The New Antifraud Rule: Is SEC Enforcement the Most Effective Way to Protect Investors from Hedge Fund Fraud?

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Hedge funds have consistently grown in both size and influence. Traditionally, hedge funds escaped regulation because access was limited to the wealthy and sophisticated. However, due to inflation, the wealth threshold has become more attainable to less sophisticated investors. Also, an increasing number of pension funds and other institutional investors have begun to invest a significant portion of their money in hedge funds. This increased growth, combined with the "retailization" of the industry, has led to concern over whether investors are adequately protected from the corresponding growth in hedge fund fraud. This Note argues that, absent new legislation, the SEC cannot effectively protect investors, but it suggests that the creation of a self-regulatory organization for hedge funds might provide the best protection for these investors.

INTRODUCTION

In 1996, Samuel Israel III and Daniel Marino started the Bayou Fund, a "private pooled investment fund, known as a 'hedge fund.'"1 Within only a few months, the fund sustained heavy trading losses.2 Israel and Marino concealed these losses from Bayou’s early investors by lying to them about “the Fund’s performance and the value of the investors’ accounts.”3 In

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1. Complaint at 5, SEC v. Israel, No. 05 civ. 8376 (S.D.N.Y. Sept. 29, 2005) [hereinafter Israel Complaint]. “The Bayou Fund apparently was conceived as a real hedge fund that traded securities.” Id. at 2. In January 2003, the Bayou Fund was reorganized and liquidated to create four separate hedge funds: Bayou Accredited Fund, LLC; Bayou Affiliates Fund, LLC; Bayou No Leverage Fund, LLC; and Bayou Superfund, LLC. Id. at 5.
2. Id. at 5.
3. Id. at 2 (alleging defendants “knowingly misrepresented the value and performance of the Bayou Fund and the four successor Funds to clients; [and] issued false and misleading financial statements, account statements and performance summary documents”); see also Greg Farrell, Empty Promises in Hedge Fund Fraud: SEC Says Bayou’s Executives Deceived Investors from Start, USA TODAY, Sept. 30, 2005, at B3 (reporting that Samuel Israel and Daniel Marino “disguised trading losses from Bayou’s early investors by lying

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1998, the fund "sustained a net loss of millions of dollars from trading," and by year end, Israel and Marino could no longer manipulate the fund's records to conceal the mounting losses and withstand an independent audit. Instead of admitting their losses, Israel and Marino fired their independent auditing firm, and Marino created "Richmond-Fairfield Associates," a "fictitious accounting firm" that he used to produce fabricated "auditor's reports, financial statements, and performance summaries." After continued losses in 1999, Israel and Marino "again concealed the loss by creating and distributing to the fund's investors false performance summaries and a false financial statement that had purportedly been audited by Richmond-Fairfield Associates." According to the complaint filed by the Securities and Exchange Commission (SEC), Bayou and its successor funds received over $450 million from investors between Bayou's inception in 1996 and July 31, 2005. Despite continued losses, Israel and Marino continued to solicit capital from both new and current investors. In 2003 alone, Israel and Marino received more than $125 million from investors. Although Bayou never actually operated at a profit, Israel and Marino paid themselves "incentive fees" based on fictionalized profits.

In April 2004, Israel and Marino suspended most trading, "drained virtually all of the [funds'] prime brokerage accounts, and wired the remaining funds, approximately $150 million, into Bayou Management's account at Citibank." With the remaining money, Israel continued to "invest in a series of prime bank instrument trading programs." In a letter from Israel and Marino dated July 27, 2005, investors were informed that the Bayou funds were voluntarily liquidating and that "ninety percent of the clients' capital balances would be distributed by August 12, 2005, with the remaining ten percent to follow at the end of the month." In a subsequent letter dated August 11, 2005, Israel promised clients that "they would about the fund's performance and padding the results with infusions of cash from Bayou Securities, a stock-trading subsidiary that racked up heavy commissions from Israel's frenetic trading”). One example of their misrepresentations is documented in the funds' 2003 annual statement, in which the defendants reported "that Bayou Superfund had earned more than $25 million." Israel Complaint, supra note 1, at 8. In reality, "Bayou Superfund took in more than $90 million in investments [in 2003], but lost approximately $35 million through trading."
receive ninety percent of their investments the following week and the remaining ten percent by the end of the month.”14 However, the redemption checks sent to investors were returned for insufficient funds, and most investors were unable to retrieve their money.15

The story of the Bayou funds is just one of the many examples of how investors are harmed by the fraud committed by hedge fund advisers. Issues relating to the magnitude of these frauds and how best to protect investors remain unsettled and controversial. One of the most significant hurdles faced by these victims of fraud is producing sufficient evidence to support their claims. The San Diego County Employees Retirement Association (SDCERA) is currently grappling with this issue in its lawsuit against Amaranth Advisers LLC.16

In 2005, SDCERA invested $175 million with Amaranth Advisers LLC.17 Amaranth was a Greenwich, Connecticut-based hedge fund that once managed over $9 billion in assets.18 SDCERA is currently in the midst of litigation resulting from Amaranth’s collapse after the hedge fund sustained $6.6 billion in natural gas trading losses in September 2006.19 The complaint, filed by SDCERA in the U.S. District Court for the Southern District of New York, accuses Amaranth of “defrauding clients by misrepresenting itself as a fund that invested in many different assets.”20 The complaint claims that “[t]he fund, against its own espoused investment policies, effectively operated as a single-strategy natural-gas fund that took very large and highly leveraged gambles and recklessly failed to apply even basic risk-management techniques and controls.”21

Although SDCERA hopes to prevail at trial, it faces a long process with a heavy burden of proof.22 Nonetheless, the failure of the fund has left San Diego County employees with “jitters and some panic.”23 According to

14. Id.
15. Id. (“Documents obtained from Bayou-related bank accounts show that the accounts were overdrawn before the liquidation and redemption checks were drafted.”).
18. Id. (quoting SDCERA Complaint, supra note 16, at 2).
19. Id. (“Investors ‘must show that the firm engaged in fraud and malfeasance, with direct evidence establishing more than just that someone could have done a better job with a risky investment.’” (quoting Seth Berenzweig, a lawyer with Virginia-based Albo & Oblon LLP)).
Dorothy Sloter, the head of SDCERA, the employees are “very concerned... about their retirement, and the security of their pensions.”

The collapse of Bayou and Amaranth illustrate how fraud and mismanagement of hedge funds can significantly harm investors. Cases such as these have fueled discussions over the need for additional regulatory oversight and protection for investors from fraud. Fraud is defined as a “knowing misrepresentation of the truth or concealment of a material fact.” Fraud is therefore an intentional deception, making it inherently difficult to discover, even through regular SEC inspections.

Although the exact number of hedge funds is hard to quantify, it is clear that hedge funds are continually growing in “size, scope and influence.” In 2006, the number of hedge funds grew by 10%, and there are currently about 9000. Hedge funds are estimated to “account for 20% to 50% of the daily trading volume on the New York Stock Exchange.” The “total assets under management by hedge funds have reached approximately $2 trillion and assets under management are expected to grow at an annualized rate of 15% between 2005 and 2008.”

Traditionally, investors in hedge funds were not thought to need the full protections of federal securities laws and regulations. Hedge funds were considered “private and largely unregulated investment pools for the rich.” However, over time, inflation has lowered the wealth threshold to buy into these funds, making them more accessible to many unsophisticated investors. Additionally, much of the growth of the hedge fund industry
"can be attributed to the investments of institutional investors." An increasing number of institutional investors such as public and private pension funds, university endowments, charitable organizations, and foundations are investing a significant portion of their money in hedge funds. Hedge funds have also become accessible to small investors who are now able to invest through broker firms that package hedge funds into "funds of hedge funds."

The growth in the number of hedge funds and the value of assets under their management, combined with the "retailization" of the industry, has led to concern over whether investors are adequately protected from the corresponding growth in hedge fund fraud. In the past, the SEC was able to use various securities laws to enforce fraud actions against hedge funds. However, this enforcement power was questioned by the U.S. Court of Appeals for the District of Columbia Circuit in Goldstein v. SEC. The SEC responded to the resulting uncertainty by creating a new antifraud provision aimed at prohibiting advisers to pooled investment vehicles from defrauding investors in the investment vehicles they advise.

Part I of this Note traces the history of hedge fund regulation and the industry in general. Part II assesses the most recent SEC antifraud rule relating to hedge funds. Part II also discusses alternatives to SEC regulation proposed to protect investors from fraud within the hedge fund industry. Part III argues that the current SEC rule will not effectively protect investors or deter fraud within hedge funds. Part III then proposes


34. Investor Protection and the Regulation of the Hedge Funds Advisers: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 108th Cong. 5–6 (2004) (statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission). Best industry estimates indicate "that pensions' investments in hedge funds have increased from $13 billion in 1997 to more than $72 billion so far in 2004, an increase of more than 450 percent." Id. at 6.

35. U.S. Securities and Exchange Commission, Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds, http://www.sec.gov/answers/hedge.htm (last visited Oct. 24, 2008). "A fund of hedge funds is an investment company that invests in hedge funds—rather than investing in individual securities." Id. "Many registered funds of hedge funds have much lower investment minimums (e.g., $25,000) than individual hedge funds. Thus, some investors that would be unable to invest in a hedge fund directly may be able to purchase shares of registered funds of hedge funds." Id.


that investors will be better protected by creating a self-regulatory organization for hedge funds.

I. HEDGE FUNDS AND THE SEC

This part explores the history of hedge funds and their rapid growth that attracted increased attention regarding the role of the SEC in protecting hedge fund investors from fraud committed by their advisers. Part I.A defines hedge funds and details how they have historically escaped regulation under the federal securities laws. Part II.B explains how the expansion of the hedge fund industry and the near-collapse of Long-Term Capital Management led the SEC to investigate and enact a new “hedge fund rule” requiring hedge fund advisers to register with the Commission. Part I.C discusses the D.C. Circuit Court’s decision to vacate this rule and how the SEC responded by enacting a new antifraud provision to protect investors in hedge funds from fraud. Finally, Part I.D discusses government and industry responses to these events and the role of self-regulatory organizations within the federal securities laws.

A. Hedge Fund History and Regulation

In the early 1990s, more Americans owned investments than ever before, and stock prices were “rising to astonishing heights.” As a result, “no fewer than 6 million people around the world counted themselves as dollar millionaires, with a total of $17 trillion in assets.” With this increased number of wealthy investors came an increased interest in investing in hedge funds. Part I.A.1 discusses the nature of hedge funds while Part I.A.2 discusses how hedge funds have dodged regulation by the Commission under the federal securities laws.

