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The Myth of the Unregulated Hedge Fund

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Introduction

Attacking sources of hidden and systemic market risk will continue to be headline material for legislators and regulators in 2009. Notwithstanding the disastrous performance of the most highly regulated market participants, hedge funds continue to be targeted as culpable actors contributing to the dramatic developments of 2008. Most media references to hedge funds describe them as "secretive" and "unregulated," or perhaps "lightly regulated." It is generally also implied that all professionals in the hedge fund sector are magnificently wealthy. It is relatively easy to add the charges "secretive," "unregulated" and "rich" together and produce a publicly acceptable scapegoat for current market woes. In fact, the pace of attack has so much momentum, this article cannot hope to address all the recent reform and obloquy heaped on the hedge fund industry of late.[1]

This article assumes that it is the duty of responsible government to marshal public resources such that action is taken against actual threats to public welfare and sound economy and, likewise, to refrain from acting where no need exists. In order to fulfill this duty, one must be sure to ask the right questions. Accordingly, we ask, is it accurate to suggest that the activities of hedge funds pose a risk to the markets on account of too little regulation?

For purposes of this discussion, "hedge funds" shall refer to pooled investment vehicles that are exempt from registration under the Investment Company Act of 1940, as amended (the Company Act), by virtue of compliance with either Section 3(c)(1) or 3(c)(7) of such Act[2], that offer interests in such funds in a manner exempt from registration under the Securities Act of 1933, as amended (the Securities Act), and that invest using strategies and terms that aim to provide some degree of current liquidity not tied to the realization of particular portfolio assets (*i.e.,* as distinguished from private equity funds).

Of course, hedge fund enterprises also include one or more entities that serve in investment management capacities, as investment advisers, general partners, managing members or similar roles. For ease of reference and argument, this article refers to such entities collectively as the "adviser" or "manager," and, unless otherwise noted, shall assume an adviser that is not registered nor required to be registered under the Investment Advisers Act of 1940, as amended (the Advisers Act).

Regulation Under the Securities Act

Regulation As To Manner of Offering

We have stipulated that hedge funds are funds that offer interests pursuant to an exemption from registration under the Securities Act. Congress provided an exemption from the registration requirements of the Securities Act for "transactions by an issuer not involving any public offering."[3] In 1982 and 1989 the Securities and Exchange Commission (SEC) adopted Rules that provide certain issuers exemption from the requirement to register their securities in certain limited offerings.[4] These Rules, known as "Regulation D,"[5] provide a safe harbor from registration upon which most domestic hedge funds rely.

In order to use the safe harbor provided in Regulation D, a hedge fund submits to the regulation implicit in the conditions of exemption. Rule 502 imposes limitations on the manner of offering, crafted by the SEC to assure that issuers do not make unregistered offers of securities to the general public and that certain

disclosure requirements apply when such offers are made to persons who are not accredited investors.[6] Thus, a hedge fund relying on Regulation D may not offer its securities through general solicitation or advertising.[7] This prohibition is quite broad, and covers even offers to accredited investors not conducted in a permissible manner. A substantive pre-existing relationship between the issuer and the potential investor is generally considered necessary to avoid this prohibition on general solicitation.[8]

It is interesting to note that the breadth of the prohibition against general solicitation may itself be responsible for some of the aspersive "secretiveness" previously discussed. This is perhaps a place where new rules articulating standards encouraging communication with investors and potential investors that meet eligibility standards, perhaps within safe-harbor type conditions, could alleviate public concern about industry opacity. Similarly, there is a large body of intermediated information provided by index publishers, news sources, etc.[9] Regulators should consider whether the adoption of clearer standards, including perhaps, appropriate safe harbors for issuers to communicate with bona fide publishers, indexers, and data services, would also be useful to promote greater industry transparency.

Regulation via Public Disclosure

Hedge funds relying on Regulation D must file a notice of sale of unregistered securities on Form D with the SEC within 15 days after the first sale of securities.[10] In this regulatory filing, hedge funds provide significant information about the fund and the offering, including: information about related persons, executive officers, directors and promoters;[11] formation details, including jurisdiction, type of entity and duration of existence; aggregate net asset value range;[12] the federal exemptions and exclusions claimed;[13] and information about the offering, including duration, types of securities offered, minimum investment, any payable sales-related compensation, investor accreditation requirements and the use of proceeds for compensation of executives, if applicable.[14] Form D filings are also accessible to the general public.[15] The SEC deems this information to be "useful and justified in the interests of investor protection and capital formation."[16] As such, the SEC directs potential investors to check whether the issuer has filed a Form D notice and advises investors that "'[i]f the company has not filed a Form D, this should alert you that the company might not be in compliance with the federal securities laws.'"[17] Beginning on March 16, 2009, issuers will be required to update their Form D on an annual basis if engaged in a continuing offer.[18]

Regulation D also mandates the use of a disclosure document in offering many hedge funds, in that most hedge funds seek to comply with the exemption in Rule 506. Offers under Rule 506 are not subject to any dollar limit, but rather offerees must be limited to accredited investors[19] and no more than 35 non-accredited investors, each of whom the fund reasonably believes has the knowledge and experience in financial and business matters to evaluate the merits and risks of the proposed investment.[20] If an offer is made to a non-accredited investor, Rule 502(b)(1) requires the issuer to provide extensive information to such investor.[21] The inclusion of non-accredited investors, in turn, has disclosure implications for all investors. In an endnote in Rule 502(b)(1), the SEC advises issuers providing information to non-accredited investors to provide this information also to accredited investors "in view of the anti-fraud provisions of the federal securities laws." Thus, any hedge fund intending to include non-accredited investors, or wanting to preserve the flexibility to do so, is well-advised to prepare a full disclosure package for use with all offerees from the beginning of the offering.[22]

