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Cover Page Footnote

Professor Pierre-Louis researches and writes in the areas of corporate, securities, commercial, property, communications and international law. Prior to joining the St. Thomas University faculty, Professor Pierre-Louis was an Assistant Clinical Professor at St. John's University School of Law, and the inaugural Director of the St. John's University School of Law, Securities Arbitration Clinic. Professor Pierre-Louis began her legal career as a legal assistant working on the Michael Milken securities fraud legal defense team at Rifkin, Wharton & Garrison under the supervision of Arthur Liman in New York. Professor Pierre-Louis is a former finance associate at Winthrop, Stimson, Putnam & Roberts (now known as Pillsbury Winthrop, LLP). Professor Pierre-Louis is a former Assistant Attorney General with the Office of New York State Attorney General, Eliot Spitzer, in the Bureau of Investment Protection where she enforced New York State securities law, the Martin Act, against the financial service industry. The Author is currently an LLM candidate at University of London, Queen Mary University, specializing in international business law. Professor Pierre-Louis received her B.A., Columbia University, Barnard College with a degree in economics and sociology; her M.A., New York University, Graduate School specializing in finance and international development; and her J.D. Fordham University School of Law. Comments and criticisms are welcome, please address comments to the author at St. Thomas University School of Law, 16401 NW 37th Avenue, Miami, FL, 33054 or by email at lplouis@stu.edu. This Article was presented at the Law & Society Annual Conference in Denver Colorado and at the LatCrit, Inc. XII Conference at Florida International University Law School, Miami, FL. The author would like to thank Professor Derrick A. Bell for his words of wisdom and unconditional support; Professors Leonard M. Baynes, William W. Bratton, Regina F. Burch and Lisa H. Nicholson for reviewing earlier drafts of this Article, Assistant Librarian Katie Brown for her excellent research assistance, and law students Andreas Koutsoudakis, Angela Jones and Gigi Wolf-Blanco for their footnoting expertise. This article was written, in part, due to a writing stipend from St. Thomas University School of Law for which the author is grateful. All errors are the author's.

ARTICLES

HEDGE FUND FRAUD AND THE PUBLIC GOOD

Lydie N.C. Pierre-Louis[†]

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Today we shall have come through a period of loose thinking, descending morals, an era of selfishness, of individual men and women and of whole nations. Blame not government alone for this. Blame ourselves in equal share. . ..

—President Franklin Delano Roosevelt[1]

ABSTRACT

The current financial crisis resonates with every American, regardless of their connection to the securities markets. Many struggle to understand how and why the American financial and securities markets collapsed last year. In essence, why did the regulators fail to prevent the collapse? Government officials continue to analyze the relationship between the structural collapse of the markets and regulators' limited jurisdiction over a class of entities whose transactions substantially impact the markets: hedge funds. Congress can no longer deny hedge funds' detrimental impact on the financial and securities markets. The impetus for financial re-regulation has arrived. It is incumbent upon Congress to enact laws which extend the jurisdiction of federal regulators to hedge funds. At a minimum, such supervision is necessary to protect the investing public.

The elusiveness of hedge funds and their investment strategies is of particular concern. Federal regulation may take the form of a registration requirement. Perhaps publicly-traded companies should disclose their transactions with hedge funds. More comprehensive regulatory reform options include the creation of a hybrid regulatory hedge fund governance matrix based upon the dollar volume, frequency of trades and potential losses that hedge funds may experience. It is incumbent upon Congress to create the proper balance between protecting the investing public and maintaining sustainable American financial and securities markets, which in turn stabilizes the global economy.

1. Franklin D. Roosevelt, Roosevelt's Nomination Address, Chicago, III. (July 2, 1932) (transcript available at http://newdeal.feri.org/speeches/1932b.htm) [hereinafter Roosevelt Address].

INTRODUCTION

He that is of opinion money will do everything may well be suspected of doing everything for money.

—Benjamin Franklin[2]

The red light on my office phone flashed incessantly, demanding attention. I ignored it. My small, government issued office, courtesy of New York State Attorney General, Eliot Spitzer, would seem to the casual observer the epitome of efficiency; no space was left unused. Each square inch of the office had documents appropriately labeled, categorized, read and re-read. Ah, the duty to read. The fiduciary duty to read, established by the court in *Francis v. New Jersey Bank*,[3] remained with me years after my corporations class. I read and re-read everything.

My attention was pulled back to the flashing red light on my phone. I wondered if that strange woman who kept leaving me all those bizarre messages about mutual funds, *late trading*, *capacity*, hedge funds and *market timing* had called again. She had left at least three messages all in rapid fire, exacting phrases like, "you should look into mutual funds and hedge funds late trading stocks. What they are doing is illegal!"[4] She left no explanation and certainly not her name. More importantly, she did not indicate how she knew about the alleged fraud. But there was something about her tone that got my attention and piqued my interest. I brought her phone calls to the attention of Roger Waldman, my immediate supervisor.[5] I wanted to find out if he knew anything about

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2. BENJAMIN FRANKLIN, POOR RICHARD'S ALMANACK 27 (U.S.C. Publ'g Co. 1914).

3. Francis v. United Jersey Bank, 432 A.2d 814, 822 (N.J. 1981) (holding that "[d]irectors are under a continuing obligation to keep informed about the activities of the corporation. Otherwise, they may not be able to participate in the overall management of corporate affairs." (citing Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924))). *Id.* at 822 ("Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect." (citing Wilkinson v. Dodd, 42 N.J. Eq. 234, 245 (N.J. Ch. 1886))).

4. *See* BROOKE MASTERS, SPOILING FOR A FIGHT—THE RISE OF ELIOT SPITZER 135 (Times Books 2006).

5. *See* Press Release, Office of the New York State Attorney General, Robertson Stevenson Settles Market Timing Case (Oct. 6, 2004), *available at* http://www.oag.state.ny.us/media_center/2004/oct/oct6b_04.html.

terms such as *capacity*, *timing*, and *late trading*, which I may have missed during my own corporate transactional days on Wall Street, from his days at Sullivan & Cromwell. He knew nothing. I could tell because he had no reaction when I mentioned mutual funds and late trading. I also shared the curious messages from the strange woman with Bureau Chief, Eric Dinallo.[6] I received permission to offer her transactional immunity and to have her come to the New York State Attorney General's Office to be queen for the day and share her story. All I had to do was find her, convince her to testify, and turn state's witness—because it was her civic duty.

For the next four days, I spent every spare moment in my office awaiting the proverbial phone to ring and astutely avoided calls from reporters, lawyers and persons of interest. At last, the phone rang in its usual trill manner; I answered it half expecting a reporter or security guard informing me that my afternoon appointment had arrived. It was neither. "I'm that woman who has been calling you," a very polished voice stated. "I'm glad you called," I replied with a mixture of relief and elation in my voice. "I would like to help in any way that I can. Tell me what's going on that has so disturbed you that you felt compelled to contact me." It took forty-five minutes to transcribe what was either one of the biggest frauds in corporate history or the biggest piece of nonsense that ever came to my attention. Where the truth laid would take months of detailed investigation, depositions, outright threats and negotiated settlements to uncover. Through it all, the unfailing courage of Noreen Harrington,[7] a woman willing to risk everything to help the American investing public, would be challenged again and again.

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6. *See* Profile of Eric R. Dinallo, Henry Kaufman Visiting Professor of Finance at New York University's Leonard N. Stern School of Business, http://w4.stern.nyu.edu/faculty/facultyindex.cgi?id=554 (last visited Nov. 2, 2009) (profiling Dinallo and highlighting his service as 39th Superintendent of the New York State Insurance Department).

7. Noreen Harrington, a respected 20-year Wall Street veteran, exposed the worst scandal in mutual fund history. *See* Rebecca Leung, *Meet a Major-League Whistleblower: Woman Who Exposed Mutual Fund Scandal Talks to 60 Minutes II*, CBS NEWS, July 7, 2004, http://www.cbsnews.com/stories/2004/02/17/60II/main600649.shtml. She was the whistleblower who revealed the misconduct in the recent mutual fund scandals. *Id.* Her efforts, along with the Office of New York Attorney General Eliot Spitzer, led to the end of late trading and market timing abuses, and created industry reforms that benefit and protect an estimated 95 million investors. *Id.*

The mutual fund fraud investigation focused on mutual fund companies and their corresponding boards who prevented investors from realizing the increased growth of particular mutual funds by inappropriately permitting hedge funds to engage in activities such as market timing[8] and late trading.[9] These fraudulent practices allowed hedge funds to remove the unrealized profits from the mutual funds before the mutual funds could recognize the gain for the benefit of the investors in the mutual fund. Canary Capital, LLC was one of the few hedge funds to reach a settlement with New York State Attorney General Eliot Spitzer or the SEC, although dozens of hedge funds were investigated by both regulatory agencies. Despite the questionable conduct engaged in by dozens of investigated hedge funds, their conduct was not per se illegal because it did not violate any specific federal or state securities laws that applied to hedge funds. Ultimately, the investigation resulted in a series of unprecedented agreements between regulators—the Office of New York State Attorney General, Eliot Spitzer, and the Securities & Exchange Commission[10]—and financial

8. Market timing is defined as "[t]he purchase and sale of securities based on short-term price patterns as well as on asset values." TheFreeDictionary.com, Market Timing, http://financial-dictionary.thefreedictionary.com/market+timing (last visited Oct. 7, 2009). "Some analysts use fundamental analysis to select the securities to purchase or sell; then they rely on market timing to decide when to trade those securities." *Id.*

9. Late trading is defined as the "[i]llegal practice of obtaining the next day's net asset value (NAV) of a mutual fund's shares and using this information to buy or sell those shares at the previous day's prices." InvestorWords.com, Late Trading, http://www.investorwords.com/7371/late_trading.html (last visited Oct. 7, 2009).

> As mutual funds usually compute the NAV at the close of a trading day (4:00 p.m. Eastern Time) for the next day's trades, a trader placing a buy or sell order after the closing time can still get that day's prices and can gain an unfair advantage over other traders. According to the SEC, "Late trading violates the federal securities laws . . . and defrauds innocent investors." Late trading, however, is not the same as after-hours trading which is a legal practice.

Id.

10. The Securities and Exchange Commission (SEC) is a federal regulatory agency that has jurisdiction over the U.S. securities market. *See* SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilities Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Oct. 7, 2009) [hereinafter Investor's Advocate]. Congress established the SEC in 1934 to enforce the newly adopted 1933 Securities Act and the 1934 Exchange Act, to promote stability in the markets and, most importantly, to protect investors. *Id. See also* 15 U.S.C. § 78d(a) (2006) (establishing the SEC); 15 U.S.C. § 78b (2006) (setting out the rationale for the

firms.[11] The 2004 settlements resulted in payments of approximately $2 billion. They also required numerous structural changes in mutual fund regulation, such as changes to mutual fund fee calculation, board structure and disclosure to investors. Hedge funds emerged from the mutual fund fraud investigation unscathed; the industry was not subject to any new regulatory oversight.

Few, if any, federal or state securities laws apply to hedge funds. This lack of regulation makes it nearly impossible for the government or investors to these pools of capital accountable for any questionable conduct in the securities and financial markets. During the last decade, the rapid growth of the hedge fund industry—evidenced by increases in metrics such as assets under management, volume of trading, frequency of transactions and the scope of the firms' activities—has given regulators and the investing public cause for concern. Important questions remain unanswered: most importantly, what should be done when hedge funds employ manipulative schemes which enrich hedge funds at the expense of the integrity, stability and soundness of the financial system?

For example, imagine a hedge fund has slowly accumulated a sizable amount of credit default swaps ("CDS"), which require the CDS issuer to compensate the CDS purchaser in the event a company whose credit risk is insured by the swap ('target') cannot repay its debts.[12] The fund's purchases put upward pressure on the price of these swaps, a development which is perceived by the market as a reflection of

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SEC and regulation of securities markets). The SEC describes its function as promoting and facilitating investor access to essential investment related information by "promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud." Investor's Advocate, *supra*.

11. *See, e.g.*, Press Release, Office of the New York State Attorney General, Spitzer, S.E.C. Reach Largest Mutual Fund Settlement Ever (Mar. 15, 2004), *available at* http://www.oag.state.ny.us/media_center/2004/mar/mar15c_04.html.

12. InvestorWords.com, Credit Default Swap, http://www.investorwords.com/5876/credit_default_swap.html (last visited Oct. 7, 2009).

> A specific kind of counterparty agreement which allows the transfer of third party credit risk from one party to the other. One party in the swap is a lender and faces credit risk from a third party, and the counterparty in the credit default swap agrees to insure this risk in exchange of regular periodic payments (essentially an insurance premium). If the third party defaults, the party providing insurance will have to purchase from the insured party the defaulted asset. In turn, the insurer pays the insured the remaining interest on the debt, as well as the principal.

Id.

investors' concerns about the target's ability to meet its financial obligations. If the hedge fund were to publish and widely disseminate a negative research report about the target company, whose securities are subject to the fund's substantial 'short position,'[13] then the price of the target's equity is likely to decline and the cost of CDS payable in the event of the target's default[14] would rise. The hedge fund could then capitalize on these developments and sell into a market reacting to the fund's report. The hedge fund's profits would come at the expense of the target's shareholders, creditors,[15] employees and business partners.[16]

A more striking example is when a hedge fund *trades* the mutual fund's shares after the close of the market. Due to technological advances, these *late trades* appear to be a routine part of the mutual fund's after hours clearing process.[17] Late trading in mutual fund shares should be deemed illegal. These activities are barely within the periphery of legitimate transactions on behalf of the mutual fund's long-term investors. Unfortunately, the drafters of current federal and state securities laws did not envision this type of schemes.

These hedge fund investment schemes detrimentally impact the investing public both financially and psychologically. The value of assets held by traditional investors is impaired as the schemes unjustifiably siphon long-term investors' unrealized profits. Perhaps more importantly, such schemes call into question the integrity of the markets and diminish the markets' appeal for many investors. Such dubious hedge fund activities are cause for concern about the lack of

13. InvestorWords.com, Short Position, http://www.investorwords.com/4554/short_position.html (last visited Oct. 7, 2009). A short position is defined in two ways: a futures contract where there is "the promise to sell a certain quantity of a good at a particular price in the future" and as "[selling] a stock short." *Id.*

14. Products with the characteristics of a CDS might otherwise be called "protection" or "insurance." Here, however, the hedge fund has no underlying credit exposure to the target. The fund's investment in the CDS is purely speculative. Under such circumstances, a CDS is neither insurance, nor protection; it is just a bet.

15. The target's creditors include holders of its publicly-traded debt, which would presumably fall in value as the market reacts to the price of CDS involving the target.

16. As the target's equities and bonds decline in value, the target will find it more costly to make acquisitions or borrow. These developments will impede any new investment, expansion, or hiring by the target company.

17. *See* Bloomberg News, *2 Sued on Trading Charges*, N.Y. TIMES, Dec. 23, 2005, at C4. The SEC filed a complaint against two hedge funds who allegedly "took advantage of a Bear Sterns system that allowed them to buy or sell mutual fund shares after a 4 p.m. regulatory cutoff." *Id.*

hedge fund regulation. The current financial crisis makes Congressional action to address the lack of hedge fund regulation imperative.

This Article offers an alternative legal and factual framework to monitor and regulate hedge fund activity. Its proposed solutions could be adopted by state, federal and international regulators. After examining the policy arguments commonly advanced by opponents of hedge fund regulation, this Article concludes that public good principles strongly support comprehensive hedge fund regulation based on a hybrid hedge fund governance matrix.

The foundation for this Article's conclusion is the principle of 'public good.' Part I discusses the historical development of the American public good concept and, in particular, its application to early corporations. Rampant fraud led state governments to assume responsibility for protecting the investing public and adopt anti-fraud provisions in state securities laws. New York State's Martin Act is a prominent example of such state regulation.[18] The federal government, pressured by the states, responded with comprehensive anti-fraud regulation and disclosure requirements.

Hedge funds are a recent and confusing phenomenon. Part II discusses the historical development of hedge funds, including their exemptions from federal securities regulation. In particular, the industry

18. N.Y. GEN. BUS. LAW § 352 (McKinney 2009). "There is also an ongoing debate whether the consumer fraud provisions of the General Business Law [Section] 349, extend to securities transactions. New York is one of the few states which have not adopted the Uniform Securities Act. . . ." Robert A. McTamaney, *New York's Martin Act: Expanding Enforcement in an Era of Federal Securities Regulation*, 18 LEGAL BACKGROUNDER 1 n.1 (2003). New York State's "securities laws were left largely in place when the series of federal securities laws were passed in the 1930s and 1940s." *Id.* at 2. "The Martin Act really became a sleeping giant in 1955, with the addition of criminal penalties." *See id.* These are unique remedies which few other state securities laws possess especially when "coupled with the [Martin Act's] broad 'fraud' provisions," which can be triggered without the necessity of proving intent, also known as scienter. *Id.* Scienter is "the *willful and knowing* commission of an illegal act, without proof of intent to defraud." *Id.* at 2 (emphasis in original). "In 1986, intentional violations were made felonies." *Id.* at 3. "[T]he Martin Act arguably is hardly a fraud statute at all, but rather is specifies virtually *per se* criminal and civil liability" if the prohibited conduct occurs. *Id.* at 3. An interesting "absence is any provision for civil damage suits by individuals, and the courts have consistently refused to imply one." *Id.* Additionally, the Martin Act provides broad administrative discovery and subpoena power and *ex parte* injunctive relied are all permitted and available to the Attorney General's Office. *Id.*

is exempt from the public offering registration requirements of the Securities Act of 1933,[19] the periodic reporting obligations of the Securities Exchange Act of 1934,[20] the registration requirements of the Investment Company Act of 1940[21] and the registration requirements of the Investment Advisers Act of 1940.[22]

Part III discusses federal regulators' concerns about hedge funds, including the public's increasing exposure to hedge funds vis-à-vis public pension funds. Part III also examines the SEC's failed attempt to regulate hedge funds.

This theoretical, historical and legislative backdrop belies the hedge fund industry's pervasive lack of disclosure and reliance on objectionable investment strategies such as short selling, credit default swaps and the use of excessive leverage. Part IV examines such practices. Part V continues with an examination of manipulative hedge fund activities such as late trading, marketing timing and publication of negative research reports.

This Article makes a compelling case for new regulation. Part VI outlines an alternative approach to hedge fund regulation based on a four-prong hybrid hedge fund governance matrix.

Finally, the Article concludes the public interest in the viability of the financial and securities markets and the economic stability of global economies is advanced by comprehensive hedge fund regulation.

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19. Securities Act of 1933 § 7, 15 U.S.C. § 77g(2) (2006); Philip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisor's Act of 1940*, 28 GEO. WASH. L. REV. 214, 215 (1959) ("The [Securities Act] deals principally with distribution of new issues . . . .").

20. Loomis, *supra* note 19, at 214 ("The [Securities Exchange Act] superimposes a rather complex regulatory structure upon the intricate and sensitive mechanism of the securities market."); Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (2006).

21. Investment Company Act of 1940 § 1, 15 U.S.C. § 80a-1 to 80a-b4 (2006).

22. Loomis, *supra* note 19, at 214 ("The [Investment Advisors Act] by contrast is a rather simple statute touching on a few aspects of a field not yet completely explored."); Investment Advisors Act of 1940 §§ 201-22, 15 U.S.C. §§ 80b-1 to 80b-22 (2006).

I. ORIGINS OF THE AMERICAN PUBLIC GOOD CONCEPT

No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable.

—Adam Smith[23]

In the mid-1800s, Alexis de Tocqueville left France to travel through the young American republic, and he made an interesting discovery. He observed Americans' concept of public good was grounded in the belief that "[t]he personal advantage of each member of the community may result in working for the good of all."[24] Such an outlook did not specifically require virtue or institutions to per se reward cooperation for the public good. In fact, those who declined to cooperate for the public good were not punished. The structure of the American public good concept, in Tocqueville's view, was analytically incoherent. It offered no reason to believe an individual, motivated by self-interest, would come to adopt cooperative behavior as a voluntary selection for the public's good. Opportunities to *free ride* on the cooperative behavior of others exist simply by virtue of community membership. While this seemed especially strange to Tocqueville, he found Americans were convinced it was in their interest to be virtuous.[25]

A. Application of Public Good to Early American Corporations

Corporations are such an integral part of American culture that it is difficult, if not impossible, to imagine a time when they did not exist. The historical development of American corporate law is rooted in economic, military, and political forces. Early American corporations were established primarily to allow private resources to accomplish public functions that government was unable to finance, such as the

23. I ADAM SMITH, AN INQUIRY TO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 70 (J.M. Dent & Sons Ltd. 1914) (1910).

24. ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 500 (Henry Reeve & Delba Winthrop trans., Univ. of Chicago Press 2000) (1835). The conflict between private and public good had become congruent for most Americans—that is to say, "self interest well understood" became "the interest of each to be honest." Tocqueville described the concept of "self interest well understood" in the quoted language above. *Id.*

25. *Id.* at 501.

creation of canals, railroads, bridges, tunnels, and highways.[26] Initially, corporations were largely creatures of the state government, borne of legislative charter and limited in duration.[27] Once a corporation achieved its purpose, such as the completion of a bridge, it ceased to exist. As the American economy expanded, popular acceptance of corporations as a means of facilitating public work projects grew[28] in tandem with the demand for business ventures and corporate charters.[29] As a result, a number of states enacted general business corporate statutes and the incorporation process was increasingly uniform.[30]

In the 1800s, America experienced an industrial revolution. The explosion of industry transformed an agrarian America into an industrial society.[31] This change required large infusions of capital to fund development and growth.[32] Fueling industrial growth was the emergence of markets in which all Americans could invest in private corporations for profit. Previously, investment was an activity only available to the rich. The expanded pool of investors needed stock markets[33] in which they could acquire and dispose of their holdings.

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26. *See* Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 AM. U. L. REV. 81, 93 (1999). "As the eighteenth century came to a close and the early decades of the nineteenth century unfolded, state legislatures began to issue significant numbers of corporate charters for banks and transportation projects." *Id.*

27. *See* ALFRED F. CONARD & HENRY M. BUTZEL, CORPORATIONS IN PERSPECTIVE 178 (Foundation Press 1976). "[I]ncorporation was the formation of a contract which was unconditionally binding on all of the parties. The principle escape hatch was the expiration of the contract; many early corporations were apparently formed for limited terms, and some 19th century laws required limitations ranging from 25 to 100 years." *Id.* The idea that a corporation has an expiration date is no longer espoused, and most modern day "corporation codes grant perpetual life." *Id.*

28. *See* Hamill, *supra* note 26, at 92. "the colonial assemblies and the early state legislatures issued the vast majority of corporate charters for public purposes." *Id.*

29. *Id.* at 97-98.

30. *Id.* at 101-03.

31. *See id.* at 98. "America's transformation from a predominantly agricultural and mercantile economy to a market economy displaced and negatively affected many individuals." *Id.*

32. *See id.* at 98. "[F]or most of the 1820s, business and commerce grew steadily, and the state-chartered business corporation, which was on its way to becoming the dominant legal form for conducting all commercial enterprises, experienced little overt controversy." *Id.*

33. *See* BLACK'S LAW DICTIONARY 1554 (9th ed. 2009). The business of a stock market is to facilitate investors coming together to buy and sell stocks. *Id.*

B. Anti-Fraud Provisions of Blue Sky Laws

Initially, regulation did not keep pace with the development of markets. During the late 1800s and early 1900s, the federal securities laws did not exist.[34] In 1911, Kansas became the first state to create state securities laws to protect its residents.[35] Throughout the 1920s, many states adopted securities laws to protect their residents.[36] New York developed its famous securities laws through the adoption of the 1921 Martin-Webb Act.[37] Many other states followed suit and began to adopt state securities laws commonly referred to as *blue sky laws*,[38] so-named when the Supreme Court explained, in *Hall v. Geiger-Jones Co.*, "[t]he name that is given to the law indicates the evil at which it is aimed . . . [the] 'speculative schemes which have no more basis than so many feet of blue sky . . . .'"[39]

Despite the Court's appreciation of the legislative intent behind the

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34. *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Market*, 95 VA. L. REV. 1025, 1028 (2009). The Federal Trade Commission acquired jurisdiction to pass the first federal securities laws in 1933. *Id.*

35. *See* Jonathan M. Sobel, *A Rose May Not Always Be a Rose: Some General Partnership Interests Should Be Deemed Securities Under the Federal Securities Acts*, 15 CARDOZO L. REV. 1313, 1323 n.49 (1994).

36. *See* Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 229 (2003) ("Between 1911 and 1931, 47 of the 48 states adopted statutes that regulated the sale of securities."). *See also* CONARD & BUTZEL, *supra* note 27, at 22 (discussing how Kansas took the lead among state legislatures passing securities laws requiring substantial disclosures and laying hefty penalties for non-compliance).

37. *See* N.Y. GEN. BUS. LAW § 352 (McKinney 2009). Former New York State Attorney General, Eliot Spitzer, used the Martin Act vigorously between 2001 and 2006 to prosecute financial service entities that defrauded New York State residents. *See* MASTERS, *supra* note 4, 70-72, 88-99.

38. SEC, Blue Sky Laws, http://www.sec.gov/answers.shtml (last visited Oct. 7, 2009) (defining blue sky laws as state securities laws that are designed to protect investors against fraudulent sales practices and activities). *See* Mahoney, *supra* note 36, at 229.

39. Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1916) (stating that name [blue sky] comes from testimony that such state statutes protect investors from "speculative schemes which have no more basis than so many feet of 'blue sky'"). "[T]he law is a regulation of business, [it] constrains conduct only to that end, the purpose being to protect the public against the imposition of unsubstantial schemes and the securities based upon them." *Id.*

statutes, remedies were limited. Very few blue sky laws provided a private right of action.[40] Only state regulators could commence lawsuits against corporations on behalf of the injured shareholders and state residents. In addition, corporations were required to provide *full and fair disclosure* as to the purpose of the investment.[41] Several states also allowed state regulators to prevent the filing of a security offering if they had reason to believe that a particular securities offering would result in a fraud, inequity, or that the offering failed to meet the standard of being *fair, just, and equitable.*[42]

New York's 1921 enactment[43] of the Martin Act finally enshrined the principle "thou shall not commit fraud" into state law.[44] The Martin Act vested the power to prosecute fraud, but only minimal control over the sale of securities, in the New York Attorney General's Office. The original Martin Act was a weak law and no enforcement actions were commenced for years after its adoption. In 1925, New York State Attorney General Albert Ottinger successfully advanced a broad view of the Attorney General's Office's powers under the Martin Act. "Ottinger sought out high-profile fraud cases and used the Martin Act to shut down the Consolidated Stock Exchange".[45] While Ottinger's actions

40. *See, e.g.*, Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Secs., 592 F. Supp. 2d 608, 623 (S.D.N.Y. 2009) (stating there is no implied right of action under New York's Martin Act); *In re* Nat'l Century Fin. Enters., Inc., 541 F. Supp. 2d 986, 1010 (S.D. Ohio 2007) (stating that while New Jersey and Oregon's Blue Sky Laws delineated prohibited conduct and allowed for civil remedies, neither provided a private right of action); Pearce v. Duchesneau Group, Inc., 392 F. Supp. 2d 63, 76 (D. Mass. 2005) (stating that plaintiff faced a problem because Massachusetts Blue Sky Laws did not provide a private right of action).

41. *See* Mahoney, *supra* note 36, at 231. "Prior to selling a security in Kansas, the issuer had to file an application with the banking commissioner detailing financial and narrative information about its business. No sales could be made unless the commissioner approved the offering." *Id.*

42. *See id.* "[T]he commissioner . . . could reject an offering if he concluded that the issuer '[did] not intend to do a fair and honest business' or '[did] not promise a fair return on the stocks, bonds, or other securities it offered for sale.' This broad authority came to be known as 'merit review.'" *Id.*

43. *See* MASTERS, *supra* note 4, at 49.

44. *See* Symposium, *Sixth Annual Corporate Law Symposium: Contemporary Issues in Securities Regulations*, 62 U. CIN. L. REV. 393 (1993) (stating that "blue sky laws" were enacted to provide regulation of securities offerings/sales for the purpose of preventing fraud).

45. Nicholas Thompson, *The Sword of Spitzer*, LEGAL AFFAIRS, May/June 2004, at 50. Attorney General Ottinger summed up his record as "Hammer, hammer, hammer,

angered major financial institutions and prompted several prominent court challenges, a series of favorable court rulings noted endemic fraud called for an expansion of the Martin Act.[46] In 1955, Attorney General Jacob Javits appointed David Clurman to rewrite the Martin Act in a manner more protective of the public. Clurman, building on the interpretation of the mail-fraud statutes by Judge Learned Hand a few decades earlier, drafted provisions which granted the Attorney General civil and criminal prosecution power. Other provisions relieved the Attorney General of the responsibility to prove any buyer was actually defrauded or sale actually took place. Such measures allowed the Attorney General to prosecute fraudulent schemes before investors were victimized by the schemes. Clurman's mandate was simple: "thou shall not commit fraud."[47] Since Clurman's revisions, the Martin Act has evolved into a broad sweeping investigative statute.

The Martin Act provided New York State Attorney General Eliot Spitzer with broad civil and criminal powers to prosecute entities for financial fraud.[48] Spitzer's Office initiated a Martin Act investigation of Merrill Lynch in April 2001 for failure to disclose conflict of interest between Merrill Lynch's investment banking business and research department based. Spitzer built the case against Merrill, in part, on e-mails sent from stock analyst Henry Blodget.[49] Emails snippets suggested the technology analyst routinely recommended stocks he did not personally believe where worthwhile.[50] Merrill agreed to a settlement within a few weeks and paid $100 million in penalty.

In 2002, Eliot Spitzer's Office initiated a Martin Act investigation

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at every manner and means of fraud and dishonesty, the prevention and assertion of which the Legislature has assigned to the Attorney General." *Id.* at 51-52.

46. *Id.*

47. Thompson, *supra* note 45, at 50.

48. *See* Dietrich L. Snell & Wendy T. Wu, *New York State's Martin Act an Outline of the New York Attorney General's Powers and Practices*, *in* PARALLEL PROCEEDINGS IN SECURITIES ACTIONS (PLI Corp. Law & Practice Course Handbook Series, PLI Order No. 14655, 2008).

49. *See* Charles Gasparino, *The Stock-Research Pact: How Settlement Train Kept on Track*, WALL ST. J., Dec. 23, 2002, at C1.

50. Press Release, Office of the New York State Attorney General, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices (May 21, 2002), *available at* http://www.oag.state.ny.us/media_center/2002/may/may21a_02.html; *but see* John J. McConnell, *Spitzer Spears the Truth*, WALL ST. J., May 15, 2002, at A18 (arguing "[u]pon closer examination, however, [Spitzer's] charges appear to be a fundamental mischaracterization of the messages in question").

against several investment banking firms.[51] Allegations suggested the banks inflated stock prices through the issuance of research reports by their affiliated brokerage firms and doled out valuable opportunities to invest early in initial public offerings to influential members of the business community in order to curry their favor. The banks entered into a global settlement and paid approximately $1.4 billion in fines.[52] The settlement also required the firms to establish compliance divisions to supervise stock analysts and investment bankers and insulate stock analysts from internal pressure to attract investment banking business.[53]

In 2003, Eliot Spitzer's Office started a Martin Act investigation against several commercial banks, mutual funds and hedge funds which led to the disclosure of one of the greatest frauds against the investing public. Spitzer's Office investigation revealed that mutual funds failed to disclose that they allowed select clients (primarily hedge funds) trading privileges which harmed ordinary investors. Spitzer's Office targeted two practices, in particular, late trading[54] and market timing.[55] Through a series of prosecutions and lawsuits, joined in many instances by the SEC, the CFTC,[56] and various state securities regulators, Spitzer's

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51. Ten investment banking firms were named in the complaint including Bear Stearns, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, J.P. Morgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, Salomon Smith Barney, and UBS Warburg. Jane Ulick, *Wall Street Deal Inked*, CNNMONEY, Dec. 20, 2001, http://money.cnn.com/2002/12/20/news/economy/settlement_wallstreet/index.htm.

52. Press Release, SEC, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* http://www.sec.gov/news/press/2003-54.htm.

53. *See id.*

54. *See supra* note 9 and accompanying text.

55. *See supra* note 8 and accompanying text.

56. The Commodity Futures Trading Commission is hereinafter referred to as the CFTC. However, certain footnotes cite to the CFTC as the Commission. *See* 7 U.S.C. § 2(a)(2) (2006) (establishing Commodity Futures Trading Commission as an independent agency under Commodity Exchange Act). The statute provides, in relevant part:

> The Commission shall have exclusive jurisdiction . . . over accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery . . . , traded or executed on a contract market designated or derivatives transaction execution facility registered pursuant to section 7 or 7a [7 U.S.C. § 7] or any other board of trade, exchange, or market, and transaction subject to regulation by the Commission pursuant to [7 U.S.C. § 23].

7 U.S.C. § 2(a)(1)(A).

The CFTC describes itself as an independent agency with the mandate to regulate

Office secured approximately $2 billion in fines and remuneration for investors as well as forcing many managerial reforms within the mutual fund industry to protect the investing public.

C. Disclosure Under the Federal Securities Laws to Protect Investors

Federal rules were designed to protect the general public from fraud in the securities market. The laws' mechanisms for protection include disclosure and trading restrictions. The Securities Act requires a securities issuer, typically a mid-sized to large corporation, to disclose a broad array of financial and operational information in exchange for the right to sell stocks to the public in the capital markets.[57] Congress established the Exchange Act to prevent manipulation of the secondary market for an issuer's outstanding publicly traded securities. The issuer must continually appraise the public about the state of its operations and finances.[58] The issuer's insiders, including members of its board of directors, its officers, employees and advisers, are subject to trading restrictions if they possess certain non-public information.[59]

The stock market crash of 1929,[60] and the subsequent Great

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commodity futures and option markets in the United States. The agency's mandate has been renewed and expanded several times since its establishment, most recently by the Commodity Futures Modernization Act of 2000 ("CFMA"). Pub. L. No. 106-554 § 1(a)(5), 114 Stat. 2763 (2000) (enacting into law § 401 of Title IV of H.R. 5660, 114 Stat. 2763A-457, as introduced on Dec. 14, 2000) (codified in 7 U.S.C. § 2). Today, the CFTC assures the economic utility of the futures market by encouraging competitiveness and efficiency, ensuring integrity, protecting market participants against manipulation, abusive trading practices, fraud, and ensuring the financial integrity of the clearing process. The CFTC enables the futures market to serve the important function of providing a means for price discovery and offsetting price risk.

57. *See* 15 U.S.C. § 77g (2006).

58. *See* Loomis, *supra* note 19, at 214-15.

59. *See* 17 C.F.R. § 240.10b-5 (2009).

60. *See, e.g.*, Great N. Ry. Co. v. Weeks, 297 U.S. 135, 149 (1936) (stating that the stock market crash of 1929 ushered in the Great Depression); *see* Ben Wattenberg, Stock Market Crash, The First Measured Century, PBS, http://www.pbs.org/fmc/timeline/estockmktcrash.htm (hereinafter Wattenberg). From 1920 to 1929 stocks more than quadrupled in value. *Id. See also In re* Pate's Estate, 84 N.Y.S.2d 853, 856 (N.Y. Sur. 1948).

> Many investors became convinced that stocks were a sure thing and borrowed heavily to invest more money in the market. But in 1929, the bubble burst and stocks started down an even more precipitous cliff. In 1932 and 1933, they hit bottom, down about 80% from their highs in the late 1920s. This had sharp effects on the economy . . .

Depression[61] led Congress to enact the Securities Act[62] and the Securities Exchange Act.[63] The public policy imperative, to protect the investing public through the promotion of equal access to information for all market participants, has not changed since Congress enacted the Securities Act and the Securities Exchange Act.[64]

> [and it caused] chaos in the banking system as banks tried to collect on loans made to stock market investors whose holdings were now worth little or nothing at all. Worse, many banks had themselves invested depositors' money in the stock market. When word spread that banks' assets contained huge uncollectable loans and almost worthless stock certificates, depositors rushed to withdraw their savings. Unable to raise fresh funds from the Federal Reserve System, banks began failing by the hundreds in 1932 and 1933. . . . [T]he banking system of the United States had largely ceased to function. Depositors had seen $140 billion disappear when their banks failed.

Wattenberg, *supra*. As a result, the federal government established the Federal Deposit Insurance Corporation to ensure depositors' money; the government promise to reimburse depositors. *Id.*

61. *See* JOHN P. MORIARTY & CURTLAN R. MCNEILY, 19 REGULATION OF FINANCIAL PLANNERS § 3:1 n.1 (2009) ("The Advisers Act was the end of a string of federal statutes enacted to correct conditions which Congress believed had contributed to the 1929 stock market crash and the Great Depression which followed. Specifically, the Advisers Act was adopted to correct the 'problems and abuses' in investment counselling services." (citing S. REP. NO. 76-1775, at 21 (1940))).

62. *See* Securities Act of 1933, 15 U.S.C. §§ 77a to 77aa (2006).

63. *See* Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to 78oo (2006).

64. *See* Andrew Downey Orrick, Commissioner, Securities & Exchange Commission, Address at Town Hall, Los Angeles, California: What Is the SEC Doing to Protect the Public from Securities Fraud 1 (Nov. 13, 1956) (transcript available at http://www.sec.gov/news/speech/1956/111356orrick.pdf). "The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." Investor's Advocate, *supra* note 10.

> [T]he SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions. The result of this information flow is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation's economy. To insure that this objective is always being met, the SEC continually works with all major market participants, including especially the investors in the securities markets, to listen to their concerns and to learn from their experience. The SEC oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisors, and mutual funds. Here the SEC is concerned primarily with promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud.

Id.

Disclosure remains the heart of the regulatory scheme. "[P]rofessional market participants [must] assimilate publicly available information and disseminate it to the investing public."[65] Investors are expected to read and comprehend this material for their own protection.[66] Mandatory and ongoing disclosure by publicly-traded companies facilitates investor education. All securities are registered under the Securities Act[67] and issuers must comply with the disclosure requirements under the Securities Exchange Act, and the Investment Advisers Act.[68] Provisions of the Investment Company Act may also apply.[69]

The hedge fund industry argues transactional risk and compliance with federal securities laws is regulated under the laws which apply to the public companies with which they trade.[70] Specifically, hedge funds argue, heavily regulated banks, broker-dealers and insurance companies

65. Henry Odower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 331 (2007).

66. *See* Vadim Kotelnikov, Venture Financing: Process and Selection Criteria, http://www.1000ventures.com/venture_financing/due_diligence.html (last visited Oct. 3, 2009). "Due diligence emphasizes understanding and quantifying the *risk* of the proposed deal, rather than the upside." *Id.*

67. *See* 15 U.S.C. § 77e (2006); *see also* 15 U.S.C. § 77b (2006) ("[t]he term 'security' means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement . . . .").

68. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2006). "[T]he Investment Advisers Act of 1940 emerged as a statute which would require investment advisers to register and to furnish certain information about themselves, thus providing a 'compulsory census' of investment advisers and which would provide 'in a small degree for the regulation of some of their activities." Loomis, *supra* note 19, at 218, 245.

69. *See* Laurin Blumenthal Kleiman & Carla G. Teodoro, *Forming, Organizing and Operating a Mutual Fund—Legal and Practical Considerations*, *in* THE ABCS OF MUTUAL FUNDS 11, 15, 37 (PLI Corp. Law & Practice Course Handbook Series, PLI Order No. 18809, 2006). "Funds that are excepted from the definition of 'investment company,' as that term is defined under the Investment Company Act, under certain provisions that strictly limit the manner in which fund interests are sold and the number and/or qualifications of their investors. These unregistered funds are offered privately and are commonly referred to as 'hedge funds.'" *Id.* at 15.

70. Dale A. Oesterle, *Regulating Hedge Funds* (Ohio State Public Law Working Paper No. 71 & Center for Interdisciplinary Law and Policy Studies Working Paper Series No. 47, 2006), *available at* http://ssrn.com/abstract=913045 [hereinafter Oesterle Report].

are required to implement proper internal controls to monitor their exposure to hedge fund activity and potential losses.[71] They also argue the economic efficiency and capital allocation benefits they provide to the markets outweigh the potential risk of loss their counterparties face.[72] Disclosure, the industry argues, is valuable where the economic benefits of disclosure are equal to its economic cost.[73] Still, even the industry must acknowledge the many ways they benefit from disclosure: the possibility of achieving more favorable terms on loans, lower costs of trading and increased attractiveness to investors.[74]

Some argue regulation would hinder hedge funds competitive advantage[75] and favor measures to even the playing field. They call for the deregulation of registered investment companies, like mutual funds, so a broader range of investors can enjoy the same advantages as hedge funds.[76] Such sentiments are misguided. Many of the strategies hedge funds employ; short-selling, excessive leverage and strategic publication of negative research reports; are inappropriate for mutual funds. Registered companies profitability is better achieved through long-term growth than a methodological race to the bottom in which even unscrupulous means of turning a profit are permitted and encouraged.[77] A mutual fund's performance should not be a function of indiscriminate use of any and all strategies with the potential to generate double digit returns, irrespective of the impact of said strategies on the markets and global economy.

The main purpose of federal regulation is protection of the general public even to the extent of foregoing the extraordinary profits. Other

71. *See* Editorial, *Hedge Fund Realities*, WALL ST. J., Feb. 26, 2007, at A18. *See infra* note 200 and accompanying text for a discussion on Lehman Brothers and how regulated companies are unable to properly monitor and quantify their potential losses as a result of engaging in hedge fund activities.

72. *See* J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 815 (2007).