1. Defining “Hedge Funds”

Hedge funds are “notoriously difficult to define.” The term “hedge fund” is not mentioned anywhere in the federal securities laws, and even within the industry, there is no single, agreed upon definition. The term is commonly used as a catchall to encompass “any pooled investment vehicle that is privately organized, administered by professional investment

39. LOWENSTEIN, supra note 32, at 23.
40. Id. (citing Franklin R. Edwards, Hedge Funds and the Collapse of Long-Term Capital Management, J. ECON. PERSP., Spring 1999, at 189, 193).
41. Goldstein, 451 F.3d at 874.
42. Id. at 874–75; see also STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at viii (“The term generally identifies an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act.”); David A. Vaughn, Dechert LLP, Comments for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds (May 13, 2003), http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm (providing fourteen different definitions found in government and industry publications).
managers, and not widely available to the public."43 Hedge funds generally pool capital from investors and invest those funds in securities and other financial instruments in an effort to "limit risk and volatility while providing positive returns under all market conditions."44

a. Structure of Hedge Funds

Most hedge funds are structured as limited partnerships to benefit investors who are subject to U.S. taxation.45 They may also be organized as limited liability companies or business trusts.46 A hedge fund organized as a limited partnership has a general partner (also commonly referred to as the fund manager or fund adviser), often itself a limited liability company or other entity, which manages the fund (or several funds) and numerous limited partners who are relatively passive investors.47 The fund manager is given "broad investment discretion in selecting investments and trading for the fund."48 The day-to-day operations of the partnership are usually governed by an Agreement of Limited Partnership.49

As discussed below, hedge funds do not typically offer securities to the public. Instead, "[h]edge funds distribute securities in private offerings, traditionally ‘marketing’ their interests through word of mouth and the personal relationships with the hedge fund’s advisory personnel."50

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45. Id. § 2.8, at 14.
46. Staff Report on the Growth of Hedge Funds, supra note 33, at 9 n.27. Each of these formations are beneficial to the investors because they “are generally not separately taxed and, as a result, income is taxed only at the level of the individual investor.” Id. Other benefits of these forms of organization include limiting the liability of an investor to the extent of its investment in the fund and providing the general partner with broad authority with respect to management. Id.
47. Lemke et al., supra note 44, § 2.8, at 14. The general partner is responsible for the general management of the fund, which includes selection of which investments to add to the fund’s portfolio, management of the assets and a number of other activities for the fund. Id. § 2.2, at 10. With the exception of the general partner, all investors are limited partners, who “share in the partnership’s income, expenses, gains and losses based on the balances in their respective capital accounts, but do not exercise any day-to-day management or control over the partnership.” Id. § 2.8, at 14.
48. Id. § 2.2, at 10.
49. Id. § 2.8, at 15. The Agreement of Limited Partnership usually sets forth important aspects of operating the fund, including, but not limited to, who is responsible for managing the fund, the powers of the general partner, the object or purpose of the partnership, indemnification, the management fees and performance allocations and valuation of portfolio assets. Id. § 2.8, at 15–16.
50. Staff Report on the Growth of Hedge Funds, supra note 33, at ix.
b. Compensation

One common characteristic among hedge funds is their fee structure. Fund advisers or managers are typically compensated with a base management fee (usually a percentage, commonly one to two percent, of the fund's assets).\(^1\) In addition to this base fee, there is typically a performance component to their compensation, which is usually a percentage of the increase in the fund's value (e.g., twenty percent of positive return).\(^2\) Managers commonly make significant direct investments in the funds they manage.\(^3\) The performance component of a manager's compensation, along with their personal investment, tends to create a strong alignment of interests between the outside investors in the hedge fund and the manager.\(^4\)

c. Relationships with Investors and Disclosure

Hedge funds are generally not required to make extensive disclosures to investors or regulators.\(^5\) Therefore, "limits or restrictions on hedge funds' activities are determined not by regulation but primarily by the contractual relationships they have with their investors and by market discipline exerted by the creditors, counterparties, and investors with whom they transact."\(^6\) Investors typically receive information from hedge fund advisers "during an investor's initial due diligence review of the fund, although some, more proprietary information may not be provided until after the investor has made a capital commitment to the fund, if at all."\(^7\)

The relationship between the fund manager and the investors is usually governed by an Agreement of Limited Partnership.\(^8\) Although hedge funds typically are not legally required to provide disclosure to investors, many "unregistered and unregulated hedge funds make some disclosures in the form of private placement memoranda, conference calls, informal conversations, and other unofficial devices."\(^9\) In addition, some hedge funds use other legal documents to cover the relationship between investors

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51. LEMKE ET AL., supra note 44, § 1.1, at 2; STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at ix.
52. LEMKE ET AL., supra note 44, § 1.1, at 2.
53. MANAGED FUNDS ASS'N, SOUND PRACTICES FOR HEDGE FUND MANAGERS intro., at 8 (2007) [hereinafter SOUND PRACTICES], available at http://www.managedfunds.org/downloads/Sound%20Practices%202007.pdf. This investment approach "can be particularly important in attracting outside investors since it aligns the fund manager's interests with those of outside investors and exposes the fund manager to the same investment risks."
54. SOUND PRACTICES, supra note 53, intro., at 8.
55. Edwards, supra note 36, at 10.
56. Id.
57. STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at 46.
58. SOUND PRACTICES, supra note 53, intro., at 9.
and managers, including offering memoranda, subscription agreements, or similar contracts.  

Given the structure of most hedge funds, it is generally understood that the client of the manager is the hedge fund itself—not the individual investors. Even though the manager may, and often does, interact with the investors, the manager is viewed as providing “its investment advice to the Hedge Fund in accordance with the investment strategy and objectives set forth in the Hedge Fund’s offering documents, rather than any specific objectives or directives of any individual Hedge Fund investor.”

In order to invest in a hedge fund, investors are required to meet certain standards, such as net worth or other financial sophistication requirements. U.S. securities laws require that hedge fund investors, whether institutional or individual, satisfy the specified eligibility requirements based on their wealth and sophistication because investment in the funds is not available to the public. In addition to these restrictions, “managers of certain institutional investors, such as pension fund plans, are fiduciaries with a legal duty to act in the best interest of plan beneficiaries when making any investments on behalf of the institution.”

d. Investment Goals and Strategies

In the current financial market, the term “hedge fund” has been understood to describe a “wide range of investment vehicles that can vary substantially in terms of size, strategy, business model, and organizational structure.” The first hedge funds “invested in equities and used leverage and short selling to ‘hedge’ the portfolio’s exposure to movements of the corporate equity markets.” However, since hedge funds are not generally restrained or restricted by diversification requirements, they began to diversify their investment portfolios and engage in a wider variety of investment strategies. Hedge funds today trade not only equities, but also “fixed income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options

60. SOUND PRACTICES, supra note 53, intro., at 9.
61. Id. intro., at 8. Although a manager’s client is considered the hedge fund itself, the manager often communicates with the investors about matters related to the fund, including “its investment objectives, strategies, terms, and conditions of an investment in the hedge fund.” Id. intro., at 9.
62. Id. intro., at 8.
63. Id. intro., at 9; see infra Part I.A.2.
64. SOUND PRACTICES, supra note 53, intro., at 9.
65. Id.
66. Id. intro., at 7.
67. STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at 3 (discussing Alfred Winslow Jones, who “is credited with establishing one of the first hedge funds as a private partnership in 1949”). Hedge funds “may obtain leverage by purchasing securities on margin, selling short, obtaining funding from banks or other sources, engaging in repurchase agreements, or using various derivative or synthetic instruments.” LEMKE ET AL., supra note 44, § 1.1, at 1–2.
68. STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at 3.
and other non-securities investments." Also, hedge funds today are not tied to utilizing the hedging and arbitrage strategies that hedge funds historically employed, and now many engage in relatively traditional long-only equity strategies.

Hedge funds seek to achieve positive, absolute investment returns under all market conditions, often with less volatility and risk than traditional asset classes such as stocks and bonds. The funds typically engage in many different investment strategies to achieve their investment goals, including investment in "distressed securities, illiquid securities, securities of companies in emerging markets and derivatives, as well as pursue arbitrage opportunities, such as those arising from possible mergers or acquisitions." Managers of hedge funds are known to "employ more complicated, flexible investment strategies than advisers at mutual funds [and] brokerage firms."

e. Benefits of Hedge Funds

Hedge funds in many respects tend to foster financial stability and provide benefits to financial markets. Some of the important benefits that hedge funds offer to capital markets include "liquidity, price efficiency and risk distribution." For example, "many hedge funds take speculative, value-driven trading positions based on extensive research about the value of a security." Funds that take such positions can enhance liquidity and contribute to market efficiency. Also, "hedge funds offer investors an important risk management tool by providing valuable portfolio diversification because hedge fund returns in many cases are not correlated to the broader debt and equity markets." However, there are increasing concerns expressed by policy makers with respect to certain activities of hedge funds and the potential for systematic risk. In particular, regulatory supervisors have taken interest in over-the-counter derivatives, expressing

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69. Id.
70. Id. at 3–4. Long-only investment strategy is when a fund "purchases and sells securities, but does not sell securities short to a significant extent." LEMKE ET AL., supra note 44, § 1.2, at 2.
71. See LEMKE ET AL., supra note 44, § 1.1, at 1–2; STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at 4.
72. STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at 4.
73. Id.
76. STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at viii.
77. Id.
their "concern that a major credit event could have a substantial impact on
global financial markets."

2. The Regulation of Hedge Funds and Their Advisers

In the United States, hedge funds are neither authorized nor restricted by
the government; nor does the government mandate that hedge funds and
their advisers make specific disclosures to investors. The United States
does not have a strict comprehensive system to regulate hedge funds;
instead, "[i]n the United States the regulation of hedge funds might be best
categorized as a patchwork of exemptions from various investor-
protection laws." Hedge funds are investment pools with substantial
investments in securities, whose activities could potentially subject them to
legal restrictions and regulations. Therefore, most funds operate themselves
in such a manner that exempts them from regulation under the four major
U.S. securities laws that could potentially affect them—the Securities Act
of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange
Act), the Investment Company Act of 1940 (Company Act), and the
Investment Advisers Act of 1940 (Advisers Act). Hedge funds escape
registration under these Acts through certain exclusions or exemptions,
which include limiting availability only to certain sophisticated or
accredited investors and not offering or selling interest or shares to the
general public.