Regulation D does not exempt any transactions from the antifraud, civil liability or other provisions of the securities laws.[23] In addition, Regulation D is not available for a transaction that is technically in compliance with Regulation D if the transaction is part of a plan or scheme to evade registration provisions of the Securities Act.[24]

Regulation Under the Advisers Act

Hedge fund managers are subject to the Advisers Act in the same measure as any other investment adviser exercising discretion over accounts that trade securities. Hedge fund managers generally do meet the definition of "investment adviser" in Section 202(a)(11) of the Advisers Act[25] and, thus, must either register with the SEC or qualify for an exemption from registration. While only a small percentage may be required to register,[26] many choose to register because of the perceived benefits in marketing or to achieve the status of a qualified professional asset manager (QPAM) under the Employee Retirement Income Security Act of 1974 (ERISA).[27] Other hedge fund managers choose to qualify for an exemption from registration, usually the "private adviser" exemption in Section 203(b)(3).[28]

The private adviser exemption is itself a form of regulation and hedge fund managers electing to use it must comply with its conditions and certain other provisions of the Advisers Act that, by their terms, apply to all investment advisers, whether registered or not. Moreover, the SEC has broad cease and desist authority to enforce penalties against all investment advisers for violations of the Advisers Act and other securities laws. In addition, the anti-fraud provisions of the Advisers Act implicitly regulate a wide variety of activities and conduct of even unregistered advisers.

Conditions of Exemption from Registration

A private adviser need not register with the SEC if: (1) it has had fewer than fifteen clients in the preceding twelve month period; (2) it does not hold itself out to the public as an investment adviser; and (3) it does not advise any registered investment companies or business development companies.[29] For private fund managers, each fund that the manager advises counts as one "client".[30] Few hedge fund advisers manage enough funds to make this exemption unavailable. In addition, Rule 203(b)(3)-1 under the Advisers Act stipulates how to count clients for purposes of this exemption. These instructions prevent evading the fourteen client limit through the layering of corporations and other collective entities.

Unregistered advisers are substantially restricted in the manner in which they can communicate with the public. The "holding out to the public" stricture is broadly interpreted by the SEC to include any advertising related to investment advisory activities; telephone or building directory listings or business cards referring to investment advisory services; word of mouth advertising regarding the availability of investment advisory services; or letting it be known that one will provide investment advice or accept new clients.[31] [32]

There is, as noted, increasing policy concern expressed about the lack of transparency in the hedge fund industry. Existing SEC interpretations of "holding out" give almost no berth to private advisers that wish to be more open. Private advisers are properly counseled that almost any public visibility puts them at risk of violating Section 203(b)(3). To the extent public policy favors transparency, the SEC should consider regulatory relief confirming, for example, that private fund advisers who do not accept separate accounts (that is, who are not soliciting or accepting new clients) may talk about their funds without breaching the "holding out" prohibition. Such an interpretation is consistent with Rule 203(b)(3)-1(c), which states that a private adviser will not be deemed to hold itself out to the public as an investment adviser solely because the adviser participates in a non-public offering of interests in a limited partnership under the Securities Act.[33]

Conduct Subject to Cease and Desist Authority

Unregistered advisers also are subject to the civil enforcement powers of the SEC for serious misconduct. Section 203(e) of the Advisers Act gives the SEC the authority to censure, limit or suspend for up to one year the activities of registered and unregistered investment advisers, if the adviser engages in enumerated unlawful conduct and the SEC deems it in the public interest to do so.[34] Enumerated types of misconduct include any felony or misdemeanor conviction, in the U.S. or abroad, that (a) involves trading

in securities, filing false reports, bribery, perjury, burglary or conspiracy to commit such offenses; (b) arises from operating a business as a broker, dealer, investment adviser, bank, insurance company or any one of a number of other financial services businesses; (c) involves larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; or (d) involves violation of enumerated federal criminal laws prohibiting forgery, counterfeiting, fraud and false statements.[35] The SEC can also use its authority under Section 203(e) against persons subject to a wide variety of state or foreign bars against operating or associating with financial or securities industry businesses, and against any person who has willfully violated, or aided and abetted the violation of, the Securities Act, the Securities Exchange Act of 1934 (the Exchange Act), the Company Act, the Advisers Act, the Commodity Exchange Act, any rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board (together, the Federal Securities Laws).[36]

In addition, two other provisions of Section 203 are worth noting on account of their regulatory impact for unregistered advisers. Section 203(e)(6), creates broad personal liability for failure to supervise persons whom one is charged with supervising, in the event such supervised person violates the Federal Securities Laws. The SEC has brought enforcement proceedings against unregistered fund managers for failure to supervise, so the potential for liability is real.[37] Section 203(e)(6) also provides a safe harbor. No person shall be found to have failed to supervise if he or she was operating under established procedures which would reasonably be expected to prevent and detect, insofar as practicable, the relevant violation by supervised persons and the supervisor has reasonably discharged the duties incumbent upon him or her by reason of such procedures, without reasonable cause to believe that such procedures were being breached or ignored.[38] This safe harbor from personal liability for failure to supervise exists today as a strong incentive for unregistered advisers to maintain compliance policies and procedures reasonably designed to detect and prevent violations of all the Federal Securities Laws.[39] Finally, Section 203(f)[40] makes it unlawful for any investment adviser to allow a person who is barred from associating with investment advisers to associate with it. This affirmatively prohibits registered and unregistered advisers alike from allowing bad actors to use a legitimate organization as a platform to continue their offenses against investors and the public interest.