73. *See* Kathleen E. Lange, *The New Antifraud Rule: Is SEC Enforcement the Most Effective Way to Protect Investors from Hedge Fund Fraud?*, 77 FORDHAM L. REV. 851, 882 (2008).

74. Houman B. Shadab, *The Challenge of Hedge Fund Regulation: As Other Nations Expand Access to Hedge Funds, Should the U.S. Adopt Tighter Regulation?*, ALLBUSINESS.COM (Mar. 22, 2007), http://www.allbusiness.com/banking-finance/financial-markets-investing-funds/8940884-1.html.

75. *See* Oesterle Report, *supra* note 70.

76. *See id.*

77. *See, e.g.*, Verret, *supra* note 72, at 824.

commentators argue that the SEC is a reactionary agency. In the absence of a crisis, they say, it is unlikely the SEC or any other regulators will move to reform the hedge fund industry.[78] Today's dire economic times are ripe for decisive congressional action to adopt comprehensive hedge fund regulation.

II. UNDERSTANDING HEDGE FUNDS

No enterprise is more likely to succeed than one concealed from the enemy until it is ripe for execution.

—Niccolo Machiavelli[79]

"Who are [hedge fund managers] and what are they doing?"[80] There is not a single definition of hedge funds.[81] The term hedge fund was first used by Alfred Winslow Jones in 1949[82] when he attempted to manage a fund comprised of pooled investments. The pool consisted of

78. *See* Roberta S. Karmel, *The SEC at 70: Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Is Appropriate?*, 80 NOTRE DAME L. REV. 909, 949 (2005) (arguing that "in the absence of a new crisis involving derivatives, excessive leverage in the market or manipulative activities by institutional investors, it is unlikely that Congress, the SEC or any other financial regulator will decide to study and reform institutional investors' behavior").

79. NICCOLO MACHIAVELLI, THE ART OF WAR 202 (Ellis Farneworth trans., De Capo Press, 2d ed. 2001) (1520).

80. Kara Scannell et al., *No Consensus on Regulating Hedge Funds*, WALL ST. J., Jan. 5, 2007, at C1 (quoting Lisa McGreevy, Director, Managed Funds Ass'n).

81. *See* Goldstein v. SEC, 451 F.3d 873, 874-75 (D.C. Cir. 2006) (stating there is no single definition of the phrase "hedge fund"); *see also* SEC STAFF, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 9-10 (2003) [hereinafter SEC STAFF REPORT], *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf; Troy A. Paredes, *Hedge Funds and the SEC: Observations on the How and Why of Securities* 1-2 (Wash. Univ. Sch. of Law, Faculty Working Paper Series, Working Paper No. 07-05-01, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984450 (citing ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000)).

82. Douglas W. Hawes, *Hedge Funds—Investment Funds for the Rich*, 23 BUS. LAWYER 576, 577 (1967-68) (stating that the first hedge fund was established by A.W. Jones & Co. in 1949); *see also* Carol Loomis, *The Jones Nobody Keeps Up With*, FORTUNE, Apr. 2006, at 237; Stephen J. Brown, Keynote Address at the PACAP/FMA Meeting, Melbourne, Australia: Hedge Funds: Omniscient or Just Plain Wrong (July 7, 2000), *available at* http://pages.stern.nyu.edu/~sbrown/omniscient.pdf.

various investors and Jones used an investing strategy of long and short equity positions.[83] Jones envisioned that short sales of the equity positions would counter-balance the risk of holding long positions. In turn, the strategy would allow for capital appreciation while "hedging" against risk of loss due to events in the market.[84] One court[85] noted the phrase 'hedge fund' better described the legal management structure than the investment strategy used by the fund.[86] Hedge funds are intentionally structured to minimize federal regulation, federal and state taxes, and to maximize trading strategies which result in phenomenal returns.[87]

In general, hedge funds are unregulated pools of private money.[88] They are funded with capital in search of an investment vehicle which utilizes sophisticated financial strategies in the securities, currency, and derivative markets to obtain above average returns. Some hedge fund managers achieve lofty returns for their clients and are handsomely rewarded. Hedge fund managers typically receive a one to two percent annual management fee and twenty percent of any profits.[89] In 2005, the top 25 hedge funds took in more than $130 million in fees.[90]

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83. *See* Loomis, *supra* note 82, at 237.

84. *See* Brown, *supra* note 82, at 5; *see also* Loomis, *supra* note 82, at 240.

85. *See* Brown, *supra* note 82, at 5; *see also* Loomis, *supra* note 82, at 240.

86. Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) ("distinctive feature of hedge funds is their management structure"). "[D]omestic hedge funds are usually structured as limited partnerships to achieve maximum separation of ownership and management." *Id.*

87. *See* Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 330 (2007) (describing popular hedge fund structures to avoid registration, and explaining the regulatory planning that accounts for hedge fund success).

88. *See id.* at 324. Private money is defined as money raised by hedge funds from wealthy and institutional investors utilizing the "private offering" exemption under the 1933 Securities Act, Regulation 506 of Regulation D. *See* STUART A. MCCRARY, HEDGE FUND COURSE 129 (2005); *see also* 15 U.S.C. § 77d(2) (2006).

89. *See* SCOTT J. LEDERMAN, HEDGE FUNDS IN FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS 11:2.2, at 11-15 (Clifford E. Kirsch ed. 2000). *See also* Jenny Anderson, *Atop Hedge Funds, Richest of the Rich Get Even More So*, N.Y. TIMES, May 26, 2006, at C2 ("[the] magic behind the money is [the] compensation structure of hedge funds"). Endowments and pensions funds flocked to invest in hedge funds, further fueling the hedge fund boom. *Id.*

90. *See* Oesterle Report, *supra* note 70 (stating that the hedge fund managers who are able to deliver high returns will be able to create new, "follow-up funds" to which investors will continue to flock with the expectation of receiving the same fabulous

A. Brief History of Hedge Funds

In theory, a hedge should deliver positive returns in any market cycle.[91] Hedge funds' most attractive trait is their theoretical ability to earn positive returns un- or minimally correlated with macroeconomic market returns[92] or volatility.[93] In the parlance of sophisticated investors, hedge funds provide excellent 'alpha,' or risk adjusted performance.[94] As a class, the hedge fund sector was spared from the damage inflicted when the internet bubble of the late 1990s bursted shortly after the turn of the twenty-first century.[95] Such returns, especially in declining or 'bear' markets, are arguably bolstered by hedge funds' ability to exploit lax trading regulations to profit from the misfortune of others;[96] hedge funds are more likely to employ short-selling[97] and other trading strategies which enable them to profit from

returns).

91. *See* Erika Kinetz, *Little Guys in the Big Leagues*, INT'L HERALD TRIB., Oct. 8, 2005, at § 3.

92. *See* David J. Brophy et al., *Hedge Funds as Investors of Last Resort*, 22 REV. FIN. STUDIES 541 (2009) (stating that struggling companies that receive financing from hedge funds significantly underperform as compared to struggling companies that receive funding elsewhere).

93. Nicole M. Boyson et al., *Is There Hedge Fund Contagion?* (Nat'l Bureau of Econ. Research, Working Paper 12090, 2006); Bing Liang et al., *Market Volatility, Investor Flows and the Structure of Hedge Fund Markets* (Inst. for Quantitative Research in Fin., Working Paper, 2006); *see also* Barry Riley, Editorial, *Weekend Money: Through the Hedge Fund Maze: Do British Investors Really Need These "Alternative Strategists?"*, FIN. TIMES MANDATE, May 11, 1996 ("you could call most of them speculators").

94. Nicholas Chan et al., *Systemic Risk and Hedge Funds*, *in* THE RISKS OF FINANCIAL INSTITUTIONS 235 (Mark Carey & René Stultz eds., Univ. of Chicago Press 2007); Robert Kosowski et al., *Do Hedge Funds Deliver Alpha? A Bayesian and Bootstrap Analysis*, 84 J. FIN. ECON. 229 (2007).

95. *See* Emma Trincal, *Merrill Says Diversify with Bonds, Not Hedge Funds*, HEDGEWORLD DAILY NEWS, Feb. 26, 2008 (stating hedge funds were "an asset class that investors found attractive for downside protection during the bear market that followed the burst of the Internet bubble").

96. *See* SEC STAFF REPORT, *supra* note 81, at 31.

97. *See id.* at 34-35; Investopedia.com, Short Selling, http://www.investopedia.com/terms/s/shortselling.asp ("[t]he selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short"); *see also* SEC STAFF REPORT, *supra* note 81, at 33-36; Hedge Fund Research, Strategy Definitions (2001), *available at* http://www.hedgefund

market declines.[98]

Despite the hedge fund industry's complexity and technology, hedge funds have not historically outperformed market indexes. [99] In fact, hedge funds do not display any stock picking ability superior to the average investor.[100] A recent study determined the average investor would fare better in a passive and diversified portfolio[101] given the efficient market hypothesis, which postulates current prices reflect all available knowledge material to the performance of a public company. If accepted, an attempt to select undervalued stocks is an exercise in futility.[102]

Hedge funds investments are typically subject to a "lock-in" arrangement. During the lock-up period investors may not withdraw their funds.[103] Lock-up periods can range from six months to five years.[104] Lock-up period restrictions apply to investors' ability to transfer or sell their interest in a hedge fund.[105] Even after the expiration of the lock-up period, investors may not transfer or sell their interests in a hedge fund without the hedge fund manager's prior written consent.[106] These restrictions on transferability are the mechanism most hedge funds use to induce wealthy investors to invest in other funds within the hedge fund family.[107] The measures to restrict the ability of investors to transfer their interest in the fund also further the funds' efforts to preserve their private offerings exemption.

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research.com/pdf/HFR_Strategy_Definitions.pdf.

98. *See* SEC STAFF REPORT, *supra* note 81, at 36.

99. *See* Patrick Darby, *Southeast and New England Mean New York: The Rule of Explicitness and Post-Bankruptcy Interest on Secured Debt*, 38 CUMB. L. REV. 467, 469 n.6 (2008).

100. *See* Riley, *supra* note 93 ("you could call most of them speculators").

101. Burton G. Malkiel & Antanu Saha, *Hedge Funds: Risk and Return*, 61(6) FIN. ANALYSTS J. 80 (2005).

102. *Id.*

103. *See* SEC STAFF REPORT, *supra* note 81, at ix.

104. Citigroup Alternative Investments, Hedge Fund Primer: A Guide to Investing in Hedge Funds (2004), *available at*http://www.smithbarney.com/pdf/HedgeFund Prime_0305.pdf [hereinafter Hedge Fund Primer] (stating most hedge funds disclose the lockup period of six months to five years during which an investment cannot be redeemed).

105. *Id.*

106. *See* Oesterle Report, *supra* note 70, at p. 4 n.22.

107. *Id.*

B. Hedge Funds Distinguished from Mutual Funds

Although hedge funds and mutual funds are both pooled investment vehicles, the similarity between the two types of funds ends there. Hedge funds' legal structures, management, size, investor qualification requirements and regulation differ dramatically from mutual funds.[108]

Mutual funds are heavily regulated. The Investment Company Act[109] applies to mutual funds.[110] It requires all mutual funds to register,[111] limit insider transactions,[112] maintain sufficient liquidity for investor redemption requests[113] and adhere to portfolio pricing rules.[114] The Act effectively imposes debt aversion on mutual funds by imposing very restrictive leverage limitations on registered mutual fund companies.[115] Furthermore, mutual fund companies are prohibited from buying securities on margin,[116] and shorting[117] stocks.[118] The Investment Company Act explains, "the national public interest and the interest of investors are adversely affected" when the interests of fund insiders and those they contract with, among others, prevail over, "the interest of all classes of such companies' security holders. . . ."[119]

Disclosure is a key component of the Investment Company Act's regulatory regime for the mutual fund industry.[120] Mutual funds are

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108. *See* Hedge Fund Primer, *supra* note 104.

109. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-22 (2006).

110. *See* 15 U.S.C. § 80a-16 (2006) (covering board of directors and elections).

111. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (2006).

112. *See* §§ 80a-9, 80a-10, 80a-12, 80a-17 (limiting transactions with affiliated persons as employees, directors, overlapping ownership, and prohibited transactions).

113. *See* § 80a-22 (covering purchase and sale of shares in the company).

114. *See id.*

115. Section 1 of the Act provides, in relevant part, that "the national public interest and the interest of investors are adversely affected . . . (7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities . . . ." § 80a-1(b). *See also* §§ 80a-18(a), 80a-18(f) (2006) (specifying debt requirements applicable to closed-end funds and open-end funds).

116. 15 U.S.C. § 80a-12(a)(1) (2006).

117. *See supra* note 97 and the accompanying discussion.

118. 15 U.S.C. § 80a-12(a)(3).

119. *Id.* § 80a-1(b)(2).

120. *See, e.g.*, Enhanced Disclosure and New Prospectus Delivery Option, For Registered Open-End Management Investment Companies, Securities Act Release No. 8998; Investment Company Act Release No. 28,584 (codified at 17 C.F.R. §§ 230, 232, 239, 274 (2009)) (promulgating new mutual fund disclosure rules which require the

required to disclose[121] some information about their portfolio holdings,[122] such as a list of the fund's portfolio securities holdings as of the date of the particular report, on a biannual basis.[123] Only seven of the top 25 largest mutual fund companies allow investors to examine their full portfolios more frequently.[124]

C. Federal Exemptions Allow Hedge Funds to Avoid Regulation

Federal securities laws restrict the ability to invest in hedge funds to wealthy or sophisticated investors, defined under the Securities Act as accredited investors.[125] Hedge funds, by contrast, fall under many

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provision of a plain English prospectus).

121. 15 U.S.C. § 80a-29(e) (2006).

122. *See* SEC, Investing Wisely, http://sec.gov/investor/pubs/inwsmf.htm (last visited Oct. 7, 2009) (stating investors cannot easily ascertain the exact make-up of their fund portfolio at any given time).

123. *See* David Dietz, *What's the Big Secret About Mutual Fund Holdings*, THESTREET.COM, Apr. 26, 2000, http://www.thestreet.com/story/925755/whats-the-big-secret-about-mutual-fund-holdings.html.

124. *Id.*

125. The U.S. Securities and Exchange Commission defines "accredited investors" as:

> (1) a bank, insurance company, registered investment company, business development company, or small business investment company; (2) an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million; (3) a charitable organization, corporation, or partnership with assets exceeding $5 million; (4) a director, executive officer, or general partner of the company selling the securities; (5) a business in which all the equity owners are accredited investors; (6) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase; (7) a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or (8) a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

SEC, Rule 501 of Regulation D of the Securities Act of 1933, 17 C.F.R. § 230.501(a) (2009); *see also* Charles Stein, *The Smart Money Is Going into Hedge Funds, But How Smart Is It?*, BOSTON GLOBE, Oct. 24, 2004, at F1 ("hedge funds are only available to institutional investors and only the most wealthy individuals"). However, the popularity of hedge funds may eventually undermine their performance by decreasing profit margins. *See id.* ("[t]he return will gradually decline until they get to be very uninteresting" (quoting Jack Meyer, President of Harvard Management, the investment arm of Harvard University)).

Securities Act exemptions from SEC regulation.[126] The exceptions involve institutional or wealthy accredited individuals,[127] and in particular, the Securities Act provides exemptions for private placement offerings.[128] These offerings are securities not offered to the general public rather they are offered privately to wealthy accredited or institutional investors who have the ability to assess the risk of the particular security offered. Private placement offerings are exempt under section 4(2) of the Securities Act.[129] The Securities Act creates certain *safe harbors* which afford private placement issuers the protection of the section 4(2) exemption, if the requisite guidelines set forth by SEC rules, commonly referred to as Regulation D, are observed.[130]

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126. *See* Ordower, *supra* note 87, at 324.

127. *See id.* at 324-25.

128. *See generally* 15 U.S.C. §§ 77d(1), (2) (2006); *see also* Gustafson v. Alloyd Co., Inc., 513 U.S. 561, 591 (1995).

129. Section 4 of the Securities Act, Exempted Transactions, provides in relevant part, that the provisions of Section 5 shall not apply to:

(1) transactions by any person other than an issuer, underwriter, or dealer.

(2) transactions by an issuer not involving any public offering.

(3) transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except—

* * *

(4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders.

(5)(A) Transactions involving offers or sales of one or more promissory notes directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or

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(B) Transactions between any of the entities described in subparagraph (A)(i) or (A)(ii) involving non-assignable contracts to buy or sell the foregoing securities . . . or

(C) The exemption provided by subparagraphs (A) and (B) shall not apply to resales of the securities acquired pursuant thereto . . . .

(6) transactions involving offers or sales by an issuer solely to one or more accredited investors . . . .

Securities Act of 1933, Section 4(2), 15 U.S.C. § 77d(2) (2006).

130. *See* 17 C.F.R. § 230.506 (2009). Rule 506 of Regulation D is considered a "safe harbor" for the private offering exemption of Section 4(2) of the Securities Act. *See* SEC, Rule 506 of Regulation D, http://www.sec.gov/answers/rule506.htm (last visited Sept. 10, 2009). Companies using the Rule 506 exemption can raise an unlimited amount of money. *Id.* A company can be assured it is within the Section 4(2) exemption by satisfying the following standards:

The company cannot use general solicitation or advertising to market the securities;

The company may sell its securities to an unlimited number of "accredited investors" and up to 35 other purchases. Unlike Rule 505, all non-accredited

Qualified private offerings are only marketed to institutional or accredited investors. In order to fall within the safe harbor of Rule 506, hedge funds are prohibited from marketing, or using any type of *general solicitation or general advertising*[131] to the general public.[132] The SEC applies a *pre-existing, substantive relationship*[133] standard when it determines whether a hedge fund violated the general solicitation rule. The standard is analogous to a strict liability standard. Once the SEC determines a hedge fund made a non-solicited advertisement to at least one investor in the fund, the hedge fund automatically loses the exemption.[134] Mindful of this rule, hedge funds are very careful not to violate the SEC general solicitation requirements; they do not send out glossy brochures to prospective investors or provide detailed information about their trading philosophy on their websites. Hedge funds provide limited disclosure materials to potential investors after

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investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment;

Companies must decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws. But companies must give non-accredited investors disclosure documents that are generally the same as those used in registered offerings. If a company provides information to accredited investors, it must make this information available to non-accredited investors as well;

The company must be available to answer questions by prospective purchasers; Financial statement requirements are the same as for Rule 505; and

Purchasers receive "restricted" securities, meaning that the securities cannot be sold for at least a year without registering them.

Id. While companies using the Rule 506 exemption do not have to register their securities and usually do not have to file reports with the SEC, they must file what is known as a "Form D" after they first sell their securities. Form D is a brief notice that includes the names and addresses of the company's owners and stock promoters, but contains little other information about the company. *Id.*

131. Securities Act Rule 502(c), 17 C.F.R. § 230.502(c) (2009); *see also* Doug Cornelius, *Advertising or Solicitation to Offer or Sell Securities Under Rule 502(c)*, COMPLIANCEBUILDING.COM, May 12, 2009, http://www.compliancebuilding.com/2009/05/12/advertising-or-solicitation-to-offer-or-sell-securities-occur-under-rule-502c/.

132. 17 C.F.R. § 230.502(c) (2009).

133. *See* Lamp Technologies, Inc., SEC No-Action Letter, 1997 WL 282988 (May 29, 1997). The letter establishes that a pre-existing relationship must exist between a hedge fund and its investor at least thirty (30) days before the investor may invest in the fund. *Id.*

134. *See id.* at *3, n.8.

confirming that the potential investors satisfy the funds investment profile. In order to qualify for these exemptions, hedge funds are prohibited from advertising to the general public and may only accept investment capital from institutional or wealthy accredited investors.

Perhaps the most important loophole hedge funds exploit is located within the Investment Company Act's definition of an 'investment company.' Exempt from the Act's reach are funds with less than one hundred investors[135] or those available only to "qualified purchasers," a group made up of wealthy or substantial institutional and (often) sophisticated investors.[136] A hedge fund which falls outside the Act's scope is free to engage in short selling[137] and 'lever up' the investments[138] through substantial borrowing, known as 'leverage.'[139] Such speculative, esoteric and exotic transactions are 'off-limits' to regulated investment companies. In addition, hedge funds are exempt from the Commodity and Futures Trading Commission's rules governing "commodity pools."[140]

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135. *See* 15 U.S.C. § 80a-3(c)(7)(B)(i) (2006).

136. *See* 15 U.S.C. § 80a-2(a)(51)(A) (2006) (defining qualified purchasers as individuals who own over $5 million in investments or companies with over $25 million in investments).

137. ROBERT A. JAEGER, ALL ABOUT HEDGE FUNDS: THE EASY WAY TO GET STARTED 4-5 (McGraw-Hill 2000) (stating that mutual funds must comply with SEC regulations which limit and prohibit certain strategies which hedge funds may engage in—such as short selling and over leveraging); *see* Investopedia.com, *supra* note 97 (defining short selling as "[t]he selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller").