The Company Act restricts registered investment companies to the types
of transactions they may undertake. The Act charges the Commission
with regulation of any issuer of securities that "is or holds itself out as being
engaged primarily . . . in the business of investing, reinvesting, or trading in
securities." Since most hedge funds have substantial investments in
securities, they fall within the definition of an investment company under
the Act. However, most hedge funds avoid regulation by fitting into one of

78. SOUND PRACTICES, supra note 53, intro., at 4-5.
80. Id.
disclosure in securities transactions." STAFF REPORT ON THE GROWTH OF HEDGE FUNDS,
supra note 33, at 13. The Act generally "requires issuers to register a security with the SEC
before it is offered to the public." Jennifer Ralph Oppold, The Changing Landscape of
Hedge Fund Regulation: Current Concerns and a Principle-Based Approach, 10 U. PA. J.
BUS. & EMP. L. 833, 843 (2008). Hedge funds typically escape regulation under the
Securities Act by obtaining their "investors through private placements rather than a public
offering," which requires that they meet "the requirements of section 4(2) or Regulation D"
of the Securities Act, and "usually means restricting their investors to 'accredited'
investors." Edwards, supra note 36, at 8.
82. 15 U.S.C. §§ 78a–78lll. For a discussion of the Exchange Act and how it regulates
hedge funds, see Oppold, supra note 81, at 845–46.
83. 15 U.S.C. §§ 80a-1 to -64.
84. Id. §§ 80b-1 to -21.
85. LEMKE ET AL., supra note 44, § 1.1, at 1–2.
86. Id.
two statutory exclusions to the definition of an investment company.\textsuperscript{88} Section 3(c)(1) excludes an entity from the definition if the outstanding securities are "beneficially owned by not more than 100 persons" and if the entity does not presently or in the future plan to offer its securities to the public.\textsuperscript{89} The second provision that hedge funds typically rely on is section 3(c)(7). Under this section, a fund is not considered an investment company if outstanding securities are owned exclusively by "qualified purchasers" and its securities are not offered to the public.\textsuperscript{90}

Since most hedge funds are not regulated by the Company Act, they have greater flexibility in their investment strategies than the investment vehicles defined as investment companies, such as mutual funds.\textsuperscript{91} Because of their exemption, hedge funds can remain secretive about their positions and strategies, while mutual funds are required to "disclose their investment positions and financial condition."\textsuperscript{92} Also, mutual funds and other registered investment companies face significant restrictions on permissible transactions.\textsuperscript{93} Freedom from these constraints allows hedge funds to trade in a much greater variety of assets, "from traditional stocks, bonds, and currencies to more exotic financial derivatives and even non-financial assets."\textsuperscript{94}

The Advisers Act is mainly a registration and antifraud statute that regulates most investment advisers by imposing registration and disclosure

\textsuperscript{88} STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at 11. Sections 3 and 4 of the Securities Act exempt certain securities and transactions from the registration requirements. ARNOLD S. JACOBS, 5 DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAW § 3.3 n.3 (2008). Section 3(a) exempts specific securities. \textit{Id.} "In addition to the exemptions provided by statute under Section 3(a), Sections 3(b) and 3(c) permit the SEC to promulgate rules and regulations adding other exempt classes of securities." \textit{Id.}

\textsuperscript{89} 15 U.S.C. § 80a-3(c)(1). Funds that rely on section 3(c)(1) must "comply with Section 4(2) of the Securities Act, and frequently do so by relying on the safe harbor available under Regulation D under that Act." STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at 12. Reliance on Regulation D requires that hedge funds "offer their securities only to 'accredited investors,' and [that they] not engage in any general solicitation or general advertising of their shares." \textit{Id.} Accredited investors include "individuals with a minimum annual income of $200,000 ($300,000 with spouse) or $1 million in net worth and most institutions with $5 million in assets." \textit{Id.}

\textsuperscript{90} 15 U.S.C. § 80a-3(c)(7)(A). Under section 2(a)(51) of the Company Act, a "qualified purchaser" means "any natural person . . . who owns not less than $5,000,000 in investments" or "any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments." \textit{Id.} § 80a-2(a)(51)(i), (iv).

\textsuperscript{91} Federal Bureau of Investigation, supra note 29 ("Hedge funds can invest in equities, bonds, options, futures, commodities, arbitrage and derivative contracts, as well as illiquid investments such as real estate.").

\textsuperscript{92} Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006).

\textsuperscript{93} \textit{Id.} For example, registered investment companies are "foreclosed from trading on margin or engaging in short sales and must secure shareholder approval to take on significant debt or invest in certain types of assets, such as real estate or commodities." \textit{Id.} (citing 15 U.S.C. §§ 80a-12(a)(1), (a)(3), 80a-13(a)(2)).

\textsuperscript{94} \textit{Id.} at 876.
requirements, as well as substantive regulatory requirements on them.\textsuperscript{95} Hedge fund advisers generally satisfy the definition of an "investment adviser" under the Advisers Act.\textsuperscript{96} However, advisers to hedge funds may avoid registering with the Commission if they satisfy the elements of the exemption under section 203(b) of the Act. An adviser may rely on the "private adviser exemption" of section 203(b)(3) if the following conditions are met: (1) the investment adviser has had "fewer than fifteen clients" in the preceding twelve months; (2) the adviser does not hold "himself out generally to the public as an investment adviser"; and (3) the adviser does not act "as an investment adviser to any investment company registered under [the Company Act]."\textsuperscript{97} Although many hedge funds are not registered under the Company Act, and their managers are exempt from registration under the Advisers Act, they are still subject to the antifraud provisions of the federal securities laws.\textsuperscript{98}

For the purposes of section 203(b), the Commission rules provided that a "legal organization," such as a hedge fund, would be counted as a single "client."\textsuperscript{99} Since even the largest hedge fund managers do not run fifteen hedge funds, this provision provides an exemption for most hedge fund managers.\textsuperscript{100}

\textsuperscript{95} Lemke et al., \textit{supra} note 44, § 3.1, at 25; see also Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 1A-2333, 69 Fed. Reg. 72,054, 72,054 (Dec. 10, 2004) [hereinafter SEC Release: Hedge Fund Rule] ("The Act contains a few basic requirements, such as registration with the Commission, maintenance of certain business records, and delivery to clients of a disclosure statement ('brochure').").

\textsuperscript{96} Staff Report on the Growth of Hedge Funds, \textit{supra} note 33, at 20. Section 202(a)(11) of the Advisers Act generally defines an "investment adviser" as one who "for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." 15 U.S.C. § 80b-2(a)(11).

\textsuperscript{97} 15 U.S.C. § 80b-3(b)(3).

\textsuperscript{98} SEC Release: Hedge Fund Rule, \textit{supra} note 95, at 72,054. Although advisers who take advantage of the "private adviser exemption" must comply with the Act's antifraud provisions, they "do not file registration forms with [the SEC] identifying who they are, do not have to maintain business records in accordance with [SEC] rules, do not have to adopt or implement compliance programs or codes of ethics, and are not subject to Commission oversight." \textit{Id.} These exempt advisers "are also subject to antifraud provisions of other federal securities laws, including rule 10b-5" under the Exchange Act. \textit{Id.} at 72,054 n.6.

\textsuperscript{99} \textit{Id.} at 72,055 n.10. "Rule 203(b)(3)-1 under the Advisers Act provides that an adviser may count a legal organization as a single client if the legal organization receives investment advice based on its investment objectives rather than on the individual investment objectives of its owners." \textit{Staff Report on the Growth of Hedge Funds, supra} note 33, at 21 n.72.

\textsuperscript{100} Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006). Some hedge fund managers do register as an investment adviser because they do not meet the requirements of section 203(b), or they register "voluntarily because their investors demand it or for competitive reasons." \textit{Staff Report on the Growth of Hedge Funds, supra} note 33, at 22.
B. Long-Term Capital and the SEC's Response

This section discusses the SEC's growing interest and concern that led to its attempt to increase regulation of hedge funds. Part I.B.1 discusses the near failure of Long-Term Capital Management (LTCM) and how this event prompted the SEC to commence an investigation into the hedge fund industry. Part I.B.2 summarizes the relevant findings reported by the SEC's staff that led the Commission to adopt a new rule aimed at regulating hedge funds. Part I.B.3 then sets forth the SEC's "Hedge Fund Rule" and how the Commission believed this would help deter or detect fraud committed by unregistered hedge fund advisers.

1. The Near Failure of LTCM

LTCM was a Greenwich, Connecticut-based fund that, at its peak, held over $125 billion in assets under management. LTCM was a bond-trading firm run by John W. Meriwether, a former well-known trader at Salomon Brothers, and comprised of "a group of brainy, Ph.D.-certified arbitrageurs," many of whom were professors and two of whom had won the Nobel Prize. Due to Meriwether's popularity among the bankers, he was able to obtain financing from every major Wall Street bank on highly generous terms. LTCM became the envy of Wall Street. For over four years, "[t]he fund had racked up returns of more than 40 percent a year, with no losing stretches, no volatility, seemingly no risk at all." It seemed that this incredibly smart group of men had "been able to reduce an uncertain world to rigorous, cold-blooded odds."

In mid-August of 1998, Russia defaulted on its ruble debt which caused the global bond markets to be highly unsettled. This left LTCM on the brink of failure. However, in addition to its bond trading, LTCM had entered into thousands of derivative contracts that had intertwined the fund with every bank on Wall Street, and "[a]lmost all of the country's major financial institutions were put at risk due to their credit exposure to Long-Term." William J. McDonough, the president of the Federal Reserve Bank of New York, feared that, if LTCM failed, "the markets would stop working; that trading would cease; that the system itself would come

101. Goldstein, 451 F.3d at 877. For a complete account of the story of Long-Term Capital Management (LTCM), see Lowenstein, supra note 32.
102. Lowenstein, supra note 32, at xix.
103. Id. LTCM had amassed $100 billion in assets, virtually all of it borrowed from the major Wall Street banks. Id. The fund had also "entered into thousands of derivative contracts, which had endlessly intertwined it with every bank on Wall Street." Id. These derivative contracts were essentially side bets on market prices and they created more than $1 trillion worth of exposure. Id. If LTCM defaulted on these contracts, these banks "would be exposed to tremendous—and untenable—risks." Id.
104. Id.
105. Id.
106. Id. at xx.
crashing down.”

McDonough personally intervened by summoning the heads of every major Wall Street bank to engineer a bailout of the fund and avoid a national financial crisis. Although the Commission had previously been interested in regulating hedge funds, the failure of LTCM led the Commission to explore ways to increase the regulation of hedge funds.

2. The SEC Investigation of Hedge Funds

Beginning in June 2002, the SEC Staff of the Commission’s Division of Investment Management and Office of Compliance Inspections and Examinations conducted a study aimed at reviewing the operations and practices of hedge funds. When the study was complete, the Commission held a two-day roundtable on the hedge fund industry. After the Hedge Fund Roundtable, Chairman William H. Donaldson asked the staff to compile a summary report (Staff Report) of its findings and recommendations. Based on the investigation and report, the Commission decided that a new rule was necessary to detect fraud in hedge funds in its early stages.

The study was largely the result of concern over the lack of information available to the Commission “about hedge fund advisers that are not registered under the Advisers Act and the hedge funds that they manage.” Since hedge funds are generally not registered with the SEC, “they are not subject to any reporting or standardized disclosure requirements, nor are they subject to Commission examination.” The Staff Report concluded that SEC efforts to detect hedge fund fraud at early stages were unsuccessful due to an inability to obtain information.

As previously mentioned, even hedge funds that are not registered under the Company Act and their advisers who are not registered under the Advisers Act are subject to the antifraud provisions of the federal securities laws. At the time of the investigation, the Commission had brought approximately thirty-eight enforcement actions since 1999 involving hedge

108. LOWENSTEIN, supra note 32, at xix–xx.
109. Id. at xviii.
110. Id.
111. STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at 2.
112. Id. at vii.
113. Id. at vii–viii.
114. See id. at x.
115. Id.
116. Id.
117. Id. This Note focuses only on the fraud aspects of the Staff Report, but the report also addresses concern over the increasing participation of hedge funds in financial markets, whether they are a danger to the stability of the U.S. financial markets and whether they subject investors to inordinately high levels of risk.
118. Id.
fund fraud—fraud that resulted in significant losses to investors. Also at the time of the Staff Report, the Commission was seeing a steady increase in the number of fraud enforcement actions; however, it found that “[t]here was no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity.”