Antifraud Provisions

In 1960, the Advisers Act was expressly amended to extend the antifraud provisions of Section 206 to unregistered advisers.[41] The plain language of Section 206[42] is clear in that respect and is drafted broadly to capture conduct that deceives clients, prospective clients and other persons generally. In some ways, Section 206 creates a higher standard of conduct than Rule 10b-5 under the Exchange Act, the principal anti-fraud rule applicable to market participants that are not investment advisers. Unlike Rule 10b-5, Section 206 reaches conduct that operates as a fraud, without specific intent or recklessness in that regard,[43] and conduct that is manipulative or deceptive without involving the purchase or sale of a security. In addition, the SEC can enforce Section 206 without the predicate of any actual harm to an adviser's clients.[44] The Advisers Act sets this same high bar for the conduct of hedge fund advisers as it does for all investment advisers.

Sections 206(1), (2) and (4), respectively, make it unlawful for any investment adviser: "to employ any device, scheme, or artifice to defraud any client or prospective client," "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," or "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." In addition, Section 206(3), discussed separately below, prohibits principal and agency cross trading absent client consent.

The SEC has consistently enforced Section 206 against unregistered advisers, bringing actions for conduct such as misappropriation of fund assets,[45] manipulating fund valuations,[46] and material misrepresentations and omissions to investors.[47] SEC enforcement has also made it clear that Section

206 reaches front-running,[48] misrepresentations in marketing and client reporting materials,[49] market manipulation,[50] misconduct through forging or failing to properly record trade orders,[51] trading in violation of stated investment policies,[52] self-dealing in allocation of profitable trades,[53] failing to disclose material information regarding the use of soft dollars and other brokerage practices,[54] failing to disclose personal financial interests in transactions for client accounts,[55] failing to seek best execution,[56] and failing to disclose that commissions are used to compensate brokers for client or investor referrals.[57]

In addition, Rule 206(4)-8, promulgated by the SEC in the wake of the Goldstein decision,[58] clarifies the SEC's view that Section 206 also prohibits fund managers' fraudulent conduct that affects investors in their funds, notwithstanding that such investors are not clients, within the meaning of the Advisers Act. [59] Under Rule 206(4)-8, an investment adviser is prohibited from: (i) making false or misleading statements to investors or prospective investors in pooled investment vehicles, whether the pool is offering, selling or redeeming securities or (ii) otherwise defrauding those investors or prospective investors.[60] Prohibited conduct includes, but is not limited to, false or misleading statements about investment strategy, credentials of the adviser, risks associated with investing, allocation of investment opportunities, and fund valuation and performance.[61] Rule 206(4)-8 also encompasses negligent or reckless conduct on the part of an adviser.[62] In the past year, the SEC brought enforcement actions against hedge fund managers, including charges under Rule 206(4)-8, for making false statements about fund performance[63] and fund trading strategy.[64]

Given that, in many cases, fund managers can avoid violating the Advisers Act anti-fraud provisions if appropriate disclosure precedes the subject conduct, this statute and its related regulations provide potent investor protections. Taken together with the SEC's already broad enforcement authority, they effectively obligate hedge fund advisers to be communicative, truthful, and complete about all aspects of their strategies and operations that might be material to investors' decisions.

Regulation of Self-Dealing through Principal Trades

Finally, because principal and agency cross trading provide unique opportunities, or temptations, for self-dealing, Section 206 also contains a specific prohibition of such transactions absent prior informed consent from the client.[65] In principal trades, the adviser, acting as a principal for its own account, knowingly sells or purchases a security to or from a client. In an agency cross trade, an adviser, acting as a broker for a person other than such client, knowingly effects a sale or purchase of any security for the account of such client. In each case, the adviser's interest, on behalf of itself or the other person for whom it is acting as broker, coupled with its ability to affect material aspects of the trade, is a significant conflict with its duty to put the interests of the subject client first. There are content requirements for the information advisers must provide to clients when soliciting consent. Depending on the facts and circumstances, these include the capacity in which the adviser is acting, an explanation of pricing and best price available (or commitment to match best price), commission charges, the adviser's purchase price, and an effective method of indicating consent. Accounts of the adviser's affiliates are similarly restricted from these transactions.[66]

Regulation Under the Company Act

The Company Act is another source of hedge fund regulation. Hedge funds ordinarily seek to comply with the conditions of Section 3(c)(1) or 3(c)(7) of the Company Act to enjoy exception from the definition of "investment company."[67] Congress provided these exceptions for funds that do not sufficiently affect the public interest to merit the same dedication of public resources to their oversight as, for example, mutual funds do. In addition, compliance with all the substantive provisions of the Company Act would make it impossible for hedge funds to operate, and the markets would lose these participants that provide salutory functions in terms of liquidity, price discovery, and innovation.[68] Although Section 3(c)(1) and 3(c)(7) funds are not, even today, excluded from the definition of "investment company" for all purposes,

broader regulation of the operation and infrastructure of these vehicles under the Company Act should not be seen as an avenue to reach the impact of hedge fund trading on systemic risk.

