proposes that the hedge fund sector does not require further regulation—what is already in place serves its purpose well. The Treasury Department has stated that based on research, the present system of hedge fund regulation does not show any evidence of being broken.²²⁰ Additionally, like

²¹⁶ See Final Rule, *supra* note 13, pt. III.A (“Benefits”).

²¹⁷ See *id.*

²¹⁸ For a complete discussion as to why the Final Rule would not have protected investors as the SEC had hoped, see *supra* Part II.A.–C.

²¹⁹ Proposed Rule, *supra* note 9, at 45,199.

²²⁰ See Liz Moyer, *Hedge Fund Heaven*, FORBES.COM, July 25, 2006, http://www.forbes.com/2006/7/25/sec-hedge-fund-regs-cx_lm_0725hedge_print.html (describing the decision as “a surprise” and relaying comments made by Randy Quarles, undersecretary for domestic finance for the Treasury Department).

Chairman Alan Greenspan before him, current Federal Reserve Chairman Ben Bernanke opined that enforcing the multitude of existing laws which pertain to hedge funds is a more prudent course of action at this point than passing new regulation.²²¹ Despite this well-reasoned sentiment, many feel changes are necessary—even if the Final Rule was not. There are many legally sound alternatives than that which the SEC has attempted that could produce superior, more targeted results in striving to meet the SEC's stated goals of better protecting investors and the securities markets. This final part of the Note will explore several viable alternatives that could produce these sought-after results if it is decided that more action should be taken.

A. *New Legislation*

Those that are against further regulation stress that although they prefer regulation as it stands now, if new law is to be implemented, Congress is the appropriate body to do so.²²² Congress passed the original Advisers Act, and all of its later amendments, in a conscious manner to ensure that investors in an investment pool such as a hedge fund are not counted as "clients" for the sake of registration.²²³ The court in *Goldstein* demonstrated this clearly.²²⁴ When, as here, the intent of Congress is unambiguous from the statute, the intended interpretation must be used.²²⁵ If at some point Congress believes that the statute is not clear, Congress is the appropriate conduit through which to effectuate change.

Many parties in favor of stricter regulations for hedge funds have called for new legislation, especially since the *Goldstein* decision. Right after the decision came down, a bill sponsored by

²²¹ See Dan Caterinicchia, *SEC Won't Challenge Hedge Funds Ruling*, HOUSTON CHRON., Aug. 7, 2006 (referencing Chairman Bernanke's thoughts while discussing the SEC's decision not to appeal the *Goldstein* decision).

²²² See, e.g., Letter from Wilmer Cutler Pickering Hale & Dorr LLP to Jonathan G. Katz, Sec'y, SEC (Sept. 8, 2004), <http://www.sec.gov/rules/proposed/s73004/wilmer090804.pdf>.

²²³ See, e.g., *id.* (demonstrating how the word "client" has been interpreted as one receiving direct investment advice, beginning with the inception of the Advisers Act).

²²⁴ See *Goldstein v. SEC*, 451 F.3d 873, 878–84 (D.C. Cir. 2006).

²²⁵ See *Chevron U.S.A., Inc. v. Nat'l Res. Def. Council, Inc.*, 467 U.S. 837, 842–43 (1984).

Congressman Barney Frank (D-Mass.) was introduced to Congress.²²⁶ The bill called for an amendment to the Advisers Act that would, in effect, make the Advisers Act resemble what the SEC had intended with the Final Rule.²²⁷ It also stated that this authority and interpretation does not extend to other sections of the Advisers Act, so as not to present fiduciary conflicts of interest.²²⁸

This bill will most likely not become law because the second component, informing that the new interpretation of “client” does not extend to other sections of the Advisers Act, is precisely one of the criticisms that Judge Randolph leveled on the Final Rule.²²⁹ He stated that the rule is arbitrary if it only applies to one subsection of the statute with no justifiable reasons as to why it should not extend to the entire statute.²³⁰ Further, it will be hard to explain why an adviser to a hedge fund is any different from an attorney to a hedge fund or an accountant to a hedge fund. All three professionals perform advisory services to the actual business entity—the hedge fund—and it is understood that the attorney or accountant is only serving the business entity. They don’t owe any fiduciary duty to the shareholders of the business entity—the investors are not their clients.²³¹ The same logic should thus apply to hedge fund advisers.