The investigation found that the fraud charges previously brought by the Commission against hedge fund advisers were “similar to the types of fraud charged against other types of investment advisers.” These include: “misappropriation of assets; misrepresentation of portfolio performance; falsification of experience, credentials and past returns; misleading disclosure regarding claimed trading strategies; and improper valuation of assets.” It found that “[t]he overwhelming majority of the cases the Commission has instituted involve charges under . . . the Securities Act, the Exchange Act and the Investment Advisers Act.”

The report provided four observations with regard to the hedge fund enforcement actions brought by the Commission since 1999. First, it noted that “nearly a third of the hedge fund cases brought in the last four years involved criminal charges.” Also, the staff noted that one characteristic that seems common to hedge fund cases is how far violators will go to conceal their fraud. The staff found that “[i]n almost half of the enforcement actions brought since 1999, the defendants or respondents created false documentation in an effort to hide their fraud.” Another characteristic “that is perhaps more common to hedge fund cases than the typical investment adviser’s case is the greater frequency of outright theft, or misappropriation, of investor funds.” Lastly, the staff reported that “both registered and unregistered investment advisers have engaged in hedge fund fraud.”

Typically the Commission identifies frauds and other misconduct involving hedge funds only after they are contacted by “fund investors or service providers [who] suspect fraudulent activity.” This translates to

119. Id. at 73. “In most cases involving hedge funds, the Commission institutes enforcement actions against the hedge fund adviser and/or the adviser’s principals.” Id. at 73 n.252.
120. Id. at 73. The staff listed several factors that may be linked to the increase in the number of hedge fund fraud cases, including “the popularity of hedge fund investments and the large amounts of money they involve (and thus their attractiveness to perpetrators of fraud); the entrance to the industry of inexperienced, untested and, in some cases, unqualified individuals; and lack of adequate controls on the operations of some hedge fund advisers.” Id.
121. Id.
122. Id. at 73–74 (footnotes omitted).
123. Id. at 74.
124. Id.
125. Id.
126. Id. (“These documents included account statements and other types of reports to customers, confirmations and pricing sheets.”).
127. Id.
128. Id.
129. Id. at 76.
the Commission "instituting enforcement action against an unregistered hedge fund adviser only after significant losses have occurred." In contrast, the Staff Report found that "the Commission has an advantage in identifying the misconduct of registered investment advisers because they are subject to periodic examinations by Commission staff." Therefore, the report suggested that when registered investment advisers partake in fraudulent or other unlawful activity, their examinations could lead to earlier discovery that could potentially prevent significant losses. Also, they suggested that the Commission's "potential for a surprise examination and deficiency letters to encourage a culture of compliance at regulated entities" would serve to deter fraud and other misconduct.

3. The Hedge Fund Rule

After completing its study of the hedge fund industry in 2003, the SEC issued a new rule over the dissent of two of the five SEC commissioners in December 2004. Rule 203(b)(3)-2 (the Hedge Fund Rule) required that investment advisers "count each owner of a 'private fund'" as a client, which included "each shareholder, limited partner, member, or beneficiary of the 'private fund.'" Therefore, it required fund advisers to register under the Advisers Act so that the Commission could gather "basic information about hedge fund advisers and the hedge fund industry," "oversee hedge fund advisers," and "deter or detect fraud by unregistered hedge fund advisers." The rule sought "to increase disclosure in an industry with little transparency and to oversee an allegedly growing pool of assets."

130. Id.
131. Id. Although the Staff Report indicated that registration provides the SEC with an advantage, others argue that there is no evidence that periodic examinations of registered companies aid in preventing fraud. See, e.g., Hedge Fund Hearing, supra note 26; Jenny Anderson, A Modest Proposal to Prevent Hedge Fund Fraud, N.Y. TIMES, Oct. 7, 2005, at C6 ("The commission is not adequately staffed or technologically equipped to effectively regulate the markets today. Adding 5,000 hedge funds to its to-do list is a dangerous undertaking. While it is desirable to have a watchdog, there is no way the staff of the S.E.C. can do it well...."). When expressing his opposition to hedge fund regulation, Commissioner Paul S. Atkins argued that "the commission did not have the resources to police the mutual fund industry—one chock-full of small investors—so taking on the hedge fund industry was an exercise in futility." Anderson, supra.
132. STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra note 33, at 76.
133. Id. at 76–77.
134. SEC Release: Hedge Fund Rule, supra note 95, at 72,087; see also Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006).
135. 17 C.F.R. § 275.203(b)(3)-2(a) (2008); SEC Release: Hedge Fund Rule, supra note 95, at 72,070.
136. Goldstein, 451 F.3d at 877 (quoting SEC Release: Hedge Fund Rule, supra note 95, at 72,059).
The Commission believed that, if it were able to continuously monitor and examine the practices of hedge fund advisers, it would be able to "effectively detect fraud and misconduct at much earlier stages, deter fraudulent activities, better protect the investing public, and increase the quality and fairness of hedge fund price valuation."\(^{138}\) The Commission stated in the release of the final rule that the "rule and rule amendments are designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets."\(^ {139}\)

Under the Hedge Fund Rule, previously exempt advisers to hedge funds now had to register with the Commission if they had fifteen or more "clients." The rule defines a "private fund" as

an investment company that (a) is exempt from registration under the Investment Company Act by virtue of having fewer than one hundred investors or only qualified investors; (b) permits its investors to redeem their interests within two years of investing; and (c) markets itself on the basis of the 'skills, ability or expertise of the investment adviser.'\(^ {140}\)

Due to the new definition of "private funds," and the specifications with regard to who must be counted as a "client," most hedge fund managers were required to register.\(^ {141}\) The rule mandated that these advisers, now required to register under the new rule and rule amendments, do so by February 1, 2006.\(^ {142}\)

C. Hedge Fund Regulation After Goldstein

This section discusses the D.C. Circuit's decision in Goldstein to vacate the Hedge Fund Rule, and how the SEC has responded to the court's holding. Part I.C.1 sets forth the court's reasoning as to why it held that the SEC had exceeded its authority when it tried to interpret the term "client" to include the "shareholders, limited partners, members, or beneficiaries" of a hedge fund.\(^ {143}\) Part I.C.2 addresses the Commission's response in choosing not to challenge the circuit court's decision and then sets forth the elements of the new antifraud rule that the SEC promulgated in response to Goldstein.

\(^{138}\) Id. at 125 (citing Staff Report on the Growth of Hedge Funds, supra note 33, at 76–80).

\(^{139}\) SEC Release: Hedge Fund Rule, supra note 95, at 72,054.

\(^{140}\) Goldstein, 451 F.3d at 877 (citation omitted) (quoting 17 C.F.R. § 275.203(b)(3)-1(d)(1)).

\(^{141}\) Id. (quoting 17 C.F.R. § 275.203(b)(3)-2(a)). The rule also trigger[ed] certain regulations that apply only to registered advisers. Most importantly, registered advisers [were required to] open their records to the Commission upon request and [could not] charge their clients a performance fee unless such clients [had] a net worth of at least $1.5 million or at least $750,000 under management with the adviser.

\(^{142}\) Id. at 877 n.3 (citing 15 U.S.C. §§ 80b-4, 80b-5 (2006)).

\(^{143}\) Goldstein, 451 F.3d at 874 (quoting 17 C.F.R. § 275.203(b)(3)-2(a)).
1. Goldstein v. SEC

In Goldstein, Philip Goldstein, Kimball & Winthrop, Inc. (an investment advisory firm Goldstein co-owned), and Opportunity Partners L.P. challenged the Hedge Fund Rule's equation of "client" with "investor." Goldstein's main contention with the rule was "that the Commission's action misinterpreted § 203(b)(3) of the Advisers Act." The court acknowledged that the Advisers Act does not define the term "client," but rejected the SEC's argument that the lack of a definition rendered the statute "ambiguous as to a method for counting clients." Although "client" is not defined, the court found that legislative history and the definition of "investment adviser" provided support for the view that "Congress did not intend 'shareholders, limited partners, members, or beneficiaries' of a hedge fund to be counted as 'clients.'" The court held that the SEC's definition of "client" under the Hedge Fund Rule was "outside the bounds of reasonableness" and that it came close to "violating the plain language of the statute." The new rule was overturned by the court, stating that "absent ... a justification" their new interpretation of "client" seemed "completely arbitrary."

Although the court invalidated the rule, it noted that a later registration requirement that is more narrowly tailored with regard to look-throughs may be upheld. Also, if Congress were to amend the Advisers Act, it "would effectively supersede Goldstein and expand the range of options available to regulate this area."

144. Id.
145. Id. at 878.
146. Id. The court pointed out that just because a word is not defined, it does not automatically render it ambiguous. Id.
147. See id. at 879. The court noted, although the statute does not define 'client,' it does define 'investment adviser' as 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.' Id. (quoting 15 U.S.C. § 80b-2(11) (2006)). The court found this definition indicates that an investor is not a client because an adviser to a hedge fund does not advise an investor as to how to handle his capital, but rather, the adviser provides advice to the fund itself as to how to invest the capital it has collected from its investors. Id. at 879–80.
148. Id. at 879–81.
149. Id. at 881 ("At best it is counterintuitive to characterize the investors in a hedge fund as the 'clients' of the adviser.").
150. Id. at 883.
151. 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, 810 n.64 (2007) ("'[T]he Commission has not justified treating all investors in hedge funds as clients for the purpose of the rule. If there are certain characteristics present in some investor-adviser relationships that mark a 'client' relationship, then the Commission should have identified those characteristics and tailored its rule accordingly.'" (quoting Goldstein, 451 F.3d at 883)).
152. Id. at 810.
After the *Goldstein* decision, SEC Chairman Christopher Cox told Congress that the SEC would continue to bring enforcement actions against hedge funds and hedge fund advisers that violate the antifraud and other provisions of the securities laws. ¹⁵³ During Chairman Cox’s testimony, he declared that “[h]edge funds are not, should not be, and will not be unregulated.”¹⁵⁴ With the importance that hedge funds have on the market, it is inevitable that they will face “increased regulatory scrutiny which, after *Goldstein*, will come largely in the form of enforcement actions and investigations.”¹⁵⁵

2. The New Antifraud Rule: The SEC’s Response to *Goldstein*

In July 2007, the five SEC commissioners voted unanimously to adopt a new antifraud rule under the Advisers Act that “prohibit[s] advisers to pooled investment vehicles from defrauding investors or prospective investors in pooled investment vehicles they advise.”¹⁵⁶ Rule 206(4)-8 (New Antifraud Rule) was promulgated in response to the *Goldstein* decision.¹⁵⁷ The rule became effective on September 10, 2007, thirty days after publication in the Federal Register.¹⁵⁸

The Commission felt that *Goldstein* created uncertainty with regard to the application of sections 206(1) and (2) of the Advisers Act in relation to investors who are defrauded by an investment adviser to that pool.¹⁵⁹ Prior to *Goldstein*, the SEC “brought enforcement actions against advisers alleging false and misleading statements to investors under sections 206(1) and 206(2) of the Advisers Act.”¹⁶⁰ The court of appeals in *Goldstein* held that, “for [the] purposes of sections 206(1) and (2) of the Advisers Act, the ‘client’ of an investment adviser managing a pool is the pool itself, not an

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> [L]et me make very clear that notwithstanding the *Goldstein* decision, hedge funds today remain subject to SEC regulations and enforcement under the antifraud, civil liability, and other provisions of the federal securities laws. We will continue to vigorously enforce the federal securities laws against hedge funds and hedge fund advisers who violate those laws.


