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Pruning the Hedge: Who is a "Client" and Whom Does an Adviser Advice?

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The Author holds a Corporate, Banking and Finance LLM degree from Fordham University School of Law; J.D., Cleveland-Marshall College of Law; and a B.A., The College of Wooster. The Author thanks Fordham University Adjunct Professors John F.X. Peloso and Barry W. Rashkover for their kind guidance and sage observations. The foregoing opinions, conclusions, and perhaps errors, are solely those of the Author, who can be contacted at mail@edpekarek.com.

COMMENT

PRUNING THE HEDGE: WHO IS A "CLIENT" AND WHOM DOES AN ADVISER ADVISE?

Edward Pekarek[*]

I. INTRODUCTION

Phillip Goldstein, government gadfly and a former New York City municipal employee,[1] is now manager of a group of pooled investments that operates under the moniker "Bulldog Investors."[2] Mr. Goldstein[3] took the Securities and Exchange Commission to task in a successful challenge[4] of the so-called "Hedge-Fund Rule."[5] The U.S. Court of Appeals for the District of Columbia Circuit was apparently persuaded

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1. *See* Jay Loomis, *Activist Investing on the Rise*, THE J. NEWS, Feb. 18, 2007, *available at* http://www.thejournalnews.com/apps/pbcs.dll/article?AID=/20070218/BUSINESS01/702180320/1066 (last visited Mar. 26, 2007) ("[Phillip Goldstein] previously worked 25 years as a civil engineer for New York City.").

2. *See generally* http://www.bulldoginvestors.com/.

3. *See*, *e.g.*, *infra* note 80.

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

5. The respondent SEC apparently took umbrage with the Goldstein petitioners' use of this phrase because it created some confusion that the Rule itself governed hedge funds, when in fact it acted as an oversight measure for investment advisers, rather than the funds under management. *See* Goldstein v. SEC, 2005 WL 1636146, at *5 n.1 (D.C. Cir. 2005) [hereinafter SEC's Appell. Brief] ("[P]etitioners' pervasive references to the 'Hedge Fund Rule' create a misleading impression."). Despite these comments by the SEC in brief, the Goldstein court adopted the phrase coined by the petitioners and used it throughout its opinion, including in its ruling statement. *Goldstein*, 451 F.3d at 884, 877, 880-81, 883-84 ("The petition for review is granted, and the *Hedge Fund Rule* is vacated and remanded.") (emphasis added).

by the "Bulldog's" theory, and vacated the entire investment adviser registration regime as "arbitrary."[6] The court of appeals largely based this decision upon the contextual meaning of the word "client,"[7] and the prior use and interpretation of that term by the SEC.[8]

The "Bulldog's" challenge of the investment adviser registration framework may prove to be among a handful of events responsible for the introduction of the phrase "hedge fund" into mainstream[9] America's lexicon and perhaps our collective culture.[10] The resolution of the *Goldstein* matter now appears to be a temporary regulatory setback that might later be viewed as an instance of regulatory "creative destruction" that leads to meaningful regulatory reform.[11] Perhaps the "Bulldog" chewing up the investment adviser registration regime also ushered in a new era of how we perceive these pooled investments and their respective roles in domestic capital markets, how they might be monitored by market regulators in the U.S. and abroad, and the substantive debate it fostered may later be recognized as the catalyst for a pragmatic regulatory reform of the hedge fund landscape.

II. "BULLDOG" CHALLENGES SEC "CLIENT" COUNTING

During its review of the so-called "Hedge Fund Rule" (the "Rule")[12] in the matter of *Goldstein v. SEC*,[13] the U.S. Circuit Court of

6. *Goldstein*, 451 F.3d at 883.

7. *Goldstein*, 451 F.3d at 876 (citing 17 C.F.R. § 275.203(b)(3)-1 ("[T]he Commission has interpreted this provision to refer to the partnership or entity itself as the adviser's 'client.'")).

8. *See* Part II, *infra*.

9. Even one of the most mainstream Internet sources, *Wikipedia*, now has a lengthy entry for "hedge funds." *See*, *e.g.*, http://en.wikipedia.org/wiki/Hedge_fund (last visited Apr. 4, 2007).

10. The creator and executive producer of the HBO series "Entourage," Doug Ellin, is currently developing an untitled HBO comedy series based on the fictitious lives of hedge fund managers. *See* Denise Martin, *Boys' night out at HBO, Ellin's next comedy series set on Wall Street*, VARIETY, Oct. 10, 2006, *available at* http://www.variety.com/article/VR1117951668.html?cs=1&s=h&p=0 (last visited April 24, 2007); *see also* Andrew Ross Sorkin, *Wall Street TV*, N.Y. TIMES DEALBOOK, *available at* http://dealbook.blogs.nytimes.com/2006/10/18/wall-street-tv/ (last visited April 24, 2007).

11. Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, pp. 82-85 (Harper, 1975) [orig. pub. 1942].

12. *See* SEC's Appell. Brief, 2005 WL 1636146, at *5.

13. 451 F.3d 873 (D.C. Cir. 2006).

Appeals for the District of Columbia addressed some of the key issues in the interpretive debate of the definition of the word "client" within the context of the Investment Advisers Act of 1940 (the "Advisers Act").[14] This Comment addresses some of those issues, including: (i) the current state of the hedge fund market sector, (ii) background related to the adoption of the Rule, (iii) the key challenges asserted by the *Goldstein* petitioners, (iv) interpretation of the term "client" as it relates to the "private fund adviser" exemption within the Advisers Act, and (v) the factual bases cited by the Respondent Securities and Exchange Commission (the "SEC" or the "Commission") in support of the Commission's promulgation of the Rule, and the resultant challenges raised by the *Goldstein* petitioners to those seemingly sound bases. The "Bulldog" prevailed in his challenge of the Rule due in no small part to the SEC's inconsistent interpretations of the term "client" over the years in various contexts.

A. Is the Hedge Fund Sector an Overgrown Landscape?

The term "hedge fund" has defied precise definition, and what started as a rather simple concept of pooling investment funds and utilizing strategies to insulate the pooled capital from significant market risk has evolved greatly in a half century. Sociologist turned–journalist–turned fund manager Alfred Winslow Jones[15] coined the phrase "hedge fund" in 1949,[16] less than a generation after the epic crash of the U.S.

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

15. David A. Vaughan, Partner, Dechert LLP, Comments for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds, May 14-15, 2003, *Selected Definitions of "Hedge Fund"* (citing Roger Lowenstein, *When Genius Failed* (2000)); Scott J. Lederman, *Hedge Funds*, FIN. PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS 11-3, 11-4, 11-5 (Clifford E. Kirsch Ed., 2000); Carol Loomis, *The Jones Nobody Keeps Up With*, FORTUNE (Apr. 1966), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm (last visited Feb. 25, 2007); s*ee also* Ted Gogoll, *What's Driving the Hedge Fund Boom?*, BUSINESSWEEK.COM, Oct. 13, 2006, *available at* http://www.businessweek.com/investor/content/oct2006/pi20061013_353103.htm (last visited Dec. 2, 2006); *see* Goldstein v. SEC, No. 1:04CV02216, 2004 WL 3633837 (D.C. Cir. 2004) [hereinafter Goldstein Complaint].

16. Stephen J. Brown, Keynote Address at the PACAP/FMA Meeting, Melbourne, Australia, July 7, 2000, *Hedge Funds: Omniscient or Just Plain Wrong*, NYU Stern School of Business (Mar. 9, 2001), *available at* http://pages.stern.nyu.edu/~sbrown/omniscient.pdf (last visited Dec. 1, 2006).

stock market—the financial event widely considered to be the economic "tipping point" that ushered in the "Great Depression."[17] Jones's term originally contemplated pooled investment portfolios[18] composed of a combination of long and short equity positions,[19] where the short sells presumably counter-balance long positions allowing for capital growth opportunities while insuring, or "hedging," against any significant risk of loss, irrespective of the market's direction.[20]

Today, Mr. Jones's coined phrase better describes the legal management structures[21] of investment pools[22] rather than the

17. Stanley K. Schultz, Professor of History, *American History 102: Civil War to the Present*, Lecture 18 at the Univ. of Wis. (1999), *available at* http://us.history.wisc.edu/hist102/lectures/lecture18.html (last visited Nov. 29, 2006). In the fall of 1929, Yale University economist Irving Fisher confidently declared: "The nation is marching along a permanently high plateau of prosperity." Federal Reserve Bank of Dallas, *Irving Fisher: Origins of Modern Central Bank Policy*, ECON. INSIGHTS, Vol. 10, No. 1 (Dec. 6, 2006), *available at* http://www.dallasfed.org/research/ei/ei0501.html (last visited Dec. 2, 2006). Five days later (Oct. 29, 1929), on "Black Tuesday," the U.S. stock market's bottom dropped out and ushered in the Great Depression—the worst economic downturn in American history. *Id*. Mr. Fisher suffered huge losses in his personal portfolio (as well as in his reputation as an economist) after the 1929 crash and Great Depression, "eventually leaving an estate so small it wasn't even taxed." *Id.*

18. During the mid-twentieth-century, pooled investment funds largely functioned at the fringes of the market. Vaughan, *supra* note 15.

19. *Id*; *see* Brown, *supra* note 16.

20. *See* Brown, *supra* note 16; Goldstein Complaint, *supra* note 15, at ¶ 17.

21. Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (citing 15 U.S.C. §§ 80a-10, 80a-13); The *Goldstein* court recognized that:

> Another distinctive feature of hedge funds is their management structure. Unlike mutual funds, which must comply with detailed requirements for independent boards of directors, and whose shareholders must explicitly approve of certain actions, domestic hedge funds are usually structured as limited partnerships to achieve maximum separation of ownership and management. In the typical arrangement, the general partner manages the fund (or several funds) for a fixed fee and a percentage of the gross profits from the fund. The limited partners are passive investors and generally take no part in management activities.

Id. at 876 (internal citations omitted).

22. David Pilla, *With Amaranth's Implosion, Experts Eye Insurers' Exposure to Hedge Fund Risks*, BEST'S INV. NEWS (via Comtex News), Oct. 2, 2006. Hedge fund structure has been a "tricky aspect" according to at least one legal pundit:

> One tricky aspect of hedge funds is that they generally are structured as limited partnerships, said [Nixon Peabody LLP investment partnership litigation specialist Tim] Mungovan. An investor in a hedge fund is a limited partner – a very different arrangement from the shareholder in a mutual fund or stock. "There are 75 years worth of accumulated corporate law on the duties that a company's directors and

investment strategies employed. Today's hedge funds typically issue unregistered securities in "private offerings," which, in general, are privately held by a restricted number of "accredited" investors,[23] and which experienced record capital inflows of roughly $126.5 billon in 2006.[24] These pooled funds are typically either single or multiple strategy vehicles[25] that employ an array of investment approaches

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> officers owe to their shareholders," he said. "There is not anywhere near the history of laws and court cases involving limited partnerships." That means there is greater uncertainty about the rights, duties and obligations surrounding the limited partnership, he said.
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> . . .
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> So why are most hedge funds structured as limited partnerships? "My personal opinion is that many of them have adopted the limited-partnership structure in part to avoid regulation by the U.S. Securities and Exchange Commission," said Mungovan . . . . The limited-partnership structure of hedge funds, along with their penchant for secrecy in terms of trading positions, means they shy away from such terms as "investment adviser," said Mattessich. Investment advisers generally are taken to be under the regulatory jurisdiction of the SEC.

Id.

23. *Securities and Exchange Commission Staff Hedge Fund Report Fact Sheet, Implications of the Growth of Hedge Funds*, REPORT OF THE STAFF OF THE U.S. SECURITIES AND EXCHANGE COMISSION [sic], at 9-10, 61 (Sept. 2003) [hereinafter 2003 SEC Staff Report], *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf (last visited Dec. 1, 2006). The term "accredited investor" was defined in 2006 to include:

> Individuals who have a net worth, or joint worth with their spouse, above $1,000,000, or have income above $200,000 in the last two years (or joint income with their spouse above $300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and
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> Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than $5,000,000 in assets; and many, if not most, employee benefit plans and trusts with more than $5,000,000 in assets.

Id. at 15 (citing Rule 501(a) of Regulation D under The Securities Act of 1933).

24. *See* Aaron Seigel, *Hedge Funds Rake in $126.5 billion*, INV. NEWS, Jan. 17, 2007, *available at* http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070119/REG/70119027/0/FRONTPAGE (last visited Jan. 20, 2007) ("Hedge fund inflows for the quarter ended Dec. 31[, 2006] were $15.8 billion in a year that brought in a record $126.5 billion of hedge fund inflows, according to data released by Hedge Fund Research Inc. in Chicago."); SEC, *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, *available at* http://www.sec.gov/answers/hedge.htm (last visited Nov 30, 2006).

25. *See, e.g.*, *Rolling In It, Why Investors Should Kick Up a Fuss About Hedge-Fund Fees*, THE ECONOMIST, Nov. 16, 2006, *available at*

ostensibly designed to generate above-market returns, including the hedge fund adviser's quest for the premium compensation known in the industry as "alpha."[26]

The investment strategies utilized by hedge funds today are as diverse as the assets classes they hold. Roughly nine-thousand hedge funds[27] are currently in operation and control approximately two trillion dollars,[28] reportedly five-percent of America's total net worth.[29] The

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http://www.economist.com/finance/displaystory.cfm?story_id=8173853 (last visited Feb. 18, 2007). The strategies vary among hedge-funds, but:

> Hedge-fund managers are well aware of the limits of specializing [sic] in niche products. Some simply close to new investors after reaching their target for funds under management. But others want to keep growing. A number develop private-equity or banking characteristics, by providing capital directly to companies or making loans. Some are diversifying into multi-strategy funds, which invest across a range of sectors. Others have started long-only funds, thereby opening up a much bigger market. As Peter Harrison of MPC investors, a fund manager, says: "There's $1 trillion or so in hedge funds but $90 trillion of long-only money and that's the big prize."

Id.

26. *See* Hedgeworld.com Glossary, *available at* http://www.hedgeworld.com /bottom_links/index.cgi?page=glossary (last visited Mar. 26, 2007) ("Alpha: A numerical value indicating a manager's risk-adjusted excess rate of return relative to a benchmark. Measures a manager's 'value-added' in selecting individual securities, independent of the effect of overall market movements."); Raghuram G. Rajan, *Benign Financial Conditions, Asset Management, and Political Risks: Trying to Make Sense of our Times*, Oct 5-6, 2006, Speech at Conference on International Financial Instability: Cross-Border Banking and National Regulation Organized by the Federal Reserve Bank of Chicago, *available at* http://www.imf.org/external/np/speeches /2006/100506.htm (last visited Mar. 26, 2007). *But see* Steve Johnson, *Replication is the New Buzzword*, FIN. TIMES, Nov. 20, 2006, *available at* 2006 WLNR 20138222 (last visited Dec. 1, 2006); *see also*, Jeff Benjamin, *Hedge funds embracing social mandate*, INVESTMENT NEWS, June 25, 2007, *available at* http://www.investmentnews.com/apps/pbcs.dll /article?AID=/20070625 (last visited June 26, 2007). Mr. Goldstein noting that the creation of "alpha" is a hedge fund's *raison d'etre*, and adding a hint of what seems to suggest some sort of Machiavellian investing philosphy:

> "The function of a hedge fund is to create alpha, and *anything that gets in the way of that is unwanted*," said Phillip Goldstein, a manager of Opportunity Partners LP, a hedge fund based in Pleasantville, N.Y. "It sounds like a marketing gimmick, and I don't know that any individuals would invest in something like that."

Id. (emphasis added).

27. *See Rolling In It*, *supra* note 25.

28. *See* Gogoll, *supra* note 15; *see also* Angela Ubide, *Demystifying Hedge Funds*, FINANCE & DEVELOPMENT (IMF Q. MAGAZINE), Vol. 43, No. 2, June 2006, *available at* http://www.imf.org/external/pubs/ft/fandd/2006/06/basics.htm (last visited Mar. 26,

breadth of alternative asset classes held and strategy types employed by investment advisers are incredibly diverse.[30] Hedge funds have also

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2007). The International Monetary Fund (the "IMF") reported:

> Currently, there are about 8,500 hedge funds operating worldwide, managing over $1 trillion in assets. Quite a leap from the 2,800 hedge funds, managing $2.8 billion in assets in 1995, not to mention the amounts involved in the earliest hedge fund–type investments in the days of Aristotle.

Id.

29. *Power and Money – Rally for Regulation*, Interview by Maria Bartiromo with Attorney Paul Roth, Columbia Law Prof. Jack Coffee, and CNBC correspondent Charlie Gasparino (CNBC television Broadcast Dec. 5, 2006).

30. *See*, *e.g*., Goldstein v. SEC, 451 F.3d 873, 875-76 (D.C. Cir. 2006) (citing The Investment Company Act of 1940, 15 U.S.C. §§ 80a-12(a)(1),(3), 80a-13(a)(2), 2003 SEC Staff Report, *supra* note 23, at 33-43). The restrictions on investment classes and transaction types that apply to "Investment Companies" (*i.e.*, mutual funds) do not apply to unregulated hedge funds:

> The Investment Company Act places significant restrictions on the types of transactions registered investment companies may undertake. Such companies are, for example, foreclosed from trading on margin or engaging in short sales and must secure shareholder approval to take on significant debt or invest in certain types of assets, such as real estate or commodities. These transactions are all core elements of most hedge funds' trading strategies.

Id. (internal citations omitted); *see Goldstein*, 453 F.3d at 876 (citing 2003 SEC Staff Report, *supra* note 23):

> "Hedging" transactions, from which the term "hedge fund" developed, involve taking both long and short positions on debt and equity securities to reduce risk. This is still the most frequently used hedge fund strategy, though there are many others. Hedge funds trade in all sorts of assets, from traditional stocks, bonds, and currencies to more exotic financial derivatives and even non-financial assets. Hedge funds often use leverage to increase their returns.
>
> Another distinctive feature of hedge funds is their management structure. Unlike mutual funds, which must comply with detailed requirements for independent boards of directors, 15 U.S.C. § 80a-10, and whose shareholders must explicitly approve of certain actions, *Id.* § 80a-13, domestic hedge funds are usually structured as limited partnerships to achieve maximum separation of ownership and management. In the typical arrangement, the general partner manages the fund (or several funds) for a fixed fee and a percentage of the gross profits from the fund. The limited partners are passive investors and generally take no part in management activities.

Id. (internal citations omitted); *see also* Emil W. Henry, Jr., Assistant Secretary for Financial Institutions, U.S. Dep't of Treasury, Remarks Before the Exchequer Club, May 17, 2006, JS-4270, *available at* http://www.treas.gov/press/releases/js4270.htm (last visited Dec. 1, 2006). Investment advisers have almost unlimited investment options available:

> For example, many like me believe hedge funds are not properly classified when labeled an "asset class." Hedge funds are not an asset class. There is just too much dispersion of strategy, leverage, and exposure to codify the group as such.
>
> A hedge fund, by contrast, has virtually unlimited flexibility. All strategies are on the table—long positions, short selling, leveraged holdings, equities, bonds, currencies,

grown recently at an almost viral-like rate,[31] both in the number of active funds,[32] and in terms of the staggering amount of assets currently under management. Hedge fund securities trading dominates the daily volume of many of the world's markets,[33] and a significant portion of recent SEC enforcement attention has been dedicated to alleged trading abuses by these funds.[34] In many respects, however, the domestic mutual fund industry still dwarfs the hedge fund sector and demands much of the SEC's already overextended attention; yet some market

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> derivatives, multiple industries, *et cetera*. All of these approaches are available and widely utilized by the hedge fund community. Because capital tends to gravitate to where it is least encumbered and restricted, and hence earns the highest risk-adjusted return, it is not surprising that capital migrated from traditional funds to hedge funds. Of course, like most things in life, one thing's greatest strength can be its greatest weakness. The great flexibility of the hedge fund structure also lends itself to conduct that can lead to trouble, the most common being outsized risk-taking, concentrated positions, and over-leveraging.

Id.; *see* Ubide, *supra* note 28.

> Hedge funds may have an aura of exoticism and modernism, but their goals are as old as the art of investing itself. They seek a positive annual return (the higher the better), limited swings in value, and, above all else, capital preservation. They do so by using the best of what modern financial science can provide—rapid price discovery; massive mathematical and statistical processing; risk measurement and control techniques; and leverage and active trading in corporate equities, bonds, foreign exchange, futures, options, swaps, forwards, and other derivatives.

Id.; *see* CNBC report, *Power and Money*, CNBC Correspondent Melissa Lee reported from the Alternative Asset Management Conference, Dana Point, Calif., Dec. 5, 2006. Hedge funds are now reportedly taking direct positions in such diverse alternative assets as infrastructure projects (*e.g.*, bridges, toll roads, and oil-gas delivery pipelines, timber properties, and Napa Valley vineyards). *Id.*

31. *See* Gogoll, *supra* note 15 (Hedge funds are expected to balloon to 11,700 with $1.7 trillion in assets by 2008, according to Van Hedge Fund Advisors).

32. *Id.*; *see also* Ubide, *supra* note 28.

33. Heather Timmons, *A London Hedge Fund That Opts for Engineers, Not M.B.A.'s*, N.Y. TIMES, Aug. 18, 2006, *available at* http://www.nytimes.com /2006/08/18/business/worldbusiness/18man.html? ex=1313553600&en=b2 fee1b41c85 af15&ei=5088 (last visited Mar. 26, 2007) (stating that hedge funds account for an "estimated half of all United States stock trades and a quarter of worldwide currency trades").