B. *More Focused Promulgation of Rules*

A far better and far less intrusive alternative would be to merely change the definition of who qualifies as an “accredited investor.” This is the standard by which hedge funds usually determine which individuals are allowed to invest in their

²²⁶ See H.R. 5712, 109th Cong. (2d Sess. 2006).

²²⁷ See *id.* (stating that for the purposes of counting clients for the sake of the exemption, the SEC has the authority to count investors, shareholders, and beneficial owners of hedge funds as clients).

²²⁸ See *id.* (“The treatment of [certain individuals] as a client for the purposes of registration under this section shall not affect, and shall not be affected by, the treatment of such persons not as clients for purposes of section 206 or any other section of this title.”).

²²⁹ See *Goldstein*, 451 F.3d at 881–84.

²³⁰ See *id.* at 881–84 (explaining that courts usually presume that the same word in different sections of a statute have the same definition, and how the SEC has not showed any reason as to why this rule of law should not apply here).

²³¹ See *id.* at 881 (demonstrating how all three professional types would be burdened with the same conflicts of fiduciary duties if these duties were not owed solely to the business entity).

funds.²³² Under the Securities Act of 1933, investment companies which are exempt from registration can offer their funds only to “accredited investors.”²³³ The SEC was aware of this alternative at the time they announced the Final Rule,²³⁴ but they chose not to proceed with it on the grounds that it would not satisfy all of the concerns regarding hedge funds which the SEC had expressed.²³⁵ If the SEC is intent on protecting investors, especially “unsophisticated,” inexperienced investors,²³⁶ perhaps it would be wiser to make one shrewd change rather than attempting to cast too wide a net that ends up catching nothing at all.²³⁷

The SEC does have the authority to change requirements or thresholds demanded in order to invest in certain vehicles.²³⁸ In an about-face, Chairman Cox recently confirmed that the agency will be raising the standards necessary to be eligible to invest in hedge funds. He said that in order to make it harder for certain individuals to invest in the sector, the definition of an “accredited investor” would be increased from the current level of \$1 million in net assets to a threshold of \$1.5 million.²³⁹ This Note proposes that the current definition of “accredited investor” should be

²³² See, e.g., Astarita, *Registration of Managers*, *supra* note 167 (explaining that normally hedge funds do not accept investors unless they are “accredited,” meaning the person earns over \$200,000 annually or has a net worth of at least \$1 million).

²³³ See *supra* notes 72–73 and accompanying text for more detailed information regarding “accredited investors” and where the law is located.

²³⁴ See Final Rule, *supra* note 13, pt. II.B.9 (“Alternatives Submitted”).

²³⁵ See *id.*

²³⁶ See, e.g., Moyer, *Whither Hedge Funds?*, *supra* note 19 (summarizing Chairman Cox’s remarks in front of the U.S. Senate Banking Committee about how he would like it made more difficult for retail investors to gain access to hedge funds).

²³⁷ For instance, the two-year lockup loophole is wide enough for a whale to swim right on through. For a discussion of this loophole, see *supra* notes 187–91 and accompanying text.

²³⁸ See, e.g., Investment Advisers Act of 1940 § 211(a), 15 U.S.C. § 80b-11(a) (2000) (“For the purposes of its rules or regulations the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters.”).

²³⁹ Jesse Westbook & Alison Vekshin, *SEC’s Cox Says Hedge Fund Regulation Is ‘Inadequate,’* BLOOMBERG.COM, July 25, 2006, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a2VWRiBAROA0&refer=home>. This demonstrates that the Final Rule was unfocused and not necessary, for if the SEC truly believed that the Final Rule was the correct course of action, they would have pushed harder for new legislation instead of looking to raise the “accredited investor” thresholds.

changed to allow an amount even higher than that which Chairman Cox announced.