¹⁵⁸. *Id.*

¹⁵⁹. *Id.* at 44,756–57.

¹⁶⁰. *Id.* at 44,757 n.4 (citations omitted).
investor in the pool." The court "distinguished sections 206(1) and (2) from section 206(4) of the Advisers Act, which is not limited to conduct aimed at clients or prospective clients of investment advisers." The Commission found that this view made it unclear whether the Commission could continue to bring enforcement actions under sections 206(1) and (2) when investors are defrauded by an investment adviser to that pool.

The New Antifraud Rule was adopted pursuant to the authority granted to the SEC in section 206(4) of the Advisers Act. Under the Advisers Act, the Commission has "broad authority to protect against fraud" by investment advisers. Section 206(4) of the Advisers Act provides that it is unlawful for investment advisers "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative," and it instructs the Commission to adopt rules and regulations that "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative" by advisers. Although Goldstein called into question the scope of sections 206(1) and 206(2), the Commission's authority to adopt rules under 206(4) to protect investors in pooled investment vehicles was not questioned. The authority granted under section 206(4) is "broader in scope and [is] not limited to conduct aimed at clients or prospective clients."

The new rule seeks to enforce the authority of the Advisers Act governing cases in which investors in a pool are defrauded by an adviser. It has two parts: The first part, 206(4)-8(a)(1), specifically makes it unlawful for an investment adviser to a pooled investment vehicle to make any materially false or misleading statements to investors or prospective investors. The second part of the rule, 206(4)-8(a)(2), is purposefully broader in prohibiting "other frauds."

All investment advisers to pooled investment vehicles, regardless of whether or not they are registered with the SEC, are subject to enforcement of the new rule. Rule 206(4)-8 covers investment advisers with respect to any "pooled investment vehicle" they advise. A pooled investment vehicle is defined as "any investment company defined in section 3(a) of

161. Id. at 44,756–57.
162. Id. at 44,757 (citing Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006)).
163. See id. at 44,756–57.
164. See id. at 44,757.
168. Id. at 401.
170. Id. at 44,758.
171. Id. at 44,759.
172. See id.
173. Id.
the Investment Company Act and any privately offered pooled investment vehicle that is excluded from the definition of investment company by reason of either section 3(c)(1) or 3(c)(7) of the Investment Company Act.\textsuperscript{174} This definition results in the rule’s applicability to “advisers to hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities, as well as advisers to investment companies that are registered with [the Commission].”\textsuperscript{175}

a. Prohibition of False or Misleading Statements

Under the first part of New Antifraud Rule, it would constitute a “fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4)” if any investment adviser to a pooled investment vehicle were to make

any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle.\textsuperscript{176}

The new rule prevents advisers from making false or misleading statements to investors and prospective investors regardless of the context in which those statements are made. This aspect of the rule differs from rule 10b-5 under the Exchange Act, which is applicable only when the fraud is committed in connection with the offering, selling, or redeeming of securities.\textsuperscript{177} The Commission provided some examples of what is prohibited under this part of the rule:

materially false or misleading statements regarding investment strategies the pooled investment vehicle will pursue, the experience and credentials of the adviser (or its associated persons), the risks associated with an investment in the pool, the performance of the pool or other funds advised by the adviser, the valuation of the pool or investor accounts in it, and practices the adviser follows in the operation of its advisory business such as how the adviser allocates investment opportunities.\textsuperscript{178}

This part of the New Antifraud Rule is modeled after sections 206(1) and 206(2) of the Advisers Act, which make it unlawful for advisers to commit fraud upon clients or prospective clients.\textsuperscript{179} Accordingly, the rule applies to

\textsuperscript{174} Id. Under section 3(c)(1) of the Investment Company Act, issuers of securities (other than short-term paper) of which are beneficially owned by not more than 100 persons and that is not making or proposing to make a public offering of its securities, are exempt from regulation. Id. at 44,758 n.21. Section 3(c)(7) of the Act “excludes from the definition of investment company an issuer the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are ‘qualified purchasers’ and that is not making or proposing to make a public offering of its securities.” Id.

\textsuperscript{175} Id. at 44,758.


\textsuperscript{177} Proposal Release: Antifraud Rule, supra note 165, at 402.

\textsuperscript{178} SEC Release: Antifraud Rule, supra note 38, at 44,759.

\textsuperscript{179} Id.
communications not only with current investors in the fund, but also to prospective investors. Therefore, the rule covers, for example, false or misleading statements to prospective investors in “private placement memoranda, offering circulars, or responses to ‘requests for proposals,’ electronic solicitations, and personal meetings arranged through capital introduction services.”

b. Prohibition of Other Frauds

The second part of rule 206(4)-8 is purposefully broad in order to prohibit deceptive conduct that may not involve statements. The rule makes it “a fraudulent, deceptive, or manipulative act, practice, or course of business” for an investment adviser to “[o]therwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.”

In enforcing the rule, the SEC is not required to demonstrate that an adviser has violated rule 206(4)-8 deliberately. Therefore, the rule covers negligent conduct, as well as reckless or deliberately deceptive conduct. The rule does not give rise to a private cause of action, so investors are not able to use it to sue a manager, but the Commission will enforce it through civil and administrative enforcement actions.

D. The Role of Government and Alternatives to SEC Enforcement

The continued growth of the hedge fund industry has attracted increased attention and questioning as to whether there should be greater legal or regulatory protections for investors in hedge funds. "Debate continues among civil regulatory agencies and in Congress as to what, if anything, should be done to regulate the industry to control potential fraud and abuse." Critics of regulation of the hedge fund industry argue that overregulation could stifle the liquidity hedge funds bring to the securities market. Others argue that hedge funds will move offshore to avoid the
This section discusses alternatives to SEC regulation in response to increasing interest and concern over the growth of the hedge fund industry. Part I.D.1 analyzes the response of the President’s Working Group on Financial Markets (PWG) and summarizes its February 2007 release of Principles and Guidelines for Private Pools of Capital. Part I.D.2 reviews the best practices for hedge fund participants that were written by two industry groups established by the PWG and released in April 2008. Part I.D.3 discusses recommendations promulgated by the Managed Funds Association (MFA) in response to the PWG’s February release. Finally, Part I.D.4 explores the role of Self-Regulatory Organizations (SROs) in the U.S. securities industry.

1. PWG Principles and Guidelines

The PWG is chaired by the Secretary of the Treasury and comprised of the chairs of the Federal Reserve Board, the SEC, and the Commodity Futures Trading Commission (CFTC). The PWG was created by President Ronald Reagan’s executive order issued “on March 18, 1988 in order to [enhance] the integrity, efficiency, orderliness, and competitiveness of our Nation’s financial markets and [maintain] investor confidence.”

On February 22, 2007, the PWG released its Principles and Guidelines Regarding Private Pools of Capital (PWG Principles). The PWG Principles were intended to “guide U.S. financial regulators as they address public policy issues associated with the rapid growth of private pools of capital, including hedge funds,” while trying to preserve the benefits provided by these funds. The principles provide a framework for

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addressing two key goals: "mitigating the potential for systemic risk in financial markets and protecting investors."\(^{194}\) The underlying philosophy of the PWG Principles is "to encourage and improve transparency and disclosure by pools and managers to counterparties, creditors, fiduciaries and investors" while recognizing that "this transparency, disclosure and supervisory vigilance should not discourage innovation."\(^{195}\) These broad principles are comprehensive but flexible in order "to endure as financial markets continue to evolve" while providing a clear "principles-based approach to address the issues presented by the growth and dynamism of these investment vehicles."\(^{196}\)

The preamble to the PWG Principles highlights, as the PWG noted in 1999, that "'[i]n our market-based economy, market discipline of risk-taking is the rule and government regulation is the exception.'"\(^{197}\) The report emphasizes as one of its "overarching principles" that "'[p]rivate pools of capital bring significant benefits to the financial markets," but recognizes that they also "present challenges for market participants and policymakers."\(^{198}\) The principles state that "'[p]ublic policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk,"\(^{199}\) They further provide that investor protection concerns are most effectively addressed "through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors."\(^{200}\)

The principles address private pools of capital and suggest that they "maintain and enhance information, valuation, and risk management systems to provide market participants with accurate, sufficient, and timely information."\(^{201}\) Investors are encouraged to "consider the suitability of investments in a private pool in light of investment objectives, risk tolerances, and the principle of portfolio diversification."\(^{202}\) In addition, the PWG calls on regulators and supervisors to "work together to communicate and use authority to ensure that supervisory expectations regarding counterparty risk management practices and market integrity are met."\(^{203}\)

The PWG Principles accept and address the risk involved with investment in these private pools of capital. Although many of the strategies and vehicles used by these private pools of capital "are by their


\(^{195}\) Id.

\(^{196}\) PWG Release, supra note 193.

\(^{197}\) PWG PRINCIPLES AND GUIDELINES, supra note 192, at 1 (quoting LESSONS OF LTCM, supra note 43, at 26).

\(^{198}\) Id.

\(^{199}\) PWG Release, supra note 193.

\(^{200}\) PWG PRINCIPLES AND GUIDELINES, supra note 192, at 1.

\(^{201}\) PWG Release, supra note 193.

\(^{202}\) Id.

\(^{203}\) Id.
very nature potentially more opaque, illiquid, and complex than other products," the option to invest in them is offered "only to certain approved investors." Therefore, when Under Secretary for Domestic Finance Robert K. Steel discussed the PWG Principles, he stressed that investors should "understand their investments and the corresponding risks and should not expose themselves to intolerable risk levels." He also addressed the "possibility of a retiree having his or her pension reduced or eliminated as a result of losses from a poorly performing hedge fund investment." Steel admonished that managers should "disclose risks to investors" and that "investors [should] assess and understand the risks associated with their investments." He also underscored that "[a]ll investment fiduciaries have a duty to perform due diligence to ensure that their investment decisions on behalf of their beneficiaries and clients are prudent and conform to established sound practices consistent with their responsibilities."

2. PWG Principles and Best Practices

In September 2007, the PWG established two “blue-ribbon private-sector committees” to build upon the PWG Principles by collaborating on industry issues and developing best practices for hedge fund investors and asset managers. In June 2007, U.S. Secretary of Treasury Henry Paulson announced the PWG’s plan to “call upon experienced industry participants who could lead the charge to raise standards for improving transparency and accountability.” Thereafter, the PWG selected Eric Mindich, CEO of Eton Park Capital Management, as chairman of the Asset Managers’ Committee, and Russell Read, Chief Investment Officer of the California Public Employees’ Retirement System, to chair the Investors’ Committee. The Asset Managers’ Committee (AMC) is comprised of “representatives from a diverse group of hedge fund managers representing many different investment strategies” and is “charged with developing best practices specifically for managers of hedge funds.” The Investors’ Committee is comprised of “senior representatives from major classes of institutional investors including public and private pension funds, foundations, endowments, organized labor, non-U.S. institutions, funds of hedge funds, and the consulting community” and is “charged with developing best practices specifically for those making hedge fund

204. Steel on Private Pools of Capital, supra note 194.
205. Id.
206. Id.
207. Id.
208. Id.
210. Id.
211. Id.
212. Id.; see also PWG BEST PRACTICES—INVESTORS, supra note 191, at 4.
investments.” The April 2008 press release about the resulting “separate yet complimentary sets of best practices” heralded this to be “the most comprehensive public-private effort to increase accountability for participants in this industry.”