34. Jesse Westbrook & Otis Bilodeau, *U.S. Insider Trading Bill Takes Aim at Hedge Funds*, INT'L HERALD TRIB., Nov. 23, 2006, *available at* www.iht.com/articles/2006/11/23/business/hedge.php (last visited Apr. 13, 2007) ("Lawsuits involving hedge funds made up 11 percent of the SEC's insider trading cases in fiscal 2006, according to agency figures. The SEC expects to file more cases against the industry alleging illegal trading in 2007, the commission's enforcement director, Linda Thomsen, said at a securities conference last week.").

commentators remain concerned that another market meltdown is imminent and see hedge funds as its likely catalyst.[35]

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35. Ambrose Evan-Pritchard, *Economic Storm Brewing In America*, LONDON TELEGRAPH, Dec. 7, 2006, *available at* http://www.telegraph.co.uk/opinion/main.jhtml?xml=/opinion/2006/12/07/do0702.xml&sS (last visited Feb. 18, 2007). U.S. Treasury Secretary (and former Goldman-Sachs chief), Henry "Hank" Paulson publicly expressed some concern about the degree of economic influence that hedge funds represent, and their potential for systemic damage:

> The world economy is what matters, and I don't like the smell of it. Nor, apparently, does Hank Paulson, who made $700 million at Goldman Sachs before taking over the U.S. Treasury this year. He has reactivated a crisis team with a command centre [sic] in Washington to cope with the "systemic risk" in a market melt-down. His worry? 8,000 unregulated hedge funds with $1.3 trillion at hand, and derivative contracts now worth $370 trillion. "We need to be very careful here," he said. A well-sourced article in Washington's Weekly Standard says Mr. Paulson fears a "serious crisis that would be a body-blow to the US economy."

Id; see SEC Commissioner Paul S. Atkins, Remarks Before the N.Y. City Bar Assoc. (May 5, 2006), *available at* http://www.sec.gov/news/speech/2006/spch050506psa.htm (last visited Dec. 2, 2006) [hereinafter Speech]. Commissioner Atkins has noted the "opportunity costs" the SEC encounters with hedge fund regulation:

> One of the issues that Commissioner Glassman and I raised when we dissented from the hedge fund rule was the opportunity cost to the Commission, which will result from diverting resources from overseeing mutual funds to overseeing hedge fund advisors. After all***, there are more than 90 million mutual fund investors, compared to an estimated 100,000 to 200,000 hedge fund investors*** . . . .

Id. (emphasis added); *see* Government Accountability Office, Report to Congressional Requesters, Mutual Fund Industry: SEC's Revised Examination Approach Offers Potential Benefits, but Significant Oversight Challenges Remain, Report No. 05-415, Aug. 2005, *available at* http://www.gao.gov/new.items/d05415.pdf, at 35 (citing hedge fund oversight challenges in the SEC's mutual fund examination program and questioned the "SEC's capacity to effectively monitor the hedge fund industry given the tradeoffs that the agency has had to make in overseeing the mutual fund industry."); *Goldstein*, 451 F.3d at 875 (stating that hedge funds "have historically been understood not to present the same dangers to public markets as more widely available investment companies, like mutual funds"); CNBC report, Nov. 29, 2006 (stating that mutual fund assets rose to $10.01 trillion in October 2006, and hedge fund assets rose to $2 trillion in the same month, according to Investment Company Institute ("ICI") and HFM Week data (respectively)); Melanie Waddell, *Will the SEC Appeal? Dealing with hedge fund registration's legal challenge*, INVESTMENTADVISOR, Aug. 2006, *available at* http://www.investmentadvisor.com/article.php?topic=Alternative+Investments&article=6648 (last visited Dec. 5, 2006) ("During a conversation with Lori Richards, director of the SEC's Office of Compliance Inspections and Examinations (OCIE), earlier this year, she admitted that the SEC's exam staff is overextended.").

B. The Former Registration Regime's Virtually Presumptive Exemption

Absent an exemption, an investment adviser was generally required to register with the SEC.[36] The proposal of the revised and so-called "Hedge Fund Rule"[37] signaled the threat of a sweeping departure from the former hedge investment adviser regulatory regime. Section 203(b)(3) of the Advisers Act formerly excluded hedge fund investment advisers from registration requirements (among other regulatory requirements), provided only that direct investment advice was given to less than fifteen "clients," a figure that was formerly tabulated by the number of private fund entities directly advised.[38] For purposes of determining an adviser exemption, a rolling prior twelve month client counting method was used.[39] Many hedge fund investment advisers had

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36. *See generally* § 203(b)(3) of Advisers Act 15 U.S.C. § 80b-3(b)(3) [hereinafter Registration of Investment Advisers]; *see* 15 U.S.C. § 80b-3a which states that:

> No investment adviser that is regulated or required to be regulated as an investment adviser in the State in which it maintains its principal office and place of business shall register under section 80b-3 of this title, unless the investment adviser-
>
> (A) has assets under management of not less than $25,000,000, or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this subchapter;

15 U.S.C. § 80b-3a(a)(1)(A); 17 C.F.R. § 275-203A-1 [Eligibility for SEC Registration]; 17 CFR 275.203A-2 [Exemptions from prohibition on SEC registration]; Goldstein Complaint, *supra* note 15, at ¶ 25.

> [T]he Commission estimates that approximately half of the advisors [sic] to large hedge fends [sic] are currently registered. Advisers who have 15 or more clients, whether funds or individuals, to whom they provide personalized advice must register because they do not fall within the terms of the exemption. Many advisers, even though exempt, also register with the Commission voluntarily for competitive reasons or because their investors demand it.

Id.

37. *See* SEC's Appell. Brief, *supra* note 5.

38. Rule 203(b)(3) of the Advisers Act 17; CFR § 275.203(b)(3) (adopted by the SEC in late 2004). *But see* Rule 203(b)(3)-2 of the Advisers Act 17; CFR § 275.203(b)(3)-2 (adopted by the SEC in late 2004). This required an investment adviser of a "private fund" to look through and count each investor of the fund as a single client – for purposes of Adviser Act registration requirement. This rule was vacated by *Goldstein*. *See* Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006).

39. *See* 15 U.S.C. § 80b-3(b)(3); Rule 203(b)(3)-1; 17 C.F.R. § 275.203(b)(3)-1). Vacated by *Goldstein*, 473 F.3d 873 (D.C. Cir. 2006). Advisers to private pooled investments, such as hedge funds, depended on the SEC Staff's perspective that a private fund, rather than the beneficial owner-investors in that fund, was considered to be the firm's "client" for purposes of the exemption provided in § 203(b)(3) of the Advisers Act. This "private adviser exemption" provision was codified in Advisers Act Rule 203(b)(3)-1, which allows a "private fund" to be treated as a "client" for purposes

previously been exempted from the Advisers Act registration provisions,[40] despite the fact that the Act was "[e]nacted by Congress to 'substitute a philosophy of full disclosure for the philosophy of *caveat emptor*' in the investment advisory profession,"[41]

Under the statute, an investment adviser was considered to be exempt from registration provided it (i) had fourteen or fewer "clients"[42] during the preceding twelve months, (ii) did not hold itself out generally to the public as an investment adviser, and (iii) was not an adviser to any

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of the § 203(b)(3) exemption, provided the investment advice given to the "private fund" was based on the fund-client's financial objectives rather than the individual investment objectives of the fund's investors. *Id.* However, the Rule provided at least one alternative method for counting "clients":

> The 1985 "Safe Harbor" of Rule 203(b)(3)-1 is not the only method for determining who might be considered a "client" for purposes of § 203(b)(3). For example, paragraph (a)(2) of the Rule indicates that an Adviser may count as one client any "corporation, general partnership, limited partnership, limited liability company, trust . . . or other legal organization . . . to which [the Adviser] provide[s] investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries . . . ."

Id. (quoting § 203(a)(2)). As such, an Adviser with investment discretion over less than 15 "clients" was not required to register with the SEC. This rule was apparently adopted to address the inference drawn by *Abrahamson v. Fleschner*, which held that a limited partnership's general partner investing in securities was considered an "investment adviser" within the context of the Advisers Act. Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978) *overruled on other grounds by* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979). Incidentally, the first circulated opinion in Abrahamson indicated that the limited partners were also considered to be "clients" under this standard, but that portion of the opinion was redacted from the amended published version according to the SEC's Appell. Brief. *See* SEC's Appell. Brief, *supra* note 5, at 22 n.7 (citing Robert Hacker & Ronald Rotunda, *SEC Registration of Private Investment Partnerships after Abrahamson v. Fleschner*, 78 COLUM. L. REV. 1471, 1484 n.72 (1978)) ("The court's original opinion stated, 'the general partners were the investment advisers to the limited partners.' The court's amended opinion deleted 'to the limited partners.'").

40. *See generally* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266 (July 20, 2004), 69 Fed. Reg. 45,172 (July 28, 2004).

41. *See Goldstein*, 436 F.3d at 876 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)).

42. In order to comply with the so-called "Hedge Fund Rule," investment advisers were required to "look through" and count each shareholder, limited partner, member or beneficiary of a "private fund" towards the fourteen or fewer client threshold of the "private adviser exemption." Rule 203(b)(3)-2 of the Advisers Act.

registered investment company.[43] The practical effect of the former Rule with its broad exemption provisions was that virtually all hedge fund advisers had been eligible for exemption and could avoid registration altogether. It permitted hedge fund advisers freedom to operate in a largely secretive manner, without interference or federal oversight and in stark contrast with the above referenced "full disclosure" philosophy of the 1940 Advisers Act.[44]

C. Regulatory Response to Hedge Fund Growth and Perceived Secondary Effects

Responding to the accelerating trend of explosive hedge fund growth, the Commission directed its staff to undertake a comprehensive investigation of hedge fund activities in 2002.[45] The SEC staff produced an extensive study in 2003 that identified key areas for concern regarding the changing dynamics of the hedge fund sector—some of the notable potential underlying problems identified by the 2003 SEC report included (i) a lack of information regarding what is arguably the fastest-

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43. *See* 15 U.S.C. § 80b-3(b)(3). Exempted "private advisers" remain subject to anti-fraud provisions of the federal securities laws. *See*, *e.g.*, § 10(b) of the 1934 Securities Exchange Act and Rule 10b-5 thereunder (15 U.S.C. § 78j(b) and 17 C.F.R. § 240-10b.5); § 206 of the Advisers Act (15 U.S.C. § 80b-6).

44. *See supra* note 39 and accompanying text.

45. *See* 2003 SEC Staff Report, *supra* note 23; *see also* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. Parts 275 and 279 (2004), *available at* 2004 WL 2825810 [hereinafter Investment Adviser Registration Final Rule]). The Hedge Fund Advisers Rule took effect on February 10, 2005 "except for the amendments to § 275.206(4)-2 [Rule 206(4)-2] and § 279.1 [Form ADV], which bec[a]me effective January 10, 2005." *Id.* The 2003 SEC Staff Report made a number of findings that formed the primary bases for implementing the Hedge Fund Adviser Rule:

> In 2002, we requested that our staff investigate the activities of hedge funds and hedge fund advisers. First, we were aware that the number and size of hedge funds were rapidly growing and that this growth could have broad consequences for the securities markets for which we are responsible. Second, we were bringing a growing number of enforcement cases in which hedge fund advisers defrauded hedge fund investors, who typically were able to recover few of their assets. Third, we were concerned that the activities of hedge funds today might affect a broader group of persons than the relatively few wealthy individuals and families who had historically invested in hedge funds. We directed the staff to develop information for us on a number of related topics, and advise us whether we should exercise greater regulatory authority over the hedge fund industry.

Id. at 72,055 n.15 (internal citation omitted).

growing sector of the U.S. financial system, (ii) an increasing incidence of fraudulent activity involving hedge fund advisers, and (iii) a trend towards "retailization" (hedge fund investments held by less sophisticated individuals (see Part III.B.3 below)).[46] The 2003 SEC Staff Report findings served as the primary bases for promulgation of the Rule at issue in *Goldstein*.

After the SEC staff review and in apparent response to its reported findings,[47] the Commission adopted a revised investment adviser registration Rule[48] that would effectively govern a wide swath of the hedge fund sector by and through its grant of regulatory authority pursuant to the Advisers Act.[49] The Advisers Act established the boundaries of conduct for a segment of registered advisers under the prior registration regime since 1970[50] and regulated certain aspects of

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46. *Id.* at 72,055 (citing 2003 SEC Staff Report, *see supra* note 23). The SEC implementation of the Rule noted concern regarding the explosive growth of hedge funds and the increasing influence over the capital markets:

> In September 2003, the staff published a report entitled Implications of the Growth of Hedge Funds. The 2003 Staff Hedge Fund Report describes the operation of hedge funds and raises a number of important public policy concerns. The report focused on investor protection concerns raised by the growth of hedge funds. The 2003 Staff Hedge Fund Report confirmed and further developed several of our concerns regarding hedge funds and hedge fund advisers.

Id.

47. Investment Adviser Registration Final Rule, *supra* note 45.

48. *See Id.*; 17 C.F.R. § 275.203 (b)(3)-1 (Rule 203 (b)(3)); The Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970) [hereinafter 1970 Amendments Act] (Prior to 2004, investment advisers with fewer than 15 "client" during the preceding 12 months, were specifically exempted from Section 203(b)(3) of the Advisers Act; Goldstein v. SEC, 451 F.3d 873, 879 (D.C. Cir. 2006). The *Goldstein* court looked to the 1970 amendment of the Advisers Act for inferences of how Congress contemplated counting "clients":

> On the other hand, a 1970 amendment to § 203 appears to reflect Congress's understanding at the time that investment company entities, not their shareholders, were the advisers' clients. In the amendment, Congress eliminated a separate exemption from registration for advisers who advised only investment companies and explicitly made the fewer-than-fifteen-clients exemption unavailable to such advisers. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 24, 84 Stat. 1413, 1430 (1970). This latter prohibition would have been unnecessary if the shareholders of investment companies could be counted as "clients."

Goldstein, 473 F.3d at 879.

49. *See* Advisers Act, *supra* note 14; *see also* "Rules Under the Investment Adviser Act," 17 C.F.R. § 275.01; *and* SEC 2003 Staff Report, *supra* note 23.

50. *See* 1970 Amendments Act, *supra* note 48; *see* Goldstein Complaint, *supra* note 15, at ¶ 26 ("[A]ll advisers, registered or unregistered, must report beneficial

unregistered investment advisers to a lesser extent.[51] The Rule and its new method of client counting had seemingly closed the loophole that the hedge fund sector had previously relied upon for almost unfettered opacity.

In order to determine whether an investment adviser was eligible for exemption from registration pursuant to the proposed and so-called "Hedge Fund Rule,"[52] hedge fund managers were required to count each individual investor-shareholder of a private fund under management as a separate "client" (instead of the former method of counting only the private fund entities that directly received investment advice as "clients").[53] As a result, almost every hedge fund adviser in America would no longer be exempt and would be potentially subject to the registration requirements, based on the Rule's more inclusive new definition of "client," as well as being subjected to periodic SEC audits, required filings and disclosures, restrictions on the charging of performance fees and the possibility of unannounced SEC examinations of books and records.[54]

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ownership of securities in excess of a certain amount under Section 13(d) and (g) of the Securities Exchange Act of 1934 (the "Exchange Act"), and must further file quarterly reports of security positions under Section 13(f) of the Exchange Act if they manage in excess of $100 million in assets.").

51. *See* 2003 SEC Staff Report, *supra* note 23, at 88-89 (The SEC adoption of the main recommendation of the 2003 Staff Report to amend Rule 203(b)(3)-1 of the Advisers Act (the "Safe Harbor Rule"), eliminated that "safe harbor" by requiring managers of so-called "private funds" to count as a separate client each investor (beneficial owner/shareholder) in a hedge fund); 15 U.S.C. § 80b-3(b)(3) (2000) (Small Advisor Exemption); 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2003) (allowing corporations, limited and general partnerships, and limited liability companies to be counted as single "clients"); *see also* Goldstein Complaint, *supra* note 15, at ¶ 20.

52. *See* 1970 Amendments Act, *supra* note 48 (discussing investment advisers and their affiliates, and mutual fund directors; breach of fiduciary duty was addressed in this amendment in Section 36).

53. In order to comply with the so-called "Hedge Fund Rule," Advisers were required to "look through" and count each shareholder, limited partner, member, or other investor of a "private fund" towards the fourteen or fewer "client" threshold of the "private adviser exemption." *See* Investment Adviser Registration Final Rule, *supra* note 45, at 72,065.

> Our actions today withdraw that safe harbor and require advisers to "private funds"—which will include most hedge funds—to "look through" the funds to count the number of investors as "clients" for purposes of the private adviser exemption.

Id.

54. *See, e.g.*, 15 U.S.C. § 80b-4 [hereinafter Reports by Investment Advisers]; Steven B. Nadel, *U.S. Regulation of Private Investment Funds*, 37 REV. OF SEC. &

It is a distinct possibility that the SEC encountered pressure to accelerate its hedge fund regulation in the aftermath of the mutual fund market timing scandal that Massachusetts Secretary of the Commonwealth William Galvin characterized as allowing "hedge funds [to] buy shares in mutual funds is like putting a shark in a goldfish tank."[55] Perhaps it was a source of embarrassment at the federal level that then-New York Attorney General, Eliot Spitzer, swept in with the extensive powers of the Martin Act[56] and demanded substantial

COMMODITIES REG. 47 (Mar. 17, 2004), *available at* http://www.sewkis.com /Documents/attachments/599.pdf (last visited Mar. 26, 2007).

55. *See* Investment Adviser Registration Final Rule, *supra* note 45, at 72,057. Perhaps most disturbing is that hedge fund advisers have been key participants in the recent scandals involving late trading and inappropriate market timing of mutual fund shares. *See also* Goldstein Complaint, *supra* note 15, at ¶ 37. *See also* Allan Sloan, *The Mutual Fund Scandal: Unfair Fight*, NEWSWEEK, Dec. 8, 2003, *available at* http://www.msnbc.msn.com/id/3606191/ (last visited Dec. 5, 2006). *Newsweek* reported that the SEC has been playing catch-up to state regulators like Mr. Spitzer and Massachusetts Secretary of the Commonwealth William Galvin:

> Hedge funds have been involved in most of the allegations of wrong-doing, which first surfaced in September when New York's Spitzer brought a case against four fund companies and a big hedge fund, Canary Capital. [William] Galvin, the Massachusetts secretary of [the Commonwealth], says, "Letting hedge funds buy shares in mutual funds is like putting a shark in a goldfish tank." The SEC, which is supposed to regulate mutual funds, has been scrambling to catch up with Spitzer and Galvin, and has vowed changes.

Id.

56. NY GEN. BUS. LAW, Art. 23-A, § 352 (McKinney 1996); *see also* Janice Revell and David Stires, *Making Sense of the Mutual Fund Scandal Everything you may not want to ask (but really should know) about the crisis that's rocking the investment world*, FORTUNE, Nov. 24, 2003, http://money.cnn.com/magazines/fortune/fortune_archive/2003/11/24/353794/index.htm (last visited Dec. 1, 2006) [hereinafter Revell]. CNN Money reported that Mr. Spitzer's market timing investigation led to "widespread criticism" of the SEC, including from at least one former Commission staff attorneys:

> How did the scandal get started?
>
> The crisis erupted in September, when New York attorney general Eliot Spitzer alleged that four mutual fund companies had struck illicit relationships with Canary Capital Partners, a New Jersey hedge fund. Spitzer charged that Bank of America's fund business allowed Canary to trade several funds after the markets had already closed at that day's prices. Known as "late trading," this illegal practice allowed Canary to trade on after-hours news (such as earnings announcements) at before-closing prices. Spitzer also charged that Banc One, Janus, and Strong (see "Up Against the Wall") allowed Canary to quickly jump in and out of their mutual funds to make a fast profit, a practice known as "market timing." While market timing is not illegal *per se*, fund companies can violate securities law if they state in their fund prospectuses that they discourage market timing but then make exceptions for "select" investors or their own employees. . . . Industry experts say that market timing of

monetary concessions as a result of alleged "front-running" malfeasance.[57] SEC staffers apparently first learned of Mr. Spitzer's enforcement conquest in published reports only after the New York Attorney General's office had already hammered out the first of its market timing settlements.[58] It remains possible, as the *Goldstein* petitioners pleadings strongly suggested, that state regulatory prowess may have contributed to the SEC's motivation to expand its hedge fund oversight authority.[59] During a recent visit to Fordham University

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> mutual fund shares is hardly a new phenomenon. And the SEC's failure to lead the way in uncovering recent scandals has led to widespread criticism of the commission. The SEC does perform detailed inspections of mutual fund firms every three years or so, about 90% of which result in the issuance of "deficiency letters," which outline ethical violations ranging from minor to extremely serious. But fund management doesn't have to disclose the contents of the deficiency letters either to fund shareholders or to its own board of directors. "Ninety-five percent of what managers are doing wrong never is made public," says Edward Siedle, a former attorney for the SEC who now investigates abuses at money-management firms for pension funds. If they were, he adds, they would be guaranteed to scare off a lot of investors.

Id.