One million dollars is worth far less today than it was worth when Regulation D, the rule establishing the “accredited investor” threshold was adopted in 1982.²⁴⁰ The irresponsibility in failing to increase this threshold for twenty-five years may explain why unsophisticated investors may now be gaining access to hedge funds—it is not that more registration is needed, but that the SEC cannot allow a financial threshold to grow as stale as it has. If the standard was \$1 million in 1982, then according to the Consumer Price Index (“CPI”), the threshold should now be approximately \$2 million.²⁴¹

This Note proposes that the threshold of who qualifies as an “accredited investor” should be raised to at least \$2 million. Meeting a number this high appears to be reasonably necessary to allow a person to invest in a sector with the potential to produce enormous losses²⁴² in addition to huge gains. A million dollars is just not what it used to be. Further, apart from meeting the threshold through net assets, one can be an “accredited investor” if one earned at least \$200,000 in each of the past two years with the reasonable expectation that such earnings will continue.²⁴³ Instead, the threshold to be considered an “accredited investor” based on the previous year’s earnings should be raised from \$200,000 to \$430,000. This number was chosen because, according to the CPI, in today’s dollars, \$430,000 is equivalent to what \$200,000 was in 1982.²⁴⁴

Further, a time-based system should be promulgated whereby every “x” number of years the thresholds needed to be

²⁴⁰ See Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982); see also 17 C.F.R. § 230.501(a)(5) (2007).

²⁴¹ See Consumer Price Index Home Page, Inflation Calculator, <http://www.bls.gov/cpi> [hereinafter Inflation Calculator]; see also Interview with Michael Perino, Professor of Law, St. John’s University School of Law, in Queens, N.Y. (Nov. 9, 2006) [hereinafter Perino Interview] (showing through statistics what are the modern day equivalents).

²⁴² See, e.g., Jim McWhinney, *Massive Hedge Fund Failures*, INVESTOPEDIA.COM, Nov. 17, 2005, <http://www.investopedia.com/articles/mutualfund/05/HedgeFundFailure.asp> (going over some of the biggest and most “spectacular” recent hedge fund failures).

²⁴³ See *supra* notes 72–73 and accompanying text.

²⁴⁴ See Inflation Calculator, *supra* note 241; see also Perino Interview, *supra* note 241.

considered an “accredited investor” are automatically raised a certain percentage.²⁴⁵ For instance, the number can be increased every five years to mimic the effect that inflation has had on the value of money. This will ensure that these higher thresholds, in place to protect unqualified investors, do not outlive their timeliness, as, it appears, has happened with the current “accredited investor” thresholds. Therefore, raising both of the “accredited investor” thresholds to significant levels, and keeping such thresholds current, would be a strong alternative to the failed solution attempted by the SEC.

C. Education & Information

No further registration demands are necessary. One reason for this is because the capitalist system of this country will produce more investor protection organically. The SEC, and any other investor advocacy groups interested, should focus instead on educating investors about the risks and rewards of hedge funds, instead of trying to over-regulate them²⁴⁶ while perhaps giving investors a false sense of the funds’ safety. With awareness and education, investors themselves could then choose which, if any, hedge fund is correct for them.

There are many ways to educate investors. One way is to inform the investors which questions to ask when researching the sector. The SEC’s website gives some basic guidance as to what should be asked,²⁴⁷ but it could go a whole lot farther. For instance, there are available on the internet “due diligence guides” that present in-depth steps to take when researching a hedge fund.²⁴⁸ It recommends asking detailed questions pertaining to, among other things, the fund’s volatility, risk,

²⁴⁵ The efficient number of years between increases and the smartest percentage by which to raise the thresholds should be determined by the SEC in tandem with expert economists.

²⁴⁶ For a more detailed discussion of the fear of over-regulation, see *supra* Part II.D.1.

²⁴⁷ Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds, <http://www.sec.gov/answers/hedge.htm> (last visited Sept. 16, 2007).