Consistent with the PWG Principles, the Best Practices for Hedge Fund Investors (Best Practices for Investors) cautions that investment in hedge funds is only suitable for “sophisticated and prudent investors who are able to identify, analyze and bear the associated risks, and follow appropriate practices to evaluate, select, monitor, and exit these investments.” The stated goal of the report, which is comprised of a “Fiduciary’s Guide” and an “Investor’s Guide,” is “to define a set of practice standards and guidelines for fiduciaries and investors considering or already investing in hedge funds on behalf of qualified individuals and institutions.”

The Fiduciary’s Guide, which is aimed at those with portfolio oversight responsibilities, “provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio.” Fiduciaries are directed to “exercise proper care in assessing whether a hedge fund program is appropriate and whether they employ or can engage investment professionals with sufficient skill and resources to initiate, monitor, and manage such a program successfully.”

The Fiduciary’s Guide then discusses hedge funds and outlines important characteristics and issues that should be considered by a fiduciary when deciding what percentage of a fiduciary’s total portfolio should be allocated to hedge funds. It then discusses minimum requirements for developing “policies that define the key features and objectives of the hedge fund investment program” and includes a list of questions that should be addressed. The final issue addressed under the Fiduciary’s Guide is the

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213. PWG Best Practices—Investors, supra note 191, at 4. The Investors’ Committee plans to “meet semiannually and issue clarifications and additions when appropriate.” Id.

214. PWG Best Practices Release, supra note 209 (“The recommendations complement each other by encouraging both types of market participants to hold the other more accountable.”).


216. Id. at 2. The Investors’ Committee is clear to point out that each individual or institution considering or managing hedge fund allocations is different and therefore, each much evaluate the best practices, “determine which apply, and implement the recommendations that are reasonable given the resources available to the investor, its objectives and risk tolerance, and the particular investments under consideration.” Id. at 3.

217. Id. at 1.

218. Id. at 6. In order to assess the appropriateness of a hedge fund program, the Investors Committee instructs a prudent fiduciary to address questions on the following issues: “Temperament”; “Manager Selection”; “Portfolio Level Dynamics”; “Liquidity Match”; “Conflicts of Interest”; “Fees”; and “Citizenship.” Id. at 6–7.

219. Id. at 8–9. Some of the important features discussed include the typical fee structure of hedge fund managers, whether hedge funds are newly formed, the experience or sophistication of hedge fund managers. Id. at 9–12.

220. Id. at 12. The list of questions includes the following: “What is the strategic purpose of investing in hedge funds?” “What role will hedge funds play in the total investment portfolio?” “Is the hedge fund program consistent with the applicable investment beliefs, objectives, and risk profile of the investment program?” “What are the performance
due diligence process, which is "the set of procedures used to gather information about a particular investment for the purpose of deciding whether the investment opportunity is appropriate." 221 A fiduciary is instructed to "review the history of the investment management firm and its professionals, the firm’s past and current portfolios, its investment philosophy, its decision processes for implementing the investment strategy, its organizational culture, and its internal economic incentives" in order to understand how a hedge fund may perform in different future scenarios. In addition, "the due diligence process should also include an evaluation of the business infrastructure, investment operations, and controls in place to support the hedge fund’s investment strategy." 222 Finally, it is important that a fiduciary continually monitor a manager and a hedge fund investment because, "[w]hile the initial due diligence serves to qualify a hedge fund as a desirable investment, the ongoing monitoring process continually reaffirms that the assumptions used in the initial selection remain valid." 223

The Investor’s Guide describes best practices and guidelines for investment professionals charged with "executing and administering a hedge fund program once a . . . hedge fund [has been added] to the investment portfolio." 224 This portion of the report provides recommendations that "focus on how investors can apply appropriate due diligence standards to verify that hedge fund managers are following best practices and identify independent controls and processes to further safeguard their assets." 225 These recommendations are divided into seven broad categories: "the due diligence process; risk management; legal and

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221. Id. Although due diligence is generally important for all investment activities, the committee warns that particular care should be exercised in due diligence of hedge funds, because of the complex investment strategies they employ; the fact that hedge fund organizations are frequently young and small; their use of leverage and the associated risks; the possibilities of concentrated exposure to market and counterparty risks, and the generally more lightly regulated nature of these organizations.

Id.

222. Id. at 13.

223. Id. at 14 ("Key aspects of the monitoring process should include reviewing the investment strategy and investment performance for consistency, maintaining awareness of factors that could indicate potential style drift, and confirming that there has been no material change to the business operations of the fund manager.").

224. Id. at 1. The term "investor" is used narrowly in the Investor’s Guide "to refer to the internal and external personnel who are responsible for actually implementing and executing these programs." Id. at 16.

225. Id. at 16. Where appropriate, the committee “specified certain procedures or approaches that [it] believe[s] would add significant transparency and increase investors’ ability to understand and evaluate funds’ risks and returns." Id.
regulatory considerations; valuation; fees and expenses; reporting; and taxation.”  

The due diligence process for investors begins prior to making an investment and is continued while the investment is held. When deciding whether to invest in a hedge fund, investors often use due diligence questionnaires to gather information about managers, conduct meetings with fund managers, and interview a fund’s current investors and business counterparties. The committee recommends that “[i]nvestors should check references, research the hedge fund’s key service providers, verify factual information using independent sources, and follow-up with the fund’s personnel if the investors have trouble locating data or discover information that poses concerns.” Moreover, investors should “evaluate the reputation, credit rating, regulatory history, and background of the individuals and entities who will be involved in the management and administration of the hedge fund’s investments.” After the investment is made, its long-term success requires “[o]ngoing monitoring of all the hedge funds in a portfolio, and the management of those funds.”

The next section of the Investor’s Guide addresses risk management through suggesting “best practices for establishing the investor’s own risk management framework and best practices for evaluating the risk management framework employed by a hedge fund manager.” This is important because “[e]ffective risk management practices help investors protect their assets, manage their expectations in selecting hedge funds, mitigate exposure to unanticipated risks, and support informed, disciplined investment decisions.” This section discusses various categories of risk that are important for a hedge fund investment program to address, such as “investment risk, liquidity and leverage, market risk, operational risk, business continuity, and conflicts of interest.” Best practices are suggested in order to monitor and manage each of these risks.

The Legal and Regulatory section of the Investor’s Guide surveys the laws applicable to hedge funds and what investors should be aware of,
including, but not limited to, confirmation that the fund complies with these laws, confirmation of jurisdiction over the fund, and the elements relating to a hedge fund's governing documents that "describe the legal and business terms of an investment in that fund."\textsuperscript{235} The Investor's Guide also discusses what an investor should consider with regard to valuation, which "is the key to deciding whether to make an investment and to calculate returns from that investment over time."\textsuperscript{236} Guidance is provided on what a valuation policy should include, how valuation is governed, and on different valuation methodologies and controls.\textsuperscript{237} The report also provides guidance on the fees and expenses of hedge fund managers, the quality of reports and fund transparency, and taxation.\textsuperscript{238} The Investor's Guide concludes by reinforcing that "hedge funds require in depth and continuous oversight by their investors," and that it is the investor's responsibility "to understand the essential risk and reward prospects of each hedge fund investment."\textsuperscript{239}

The Best Practices for the Hedge Fund Industry (Hedge Fund Industry Report) recommends "innovative and far-reaching practices that exceed existing industry-wide standards" that seek to increase accountability for hedge fund managers and "[c]alls on hedge funds to adopt comprehensive best practices in all aspects of their business including the critical areas of disclosure, valuation of assets, risk management, business operations, and compliance and conflicts of interest."\textsuperscript{240} The AMC states their belief that these recommendations raise "the bar for the industry by providing strong and clear guidance to managers for strengthening their practices in ways that investors demand and the markets require," but also provide "managers with appropriate flexibility to continue to innovate and grow."\textsuperscript{241}

The Hedge Fund Industry Report focuses on five key areas that "would most effectively promote investor protection and reduce systematic risk," including disclosure, valuation, risk management, trading and business operations and compliance, conflicts, and business practices.\textsuperscript{242} The first

\begin{itemize}
  \item \textsuperscript{235} Id. at 39; see also id. at 37–43.
  \item \textsuperscript{236} Id. at 43.
  \item \textsuperscript{237} See id. at 43–48.
  \item \textsuperscript{238} See id. at 49–57.
  \item \textsuperscript{239} Id. at 57.
  \item \textsuperscript{241} Id.
  \item \textsuperscript{242} Id. The report establishes a framework for each of the five issues that 1) states the goal and essential elements of the framework; 2) outlines clear and consistently applied policies and procedures that provide a structure to help ensure better educated investors and better managed hedge funds implement the framework; 3) incorporates a regular process for reviewing and updating the
\end{itemize}
issue addressed by the report is disclosure, which "sets forth basic elements of disclosure that managers should make available to all investors."243 Disclosure is particularly important because "[i]nvestors need material information to assess whether to invest in a fund or redeem an investment, as well as to monitor their exposure to their ongoing investment."244 The AMC looked at the disclosure requirements for U.S. public companies and sought to use elements of this regime in adopting best practices for the hedge fund industry. Necessary information "includes the provision of a private placement memorandum, annual audited financial statements, periodic performance information and other investor communications, as well as timely disclosure of significant events in light of the circumstances."245 Furthermore, the report recommends that hedge funds "produce independently audited, [Generally Accepted Accounting Principles (GAAP)]-complaint financial statements."246 Disclosure to counterparties, such as banks and broker-dealers, is also addressed in addition to disclosure to investors.247

The Hedge Fund Industry Report then addresses valuation and "recommends that managers adopt a valuation framework that provides for consistent and documented policies and appropriate controls for segregation of responsibilities between portfolio managers and those responsible for valuations."248 As previously discussed, valuation of investments is of critical importance to investors. The report discusses several valuation considerations that are unique to hedge fund investments and "recommends establishing clear practices for effective control and segregation systems."249 With regard to risk management, the AMC recommends that "managers adopt a comprehensive framework to measure, monitor, and manage risk consistently with the intended risk profile."250 After a risk

framework; and 4) requires adequate resources and knowledgeable personnel to support the framework.