138. *See* David Harper, *Hedge Funds Hunt for Upside, Regardless of the Market*, INVESTOPEDIA.COM, http://www.investopedia.com/articles/03/112603.asp.

139. *See* Investopedia.com, Leverage, http://www.investopedia.com/terms/l/leverage.asp (last visited Sept. 13, 2009) ("[T]he use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment.").

140. *See* 17 C.F.R. § 4.5(a)(4) (2009). The CFTC rule exempts commodity pools that sell only to sophisticated participants defined as "accredited investors under Regulation D" or "qualified purchasers under the Investment Company Act." *See* U.S. Commodity Futures Trading Commission, Commodity Pool Operator and Commodity Trading Advisor Exemptions and Exclusions, *available at* http://www.cftc.gov/industryoversight/intermediaries/cpoctaexemptionsexclusions.html. Hedge funds further avoid regulation under Employee Retirement Income Security ACT ("ERISA"), because hedge funds limit the ownership interests that an employee benefits plan may possess to less than 25% of the fund, thereby avoiding regulation. 29 C.F.R. § 2510.3-101(f)(1) (2009). *See also* Hedge Fund Law Blog, Overview of Issues Related to ERISA Hedge Fund Investments (Oct. 27, 2008), http://www.hedgefundlawblog.com/

Hedge funds are indirectly regulated through federal laws governing banks, insurance companies and broker-dealers from whom the hedge funds trade and borrow. U.S. Treasury Department regulations limit the ability of banks to lend to hedge funds by limiting the amount of money that banks may lend to hedge funds as a percentage of the hedge fund's total assets.[141] Banks must comply with minimum, risk-based capital reserves under the Basel Capital Accord, and they are subject to inspection and examination by bank examiners who determine if a bank's risk is over-extended.[142] These capital reserves requirements and risk assessment analysis are designed to limit the amount of money that banks may lend to hedge funds, as well as the potential risks to which banks may be exposed as result of their investment or transactions hedge funds.

Despite their pervasive presence in the financial services industry, hedge funds are completely dependent upon other entities for their very existence. In fact, they depend almost entirely on regulated companies

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overview-of-issues-related-to-erisa-hedge-fund-investments.html.

141. *See* 12 C.F.R. § 32.3(a) (2009). This statute provides, in relevant part, that a bank may not lend more than 15% of its asset value to any one borrower. *Id.* Banks may mark an additional 10% of its capital to one borrower if the additional funds are secured by *readily marketable collateral* which is statutorily defined as an asset that is fairly liquid or exchange traded. *Id.*; *see also* 12 C.F.R. § 32.2(n) (2009).

142. *See generally* Bank for International Settlements, Basel II: Revised International Capital Framework, http://www.bis.org/publ/bcbsca.htm (last visited Sept. 14, 2009). After the implosion of Long-Term Capital Management, the Basel Committee on Banking Supervision issued recommendations on managing counterparty risk. *See* BASEL COMMITTEE ON BANKING SUPERVISION, BANKS' INTERACTIONS WITH HIGHLY LEVERAGED INSTITUTIONS: IMPLEMENTATION OF THE BASEL COMMITTEE'S SOUND PRACTICES PAPER (2000). Additionally, the Federal Reserve Board of Governors, the SEC, and the U.S. Department of Treasury, and a working group of twelve major banks (including Bankers Trust, Bear Stearns, Chase Manhattan, Goldman Sachs, Deutsche Bank, J.P. Morgan, Lehman Brothers, Merrill Lynch, Morgan Stanley, Dean Witter, and Solomon Smith Barney) formed a Counterparty Risk Management Policy Group ("CRPG") to analyze hedge funds impact on the markets. *See* COUNTERPARTY RISK MANAGEMENT POLICY GROUP, IMPROVING COUNTERPARTY RISK MANAGEMENT PRACTICE (1999). The CRPG issued a similar set of recommendations on managing counter-party risk when dealing with hedge funds. *Id.* The CRPG's recommendations were incorporated in the Federal Reserve Supervisory Guidance and Examination Procedures. *See* FEDERAL DEPOSIT INSURANCE CORPORATION, BASEL I AND THE EVOLUTION OF CAPITAL REGULATION: MOVING FORWARD, LOOKING BACK (2003).

for vital services, such as investment banking, prime brokerage,[143] insurance and lending. Additionally, investment banks and broker-dealer firms often *prime brokerage services* to hedge funds.

Prime brokerage services were created to meet the needs of the hedge fund industry because hedge funds where unable to enter and clear large trading transactions on their own. Not surprisingly, a number of large investment banks and broker-dealers sought to meet hedge funds' needs by serving as prime brokers in exchange for handsome fees. As investment banks and broker-dealers discovered the amount of money that hedge funds were generating from their transactions, many investment banking and broker-dealers seduced by the extraordinary returns that hedge funds were generating, established hedge fund subsidiaries of their own. These hedge fund subsidiaries did not need to comply with federal regulations to which their parents were subject.[144] As such, bank-owned hedge fund subsidiaries were liberated from U.S. Treasury Department regulations, Federal Reserve Board lending restrictions, and Basel Capital Reserve requirements. The current financial crisis can in relevant part be traced to the development of bank-owned investment hedge funds that provided liquidity and/or securitized sub-prime mortgaged-backed securities.

Fortunately, federal securities laws do not exempt hedge funds from anti-fraud provision of the Securities Act, the Exchange Act, or state securities anti-fraud laws such as New York State's Martin Act. The Securities Exchange Section 10(b), Rule 10b-5 and the insider-trading prohibitions promulgated thereunder[145] also apply to hedge funds. Hedge funds may not make any false or materially misleading

143. "Prime Brokerage Services" are defined as a special group of services that many brokerages give to special clients. The services provided under prime brokering are securities lending, leveraged trade executions, and cash management, among other things. Prime brokerage services are provided by most of the large brokers, such as Goldman Sachs, Paine Webber, and Morgan Stanley Dean Witter. Hedge funds were what started the prime brokerage option. Hedge funds placed large trades and need special attention from brokerages. Investopedia.com, Prime Brokerage Services, http://www.investopedia.com/terms/p/primebrokerage.asp (last visited Sept. 18, 2009). *See also* Richard R. Lindsey, Tips for Choosing a Prime Broker (Bear Stearns Securities Corp.), *available at* http://www.globalclearing.com/gcsportal/pdf/tips_primebroker.pdf.

144. *See* Investopedia.com, Shadow Banking System, http://www.investopedia.com/terms/s/shadow-banking-system.asp (last visited Sept. 18, 2009) (stating hedge-fund intermediaries of banks are not regulated).

145. *See* 17 C.F.R. § 240.10b-5 (2009).

statements regarding their investments.[146] The Exchange Act requires publicly traded companies to report "nontrivial" positions held in off-balance sheet entities with the SEC[147] and report on quarterly basis investments of $100 million or more invested in off-balance sheet entities.[148] Furthermore, the Investment Advisers Act deems hedge fund managers to be legal fiduciaries.[149] As a legal fiduciary, hedge fund managers must place the interest of the hedge fund, and investors of the hedge fund, before their own personal interest.

Nonetheless, some hedge funds engaged in questionable, and sometimes fraudulent, transactions which harmed investors or the general public.[150] The line between questionable and fraudulent conduct within the context of the federal securities or common law is blurry. The key question is does an overly zealous hedge fund manager's promise of an outrageously high return to investors rise to the level of misrepresentation and fraud?[151] Some cases, such Bayou Capital, which failed in 2004, are clearly within the realm of fraud. Bayou's principals disappeared, leaving investors with significant losses.[152] Eventually,

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146. *See* 15 U.S.C. § 80b-6(1) (2006).

147. *See* 17 C.F.R. § 240.13(f)(1) (2009); *see also* Shadab, *supra* note 74, at 1-2.

148. 17 C.F.R. § 240.13(f)(1) (2009); *see also* Shadab, *supra* note 74, at 1-2. The Exchange Act provides, in relevant part:

> Every institutional investment manager which exercises investment discretion with respect to accounts holding section 13(f) securities, as defined in paragraph (c) of this section, having an aggregate fair market value on the last trading day of any month of any calendar year of at least $100,000,000 shall file a report on Form 13F (§ 249.325 of this Chapter) with the Commission within 45 days after the last day of such calendar year and within 45 days after the last day of each of the first three calendar quarters of the subsequent calendar year.

17 C.F.R. § 240.13(f)(1)(a)(1) (2009).

149. *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,716 n.22 (Dec. 24, 2003).

150. *See generally* GARY WEISS, WALL STREET VERSUS AMERICA THE RAMPANT GREED AND DISHONESTY THAT IMPERIL YOUR INVESTMENTS (Portfolio 2006) (describing the various techniques that the financial industry, including hedge funds use to prey on small investors).

151. Will Shanley, *Police Arrest 3 for Alleged Hedge Fund Fraud*, DENVER POST, May 17, 2006, at C01 (stating that two men were arrested for defrauding investors of approximately $7.5 million—the investors were mesmerized by the false promise of big returns).

152. Gretchen Morgenson, *What Really Happened at Bayou*, N.Y. TIMES, Sept. 17, 2005, at C1.

some of the principals were apprehended, and pled guilty to conspiracy and fraud charges.[153] The 2003 civil charges filed by Spitzer against Canary Capital Partners, LLC arguably, arose from fraudulent conduct as well. The New York Attorney General's complaint alleged the Canary funds late trading and market timing mutual fund shares was fraudulent and illegal.[154] These actions breached the trust of Canary's investors, who were unaware their capital facilitated such conduct. Instances such as Bayou and Canary raise questions about the legitimacy of hedge funds' complex trading strategies. They also fuel skeptics' suspicions hedge funds' purported aversion to disclosing "proprietary" trading strategies is, in fact, a cover for more sinister activity.[155]

During the past decade many hedge funds have posted phenomenal returns.[156] These returns, however, are arguably attributable to the fact hedge funds were exempt from federal regulation and free engage in questionable trading practices unavailable to other market participants. It is unfortunate no substantive congressional hedge fund regulatory proposals emerged until the current financial disaster. Perhaps Professor Karmel's argument is correct:

> . . .in the absence of a new crisis involving derivatives, excessive leverage in the market or manipulative activities by institutional investors, it is unlikely that Congress, the SEC or any other financial regulator will decide to study and reform institutional investors' behavior.[157]

It is as if Congress had learnt nothing from the Long Term Capital Management[158] and Enron[159] debacles. The reevaluation of the wisdom

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153. *Hedge Fund Founder, CFO Plead Guilty in Fraud Case, Losses Estimated at $450 Million in Bayou Scandal*, CHICAGO TRIB., Sept. 30, 2005, at C3.

154. Complaint, New York v. Canary Capital Partners, LLC (Sept. 3, 2003), *available at* http://www.oag.state.ny.us/media_center/2003/sep/canary_complaint.pdf [hereinafter Canary Complaint].

155. *See* Daniel L. Liffman, *Registration of Hedge Fund Advisers Under the Investment Advisers Act*, *38* LOY. L.A. L. REV. 214 (2005) (arguing that the increase popularity of hedge funds have a direct correlation to increase in fraud, whish hurts small investors and negatively impacts the markets).

156. *But see* text accompanying notes 99-102, *supra*.

157. *See* Karmel, *supra* note 78, at 948, and accompanying text.

158. Long Term Capital Management was a hedge started in 1994 with much fanfare about its technical trading strategies. It had two Nobel laureates in economics on its board—Robert Merton and Myron Scholes. It maintained a 28-to-1 leverage of its portfolio. Long Term imploded in 1998 by losing approximately $2.3 billion in a matter of months. *See id.*

of unfettered markets prompted by the recent financial crisis presents Congress with a wonderful opportunity to adopt clear unambiguous hedge fund regulation. Reformative and preventative measures are necessary to adequately protect American investors.

Until recently, a *laissez faire*[160] trend permeated discussions about hedge fund regulation. Former SEC Chairman Cox testified before Congress that "to the maximum extent possible, our actions regarding hedge fund regulation should be non-intrusive."[161] While President of the New York Federal Reserve, Treasury Secretary Timothy Geithner stated that hedge funds should be regulated.[162] This *laissez faire* attitude is all the more alarming when considered in the light of the financial implosions of Long-Term Capital and Enron. True to form, the aftermath of Enron led Congress to adopt Sarbanes-Oxley[163] to protect against bad corporate governance and to reassure investors that it was

159. Enron began in 1985 as a company that shipped natural gas through pipelines, but it changed in the next sixteen years to one of the nation's most dominant energy traders. BBC, Enron Timeline, http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline/default.stm. Enron allegedly dealt in illegal, off-the-balance-sheet transactions and partnerships, which allowed the company to conceal its growing debt problem. *See* Complaint, SEC v. Fastow, Civil Action No. H-02-3666 (S.D. Tex. Oct. 2, 2002). Enron high-level executives may have known about the company's financial issues and woes for some time. Former Vice President for Corporate Development Sherron Watkins warned Enron's Chief Executive Officer of impending financial problems based on a number of accounting scandals in August 2001. *Financial Collapse of Enron Corp.: Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Energy & Commerce*, 108th Cong. (Feb. 14, 2002) (statement of Sherron Watkins, Vice President of Corporate Development, Enron Corp.).

160. AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 981 (4th ed. 2000).

161. *Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 109th Cong. (2006) (statement of Christopher Cox, Chairman, SEC) (transcript available at http://www.sec.gov/news/testimony/2006/ts072506cc.htm) [hereinafter Cox Statement].

162. See J. Bradford DeLong's Grasping Reality with All Eight Tentacles, http://delong.typepad.com/sdj/2007/07/regulating-hedg.html (July 24, 2007, 21:29 PST).

163. The official title of the bill is "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11 U.S.C, 15 U.S.C., 18 U.S.C., 28 U.S.C., and 29 U.S.C.).

safe to invest.[164]

III. FEDERAL REGULATORS' CONCERN REGARDING CERTAIN HEDGE FUND ACTIVITY

Markets would. . ..possibly cease to function.
—William J. McDonough[165]

Federal regulators' authority is not absolute. The SEC[166] is limited to the authority granted to it under the Securities Act,[167] the Securities Exchange Act,[168] the Investment Company Act,[169] the Investment Advisers Act,[170] and the Rules promulgated thereunder. Likewise, the CFTC[171] authority is limited to the powers granted to it under the Commodities Exchange Act[172] and the Rules promulgated thereunder. The Federal Reserve Board's[173] power is limited to the authority granted

164. 149 CONG. REC. S12976 (daily ed. Oct. 21, 2003) (statement of Rep. Levin) (to restore trust in the financial markets after the Enron "debacle"). Sarbanes-Oxley is a broad package of federal legislation intended to rein in corporate executives run amok and restores investor confidence. Unlike most of the federal initiatives that preceded it, Sarbanes-Oxley established some mandatory rules governing the internal affairs of publicly listed corporations. In particular, Sarbanes-Oxley includes changes to many different areas of the law: (1) accounting and auditing procedures, (2) financial disclosures, (3) corporate tax law, (4) securities law, and (5) bankruptcy law. The Sarbanes-Oxley's goal is to guarantee "trust in the financial markets by ensuring that the corporate fraud and greed may be better detected, prevented and prosecuted" and to "ensure that such greed does not succeed." *See* S. REP. NO. 107-146 (2002), 2002 WL 863249, at *2 (statement of Senator Leahy) [hereinafter Leahy Statement] (stating that the Act is intended to restore trust in the financial markets after the Enron "debacle").

165. *Hedge Fund Operations: Hearing Before the H. Comm. on Banking & Financial Services*, 105th Cong. (1998) (statement of William J. McDonough, President, Federal Reserve Bank of New York).

166. *See supra* note 10 and accompanying text.

167. 15 U.S.C. §§ 77a to 77aa (2006).

168. 15 U.S.C. §§ 78a to 78oo (2006).

169. 15 U.S.C. §§ 80a-1 to 80a-64 (2006).

170. 15 U.S.C. §§ 80b-1 to 80b-22 (2006).

171. *See supra* note 57 and accompanying text.

172. Commodities Exchange Act of 1936, 7 U.S.C. § 15 (2006).

173. The Federal Reserve System serves as the nation's central bank. The System consists of a seven member Board of Governors with headquarters in Washington, D.C., and twelve Reserve Banks located in major cities throughout the United States.

to it under Federal Reserve Act[174] and the Rules promulgated thereunder. The enormous impact of hedge funds' activities on the equity and financial markets calls the wisdom of such restrictions on regulators' authority into question.

A. Hedge Fund Growth and Public Investors

An enormous swath of Americans is indirectly exposed to hedge fund investments as beneficiaries of pension funds or institutional endowments. Large public pension funds, such as CALPERS,[175] and private pension funds, like Harvard's Sowood Management,[176] invest in hedge funds either directly or indirectly. CALPERS and Sowood Management are institutional investors as defined under the Securities Act.[177] CALPERS and Sowood Management invest on behalf of millions of working-class Americans, who depend on the performance of the instutitions' investments to fund their retirement.

Unsurprisingly, the SEC promulgated a package of new rules in

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Primary responsibility of the Board members is the formulation of monetary policy. The Board sets reserve requirements and shares the responsibility with the Reserve Banks for discount rate policy. These two functions plus open market operations constitute the monetary policy tools of the Federal Reserve System. In addition to monetary policy responsibilities, the Federal Reserve Board has regulatory and supervisory responsibilities over banks that are members of the System, bank holding companies, international banking facilities in the United States, Edge Act and agreement corporations, foreign activities of member banks, and the U.S. activities of foreign-owned banks. The Board is also responsible for the development and administration of regulations that implement major federal laws governing consumer credit such as the Truth in Lending Act, the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act and the Truth in Savings Act. *See* Federal Reserve Board, The Structure of the Federal Reserve System, http://www.federalreserve.gov/pubs/frseries/frseri.htm.

174. *See generally* 12 U.S.C. ch.3.

175. The California Public Employees' Retirement System (CalPERS) is a defined benefit retirement plan that manages pension and health benefits for approximately 1.5 million California public employees, retirees, and their families. CalPERS provide benefits based on a member's years of service, age, and highest compensation. Benefits are also provided for disability and death. CalPERS, Facts at a Glance: General (Oct. 10, 2009), http://www.calpers.ca.gov/eip-docs/about/facts/general.pdf.

176. *See* Jenny Strasburg & Katherine Burton, Sowood Funds Lose More Than 50% as Debt Markets Fall (Update 4), BLOOMBERG, July 31, 2007, http://www.bloomberg.com/apps/news?pid=20601103&sid=a5He2yClHjJE.

177. *See* 15 U.S.C. § 77b-(a)(15)(i) (2006).

2004 to regulate the hedge fund industry.[178] The proposed rules recognized hedge funds' outsized impact on the securities industry.[179] Larger hedge funds would become subject to the Investment Advisers Act.[180] Congress held extensive hearings and roundtable discussions with state regulators to determine whether the proposed hedge fund rule was adequate.[181] In adopting this new hedge fund rule in 2005, the SEC extended its oversight over the $1.5 trillion hedge fund industry.[182]

The proposed hedge fund rule required all qualifying hedge funds to meet the registration requirements by February 1, 2006. The proposed hedge fund rule attempted to amend hedge fund' advisers method of counting that allowed hedge fund advisers to fall within the scope of the "private adviser exemption" under the Investment Adviser Act.[183] Traditionally, the Investment Adviser Act exempted investment advisers who had fifteen clients or less counted within the hedge fund entity itself.[184] In essence, an investment adviser could have 499 individual investors in a hedge fund but not be required to register because the investment adviser was advising only "one client" - the hedge fund.[185] However, the moment a hedge fund had 500 investors (which it rarely did); it was required to register with the SEC. Additionally, hedge fund advisers whose principal offices and places of business were within the United States, and who managed at least $25

178. *See* Registration Under the Advisers Act of Certain Hedge Funds Advisers, Investment Advisers Release No. 2333, 69 Fed. Reg. 72,054, 72,054 (Dec. 10, 2004) [hereinafter Hedge Fund Rule].

179. *See generally* Luis A. Aguilar, Commissioner, SEC, Address at the Hedgeworld Fund Services Conference: Hedge Fund Regulation on the Horizon—Don't Shoot the Messenger (June 18, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch061809laa.htm).

180. *See* 15 U.S.C. §§ 80b-1 to 80b-3.

181. *See Hedge Funds and Capital Markets: Hearings Before the Subcomm. on Capital Markets, Insurance & Investment Securities of the S. Comm. on Banking, Housing. & Urban Affairs*, 109th Cong. 8 (2006) (statement of Randal Quarles, Undersecretary for Domestic Finance) (stating that the Treasury Department will examine in detail whether the growth of hedge funds holds the potential to change the overall level or nature of risk in our markets).

182. Michael Steinhardt, *Do You Really Need a Hedge Fund?*, WALL ST. J., Apr. 14, 2006, at A16.

183. *See* 15 U.S.C. §§ 80b-1, 80b-3(b)(1) to (b)(6) (2006).

184. *See* § 80b-3(b)(3).