Compliance With Applicable Exemptions

Section 3(c)(1) exempts from the definition of "investment company" any issuer whose outstanding securities are held by not more than 100 persons and which is not making, and does not presently propose to make, a public offering.[69] Subsections of, and rules related to, Section 3(c)(1) provide additional guidance and limitations about counting beneficial owners to assure that Section 3(c)(1) is not circumvented by the pyramiding of collective vehicles nor the formation of collective vehicles for the purpose of evading the 100 beneficial owner limit.[70] Hedge funds maintaining exemption from registration under Section 3(c)(1) must maintain procedures to monitor compliance with its conditions. Given the extremely limited number of investors in 3(c)(1) funds, even recent market dislocation does not change the calculus, weighing the cost of public regulation to the benefits, where the outstanding shares of a hedge fund are held by so few.

Similarly, Section 3(c)(7) exempts any issuer whose outstanding securities were owned exclusively by persons who, at the time they invested in the fund, were "qualified purchasers."[71] Thus, hedge funds seeking to establish exemption from Company Act registration under Section 3(c)(7) must maintain procedures to assure that their investors meet the enhanced eligibility standard defined in Section 2(a)(51) of the Company Act.[72] That section describes four types of persons who are qualified purchasers, essentially, natural persons and family-owned companies having at least five million dollars in investments, corporate entities with at least $25 million in investments, and any trust with respect to which each settlor meets one of the other standards and that was not formed for the purpose of investing in the 3(c)(7) hedge fund.

The issuing release relating to the passage of Section 3(c)(7)[73] explained the "investment" assets standard, which differs from the net worth or income tests that are used to define "accredited investor" under the Securities Act. It excludes the value of a personal residence and includes only those assets held for investment purposes. The use of the "investment" measure and the higher dollar thresholds in the "qualified purchaser" definition are intended to exempt from Company Act registration those funds where the investors are not only wealthy enough to bear the economic risk of investing in hedge funds, but also have prior investment experience such that they are more qualified to assess the risks and other characteristics of their investment, including the implications of an absence of Company Act registration. Given the other laws and rules previously discussed that directly or indirectly require hedge funds to provide investors with substantial and accurate disclosure, even the current market woes do not force us to conclude that greater application of the substantive Company Act to hedge funds is an appropriate or essential use of public regulatory resources.

Case for Continued Exemption

After the market turmoil of 2008, the calculus as to whether hedge funds (and other private funds) ought to remain excepted from the definition of "investment company" has been called into question by proposed legislative reforms.[74]

Section 1 of the Company Act sets forth the justification for the statute in eight types of investment company conduct that adversely affect the interests of investors and the public. These are, in sum: (1) when investors make investment decisions (including the exercise of voting and redemption rights) with inadequate disclosure from the investment company; (2) when investment companies operate their business or manage portfolios in a manner that serves the interests of persons other than the company's shareholders (*i.e.*, poor handling of conflicts of interest); (3) when investment companies issue securities that devalue the preferences and privileges of holders of outstanding securities; (4) when investment companies are controlled through pyramiding or by irresponsible persons; (5) when financial operations

and reporting practices are unsound or misleading; (6) when investment companies change control, cease operating, or change the character of their business without shareholder consent; (7) when investment companies engage in excessive borrowing; and (8) when investment companies operate with inadequate capital.

These purposes are worth reviewing as a back-drop for considering whether and in what area new hedge fund regulation under the Company Act would add value to existing protections. Many of the eight categories are adequately addressed through existing law and regulation. The first and second stipulate that we should expect investment companies to give investors adequate disclosures, to operate in the interests of investors and to handle conflicts of interest appropriately. We have discussed above how Rule 506 under the Securities Act and Section 206 of the Advisers Act express the government's expectation that private fund advisers provide disclosure that is complete and not misleading as to material matters, including disclosure of conflicts of interest and how they will be resolved. Federal anti-fraud provisions (and common law standards of fiduciary conduct) also set legal standards for hedge funds with regard to proper handling of conflicts of interest. Finally, hedge fund investors can assure that their fund advisers will manage risk and reward in the best interests of fund investors by seeking out those advisers who invest a substantial portion of their own net worth in their funds.

Section 18 of the Company Act addresses the third category, regulating the capital structure of registered funds by prohibiting the issuance of "senior securities" that devalue the preferences and privileges of holders of outstanding securities. To a great extent, the ability of hedge funds to negotiate terms with their investors, and to borrow for investment purposes are principal characteristics of this class of investment vehicles. To the extent lawmakers and policy experts conclude that hedge funds provide a valuable function in the markets, it would not be advisable to apply the capital structure limitations for registered funds to hedge funds. With regard to the fourth category, anti-pyramiding and responsible management, Sections 3(c)(1) and 3(c)(7) state that funds they describe, while exempt from company Act registration requirements, remain subject to the Company Act's anti-pyramiding provisions in Section 12. In addition, Sections 3(c)(1) and 3(c)(7) restrict the use of layered investment structures to evade the limitations of the exemptions they provide. The Company Act also seeks to assure that investment companies are not controlled by irresponsible persons. As discussed, Section 203(e) of the Advisers Act empowers the SEC to censure, limit the activities of, or suspend for up to 12 months[75] any adviser whose associated persons engaged, before or after becoming associated persons, in any item in a lengthy inventory of market misconduct.