Id. at iv.
243. Id. at iv.
244. Id.
245. Id. at v. The "manner and frequency with which these disclosures will be made" should be determined by managers and clearly communicated to investors. Id.
246. Id. ("Public companies produce independently audited, GAAP-compliant financial statements. Because hedge fund investors share the need for accurate, independently verified financial information, we recommend that all hedge funds do (or continue to do) the same."). It is further recommended that managers "provide periodic performance information to investors and provide an investor letter or similar communication and risk report on at least a quarterly basis." Id.
247. Id. at v–vi.
248. Id. at vi.
249. Id. The framework provided "establishes a governance mechanism, such as a valuation committee, which [would] have ultimate responsibility for establishing and monitoring compliance with the manager's valuation policies." Id.
250. Id. at viii ("The common elements of the framework should be that managers identify risks to the portfolio, measure the principal categories of risk (such as liquidity risk, leverage, market risk, counterparty credit risk and operational risk), adopt policies and procedures that establish monitoring and measurement criteria, maintain a regular and
profile is established, managers should develop a "process to measure, monitor and manage risk in order to achieve that intended risk profile."\(^{251}\)

Although the report "recommends that managers regularly disclose risk information," the AMC recognizes "that confidentiality remains important to the manager’s business, so it is not expected that investors will be provided with all information used to monitor risk."\(^{252}\)

Additionally, the report discusses how managers must continuously assess the effectiveness of their operational and internal control, which includes "processes for documenting relationships with counterparties, establishing appropriate infrastructure to accommodate the types of investments traded by the fund and adequately managing and accounting for the fund’s internal operations."\(^{253}\) The last issue requires "a continued commitment to the highest standards of integrity and professionalism within the industry."\(^{254}\) The report emphasizes that the managers that have already developed strong and effective practices to address the five areas discussed above "have found that implementing strong internal controls and business practices has provided a platform for stability and growth, enhanced client relationships, and enabled them to carry out investment activities more effectively and efficiently."\(^{255}\)

3. Best Practices for Hedge Funds

Over the past few years, major groups related to the hedge fund industry "have published extensive documents related to ‘best practices’ for both investors in and managers of hedge funds."\(^{256}\) The Investor’s Committee suggested that these best practices "may be useful resources for investors."\(^{257}\) One example of such a publication is 2007’s *Sound Practices for Hedge Fund Managers* (*Sound Practices*). The MFA, a leading hedge fund trade group, released *Sound Practices* in response to the PWG’s call for the hedge fund industry to adopt best practice standards.\(^{258}\) *Sound Practices* is a set of recommendations that provides hedge fund managers "with a framework of internal policies, practices, and controls from a peer-

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251. *Id.*

252. *Id.*

253. *Id.* at ix.

254. *Id.*

255. *Id.* at x-xi.

256. PWG BEST PRACTICES—INVESTORS, supra note 191, at 16. Some of the groups listed in the Investor’s Guide include the Managed Funds Association (MFA), the Greenwich Roundtable, the Alternative Investment Management Association (AIMA), and the Chartered Financial Institute (CFA) Institute. *Id.*

257. *Id.*

258. See generally *SOUND PRACTICES*, supra note 53. The MFA has been "the unifying voice of the hedge fund industry" for over 16 years. *Id.* preface, at 1. The MFA’s mission is "to protect the interests of the industry, to educate policy makers, and to assist its Members [to] better grow and conduct their businesses." *Id.* For more information about the MFA, see Managed Funds Association, http://www.managedfunds.org (last visited Oct. 24, 2008).
to-peer perspective." 259 The MFA intends for these recommendations to enhance the ability of fund managers to "manage operations, satisfy responsibilities to investors, comply with applicable regulations, and address unexpected market events." 260

The recommendations specifically address a hedge fund manager's relationship and responsibility to investors. They suggest, among other things, that "investors should have the tools to understand and evaluate for themselves the risks associated with" investing in a hedge fund and that hedge fund managers "should provide investors with adequate information to enhance the investors' ability to understand and evaluate their investment." 261 Section 2.1 provides that a hedge fund manager has a responsibility to act in the best interest of the fund and its investors, and that they "must also act in accordance with its investment management agreement with the Hedge Fund, the offering documents of the Hedge Fund, and applicable law." 262 Section 2.2 recommends that a

[m]anager should provide prospective and existing Hedge Fund investors with information regarding the Hedge Fund's investment objectives and strategies, range of permissible investments, material risk factors, and the material terms of an investment in the Hedge Fund. This information should be sufficient to enhance the ability of investors to understand and evaluate their investment in the Hedge Fund. 263

The MFA also provides a "Model Due Diligence Questionnaire for Hedge Fund Investors," which was "designed to identify the kinds of questions that a potential investor may wish to consider before investing in a hedge fund." 264 It "addresses risks to potential investors such as hedge funds' incentive compensation structure, their use of leverage and margins and the valuation of assets, including illiquid investments." 265 This questionnaire can assist prospective and existing investors in hedge funds in asking hedge fund managers valuable questions regarding the terms of an investment, as well as in learning about the management and investment practices of the hedge fund manager. 266 Providing an investor with "[i]nformative disclosure regarding the material terms of an investment in a Hedge Fund (e.g., applicable charges, expenses, withdrawal or redemption rights and restrictions, reporting, use of 'side pockets', etc.) and the Hedge Fund's investment objectives and strategies enhance[s] the ability of investors to form proper expectations as to the Hedge Fund's

259. SOUND PRACTICES, supra note 53, intro., at 1.
260. Id. intro., at 5.
261. Id. § 2, at 1.
262. Id. § 2.1, at 2.
263. Id. § 2.2, at 2.
264. Id. app. II.
266. Id.
Since investors should be able to understand and evaluate their investment, managers "should attempt to prepare appropriate disclosures for dissemination to Hedge Fund investors on a timely basis, without compromising proprietary information regarding the Hedge Fund's trading positions."\textsuperscript{268}

Section 2.4 advises that a manager identify and adequately describe risks to be disclosed to hedge fund investors.\textsuperscript{269} A manager should also "periodically provide investors with relevant performance data and, when appropriate, risk information regarding the strategy and terms of the Hedge Fund."\textsuperscript{270} The manager "should engage qualified independent auditors to audit the annual financial statements of any Hedge Fund with investors not affiliated with the Hedge Fund Manager."\textsuperscript{271} A manager should develop valuation policies and procedures, recognizing that investors "may both subscribe to and redeem interests in a Hedge Fund in reliance on the values derived from such policies and procedures."\textsuperscript{272}

4. Statutory Self-Regulatory Organizations

One of the key components in the SEC's regulation of the U.S. securities markets is self-regulation.\textsuperscript{273} Prior to the enactment of the federal securities laws, the securities industry had already established an unofficial system of self-regulation.\textsuperscript{274} In 1792, the historic Buttonwood Agreement formed the New York Stock Exchange (NYSE), the first organized stock market.\textsuperscript{275} As stock exchanges developed, trading conventions became formalized as exchange rules.\textsuperscript{276}

Following the Great Depression and the stock market crash of 1929, Congress promulgated a collection of acts known as the federal securities laws.\textsuperscript{277} In section 6 of the Exchange Act, "Congress recognized the regulatory role of exchanges, and required all existing securities exchanges,
including the NYSE, to register with the Commission and to function as self-regulatory organizations." The Exchange Act called for a "cooperative regulatory effort by the SEC and industry-sponsored groups (SROs)."

In 1938, the securities industry and the SEC joined forces to convince Congress to amend the Exchange Act. The Maloney Act, which was adopted in 1938, "amended the Exchange Act by adding a new Section 15A and establishing the concept of registered national securities association SROs." The task of these "national securities association[s]" is to "prevent fraudulent and manipulative acts and to promote just and equitable trade practices among over-the-counter broker-dealers." Currently, the National Association of Securities Dealers (NASD) and the National Futures Association (NFA) are the only registered national securities associations. The NASD was registered in 1938 as the first national

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280. COX ET AL., supra note 277, at 16. Over-the-counter (OTC) securities are securities that are not registered with a stock exchange. Smythe, supra note 279, at 483. The stock market crash of 1929 severely damaged the public reputation of OTC securities dealers. "In 1933, in an effort to improve their collective image, OTC dealers formed the Investment Bankers Code Committee ('IBCC'), which promulgated industry best practices." Concept Release, supra note 273, at 71,257. After observing the efforts of such groups, "the Commission and leaders of the investment banking community generally agreed that an industry association needed official legal status in order to effectively carry out the task of self-regulating the OTC market." Id.

281. Concept Release, supra note 273, at 71,257; see The Maloney Act, Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o). The Maloney Act authorized the SEC "to register national securities associations." Concept Release, supra note 273, at 71,256 n.4. Under the original Exchange Act, OTC brokers and dealers were directly regulated by the SEC. However, after the Act was passed it became apparent that it would be too burdensome for the SEC to directly regulate this OTC market. Smythe, supra note 279, at 483–84.

282. COX ET AL., supra note 277, at 16. "[T]here are four types of [self-regulatory organizations (SROs)] embraced by the Exchange Act: the national securities exchanges, the national securities association, registered clearing agencies, and the Municipal Securities Rulemaking Board (MSRB)." Id. The two most important SROs are the exchanges and the National Association of Securities Dealers (NASD). Id. "A 'national securities exchange' is a securities exchange that has registered with the SEC under Section 6 of the Securities Exchange Act of 1934." U.S. Securities and Exchange Commission, Exchanges, http://www.sec.gov/divisions/marketreg/mrexchanges.shtml (last visited Oct. 24, 2008). There are currently ten securities exchanges registered as national securities exchanges with the SEC. Id. The ten registered national securities exchanges are: American Stock Exchange; Boston Stock Exchange; Chicago Board Options Exchange; Chicago Stock Exchange; International Securities Exchange; Nasdaq Stock Market LLC; National Stock Exchange (formerly the Cincinnati Stock Exchange); New York Stock Exchange; NYSE Arca, Inc. (formerly the Pacific Exchange); and Philadelphia Stock Exchange. Id.

283. Concept Release, supra note 273, at 71,257. The NASD was the only registered national securities association until recently. The NFA was "registered for the limited purpose of regulating the activities of members who are registered as brokers or dealers in security futures products under Section 15(b)(11) of the Exchange Act." Id. at 71,257 n.26.
securities association under section 15A of the Exchange Act.²⁸⁴ The NASD is the largest of all SROs.²⁸⁵ It has a broad scope of responsibility that "includes overseeing the operation of the over-the-counter market and establishing and enforcing rules for its efficient and fair operation."²⁸⁶ Brokers or dealers are required to register with the SEC under section 15(a)(1) if they offer, sell, or purchase securities.²⁸⁷ Pursuant to sections 15(b)(8) and (9), it is "unlawful for any registered broker or dealer who is not a member of a national securities association to make any security transaction unless those transactions occur solely on an exchange in which he is a member."²⁸⁸

The Exchange Act has always provided the SEC with a certain degree of oversight of SRO activity.²⁸⁹ The objective is to have the SEC act as both the regulator and supervisor of the self-regulation carried out by the SROs.²⁹⁰ Concurrently, the SROs act as regulators, having rulemaking and disciplinary powers over their members.²⁹¹ The Exchange Act’s vehicle for providing the SEC with power over each type of SRO rests heavily upon the requirement that each SRO must register with the SEC.²⁹² Before any SRO is eligible to register with the SEC, it must satisfy certain minimum requirements.²⁹³ These requirements include:

1. The SRO must not be a burden on commerce and must accept as members all persons satisfying its requirements.

2. The SRO’s governance procedures must ensure fair representation for its members (one or more of its directors must, however, be a representative of issuers or investors).