57. *See*, *e.g.*, N.Y. Att'y Gen. Dep't of Law Press Release, *Spitzer, SEC Reach Largest Mutual Fund Settlement Ever, Bank of America, FleetBoston Agree to Pay $675 Million and Adopt Precedent-Setting Reforms to Improve Accountability*, Mar. 15, 2004, *available at* http://www.oag.state.ny.us/press /2004/mar/mar15c_04.html; *see also* Revell, *supra* note 56. *CNN Money* reported that mutual fund "front-running" was on the SEC's regulatory radar as early as 1998:

> [A] 1998 deficiency letter [was] issued by the SEC to a firm that was later purchased by one of the country's largest mutual funds. The letter contains details of more than two dozen occasions when a senior executive bought and sold individual stock positions in his personal account before trading the same stocks for his clients—a highly unethical (and in many circumstances illegal) kind of trading known as front-running.

Id.

58. *See*, *e.g.*, New York Attorney General, press release, *State Investigation Reveals Mutual Fund Fraud*, Sept. 3, 2003, *available at* http://www.oag.state.ny.us /press/2003/sep/sep03a_03.html.

> Attorney General Eliot Spitzer announced today that his office has obtained evidence of widespread illegal trading schemes that potentially cost mutual fund shareholders billions of dollars annually.
>
> Spitzer announced that one of the perpetrators of the schemes – a hedge fund and its managers – has agreed to make restitution $30 million in illegal profits generated from unlawful trading and pay a $10 million penalty. The agreement further commits the hedge fund and its officers and employees to continue to cooperate in the Attorney General's ongoing investigation of the mutual fund industry.

Id.; Complaint in the Matter of State of New York v. Canary Capital Partners, LLC et al., *available at* http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf.

59. *See* Goldstein Complaint, *supra* note 15, at ¶¶ 36-38.

School of Law, Governor Spitzer (then-New York Attorney General) remarked that the controversial registration regime "will not reveal any of the underlying problems."[60] Mr. Spitzer's successor, Attorney General Andrew M. Cuomo, has followed suit and not articulated any

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60. Former N.Y. Attorney General Eliot Spitzer Remarks, Fifth Annual Albert A. DeStefano Lecture on Corporate, Securities & Financial Law at Fordham University, 11 FORDHAM J. CORP. & FIN. L. 1, 27-28 (2005). Governor Spitzer commented to an audience at Fordham University School of Law:

> I do not have any plans for hedge-fund regulation. Occasionally - more than occasionally - I am asked, "Do you think the SEC is doing something smart or not in requiring hedge funds to register?" I do not think there is any great harm that results from it. I also don't think there is any great good. The reason for that is that the registration form itself will not reveal any of the underlying problems.
>
> Hedge funds do some bad things. Hedge funds sometimes take short positions and intentionally circulate misinformation to try to drive the stock down, to benefit from a short position. But that is not a game that is intrinsic to being a hedge fund. In other words, there is nothing about the hedge-fund structure, as a structure, that I have seen that is problematic. In fact, I would argue that, in a way, a hedge fund is more closely aligned with the interest of its investor, because usually, the way their fees are structured, you get one percent, two percent as a fee, and then an override. So the fund manager wants to do well, wants to perform well, and his investors will do well as a result.
>
> The improprieties come in their trading practices. Those trading practices have to be addressed, and should be addressed. But those are not trading practices that result because they are hedge funds. They are just games that are played in the marketplace on a regular basis by all sorts of investors.
>
> One area where hedge funds do often get into trouble is in valuation of their portfolio. The reason for that does go back to the compensation system. If a hedge-fund manager gets an override, if you have been up by more than twenty percent in any given year, if you have a portfolio of liquid stocks, you can mark-to-market every day. That is easy. If you have a portfolio of thinly traded debt, then you can come up with a valuation that may not be a real one, go back to your investors and say, "Look at what a great year we had. You owe me 'X' dollars," and it may not be a real market valuation.
>
> But that is, I think, a secondary issue.

Id.; s*ee* Alex Akesson, *Hedge Funds Sued by Attorney General*, HEDGECO.NET, Nov. 17, 2006, http://www.hedgeco.net/news/11/2006/hedge-funds-sued-by-attorney-general.html (last visited Dec. 1, 2006). A hedge fund news website noted that Mr. Spitzer alleged that certain hedge funds were involved in the alleged market timing schemes:

> State Attorney General Eliot Spitzer sued Samaritan Asset Management Services Inc, their advisors, Johnson Capital Management Inc, and Edward Owens, a principal at the hedge fund. The company allegedly engaged in a fraudulent mutual fund market-timing scheme. The defendants secretly "piggy-backed" their trades on the investment accounts of retirement plans. The suit claims that the market timing trades hurt long-term investors and the suit seeks restitution and an order to stop them from carrying out improper trades.

Akesson, *Hedge Funds Sued by Attorney General*, HEDGECO.NET.

state registration program for hedge fund investment advisers as a regulatory priority.[61] SEC Commissioner Paul Atkins wondered in a New York Bar Association speech whether SEC staff members had not funneled data into the hedge fund category in order to justify and facilitate the registration rule-making agenda.[62] According to Commissioner Atkins, the SEC "rushed this rule with little analysis or consideration to the ramifications."[63] Mr. Atkins has also quoted former

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61. *See*, *e.g.*, Russ Buettner, *Cuomo Turns to Hedge Fund and It Pays Off*, N.Y. TIMES, Oct. 6, 2006, http://www.nytimes.com/2006/10/06/nyregion/06hedge.html?ex=1317787200&en=5092a7fa664cad61&ei=5090&partner=rssuserland&emc=rss (last visited Dec. 6, 2006) (reporting that "[t]wo years ago, Andrew M. Cuomo put more than half of his campaign treasury into a hedge fund, making him one of the few New York politicians to invest campaign money in anything riskier than a sure bet"); *A campaign hedge: Andrew Cuomo realizes a nice return by investing in a high yield fund*, ALBANY TIMES-UNION, Oct. 11, 2006. Mr. Cuomo's campaign for New York Attorney General actually invested a portion of its political "war chest" in a hedge fund:

> In the case of Andrew Cuomo, the Democratic candidate for attorney general, an investment of $750,000 of campaign contributions in a hedge fund two years ago paid off nicely—with a return of almost 20 percent in just a year. It also represents a particularly slippery slope for a business, political fundraising, that already smacks of high stakes . . . . In Mr. Cuomo's case, some special arrangements were made, including the waiving of minimum investment requirements by EnTrust, according to a New York Times report.
>
> As it happens, Mr. Cuomo is also as committed to sweeping campaign finance reform as anyone on the ballot in New York this year. He speaks of a determination to enforce all available laws to end the culture of pay to play that pervades state government.

Id.

62. *See* Speech, *supra* note 35. Commissioner Atkins stated that:

> It is true that the rule's proponents have an incentive to find problems in order to show how necessary the rule was in the first place. I anticipate a bandying about of hedge fund fraud statistics as evidence that the registration mandate was long overdue. My experience with hedge fund fraud statistics before the adoption of the rule means that I will look at such statistics with a skeptical eye. As Commissioner Glassman's and my analysis of the cases that were cited in support the rule revealed, lots of types of cases get labeled as hedge fund cases. The 51 cases that were cited in the Adopting Release as evidence of a, "troubling growth in the number of our hedge fund fraud enforcement cases" largely implicated advisors who would have been too small to be registered with the Commission, were already registered in some capacity, should have been registered, or were simply garden-variety fraudsters. The cynic in me wonders whether, if the Commission decides to turn its attention to venture capital and private equity funds, the "hedge fund" cases will get relabeled.

Id. (citing Investment Advisers Act Release No. 2266 (July 20, 2004), 69 FR 45171, (July 28, 2004)).

63. *See* Lee Conrad, *Compliance: Hedge Fund Registration Sparks Broad Criticism*, US BANKER, Dec. 2004, *available at* http://www.us-

Federal Reserve chairman Alan Greenspan who stated that the "initiative cannot accomplish what it seeks to accomplish."[64] Former Commissioner Cynthia A. Glassman has also publicly remarked that the former SEC Chairman Donaldson era remnant[65] was little more than a "heavy-handed way of regulating the hedge fund industry,"[66] and apparently many industry professionals shared Ms. Glassman's pointed observations.[67] The Rule was presumably designed to eliminate the availability of the private adviser exemption for "essentially all"[68] advisers, and bring much of the hedge fund sector under the specter of federal regulatory oversight, pushing all but a slim minority of advisers beyond the newly defined threshold.[69] However, as Commissioner Atkins suggested, it may have been the hurried pace of promulgation that led to the Rule's demise.

D. Proposed "Hedge Fund Rule" Met With Industry Resistance

The controversial registration regime was met with "vigorous dissent" from two of five SEC Commissioners and faced zealous

banker.com/article.html?id=20041201J3Q4VGSK (last visited April 24, 2007).

64. *Id.*

65. William H. Donaldson was SEC Chairman when the so-called "Hedge Fund Rule" rule-making process was initiated. *See* SEC Biography: Chairman William H. Donaldson, *available at* http://www.sec.gov/about/commissioner/donaldson.htm (last visited Dec. 5, 2006).

66. Kevin J. Shay, *SEC Member Dismayed that SOX Costs, Burdens Still High*, BETHESDA GAZETTE, Nov. 4, 2005, *available at* http://gazette.net/stories/110405/businew180555_31896.shtml (last visited April 24, 2007).

67. *See* Conrad, *supra* note 63.

> The [SEC's] decision to register most of the estimated 8,350 hedge funds is drawing heavy criticism from the business community and some government officials. The SEC says the rule, passed on October 26 [2004], will help protect investors and decrease fraud. Nearly 400 hedge funds have been identified by the SEC as being involved in late trading and inappropriate market-timing cases, which hurts mutual-fund investors because mutual funds are large enough to be market movers, the agency says.

Id.

68. *See* Goldstein Complaint, *supra* note 15, at 1.

69. *See* C. Evan Stewart, *The Wrong Track to Reforming Corporate Governance*, GC NEW YORK, Oct. 10, 2006, *available at* http://www.zuckerman.com/media/news/media.168.pdf (last visited April 24, 2007) (explaining that in regulating hedge funds the SEC defined registration as "*inter alia*: (i) filing disclosures on Form ADV; (ii) adopting a compliance program; (iii) adopting a code of ethics; and (iv) being subject to SEC examinations").

industry opposition.[70] Nonetheless, a sharply divided SEC adopted the Rule, portions of which took effect on January 10, 2005 (certain other remaining aspects took effect on February 10, 2005).[71] All affected advisers were to have registered via "Form ADV"[72] and employ the other newly promulgated requirements not later than February 1, 2006.[73] The proposed Rule ignited one of the more widely reported regulatory conflicts in recent market history, and included publication of both Commissioner Atkins's and Glassman's dissents.[74]

A significant number of hedge fund investment advisers who had previously relied upon the "private adviser exemption" in order to avoid registration with the SEC were faced with the dilemma of whether to register in compliance with the Rule, find a new "loophole" to exempt them from registration, or to simply disobey the new disclosure

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70. *See* Kenneth J. Berman et al., *Hedge Fund Investment Advisers: To Be or Not to Be (Registered)?,* 20 INVESTMENT ADVISER 9, Sept. 2006, at 11 n.6; Speech, *supra* note 35 (Commissioner Atkins noted that, "[a]s you know, in October of 2004, one week before the 2004 elections, the Commission adopted the hedge fund registration mandate over my objections and those of my colleague, Commissioner Glassman").

> At the meeting adopting the rule, Commissioner Glassman famously asked the staff if they had talked to the other regulators regarding alternatives to our registration requirement. Upon getting the response that yes, they had, she asked: "*Well, did you listen to what they had to say?*"

Id. (emphasis added).

71. Investment Adviser Registration Final Rule, *supra* note 45. The Final Rule, as published, included the dissent of Commissioners Atkins and Glassman in a section titled, "Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers":

> Four months ago, the majority proposed to regulate hedge fund advisers over our dissent. We were nevertheless hopeful that a careful review of commentary on the proposal would convince the majority, instead of taking further action on this proposal, to consider better alternatives. Our hope was fueled by the fact that many commenters offered excellent insights and recommendations to the Commission. We are disappointed that the majority, unmoved by the chorus of credible concerns from diverse voices, has determined to adopt the hedge fund registration rules largely as proposed. As discussed below, we continue to agree that we need more information on hedge funds, but we disagree with the majority's solution.

Id.

72. *See* SEC Form ADV, *available at* http://sec.gov/answers/formadv.htm (last visited Apr. 13, 2007).

73. *See*, *e.g.*, Reports by Investment Advisers, *supra* note 55 (Hedge Fund Investment Adviser books and records requirement and SEC power of examination); *see* Goldstein Complaint, *supra* note 15, at ¶ 21; *see also* Conrad, *supra* note 63.

74. *See* Investment Adviser Registration Final Rule, *supra* note 45.

regime.[75] Many advisers increased the "lock-up periods" for their funds in order to circumvent the reporting requirements.[76] Many other advisers apparently elected to comply with the Rule, but according to Commissioner Atkins, a significant number of leading hedge funds chose to disregard the Rule.[77]

And at least one hedge fund adviser, market maverick Phillip Goldstein,[78] the irascible manager of the "Bulldog Investors" fund

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75. *See* § 203(b)(3) of Advisers Act, *supra* note 36.

76. *See*, *e.g.*, Susan L. Barreto, *Hedge Fund Adviser Registration Tops 2,000 Post-Goldstein*, INVESTMENT ADVISOR, Aug. 7, 2006 ("The experience of Sellers Capital sums up the choices many hedge fund managers faced in deciding whether or not to register. The firm's founder, Mark A. Sellers, originally imposed a two-year lock-up and told investors that if they didn't want the longer lock-up they needed to invest before Feb. 1 [2006]"), *available at* http://www.investmentadvisor.com/article.php?topic=Hedge+Funds&article=6717; *see* Bingham-McCutchen, *Hedge Fund Ruling: What's Next?*, INVESTMENT MGMT. ALERT , June 2006, at n.2 ("Many hedge fund managers chose not to register by instituting a two-year lock-up as to all new investments received on or after February 1, 2006, which allowed them to continue to count the fund as the client rather than each of the investors in the fund."), *available at* http://www.bingham.com/bingham/webadmin/documents/radD7D5C.pdf; In The Matter Of: Bulldog Investors General Partnership et al., Docket No. E-07-0002, at 70, *available at* http://www.sec.state.ma.us/sct/sctpdf/bulldogcomplaint.pdf (last visited Feb. 18, 2007); Massachusetts Commonwealth Secretary's Exhibit C-4, Goldstein-Dakos "Dear Partner" letter dated July 13, 2006.

> Like many other respected and successful private investment partnerships, we recently instituted a two-year lockup for new contributions . . . . A secondary benefit was that a two-year lockup allowed us to avoid the costly red tape that goes with registration while our lawsuit was pending . . . . Assuming the SEC does not appeal the [*Goldstein*] decision, we may modify the lockup policy.

Id.

77. Commissioner Atkins NY Bar Assoc. Speech, *supra* note 35 (noting that, "we have seen more than one thousand new hedge fund advisor registrants . . . . The newly registered hedge fund advisors have approximately doubled the pool of hedge fund registrants."). The number of registered Advisers reportedly more than doubled again within one month of Commissioner Atkins's speech: "[b]y June 2006, approximately 2,400 hedge fund advisers had registered with the commission, including more than 1,100 who had registered after Feb. 1 (this is out of a total universe of circa 9,000 funds)." *Id.*; *see also* C. Evan Stewart, *The Wrong Track to Reforming Corporate Governance*, GC NEW YORK, Oct. 10, 2006, *available at* http://www.zuckerman.com/media/news/media.168.pdf (last visited Apr. 13, 2007).

78. Mr. Goldstein refers to himself as "a widely-quoted expert on value investing and corporate governance." BULLDOGINVESTORS.COM, *available at* http://www.bulldoginvestors.com. The "Bulldog" website utilizes "masking" technology that conceals most of the site's "deep links." Moreover, the "Bulldog" website was removed from the Internet in response to an administrative action brought

family, stood firm in his defiance of the Rule, alleging that it was invalid as an arbitrary and capricious abuse of administrative rulemaking authority under an apparent *ultra vires* theory, despite the traditional deference afforded to the Commission's "substantial discretion as to whether to proceed by rulemaking or adjudication."[79] Mr. Goldstein already had a history of taking the SEC to task,[80] and thrusting his

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by Massachusetts Secretary of the Commonwealth William Galvin on January 31, 2007. *See* Edward Pekarek, *Hogging the Hedge: The "Bulldog's" 13F Theory May Not Be So Lucky*, 12 Fordham J. Corp. & Fin. L. 1077 (2007) at Part VII.D.1 (discussing the "Bulldog" website and the Massachusetts administrative matter)]. *But see* the "Internet Archive," particularly the "Principals" page of the "Bulldog" website, *available at* http://web.archive.org/web/20060116131029/http://www.bulldoginvestors.com/ (last visited April 24, 2007). Incidentally, the "Press Room" portion of the "Bulldog" website includes a variety of media articles regarding Mr. Goldstein's many proxy battles, but for some reason, barely notes media coverage of *Goldstein*. *See* http://www.bulldoginvestors.com/pdf.php?ID=20 (last visited April 24, 2007); *see also* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

79. Opening Brief of Petitioner at 25, Goldstein v. SEC, No. 04-1434, 2005 WL 1666937 (D.C. Cir. 2005) [hereinafter Goldstein Opening Brief] ("Finally, the Rule is unreasonable because the SEC's development and evaluation of the record was arbitrary and capricious."); *see also id.* at 56 ("In sum, the SEC's development and consideration of the record was arbitrary, capricious and unreasonable."). The Goldstein theory of the case did not specifically allege that SEC rule-making was an *ultra vires* act, but repeatedly asserted that the SEC exceeded the authority granted to it by Congress. *Id.*

> This case involves the SEC's adoption of the Hedge Fund Rule, which requires advisers to private investment entities known as hedge funds to register under the Advisers Act. The Rule seeks to do what Congress has precluded the Commission from doing – regulate private investment entities and advisers that Congress has expressly exempted from regulation under the Investment Company Act and the Advisers Act.

Id. at 8 (emphasis added); *see also* FCC v. Nat'l Citizens Comm. for Broadcasting, 436 U.S. 775, 808 n.29 (1978) (citing SEC v. Chenery Corp., 332 U.S. 194, 201-02 (1947)).

80. *See*, *e.g.*, Brief for Phillip Goldstein and Bulldog Investors as *Amici Curiae* Supporting Respondent Dabit in the matter of Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006), *available at* 2005 WL 3485822; *see* Phillip Goldstein Letter to SEC, Mar. 14, 2004, Re: File No. S7-03-04 Investment Company Governance, http://www.sec.gov/rules/proposed/s70304/pgoldstein031404.htm (last visited Dec. 2, 2006) [hereinafter Goldstein Mar. 2004 SEC Letter]. Among the numerous seemingly taunting letters by Mr. Goldstein, is the following:

> Dear Mr. Katz:
>
> In the summer of 1967, some friends and I rented an apartment in Cape Cod. One day, a girl brought us a turtle she found at a nearby stream. She put the turtle on the floor to let it acclimate itself to its new home. But the turtle was frightened and proceeded to walk to the nearest wall. It tried to climb up the wall for what seemed like hours but it never succeeded because turtles cannot climb walls. Eventually, we felt sorry for the poor frustrated critter and put it back by the stream.

opinions into the center of securities law controversies. This time he took his fight to Washington.[81]

> Like our turtle, the Commission seems to be unable to grasp a basic truth, *i.e.*, without appropriate incentives, tinkering with the governance structure of a fund cannot transform unwilling so-called independent directors into effective monitors of management.

Id.; s*ee* Phillip Goldstein Letter to SEC [hereinafter Goldstein January 2004 SEC Letter], Jan. 30, 2004, Re: File No. S7-19-03 Security Holder Director Nominations, *available at* http://www.sec.gov/rules/proposed/s71903/pgoldstein013004.htm (last visited Dec. 1, 2006). This mocking missive by Mr. Goldstein includes the absurd disclaimer to SEC staffers that his "critters" have expressed support:

> Dear Mr. Katz:
>
> I want to correct some misconceptions about the proposed proxy rules.
>
> First, a disclaimer. The views expressed herein do not necessarily represent those of the Securities and Exchange Commission or any of its Commissioners or staff members, any members of the American Bar Association, the Business Roundtable, Wachtell, Lipton, Rosen & Katz or any other law firm representing corporate interests, any manager of any publicly traded corporation, *my wife, my dog, my cat, any other member of my immediate family or anyone else although my wife and the critters have expressed support.*

Id. (emphasis added); *see also* Phillip Goldstein Letter to SEC, Dec. 22, 2003, Re: File No. S7-19-03 Security Holder Director Nominations http://www.sec.gov/rules/proposed /s71903/pgoldstein122203.htm quoting Bob Dylan "Blowin' in the Wind" © 1962. (last visited Dec. 1, 2006). Mr. Goldstein wrote to the SEC in December 2003, citing Bob Dylan and making the ludicrous comparison between the nascent Iraqi democracy and proxy voting:

> The plain fact is that many persons are currently sitting in director's [sic] chairs who would not be there if the Commission had adopted a rule that ensured that stockholders had a fair opportunity to vote for *any bona fide* nominee. That was true in 1934 and that will continue to be true whether or not the Commission adopts rule [sic] 14a-11 as proposed. As Bob Dylan put it:
>
> Yes, 'n' how many years can some people exist
> Before they're allowed to be free?
> Yes, 'n' how many times can a man turn his head,
> Pretending he just doesn't see?
> The answer, my friend, is blowin' in the wind,
> The answer is blowin' in the wind.
>
> I hope the wind reaches 450 Fifth Street [SEC's Washington, D.C. address] in my lifetime. Until then, shame on anyone and everyone at the Commission who is responsible for not acting forcefully to eliminate the continuing disenfranchisement of stockholders and for producing a lame "compromise" proposal!
>
> In its bloated release, the Commission solicits responses to more than two hundred questions, most of which have nothing to do with ensuring that proxies are not utilized so as to frustrate fair corporate elections. I have just one question for the Commission. Who will get fair elections first: Iraqi citizen or American stockholders? American stockholders eagerly await a response.