185. *See id.*

million in assets, were required to register with the SEC.[186] This was a marked change from the SEC's previous rule exempting investment advisers from registering with the SEC, if the adviser managed no more than $25 million of a fund that was located within the United States.[187]

Additionally, the proposed hedge fund rule created a "look through" provision, which required hedge fund advisers to count each individual owner of a private fund as a client for purposes of determining whether the private adviser exemption applied. As such, a hedge fund that had more than fourteen investors in the previous twelve months would no longer qualify for a private adviser exemption, and would need to register with the SEC. Previously, the Investment Adviser Act exempted entities that had "fewer than fifteen clients" from registering with the SEC.[188] Most investment advisers to hedge funds were exempt from the requirements of the Investment Adviser Act because the advisers intentionally limited their advisory services to less than 15 clients. Under the proposed hedge fund rule most hedge fund advisers would have to register with the SEC if the funds they advises had fifteen or more individual "shareholders, limited partners, members, or beneficiaries."[189]

Additionally, the SEC noted that pension funds that invest in hedge funds have a fiduciary duty to ensure that pensioners' investments are not placed at risk through reckless investments.[190] Fiduciary duty is the fundamental hallmark of any relationship in which trust is the cornerstone of the relationship. In reliance upon such trust, the fiduciary is entrusted with the financial care giving of another. Certainly, pension' funds fiduciary duties required them to conduct appropriate due diligence inquiries about the types of investment strategies used by a hedge fund. This must be a prerequisite to a pension fund manager making an investment in a hedge fund. However, a question arises as to whether hedge funds provide adequate disclosure to allow pension fund manager to adequately satisfy their fiduciary duties.

186. *See* 15 U.S.C. § 80b-3a(a)(1)(A).
187. *See* 15 U.S.C. § 80b-3(b)(1).
188. *See id.* § 80b-3(b)(3).
189. 17 C.F.R. § 275.203(b)(3)-2(a) (2009).
190. *See, e.g.*, AM. JUR. 2D *Pensions and Retirement Funds* § 454 (1988).

B. SEC Attempt to Regulate Hedge Funds

The SEC offered several rationales for regulating hedge funds. First, the SEC cited the exponential growth of hedge funds industry as a basis for adopting hedge fund regulation. At the time there were approximately 8,350 active hedge funds that control $875 billion in assets.[191] The hedge fund industry had experienced capital inflows of approximately $126.5 billion in 2006.[192] Hedge fund capital inflow accounted for "$16.4 billion dollars in the first quarter of 2008."[193] In 2006 alone, nearly 2,000 new hedge funds began operation.[194] The inverse is also true, however. Many hedge funds shut down without providing their investors with any notice.[195] In 2005, nearly 600 hedge funds failed.[196] The impact of a hedge fund's failure on its investors can be fatal especially when the investor is a pension fund comprised of retirement savings.

Such fears about the risks to average investors proved justified. Hedge funds' trading strategies did not result in sufficient profit to fulfill their existing or future trading obligations, and created a substantial burden on hedge funds' trading counter-parties to fulfill. Counterparties are almost always publicly-traded companies, which must either absorb the loss, or default on the existing or future trading obligations. It is a financial domino effect — as one hedge fund fails or defaults on existing trading obligation, its creates defaults with counter-parties, which causes defaults with other counter-parties with trading contracts. As such, hedge fund failures create cross-defaults,[197] in the financial and

191. *See id.*

192. See Aaron Siegel, *Hedge Funds Rake in $126.5 Billion,* INVESTMENT NEWS, Jan. 17, 2007 (stating that hedge fund inflows for the quarter were $15.8 billion that brought in a record $126.5 billion for the year).

193. Posting to DaveManuel.com, http://www.davemanuel.com/2008/09/03/hedge-fund-capital-inflows-have-slowed-to-a-trickle-in-2008/ (Sept. 13, 2009, 23:41 EST).

194. Cox Statement, *supra* note 163, at 8.

195. See *generally* The Hedge Fund Implode-O-Meter, http://hf-implode.com/imploded.html (listing of hedge funds that have imploded since late 2006).

196. *Hedge Fund Realities*, WALL ST. J., Feb. 26, 2007, at A18.

197. Investopedia.com, Cross Default, http://www.investopedia.com/terms/c/cross default.asp (last visited Oct. 12, 2009) (defining cross-defaults or cross acceleration as "provisions in a bond indenture or loan agreement that puts the borrower in default if the borrower defaults on another obligation").

securities markets which, in turn, create market liquidity[198] problems or market credit[199] complications. This is why hedge funds have such a significant impact on the financial and securities markets. For example, the current financial crisis that began in October 2008 can trace its origins to the collapse of Lehman Brothers in September 2008.[200] The inability of regulators to ascertain the true state of Lehman's finances, in light of the uncertain value of the bank's extensive holdings of esoteric derivatives contracts and counterparty liabilities impeded their efforts to rescue the firm. Ultimately all investors and the entire global economy suffered devastating losses, at least in part, because hedge fund style trading instruments were so interconnected with the broader economy.

The second reason the SEC offered for adopting hedge fund regulation was the correlation of significant growth and allegation of fraud by hedge fund investors and subsequent hedge fund enforcement actions commenced by the SEC and a number of state securities regulators.[201] Enforcement actions increased against hedge funds because hedge funds began to impact the securities and financial markets. The impact was felt both in terms of hedge fund failures, and the growing number of unsophisticated investors who were able to invest in hedge funds. As previously noted in this article, hedge fund failures created significant ripple effects in the markets because of the cross-defaults, liquidity and credit crunches their failure triggered. The unsophisticated investor is in danger because hedge fund advisers

198. Investorwords.com, Liquidity, http://www.investorwords.com/2837/liquidity.html (last visited Oct. 12, 2009) (defining liquidity as the "ability of an asset to be converted into cash quickly and without any price discount").

199. Investorwords.com, Credit, http://www.investorwords.com/1193/credit.html (last visited Oct. 12, 2009) (defining credit as the "borrowing capacity of an individual or company").

200. *See, e.g.*, Justin Fox, *The Bailout's Biggest Flaw*, TIME, Sept. 28, 2009, at 44; David Ellis, *Lehman Brothers Collapse Stuns Global Markets*, CNN.COM, Sept. 15, 2008, http://edition.cnn.com/2008/BUSINESS/09/15/lehman.merrill.stocks.turmoil/index.html; Posting of Lydie Nadia Cabrera Pierre-Louis to Corporate Justice Blog, http://corporatejusticeblog.blogspot.com/2009/09/remembering-lehman-on-eve-of-first.html (Sept. 8, 2009 16:32 EST).

201. *See, e.g.*, Jeffrey Robins & Steven Lofchie, *Regulation of Private Funds* (May 1, 2008), *available at* http://www.cadwalader.com/assets/article/050108LofchieRobinsRegPriv.pdf ("As the number of hedge funds have grown, so has the number of reported cases of frauds on investors."). Included in the state regulation enforcement actions are the actions commenced by the former Office of the New York State Attorney General, Eliot Spitzer. *See id.*

defrauded both hedge fund investors and non-hedge fund investors in amounts exceeding approximately $2 billion.[202]

The third reason the SEC offered for adopting hedge fund regulation was the growing and sizable number of small investors, pensioners and others charitable organizations which were indirectly investing in hedge funds. Small investor involvement was increasing because hedge funds were expanding their marketing to attract them. The hedge funds attracted small investors by decreasing the minimum investment requirements. Hedge funds offered diversified investment options in a *fund of funds*.[203] A fund of funds is a portfolio of uncorrelated hedge funds, bundled together to provide access to a variety of hedge funds with different investment styles, strategies and risks. The fund of funds may also be a pension fund, foundation, university or other charitable organizations that invests in hedge funds.[204] The danger was that the retirement monies of small investors were exposed to exponential risk, possibly leading to sizeable losses, which may not have been properly disclosed to the pension fund investors. The SEC's proposed hedge fund rule sought to remove the secrecy by which hedge funds operated. Once subjected to federal disclosure requirement, hedge funds would have to register with the SEC, submit to discretionary SEC examinations, and the SEC would be permitted to conduct background investigation of hedge fund advisers to reveal prior criminal convictions and professional misconduct.[205]

C. Legal Challenge to Proposed Hedge Fund Rule

In 2006, Phillip Goldstein, the President of Kimball & Winthrop,

202. *See* Hedge Fund Rule, *supra* note 180, at 72,056-75 (stating that complex trading strategies takes advantage of the gap in the federal regulation).

203. *See id.* at 72,057.

204. SEC, Hedge Funds, http://www.sec.gov/answers/hedge.htm (last visited Oct. 12, 2009) (defining a fund of hedge funds as "an investment company that invests in hedge funds—rather than investing in individual securities. Some funds of hedge funds register their securities with the SEC. These funds of hedge funds must provide investors with a prospectus and must file certain reports quarterly with the SEC.").

205. *See* Hedge Fund Rule, *supra* note 178, at 72,078 (providing that the Commission may screen the adviser and associated individuals, and deny registration if they have been convicted of a felony or otherwise have a prior disciplinary record subjecting them to disqualification).

Inc. challenged the SEC proposed hedge fund registration rule[206] in court. The SEC proposed hedge fund rule altered the manner in which investment advisors counted their clients. Before the SEC proposed a hedge fund registration rule, hedge fund advisers did not have to register with the SEC if they had fewer than fifteen clients. The proposed change in regulation meant that hedge fund managers would be required to count each investor in a hedge fund, rather than counting only the fund itself as the client. The ability to count only the fund as the client, instead of each individual investor in the fund, allowed hedge funds advisers to stay within the fewer than fifteen client rule.[207]

The Court of Appeals for the D.C. Circuit invalidated the SEC proposed hedge fund registration rule.[208] Judge Randolph, writing for a unanimous panel, held that the SEC re-definition of the term "client" was arbitrary, rendering the definition inapposite to the SEC previously promulgated safe harbor rule, and conflicted with the purpose of the Investment Adviser Act.[209] The SEC argued that determining whether the proposed hedge fund rule's use of the term "client" was ambiguous triggered the deferential standard outlined by the Supreme Court in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*[210] The court rejected the SEC argument, stating that SEC's construction of the term "client" was unreasonable in light of the court's own interpretation of the word, the Investment Adviser Act's definition of the term "investment adviser," and the SEC's prior definition of the term "client" in the safe harbor rule.[211]

Goldstein, emboldened by his court victory, requested an SEC exemption for Kimball & Winthrop, Inc. from a proposed rule which would require hedge fund advisers with over $100 million under management to disclose their equity positions on a quarterly basis.[212] Goldstein believed that his firm's equity positions were intellectual

206. *See id.* at 72,054.

207. Isaac Ruiz-Carus et al., What Is a Hedge Fund?, University of Iowa Center for International Finance and Development, *available at* http://www.uiowa.edu/ifdebook/faq/Hedge.shtml.

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

209. *Id.* at 879 & n.5.

210. *Id.* at 878.

211. *Id.* at 879 & n.5 (finding that the safe harbor rule defined "client" as "the limited partnership," itself not the individual partners who invest in the limited partnership).

212. *See* Scannell et al., *supra* note 82.

property that should be protected under federal law rather than disclosed under it.[213] Federal disclosure requirement for mutual funds currently mandates that mutual funds disclose their top five portfolio holdings to their investors at least on a biannual basis.[214]

The court's ruling in *Goldstein v. SEC* was incorrect. The *Goldstein* court's refusal to accept the SEC argument regarding the Supreme Court's deferential treatment of agency decision-making, adopted in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,[215] conflicts with the purpose of the Investment Advisers Act. Perhaps more troubling, is the *Goldstein* Court's refusal to adapt its jurisprudence to a more flexible adaptive rule-making framework that is unique to the financial services industry— where the risk of loss, which is often shifted onto the unsuspecting public, is enormous. The financial institutions such as banks, insurance companies who execute trades with hedge funds, often have the financial wherewithal to withstand the financial fallout when a hedge funds defaults on trade transactions, which may ultimately lead the hedge fund to fail. However, the pensioner who indirectly invest in hedge funds do not have the financial wherewithal to withstand such financial fallout when hedge funds default on trade transactions and, often pensioners are left holding the proverbial bag. How federal regulators protect should small investors in this type of financial quagmire will require innovative regulatory techniques and expansive scope of current federal financial reporting requirements to capture hedge fund activity in the markets.

The SEC declined to appeal the *Goldstein* decision.

Senator Charles Grassley's (R-IA), the former ranking Republican on the Senate Finance Committee, criticized the SEC for not aggressively trying to root out potential for illegal insider trading by hedge funds, rather than proposing a new net worth rule.[216] Grassley,

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213. *See id.*

214. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8861, Investment Company Act Release No. 28,064, 72 Fed. Reg. 67,790 (proposed Nov. 21, 2007). However, concerns raised by the mutual fund industry regarding the need to protect a fund and its shareholders from predatory trading that may occur given the concentration of certain funds in fewer issuers convinced the SEC to leave holdings disclosure unchanged in the final rule. *See id.*

215. 467 U.S. 837 (1984).

216. Brody Mullins & Kara Scannell, *Politics and Economics: Hedge Funds Coming of Age Politically—Politicians' Growing Scrutiny Coincides with Calls for*

disappointed with *Goldstein* court's ruling, attempted to reinstate a registration requirement for hedge fund advisers with the SEC but his attempt was unsuccessful.[217] It would take Congress three years to re-consider proposed legislation to directly regulate hedge funds.[218]

The adverse outcome of *Goldstein*, at first, appeared to dampen the SEC's resolve to regulate the hedge fund industry. This sentiment was compounded when the hedge fund industry responded to the decision by withdrawing their registration applications from the SEC en masse. Backing away from an entirely new regime, the SEC tweaked the old requirements.

The Commission promulgated revised anti-fraud rules, instead. In a move which the SEC estimated would reduce the number of hedge fund investors by 88%,[219] the Commission increased the net worth requirement for hedge fund investors.[220] It also clarified disclosure requirements applicable to registered and unregistered investment advisers to hedge funds and other private investment pools.[221] The proposed net worth rule makes it unlawful for an investment adviser, irrespective of its registration status under the Investment Advisers Act to "make any untrue statement of material fact or to omit to state a material fact . . . to any investor or prospective investor in a pooled investment vehicle."[222] The new anti-fraud rule also prohibits hedge

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Cash; Will New PAC Provide Cover?, WALL ST. J., Apr. 19, 2007, at A6.

217. David M. Katz, *Sen. Grassley Seeks Hedge-Fund Rule*, CFO.COM, Mar. 8, 2007, http://www.cfo.com/article.cfm/8834476/c_8913455?f=insidecfo.

218. Posting of Zachery Kouwe to Dealbook Blog, Senators Seek to Regulate Hedge Funds, http://dealbook.blogs.nytimes.com/2009/01/29/senators-seek-to-regulate-hedge-funds (Jan. 28, 2009, 18:53 EST). The proposed legislation is aptly titled, *Hedge Fund Transparency Act of 2009*. On July 16, 2009, the Senate Committee on Banking, Housing, and Urban Affairs held a hearing entitled *Regulating Hedge Funds and Other Private Investment Pools* to discuss legislation that would require all hedge fund advisers and the advisers of private equity and venture capital funds to register with the SEC. President Obama's administration has also submitted proposed legislation to regulate hedge funds titled *Private Fund Investment Advisers Registration Act of 2009*. *See id.*

219. 17 C.F.R. § 206(4)-8(a)(1) (2009).

220. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 8766, Investment Advisers Act No. 2576, 72 Fed. Reg. 400 (proposed Jan. 4, 2007) (Proposed Regulation § 206(4)-8).

221. *See* 17 C.F.R. § 206(4)-8(a)(1).

222. *Id.* § 206(4)-8(a)(1). Compare the language of the general antifraud rule under

funds from engaging in deceptive or manipulative practices.[223]

The new regulation is much broader in scope than the 10b-5 general antifraud rule because it applies even when the statement, omission or deceptive practice does not accompany the purchase or sale of an interest in the pooled investment vehicle or any other security.[224] Conceptually, this would pull questionable conducts that previously were outside the scope of 10b-5 anti-fraud rule within its scope. For example a questionable strategy that hedge funds employ is to publish negative research reports[225] which they distribute to the public to create negative impression of the financial viability and management of targeted publicly-traded companies with AAA credit rating that they have shorted and against whom hedge funds have purchased substantial amounts of credit default swaps. Hedge funds target these publicly-publicly traded companies because these companies are the most vulnerable to negative news. The stock prices of these targeted companies can move almost instantaneously based upon such unsubstantiated widely dispersed negative news.

IV. CERTAIN HEDGE FUND ACTIVITY NEGATIVELY AFFECTS THE PUBLIC GOOD

Hell, there are no rules here—we're trying to accomplish something.
—Thomas A. Edison[226]

Disclosure and transparency are critical to the balanced operation of the markets. The current *modus operandi* of hedge fund non-disclosure can lead to eminent implosion of the hedge fund industry.[227] The principle purpose of financial regulation is to protect the investing public from fraud by requiring publicly traded companies to provide adequate

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the Exchange Act, Rule 10b-5. 17 C.F.R. § 240.10b-5 (2009).

223. 17 C.F.R. § 206(4)-8(a)(2).

224. *Id.* § 206(4)-8; see discussion of enforcement action in Securities Act Release No. 8766, *supra* note 222.

225. *See infra* Section V.B.

226. LANCE SECRETAN, INSPIRE! WHAT GREAT LEADERS DO 30 (John Wiley & Sons, Inc. 2004).

227. *See* Joseph Nocera, *Offering Up an Even Dozen Odds and Ends*, N.Y. TIMES, Dec. 24, 2005, at C1 (stating that secrecy is the biggest problem with the hedge fund industry).

disclosure through financial reporting regulation such as annual reports, quarterly reports and other public disclosure filings with the SEC.[228] The secondary purpose of financial regulation is to protect the investing public from the agency costs associated with the delegation of investment services and/or decisions to third parties. Investors should be confident securities' markets are operated to ensure all participants are treated fairly. Regulation exists to ensure the integrity of the marketplace.[229] American investors have come to expect this *parens patriae*[230] role that government has assumed to protect and serve.

Hedge funds' operations, culture and strategy are antithetical to this tradition. The hedge fund industry is a closely knit group.[231] They all seem to know each other or know about each other.[232] Hedge funds are not known for readily revealing their investment strategies, positions,

228. *See* Securities Act of 1933, 15 U.S.C. § 77g (2006). The SEC describes its function as promoting and facilitating investor access to essential investment related information by "promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud." *See* Investor's Advocate, *supra* note 11; *see, e.g.*, DANIEL REINGOLD & JENNIFER REINGOLD, CONFESSIONS OF A WALL STREET ANALYST: A TRUE STORY OF INSIDE INFORMATION AND CORRUPTION IN THE STOCK MARKET (2006) (exposing the illegal use of insider information on Wall Street).

229. *See* David Skeel, *Behind the Hedge*, LEGAL AFFAIRS, Dec. 2005, at 28 (Dec. 2005) (arguing that the basic integrity of the market, and investment of million of Americans who think they have nothing to do with hedge funds will be in danger, as long as the need to take unreasonable risks, and show large returns continues to be expected from the investing public).

230. BLACK'S LAW DICTIONARY 1221 (9th ed. 2009) (defining parens patriae as "a doctrine by which a government has standing to prosecute a lawsuit on behalf of a citizen, especially on behalf of someone who is under a legal disability to prosecute the suit").

231. Riva D. Atlas, *Hedge Fund Rumors Rattle Markets,* N.Y. TIMES, May 12, 2005, at C2 (stating that the secrecy of hedge funds makes a number of investors nervous).

232. *See generally* David A. Katz & Laura A. McIntosh, *Corporate Governance: Advice on Coping with Hedge Fund Activism*, N.Y. L.J., May 25, 2006, at 5 (stating that when one hedge fund takes a position in a company, other hedge funds will buy stock shortly thereafter. When hedge funds act in concert, their behavior is referred to as a "wolf pack" approach.); *see also* Andrew Kulpa & Butzel Long, *The Wolf in Shareholder's Clothing: Hedge Fund Use of Cooperative Game Theory and Voting Structures to Exploit Corporate Control and Governance*, 6 U.C. DAVIS BUS. L.J. 78, 97-100 (2005) (arguing that cooperative behavior among hedge funds allows hedge funds to attack companies in packs; several hedge funds may combine their voting power to exert governance over a firm or corporation).

profits or losses.[233] The proprietary trading strategies that they utilize, each with its own risk level and potential return signature, are not revealed to the investors, competitors or regulators.[234] The secrecy of hedge funds' operations prompted Federal Reserve Board Chairman Ben Bernanke to describe hedge funds as opaque—in that hedge funds do not have to disclose their trading strategies to anyone and rely heavily on secrecy, speed, and leverage to be profitable.[235]

C. Questionable Investment Strategies Impact Markets

Federal regulators are concerned about the investment funds that invest in hedge funds—typically called *funds of funds*.[236] Funds of funds usually invest in from fifteen to twenty-five hedge funds at a time.[237] Funds of funds are defined by their registration status.[238]

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233. *See* Joseph Nocera, *Offering Up an Even Dozen Odds and Ends*, N.Y. TIMES, Dec. 24, 2005, at C1 (stating that it is scary that nobody knows what hedge funds are doing or how much they are leveraged; it conjures up visions of Long-Term Capital Management, which put a huge scare into the financial system when it blew up in the late 1990s).