²⁴⁸ See, e.g., HedgeFund.Net’s Due Diligence Guide for Investing in Hedge Funds, http://www.hedgefund.net/dd_index.php3 (last visited Sept. 16, 2007) (presenting an extensive guide to what investors should ask of a hedge funds in a clear and detailed fashion).

investment style—and which styles to be more weary of, the profile of the investment adviser, fund structure, and fees.²⁴⁹

Our capitalist system encourages individuals and entities to release innovative products that they believe will help consumers. This system has already produced one solution for the hedge fund industry that will give investors more information than ever before regarding hedge funds and the risks associated with particular funds. The nation's largest credit-rating companies are rolling out services offering detailed information on numerous hedge funds.²⁵⁰ The services intend to provide vital information that is not yet easily available. For example, the service that Standard & Poor's has introduced gives investors the probability that a specific fund will default on its loans, takes into account the fund's operational risk, and analyzes whether the fund would be able to repay all of its creditors if some catastrophe requires it to liquidate its portfolio.²⁵¹ These rating services will calm one of the major concerns of the SEC, that investors and the SEC don't know enough about the hedge fund arena to make proper investment decisions.

Two other practices should also be implemented by the SEC and the hedge fund industry. First, the dissenting commissioners suggested in the Proposed Rule that the SEC should perform additional studies to analyze which information should be viewed as "red flags [in order to] provide systematic data on hedge fund trends and practices."²⁵² Second is a suggestion Phillip Goldstein has proposed to several individuals in the hedge fund industry.²⁵³ Indeed, hedge fund managers are consistently sent due diligence questionnaires from investors inquiring about the fund before they invest.²⁵⁴ The information sought includes manager biographies, compliance policies,

²⁴⁹ *See id.*

²⁵⁰ *See* Serena Ng & Shefali Anand, *Hedge Funds' Next Wrinkle: Ratings*, WALL ST. J., Aug. 25, 2006, at C3 ("The ratings firms are hoping to fill an information gap in an industry that is fast gaining popularity with a broader range of investors but remains largely shrouded in secrecy.").

²⁵¹ *Id.*

²⁵² Proposed Rule, *supra* note 9, at 45,200.

²⁵³ *See* E-mail from Phillip Goldstein, Principal, Bulldog Investors, to author (Nov. 2, 2006, 19:27 EST) (on file with author).

²⁵⁴ *Id.*

investment styles, "lockup periods," and more.²⁵⁵ To address these concerns, Goldstein suggests that the hedge fund industry adopt a "best practices" model to determine what information should be available for investors, and to go even farther by including explanations of hedge fund concepts, such as leverage, as well.²⁵⁶

Implementation of these two proposals would succeed in quelling many of the fears held by the SEC and should be considered as a productive, free-standing alternative. If these suggestions were combined with the hedge fund rating services and with an emphasis on investor education by the SEC, an efficient and expansive understanding of hedge funds and their risks would be provided. This would be a strong alternative to the failed solution forced by the SEC.

D. *Self-Regulatory Organization*

Self-regulatory organizations play a key role in this country, and another alternative solution to the failed Final Rule would be for the hedge fund industry to follow suit and create a bona fide self-regulatory organization. The SEC has stated that these organizations may actually present certain advantages over direct governmental regulation.²⁵⁷ It explains that these organizations allow for guidance by industry participants whom possess specialized knowledge, and bring a unique understanding of the industry and a heightened ability to react swiftly to regulatory concerns.²⁵⁸ Further, they lessen the time and financial burdens that would be required of the SEC if it alone regulated the industry.²⁵⁹ Yet another benefit is that these organizations often implement higher standards than the federal law would require.²⁶⁰ Of course, in order to have a legitimate self-regulatory organization, "[it] must vigilantly [search for] and

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ U.S. SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET 7 (1996) (commenting on the benefits of self-regulatory organizations).

²⁵⁸ *Id.*

²⁵⁹ *See id.*

²⁶⁰ *See id.* One possible area where self-regulation may be higher is in the area of ethics. *Id.*

investigate the activities of . . . participants and take appropriate action as warranted under the facts and as required by law.”²⁶¹

As the hedge fund industry has continued to mature, its managers have demonstrated that as a whole, they take the integrity of their funds, their reputations, and of the entire industry quite seriously.²⁶² Even without a self-regulatory organization, they have done a fine job of “self-policing.”²⁶³ Also, hedge funds dwell in a unique corner of the broad markets due to the investors attracted, the strategies used, and the market benefits provided. Therefore, the industry is ripe for this type of self-regulatory control. The SEC, with its tight budget and rationed resources, would benefit from this as well because the self-regulatory organization would be self-sustaining due to membership fees, thereby allowing the SEC to divert its resources elsewhere.²⁶⁴ Additionally, the industry is large enough to command and support a self-regulatory organization, with assets exceeding \$1.2 trillion dollars and showing no signs of slowing down.