Id.

81. *See generally* Goldstein Complaint, *supra* note 15; *see also* Goldstein v. SEC,

III. MR. GOLDSTEIN GOES TO WASHINGTON

Just eleven days after the SEC published the final Rule,[82] the *Goldstein* petitioners[83] filed substantially similar administrative agency review petitions concurrently with both the District Court for the District of Columbia and the Court of Appeals for the District of Columbia Circuit, ostensibly due to perceived jurisdictional ambiguities.[84] The district court action was later stayed, pending the decision in the circuit court, pursuant to an unopposed petitioners' motion.[85] The *Goldstein* petitioners' pleadings stated that the challenge arose under the Administrative Procedure Act, as well as the Advisers Act.[86] Their pleadings also prominently relied upon the definitions of "client" and "investment adviser" as derived from the U.S. Supreme Court's interpretation in *Lowe v. SEC*, and asserted that within the context of the Advisers Act, the SEC definition was arbitrary.[87]

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451 F.3d 873 (D.C. Cir. 2006).

82. *See generally* Investment Adviser Registration Final Rule, *supra* note 45.

83. The named petitioners in the pleadings first filed in the D.C. District Court included: Phillip Goldstein and Goldstein-controlled entities Kimball & Winthrop, Inc. and Opportunity Partners L.P. *See* Goldstein Complaint, *supra* note 15, at ¶¶ 8-10.

84. *See* Goldstein Opening Brief, *supra* note 79, at 4 (citing Investment Co. Inst. v. Board of Governors, 551 F.2d 1270, 1280 (D.C. Cir. 1977)) ("Decisions of this Court indicate that where an agency's governing statute provides for direct review of agency 'orders,' but is unclear whether agency 'rules' are reviewable in the court of appeals, uncertainties about jurisdiction are resolved in favor of appellate court review.").

85. *See generally* Petitioners' Motion, with Respondent's Consent, to Stay Proceedings, Pending Decision in Related Action by the United States Court of Appeals for the District of Columbia Circuit, 2004 WL 3144173 (D.D.C.) (filed Jan. 13, 2004); *id.* at ¶ 5. The *Goldstein* petitioners stated with respect to question of the proper forum for the challenge of the Rule:

> On January 12, 2005, counsel for Plaintiffs and counsel for the SEC conferred by telephone regarding their views and positions regarding the proper forum for review of the Hedge Fund Rule. Counsel for the SEC stated that the SEC believes the proper forum is the Court of Appeals and wants to avoid the wasteful duplication of litigating in both forums. Counsel for Plaintiffs stated that they also believe the proper forum is the Court of Appeals but that Plaintiffs do not want to be delayed in challenging the Hedge Fund Rule in this Court if the Court of Appeals determines that this Court is the proper forum.

Id.

86. *See* 5 U.S.C. §§ 701-706 ("APA"); *see also* Adviser Act, *supra* note 14.

87. *See* Goldstein Complaint, *supra* note 15, at ¶ 18, citing Lowe v. SEC, 472 U.S. 181 (1985) ("[A]fter reviewing the legislative history of the Advisers Act, that the act was 'designed to apply to those persons engaged in; the investment-advisory profession - those who provide personalized advice attuned to a client's concerns, whether by

A "Client" By Any Other Name

The *Goldstein* petitioners' pleadings contended that in order to determine whether a hedge fund adviser was eligible for the "private adviser" exemption, one must first interpret the essence of the definition of the term "client," and discern the legislative intent of the statutory construction within the Advisers Act. The *Goldstein* petitioners asserted that the congressional intent was consistent with that articulated in the 1985 U.S. Supreme Court decision *Lowe v. SEC*, and that it necessarily, albeit circularly, turns on whether an adviser "directly" provides "personalized advice attuned to a client's concerns."[88] The *Goldstein* pleadings further asserted that, with respect to the 1985 "safe harbor" provision that created the "private adviser" exemption at issue, that the Commission

> proposed the safe harbor rule to make clear that it would not take the position that the limited partners of a limited partnership are "clients" of the general partner, as long as the general partner provided advice to the limited partnership and did not provide individualized personal investment advice to the limited partners[,] [and] [t]he safe harbor rule thus reflected not only the *universally accepted* meaning of the term "client," but also Congress's desire to regulate only those persons who render personalized investment advice attuned to a client's concerns.[89]

The Commission correctly noted in its brief that when promulgating the Advisers Act, Congress did not establish how one could (or should) count "clients" for the purposes of the "private adviser" exemption. This suggests that the *Goldstein* petitioners' assertion that the meaning of "client" was "universally accepted" was somewhat disingenuous.[90] Despite the history of the SEC's previous use of "client," the SEC presented a plausible interpretation of the term that may have persuaded Congress to amend the Act.[91] Moreover, the Commission specifically "recognized in proposing the [1985] safe harbor that 'a different

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written or verbal communication.'") (citing Advisers Act, *supra* note 14).

88. *Lowe*, 472 U.S. 181 (1985); *see* Goldstein Complaint, *supra* note 15, at ¶ 22.

89. Goldstein Complaint, *supra* note 15, at ¶ 24 (emphasis added).

90. SEC's Appell. Brief, *supra* note 5, at 2.

91. *Id.* at 2-3 ("[T]he proper construction of the statute might well require an adviser to count as its clients the investors whose assets were brought under management through an investment vehicle operated by the adviser, *rather than counting only the vehicle itself*.") (emphasis added).

approach could be followed in counting clients.'"[92]

The same year that the SEC adopted the "safe harbor" for general partners of investment limited partnerships, the U.S. Supreme Court decided *Lowe v. SEC*.[93] According to the *Goldstein* petitioners' theory throughout the case, the Rule's "look through" method of counting "clients" was inconsistent with congressional intent, with the Supreme Court's interpretation of the term in *Lowe*,[94] and with the SEC's past use of the term.[95] In many respects, the entire *Goldstein* matter, and the fate of the Rule, would turn on the meaning of a single word.

The *Goldstein* court identified past instances of SEC interpretations of the term "client" that substantially undermined the government's theory of the case.[96] The court also noted that hedge fund managers

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92. *Id.* at 3 (quoting Investment Advisers Act Release No. 956 (Feb. 22, 1985), 50 Fed. Reg. 8740, 8741 (Mar. 5, 1985) (JA 001, 002)).

93. The SEC correctly noted in its Final Brief that the discussion in *Lowe* regarding 'personalized' versus 'impersonal' advice, however, is solely for the purposes of determining which type of publishers fall within the definition of an investment adviser. *See* SEC's Appell. Brief, *supra* note 5, at 17 and 34-37; § 202(a)(11) of the Advisers Act (defining "investment adviser" as "one who 'engages in the business of advising others, either directly or through publications or writings.'") (citing *Lowe*, 472 U.S. at 188-89 (1985)).

94. *See* SEC's Appell. Brief, *supra* note 5, at 38-39. The *Goldstein* petitioners contended the interpretation of the term "client" within Lowe v. SEC should govern the analysis of the challenged Rule:

> Once it is established that an adviser – such as petitioner Kimball & Winthrop here – directly manages a number of investors' assets sufficient to render it an 'investment adviser' under the Act, *Lowe* does not direct how to determine who is the adviser's "client" for any purpose . . . . *Lowe* does not dictate that the adviser's "clients" are only those who have a person-to-person relationship with the adviser. It is therefore entirely consistent with *Lowe* to conclude that, with respect to "private funds," each investor (often a limited [partner] in a fund organized as a limited partnership), who is receiving the same asset management services from the adviser, can be considered the adviser's "client" for purposes of the Section 203(b)(3) private adviser exemption.

Id. (internal citation omitted).

95. Goldstein Opening Brief, *supra* note 79, at 17 (citing Advisers Act Release No. 983, Definition of "client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 29, 206 (July 18, 1985)).

96. Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (citing 17 C.F.R. § 275.203(b)(3)-1) ("[T]he Commission has interpreted this provision to refer to the partnership or entity itself as the adviser's 'client.'"); *see* Giselle Abramovich, *Judges Grill SEC over Hedge Fund Rule*, MONEY MGMT. EXECUTIVE., Dec. 12, 2005, *available at* http://www.financial-planning.com/pubs/fpi/20051212101.html (last visited Dec. 3, 2006) (stating that during oral arguments in *Goldstein*, Circuit Judge Harry Edwards told the defendant SEC, "You can't just come in here and say we're going to make

"*usually* satisfy the 'private adviser exemption,'"[97] and with regard to the contested definition of "investment adviser," stated:

> Hedge fund general partners meet the definition of "investment adviser" in the Advisers Act (defining "investment adviser" as one 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. . . .").[98]

1. Whom Does an Adviser Advise?

The *Goldstein* court placed little weight on the fact that authority it cited, *Abrahamson v. Fleschner*, had stated that limited partner investors *did* receive investment advice from a general partner in its first circulated opinion, but that language was redacted from a subsequent version of the opinion.[99] The SEC highlighted in its brief the language redacted from the *Abrahamson* opinion to no avail.[100] By negative inference, one could presumably surmise that the Second Circuit found that, at least in its first version of the *Abrahamson* opinion, limited partner beneficial owners were recipients of an adviser's advice, a key factual criterion for determining whether an investor is a "client," and whether a hedge fund adviser might qualify for the "private adviser" exemption.

Mr. Goldstein did not volunteer to the court that certain investors in his hedge funds had "different investment objectives and varying degrees of control of the funds in their brokerage accounts," and that

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'client' mean whatever we want because we're the [SEC] . . . . We have to test your thesis and your thesis doesn't stand up."). *Id.*

97. *Goldstein*, 451 F.3d at 876 (citing Abrahamson v. Fleschner, 568 F.2d at 869-71 (2d Cir. 1977)) (emphasis added) (holding that hedge fund general partners are "investment advisers"), *overruled in part on other grounds by* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

98. Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (citing Abrahamson v. Fleschner, 568 F.2d at 869-71 (2d Cir. 1977)) (internal citation omitted).

99. *See* SEC's Appell. Brief, *supra* note 5, at 23 n.7; *Goldstein*, 451 F.3d at 878-79 (citing *Abrahamson*, 568 F.2d at 871 n.16) ("The final published opinion omits those four words ['to the limited partners'] suggesting that the court expressly declined to resolve any ambiguity in the term "client." If – as we generally assume – Congress was aware of this *judicial confusion*.") (emphasis added). *Id.*

100. *See* SEC's Appell. Brief, *supra* note 5, at 23 n.7.

some of those investors had testified that they actually consulted with him regarding the funds' investments, and even expected him to consider *their advice* as it related to the funds' investment decisions.[101] It seems that those individual investors had highly personalized needs and objectives, consistent with the term "client," despite its purportedly "universally accepted" meaning.[102] This "universally accepted" terminology, at least according to the *Goldstein* petitioners' contention, was perhaps something upon which reasonable minds could conceivably disagree, when one considers the findings of the court in *Phillip Goldstein v. Lincoln Nat'l Convertible Securities Fund, Inc*. The omission of the prior testimony of these investors is conspicuous, irrespective of whether the term "client" is in fact "universally accepted."

Despite the omission, the unanimous *Goldstein* court was apparently persuaded by the petitioners' theory, presumably in no small part because of the examples cited of the Commission's prior use of "client" that were consistent with *Goldstein's* argument. The court construed the meaning of "client" in accordance with the petitioners' position, despite noting that, "the Investment Advisers Act of

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101. Phillip Goldstein v. Lincoln Nat'l Convertible Securities Fund, Inc., Case No. 00-2653, Memorandum and Order (E.D. Pa. Apr. 27, 2001), *available at* http://www.paed.uscourts.gov/documents /opinions/01D0329P.pdf (last visited Dec. 19, 2006). This unrelated civil matter is revealing in terms of who Goldstein may have directly advised:

> ¶ 47. Goldstein provided investment advice and money management services to family, friends and four clients—Opportunity Partners, Mercury Partners, LP ("Mercury Partners"), Calapasas Investment Partnership ("Calapasas"), and Jasso, Inc. ("Jasso"). Transcript at 115–22 (testimony of Phillip Goldstein, Apr. 16, 2001).
>
> ¶ 48. All of the persons or entities to whom plaintiff offered investment advice and money management services had different investment objectives and varying degrees of control of the funds in their brokerage accounts over which Goldstein had discretionary trading authority; *Id.* at 53 (testimony of Glenn Goodstein, Apr. 18, 2001) (testifying that decisions as to which securities were bought and sold for Mercury Partners were made jointly by himself and Goldstein); *Id.* at 65 (testimony of Jeff Robertson, Apr. 18, 2001) (testifying that *he monitored all trades* made on behalf of Calapasas by Goldstein).
>
> ¶ 49. Glenn Goodstein of Mercury Partners, Jeff Robertson of Calapasas, and Jaime Sohacheski of Jasso, *all regularly discussed their investment strategies with Goldstein*. *They expected Goldstein to follow their advice on investing their funds*. *Id.* at 55–56 (testimony of Glenn Goodstein, Apr. 18, 2001); *Id.* at 66 (testimony of Jeff Robertson, Apr. 18, 2001); and *Id.* 78–79 (testimony of Jaime Sohacheski, Apr. 18, 2001).

Id. (internal citations and numbered paragraphs in original) (emphasis added).

102. *See* Goldstein Complaint, *supra* note 15, at ¶ 24

1940, . . . a companion statute to the Investment Company Act of 1940, and the statute which primarily concerns us in this case [was] [e]nacted by Congress to 'substitute *a philosophy of full disclosure* for the philosophy of *caveat emptor*' in the investment advisory profession."[103] While the court was so exacting about the parsing of the word "client," it was apparently far more flexible with the meaning of other words and phrases.

Fortunately for the *Goldstein* camp, the issue for debate was not the parsing of the meaning of the phrase "hedge fund," as it is not even mentioned anywhere in the federal securities laws.[104] Just as fortunate for petitioners was that the debate did not focus upon the meaning of "full disclosure," as it might well be considered "universally accepted" that the word "full" is understood to mean: entire, complete, all, maximum, absolute, or without exception.[105] Here, however, at least within the context of an Advisers Act analysis of the "private adviser" exemption eligibility, "full" *usually* means something considerably closer to "half."[106]

Perhaps foreclosing the ability of the SEC to examine hedge fund advisers books and records was the real underlying motivation for Wall Street in general, and Mr. Goldstein in particular, to attack the Rule?[107]

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103. Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)) (citations omitted) (emphasis added).

104. *Id.* at 874-7, citing comments of David A. Vaughan, SEC Roundtable on Hedge Funds (May 13, 2003), *available at* http:// www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm (citing fourteen different definitions found in government and industry publications) ("'Hedge funds' are *notoriously difficult to define*. The term ["hedge fund"] appears *nowhere* in the federal securities laws, and even industry participants do not agree upon a single definition.") (emphasis added).

105. *See e.g.*, www.dictionary.com for definition of "full," http://dictionary.reference.com/browse/full (last visited Dec 27, 2006).

106. *See* Goldstein Complaint, *supra* note 15, at ¶ 25 (explaining that "approximately *half* of the advisors to large hedge fends [sic] are currently registered") (emphasis added); *see Goldstein*, 451 F.3d at 876 (stating that hedge fund partners "*usually* satisfy the 'private adviser exemption' from registration in § 203(b)(3) of the Act.") (emphasis added).

107. Norman B. Arnoff & Sue C. Jacobs, *Professional Liability: The Brandeis Rules*, N.Y.L.J 3, at 3 (Oct. 24, 2006). Arnoff & Jacob's view of securities regulation promotes a continuum of interrelated functions:

> It is not merely enough for the aspiration to be stated that the highest standards should prevail, but that these standards have to be given meaningful content with clear notice to those professionals for which the standards apply. The starting and succeeding

Some commentators have identified the significance of the so-called "Hedge Fund Rule," as it related to Justice Brandeis's maxim that sunlight is the "best of disinfectants."[108] Those critics have also correctly observed that "professionalism in the securities and financial services industries will not be meaningfully and effectively developed by the SEC and other regulators if their ability to inspect a significant number of investment advisers is curtailed."[109] The interpretive weight of *Lowe* apparently led the *Goldstein* court to confront the SEC's incongruent usage of "client" and "negate[] a rule that merely created a framework for regulatory oversight and upheld the longstanding secrecy of hedge funds and their advisers without reference to sound policy [and] did so in part on the basis of sophistic linguistic analyses."[110] The SEC's unfortunately inconsistent use of a single word proved to be sufficient to deem the Rule arbitrary, and with that cornerstone removed, dismantling of the Rule was almost inevitable.

<u>2. The Absence of Any Fiduciary Duty Analysis by *Goldstein* and the D.C. Circuit Court</u>

The *Goldstein* court's almost singular focus on whether one had received "personalized advice" as a "client" seemingly ignored the analytical significance of the concept of fiduciary duty, prominent throughout U.S. securities law doctrine.[111] The apparent lack of any

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> points are SEC registration, periodic compliance inspections, pragmatic rule-making and, in the last instance, SEC enforcement investigations and proceedings when risks to public investors have not already been abated nor wrongs corrected.

Id.

108. *See id.* at 1; *see also* L. Brandeis, OTHER PEOPLE'S MONEY 62 (Natl. Home Library Found. ed. 1933).

109. Arnoff & Jacobs, *supra* note 107 at 1. Arnoff & Jacobs properly questioned the opacity of the hedge fund sector:

> The substantial percentage of hedge fund trading to the overall trading in our capital markets today mandates judicial or legislative correction. All the Hedge Fund Adviser Rule did was to place in open, regulatory view the significant activity of hedge funds and their advisers so that the Brandeis Rule "sunlight is the best disinfectant," would have its full force and effect. Professionalism in the securities and financial services industries will not be meaningfully and effectively developed by the SEC and other regulators if their ability to inspect a significant number of investment advisers is curtailed.

Id.

110. *Id.* at 3.

111. *See* Chiarella v. United States, 445 U.S. 222 (1980) (discussing fiduciary

measurable consideration of the fiduciary duties owed by an adviser to its hedge fund investors when evaluating and parsing the term "client," left the court's analysis "seriously flawed" according to at least some jurisprudence observers.[112] The Tenth Circuit recently performed a "functional analysis" of the fiduciary duty owed by investment advisers that is in stark contrast with that of the *Goldstein* court's analysis and decision.[113]

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duties); *see also* Arnoff & Jacobs, *supra* note 107, at 4 (discussing *Chiarella's* rule of law).

> [A] financial printer "was able to deduce the names of the target companies before the final printing from other information contained in . . . documents" and "[w]ithout disclosing his knowledge . . . purchased stock in the targets companies and sold the shares immediately after takeover attempts were made public." The Court reversed Chiarella's criminal conviction in the absence of a relationship that created a fiduciary obligation). The *Chiarella* Court held:
>
> Not every instance of financial unfairness constitutes fraudulent activity under § 10(b) . . . [t]he element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from . . . [the printer's] relationship with the sellers of the target company's securities, for . . . [the printer] had no prior dealing with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.
>
> When there is a relationship between the parties and not merely "impersonal market transactions" but a degree of dependency, the law is expansive in order to create and enforce fiduciary obligations.

Arnoff & Jacobs, *supra* note 107, at 4 (citing Chiarella v. United States, 445 U.S. 222 (1980)).

112. *See* Arnoff & Jacobs, *supra* note 107, at 3. Arnoff & Jacobs noted the conspicuous absence of any discussion of fiduciary duty within the *Goldstein* opinion:

> [T]he [*Goldstein*] court's analysis is seriously flawed because it does not give recognition to the fundamental proposition and wisdom that an investment manager has fiduciary responsibility to the individual investor and his or her clientele because the adviser-manager has care, custody, and control of the funds and securities of others. The statement that "(i)f investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, the adviser will eventually face conflicts of interest" is also too simplistic in that it does not allow for the distinction between voidable and nonvoidable conflicts, as well as a proactive SEC that, *inter alia*, by reason of its essential inspection process will learn enough of the current pitfalls of the practices and procedures of investment adviser firms to be able by enlightened rule-making to correct the problems [sic].

Id.

113. *See id.* at 6. Recent Tenth Circuit analysis differs greatly from that of the *Goldstein* court in terms of the relevance of fiduciary duty considerations and the ability of the SEC to regulate the U.S. capital markets:

> ["A]n agent is a fiduciary with respect to matters within the scope of his agency." The firm, which had dual registration as a broker-dealer and an investment adviser, failed to disclose the true facts and deceived clients that they were acting as a

Hedge fund advisers receive the "highest degree of trust and confidence in regard to the care, custody and control of other people's funds and securities."[114] An adviser owes its investors a fiduciary duty, and if an adviser, for example, participates in an activity known as "scalping,"[115] it breaches that duty owed to its investors.[116] Accordingly, the Investment Company Act specifically contemplated and imposed fiduciary duties upon advisers that are owed to both the investment company and its investors.[117] The Supreme Court has also contemplated the fiduciary duties owed to investors and customers in the context of whether an investment account or the investment of capital is deemed to be on a discretionary or non-discretionary basis.[118] There can

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> principal and the differential between the client's price on a principal versus an agency trade. The firm held itself out to its clients as a fiduciary and was held to that standard. Most significantly, for this analysis and the conclusions to be drawn, is that there were serious record-keeping deficiencies . . . [that] detrimentally affected the . . . [SEC's] ability to assemble the requisite evidence in . . . [the] case.