234. The author had a rare opportunity as a New York State Assistant Attorney General to interview and depose several hedge funds regarding the legitimacy of certain research and trading activities. The information gleaned from those interviews and depositions have been invaluable to my understanding of the inner workings of the hedge fund world and the trading strategies in which hedge funds engage.

235. Benjamin Bernanke, Chairman, Fed. Reserve Bd., Remarks at the Fed. Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006) (transcript *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm.

236. Investorwords.com, Funds of Funds, http://www.investorwords.com/2129/fund_of_funds.html (last visited Oct. 12, 2009) (describing a funds of funds as a fund that invests in other funds).

> Just as a mutual fund invests in a number of different securities, a fund of funds holds shares of many different mutual funds. These funds were designed to achieve even greater diversification than traditional mutual funds. On the downside, expense fees on fund of funds are typically higher than those on regular funds because they include part of the expense fees charged by the underlying funds. In addition, since a fund of funds buys many different funds which themselves invest in many different stocks, it is possible for the fund of funds to own the same stock through several different funds and it can be difficult to keep track of the overall holdings.

Id.

237. *See* SEC STAFF REPORT, *supra* note 83, at 67.

238. *See generally* William Fung & David A. Hsieh, *A Primer on Hedge Funds*, 6 J. EMPIRICAL FIN. 303 (1999) (discussing how hedge funds are organized).

Commonly three types of fund of funds exist:(1) dual-registered funds, which are registered as the Securities Act; (2) '40 Act registered, which are registered under the Investment Company Act and make private placement offerings,[239] and (3) institutional funds, which are only offered to institutional investors.[240] Federal regulators have a growing concern about funds of funds availability to small investors via mutual funds.[241] Funds of funds usually charge a performance fee. As such, all funds of funds investors must be qualified investors under the Securities Act, Rule 205-3.[242]

The SEC has expressed concern regarding the lack of disclosure that funds of funds provide potential investors, and the limited disclosure provided to existing investors.[243] The SEC is particularly concerned about the double and sometimes triple layer of fees that investors are required to pay.[244] Typically, registered funds of funds pay a series of layered fees: (1) a management fee to the investment adviser of 1-2 percent of total assets under management, (2) a performance fee up to 20% of capital appreciation, and (3) the underlying hedge fund also pays similar investment fees.[245] Funds of funds do not disclose to their investors the actual or even the estimated fees incurred.[246] In addition to not disclosing their layered fees, funds of funds do not disclose their investment positions.[247] Registered funds of funds must disclose their financial statements and positions to investors in semi-

239. 17 C.F.R. § 230.144A (2009).

240. Hedge Fund Rule, *supra* note 178, at 72,057.

241. *Id.* (stating that over 50 funds of funds mutual funds intend to offer shares to the public, in part, because there are no minimum initial investment requirements for investors of funds of funds with registered investment advisers).

242. Rule 205-3 provides, in relevant part, that each investor must have a net worth of at least $1.5 million or have at least $750,000 of assets under management with the adviser. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054, 72,064 (Dec. 10, 2004).

243. Lisa Whitehouse, *Corporate Social Responsibility: Views from the Frontline*, 63 J. BUS. ETHICS 279 (2006).

244. *See* SEC STAFF REPORT, *supra* note 81, at 100.

245. *See id.* at ix.

246. 17 C.F.R. § 274.11a-1 (2009).

247. *See* Fund of Funds Investments, Securities Act Release No. 8297, Investment Company Act Release No. 26,198, 68 Fed. Reg. 58,226 (proposed June 24, 2004) (proposing an amendment to Form N-22).

annual reports.[248] However, funds of funds only disclose the underlying hedge funds in which they have invested, they do not reveal the actual portfolio holdings in which the underlying hedge funds have invested.[249] Additionally, registered funds of funds must disclose their overall investment strategy and valuation information of a fund of funds' positions in an underlying hedge fund's portfolio holdings.[250]

Despite the amazing growth in the hedge fund industry, investors have begun to witness a certain level of the hedge fund implosion that may be similar to Long-Term Capital Management's failure, which required a bailout by the Federal Reserve Bank of New York and several major New York banks.[251] This is evidenced by the failure of Amaranth Advisors,[252] Bailey Coates Cromwell Fund,[253] and Sowood Capital Management, a hedge fund started by former Harvard University money managers that lost $350 million in July 2007, and was forced to sell its portfolio and return $1.5 billion to investors.[254]

Hedge funds engage in primarily three types of investment strategies: (1) directional investing,[255] (2) corporate event-driven investing,[256] and (3) arbitrage.[257] Basically, directional investing seeks to profit from price gains or declines in specific markets by simply purchasing a security when investors believe that it is going up, and selling a security when investors believe that the security is going down.[258] These are not complicated strategies but they are profitable.

248. 17 C.F.R. § 270.30e-1 (2009).

249. Fung & Hsieh, *supra* note 238, at 299-300.

250. *See* SEC STAFF REPORT, *supra* note 81, at 92, 99.

251. *See Moody's Sees Potential for Big Hedge Fund Failure*, REUTERS, Aug. 16, 2007.

252. *See* Ann Davis et al., *What Went Wrong at Amaranth—Mistakes at the Hedge Fund Include Key Trader's Confusing Paper Gains with Cash Profits*, WALL ST. J., Sept. 20, 2006, at C1.

253. Jim McWhinney, *Massive Hedge Fund Failures*, INVESTOPEDIA.COM, Nov. 17, 2005, http://www.investopedia.com/articles/mutualfund/05/HedgeFundFailure.asp?&viewed=1=1&viewed=1.

254. Christopher Rowland, *How a Hedge Fund Star Lost It All*, N.Y. TIMES, Aug. 16, 2007, http://www.nytimes.com/2007/08/16/business/worldbusiness/16iht-hedge.4.7145437.html?_r=1.

255. *See* SEC STAFF REPORT, *supra* note 81, at 58; *see also* Fung & Hsieh, *supra* note 238.

256. Fung & Hsieh, *supra* note 238.

257. *See* Shadab, *supra* note 74, at 38.

258. Investopedia.com, Directional Trading, http://www.investopedia.com/terms/d/

Corporate event-driven investing seeks to profit from events like mergers or bankruptcies. Arbitrage seeks to profit from inefficient price discrepancies in the various markets such as the Asian markets in comparison to the European market or the American market.[259] In addition, to these three main investing strategies, thirty percent of hedge funds employ an equity long-short strategy, which is a mechanism by which standard stocks are hedged against the volatility of the equity position losing value by short-selling.[260] The strategy is basically to sell short the same security by betting that the value of the same asset class will decrease over a relatively short period of time.

1. Short Selling

Short-selling or shorting has a contentious global history. Napoleon Bonaparte declared short-selling tantamount to treason because it interfered with his ability to finance his military efforts.[261] During World War I, the New York Stock Exchange ("NYSE")[262]

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directionaltrading.asp (last visited Oct. 12, 2009) (defining directional trading as a "strategy used by investors [that utilizes] open positions, either long or short, on the belief that they are able to correctly predict the movement of price in a security").

259. *See* Shadab, *supra* note 74, at 38.

260. SEC, Short Sale, http://www.sec.gov/answers/shortsale.htm (last visited Oct. 12, 2009) (defining a short sale as the sale of a security that the seller does not own or that the seller owns but does not deliver). In order to deliver the security to the purchaser, the short seller will borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by returning the security to the lender, typically by purchasing equivalent securities on the open market. In general, short selling is utilized to profit from an expected downward price movement, or to hedge the risk of a long position in the same security or in a related security. *See id.*; ROBERT A. JAEGER, ALL ABOUT HEDGE FUNDS 4-5 (McGraw-Hill 2000).

261. TOM TAULLI, WHAT IS SHORT SELLING? 2 (2004).

262. The New York Stock Exchange (NYSE) traces its origins to 1792, when 24 New York City stockbrokers and merchants signed the Buttonwood Agreement. This agreement set in motion the NYSE's unwavering commitment to investors and issuers. Originally called the "curb market" because its brokers traded outdoors in the street, the Amex has been at the forefront of the U.S. financial markets over the course of two centuries. The historic combination of NYSE Group and Euronext in 2007 marked a milestone for global financial markets. It brought together major marketplaces across Europe and the United States whose histories stretch back more than four centuries. The combination was by far the largest of its kind and the first to create a truly global marketplace group. Today NYSE Euronext welcomes the historic American Stock

implemented short-selling regulations for the first time in American history because of the fear that the German Kaiser[263] would short the American markets triggering a financial disruption of the American securities and financial markets.[264] Short selling has had a catastrophic impact on the securities and financial markets, and has led historically to economic turmoil, such as the Great Depression[265] and the current financial recession. In 1917, the NYSE was authorized to regulate short-selling.[266]

Currently, short-selling is still perceived as a behavioral economics matter that may need government regulation in order to be controlled. Certain countries have gone even further and implemented corporal punishment to deter short-selling. For example, in 1995, the Malaysian Finance Ministry proposed that short-selling be punished by caning.[267]

Exchange into the world's largest and most liquid exchange group. NYSE Euronext, History, http://www.nyse.com/about/history/1089312755484.html.

263. FRANK J. FABOZZI, SHORT SELLING: STRATEGIES, RISKS, AND REWARDS 183 (2004).

264. It is interesting that many political and corporate commentators believe that the October 2008 American financial collapse was in part largely due to hedge funds shorting the financial service companies.

265. Beginning in 1929 and lasting until about 1939, the Great Depression was an economic slump that affected North America, Europe, and other industrialized areas of the world. *See* Modern American Poetry, About the Great Depression, http://www.english.illinois.edu/maps/depression/about.htm.

> The Great Depression was the longest and most severe depression ever experienced by the industrialized Western world. Though the U.S. economy had gone into depression six months earlier, the Great Depression may be said to have begun with a catastrophic collapse of stock-market prices on the New York Stock Exchange in October 1929. During the next three years stock prices in the United States continued to fall, until by late 1932 they had dropped to only about 20 percent of their value in 1929. Besides ruining many thousands of individual investors, this precipitous decline in the value of assets greatly strained banks and other financial institutions, particularly those holding stocks in their portfolios. Many banks were consequently forced into insolvency; by 1933, 11,000 of the United States' 25,000 banks had failed. The failure of so many banks, combined with a general and nationwide loss of confidence in the economy, led to much-reduced levels of spending and demand and hence of production, thus aggravating the downward spiral. The result was drastically falling output and drastically rising unemployment; by 1932, U.S. manufacturing output had fallen to 54 percent of its 1929 level, and unemployment had risen to between 12 and 15 million workers, or 25-30 percent of the work force.

Id.

266. 15 U.S.C. § 80a-12(a) (2006).

267. TAULLI, *supra* note 261, at 6.

As late as 2001, approximately ten countries prohibited short-selling.[268] In fall 2008, due to the financial collapse in the markets, the SEC issued a temporary ban on short sales of 799 financial stocks to stop traders who sought to profit from the financial crisis by betting against bank shares. The temporary emergency action was designed to protect the integrity and quality of the securities market and strengthen investor confidence.[269]

The question then becomes why is short-selling viewed as such a despised trading tactic? The answer, in part, is human nature—that is, it is natural to dislike people that benefit at the misfortune of others, which is precisely what short-sellers do—they make money when assets decline in value or when companies do not perform well.[270] There is something almost un-American with regard to short-selling. It seems almost un-American to bet on the decrease of an asset or company's value. Shorting is a phenomenon that has taken the securities industry by storm. Hedge funds have made fortunes by utilizing this mechanism.[271] Certain commentators have observed that hedge funds that use the short-selling trading technique frequently manipulate the market to obtain their desired decrease in a targeted company's stock price by publishing false negative research reports and simultaneously encouraging reputable business reporters to publish investigative reports exposing a targeted company's impending financial ruin.[272] What is often not revealed is that investigative business news articles written by the reputable business reporters are to a large extent, based on data supplied to the reporters by hedge funds, primarily the negative research report.[273]

There is evidence to support an issue that has been raised fairly often regarding hedge funds' attempts to manipulate the market. Some

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268. Arturo Bris et al., *Efficiency and the Bear: Short Sales and Markets Around the World* 31-32 (Yale ICF Working Paper No. 02-45, 2003), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-efficiency.pdf.

269. Vikas Bajaj & Graham Bowley, *S.E.C. Temporarily Blocks Short Sales of Financial Stocks*, N.Y. TIMES, Sept. 20, 2008, at B1.

270. *See* FABOZZI, *supra* note 263, at 184; TAULLI, *supra* note 261, at 9.

271. The question should not be whether hedge funds should use this trading technique. The question should be "how" do hedge funds manage to consistently employ shorting techniques that statistically beat the average. How do they do it? How do they know that the market will take a downturn with respect to one stock versus another?

272. TAULLI, *supra* note 261, at 5.

273. *Id.*

commentators argue that hedge funds, in particular, those that primarily engage in short selling, frequently engage in market manipulation.[274] Nonetheless some commentators argue that short-selling is beneficial to the market because it eliminates market over-pricing.[275] They further argue that federal regulation should not be amended to subject hedge funds to the same rules against shorting to which mutual funds must comply.[276] Traditionally, mutual funds are prohibited from utilizing derivatives to avoid margin requirements established by the Federal Reserve Board's Regulation T, which requires a margin of 50% on short sales and long positions in a stock.[277] Hedge funds do not have such short selling constraints imposed upon their trading activity. As such, they are able use short-selling combinations to make very sophisticated long/short trade combinations based upon a hedge funds' prediction of price movements in the markets.[278]

2. Massive Derivatives Losses and Liquidity Problems

In addition to the risks associated with derivatives trading, the hedge fund industry has additional risks that are particular only to hedge funds which include: (1) systemic risk, (2) contagion, (3) fund failure, and (4) extreme leverage. Many commentators trading believe that derivatives are extremely risky investments,[279] especially given the

274. *See* Sherry M. Shore, *SEC Hedge Fund Regulatory Implications on Asian Emerging Markets: Bottom Line or Bust*, 13 CARDOZO J. INT'L & COMP. L. 563, 577 (2005).

275. Edward M. Miller, *Risk, Uncertainty, and Divergence of Opinion*, 32 J. FIN. 1151, 1154 (1977).

276. Charles M. Jones & Owen A. Lamont, *Short Sale Constraints and Stock Returns*, 66 J. FIN. ECON. 207, 221 (2002); *see also The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risks: Hearing Before the Subcomm. on Capital Markets*, 108th Cong. (2003) (testimony of Owen A. Lamont, Associate Professor of Finance, Graduate School of Business, University of Chicago) (stating that 270 companies that attacked short sellers had returns that lagged the market by 42% over the following three years).

277. 12 C.F.R. § 220.18 (2009).

278. *See* WILLIAM J. CREREND, FUNDAMENTALS OF HEDGE FUND INVESTING 1 (1998).

279. Lydie Nadia Cabrera Pierre-Louis, *Controlling a Financial Jurassic Park: Obtaining Jurisdiction over Derivatives by Regulating Illegal Foreign Currency Boiler Rooms*, 8 U.C. DAVIS BUS. L.J. 35 (2007); Miguel A. Segoviano & Manmohan Singh, *Counterparty Risk in the Over-the-Counter Derivatives Market* (Int'l Monetary Fund,

highly publicized massive derivative losses arising from situations such as Orange County, California's bankruptcy[280] and Long-Term Capital Management's federal bailout.[281] Warren Buffet once referred to derivatives as "financial weapons of mass destruction."[282] Ironically, properly employed derivatives do not present any greater risk than any other financial instruments.[283] It really depends on the controls that management implements to control the risk inherently associated with derivatives. However, management of derivatives is more complex, and mis-management has resulted in significant financial losses, which has

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Working Paper No. 08/258, 2008), *available at* http://imf.org/external/pubs/ft/wp/2008/wp08258.pdf; FDIC, Derivatives Risk in Commercial Banking, Mar. 26, 2003, http://www.fdic.gov/bank/analytical/fyi/2003/032603fyi.html.

280. *See* Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 BROOKLYN L. REV. 1295, 1348 (1995) (stating that Orange County's bankruptcy, which led to major reduction in public services for California residents, was part of a larger trend of losses experienced by the public sector from derivative investment); Henry T.C. Hu, *Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class*, 84 GEO. L.J. 2319, 2326 (1996) (describing the Orange County loss as one which "dominate[d] the financial headlines").

281. *See* Symposium, *Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron*, 35 CONN. L. REV. 1097, 1107 (2003) [hereinafter *Crisis in Confidence*] (stating that a Federal Reserve bailout of $7 billion dollars for the Long Term Capital Investment crisis of 1998 was motivated by a fear of a "crisis in confidence" of the American economy); Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 709 (1999) (opining that the "trading disaster" suffered by Long Term Capital Management illustrates the risk of derivatives for individual investors, and the economy as a whole).

282. BERKSHIRE HATHAWAY, 2002 SUMMARY ANNUAL REPORT 13-15 (2003), *available at* http://berkshirehathaway.com/2002ar/2002ar.pdf.

283. *See* Kimberly D. Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 IOWA. J. CORP. L. 1, 15 (noting that speculators in these transactions embrace risk in order to profit from the fluctuations in the price of the derivatives contract and provide liquidity to a market in which traders are in direct competition); Joan E. McKown & Anita T. Purcell, *Ninth Annual Corporate Law Symposium: Securities Regulation: Article: Enforcement Actions Involving Derivatives:* BT Securities Corp. *and Beyond*, 65 U. CIN. L. REV. 117, 119 (1996) (asserting that though risky, "derivatives are not bad themselves. When used properly, derivatives are valuable tools for managing financial risk. However, the occasionally spectacular losses that are associated with derivatives and are reported by the media apparently cause some managers to ask why their firms use derivatives and lead some people to 'demonize' derivatives.").

further resulted in the need for greater federal regulatory control. There are primarily four types of risks associated with derivatives: (1) market risk; (2) credit risk; (3) operational risk and (4) legal risk.[284]

Some commentators believe that hedge funds benefit the economy by: (1) mitigating price downturns, (2) bearing risks that counter-parties do not wish to bear, (3) making securities more liquid, (4) scouring out/manipulating inefficiencies in the market. These "benefits" are possible because hedge funds are not regulated,[285] and can utilize derivatives and leverage to impunity without disclosing their strategies to the general public or regulators.

Institutional investors such as banks maintain written policies and procedures that identify the risk tolerance of the board of directors, which establishes the risk tolerance of the institutional entity engaging in the derivatives transactions. The policies also delineate the lines of authority and responsibility for managing the derivatives activities.[286] In contrast, hedge funds do not maintain any such policies and procedures. Furthermore, the small investors that invest in hedge funds via pensions funds are unaware and do not understand the derivatives transactions in which hedge funds engage.[287] Nor are small investors fully aware of all policies and procedures that relate to their trading liability that can result in massive and unexpected losses.[288]

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284. *See* Joanne Medero, *Managing Risk Derivatives—Recent Developments Affecting Dealers and End-Users*, *in* 1 27TH ANNUAL INSTITUTE ON SECURITIES REGULATION 412 (PLI Corp. L. Course Handbook Series No. B-907, 1995); *see generally* Edward S. Adams & David E. Runkle, *The Easy Case for Derivatives Use: Advocating a Corporate Fiduciary Duty to Use Derivatives,* 41 WM. & MARY L. REV. 595, 615-19 (summarizing the risks associated with derivatives).

285. Rene M. Stulz, *Hedge Funds: Past, Present, and Future* (Fischer Coll. of Bus., Working Paper No. 2007-03-003, 2007).

286. *See* David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1374 (2001) (noting that because derivative dealers cannot always take only well compensated risks, major investment banks usually have in place very strict risk management policies for derivative transactions); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 349-50 (2002) (noting that the similarities in risk management policies leads to parallel investment strategies by institutional investors, causing a potential dearth of liquidity if an adverse shock struck the OTC derivatives market).