A good model to strive for would be that currently in place by the National Futures Association (“NFA”). This is a nation-wide “self-regulatory organization for the U.S. futures industry.”²⁶⁵ It has exceptionally high standards relating to all aspects of its industry, including screening of new members, market surveillance, fraud prevention, and trade practices.²⁶⁶ Like the organization this Note proposes, the NFA does not require any taxpayer money, as it is solely supported by the dues paid by its own members and from “assessment fees paid by the users of the futures markets.”²⁶⁷ Another key practice of theirs which should be emulated by the hedge fund industry is intense investor

²⁶¹ *Id.* at 8.

²⁶² *See* Yarden, *supra* note 20 (“The hedge fund industry has, however, done a good job of self-policing with respect to fraud. Blow-ups do occur, but the majority of managers with established track records have consistently displayed fiduciary responsibility toward their investor bases and assets . . .”).

²⁶³ *See id.*

²⁶⁴ *See* Glassman, *supra* note 211 (speaking about how the SEC wasted so much money, time, and effort on the Report and the Final Rule with nothing to show for it, and how the resources could have been better used for other responsibilities).

²⁶⁵ National Futures Association—About NFA, <http://www.nfa.futures.org/aboutnfa/indexAbout.asp> (last visited Sept. 16, 2007).

²⁶⁶ *See id.*

²⁶⁷ *Id.*

education.²⁶⁸ Based on the NFA and other successful self-regulatory organizations, this Note proposes that another alternative solution brimming with potential would be for the hedge fund industry to come together and take control through the use of a self-regulatory organization.

The alternative solutions proposed by this Note are more efficient and productive than the failed Final Rule, and all are feasible. Regarding new legislation, the rule would at least be constitutionally sound if promulgated in this way, even if it would still not act to protect investors. The other solutions would assist in investor protection, confidence, and understanding. They would enable hedge funds and their advisers to continue their work in a productive manner while doing more for investors. Finally, these solutions would allow the SEC to gain more insight into hedge funds while still utilizing their minimal resources in a way that can truly maximize investor protection.

CONCLUSION

This is an exhilarating time to be an investor, with a multitude of options available as individuals strive to reach their financial goals. All of these options, though, make for an arduous task on the part of the SEC. It will always face criticism and skepticism, made even more likely due to its current lack of resources, as it attempts to enforce and promulgate rules it feels are necessary to protect investors and the securities markets. It follows that the SEC should be held up to nothing but the highest standards regarding how it accomplishes its stated goals. Specifically because of the importance of its role, the SEC should be expected to enforce and promulgate rules in the most focused, fair, and well-reasoned manner.

This Note demonstrates that when it promulgated the Final Rule, the SEC failed to live up to the understandably lofty standards placed upon it. The Final Rule was neither fairly conceived nor solidly structured, having been promulgated after dismissing too quickly various dissenting opinions that were lucid and logical. This lack of professionalism led to a rule which

²⁶⁸ *See id.* (informing how the organization provides investors with several tools to assist in making financial decisions, including the many publications it provides, and, among other things, the enormous database which includes information on all futures firms and salespeople).

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would not have accomplished the goals for which it was intended and highlighted the flaws within the SEC as currently managed. Further, this Note demonstrates why the failure of the Final Rule is beneficial for all involved and why the failure was inevitable. Finally, this Note proposes many viable alternatives to the failed Final Rule which would more efficiently deal with the concerns of the SEC, if it is ultimately decided that more actions should be taken. Thus, it was a positive and necessary development for investors, advisers, hedge funds, and for the SEC itself when the *Goldstein* court ruled that the Final Rule must be vacated. Clearly, the SEC had gone too far over the hedge.