Id. (quoting the "functional analysis" in German v. SEC, 334 F.3d 1183 (10th Cir. 2003)).

114. *Id.* at 3.

115. *Id.* (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)). Form may have prevailed over function in terms of the parsing of "client" without a detailed analysis of fiduciary duty:

> The U.S. Supreme Court has addressed fiduciary duty issues in the investment adviser context. In SEC v. Capital Gains Research Bureau, Inc. et al., a registered investment adviser engaged in the practice of purchasing shares of a security for his account before he placed the trades for his clients. He did not disclose these transactions or practices to his clients and, nonetheless, recommended the security for long-term investment for the client while immediately reselling for a profit on a market upswing. *This practice has come to be known as "scalping" and the antithesis of the legislative intent of the Investment Adviser Act of 1940.*

Id. (emphasis added).

116. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (explaining that scalping is a mechanism for fraud or deceit upon any client or prospective client within the meaning of the Investment Advisors Act).

117. *See* Advisers Act, *supra* note 14.

118. *Cf.* De Kwiatkowski v. Bear Stearns, 306 F.3d 1293 (2d Cir. 2002) (stating no fiduciary duty owed to brokerage client for advice where client holds a non-discretionary account with broker); *see* Arnoff & Jacobs, *supra* note 107 ("[T]he core element of fiduciary duty is not the closest degree of privity but the dependency of client-investors upon a relationship of trust and confidence that may have been created by other contracting parties."). The Second Circuit's analysis of a client dependent upon a broker managing a discretionary account was apparently not addressed by the *Goldstein* court:

> The transformative "special circumstances" recognized in the cases are circumstances that render the client dependent—a client who has impaired faculties, or one who has

be little debate that a hedge fund adviser has full investment discretion over the capital under management and owes its investors fiduciary duties.

The *Goldstein* court almost effortlessly dispensed with (or at least profoundly discounted) the core concept of fiduciary duty in its analysis. The court did, however, consider conflicts of interest as part of its analysis and compared the hedge fund adviser-investor relationship with the relationship of an issuer's attorney and its common shareholders and stated, "if the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest."[119] The *Goldstein* court apparently did not, however, evaluate the more relevant and analogous relationship between a common shareholder and an issuer company's officers and directors. As management of an issuer company, officers and directors are functionally equivalent to a hedge fund manager-adviser as it relates to the fund's investors, and owe similar fiduciary duties to the issuer's shareholders, concurrent with fiduciary duties owed to the company, despite scenarios where conflicts of interest might arise.[120]

There can be little doubt that when an investor provides capital to Phillip Goldstein for investment in one of his "Bulldog Investors" hedge funds, Mr. Goldstein is implicitly (and perhaps expressly by contract) empowered with the discretion to invest that capital; to launch his many proxy battles as part of some perceived "value investing" theorem; and

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> a closer than arm's-length relationship with the broker, or one who is so lacking in sophistication that *de facto* control of the account is deemed to rest in the broker. The law thus imposes additional extra-contractual duties, on brokers who can take unfair advantage of their customers' incapacity or simplicity . . . . [In] absence of an express advisory contract, there is no fiduciary duty on the part of . . . [the] broker dealer "unless the customer is infirm or ignorant of business affairs."

See Arnoff & Jacobs, *supra* note 107.

119. *See* Goldstein v. SEC, 451 F.3d 873, 881 (D.C. Cir. 2006). The court addressed conflicts in the context of an issuer's outside "gatekeepers," but not those inherent in managerial relations between directors, issues and shareholders.

> Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to an investor in the fund, however, would likely be to sell. For the same reason, we do not ordinarily deem the shareholders in a corporation the "clients" of the corporation's lawyers or accountants.

Id.

120. U.S. v. Brown, 459 F.3d 509, 533 (5th Cir. 2006) (Reavley, J., dissenting) ("Enron executives are not Enron itself and, in any event, they owed a fiduciary duty to Enron *and* its shareholders.") (emphasis in original).

to even install his "Bulldog" confederates on whatever corporate boards he has successfully infiltrated through his funds' investments.[121] Mr.

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121. *See* RMR Hospitality and Real Estate Fund Form 8-K, Nov. 13, 2006, Commission File No. 811-21502, http://www.sec.gov/Archives/edgar/data/1278038/000110465906076852/a06-23938_48k.htm#scotch (last visited Dec. 1, 2006) (stating allegations pursued by RMR is a closed end mutual fund and a registered investment company against Bulldog for violations of share ownership limitation and its trust agreement); RMR Ex. 99.1 to Nov. 13, 2006 8K, at 1, http://www.sec.gov /Archives/edgar/data/1278038/0001104659060 76852/a06-23938_4ex99d1.htm (last visited Dec. 1, 2006); RMR Ex.99.1 (to Nov. 13, 2006 8K), Compl. at 2 (stating Bulldog's practices of putting pressure on management after acquiring a significant percentage of ownership, abandoning the company in a weak state and often threatens expensive litigation) [hereinafter RHR Complaint]; Proxy Statement of Bulldog Investors General Partnership and Karpus Management Stockholders of Seligman Quality Municipal Fund, Inc., DEFC14A, Sept. 26, 2006, http://www.sec.gov /Archives/edgar/data/862813/000136477306000010/sqfdefproxy.txt (last visited Dec. 8, 2006) (explaining a proposal by "Bulldog" to submit for a new slate of board of directors); Definitive Proxy Statement Relating to Merger or Acquisition [sic], filed by Hector Communications Corp., DEFM14A, Sept. 1, 2006, http://www.sec.gov/ Archives/edgar/data/863437/000110465906059347/a06-17435_1de fm14a.htm#BackgroundOfTheMerger_010243 (last visited Dec. 3, 2006) (stating that Goldstein threatened to conduct a proxy contest for a new board of directors); Angela Pruitt, *Activist Presses Closed-End Funds—Goldstein Wants Boards To Reconcile Discounts With Net Asset Values*, WALL ST. J., Apr. 5, 2005. Numerous issues have been the target of Mr. Goldstein's proxy attacks, including the First Israel Fund, which successfully fended off his "activism":

> Last month First Israel Fund thwarted an attack from Mr. Goldstein by nominating him to a seat on its board. Emerging Markets Telecommunications Fund also elected Mr. Goldstein to its board after he raised concerns about the fund's discount and valuation of its investments.
>
> "While I'm a good investor, I'm really a better shareholder activist," said Mr. Goldstein, who was an individual investor for many years before he began managing money professionally 13 years ago.
>
> Mr. Goldstein has a go-for-the-jugular style. In a Securities and Exchange Commission filing in February, he likened New Germany Fund's board to the deposed Iraqi leader Saddam Hussein, arguing the fund was "disenfranchising" shareholders.
>
> Robert Wadsworth, a director of New Germany Fund, said Mr. Goldstein looks out only for his self-interest and not other stockholders. "He is an arbitrageur," he said.
>
> "The problem is that, if you're a member of the fund board, you have to figure out what all of the shareholders want," Mr. Wadsworth said. "I try to focus on the interests of the long-term shareholders, not just those [like Mr. Goldstein] who are trying to get in and out and make a quick buck."

Id.; *cf.*, *Millennium Media Consulting: Highlights From Fall 2006 Market Outlook & Investment Press Briefing*, MARKET WIRE (Press Release), Oct. 31, 2006, *available at* http://www.marketwire.com/mw/ release_html_b1?release_id=178864 (last visited Dec. 3, 2006). Mr. Goldstein commented that:

Goldstein publicly acknowledged that he owes fiduciary duties to his investors, but not surprisingly, just as the term "hedge fund" is not mentioned anywhere in the federal securities laws, the core concept of fiduciary duty was altogether absent from the *Goldstein* petitioners' pleadings.[122] One can only surmise why a unanimous circuit court did not evaluate the issue of fiduciary duty in the hedge fund context, especially when the regulatory stakes were so high. Perhaps it was so persuaded by the inconsistencies of the SEC's past interpretation of the word "client," that it viewed further analysis to be unnecessary.

> The typical value investor will buy a stock for 50% of its intrinsic value and wait for a catalyst. Trouble is, some stocks are still cheap 10 years later . . . . Maximizing shareholder value can take awhile, but it shouldn't take forever. I believe a corporate director has a fiduciary responsibility to do something if a stock trades at a persistent discount to its intrinsic value.

Id.

122. *See generally* Goldstein Complaint, *supra* note 15 (providing no reference to fiduciary duty). *But see* Lori Pizzani, *Hedge Fund to Challenge SEC, Again: Denial of 13f Regulatory Exemption to Prompt New Lawsuit*, MONEY MGMT. EXECUTIVE, Sept. 18, 2006, *available at* http://www.accessmylibrary.com/comsite5/bin/comsite5.pl?page=library&item_id=0286-17695792 (last visited Dec. 3, 2006) (quoting Phillip Goldstein) ("Just as we [as activist shareholders] don't tolerate management abusing shareholders, I don't think any citizen should tolerate a Federal agency abusing its authority. We have good investment ideas, and we don't want them publicly out there. I have a fiduciary responsibility to [my] investors."); *Millennium Media Consulting: Highlights From Fall 2006 Market Outlook & Investment Press Briefing*, MARKET WIRE, Oct. 31, 2006, *available at* http://www.marketwire.com/mw/release_html_b1?release_id=178864 (last visited Dec. 3, 2006). Mr. Goldstein has publicly acknowledged the importance of fiduciary duty with respect to the management of his hedge funds:

> Acting within your fiduciary duty often means pressing for the sale of a company in order to maximize shareholder value, fighting to open-end a closed-end fund trading at a persistent discount or even challenging securities regulators when a rule makes no sense, said shareholder activist and hedge fund manager Phillip Goldstein, partner with Saddle Brook, N.J.-based Bulldog Investors.

Id.; Angela Pruitt, *Activist Presses Closed-End Funds—Goldstein Wants Boards To Reconcile Discounts With Net Asset*, WALL ST. J., April 5, 2005. The article stated that:

> Mr. Goldstein doesn't deny that making money is his ultimate goal, but he says his activism helps shareholders. "It's true that I have an interest and fiduciary duty to my own investors to try to make them money," said Mr. Goldstein. "If I can do that in an honest, ethical way by being an activist, I think I should do that."

Id.

B. The Commission's Stated Bases for Adoption of the Registration Rule

The SEC specifically noted that it adopted the Rule, "in response to (i) a dramatic growth in hedge funds and the impact on markets of trading by hedge fund advisers, (ii) an increase in fraud involving hedge fund advisers, and (iii) the broader exposure of smaller non-traditional hedge fund investors to the risks of hedge fund investing."[123] Not surprisingly, the *Goldstein* petitioners took almost mocking issue with each of the SEC's stated reasons, and suggested the bases were non-starters or even dubious for lack of any proffered evidence by the SEC.[124] The *Goldstein* petitioners also relied heavily on the 1999 President's Working Group Report ("PWG")[125] to refute the SEC's cited rationale. The petitioners failed to acknowledge, however, that the primary focus of the PWG was the international banking system,[126] and that the PWG "was not entrusted with protecting investors or the securities markets, [or that] much has changed in the hedge fund

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123. *See* SEC's Appell. Brief, *supra* note 5, at 4-5. The SEC contended that its regulatory framework was a benign measure that merely closed a loophole:

> The rule and rule amendments close a "loophole," which has arisen under the Commission's [1985] safe harbor, allowing hedge fund advisers to avoid registration in situations where the assets of hedge fund investors are managed similarly (or in many instances identically) to the manner in which a registered adviser manages the assets of clients who directly open accounts with the adviser. . . . Not only do the rule and rule amendments close this loophole but they do so . . . without imposing burdens on the *legitimate* investment activities of hedge funds.

Id. (emphasis in original). The SEC also noted in its brief that, "some hedge funds may offer investors different levels of access to risk and portfolio information, different lock-up periods, and different fee amounts," and found evidence of "side pocket" arrangements, in which a particular set of assets is segregated to provide different investors with distinct investment experiences. *Id.* at 43-44 (citing Carrick Mollencamp and David Reilly, *Tracking the Numbers/Street Sleuth: Some Big Investors Get to Use the Side Door – During Hedge Fund Boom, Not Everyone Is Equal*, WALL ST. J., Mar. 14, 2005, p. C1) (citing the "widespread existence of 'side letters' in the [hedge fund] industry").

124. *See* Goldstein Complaint, *supra* note 15, at ¶ 34 (stating that there was a lack of evidence of fraud in hedge funds in the industry).

125. *See generally* Report of the President's Working Group ("PWG") on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital* Management, Apr. 1999, *available at* http://www.treas.gov/press/releases/reports/hedgfund.pdf (last visited April 24, 2007).

126. *See* SEC's Appell. Brief, *supra* note 5, at 18 (stating that the Working Group was not entrusted with protecting investors or the securities markets).

industry and the market impact of hedge fund advisers since 1999."[127]

1. Future Seismic Shifts and Financial System Fissures

The *Goldstein* court observed that "the current push" for a revised hedge fund regulatory regime finds "its origins in the failure of Long-Term Capital Management ["LTCM"], a Greenwich, Connecticut-based fund that had more than $125 billion in assets under management at its peak. In late 1998, the LTCM fund nearly collapsed."[128] Certainly one could appreciate that the unexpected implosion of one of the world's largest private capital pools might be a matter of grave concern. Nonetheless, the court further observed that with regard to the LTCM debacle, "[a]lmost all of the country's major financial institutions were put at risk due to their credit exposure to Long-Term, and the president of the Federal Reserve Bank of New York personally intervened to engineer a bailout of the fund in order to avoid a national financial crisis."[129] While it is highly unlikely that the prophylactic registration requirements of the so-called "Hedge Fund Rule" could have prevented "a group of elite investors who . . . believed they could beat the market and like alchemists, create limitless wealth for themselves and their partners, [who] in fact created a trillion-dollar hole in the international banking system,"[130] the risk of systemic damage from a major hedge collapse may still lurk beneath the market's surface today. Moreover, to consciously ignore such potential systemic and catastrophic financial risk might be perceived as something akin to the mythical Major T. J. "King" Kong's fateful cinematic fall from the sky.[131]

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127. *See id.* at 18, 48 ("[T]he Commission [wa]s the only member of the [1999 President's] Working Group entrusted with the role of protecting investors and overseeing the nation's securities markets.").

128. *See* Goldstein v. SEC 451 F.3d 873, 877 (D.C. Cir. 2006).

129. *Id.* (citing ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT – HOW ONE SMALL BANK CREATED A TRILLION-DOLLAR HOLE (Hardback ed. 2001)).

130. LOWENSTEIN, WHEN GENIUS FAILED (Paperback ed. 2002); *see* Evan-Pritchard, *supra* note 35; *see also, e.g.*, Jody Shenn and Yalman Onaran, *Bear Stearns Plans $3.2 Billion Hedge Fund Bailout (Update4)*, REUTERS, June 22, 2007, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=amZ.IeL2pJHo&refer=home (last visited June 25, 2007). ("Bear Stearns Cos. offered $3.2 billion in loans to bail out one of its failing hedge funds, the biggest rescue since 1998, after creditors started seizing assets and investors demanded their money back.").

131. DR. STRANGELOVE, OR: HOW I LEARNED TO STOP WORRYING AND LOVE THE

2. Proliferation of Hedge Frauds

The *Goldstein* pleadings scoffed at the amount of securities fraud that has been discovered in the last decade with alleged connections to hedge fund trading activities, and rationalized that any degree of hedge fund fraud is *proportionate* and therefore requires no prophylactic regulatory measures.[132] The *Goldstein* camp sought to marginalize this issue by pointing to the existing anti-fraud provisions of the Advisers Act, which largely addresses fraud retrospectively.[133] It also called attention to the absence of any proffered evidence of hedge fraud in the Rule's Proposing Release, and cited the PWG report for support that there was no evidence indicating that hedge funds or their advisers engage *disproportionately* in fraudulent activity.[134] The *Goldstein* petitioners, however, cited no support whatsoever for the implied premise that the SEC was somehow required to proffer evidence as a prerequisite to its adoption of the Rule.

Mr. Goldstein's theory also seemingly shrugged off scores of recent enforcement actions brought by the SEC against hedge funds, alleging an array of fraudulent activities.[135] There can be little doubt that hedge

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BOMB (Columbia Pictures 1964), *available at* http://www.filmsite.org/drst.html (last visited Dec. 2, 2006).

132. *See* Goldstein Complaint, *supra* note 15, at ¶ 34 (emphasis added).

133. *See id.*

134. *See id*. (emphasis added).

135. *See, e.g.*, *In re* Banc One Inv. Advisors Corp., Advisers Act Release No. 2254 (June 29, 2004), *available at* http://www.sec.gov/litigation/admin/ia-2254.htm (last visited Feb. 25, 2007) [hereinafter Market Timing] (Commission found that investment adviser permitted Canary hedge fund manager Edward Stern to time the adviser's mutual funds, contrary to the funds' prospectuses; helped arrange financing for the timing trades; failed to disclose the timing arrangements; and provided Stern with nonpublic portfolio information); *see* Investment Adviser Registration Final Rule, *supra* note 45, at 72,057 n.29; *see* SEC press release, *SEC Announces $38 Million Fair Fund Distribution in the Veras Hedge Funds Settlement*, Mar. 21, 2007, *available at* http://www.sec.gov/news/press/2007/2007-50.htm (last visited Mar. 25, 2007); SEC v. Sec. Trust Co., N.A., Litigation Release No. 18,653 (Apr. 1, 2004) [hereinafter Late Trading] (consent to judgment by trust company charged with facilitating late trades and market timing by affiliated hedge funds over at least a three-year period), *available at* http://www.sec.gov/litigation/litreleases/lr18653.htm (Mar. 26, 2007); Securities and Exchange Commission v. Michael Lauer, Case No. 03-80612-CIV-ZLOCH (S.D. Fla., filed July 8, 2003) [hereinafter Market Manipulation] ("Specifically, the Complaint alleges that the defendants systematically manipulated the month end closing prices of certain securities held by the Funds to overstate the value of the Funds' holdings in virtually worthless companies."); SEC Litigation Release No. 18,247, July 23, 2003,

fraud exists every trading day, in a wide variety of schemes, including market timing, late trading, insider trading, abusive short sales, market manipulation, and a host of other deceptive (and illegal) practices.[136] The question of whether adviser registration can predict or prevent any of these activities is certainly fair, but at a minimum, it seems reasonable to conclude that the overall regulatory regime contemplated by the vacated Rule did reduce the frequency and scope of such misconduct, or at least increase the likelihood of detection.[137]

Reported hedge fund related fraud has been a growing source of concern for securities regulators. Alleged fraudulent trading by hedge funds reportedly constitutes roughly eleven percent of all recent SEC

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available at http://sec.gov/litigation/litreleases/lr18247.htm (last visited Dec. 4, 2006); *see also* Paul Tharp, *Senate Raises Heat on Funds in Panel Grilling*, N.Y. POST, Dec. 6, 2006, *available at* http://www.nypost.com/seven/12062006/business/senate_raises_heat_on_funds_in_panel_grilling_business_paul_tharp.htm (last visited Feb. 25, 2007) ("Wall Street is stacked tighter than ever against the little guy because secret investment pools that operate freely outside securities laws can actually rig stock trading, according to Senate testimony."); Jenny Anderson, *Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, *available at* http://www.nytimes.com/2006/10/16/business/16hedge.html; Alex Brummer, *Discipline for a false market*, DAILYMAIL (U.K.), Mar. 30, 2007, *available at* http://www.thisismoney.co.uk/news/columnists/article.html?in_article_id=418948&in_page_id=19&in_author_id=1 (last visited Mar. 30, 2007) ("We know from the FSA's [the U.K. Financial Services Authority] survey released earlier this month that in 2005 *almost a quarter of announced deals were preceded by insider trading*.") (emphasis added); Katherine Burton and David Scheer, *Sandell Asset Management Draws SEC Scrutiny for Short Sales*, BLOOMBERG.COM, Oct. 31, 2006, *available at* http://www.bloomberg.com/apps/news?pid=20670001&refer=funds&sid=aJoinHyJ.iyQ (last visited Feb. 25, 2007).

136. *Id*.

137. For example, the SEC examination powers and the books and records provisions within the Rule certainly appeared to have the potential to serve as effective measures to uncover fraudulent activity, and the prospect of an SEC inspection seems to intuitively establish a strong deterrent for the avoidance of misconduct. *But see* speech, *supra* note 35. Commissioner Atkins remarked that it is "wishful thinking" to believe the Rule would have effectively detected hedge funds engaging in securities fraud:

> Needless to say, we did not find the late trading and market timing problems through our examinations of any of the many registered funds, registered advisors, and registered broker-dealers that were at fault. And, those who claim that hedge fund registration would have led us to discover the fraud through examination are engaging in wishful thinking. They don't understand the craftiness of people who engage in illicit activities. As we do now, we will have to rely heavily on disgruntled investors, former employees, and suspicious third parties, such as a prime broker, to alert us to problems.

Id.

insider trading enforcement actions, a figure that does not include frauds already perpetrated but still under investigation, nor those that have eluded detection.[138] The SEC enforcement data arguably suggests a *disproportionate* degree of hedge fund fraud exists that potentially casts a menacing shadow.[139] Recently reported Senate Committee testimony asserted that "hedge funds *routinely* break securities laws and can harm smaller investors with massive insider trading that blindsides and wrecks ordinary investors."[140] Even if Mr. Goldstein's theory of proportional fraud was valid, it does not adequately explain why such a large component of the U.S. capital markets should be permitted to operate so furtively, or how that is in any way consistent with the philosophy of full disclosure.