287. April Klein & Emanuel Zur, *Hedge Fund Activism* (NYU Working Paper No. CLB-06-017, 2006).

288. Basle Committee on Banking Supervision, Bank for International Settlements,

3. Systemic Risk

The second type of trading risk particular to the hedge fund industry that can lead to widespread failure, which may create the need for federal governmental financial bailout, is systemic risk. Federal regulators are concerned about the systemic risk that hedge funds pose—that is, the risk to economic participants beyond hedge fund investors.[289] Systemic risk is the risk that hedge fund losses can, and history has shown will, spread to third parties, such as banks and broker-dealers, the broader market, and the general public. Systemic risk is in essence a market failure because the third-parties are unaware of their exposure to hedge fund losses, and are unable to react to such losses, let alone absorb such losses because the same trading activities that create fabulous returns for hedge funds (short selling, derivatives trading, and arbitrage) all create increased systemic risk for the broader financial markets.[290]

Perhaps the most infamous example of systemic risk is the collapse of Long-Term Capital Management.[291] The implosion of Long-Term Capital, its subsequent federal bailout, and continuing bankruptcy is a lesson that regulators should do well to remember, particularly as regulators discuss to what extent hedge funds should be regulated and which transactions should remain unregulated. Hedge fund unregulated status and access to federal bailout funds to cover their losses is an

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Risk Management Guidelines for Derivatives, July 27, 1994, *reprinted in* Fed. Sec. L. Rep. (CCH) ¶ 85,410, at 85,557 (Aug. 10, 1994); FUTURES INDUSTRY ASSOCIATION GLOBAL TASK FORCE ON FINANCIAL INTEGRITY, FINANCIAL INTEGRITY RECOMMENDATIONS: FOR FUTURES AND OPTIONS MARKETS AND MARKET PARTICIPANTS (1995).

289. Markus K. Brunnermeier & Stefan Nagel, *Hedge Funds and the Technology Bubble*, 59 J. FIN. 2013, 2032 (2004).

290. Ben Bernanke, Chairman, Fed. Reserve Bank, Address at the Council on Foreign Relations: Financial Reform to Address Systemic Risk (Mar. 10, 2009) (transcript available at http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm).

291. *Crisis in Confidence*, *supra* note 281 (stating that a Federal Reserve bailout of $7 billion dollars for the Long Term Capital Investment crisis of 1998 was motivated by a fear of a "crisis in confidence" of the American economy); Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 791, 709 (1999) (opining that the "trading disaster" suffered by Long Term Capital Management illustrates the risk of derivatives for individual investors, and the economy as a whole).

anomaly in American financial and securities markets.[292] In 1998, Long-Term Capital predicted that the spreads between the returns on bonds of developing and industrialized countries would narrow. The prediction was wrong. Long-Term Capital lost $4.4 billion in a matter of weeks. The New York Federal Reserve provided a $7 billion federal bailout, because it feared that a default by Long-Term Capital on its existing derivative trading contracts would cause a domino default effect throughout the U.S. and international securities markets. More than ten years later, aspects of Long-Term Capital's bankruptcy are still in litigation.[293]

In response to the Long-Term Capital debacle, several major commercial and investment banks formed a policy group which issued two reports detailing the improvements that the financial sector should make to improve risk management.[294] After the collapse of Long-Term Capital Management, federal regulators conducted a review of the hedge fund industry and concluded that if the hedge fund industry was unable to absorb its trading losses, the federal government had adequate resources to contain the financial risks that hedge fund trading strategies would have on the markets.[295] The impact on the financial and securities markets as result of hedge funds' inability to cover their trading losses resulted in abrupt cessation of trading,[296] completely

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292. *See* Riva D. Atlas, *Hedge Fund Rumors Rattle Markets*, N.Y. TIMES, May 15, 2005, at C2 (stating that the secrecy of hedge funds as well as the collapse of Long Term Capital Management have made a number of investors uneasy); Eric Altbach, *The Asian Crisis and the IMF: After the Deluge, The Debate*, 17 JAPAN ECON. INST. REP., May 1, 1998, http://www.jei.org/Reports/JEIR/98JEIRsummaries/s9817.html (stating that bailouts by the institutions such as the International Monetary Fund encourages hedge fund irresponsibility and propagate financial crisis because lenders act fully knowing that the IMF will absorb their losses).

293. Joseph G. Haubrich, *Some Lessons on the Rescue of Long-Term Capital Management* (Federal Reserve Bank of Cleveland, Policy Discussion Paper No. 19, 2007).

294. *See* PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999), *available at* http://www.treas.gov/press/releases/reports/hedgfund.pdf [hereinafter PRESIDENT'S WORKING GROUP] (examining the market crisis that the failure of Long Term Capital Management precipitated).

295. *Id.*

296. *See* Vikas Agarwal et al., *Role of Managerial Incentives and Discretion in Hedge Fund Performance* (London Business School, Working Paper No. 04-04, 2005); Stuart Feffer & Christopher Kundro, *Understanding and Mitigating Operational Risk in*

disrupting the broader markets, and resulted in catastrophic losses. For example, 1998 Long-Term Capital Management's failure required a consortium of investment banks to bail-out Long-Term Capital Management to protect the integrity of the markets.[297] In September 2006, Amaranth Advisors suffered the largest collapse in hedge fund industry, losing an estimated $6.6 billion in natural gas trades in a few weeks.[298] Amaranth lost one-third more money in a few weeks than Long-Term Capital lost over several months.[299]

4. Contagion

The third type of trading risk particular to the hedge fund industry that can lead to widespread failure, which may create the need for federal governmental financial bailout, is contagion.[300] We move, therefore, beyond the Long-Term Capital model of a single fund imploding, to the systemic failure of several funds collapsing at the same time, and the resulting domino default effect that will undoubtedly send shockwaves throughout the world's economy.[301] The likelihood of contagion occurring is not as far fetched as we think. For example, it may begin as simple as one hedge fund experiencing liquidity risk, and therefore selling its investments at a major loss because of its need for cash. The hedge fund's losses spread to the lender that loaned the hedge fund money to make the investments that it surreptitiously dumped, (the lender is now unable to recover the money lent to the defaulting hedge

Hedge Fund Investments (Capco White Paper, 2003).

297. *See* LOWENSTEIN, *supra* note 81 (relating story of growth and collapse of long term capital markets). *See also Crisis in Confidence*, *supra* note 281, at 1107 (stating that a Federal Reserve bailout of $7 billion dollars for the Long Term Capital Investment crisis of 1998 was motivated by a fear of a "crisis in confidence" of the financial economy).

298. Steven Mufson, *Hedge Fund's Collapse Met with a Shrug: Amaranth's Loss in Natural Gas Gamble Not Seen as Affecting Broader Market,* WASH. POST, Sept. 20 2006, at D01; Ludwig B. Chincarini, *Natural Gas Futures and Spread Position Risk: Lessons from the Collapse of Amaranth Advisors L.L.C.* (Working Paper Series, 2008); *see* SCOTT FRUSH, HEDGE FUNDS DEMYSTIFIED (2008).

299. *See* Shadab, *supra* note 74, at 36.

300. *See generally* Nicole Boyson et al., *supra* note 93 (finding "find strong evidence of contagion across hedge fund styles, so that hedge fund styles tend to have poor coincident returns").

301. *See* ROBERT F. BRUNER & SEAN D. CARR, THE PANIC OF 1907: LESSONS LEARNED FROM THE MARKET'S PERFECT STORM (2009).

fund), and to the counter-parties on the other side of the trading contract (who may not be able to absorb the unexpected losses of the defaulting hedge fund).[302]

Continuing with our hypothetical, let's take the hypothetical a little further. Imagine if you will that numerous hedge funds made the same investment—a common hedge fund strategy known as herding.[303] Let's further presume that the hedge funds' investment went bad (a likely occurrence), and they are all forced to sell their positions at a major loss (the ever present liquidity risk). As in our previous example, the hedge funds' losses are spread to the lenders that loaned the hedge funds money to make the investments that they surreptitiously dumped, (the lenders are now unable to recover the monies lent to the defaulting hedge funds), and to the counter-parties on the other side of the trading contracts (who may not be able to absorb the unexpected losses of the defaulting hedge funds). This multiplier effect would have a devastating effect on the U.S. and world economies.

5. Excessively or Highly-Leveraged Transactions

The fourth type of risk particular to the hedge fund industry is their continuous engagement in excessively or highly leveraged transactions. Leverage can be simply defined as the ability to lose or make more than the initial invested amount because of the ability to borrow against the invested amount or use derivatives to make additional investments.[304]

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302. At the time that the author developed this hypothetical in March 2007, it was 18 months prior to Lehman Brother's collapse and the current financial crisis.

303. *See Hearing Before the S. Comm. on Energy & Natural Resources*, 110th Cong. 15 (2008) (written testimony of Jeffrey Harris, Chief Economist, Commodity Futures Trading Commission) (defining herding as the propensity of various market participants to be trading on the same side of the market concurrently). Although many rules govern the behavior of individual traders, the CFTC recognizes that concurrent trading by groups of traders—"herds"—can detrimentally affect markets. Herding behavior can represent an impediment to the efficient functioning of markets if market participants follow the herd blindly, causing prices to over-adjust to new information. Herding typically occurs only when prices were falling and price increases were unrelated to herding activity. *See id.*

304. *See* InvestorWords.com, Leverage, http://www.investorwords.com/2786/leverage.html (last visited Oct. 12, 2009). Leverage is defined as:

> The degree to which an investor or business is utilizing borrowed money. Companies that are highly leveraged may be at risk of bankruptcy if they are unable to make

Excessive leverage or highly leveraged can be defined as significant borrowing or utilization of derivatives to finance investments, which magnify losses to such a multiple that the borrower is unable to pay the losses and is likely to file for bankruptcy.[305]

There are no limits to a hedge fund's ability to use leverage,[306] except for those limits imposed by a hedge fund's lender and counterparty.[307] Banks, in particular, are subject to risk-capital regulations that provide the minimum capital requirements based upon the risk prototype of the underlying asset, which includes loans to and trades with hedge funds.[308] The majority of hedge funds borrow heavily[309] because the borrowed funds provide the much needed capital to execute the complex and extremely risky trades. The investment strategies in which hedge funds engage require a great deal of capital. For example, hedge funds that engage in arbitrage trades need much more capital than those that engage in shareholder activism. Most hedge funds are leveraged 2 to 1

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payments on their debt; they may also be unable to find new lenders in the future. Leverage is not always bad, however; it can increase the shareholders' return on their investment and often there are tax advantages associated with borrowing.

Id.

305. *See* InvestorWords.com, Highly Leveraged Transaction, http://www.investorwords.com/7151/highly_leveraged_transaction.html (last visited Oct. 12, 2009) (defining a highly leveraged transaction as a loan made to a financial institution that already has a large amount of debt). "The large amount of pre-existing debt means that the company is already leveraged, so additional debt can increase the risk of bankruptcy if the company is unable to make interest payments." *Id. See* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681 (2000) (discussing how hedge funds' excessive use of leverage can result in huge profits or huge losses, which will spill over into the financial market and the securities market as well); Shawn Tully, *End of Wall Street as We Know It: Financial Firms Have Relied on a Highly Flawed Business Model for Years*, FORTUNE, Mar. 17, 2008, http://money.cnn.com/2008/03/17/magazines/fortune/investing/Tully_WallStIsBroken.fortune/index.htm.

306. *See* PRESIDENT'SWORKING GROUP, *supra* note 294.

307. *See id.* at 5. Hedge funds carte blanche towards leverage is restrained only by the willingness and ability of lenders and counterparties extend credit and funds to hedge funds. Broker-dealers that lend to hedge funds must comply with the margin requirements of Federal Reserve System, Regulation T. 12 C.F.R. §§ 220.1 to 220.12 (2009). Additionally, FINRRA imposes additional maintenance margins. FINRA Rule 2520(c)-(d); NYSE Rule 431(c)-(d). Furthermore banks that lend to hedge funds must comply with treasury risk-capital regulations. 12 C.F.R. § 32.3(a) (2009). *See id.*

308. *See* FDIC, Basel I and the Evolution of Capital Regulation: Moving Forward, Looking Back, Jan. 14, 2003, http://www.fdic.gov/bank/analytical/fyi/2003/011403fyi.

309. *See* PRESIDENT'S WORKING GROUP, *supra* note 294, at 5.

to their investment capital, and some are leveraged as much as 30 to 1 to their investment capital.[310]

As discussed earlier, hedge fund losses are spread to the lender that loaned the hedge fund money to make the investments (the lender is now unable to recover the money lent to the defaulting hedge fund), and to the counter-parties on the other side of the trading contract (who may not be able to absorb the unexpected losses of the defaulting hedge fund). Now let's take it one step further. Imagine that numerous hedge funds are over-leveraged—a common hedge fund occurrence. As in our previous example, these significant hedge fund losses are spread to the lenders, and to the counter-parties who may not be able to absorb the unexpected losses of the defaulting hedge funds. Again, this multiplier effect would have a devastating effect on the U.S. and world economies.[311] Regulators and hedge fund industry groups recognize that hedge fund risk management has significant challenges, primarily with operational risk as a result of derivatives trading.[312] Hedge funds borrow heavily, and when their trading strategies fail, the huge losses are passed on to investors, lenders and trading counter-parties.[313] Secretary of the Treasury Timothy Geithner, when he was President and CEO of the New York Federal Reserve, shared certain observations on hedge fund leverage and associated risk to the financial markets indicates several developments since the collapse of Long-Term Capital Management ten years ago: (1) the sheer number of hedge funds has increased drastically, (2) lender and counter-party exposure is more diversified, (3) lenders and counter-parties have dramatically increased their risk management, and (4) banks' capital relative to risk has remained constant.[314] From the comments it sounds as the markets have

310. *See id.*

311. Robert C. Pozen, *Hedge Funds Today: To Regulate or Not?,* WALL ST. J., June 20, 2005, at A14 (noting that collapse of highly leveraged funds will threaten the integrity of financial industry).

312. *See* Karmel, *supra* note 78, at 70 (arguing that in the absence of a new crisis involving derivatives, excessive leverage in the market or manipulative activities by institutional investors, it is unlikely that Congress, the SEC or any other financial regulator will decide to study and reform institutional investors' behavior).

313. *See id.*

314. Timothy F. Geithner, President & CEO, Fed. Reserve Bank of N.Y., Keynote Address: Hedge Funds and Their Implications for the Financial System (Nov. 17, 2004) (transcript available at http://www.ny.frb.org/newsevents/speeches/2004/gei041117.html).

adapted and can easily absorb any unforeseen crisis. However, Mr. Geithner continued his comments by noting that further improvements in risk management by counter-parties and lenders are needed including better due diligence and demanding that hedge fund disclose the nature of their operations.

V. HEDGE FUNDS CREATE A ZONE OF MANIPULATIVE SCHEMES

All the capital employed in paper speculation is barren and useless . . . . It nourishes in our citizens habits of vice and idleness instead of industry and morality . . . .

—Thomas Jefferson[315]

A. Hedge Funds Engaging in Late Trading and Market Timing

In 2003, based primarily upon the information Noreen Harrington provided, the New York Attorney General, Eliot Spitzer reached a $40 million settlement with Canary Capital Partners, LLC and Canary Investment Management, LLC (collectively, "Canary Capital") and Mr. Edward J. Stern, Managing Principal for violations of New York's General Business Law and Executive Law involving arrangements to engage in market timing and late trading strategies.[316] Subsequently, the New York Attorney General and the Massachusetts Secretary of the Commonwealth each launched investigations into market timing and late trading of shares of registered investment companies ("mutual funds"). The SEC and the U.S. Justice Department[317] subsequently announced

315. THE JEFFERSONIAN ENCYCLOPEDIA 932 (John P. Foley ed., Funk & Wagnalls Co. 1900).

316. Canary Complaint, *supra* note 154.

317. The Judiciary Act of 1789, ch. 20, sec. 35, 1 Stat. 73, 92-93 (1789), created the Office of the Attorney General. Originally a one-person part-time position, the Attorney General was to be "learned in the law" with the duty "to prosecute and conduct all suits in the Supreme Court in which the United States shall be concerned, and to give his advice and opinion upon questions of law when required by the President of the United States, or when requested by the heads of any of the departments, touching any matters that may concern their departments." The workload quickly became too much for one person, necessitating the hiring of several assistants for the Attorney General. With an increasing amount of work to be done, private attorneys were retained to work on cases. In 1870, after the post-Civil War increase in the amount of litigation involving the

similar investigations conducted in conjunction with the investigations already underway in New York and Massachusetts.[318] The New York Attorney General's Office investigated "arrangements"[319] between mutual funds and certain hedge funds including Canary Capital that permitted the hedge funds to engage in market timing and/or late trading. The "arrangements" are not *per se* illegal activities. However, "arrangements" entered into by mutual funds with certain hedge fund investors that were allowed to market time the purchases of mutual fund shares and redemptions of mutual fund shares for maximum profit for the hedge funds.

These "arrangements" contradicted stated mutual fund policies and were not disclosed to all mutual fund investors. These "arrangements" irrevocably harmed existing mutual fund investors by siphoning profits from the other mutual fund investors. The "arrangements" were the bases of breach of fiduciary duty claims against the mutual funds' investment advisers and board of directors because of the funds' inconsistent application of fund policies regarding restrictions or prohibitions against market timing and/or late trading. The mutual funds' prospectuses stated that the funds' attempted to restrict or

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United States necessitated the very expensive retention of a large number of private attorneys to handle the workload, a concerned Congress passed the Act to Establish the Department of Justice, ch. 150, 16 Stat. 162 (1870), setting it up as "an executive department of the government of the United States" with the Attorney General as its head. Officially coming into existence on July 1, 1870, the Department of Justice, pursuant to the 1870 Act, was to handle the legal business of the United States. The Act gave the Department control over all criminal prosecutions and civil suits in which the United States had an interest. In addition, the Act gave the Attorney General and the Department control over federal law enforcement. To assist the Attorney General, the 1870 Act created the Office of the Solicitor General. The 1870 Act is the foundation upon which the Department of Justice still rests. However, the structure of the Department of Justice has changed over the years, with the addition of the Deputy Attorneys General and the formation of the Divisions. Unchanged is the steadily increasing workload of the Department. It has become the world's largest law office and the central agency for enforcement of federal laws.

318. *Recent Commission Activity to Combat Misconduct Relating to Mutual Funds: Hearing Before the S. Subcomm. on Fin. Mgmt., the Budget, & Int'l Sec., Comm. on Gov't Affairs*, 108th Cong. (2003) (written testimony of Stephen M. Cutler, Director, Division of Enforcement, SEC).

319. "Arrangements" were contracts between hedge funds and investment advisers to allow hedge funds to have the capacity—permission to time the purchase and redemption of particular mutual funds for the maximum profit to the hedge funds. *See* Canary Complaint, *supra* note 154, at 4, 13.

discourage market timing and late trading activities (including through the imposition of short-term trading penalties, delayed exchanges or involuntary redemptions). However, that was far from the truth.

The complaint provided, in relevant part, that Canary Capital engaged in late trading on a daily basis from March 2000 until the New York Attorney General's Office began its investigation in July of 2003. During the declining market of 2001 and 2002, Canary Capital used late trading to, in effect, sell mutual fund shares short. This caused the mutual funds to overpay for their shares as the market went down, serving to magnify long-term mutual fund investors' losses. The investigation targeted dozens of mutual funds but only one hedge fund. The complaint further alleged that Canary Capital obtained some of its late trading "capacity" directly from one mutual fund manager, Bank of American N.A. Bank of America installed special computer equipment in Canary's office that allowed it to buy and sell Bank of America's mutual fund companies, the Nations Funds, and hundreds of other mutual funds at the 4:00 P.M. price until as late as 6:30 P.M. EST. In return, Canary Capital agreed to leave millions of dollars in Bank of America bond funds on a long-term basis as "sticky assets."[320] Based, in part on these allegations, Bank of America entered into a settlement agreement with the New York State Office of the Attorney General for approximately $675 million. Additionally, the settlement included corrective measures designed to set a new standard for accountability by the directors of mutual fund companies.[321]

At the center of the Bank of America story is the Nations Funds' board of directors' failure to disclose the "arrangements" that it had entered into with Canary Capital to the detriment of thousands of Nations Funds' investors. Under a specific provision of the settlement agreement, eight members of the board of directors of Nations Funds, resigned or otherwise left the board in the course of one year for their role in approving a controversial, if not *per se* illegal measure that enabled a hedge fund to conduct company-sanctioned market timing and late trading of Bank of America and other mutual funds by Canary Capital.[322] The Nations Funds' board directors breach of its fiduciary

320. These parked funds are known in the hedge fund industry as "sticky assets." Canary Complaint, *supra* note 154, at 15.

321. Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 ECON. POLICY REV. 91 (2003).

322. Amy Borrus, *A Guide to the Hedge Fund Maze: Dizzying Growth and an*

duties by failing to protect the interest, and entering into "arrangement" that created a conflict of interest with the mutual fund investors. The directors allowed Canary Capital, a favored hedge fund client, to engage in late trading and market timing practices that personally harmed thousands of mutual fund investors. Bank of America never disclosed its "arrangement" with Canary Capital in its filings with the SEC. Failure to disclose such controversial, if not *per se* illegal activity which falls within the materiality requirement of the Securities Exchange Act and the rules promulgated thereunder evidences a need for further modification and clarification of the disclosure duties of publicly-traded companies.[323]

B. Hedge Funds Distributing Negative Research Reports to the Public

Publication of questionable "research reports" is but one trading strategy that hedge funds employ. Hedge funds use a variety of investment strategies that are perceived as complex because they involve numerous combinations of trades in order to increase the probability of the hedge fund making a profitable return. Many types of investment strategies exist, including shorting, merger arbitrage,[324] distressed

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Absence of Regulation Have Spawned a Series of Scandals, BUS. WEEK ONLINE, Oct. 19, 2005, http://www.buisnessweek.com/bwdailydnflash/oct2005/nf20051019_1613_db016htm (stating hedge funds opposed to increased regulation use their money to influence legislators).