The quality of financial operations and reporting practices, the fifth goal of the Company Act, is discoverable through investor due diligence. The regulation of the private placement process, the setting of wealth and experience standards, and the availability of access to professional intermediaries and advisors serve to facilitate due diligence for hedge fund investors. As discussed in the report of the Investors' Committee formed by the President's Working Group on Financial Markets, many hedge fund investors themselves, as fiduciaries, have a duty to perform proper due diligence and all investors approaching these sophisticated portfolios with real investment and liquidity risks should be attentive to due diligence and accountable for their investment decisions.[76] In fact, most hedge fund investors represent in a signed writing that they have had a chance to review disclosures about the fund and to learn, through inquiry or otherwise, information they require to make the investment decision their subscription represents.

As for the sixth goal of the Company Act, the concentration of many aspects of control in a general partner, manager or managing member is a key feature of hedge funds that cannot be separated from the existence of the asset class. Increasingly, the early or large institutional investors use their leverage to negotiate "key person" provisions and other consent rights that meet their needs, but there is rarely value to investors in assuring the persistence of a hedge fund without involvement of the founding manager.

Finally, with regard to the seventh and eighth stated goals of the Company Act, the capital adequacy and borrowing limits of hedge funds are effectively addressed by market forces. Prime brokers and other credit sources for hedge funds impose requirements on hedge funds as borrowers as a result of extensive federal regulation of the lender's activities. Lawmakers need to assess the failure of these existing regulations and the failure of proper lending limits, collateral valuation and risk management at our highly regulated financial institutions, before they can determine the value of imposing a new set of complex capitalization and borrowing requirements on hedge funds as borrowers.

Regulation Under the Exchange Act

Hedge funds are also subject to substantial regulation under the Exchange Act,[77] to the extent that statute reaches market participants other than broker-dealers. First, there are the general anti-fraud provisions of Section 10(b) and its related rules, including 10b-5, that criminalize a wide variety of deceptive and manipulative conduct in connection with transactions in securities. In addition, hedge funds must comply with the Exchange Act rules governing short sales. This includes obligations to mark orders properly,[78] to arrange locates so as not to create naked shorts,[79] to refrain from shorting into an offering without compliance with certain detailed exceptions,[80] and to report short sales weekly to the SEC.[81] In addition, in April the SEC proposed reinstating a new iteration of the short sale uptick rule.[82] Finally, Exchange Act securities registration requirements apply to widely held hedge funds, that is, any fund that, although not publicly offered, nevertheless comes to have assets over $10 million and a class of equity securities held by 500 or more persons.[83]

Regulation From Other Sources

The preceding discussion focused on regulations arising from the principal federal securities laws. Other laws also regulate hedge fund managers and funds themselves. These include (i) anti-money laundering regulations arising under the Bank Secrecy Act,[84] the USA PATRIOT Act,[85] and related regulations;[86] (ii) financial privacy rules arising under the Gramm Leach Bliley Act,[87] related regulation and, increasingly, state laws; (iii) the Commodity Exchange Act,[88] under which fund managers trading futures or commodities need to register or comply with an exemption from registration; (iv) the Hart Scott Rodino Act,[89] an antitrust law mandating disclosure of certain significant investments; (v) ERISA,[90] as it applies to managers of pension and other tax-exempt assets, imposing in some cases a higher degree of fiduciary duty and highly specific prohibited transaction rules and exemptions; (vi) reporting requirements under various laws governing investments in regulated industries, such as telecommunications and airline carriers; (vii) oversight by the Committee on Foreign Investment in the United States (CFIUS) on investments of offshore investors in US companies affecting national security; (viii) the Internal Revenue Code; and (ix) the local corporate or partnership law governing the formation and operation of the hedge fund as a collective entity.

A Few Words about the Implications of the Madoff Fraud

The enormity, in both size and moral terms, and the publicity surrounding the fraud recently confessed by former securities regulator Bernard Madoff, has left the hedge fund industry resigned to the fact that there can be no avoiding additional future regulation. The industry seems to accept this, notwithstanding that Madoff never purported to be running, and did not run, a hedge fund; the Madoff entities were registered with FINRA and the SEC; these regulators failed to discover the fraud, ignoring red flags and legitimate whistleblowers; and, finally, the SEC also did not uncover any abnormalities via its jurisdiction over many investment advisers that directed significant client assets to Madoff.

Conclusion

Hedge funds and their advisers are not "unregulated" entities. Numerous laws and rules encourage or require complete and accurate disclosure of information material to investors. Inappropriate handling of

conflicts of interest and other conduct that flouts the law or harms investors expose hedge fund managers to real liability to enforcement and recovery, and potentially loss of livelihood. Unlike mutual fund managers, hedge fund managers have a directly negotiated relationship to investors. This proximity and the customary personal investment in their own funds, provide a strong alignment of the fund adviser's interests with those of its fund investors.

That being said, public benefits of investor protection and regulation of systemic risk can be addressed without implementing rules that choke off benefits hedge funds provide in terms of financial innovation, market liquidity, price discovery, and an option for portfolio diversification. Adviser registration for hedge fund managers can provide incremental enhancements to the current status, if it is implemented together with appropriate modernization of Form ADV. Such registration would: standardize adviser disclosure; avoid the holding out prohibitions that impose undesirable "secretiveness;" make explicit the need for a written compliance program, a code of conduct and policies for the handling of material nonpublic information and personal trading; impose the custody rules; and add revocation of registration, *i.e.*, putting the manager out of business, to the remedies available to the SEC.