3. Red Ink Risks For Retail Investors

Among the significant changes in the recent hedge fund landscape has been the increasing trend of hedge fund "retailization."[141] The *Goldstein* pleadings rebutted the findings of "retailization" in the 2003 SEC Staff Report[142] based upon the 1999 PWG findings.[143]

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138. Jesse Westbrook and Otis Bildeau, *U.S. Insider Trading Bill Takes Aim At Hedge Funds*, INT'L HERALD TRIB., Nov. 23, 2006, http://www.iht.com/articles/2006/11/23/business/hedge.php (last visited Jan 31, 2007) ("Lawsuits involving hedge funds made up 11 percent of the SEC's insider trading cases in fiscal 2006, according to agency figures.").

139. *See* SEC's Appell. Brief, *supra* note 5, at 47-48 n.1 ("[T]he Commission found that things had changed since the Working Group's report was issued in 1999: 'the size of the hedge fund industry has doubled, the exposure of investors to hedge funds has broadened, and the incidence of fraud we discover involving hedge fund advisers has increased.'").

140. Paul Tharp, *Senate Raises Heat on Funds in Panel Grilling*, *supra* note 135 (emphasis added) ("Witnesses at a Senate panel took turns yesterday bashing the expanding reach of hedge funds, which now control a third of Wall Street's trading action and wield more than $1.3 trillion of other people's money—mostly cash from well-to-do individuals and big pension funds trying to keep retirement checks flowing.").

141. 2003 SEC Staff Report, *supra* note 23.

142. *Id*.

143. *See* Goldstein Complaint, *supra* note 15, at ¶ 34. The *Goldstein* petitioners sought to marginalize each and every reason the SEC asserted for its promulgation of the Rule, repeatedly referring to the 1999 PWG report:

> Notwithstanding "concerns" expressed in the report about fraud and "retailization" of hedge funds (i.e., investment in hedge funds by significant numbers of less sophisticated investors), the report concluded that (i) there was no evidence that fraud

Nonetheless, evidence of hedge fund "retailization" has continued to mount. For instance, one of the more glaring recent examples is the nine-figure losses suffered by retirement beneficiaries of the San Diego county employees pension fund, directly attributable to its ill-fated Amaranth investment.[144] Mr. Goldstein posited, perhaps at the height of sophistry, that pension funds are all somehow "sophisticated investors."[145] The unfortunate reality, despite the incredulous *Goldstein* rhetoric, is that the real Amaranth risk exposure was incurred by the retirement fund's *beneficiaries*—municipal employees such as former public school teachers, police officers, firefighters, parks and recreation employees, trash collectors, municipal parking lot attendants, and other local government retirees who are entirely antithetical to the concept of the so-called "sophisticated investor."[146]

San Diego pension fund administrators have since fired the consultant who recommended investing in Amaranth's fund,[147] and

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> was disproportionately committed by or in hedge funds that unregistered advisers managed, (ii) the observed growth in hedge funds was fueled by increasing numbers of sophisticated investors such as pension funds, and (iii) there was no evidence of "retailization" in the industry.

Id.

144. *See*, *e.g.*, Christopher S. Rugaber, *Senator Urges Hedge Fund Transparency*, HOUSTON CHRONICLE (AP), Oct. 18, 2006, *available at* http://www.chron.com/cs/CDA/printstory.mpl/ap/fn/4268516 (last visited Oct. 18, 2006).

> [Senator Charles] Grassley (R-Iowa) said in the letter that "tens of millions of Americans may be unwittingly exposed to hedge fund investments" through public and private pension plans that invest in hedge funds. As a result, significant future losses at hedge funds could put many workers' retirement security at risk, Grassley wrote, and could cause losses at the federal pension insurance agency, the Pension Benefit Guaranty Corp.

Id. *See* Jennifer McCandless, *Pension Fund to Replace Advisor Post-Amaranth*, FINANCIAL NEWS (UK), Oct. 24, 2006, *available at* http://www.financialnews-us.com/?page=ushome&contentid=1045677634 (last visited Mar. 26, 2007) ("The San Diego County Employees Retirement Association, the Californian pension plan, is looking to replace the investment consultancy that recommended it put money in Amaranth Advisors, a move which lost the fund more than $100m (€79.6m).").

145. *See* Goldstein Complaint, *supra* note 15, at ¶ 41.

146. *Id.*

147. Sam Hodgson, *SDCERA parts ways with consultant who recommended Amaranth*, THE DAILY TRANSCRIPT, Oct. 23, 2006, *available at* http://www.sddt.com/News/article.cfm?SourceCode=20061023czf ("The San Diego County Employees Retirement Association has parted ways with the consultant who recommended purchasing $175 million worth of shares in Amaranth—an investment that is now worth an estimated $70 million.").

retained a high profile securities litigation firm in an attempt to recover at least a portion of the pension fund's reported nine-figure Amaranth losses.[148] Meanwhile, a massive hedge fund management firm that "help[ed in the] winding down of [Amaranth's] investment portfolio" completed an initial public offering on February 9, 2007, and the private equity firm, Blackstone Group, L.P., went public on June 21, 2007, despite bipartisan protests from ranking legislators to postpone the $4B NYSE offering while Congress conducted hearings into the matter.[149] Meanwhile, as financial market and media attention was still focused on the Blackstone IPO, shares of Freedom Acquisition Holdings Corp., a little-known AMEX-listed special purpose acquisition corporation ("SPAC"), had inexplicably surged on aberrant volume in a declining broader market, and on June 25, 2007, a $3.4B reverse acquisition involving GLG Partners was revealed, which prompted at least one commentator to question the "flagrantly suspicious trading ahead of the announcement regarding the "regulatory-challenged London-based hedge fund."[150] These and other recent market developments certainly

148. Michael Herman, *U.S. Fund Hires Lawyers To Prepare Amaranth Case*, TIMES ONLINE (UK), Oct. 23, 2006, *available at* http://business.timesonline.co.uk/tol/business/law/corporate/article610330.ece (last visited Feb. 24, 2007).

149. *See* Lynn Cowan, *Fortress Registers for First U.S. IPO of Hedge Fund*, WALL ST. J., Nov. 9, 2006, *available at* http://online.wsj.com/article_print/SB116308559523818612.html (last visited Nov. 10, 2006). Fortress, now trading under the ticker symbol "FIG," completed the first ever U.S. "IPO" of a hedge fund adviser:

> The company [Fortress Investment Group, LLC], which has $26 billion in assets under management, offers the public a rare opportunity to own an alternative investment manager and benefit from its hefty management fees through dividends. As an alternative asset manager, Fortress raises and manages private-equity funds and hedge funds . . . .

Id.; *see also* William Hutchings, *Fortress advises on Amaranth liquidation*, FINANCIALNEWS, Oct. 2, 2006, *available at* http://www.financialnews-us.com/?contentid=1045568680 (last visited Nov. 14, 2006); Michael J. de la Merced, *Fortress Goes Public, a First for Hedge Funds Inside U.S.*, N.Y. TIMES, Feb. 9, 2007, *available at* http://www.nytimes.com/2007/02/09/business/09hedge.html (last visited Feb. 9, 2007). Rachelle Younglai, *SEC clears Blackstone IPO despite lawmakers' plea*, Reuters, June 21, 2007, *available at* http://www.reuters.com/article/politicsNews/idUSN2139935620070621 (last visited June 24, 2007).

> A last-minute plea from [Henry Waxman] a senior U.S. House of Representatives Democrat to delay Blackstone Group LP's initial public offering was rejected by U.S. regulators on Thursday, and the IPO went ahead, eagerly grabbed up by hungry investors. In making its decision, the U.S. Securities and Exchange Commission said it "rigorously applied" U.S. laws in reviewing the offering. . . . Waxman was the fifth chairman of a congressional committee to express concerns or raise questions about

suggest that the trend towards hedge fund "retailization" is undeniable, and it may someday soon collide with the Second Circuit's "special circumstances" doctrine first articulated in *De Kwiatkowsi*.[151]

> the Blackstone IPO during the past week.

Id.

150. *See* Freedom Acquisition Holdings, Inc., Press Release, *GLG Partners to Access Public Markets Through Reverse Acquisition*, June 25, 2007, *available at* http://www.amex.com/?href=/equities/listCmp/EqLCCmpNews.jsp?Product_Symbol=FRH&listedYear=2007 (last visited June 25, 2007). The British hedge fund characterized its reverse "SPAC" acquisition as "a Key Strategic Step in Building GLG's Global Business," and revealed its expectations of an eventual NYSE listing:

> The combined company will be named GLG Partners, Inc. Shares of the combined company are expected to trade on the New York Stock Exchange under the ticker symbol 'GLG' upon consummation of the transaction. GLG will also explore the merits of a dual listing in Europe. Based on the closing price of Freedom's shares on Friday, June 22, 2007, Freedom's shareholders will own approximately 28 percent and current GLG equity holders will own approximately 72 percent of the combined company's shares on a fully diluted basis.

Id. *See also*, Greg Newton, *Somebody Blabbed: Freedom Shares Jumped 8% Friday Ahead of GLG Reverse Acquisition*, SEEKINGALPHA.COM, June 25, 2007, *available at* http://financial.seekingalpha.com/article/39308 (last visited June 25, 2007). The snarky market pundit questioned the suspicious surge in Freedom Acquisition Holdings that occurred just one trading day before GLG's reverse SPAC acquisition announcement:

> GLG, the hugely successful—$20 billion in assets—but regulatory-challenged London-based hedge fund, will slip through the backdoor to list on the New York Stock Exchange. Funnily enough, the shares of its reverse takeover vehicle, the Amex-listed SPAC (special purpose acquisition company) Freedom Acquisition Holdings Corp (FRH), magically gained more than 8 percent Friday, on almost 10 times their average volume, mostly late in the day when the major indexes were heading off a cliff. . . .
>
> The flagrantly suspicious trading in FRH Friday is ironic, or perhaps even iconic. GLG was sanctioned by British regulators last year, and French regulators last week, for separate incidents of what boiled down to insider trading; GLG plans appealing the French ruling.

Id. *See also*, Henny Sender and Alistair MacDonald, *GLG Partners Two-Stepping To U.S. Listing*, WALL ST. J., June 25, 2007, *available at* http://online.wsj.com/article/SB118273321096046620.html (last visited June 25, 2007) ("GLG is avoiding the hassles of an initial public offering by selling a stake in itself to a company that is already publicly traded. . . . A public listing is a big step for GLG, which has a somewhat checkered past."); Alexander Ferguson, *GLG Partners to float on New York Stock Exchange via reverse takeover*, FORBES (via THOMSON/AFX NEWS), June 25, 2007, *available* http://www.forbes.com/markets/feeds/afx/2007/06/25/afx3852586.html (last visited June 25, 2007).

151. For example, Goldman Sachs also recently introduced a synthetic derivative securities product (coined the "Absolute Return Tracker") that apparently "seeks to replicate" hedge fund exposure without any minimum investment requirements or

IV. THE *GOLDSTEIN* AFTERMATH, AMARANTH, AND THE SEC'S SLOW AND STEADY RESPONSE

While the SEC has used the media to press its agenda of expanded hedge fund regulation following the *Goldstein* aftermath,[152] the Commission now appears to have adopted a slower and more cautious gait on this path, allowing "more time to review their language." As its cautious deliberations continue, the SEC has not yet reached any conclusive determinations regarding the future regulatory framework for this $2 trillion market sector, but did propose a substantive anti-fraud Rule at the end of 2006.[153]

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pesky "accredited investor" thresholds. *See Goldman Plays Down Tracker Challenge To Hedge Funds*, HEDGEWEEK.COM, Dec. 8, 2006, *available at* http://www.hedgeweek.com/articles/detail.jsp?content_id =42044 (last visited Jan. 31, 2007). Goldman-Sachs has developed a securities product that seeks to mimic hedge fund performance, that is readily available to overseas retail investors:

> Despite announcing the launch of a tracker product that seeks to replicate the returns of hedge fund strategies at the cost to the investor of an index product, Goldman Sachs is playing down suggestions that the product could eat into the market for funds of hedge funds by delivering similar performance at a much lower price.
>
> The Absolute Return Tracker uses hedge fund investment data delivered by a third-party provider with a one-month lag to determine the aggregate positions of hedge funds in a basket of asset classes and to replicate their net exposure to equities, commodities, fixed income, credit and volatility through derivatives and other investments. The ART index is already available to retail investors in Italy through a tie-up with a bank there and it is likely to be rolled out in other markets in the new year.

Id. *See* De Kwiatkowski, *supra* note 118 (discussing the De Kwiatkowski court's development of the "special circumstances" doctrine in the context of a "dependent" client and the duties owed to that client by a broker).

152. *See, e.g.*, Roddy Boyd, *We Will Follow the Money: SEC*, N.Y. POST, Nov. 14, 2006, *available at* http://www.nypost.com/seven/11142006/business/we_will_follow_the_money__sec_business_roddy_boyd.htm (last visited Dec. 5, 2006).

153. *S.E.C. Delays Weighing Hedge Rules*, N.Y. TIMES, Dec. 2, 2006, *available at* http://www.nytimes.com/2006/12/02/business/02hedge.html?_r=1&dlbk&oref=slogin (last visited Dec. 5, 2006). The SEC has apparently adopted a more circumspect approach to rule promulgation following the results of *Goldstein*:

> The Securities and Exchange Commission on Friday dropped consideration of two hedge fund measures from its agenda for a Monday meeting, saying it wanted more time to review their language.
>
> One measure dealt with the minimum net worth that an investor must have to be allowed to invest in hedge funds. In September, the S.E.C. said it was preparing a measure that would raise the minimum, known as the accredited investor standard, amid concern that too many investors of limited means are putting money in hedge funds.

> The other measure involves tightening the antifraud statute dealing with hedge funds—lightly policed capital pools popular with the rich that have doubled their assets under management to $1.3 trillion in the last five years. Both measures emerged after a court in June struck down an agency regulation that required most hedge fund advisers to register with the S.E.C. The court said the S.E.C. overstepped its bounds in adopting the rule.
>
> An S.E.C. spokesman said the agency wanted "another week to make sure the technical language of the antifraud provision appropriately addresses the court's decision." The S.E.C. has scheduled another public meeting for Dec. 13, when the hedge fund measures could come up.

Id.; *see* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles (Proposed Rule - comment period ended Mar. 9, 2007), 17 CFR §§ 230 and 275 (Dec. 27, 2006, SEC Release No. 33-8766; IA-2576; File No. S7-25-06), *available at* http://www.sec.gov/rules/proposed/2006/33-8766.pdf (last visited Jan. 21, 2007); *see* comment letter from Phillip Goldstein to SEC, Mar. 3, 2007, *available at* http://sec.gov/comments/s7-25-06/pgoldstein8435.pdf (last visited Mar. 28, 2007) (criticizing the anti-fraud provisions of the Proposed Rule as "unnecessary" and characterizing the proposed increase in the financial minimums for the definition of "accredited investor" as a "massive increase in the minimum wealth an individual would need before that person could invest in a hedge fund"). Mr. Goldstein also contended the Proposed Rule is "fatally flawed" because it does not expressly include private equity funds within its ambit, and that "if investor protection is the sole objective of the proposed rule (as it should be) then excluding venture capital funds unquestionably renders the rule arbitrary and capricious." *Id*. Mr. Goldstein noted, however, that "we do not intend to challenge the rule, because . . . we do not expect it to have a material effect on our business." *Id*. Mr. Goldstein also proposed a "blanket exemption" for any otherwise unqualified investor who submits certain suggested waiver language. *Id. See also* Thomas John Holton, Ephraim Lemberger and Michael Mavrides (Bingham-McCutchen, LLP), *United States: SEC Issues Proposed Rules Affecting Hedge Funds And Other Pooled Investment Vehicles*, 18 Jan. 2007, *available at* http://www.mondaq.com/article.asp?article_id=45566&lk=1 (last visited Jan. 21, 2007). The authors, Bingham-McCutchen securities lawyers, noted certain details of the SEC's proposal of a new anti-fraud rule in late 2006:

> On December 27, 2006, the Securities and Exchange Commission published two sets of proposed new rules. Many pooled investment vehicles, including hedge funds, venture capital funds, private equity funds, listed closed-end funds, and mutual funds, will be affected by one or both sets of rule . . . . Proposed Rule 206(4)-8 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), would prohibit any investment adviser, whether or not registered, to a pooled investment vehicle from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in the pooled investment vehicle . . . . Specifically, the proposed rule would make it a fraudulent, deceptive or manipulative act, practice or course of business for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact to any investor or prospective investor in a pooled investment vehicle or omit a material fact necessary to make statements made to such investors, in light of the circumstances under which they were made, not misleading.

The U.S. Federal Reserve, SEC, and IMF have all recognized the reality that hedge fund trading activity often improves financial market pricing efficiency and, in many instances, serves to increase liquidity.[154] However, hedge funds are such an enormous component of the U.S. commodities, futures and securities markets that the related trading activities invariably affect counter-parties; overall macro (and micro) market conditions; and a variety of other market participants, sometimes with destructive (and illegal) results. Consequently, "[p]rosecutors [have] said it's impossible to fight the rampant Wild West mentality among the hedge fund crowd unless new laws are enacted to tighten the industry's loose ways and wide loopholes."[155] While the SEC adopted an arguably flawed approach when promulgating the so-called "Hedge Fund Rule," there can be little debate that a multi-trillion dollar market sector warrants some measure of regulatory oversight. Of course, the "devil is in the details,"[156] and the pressing questions now are not if the

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> In addition, the proposed rule would prohibit any act or practice which defrauds investors or prospective investors, regardless of whether such act or practice involves statements.

Id. (emphasis in original).

154. Ubide, *supra* note 28; *see also* IMF's United States: 2006 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Decision, July 2006, IMF Country Report No. 06/297, *available at* http://www.imf.org/external/pubs/ft/scr/2006/cr06279.pdf (last visited Dec. 2, 2006) (The increased activity of hedge funds had enhanced price discovery and liquidity in many of the new markets. However, they agreed with the mission that some markets had yet to be fully tested in a less benign financial environment). IMF Staff Report at 11; *see also* CNBC interview of former Goldman Sachs executive and current U.S. Treasury Secretary Henry "Hank" Pauslon, Dec. 8, 2006, *Paulson: Hedge Funds 'Positive' But Need to Be Monitored*, CNBC.COM, Dec. 8, 2006, *available at* http://www.cnbc.com/id/16109844 (last visited Dec. 8, 2006). Sec. Paulson stated that:

> By and large, hedge funds (and derivatives) have been positive for the capital markets, they have made them more efficient, more liquid, and it's been very helpful in dispersing risk, and I think that may be one of the reasons we haven't had a financial shock in the last eight years. But again, it's very important that we look very carefully at the nature of the market today.

Id.

155. *See* Tharp, *supra* note 135 ("Witnesses at a Senate panel took turns yesterday bashing the expanding reach of hedge funds, which *now control a third of Wall Street's trading action and wield more than $1.3 trillion of other peoples' money* - mostly cash from well-to-do individuals and big pension funds trying to keep retirement checks flowing.") (emphasis added).

156. RANDOM HOUSE DICTIONARY OF POPULAR PROVERBS AND SAYINGS (1st ed. 1996) shows this phrase as a variation of "God is in the details - Whatever one does should be done thoroughly; details are important." The saying is generally attributed to

SEC will regain some measure of regulatory oversight, but rather *when* and *how*.

Congress took an initial step subsequent the *Goldstein* decision, but no new legislation resulted from the proposal. The House of Representatives Finance Committee Chairman for the 110th Congress, Representative Barney Frank (Mass.), and three House co-sponsors,[157] introduced a Bill on the heels of the D.C. Circuit Court's *Goldstein* opinion[158] during the twilight of the 109th Congress. Although short on details, it was potentially profound in its post-*Goldstein* regulatory impact. The two-page Bill (H.R. 5712) titled, "The Securities and Exchange Commission Authority Restoration Act of 2006," sought "[t]o amend the Investment Advisers Act of 1940 to authorize the Commission to require the registration of hedge fund advisers under that Act."[159] If Congress had enacted H.R. 5712, the method of counting

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Gustave Flaubert (1821-80), who is often quoted as saying, "Le bon Dieu est dans le detail" ("God is in the details"); *see* BARTLETT'S FAMILIAR QUOTATIONS (16th ed.). Other attributions include Michelangelo, the architect Ludwig Mies van der Rohe, and the art historian Aby Warburg. "The Devil is in the details" is a variant of the proverb, referring to a catch hidden in the details. "Governing is in the details" and "The truth, if it exists, is in the details" are recent variants. Listed as an anonymous saying in the 16th edition of Bartlett's "Familiar Quotations." *Id.*

157. Rep. Michael Capuano (D-MA), Rep. Charles Gonzalez (D-TX), Rep. Paul Kanjorski (D-PA) were co-sponsors of The Securities and Exchange Commission Authority Restoration Act of 2006, H.R. 5712, 109th Cong. (2d Sess. 2006) [hereinafter H.R. 5712].