323. *See* S.J. Grossman & O.D. Hart, *Disclosure Laws and Takeover Bids*, 35 J. FIN. 323, 323-34 (1980).

324. *See* Investopedia.com, Merger Arbitrage, http://www.investopedia.com/terms/m/mergerarbitrage.asp (last visited Oct. 12, 2009). Merger arbitrage is defined as follows.

> A hedge fund strategy in which the stocks of two merging companies are simultaneously bought and sold to create a riskless profit. A merger arbitrageur looks at the risk that the merger deal will not close on time, or at all. Because of this slight uncertainty, the target company's stock will typically sell at a discount to the price that the combined company will have when the merger is closed. A regular portfolio manager may focus only on the profitability of the merged entity. In contrast, merger arbitrageurs care only about the probability of the deal being approved and how long it will take the deal to close.

Id.; SEC STAFF REPORT, *supra* note 81, at 4. *See also* IMF, GLOBAL FINANCIAL STABILITY REPORT: MARKET DEVELOPMENTS AND ISSUES 45 (2004), *available at* http://www.imf.org/external/pubs/ft/gfsr/2004/02/index.htm [hereinafter IMF REPORT] (listing and defining various hedge fund strategies including shorting, merger arbitrage, distresses securities, convertible arbitrage, derivatives, fixed income, risk arbitrage,

securities,[325] convertible arbitrage,[326] and derivatives trading[327] to name a few. Perhaps of the almost exhaustive list of strategic trades that hedge funds use, the most infamous are derivatives trading. Regulators have been concerned about the derivative trading strategies that hedge funds

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emerging markets, equity hedge, global macro, and sector composite).

325. *See* Investopedia.com, Distressed Securities, http://www.investopedia.com/terms/d/distressedsecurities.asp (last visited Oct. 12, 2009). Distressed securities are defined as follows.

> A financial instrument in a company that is near or is currently going through bankruptcy. This usually results from a company's inability to meet its financial obligations. As a result, these financial instruments have suffered a substantial reduction in value. Distressed securities can include common and preferred shares, bank debt, trade claims (goods owed) and corporate bonds.

Id.; SEC STAFF REPORT, *supra* note 81, at 35; *see also* IMF REPORT, *supra* note 324, at 52 (defining various hedge fund strategies including shorting, merger arbitrage, distresses securities, convertible arbitrage, derivatives, fixed income, risk arbitrage, emerging markets, equity hedge, global macro, and sector composite).

326. *See* SEC STAFF REPORT, *supra* note 81, at 35; Investopedia.com, Convertible Arbitrage, http://www.investopedia.com/terms/c/convertiblearbitrage.asp (last visited Oct. 12, 2009) (defining convertible arbitrage as an "investing strategy that involves the long position on a convertible security and a short position in its converting common stock"); *see also* IMF REPORT, *supra* note 324, at 52 (defining various hedge fund strategies including shorting, merger arbitrage, distresses securities, convertible arbitrage, derivatives, fixed income, risk arbitrage, emerging markets, equity hedge, global macro, and sector composite).

327. The author was unable to find a definition of the "derivative trading" in any financial, economic, or legal literature. Perhaps it is this opaqueness in the derivatives industry that compelled Senator Tom Harkin (D-IA) to sponsor the Derivatives Trading Integrity Act of 2009. Senator Harkin stated that he "believes that Derivatives Trading Integrity Act will bring more transparency and accountability into the marketplace." Press Release, Senate Agriculture, Nutrition and Forestry Committee, Harkin Measure Would Require Openness, Transparency, and Integrity in Swaps and All Futures Trading (Nov. 20, 2008), *available at* http://216.40.253.202/~usscanf/index.php?option=com_content&task=view&id=1812&Itemid=2. Specifically, the bill amends the Commodity Exchange Act to eliminate the distinction between "excluded" and "exempt" commodities and regulated, exchange-traded commodities; futures contracts for all commodities would be treated the same. A summary of the bill by Government Track provides, in relevant part, that the bill amends the Commodity Exchange Act to: "(1) repeal the exemption or exclusion from regulation by the Commodity Futures Trading Commission (CFTC) of specified derivative transactions, swap transactions, and related electronic trading facilities; (2) restrict futures trading to contract markets or derivatives transaction execution facilities; and (3) abolish exempt boards of trade." *See* Govtrack.us, Overview of the Derivatives Trading Integrity Act of 2009, http://www.govtrack.us/congress/bill.xpd?bill=s111-272&tab=summary (last visited Oct. 12, 2009).

employ because of their potential impact on the financial and securities markets and, in particularly on small investors.[328] Nonetheless, a relatively new trading strategy that hedge funds employ commonly referred to as "funds of funds"[329] has added an additional layer of concern for regulators because certain funds of funds are marketed to the general public.[330]

For short selling to work best in terms of the aggregate return that a hedge fund receives by speculating against a targeted company performing well, at times a hedge fund may engage in a manipulative measures to "create" a scenario where the marketplace perceives a targeted company as not performing well. A most effective means that hedge funds use to create a negative perception of a targeted company is the widespread publication of negative research reports about a targeted company to the general public.[331] Such hedge funds may spread false negative rumors on blogs and various investor chat rooms as well as release "research reports" about the company that they have shorted in order to create a wide-spread sell-off of the stock by investors which in turn drives the stock price down. As such, the hedge funds profit by purchasing the stock of the company from panicked investors who are desperate to sell the "sinking' stock. The hedge funds purchase the stock at abnormally low price locking in their predetermined profit.[332] The anti-fraud provision of the Securities Exchange Act Section 10b and

328. Michael M. Grynbaum, *As Losses Mount, the Fed and the White House Step Up Derivatives Trading Is Scrutinized*, N.Y. TIMES, June 10, 2008, at C1.

329. SEC, Hedge, http://www.sec.gov/answers/hedge.htm (defining a fund of hedge funds as an investment company that invests in hedge funds rather than investing in individual securities. Some funds of hedge funds register their securities with the SEC. These funds of hedge funds must provide investors with a prospectus and must file certain reports quarterly with the SEC).

330. Dave Kansas, *Making Sense of Wall Street: As Investment Choices Pile Up, Grasping Fundamentals Is Key, Hedge Fund Boom Explained,* WALL ST. J., Jan. 14, 2006, at B1 (describing a fund of funds as pools of money gathered from individuals and institutions, which in turn are funneled into a group of hedge funds. This practice has opened the world of hedge funds to new, smaller class of investors).

331. New York State Attorney General Eliot Spitzer's Office received copies of several negative research reports published by hedge funds which targeted public companies including Federal Agricultural Mortgage Corporation (Farmer Mac), MBIA, Inc, and Pre-paid Legal, Inc.

332. *See* DANIEL REINGOLD, CONFESSIONS OF A WALL STREET ANALYST: A TRUE STORY OF INSIDE INFORMATION AND CORRUPTION IN THE STOCK MARKET (2006) (describing the manipulative and illegal use of inside information in Wall Street).

Rule10b-5[333] does not apply because the negative reports are not issued in connection with the purchase and sale of a security. The negative research reports are not published simultaneously with the purchase or sale of security, rather the hedge funds purchase securities weeks and months before the negative research reports are published, accumulating massive short positions, totaling millions of dollars.[334]

To further ensure that the marketplace perceives a targeted company in a negative light, prior to the release of the negative research reports, the hedge would have slowly accumulated over several months a sizable amount of credit default swaps. The purchase of the credit default swaps are designed to give the appearance in the marketplace that there is concern regarding the targeted company's financial ability to repay its debts and other financial obligations.

C. Hedge Funds Purchasing Credit Default Swaps

The credit-default swaps market is $39 trillion market and has operated in the shadows. There is no public disclosure or any legal requirement governing these contracts.[335] Since there is no necessity to report these transactions to the SEC, federal regulators did not have a way to assess the amount of risk in the financial system, whether credit-default swaps have been accurately valued or honestly traded, and whether financial institutions issuing and trading credit default swaps

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333. 17 C.F.R. § 240.10b-5 (2009), provides in relevant part that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

334. Moorad Choudhry, *The Credit Default Swap Basis*; *How Credit Default Swaps Became a Timebomb*, NEWSWEEK, Dec. 29, 2008, at 83.

335. *See* PRESIDENT'S WORKING GROUP, *supra* note 294, at 25 (discussing no systemic risk from such derivatives since "private counterparty discipline"—investors' natural desire to keep their own risks to a minimum—would work to protect the broader financial system).

have taken on too much risk that threatens unsuspecting investors.[336]

Hedge funds purchase credit default swaps, which are insurance contracts that cover losses on the insured transaction in the event of a default. Credit default swaps were typically purchased to insure municipal bond, corporate debt and mortgage securities transactions.[337] Beginning in the late 1990s, hedge funds began to purchase credit default swaps in targeted companies that shorted to give the markets the misconception that company was experiencing major credit problems. The result was a decrease in the stock price of the targeted company due to the investing public's misdirected uncomfort regarding the targeted company's ability to perform and succeed in the market. Furthermore, hedge funds that engage in this type of manipulative practice will oftentimes encourage renowned business journalists to write an investigative expose of the company's eminent financial demise further feeding the sell-off fervor.[338]

Hedge funds often use credit derivatives such as credit default swaps to manage the risks to which they are exposed through their equity investments by buying credit protection through a credit default swap. The current financial meltdown has revealed the extent to which regulated financial institutions are intertwined with unregulated hedge funds, in particular hedge funds' purchase of credit default swaps from regulated insurance companies to ensure hedge funds' speculative investment. The ability of hedge funds to shift their risk to regulated financial institutions if extremely problematic. If the insurance company does not have sufficient collateral to bear the losses that the hedge fund has insured, the insurance company will collapse unless it is able to reinsure the credit default swap or receive a substantial infusion of capital to cover the losses. This is precisely the unfortunate scenario which happened with American International Group.[339]

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336. Christopher Cox, *Swapping Secrecy for Transparency*, N.Y. TIMES, Oct. 18, 2008, at § WK, at 12.

337. Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME, Mar. 17, 2008, *available at* http://www.time.com/time/business/article/0,8599,1723152,00.html.

338. Interview with Roger Waldman, Senior Enforcement Counsel, Office of the New York State Attorney General, Investment Protection Bureau (Jan. 28, 2008) (discussing investigative news articles that appeared in the *Wall Street Journal*, *New York Times*, and other financial news pertaining to Farmer Mac, MBIA, Inc., and Prepaid Legal, Inc.).

339. American International Group, Inc., About AIG, http://www.aigcorporate.com/aboutaig/index.html. AIG can trace its roots back nearly 100 years when it began as a

American International Group (AIG) issued $440 billion in credit-default swaps. As the real estate market took a precipitous decline AIG experienced downgrades in its credit ratings. As a result, holders of the credit-default swaps wanted more collateral, which AIG could not provide. Credit default swaps originally issued by AIG were widely resold in the secondary market. AIG was trapped in an intricate web of transactions. These transactions created a systemic risk that contributed to a gravitational pull that threatened to pull AIG down under the weight of its own financial obligation and would create a financial domino effect in AIG's global insurance business. As such, the U.S. government provided AIG with an $85 million rescue package. Based on the impact that credit default swaps have on world markets, there is a structural evolution currently underway to provide greater transparency and lower counter-party risk through the utilization of central counter-parties and other practices.[340] Congress has proposed legislation to regulate the credit default swap transactions.[341]

VI. RECOMMENDATION

Markets can remain irrational far longer than you or I can remain solvent.

—John Maynard Keynes[342]

The author proposes a hybrid hedge fund governance matrix be developed with a three prong regulatory structure to provide required varying levels of disclosure and transparency based on the volume,

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small insurance company. *See id.* Since that time it has grown to become one of the world's largest companies. *See id.* By the end of 2007 "AIG had assets of approximately $1 trillion, $110 billion in annual revenues, 74 million customers, and 116,000 employees in 130 countries and jurisdictions. Yet, less than a year later, AIG found itself on the brink of failure and in need of emergency government assistance." *Id.*

340. Shannon D. Harrington, *Credit Swaps To Be Overhauled as Dealers Curb Risks (Update 2)*, BLOOMBERG, Jan. 30, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aa1Y8DpE6p1I&refer=home.

341. Regulation of credit default swap market would be included in the comprehensive Over-The-Counter (OTC) Derivatives Market Act of 2009. *See* H.R. 977, 111th Cong. (2009).

342. John Maynard Keynes, Economist and Investor, http://www.maynardkeynes.org.

frequency and potential losses in which particular hedge funds may engage or experience. The hybrid hedge fund governance matrix is designed to project the potential negative impact that certain hedge fund activity may have on the financial and securities markets. Recently James Thomson, a Vice President and Financial Economist at the Cleveland Federal Reserve Bank, presented an amusing and simple drawing board presentation on YouTube, to outline a three-tiered regulatory system to determine appropriate regulator response to systemically important financial institutions.[343]

The first prong is a simple one: all hedge funds must register with the SEC and the liability for such failure to register is the automatic submission to SEC jurisdiction. This requirement is analogous to the CFTC requirement that any person who engages in commodities trading transactions on behalf of another must be registered with the CFTC.[344] Required registration with the SEC is not a novel concept. Recently, the SEC attempted to require the largest hedge funds to register with the SEC. As we have discussed in Section V, the *Goldstein* decision vacated the SEC's authority to require hedge funds to register based upon the SEC's arbitrary and capricious definition of the term "client." The *Goldstein* decision does not prohibit the SEC from regulating hedge funds. It simply prohibits the SEC from arbitrarily re-defining existing terms and removing existing definitional safe harbors that certain persons have relied on to be exempted from SEC jurisdiction. However, it is time that the SEC imposed a new definition. A definition that is as simple and expansive as the CFTC definition as to whom must register with, and be subject to, CFTC jurisdiction. The SEC may require that any person who is not already subject to other federal regulation and

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343. James Thomson, *What To Do About Systemically Important Financial Institutions* (Fed. Reserve Bank of Cleveland Policy Discussion Paper No. 27, 2009), *available at* http://www.clevelandfed.org/research/topics/finstability/three_tier_risk/.

344. Commodities Exchange Act, 7 U.S.C. § 6(d) (2006). The Commodities Exchange Act provides in relevant part, that:

> [i]t shall be unlawful for any person to engage as futures commission merchant or introducing broker in soliciting orders or accepting orders for the purchase or sale of any commodity for future delivery, or involving any contracts of sale of any commodity for future delivery, on or subject to the rules of any contract market or derivatives transaction execution facility unless—
>
> (1) such person shall have registered, under this chapter, with the Commission as such futures commission merchant or introducing broker and such registration shall not have expired nor been suspended nor revoked.

Id.

engaged in "hedging activity"[345] on behalf of another must be registered with the SEC. Such a broad definition would bring within SEC jurisdiction hedge fund activity that poses the greatest threat to the stability of the financial and securities markets.

The second prong requires registered hedge funds to disclose to the SEC investment strategies, holdings, and potential risks associated with certain hedge fund activity. This requirement is analogous to the mutual fund disclosure requirement that compels mutual funds to reveal their 10 largest portfolio holdings on a 30-day delayed cycle.[346]

The third prong also requires publicly-traded companies to disclose their exposure to hedge funds[347] and other significantly leveraged entities.[348] The purpose of the rule would be to bring hedge funds that traditionally transact with publicly-traded companies within the zone of disclosure required under the Securities Exchange Act that all material information is provided to investors and the general public. Currently, publicly-traded companies disclose on a limited basis their exposure to hedge funds primarily through the purchase of credit default swaps[349] to protect themselves from counter-party risks. However, publicly-traded companies do not provide detailed disclosure of their risk exposure to hedge fund counter-party trades, financing and investing as part of their periodic reporting duties under the Securities Exchange Act. These types of private, inadequately disclosed transactions by publicly traded

345. "Hedging activity" is a term that should be defined by the SEC to include all of the known forms of transactions in which hedge fund engage including short selling, excessive borrowing, derivatives trading and publication of negative research reports to the general public. The list of activity cannot by definition be a finite one given the innovative nature of the hedge fund industry.

346. Disclosure of each mutual fund's complete holdings is required to be made quarterly within 60 days of the end of each fiscal quarter (currently, each January 31, April 30, July 31, and October 31) in the Annual Report and Semi-Annual Report to Fund shareholders and in the quarterly holdings report on Form N-Q.

347. *See* PRESIDENT'S WORKING GROUP, *supra* note 294, at 33.

348. This disclosure requirement would satisfy the concerns raised by Federal Reserve Chairman Bernanke regarding the risk management of broker-dealers that provide prime brokering services to hedge funds such as financing, trade execution, clearing and settlement services to hedge funds. *See* Bernanke, *supra* note 235.

349. Christos Ioannidis & Giovanni Calice, *An Empirical Analysis of the Impact of the Credit Default Swap Index Market on Large Complex Financial Institutions* (Working Paper Series, 2009), *available at* http://ssrn.com/abstract=1447403. However, a detailed analysis of the impact of credit default swaps on the U.S. markets has yet to be written.

companies are at a minimum disturbing to our sense of fair and adequate disclosure.

The inadequacy of the federal regulation to protect the investing public has, in part, led to the current historical disruption of the financial and securities markets. Our federal financial disclosure policy[350] is designed to provide investors with all material information to allow investors to make a reasonable investment choice. The federal disclosure rules should be amended to require publicly-traded companies to provide a detailed description of the company's hedge fund trading activity, risk exposure, potential impact on the company's operations, and the identity of the hedge fund itself. The information can be provided in the Management Discussion and Analysis with corresponding schedules and footnotes. The disclosure should be comprehensive and analogous to disclosure requirements that are currently required for off-balance sheet transactions with which publicly-traded companies must provide pursuant to the Enron debacle.

The fourth prong is for the SEC to share the hedge fund activity disclosure information that it receives from hedge funds and publicly-traded companies with state securities regulators. The SEC may coordinate monitoring and enforcement efforts with the North American Securities Administrators Association (NASAA).[351] NASAA members which include every state securities regulatory agency in the country, such as the New York State Attorney General's Office, the Massachusetts Securities Division, and the Colorado Division of Securities can be bring a great deal of expertise, resources and existing cooperative regulatory structure to the monitoring and enforcement efforts concerning questionable hedge fund activity.

350. *See* 17 C.F.R. § 2001.1 (2009).

351. North American Securities Administrators Association, About NASAA, http://www.nasaa.org/About_NASAA/ (last visited Oct. 13, 2009) (describing NASAA as "the oldest international organization devoted to investor protection").

VII. CONCLUSION

Out of every crisis, every tribulation, every disaster, mankind rises with some share of greater knowledge, of higher decency, of purer purpose . . . .

—Franklin Delano Roosevelt[352]

Some commentators argue that American markets must remain competitive in a global financial economy. But Congress must ask, "at what cost?" How long should certain activities and participants in the financial and securities markets remain unregulated in order for the American markets to be competitive? The answer cannot be that Congress will continue to allow private unregulated groups of investors to access financial and securities markets, conduct complex trades, borrow excessively from major banks, and yet refuse to disclose who they are, and what potential negative impact their transactions may have on the financial and securities markets and, more importantly, on the American investing public.

The current financial collapse and economic struggle has proven that Congress cannot and should not deter from adopting legislation that can constrain the extravagance of certain hedge fund activity while simultaneously creating a regulatory balance that will not stifle innovation of new and creative financial products. The sustainability of the financial and securities markets, free of fraudulent or excessive hedge fund activity is imperative. The current absence of case law on this issue evidences that these are novel issues for the courts, Congress and the investing public. As such, it is uncertain whether a bright-line regulatory rule should be established. The challenge for Congress will be to amend, where necessary, the Securities Act, the Securities Exchange Act, the Investment Company Act, or the Adviser Act and the rules promulgated thereunder to provide define and to clarify "hedge fund activity" and "hedge funds," while simultaneously allowing such definitions to evolve with time, as new and innovative financial instruments are created in the hedge fund industry.

As for Noreen Harrington, the brave whistleblower who came forward to tell an amazing story of how hedge funds were defrauding American mutual fund investors—ninety-five million American

352. Roosevelt Address, *supra* note 1.

investors owe Ms. Harrington a debt of gratitude. However, as a result of her disclosure she lost her job and became subject of much media coverage. Nevertheless, because of her courage hundreds of investors impressed with her integrity and willingness to lose everything to protect the investing public have convinced Ms. Harrington that she should manage their investments. As such, Noreen Harrington created her own investment fund. She operates it with integrity and transparency. Ms. Harrington's investment fund's governance matrix utilizes a best practices model. The model confirms that money can be made without defrauding the public or compromising the integrity of the American financial and securities markets, which in turn stabilizes the global economy.