In addition, creating, as the government has already proposed, a regulated clearing agency for over-the-counter derivatives is a measure beneficial to all market participants in standardizing counterparty risk and making it more transparent. Addressing aspects of the current offering and adviser exemptions that inhibit availability of information about hedge funds would serve regulatory interest in greater transparency. More effective operating procedures inside industry regulators would also help assure that red flags are not overlooked to the detriment of markets and investors. Regulators and lawmakers should assess why extensive regulations of, and data collected from, regulated market participants like banks and broker-dealers did not yield a more timely response to the underlying causes of the current credit crisis before heaping more regulation on a sector that is needed now, more than ever, as a source of market liquidity.[91]

The current Levin Grassley proposal, the Hedge Fund Transparency Act, is the sort of rushed reform lawmakers should seek to avoid. The proposal to require disclosure of investors violates principles reflected in Section 210 of the Advisers Act[92] and consumer privacy provisions of Gramm-Leach-Bliley.[93] It also unfairly singles out the hedge fund industry and would destroy the ability of legitimate funds to attract investors at all.

Lawmakers would do well to recognize that Madoff did not run a hedge fund and the fraudulent practices he is alleged to have followed are not followed by legitimate hedge fund managers. No hedge fund losses, other than losses of those sometime hedge fund dÖppelgangers, the proprietary trading desks at regulated investment banks, have been bailed out by any government troubled asset relief program addressing the current crisis. In fact, government is now recruiting the partnership of the private investment industry to jumpstart new lending and dispose of banks' troubled assets. Hedge funds are valuable participants in our markets, as these new proposals for public/private partnerships confirm. New regulation should be approached with reason and caution. Lawmakers seeking recovery from our current market ailments should avoid imposing a cure so rushed, ill-fitting or severe that it kills one of its most valuable patients.

**Editor's Note: At the time that this article was published, in July 2009, Ms. Poe was a senior partner with Wilmer Cutler Pickering Hale and Dorr LLP.*

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[1] See, *e.g.*, Congressional Research Service Report, "Hedge funds: Should They Be Regulated," by Mark Jickling (Feb. 3, 2009), which begins, "In an echo of the Robber Baron Era, the late 20th century saw the rise of a new elite class, who made their fortunes not in steel, oil, or railroads, but in financial speculation."
[2] 15 U.S.C.§ 80a-3(c)(1) and 3(c)(7) (2004).
[3] 15 U.S.C. § 77d(2) (1980).
[4] Securities Act Release No. 6389, (Mar. 8, 1982) (hereinafter cited as Securities Act Release No. 6389); Securities Act Release No. 6825, (Mar. 14, 1989).
[5] The official title of this Rule is "Regulation D – Rules Governing the Limited Offer and Sales of Securities without Registration under the Securities Act of 1933." (hereinafter cited as Regulation D).
[6] Securities Act Release No. 6389.
[7] 17 C.F.R. §§ 230, 502(c).
[8] Interpretative Release on Regulation D, Securities Act Release No. 6455, (Mar. 3, 1983).
[9] *See* Lamp Technologies, Inc., SEC No-Action Letter, (May 29, 1997) (the SEC agreed to not recommend SEC action if a company posted information on a website concerning the private offerings of private funds if the company limited access to the website exclusively to accredited investors). *See also*, IPONET, SEC No-Action Letter (July 26, 1996).
[10] 17 C.F.R. §§ 230, 503.
[11] Note that the SEC amended Form D in February 6, 2008, with certain amendments becoming effective September 15, 2008, and at various points thereafter, with all amendments effective by March 16, 2009 (the amended Form D will herein be referred to as "Form D"). Securities Act Release No. 8891, (Feb. 6, 2008) (hereinafter cited as Securities Act Release No. 8891). Form D no longer requires information about 10 percent owners. *Id*.
[12] An issuer may decline to respond to this item by choosing "decline to disclose." *Id.*
[13] Item 6 of Form D now requires the issuer to identify the specific paragraph or subparagraph of any Rule 504 exemption being claimed, as well as any specific paragraph of Section 3(c) the Company Act being claimed as an exclusion from the definition of "investment company." *Id.*
[14] *Id.*
[15] In fact, the availability of Form D is specifically exempted as a breach of general solicitation rules. 17 C.F.R. §§ 230, 502(c)(2).
[16] Securities Act Release No. 8891.
[17] *Id*.
[18] *Id*.
[19] 17 C.F.R. §§ 230, 501(a) defines "accredited investor" to mean "any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;

(6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

(7) Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in §230.506(b)(2)(ii); and

(8) Any entity in which all of the equity owners are accredited investors."

[20] 17 C.F.R. §§ 230, 506(b)(2).

[21] The information that must be provided to a non-accredited investor, "to the extent material to an understanding of the issuer, its business and the securities being offered," includes the same kind of information as required in Part I of a registration statement under the Securities Act on a form which the issuer would be entitled to use.

[22] Commenters to Rule 502, as originally proposed, made a similar observation. The SEC had proposed that, where 60 percent or more of the total offering was purchased by certain institutional accredited investors, an issuer was not required to furnish disclosure documents unless specifically asked by an investor that was not accredited. Commenters noted that issuers were unlikely to avail themselves of this proposed safe harbor because of the difficulty of knowing, *ab initio*, whether the accredited institutions would constitute at least 60 percent of investors. *See*, Securities Act Release No. 6389 (March 8, 1982).

[23] Regulation D Preliminary Note 1.

[24] Regulation D, Preliminary Note 6.

[25] This definition, in pertinent part, provides that an "investment adviser" means any person who, for compensation, engages in the business of advising others, … as to the value of securities or as to the advisability of investing in, purchasing, or selling securities…" 15 U.S.C. § 80b-2(11) (2006).