158. H.R. 5712 was introduced on June 29, 2006, six days after the *Goldstein* opinion was released.

159. *See* The Securities and Exchange Commission Authority Restoration Act of 2006, H.R. 5712, 109th Cong. (2d Sess. 2006). Representative Frank's proposed bill would have restored the SEC authority vacated by the *Goldstein* court:

> SEC. 2. AUTHORITY TO LIMIT EXEMPTION.
>
> Section 203 of the Investment Advisers Act of 1940 (15 U.S.C. [§] 80b-3) is amended by adding at the end the following new subsection:
>
> (l) AUTHORITY TO LIMIT EXEMPTION. — (1) AUTHORITY.—The Commission may, by rule or regulation, limit the availability of the exemption provided by subsection (b)(3), and require the registration under this section, of an investment adviser by *requiring that certain shareholders, partners, and beneficial owners of, or investors in, clients of the adviser shall also be counted as clients themselves for purposes of such subsection*, as the Commission determines necessary in the public interest or for the protection of investors. (emphasis added).
>
> (2) RULE OF CONSTRUCTION.—The treatment of a shareholder, partner, beneficial owner, or investor as a client for 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.

"clients" would have reverted to the method employed within the so-called "Hedge Fund Rule" and reversed the effect of the D.C. Circuit Court's *Goldstein* decision. Three weeks after the bill's introduction, H.R. 5712 was referred to the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, where it eventually "died in committee."[160] One month after the bill's introduction, the circuit court issued its formal *Goldstein* mandate, and the SEC opted to not appeal the matter to the U.S. Supreme Court.[161]

There was a trickle of investment adviser "de-registrations" after the Rule was formally vacated, but the trend slowed dramatically, with just ten percent of all affected investment advisers electing to remove their registration as of January 2007.[162] Among the investment advisers

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Id.

160. *See* H.R. 5712 status tracking, *available at* http://www.govtrack.us/congress/bill.xpd?bill=h109-5712 (last visited Mar. 26, 2007) ("This bill is in the first stage of the legislative process where the bill is considered in committee and may undergo significant changes in markup sessions."); *Banking chairman wary of hedge fund registration*, INVESTMENT NEWS, Feb. 6, 2007, *available at* http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070206/FREE/70205030/-1/INRegulatoryAlert03 (last visited Feb. 15, 2007). The article points out that:

> At a press conference held in early December [2006], Sen. Christopher Dodd, D-Conn., said that although he's concerned about pension plan money that's invested in hedge funds, he does not see "rushing back" into legislation that would give the Securities and Exchange Commission authority to require hedge funds to register with the agency. A bill [H.R. 5712] introduced last year with that goal died in committee.

Id.

161. *See* Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in Phillip Goldstein et al. v. SEC (Aug. 7, 2006), *available at* http://sec.gov/news/press/2006/2006-135.htm (last visited Nov. 29, 2006); *see also* Amanda Cantrell, *SEC Faces Hedge Fund Deadline: The SEC has until Aug. 7 to decide what to do in the wake of a court's decision to overturn its hedge fund rule*, CNNMONEY.COM, Aug. 4, 2006, *available at* http://money.cnn.com/2006/08/04/markets/hedge_returns/ (last visited Jan. 2, 2007).

162. *More Hedge Funds Deregister After Ruling*, AFX UK Focus (U.K.), September 27, 2006. Slightly more than one hundred advisers rescinded their Form ADV registrations (out of a total exceeding 2,000):

> From June 23 [2006], through Sept. 21 [2006], 116 advisers indicating they have hedge funds as clients have withdrawn their registrations, said John Heine, a spokesman for the SEC. Of those, about 76 indicated that they withdrew due to the court decision overturning the regulatory push, he said. "Others withdrew for various other reasons, including going out of business, [Heine] said." And according to John Heine, since the appeals court decision through Sept. 21, 2006, 34 hedge fund advisers have registered with the SEC. As of September 21, 2006, there were a total of 2,468 Investment Advisers who had indicated they have hedge funds as "clients" registered with the SEC, according to the SEC's Heine.

who elected to not withdraw registration was CastleRock Management, a Manhattan-based "buy and hold" bottom-up selection strategy long equities hedge fund.[163] During a March 20, 2007 guest lecture at Fordham University School of Law, CastleRock president Paul Tanico advised Fordham students to, "[r]un the business down the middle of the road and remember the lines. . . . . The SEC and IRS are not to be messed with, . . . don't run your business over the line, [or] shortcut for something."[164] Mr. Tanico also commented about the SEC registration regime and his firm's reasoning for not withdrawing its registration Form ADV:

> I don't like regulation, and think rich people ought to be able to lose money in hedge funds without registration—we are registered though and we always run our business down the middle of the road so it wasn't a big deal and we didn't de-register. . . . I think that a lot of funds that are going down to the small investor where people have no business [investing] in these funds, and with a lot of amateurs are running it who lose money, so I think that aspect of . . . safeguarding smaller investors with the rules was right. . . . I would hate to see Congress interfere because of a few "bad apples" . . . so I come out

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Id.; *see also* Hannah Glover, *Most Hedge Funds Remain Registered: Prepare for SEC Exams; Staying Squeaky Clean*, MONEY MGMT. EXEC., Jan. 15, 2007, 2007 WLNR 871608, *available at* http://www.financial-planning.com/pubs/fpi/20070119101.html (last visited Jan. 19, 2007). Only a slim minority of investment advisers elected to withdraw their registration Forms ADV:

> After the fight for the right to remain unregistered, only about 10% of those hedge fund advisors that signed up with the Securities and Exchange Commission before last year's Feb. 1 [2006] deadline have opted to withdraw, according to data from the federal regulator. The remaining 2,200 or so are readying for examinations.
>
> The reason, industry watchers suggest, is that what was once characterized as the "Wild West" of investment management has learned that registration has its advantages, not the least of which is credibility, especially with deep-pocketed institutional investors.

Id.

163. CastleRock Management (IARD/CRD No. 132155) Investment Adviser registration Form ADV was timely filed in February 2005, *available at* http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_OrgSearch.aspx (last visited Mar. 25, 2007).

164. Videotape of Mr. Tanico's remarks on file with Fordham University School of Law's Center for Corporate Securities and Financial Law, Prof. Ann R. Rakoff, Executive Director, 140 W. 62nd St., Room 443, New York, NY 10023; telephone (212) 636-7985; e-mail: corporatecenter@law.fordham.edu.

on the side of some rules are okay but don't overdo it.[165]

Just two months after the *Goldstein* decision, the Greenwich-based and, ironically named,[166] Amaranth Advisors collapsed under the weight of its own heavily leveraged and highly speculative natural gas futures positions.[167] The market barely blinked, and JPMorgan Chase & Co. (Amaranth's prime broker) and T. Boone Pickens were among those who quickly swooped in to scoop up discounted chunks of Amaranth's decimated natural gas futures portfolio. Incidentally, just a few days later, Mr. Pickens's son was the subject of a *Wall Street Journal* article reporting his alleged involvement in a "pump and dump" stock scheme that employed "fax blasts" to induce investors to purchase touted securities.[168] Meanwhile, Representative Frank, who retreated from his

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165. *Id.* Mr. Tanico also noted during a March 20, 2007 "Mergers and Acquisitions" guest lecture at Fordham University School of Law:

> I think at the higher end if the minimum requirements are a million dollars, and in the larger fund that we have is five million dollars in investable assets without your home, you're a big boy, and you know what, if you lose your money [ ] you shouldn't be looking to the government to help you.
>
> I think there should be a higher standard to that [for pension funds], and our being registered makes us more comfortable for pension funds, so I think there's an element that I can kind of buy into.

166. am·a·ranth / Pronunciation [am-uh-ranth] – noun; 1. an imaginary, undying flower. http://dictionary.reference.com/browse/amaranth (last visited, Dec. 5, 2006).

167. Gretchen Morgenson and Jenny Anderson, *A Hedge Fund's Loss Rattles Nerves*, N.Y. TIMES, Sept. 19, 2006, *available at* http://www.nytimes.com/2006/09/19/business/19hedge.html (last visited Dec 5, 2006).

168. Geoffrey Smith and Matthew Leising, *Citadel, Funds Bet $3 Billion After Amaranth Falls (Update2)*, BLOOMBERG, Oct. 16, 2006, *available at* http://www.canadianhedgewatch.com/content/news/general/?id=1022 (last visited Dec. 6, 2006); *see* Kara Scannell, *Stock-Scam Case: a Pickens, a Fax, Bad Luck*, Oct. 30, 2006, WALL ST. J.

> [T. Boone Pickens's] son Michael O'Brien Pickens has taken a different path to try to emulate that success, federal authorities alleged yesterday. The younger Mr. Pickens, who is 51 years old, and another man were arrested and charged with securities fraud for allegedly manipulating thinly traded stocks through a 'pump and dump' scheme orchestrated via blast faxes—*including some sent to the federal agencies that nabbed them*.

Id. (emphasis added); *see Dallas billionaire's son admits to securities fraud*, DALLAS BUS. J., Oct. 31, 2006, *available at* http://dallas.bizjournals.com/dallas/stories/2006/10/30/daily14.html (last visited Dec. 30, 2006); *SEC Charges Stock Promoters in Phony Fax Scam*, SEC Litigation Release No. 19305, July 18, 2005, SEC v. Joshua Yafa, Michael O. Pickens et al., Civil Action No. 05 CV 6480 (SDNY LAK), *available at* http://www.sec.gov/litigation/litreleases/lr19305.htm (last visited Dec. 30, 2006); FBI Press Release, *Hot Stock Tip, Anyone? The Case of the Phony Faxes*, Nov. 20, rather aggressive pro-regulatory stance subsequent to the November 2006 election, called for House Committee hearings on hedge funds, and stated that he was "without any predisposition of saying more regulation is needed."[169]

Charles Grassely, an Iowa Republican, has not been nearly as ambivalent as some of his congressional peers with regard to his hedge fund policy-making approach. The former Chairman, and now ranking minority Senate Finance Committee member, unsuccessfully sought to attach a hedge fund amendment to a recent Homeland Security bill, because, as Mr. Grassley contended, various terrorist groups may have undetected hedge fund links and possibly launder money through securities trading activities of the secretive pooled investments.[170] Senator Grassley also asserted while introducing a new bill that all hedge funds managing more than $50 million in assets and serving more than 15 investors should be compelled to register with the Commission as Investment Advisers, a policy proposition generally consistent with the now "arbitrary" rule that was vacated by the *Goldstein* court.[171]

It certainly remains debatable whether the vacated Rule could have possibly prevented (or even helped to predict) Brian Hunter, a 32 year-old trader formerly employed by Amaranth, from adopting a "bet the farm" trading strategy in volatile natural gas futures during the summer

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2006, *available at* http://www.fbi.gov/page2/nov06/stock_scam112006.htm (last visited Dec. 30, 2006).

169. *Frank Wants Hearings on Hedge Fund Industry*, BOSTON GLOBE, Dec. 5, 2006, http://www.boston.com/business/globe/articles/2006/12/05/airline_to_delay_taking_delivery_of_32_small_jets/ (last visited Dec. 5, 2006).

170. Marilyn Geewax, *Powerful hedge funds present a dilemma for Congress, regulators*, SALT LAKE TRIBUNE, Mar. 17, 2007, *available at* http://www.sltrib.com/business/ci_5461412 (last visited Mar. 18, 2007) ("The secretive way that hedge funds operate might not be an issue for the super-rich who first invested in hedge funds, but today the average Joe has a stake," [Sen.] Grassley said in a statement. "Right now, a hedge fund isn't required to report even basic information about who runs the fund.").

171. *Id*. Iowa Senator Charles Grassley's "rebuffed" amendment would also have required hedge funds to make their records available for routine regulatory inspections, much like the "arbitrary" rule at issue (and vacated) in *Goldstein*. Sen. Grassley introduced a terse, two page bill aiming to amend Section 203(b)(3) of the Investment Advisors Act of 1940 titled, "The Hedge Fund Registration Act of 2007" which effectively seeks to replace the term "client" with "investor" in order reverse the effect of the U.S. Court of Appeals ruling in Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006), and expressly authorize the SEC to compel hedge fund advisor registration. Copy of Grassley bill *available at* http://grassley.senate.gov/releases/2007/05152007.pdf (last visited May 21, 2007).

of 2006.[172] Not surprisingly, many hedge fund managers seem to agree.[173] Similarly, exchange-listed and registered issuers such as Adelphia, Enron, Refco, and WorldCom all collapsed after defrauding thousands of investors of millions of dollars,[174] all while filing periodic reports, and under the regulatory auspices of major exchanges and the SEC.[175]

The split-Commission's regulatory aim embodied laudable goals and intentions, but was largely undermined by the parsing of its prior use of a single word. A unanimous three-judge circuit court opinion vacated the Rule;[176] most notably, it was apparently because of the SEC's inconsistent interpretation[177] of the term "client" for the purposes

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172. Ann Davis, *How Giant Bets on Natural Gas Sank Brash Hedge-Fund Trader - Up in Summer, Brian Hunter Lost $5 Billion in a Week As Market Turned on Him*, WALL ST. J., Sept. 19, 2006, at A1, *available at* http://online.wsj.com/article_print/SB115861715980366723.html (last visited Feb. 18, 2007). Incidentally, Mr. Hunter, Amaranth's former natural gas futures trader, began actively seeking investors in late March of 2007 for a new Calgary-based commodities hedge fund named "Solengo Capital." *See* Alistair Barr, *Amaranth investors suggest dropping legal claims*, MARKETWATCH.COM, Mar. 23, 2007, *available at* http://www.marketwatch.com/news/story/some-amaranth-investors-suggest-dropping/story.aspx?guid=%7B3E5061BB-EB8A-4184-A456-8E59C5A5249B%7D (last visited Mar. 25, 2007). *See also* Amaranth Advisors L.L.C., Comment Letter to SEC Re: File No. S7-30-04—Registration under the Advisers Act of Certain Hedge Fund Advisers, Sept. 15, 2004 ("Contrary to media stereotypes of hedge fund managers, Amaranth does not operate in the shadows' outside of regulatory scrutiny.").

173. Melanie Waddell, *Will the SEC Appeal? Dealing with hedge fund registration's legal challenge*, INVESTMENT ADVISOR, Aug. 2006, *available at* http://www.investmentadvisor.com/article.php?topic=Alternative+Investments&article=6648 (last visited Dec. 5, 2006). Some hedge fund managers are skeptical that a registration requirement will prevent securities fraud:

> Like other hedge fund advisors, Hedges says he's "unconvinced that registration is going to prevent fraud" in the $1.1 trillion hedge fund industry. "A lot of time, money, investigation, and energy has been spent under the auspices of registration being used to prevent fraud, and I don't think that's a sufficient deterrent," he says. "I think the SEC is already heavily burdened as an agency in terms of enforcement."

Id.

174. *See* Goldstein Complaint, *supra* note 15, at ¶ 36.

175. *Id.*

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

177. *See* Speech, *supra* note 35. Commissioner Atkins has noted that the Rule's flaws invited scrutiny:

> It is no wonder that the rule, with its *ad hoc* and internally inconsistent definition of 'client,' attracted a legal challenge. The majority, in adopting the registration mandate, abandoned the common-sense notion that the client is the person for whom

of the Rule, which in the court's view, fell beyond "the bounds of reasonableness."[178] The *Goldstein* court vacated what was deemed to be an "arbitrary" Rule and, while the SEC still possesses the data produced from the now defunct registration regime, it was stripped of its ability to perform hedge fund books and records inspections—perhaps the most potent of the Rule's investigative measures. Nonetheless, the glimmer of a post-*Goldstein* regulatory dawn is on the horizon for those who favor heightened regulatory oversight, or at least desire some semblance of hedge fund transparency.

The sharp focus by the media, market commentators, legislators, investors, and regulators on issues related to hedge funds in the *Goldstein* aftermath might eventually lead to a shift in U.S. hedge fund regulation (and possibly within certain foreign jurisdictions). Such reform will apparently not come without staunch resistance. Recent remarks from a presidential panel chaired by U.S. Treasury Secretary Henry Paulson, asserted "the current system of hedge-fund regulation is 'working well' and market discipline remains the best way to protect investors and guard against risks to the financial system."[179] Former

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> the advice is tailored. The final rule redefined 'client' solely for advisors to hedge funds and then only to determine their eligibility to rely on the fifteen client exemption from registration. The new definition demands that advisors look through their hedge funds and count investors as clients.
>
> Regardless of how the Court decides the case, the challenge has already served to remind us of the danger of undergoing regulatory contortions to achieve a questionable objective.

Id.

178. *See* Goldstein v. SEC, 451 F.3d 873, 881 (D.C. Cir. 2006) (quoting Aid Ass'n for Lutherans v. U.S. Postal Serv., 321 F.3d 1166, 74, 77-78 (D.C.Cir.2003)).

> An agency construction of a statute cannot survive judicial review if a contested regulation reflects an action that exceeds the agency's authority. It does not matter whether the unlawful action arises because the disputed regulation defies the plain language of a statute or because the agency's construction is utterly unreasonable and thus impermissible.

Id.; *cf.* FCC v. Nat'l Citizens Comm. for Broadcasting, 436 U.S. 775, 808 n.29 (1978) (citing SEC v. Chenery Corp., 332 U.S. 194, 201-02 (1947)).

179. Judith Burns, *Rep. Frank: No Decision Yet On Hedge Fund Regulation*, DOW JONES NEWSWIRES, Mar. 13, 2007, *available at* http://www.nasdaq.com/aspxcontent/NewsStory.aspx?cpath=20070313%5CACQDJON200703131503DOWJONESDJONLINE000587.htm& (last visited Mar. 26, 2007). Opposition to a renewed hedge fund registration framework was pronounced during recent congressional committee testimony:

> Industry officials and academics who testified before the House panel mostly opposed requiring hedge fund managers to register with the Securities and Exchange Commission, subjecting them to routine SEC inspections and annual audits. An SEC

U.S Treasury Secretary John Snow, now the chairman of hedge fund adviser Cerebus Capital Management, which recently acquired the scandal-plagued Austrian bank BAWAG, has also urged for "lighter" regulation and contended that the "real policing of these pools of capital are the investors," and that any additional regulatory efforts 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.'"[180]

The proposed "hands off" approach to today's hedge funds might produce similar results as a similar *laissez faire* philosophy did for securities traders during the "roaring twenties," such as notorious market manipulator Jesse Livermore, who considered average investors to be easy prey for poaching in a free-wheeling "survival of the fittest" stock market.[181] Corruption and market manipulation may be the end result

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> rule to require mandatory registration of hedge fund managers was rejected last year by a federal appeals court and several of those testifying to the House panel Tuesday [March 13, 2007] said it isn't needed and would give investors a false sense of security. About half of hedge fund managers now choose to register voluntarily with the SEC.

Id.; *see* David Scheer & Jenny Strasburg, *U.S. Says Hedge Fund Regulation Is 'Working Well' (Update4)*, Feb. 22, 2007 BLOOMBERG.COM, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aPwrzZyVCVx8 (last visited April 24, 2007) Secretary Paulson noted his philosophy about market regulation does not include guarding against hedge funds from "having problems":

> The panel, led by Treasury Secretary Henry Paulson and including his counterparts at the U.S. Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission, said in guidelines released today that the responsibility of maintaining discipline falls on hedge-fund managers, investors, creditors, trading partners and market regulators.
>
> "Those who would believe that the role of regulators is to guard against any losses or somehow prevent losses or to prevent a hedge fund from having problems, they have a different philosophy about regulation than I do," Paulson said in an interview.
>
> The report by the President's Working Group on Financial Markets, which Paulson called the 'unified perspective' of U.S. regulators, makes no recommendations for new government regulation.

Id.

180. Kevin Carmichael, *Funds: In new role, Snow urges 'lighter' regulatory touch*, INT'L HERALD TRIBUNE, Nov. 21, 2006, *available at* http://www.iht.com/bin/print.php?id=3349226 (last visited Mar. 26, 2007). *See also* Haig Simonian, *Sale does not close Bawag scandal*, FINANCIAL TIMES, Dec. 15, 2006, *available at* http://search.ft.com/ftArticle?queryText=BAWAG&y=0&aje=true&x=0&id=061215007121 (last visited April 6, 2007).

181. *See, e.g.*, Richard Smitten, JESSE LIVERMORE: WORLD'S GREATEST STOCK TRADER, Wiley & Sons (2001); *see* Edwin Lefèvre, REMINISCENCES OF A STOCK OPERATOR, George H. Doran & Co. (1923), republished by Wiley & Sons (1994).

from a "less is more" regulatory approach, just as it did with "junk bonds" in the Eighties, and corporate accounting scandals in the Nineties. For example, New York and Washington prosecutors charged thirteen suspects with insider trading offenses in a scheme that implicated major brokerage firm employees as "central figures in an insider-trading ring [that] illustrate[s] why regulators and lawmakers are suspicious of Wall Street's relationship with hedge funds."[182] Those recent arrests seem to suggest that perhaps market regulators have placed newfound focus on prime brokers that facilitate hedge fund trading activities after the *Goldstein* holding hindered the SEC's ability to investigate hedge funds directly.