[26] Managers of funds registered under the Company Act are required to register as advisers under the Advisers Act. Few hedge funds are registered under the Company Act, but many hedge funds of funds are and, accordingly, their managers must be registered advisers.

[27] Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 29 U.S.C.). By meeting the relevant qualifications, QPAMs have the benefit of more flexible provisions of prohibited transaction and prohibited transaction exemption rules under ERISA.

[28] 15 U.S.C. § 80b-3 (2006).

[29] 15 U.S.C. § 80b-3 (2006).

[30] *See* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

[31] *See* Resource Bank and Trust, SEC No-Action Letter, (Mar. 29, 1991); George J. Dippold, SEC No-Action Letter, (May 7, 1990); Richard W. Blanz, SEC No-Action Letter, (Jan. 28, 1985); Dale M. Mueller, SEC No-Action Letter, (Feb. 20, 1984); Peter H. Jacobs, SEC No-Action Letter, (Feb. 7, 1979).

[32] Fund managers are also strictly prohibited from using publicly available electronic media, such as the World Wide Web, to provide information about their services unless such information is directed towards accredited investors within the meaning of Regulation D. *See* Lamp Technologies, Inc.,*supra* note 9; Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940, Investment Advisers Act Release No. 1562, 61 SEC Docket 2167 (May 9, 1996).

[33] 17 C.F.R. § 275.203(b)(3)-1(c) (2006).

[34] 15 U.S.C. § 80b-3(e) (2006).

[35] *Id.*

[36] 15 U.S.C. § 80b-3(e)(5) (2006).

[37] *See* In re Sandell Asset Management Corp et al., Investment Advisers Act Release No. 2670, 91 SEC Docket 2147 (Oct. 10, 2007); In re Fanam Capital Management et al., Investment Advisers Act Release No. 2316, 84 SEC Docket 228 (Oct. 29, 2004); In re Robert T. Littell, et al., Investment Advisers Act Release No. 2203, 81 SEC Docket 2771 (Dec. 15, 2003).

[38] 15 U.S.C. § 80b-3(e)(6) (2006).

[39] It is interesting to note that this scope is broader than the scope of the compliance program rule for registered advisers. Rule 206(4)-7 requires registered advisers to implement a written compliance program reasonably designed to prevent violation of only the Advisers Act and its rules.

[40] 15 U.S.C. § 80b-3(f) (2006).

[41] S. REP. NO. 86-1760, at 7 (1960).

[42] 15 U.S.C. § 80b-6 (2006).

[43] SEC v. Capital Gains Research Bureau, Inc., 84 S. Ct. 275 (1963); In re Michael L. Smirlock, Investment Advisers Act Release No. 1393 n.4 (Nov. 29, 1993); In re Kingsley, Jennison, McNulty & Morse, Inc., et. al., Investment Advisers Act Release No. 1396 (Dec. 23, 1993); *See also*, SEC v. Steadman, 967 F.2d 636, at 647 (D.C. Cir. 1992); Investment Advisers Act Release No. 2628 n. 38 (Aug. 3, 2007).

[44] *See* SEC v. Blavin, 760 F.2d 706 (6th Cir. 1985).