Certainly not everyone is enamored with the notion of unrestrained free-market forces as the "answer" to viral-like growth of hedge funds in the domestic capital markets, and the massive influence they now wield. Connecticut Attorney General Richard Blumenthal characterized the presidential panel's *laissez faire* proposal as little more than "vague recommendations lack[ing] substance and specifics, making them

182. David Scheer, *Insider-Trading Ring Bust May Fuel Hedge-Fund Concern (Update3)*, BLOOMBERG.COM, Mar. 2, 2007, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aTDBCdaTQ774 (last visited Mar. 18, 2007). Insider trading violations continue to be a priority of securities regulators, and some pundits consider those violations to justify hedge fund registration:

> "Incidents like this strengthen the hands of those who are urging greater scrutiny of hedge-fund activities and their sources of information," said David Becker, a former SEC general counsel now in private practice at Cleary Gottlieb Steen & Hamilton LLP in Washington
>
> Legislators such as Senator Arlen Specter, the Pennsylvania Republican, want market watchdogs to take action amid mounting evidence of rampant insider trading. At least two studies show that stocks and derivatives regularly rise ahead of takeovers, and in the past week trading of options to buy shares of TXU Corp. and Hyperion Solutions Corp. surged in advance of announcements that they agreed to be acquired.
>
> Hedge funds are private pools of capital that allow managers to participate substantially in gains on the money invested. That pay structure creates an incentive for employees to trade in non- public information. Hedge-fund managers also are under pressure to boost returns that since 2000 have averaged half the industry's gains in the 1990s.
>
> The temptation to cheat extends to the securities firms, which collect $10 billion a year in fees for providing prime-brokerage services to hedge funds. "The larger the pot of gold the more likely that you'll entice someone into stealing," said William Portanova, a criminal-defense attorney and former federal prosecutor based in Sacramento. "Good people convince themselves over a cocktail that it's a victimless crime and that they're merely collecting a few crumbs from the feast that no one will ever miss."

Id.

unenforceable, [and which] amount to a buyer-beware strategy that has proven ineffective."[183] Various members of Congress also appear less than receptive to any sort of free market solution, among those is Texas Democrat Al Green, who characterized the current state of hedge funds as "the commingling of sophisticated and unsophisticated capital."[184] At least one prominent hedge fund manager, Kenneth Brody, co-founder of Taconic Capital Advisors (which did not hesitate to register with the SEC while the Rule was in effect), has become an advocate of sorts for increased regulation due to the risk exposure pension funds presently face with billions currently invested in hedge funds, and has urged for a more flexible principles-based outcome, rather than rule-driven regulations.[185] Lawmakers apparently remain uncertain about how to even define the clandestine, unregulated pools of funds with any degree of precision, which is perhaps the first step on the path towards

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183. *See* Scheer & Strasburg, *supra* note 179.

184. *See* Jenny Anderson, *House Panel Ponders the Growth and Risk of Hedge Funds*, N.Y. TIMES, Mar. 14, 2007, *available at* http://www.nytimes.com/2007/03/14/business/14hedge.html (last visited Mar. 18, 2007); *see also Wall Street Pros Say Hedge Funds Don't Need New Regulations*, CNBC.COM, Mar. 13, 2007, *available at* http://www.cnbc.com/id/17595287 (last visited Mar. 18, 2007). The article points out that:

> [M]embers of the committee, chaired by Rep. Barney Frank, D-Mass., expressed concern that average investors could be hurt without further oversight.
>
> We are now concerned about the inadvertent consequence of a systemic-like event which causes pensioners who have no idea their managers invested in a derivatives currency arbitrage to lose money as a result of a Russian currency crisis,' said Rep. Richard Baker, (R) Louisiana.

Id.

185. *See* Anderson, *supra* note 184; *see also* David M. Katz, *Lawmakers: Hedge-Fund Risk Hits Pensions*, CFO.COM, Mar. 13, 2007, *available at* http://www.cfo.com/article.cfm/8844660 (last visited Mar. 26, 2007) (Mr. Brody is also chairman of the investment committee of the University of Maryland). Hedge fund manager Kenneth Brody has become an advocate for a registration regime, and suggests that such a framework would have a prophylactic effect:

> [Kenneth] Brody's answer was, like [Iowa Republican Senator Charles] Grassley's, to require mandatory registration of hedge-fund advisers by the SEC. What registration provides, the hedge-fund manager said, "is self-discipline and self-policing, because [registration] comes with the threat of an SEC investigation."
>
> Like many other hedge funds, however, Taconic Capital Advisors registers voluntarily with the SEC. Brody pointed out that a number of the requirements of registration—including the designation of a chief compliance officer; the presence of written policies and procedures; a code of ethics; and retention of books and records—"promote investor protection."

Id.

meaningful regulatory reform.[186]

It seems that any pragmatic prediction would likely find some sort of negotiated outcome to the hedge fund regulatory question to be probable, especially when considering the sheer power that trillions of dollars in capital can wield when matched against Capitol Hill policymakers. As such, some sort of blended result appears likely where higher tier hedge funds might voluntarily file disclosures with something resembling a quasi-regulatory body, such as a voluntary membership SRO-managed association. The *quid-pro-quo* for such disclosures might be a sort of "best practices" benchmark, or "seal of approval."[187] The SEC, NYSE, NASD, CTFC, and other similar enforcement bodies, could then focus regulatory resources on the prime brokerages that call these funds clients, such as the early 2007 "trading sweep" conducted by the SEC of at least ten Wall Street firms during an investigation of suspected trading improprieties from September 2006.[188] According to

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186. *See* Geewax, *supra* note 170.

187. The National Football League Player's Association ("NFLPA") implemented a "seal of approval" program for hedge fund advisers seeking union approval to manage the investments of current and former NFL players. Nonetheless, at least one union-approved hedge fund manager allegedly "stole over $100 million in investors money." *See Jailed fund manager fined $20m for fraud*, Feb. 13, 2007, FIN. TIMES, *available at* http://news.moneycentral.msn.com/provider/providerarticle.aspx?Feed=FT&Date=20070213&ID=6473196 (last visited Mar. 26, 2007); *see also* Complaint, Atwater v. NFLPA, Civ. Case No. 106-cv-01510-JEC (N. Dist. Ga. June 23, 2006); Feb. 12, 2007 SEC Litigation Release No. 19999, re: SEC v. Kirk S. Wright; Int'l Mgmt. Assocs., LLC et al., *available at* http://www.sec.gov/litigation/litreleases/2007/lr19999.htm (last visited March 18, 2007); *Bishop: NFL, union 'failed' players hurt in scam*, *available at* http://www.nfl.com/news/story/9534836 (last visited Oct. 18, 2006); *see also Fraud lawsuit against NFL, union to proceed*, NFL.com, Mar. 30, 2007, *available at* http://www.nfl.com/news/story/10097842 (last visited April 1, 2007) (stating that U.S. District Judge Julie E. Carnes (Georgia) denied defendants' motion to dismiss on March 29, 2007 and noting that the league and players' union owe duties to the players under state law and nothing in the record suggested the NFL-NFLPA collective bargaining agreement pre-empts that duty owed). Perhaps this decision will later extend to other employer-employee contexts, such as where pension funds are imprudently placed with rogue hedge fund managers resulting in investment losses or fraud and might give rise to potential claims by pension fund beneficiaries.

188. *See* Scheer, *supra* note 182. The SEC conducted a "trading sweep" in early 2007 of at least ten Wall Street firms during an investigation of suspected trading-improprieties allegedly occurring in September 2006:

> Earlier this year, the SEC asked at least 10 Wall Street firms to turn over stock-trading records for the last two weeks of September, seeking to determine whether they leaked details about big stock trades to favored clients. The government said

newly appointed Nasdaq vice-chairman, Michael G. Oxley, it would require a ten-fold increase in the SEC budget to directly regulate hedge funds.[189]

V. CONCLUSION

A steady pace adopted by the SEC post-*Goldstein* may ultimately produce innovative results as momentum continues to build in favor of hedge fund reform. The NYSE and NASD already refer suspicious buying and selling data to the SEC, and reportedly share hedge fund market monitoring data with the SEC, according to NYSE Market Surveillance Chief, Robert Marchman.[190] During a Fall 2006 lecture at Fordham University School of Law, head of NASD enforcement, James Shorris, speculated about the eventual possibility of an SRO-like hedge

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> yesterday that it broke one of the biggest insider-trading cases since the 1980s. According to the SEC, which brought a civil suit against 14 defendants, the scheme stretched over five years, included hundreds of tips and produced more than $15 million in illegal profits.

Id.

189. Maria Bartiromo, *Michael Oxley's Next Act*, BUSINESS WEEK, April 9, 2007, *available at* http://www.businessweek.com/magazine/content/07_15/b4029107.htm?chan=top+news_top+news+index (last visited April 24, 2007). Former U.S. Representative Michael G. Oxley (Ohio), now non-executive vice-chairman of Nasdaq, considers direct SEC regulation of hedge funds to be "unrealistic":

> I think private equity plays an enormous role in our economy that is somewhat misunderstood. Whether they're hedge funds or private equity concerns, they do a real service. In many cases, private equity firms take a company private, fix it up, dress it up, and put it back on the market for an IPO. We have enormous capital there that is almost uniquely American. If we were to regulate, say, the hedge funds, you would have to increase the budget of the SEC something like tenfold. It's rather unrealistic.

Id.

190. Jesse Westbrook & David Scheer, *SEC Plans Database to Stem Illegal Hedge-Fund Trading (Update3)*, BLOOMBERG, Dec. 5, 2006, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=a41rbUuQZCZ4&refer=home (last visited Jan. 2, 2007). U.S. regulatory bodies and SROs are increasingly sharing market surveillance data:

> The New York Stock Exchange and the NASD, which refer data about suspicious buying and selling to the SEC, are coordinating efforts to share information about hedge funds, Robert Marchman, head of market surveillance for the NYSE, said in an interview.
>
> The agencies plan to build out a database with information detailing relationships between hedge funds and other 'financial business-related entities' in an effort to uncover illegal trading, [Machman] said.

Id. (quoting an anonymous Senior U.S. Securities and Exchange Commission Official).

fund registration regime managed by the NASD.[191] During Senate Committee testimony, SEC Enforcement Chief Linda Thomsen alluded to a new SEC database surveillance system that will more closely monitor hedge fund trading activities, but revealed scant details about the new technologies currently in development.[192] One can only hope

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191. Remarks by NASD Executive Vice President and head of enforcement, James Shorris, Fordham University School of Law's "Securities Enforcement" guest lecture, Nov. 1, 2006 (notes from lecture on file with aurhor).

192. *See* Westbrook & Scheer, *supra* note 190. SEC officials have hinted that new market surveillance technology is currently under development:

> "The SEC presently does not have an electronic system to aggregate referrals based on the identities of the specific traders involved," SEC Enforcement Director Linda Thomsen said before the Senate Judiciary Committee today. "We anticipate implementing a new case tracking system by mid-2007."
>
> Illegal trading by hedge funds "remains a substantial concern" to the SEC as the $1.3 trillion industry's influence over financial markets grows, Thomsen said. Hedge funds, which are loosely regulated private pools of capital, manage about 5 percent of U.S. assets and account for about 30 percent of U.S. equity trading volume.
>
> Today's [December 4, 2006] hearing is the third convened by Senator Arlen Specter, the Judiciary Committee's chairman, in six months to examine oversight of insider trading. The Pennsylvania Republican circulated draft legislation aimed at halting illegal buying and selling of stocks that would require hedge funds accepting money from pension funds to submit to random inspections by the SEC.
>
> His measure would also force hedge funds, which allow managers to participate substantially in the gains of money invested, to set up ethics codes and compliance programs and allow the Justice Department to give private citizens rewards for helping in prosecutions of insider trading cases.
>
> "Light regulation, secrecy, unregulated record keeping and limited compliance programs of hedge funds increase the difficulty of detecting and proving insider trading," according to Specter's legislation, which hasn't been introduced.

Id. However, Kit Addleman, associate director of the Fort Worth, Texas regional SEC enforcement office hinted in late March 2007 that new technologies were already being employed as part of the ongoing "Operation Spamalot" investigation that has already nabbed a number of suspects in alleged stock tout scams. *See* Brendan M. Case & Michael Grabell, *Exclusive: SEC investigating possible 'pump-and-dump' scam*, DALLAS MORNING NEWS, Mar. 25, 2007, *available at* http://www.dallasnews.com/sharedcontent/dws/news/localnews/stories/032507dnmetsecinvestigate.40477d8.html (last visited Mar. 27, 2007). The SEC has been tight-lipped about details regarding new market surveillance technology, but published reports suggest that regulators are already using new technology to detect securities fraud schemes:

> The SEC won't discuss particulars of its investigation, but such classic 'pump-and-dump' scams are a high priority for the agency because e-mail spam and instant online stock trading make small investors more vulnerable than ever.
>
> "With the Internet technology, there is so much more ability to get to the retail investors through their computers," said Kit Addleman, associate director of enforcement for the SEC's regional office in Fort Worth.

Id.

that appropriate and meaningful market reform will take effect prior to any catastrophic market break.

Considering that the NASD maintained the SEC's IARD Investment Adviser Registration Database system,[193] as well as its own internal "BrokerCheck" database[194] covering every registered representative and broker-dealer member conducting securities business in the U.S., it certainly seems that such an advent is well within the realm of possibilities. An NASD hedge fund adviser registration regime is also an entirely logical regulatory evolution in light of SEC Chairman Cox's strong support[195] for the combined NASD and NYSE enforcement functions[196] (both of which have historically provided

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193. The NASD is no stranger to enforcement issues involving hedge funds, and activities such as market timing. *See*, *e.g.*, NASD PRESS RELEASE, *NASD Orders Diversified Investors Securities to Pay Over $2.2 Million for Facilitating Market Timing - Firm Also Fined for Supervisory Breaches, Email Failures*, Feb. 14, 2006, *available at* http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_015974 (last visited Dec. 5, 2006); *see* Halah Touryalai, *Another One Bites the Dust: Broker Fined Record Amount for Market-Timing Scheme*, REGISTEREDREP.COM, http://registeredrep.com/news/record-markettime-fine/ (last visited Dec. 5, 2006); *see Hedge fund manager gets record $2.25 million NASD fine*, REUTERS, Oct. 25, 2006, *available at* http://msnbc.msn.com/id/15413254/ (last visited Oct. 30, 2006).

194. NASD BrokerCheck, http://pdpi4.nasdr.com/pdpi/Req_Type_Frame.asp (last visited Dec. 5, 2006).

195. Dan Caterinicchia, *NYSE, NASD to Meld Regulatory Operations*, FORBES, Nov. 28, 2006, *available at* http://www.forbes.com/home/feeds/ap/2006/11/28/ap3210306.html (last visited Dec. 5, 2006). SEC Chairman Cox has been among those who strongly support the combined regulatory functions of the NYSE and NASD:

> Securities and Exchange Commission Chairman Christopher Cox, who has been a vocal advocate of a single markets regulator, touted the increased enforcement efficiencies that should come from the new system.
>
> "When it comes to America's competitiveness, we are advantaged when our regulatory function is more efficient," said Cox, calling the proposed merger "a milestone."
>
> But Cox cautioned that the global regulatory landscape continues to change and will necessitate future revisions to keep the U.S. competitive.
>
> "The world in which we live isn't sitting still. This appropriate adaptation to changes all around us is going to be under constant review as the world markets continue to integrate and change," he added.

Id.

196. S.J. Caplan, *There's a New Sheriff Coming to Town*, THE MOTLEY FOOL, Nov. 29, 2006, *available at* http://www.fool.com/News/mft/2006/mft06112916.htm (last visited Mar. 26, 2007). The combined NYSE-NASD enforcement divisions will have regulatory oversight of all U.S. broker-dealers:

> [T]he two organizations announced the signing of a letter of intent to consolidate their

cooperative enforcement assistance to the SEC),[197] suggesting that significant evolution, and perhaps newfound regulatory efficiencies, might eventually result from the united SRO enforcement entities, among which could include a public-private partnership that provides some reliable and trustworthy measure of hedge fund transparency and accountability.

House Financial Services Committee Chairman Barney Frank has continued to modify his post-*Goldstein* hedge fund policy stance. While he has not yet committed to any specific conclusions, he did publicly contemplate during a March 2007 Committee hearing "whether to restrict hedge funds from accepting pension fund clients or bar pension funds from hedge fund investments."[198] According to Chairman Frank, a regulation requiring hedge funds to retain certain records "primarily for the purposes of law enforcement," is another option under House Committee consideration.[199] Self-imposed hedge fund guidelines, including a voluntary international "code of conduct," to foster transparency, and in lieu of enhanced regulation, is yet another option gaining support in some surprising circles.[200]

> regulatory operations into a new unnamed self-regulatory organization (SRO). Expected to begin operations in the second quarter of 2007, the new entity will serve as the private sector regulator for all broker-dealers doing business with the public in this country.

Id.

197. *See* Westbrook & Scheer, *supra* note 190 (The SEC announced plans to "have a database in place by next year that will help it crack down on hedge-fund insider trading."). The combined NYSE-NASD regulatory divisions are also developing new market surveillance technologies:

> The New York Stock Exchange and the NASD, which refer data about suspicious buying and selling to the SEC, are coordinating efforts to share information about hedge funds, Robert Marchman, head of market surveillance for the NYSE, said in an interview.
>
> The agencies plan to build out a database with information detailing relationships between hedge funds and other 'financial business-related entities' in an effort to uncover illegal trading, he said.

Id.

198. *See* Burns, *supra* note 179.

199. *Id.*

200. Jenny Strasburg & Michael McKee, *Steinbrueck Says Hedge Funds Should Police Themselves (Update4)*, Mar. 16, 2007, BLOOMBERG.COM, *available at* http://www.bloomberg.com/apps/news?pid=20601100&sid=aHr7iq.3kmug&refer=germany (last visited March 18, 2007). In a surprising development, the German official who referred to hedge funds as "locusts" now believes the sector should be self-regulating:

Perhaps Phillip Goldstein was more prescient than he realized when he likened the SEC to a turtle,[201] and the Commission, like Aesop's fabled tortoise,[202] may just prevail in the long race towards hedge fund regulation, though its victory may take a form substantially different from the vacated Rule. And perhaps it will prove to be a fitting legacy for the "Bulldog," who was recently bestowed with a "Braveheart Award" by the *New York Times* for his challenge of the now "arbitrary" Rule, and who has wasted little time in mounting his next challenge to further squelch required hedge fund disclosures.[203] The "Bulldog"

> German Finance Minister Peer Steinbrueck said hedge-fund managers ought to create a voluntary international 'code of conduct' to ward off more government regulation by the Group of Seven nations.
>
> Steinbrueck, whose Social Democratic Party derided private-equity firms and hedge funds as '*locusts*' two years ago, favors a push toward voluntary transparency by the private investment pools. Leaders of other G-7 members, including the U.S. and U.K., said in recent months they prefer market-based solutions, such as better policing by brokerages and pension-fund managers, to protect investors and insulate the markets from fund collapses.
>
> Steinbrueck said he has met regularly with hedge-fund managers from the U.S. and abroad since he took office in 2005. He declined to name which fund managers attended the meetings but said some expressed support for self-monitoring among funds.
>
> "There are some hedge funds that are not behaving properly," he said, declining to elaborate. "They must have the deep interest themselves to tackle these problems."
>
> A system of self-imposed guidelines would take several months to create, and government leaders aren't ready to describe what information needs to be disclosed or to whom, Steinbrueck said.
>
> "This is the very beginning of this discussion," he said. Steinbrueck said that hedge-fund managers should provide more transparency to financial firms that lend them money, service their margin accounts and clear their trades. The prime brokerages are insufficiently informed to have accurate 'risk profiles' of their hedge-fund clients, he said.

Id. (emphasis added).

201. *See* Goldstein January 2004 SEC Letter, *supra* note 80.

202. OLIVIA & ROBERT TEMPLE, AESOP: THE COMPLETE FABLES (Penguin Classics 1998).

203. Jenny Anderson, *The Private Lives of Hedge Funds*, N.Y. TIMES, at C1, Dec. 29, 2006, *available at* 2006 WLNR 22713061. The *New York Times* bestowed this tongue-in-cheek award to Mr. Goldstein for his successful challenge of the Rule:

> THE BRAVEHEART AWARD—Phillip Goldstein was an unknown hedge fund manager at an unremarkable hedge fund, Bulldog Investors, until he sued the Securities and Exchange Commission, contending that the agency did not have the authority to regulate hedge funds, and won. As a result, the court vacated the controversial registration requirement and left the S.E.C. with little authority over hedge funds.
>
> The S.E.C. is now contemplating a rule that will prohibit all but 1.3 percent of Americans from investing in hedge funds. It also rewrote a fraud provision that at

wrapped himself in the Fifth Amendment and articulated an incomplete, albeit novel, trade secrets theory in a pending battle with the SEC that challenges the enforceability of Section 13 portfolio disclosure requirements, and is championing the First Amendment in matters against the state of Massachusetts and its Secretary of the Commonwealth, William Galvin (who Mr. Goldstein has attacked in the press as a "bully" and a "pompous ass"), regarding the alleged public solicitation of prospective hedge fund investors via the Internet in yet another Goldstein hedge fund skirmish.[204]

After all the *Goldstein* dust settles, it seems certain that the "Bulldog" and his seemingly indomitable regulatory windmill-tilting will be forever recognized for having sparked substantive discourse that could eventually shape the future of the domestic capital markets in which Americans invest, perhaps for generations to come. Eventual policy reform may decide whether hedge funds will be permitted to operate under a persistent cloak of secrecy, or whether the bedrock securities principle of disclosure will apply to this enormous pool of capital that affects the U.S. markets, economy, and citizens, for better or for worse. The "Bulldog" will invariably be viewed by history as a genuine market maverick and the incendiary catalyst for much of that reformist debate, and will always be intertwined with the outcome, in whatever form it eventually takes. And it all began with a single word.

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least allows it to go after, well, fraud.

Id. *See also* Pekarek, *supra* note 78.

204. Pekarek, *supra* note 78.