[45] *See* SEC v. James G. Marquez, Litigation Release No. 20595, 93 SEC Docket 815 (May 22, 2008); In re Alexander James Trabulse, Investment Advisers Act Release No. 2728, 93 SEC Docket 389 (Apr. 28, 2008); In re Robert C. Sears, Investment Advisers Act Release No. 2099, 79 SEC Docket 1006 (Jan 13, 2003); Litigation Release No. 17825, (Nov. 1, 2002).
[46] *See* In the Matter of Medcap Management & Research LLC and Charles Frederick Toney, Jr., Investment Advisers Act Release No. 2802 (Oct. 16, 2008).
[47] *See* In re Anthony W. Blissett, Investment Advisers Act Release No. 2139, 80 SEC Docket 1572 (Jun. 26, 2003).
[48] *See* SEC v. Capital Gains research Bureau Inc., 375 U.S. 180, 84 S.Ct. 275, 11 L. Ed. 2d 237 (1963); In re Kingsley.
[49] *See, e.g.,* In re John McStay Investment Counsel L.P., Investment Advisers Act Release No. 2153, 80 SEC Docket 2265 (July 31, 2003).
[50] *See* In re Van Kampen American Capital Mgmt., Inc., Investment Advisers Act Release No. 1525, 60 SEC Docket 1045 (Sept. 29, 1995).
[51] *See* In re Scudder Kemper Investments, Inc., et al., Investment Advisers Act Release No. 1848, 71 SEC Docket 828 (Dec. 22, 1999).
[52] *See* In re Stephen H. Brown, Investment Advisers Act Release No. 1751, 68 SEC Docket 3 (Sept. 14, 1998).
[53] *See* In re Gerson Asset Management Inc. and Seth Gerson, Investment Advisers Act Release No. 2457 (Dec. 2, 2005).
[54] *See, e.g.,* In re Dawson Samberg Capital Management et al., Investment Advisers Act Release No. 1889, 72 SEC Docket 2473 (Aug. 3, 2000).
[55] *See, e.g.,* SEC v. Thomas E. Loyd, et al., Litigation Release No. 16,495, 72 SEC Docket 367 (Mar. 31 2003).
[56] *See* In re Fleet Investment Advisors, Inc. Investment Advisers Act Release No. 1821, 70 SEC Docket 1217 (Sept. 8, 1999).
[57] *See* In re Portfolio Advisory Services, LLC, Investment Advisers Act Release No. 2038, 77 SEC Docket 2759 (June 27, 1996).
[58] *See* Goldstein, *supra* note 30.
[59] *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628, 91 SEC. Docket 938 (Aug. 3, 2007).
[60] *Id*.
[61] *Id*.
[62] *Id*.
[63] *See In re* Daniel N. Jones, Investment Advisers Act Release No. 2795, (Sept. 30, 2008); SEC v. Robert L. Carver et al, Litigation Release No. 20614, (June 11, 2008).
[64] SEC v. Plus Money, Inc. and Matthew La Madrid et. al., Litigation Release No. 20587, (May 19, 2008).
[65] With limited exception, this consent is required to be obtained prior to the completion (settlement) of each transaction for principal trades, but the SEC has provided that advisers generally may obtain prospective blanket consent for agency cross trades. 17 C.F.R. § 275.206(3)-2 (2007).
[66] *See* Gardner Russo & Gardner, SEC No-Action Letter, (June 7, 2006); Interpretation of Section 206(3) of the Advisers Act, Investment Advisers Act Release No. 1732, 67 SEC Docket 1344 (July 17, 1998). We note that hedge funds do not often engage in agency cross trading because they usually do not act as brokers with respect to fund trades. Hedge funds more frequently encounter cross trades between funds without compensation, which, while not subject to Section 206(3), are subject to disclosure and fairness principles implicit in Section 206 generally. *See* In re Michael L. Smirlock, *supra* note 42.
[67] 15 U.S.C.§ 80a-3(c)(1) and 3(c)(7) (2004).
[68] Asset Managers' Committee: Best Practices for the Hedge Fund Industry: Report of the Asset Managers' Committee to the President's Working Group on Financial Markets (2009).
[69] 15 U.S.C.§ 80a-3(c)(1) (2004).
[70] 15 U.S.C.§ 80a-3(c)(1)(A) (2004) and 17 C.F.R. § 270.3c-5.
[71] 15 U.S.C.§ 80a-3(c)(7) (2004).
[72] 15 U.S.C.§ 80a-2(a)(51) (2006).
[73] Investment Company Act Release No. 22597, (Apr. 3, 1997).
[74] *See* Hedge Fund Transparency Act, S. 344, 111th Cong. (2009).
[75] If the hedge fund adviser is registered under the Advisers Act, the SEC can also revoke that registration.
[76] Investors' Committee: Principles and Best Practices for Hedge Fund Investors: Report of the Investors' Committee to the President's Working Group on Financial Markets (2009). See also, "A Few Comments About The Implications of the Madoff Fraud" below.
[77] 15 U.S.C. §§ 78a-78oo (2004).
[78] Regulation SHO, 17 C.F.R. 242.200 (2007); 17 C.F.R. 242.10b-21 (2008).

[79] *See*, 17 C.F.R 242.203(b) (2008). Under this rule, this obligation to arrange locates is imposed on the executing broker. However the executing broker can rely on its customer's assurance so in practice the duty to have a locate can be passed on to the hedge fund contractually.
[80] 17 C.F.R. 242.105 (2007).
[81] 17 C.F.R. 240.10a-3T (2008); *See also*, Securities and Exchange Act Release 34-58591 (Sept. 18, 2008) (requiring institutional investment managers to report short sales activities on Form SH); Securities and Exchange Act Release No. 34-58591A (Sept. 21, 2008) (clarifying certain technical issues and the public availability of the information provided on Form SH); Securities and Exchange Act Release No. 34-58724 (Oct. 2, 2008) (extending Form SH filing requirement through October 17, 2008 and stating that the Forms SH would remain nonpublic to the extent permitted by law); Securities and Exchange Act Release No. 34-58785 (Oct. 15, 2008) (adopting interim final rule 10a-3T requiring institutional investment managers to file Form SH through August 1, 2009).
[82] Amendments to Regulation SHO, Securities and Exchange Act Release No. 34-59748 (Apr. 8, 2009) (to be codified at 17 C.F.R. pt. 242).
[83] 15 U.S.C. 78l(g)(1) (2002).
[84] 31 U.S.C §§ 5311-5330 (2001).
[85] Pub. L. No. 89-110, 115 Stat. 272 (2001).
[86] *See, e.g,.* 31 U.S.C. § 5318A (2006).
[87] 15 U.S.C. § 6801 (2000).
[88] 7 U.S.C. §§ 1- 4a, -5-27f (2008).
[89] 15 U.S.C. § 18a (2000).
[90] Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 29 U.S.C.).
[91] *See e.g.* "Secretary Geithner Introduces Financial Stability Plan," Timothy Geithner, Secretary, U.S. Dept. of Treas., Remarks Introducing the Financial Stability Plan, (Feb. 10, 2009) (discussing the establishment of a Public-Private Investment Fund to provide government financing to help leverage private capital provided by private asset managers (including hedge fund managers) to increase liquidity in credit markets); Press Release, Board of Governors of the Federal Reserve System, (Nov. 25, 2008) (announcing the creation of the Term Asset-Backed Securities Loan Facility (TALF), a facility that aims to improve liquidity in credit markets by providing low-cost financing to private market participants (such as hedge funds) to encourage such participants to purchase asset-backed securities).
[92] 15 U.S.C. § 80b-10 (1990).
[93] 15 U.S.C. § 6801 (2000).