3. The SRO must have rules designed to prevent fraudulent and manipulative practices.

4. The SRO must enforce the Exchange Act provisions as well as its own rules.

5. Disciplinary procedures must be fair and assure minimum due process and entail appropriate sanctions.

²⁸⁴ COX ET AL., supra note 277, at 16.
²⁸⁵ Id.
²⁸⁶ Id.
²⁸⁷ Id.
²⁸⁹ COX ET AL., supra note 277, at 1022. The potential conflicts of interest raised by allowing for this type of self-regulation led Congress to provide the SEC a degree of oversight of SRO activity.
²⁹⁰ Id. at 1021.
²⁹¹ Id. at 1022. Each SRO has rules that govern conduct by members in order to protect investors, securities markets, and the trading markets operated by the SRO in question. Id.
²⁹² Id. at 1021–22.
²⁹³ Id. at 1022.
6. The SRO must have the capacity to fulfill its operational role under the Exchange Act as well as be able to enforce compliance with the Act and the SRO's rules by its members.\footnote{294}{Id.}

In 1975, Congress clarified and strengthened the SEC's regulatory role through amendments to the Exchange Act.\footnote{295}{Id.} One example of the additional oversight provided by the amendments is found under sections 19(b) and (c), which prescribe that the SEC must approve any rule change proposed by the SRO, and may, on its own motion, "abrogate, add to, and delete from" the SRO's rules.\footnote{296}{Id.} In addition, the Commission is authorized to review disciplinary actions taken by SROs against their members and to require exchanges and associations to keep records and to file reports with the Commission.\footnote{297}{Id.}

There is a moral hazard with self-regulation "when an organization both serves the commercial interests of and regulates its members or users."\footnote{298}{Id.} There are also inherent limitations in allowing an industry to regulate itself, such as

"the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a façade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anticompetitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation."\footnote{299}{Id.}

Despite the potential problems caused by conflicts of interest, the practical advantages of self-regulation have been viewed as outweighing the potential dysfunctions.\footnote{300}{Id.} In enacting these provisions, "Congress concluded that self-regulation of both the exchange markets and the OTC [over-the-counter] market was a mutually beneficial balance between government and securities industry interests."\footnote{301}{Id.} One of the most important mutual benefits of self-regulation is that it enables the securities industry to be supervised by an organization that is "familiar with the nuances of securities industry operations."\footnote{302}{Id.} Industry participants' expertise and intimate knowledge of the complex securities industry enhances their ability...
to respond quickly to regulatory problems. Self-regulation is preferred by industry participants as being less invasive regulation by their peers, as opposed to direct government regulation; and the government "benefit[s] by being able to leverage its resources through its oversight of self-regulatory organizations." In addition, due to the complexities of securities trading practices, it is desirable that SROs be intimately involved in setting and enforcing proscriptive standards. Another benefit of SROs is that regulation is funded by members of the industry or profession affected, rather than by the general public through taxation.

II. RESPONSE TO THE NEW ANTIFRAUD RULE

The SEC originally proposed rule 206(4)-8 in December 2006. The Commission received forty-five comment letters in response to the antifraud portion of the proposal. Despite a range of concerns raised over the effectiveness and sustainability of the proposed rule, the Commission adopted the rule in its original form. Part II.A discusses the two most frequently raised contentions with the rule. Part II.B then summarizes the support offered for the rule and tracks the Commission’s response to the issues raised in Part II.A. Finally, Part II.C sets forth alternative means for protecting investors in hedge funds from fraud.

A. Challenges to the New Rule

This section summarizes some of the arguments articulated in the comment letters in response to the proposal for the New Antifraud Rule, dubbed the Proposal Release. Part II.A.1 explores the argument that the "broad authority" granted to the Commission under section 206(4) is not sufficient to support the promulgation of rule 206(4)-8. Part II.A.2 discusses Commissioner Paul S. Atkins’s arguments regarding the rule, along with the disagreement expressed by others in comment letters with regard to the lack of a scienter requirement.


304. Concept Release, supra note 273, at 71,257. In enacting the Maloney Act in 1938, Congress stated that an approach to securities regulation relying solely on government regulation “would involve a pronounced expansion of the organization of the [SEC]; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase in the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by law.” Id. (citation omitted).

305. Id.

306. See generally Smythe, supra note 279.


309. Id.
1. Breadth of the Commission's Authority

Many of the comment letters argued that the promulgation of the proposed rule does not fall within the "broad authority" granted to the Commission by section 206(4).\(^{310}\) Some of the letters look to congressional intent in promulgating section 206(4) and to other rules that the SEC has created under this authority to support the argument that the language of the New Antifraud Rule is overly broad and lacks sufficient specificity or guidance, and therefore falls outside the statutorily defined authority granted to it by Congress. The authors of these comment letters express concern that the rule's overbroad language and lack of guidance may interfere with the new rule's applicability in the event of an enforcement action.

One of the arguments raised with respect to the scope of the New Antifraud Rule submits that Congress did not intend for the Commission to make such broad rules under section 206(4). In adopting section 206(4), Congress stated that,

> because of the general language of the statutory antifraud provision and the absence of any express rulemaking power in connection with them, it is not clear what fraudulent or deceptive activities are prohibited by this act and as to how far the Commission is limited in this area by common-law concepts of fraud and deceit.\(^{311}\)

The comment letter submitted by the Investment Company Institute argued that this language indicates legislative intent to "prohibit advisers from engaging in fraudulent activities in a way that was not limited by common law concepts of fraud," and to permit the Commission to make rules "that either define a particular practice as unlawful unless specific requirements are met or require advisers to implement procedures to protect against committing fraud."\(^{312}\) In particular, emphasis was placed on Congress's use of the word "define" as indicating that their intention was to grant the Commission power to enact only specific rules that "provide advisers with concrete guidance as to what constitutes fraudulent, deceptive, and manipulative behavior."\(^{313}\)

\(^{310}\) Id. at 44,757.


\(^{313}\) Comment Letter from Keith F. Higgins, Chair, Comm. on Fed. Regulation of Sec., Am. Bar Ass'n, to Nancy M. Morris, Sec'y, U.S. Sec. & Exch. Comm'n 2 (Mar. 12, 2007) [hereinafter ABA Letter], available at http://www.sec.gov/comments/s7-25-06/s72506-584.pdf; see also Sullivan & Cromwell Letter, supra note 311, at 2 ("Congress contemplated, therefore, that the Commission's rulemaking authority would be used to articulate and deal adequately with specific fraudulent activities, e.g., 'such problems as a
In support of the position that the Commission's authority is limited to creating rules that articulate and deal with "specific fraudulent activity," some of the comment letters provided examples of other provisions enacted by the Commission under section 206(4). In reviewing these rules, Sullivan & Cromwell LLP concluded that each of these other rules "either define a particular practice as unlawful unless specific requirements are met or require advisers to implement procedures to protect against fraudulent activity." Similarly, the American Bar Association (ABA) suggested that in all of these rules, the Commission defined and prescribed the prohibited conduct with the specificity required to provide advisers "with notice of prohibited conduct and to allow them to conform their practices accordingly."

Sullivan & Cromwell continued its analysis of the scope of the rule by focusing on the second part of rule 206(4)-8, suggesting that the Commission did not adequately demonstrate its authority to adopt this provision. It contended that the broadly phrased second provision "provides no detail as to what constitutes fraudulent, deceptive or manipulative conduct." In addition, the letter drew attention to the fact that the release failed to provide "any examples of the conduct it seeks to address" under this part of the rule. Therefore, the firm suggested that this provision might cause the rule to be successfully challenged.

The lack of clarity with regard to what type of conduct the New Antifraud Rule seeks to regulate led to concern over how it would be applied by the Commission and its staff. In its comment letter, Schulte

cited...
Roth & Zabel LLP claimed that the lack of clarity “may lead to Staff interpretations that do not have the benefit of the formal rule-making process.”

This may result in informal rulemaking that “sometimes leads to inconsistent interpretations from different regional offices” and does not provide sufficient notice to advisers as to what practices are prohibited by the rule. The firm suggested that this lack of clarity could “chill communications between advisers, their clients, and the Commission.”

2. Lack of a Scintor Requirement

The most consistently raised contention with the New Antifraud Rule was the lack of a scintor requirement. The comment letters suggested that a culpable mental state, for example, intent or recklessness, should be required for section 206(4) liability. The absence of a scintor requirement was also addressed by Commissioner Atkins.

Commissioner Atkins wrote a separate concurring opinion to the SEC’s adoption of the New Antifraud Rule—dubbed the Adopting Release—to express his disagreement with the Commission’s conclusion that scintor is not a required element for violation of the rule. Commissioner Atkins presented two main objections: First, “that a negligence standard is [not] consistent with the Commission’s authority under Section 206(4).” Commissioner Atkins first addressed the SEC’s argument that “the language of section 206(4) is not limited to knowing or deliberate conduct” because it prohibits “deceptive” conduct. The SEC asserted that because section 206(4) encompasses “deceptive” conduct, it includes “conduct that is negligently deceptive as well as conduct that is recklessly or deliberately deceptive.” However, Commissioner Atkins contested this conclusion, claiming it was inappropriate because it was “reached by looking at the term ‘deceptive’ apart from its companion terms,” and the U.S. Supreme Court has said “it is a ‘familiar principle of statutory construction that words grouped in a list should be given related meaning.’” Atkins instead focused on the inclusion of the word “manipulative” in section 206(4) in arguing that the rule should have a scintor requirement. He looked to the Supreme Court’s decision in Ernst &

322. Schulte Letter, supra note 315, at 3.
323. Id.
324. Id. at 2.
326. Id. at 44,762.
327. Id.
328. Id.
329. Id.
330. Id.
331. Id. (quoting Schreiber v. Burlington N., Inc., 472 U.S. 1, 8 (1985)).
332. Id.
Ernst v. Hochfelder for support of this argument. In its review of section 10(b) of the Exchange Act, the Hochfelder court found that

use of the word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.

Based on this interpretation, Commissioner Atkins concluded that, similar to the language of section 10(b), the language of section 206(4) "would seem then to suggest a scienter requirement."

Despite Commissioner Atkins's conclusion that the language of section 206(4) suggested a scienter requirement, the Commission cited the decision of SEC v. Steadman to support of its decision not to include such a requirement. In Steadman, the D.C. Circuit held that "scienter is not required under section 206(4)." In reaching this decision, the court relied on the U.S. Supreme Court's opinion in Aaron v. SEC.

In Aaron, the Supreme Court found that "the language of § 17(a) strongly suggests that Congress contemplated a scienter requirement under § 17(a)(1), but did not under § 17(a)(2) or § 17(a)(3)." The Court found that "[t]he language of § 17(a)(1), which makes it unlawful 'to employ any device, scheme, or artifice to defraud,' plainly evinces an intent on the part of Congress to proscribe only knowing or intentional misconduct." Despite the possibility that the term "defraud" is ambiguous, the Court found that "the terms 'device,' 'scheme,' and 'artifice' all connote knowing or intentional practices." For additional support for their decision, the Court noted that the term "device" was also prominent in the Court's decision in Hochfelder, where it held "that the plain meaning of § 10(b) embraces a scienter requirement."

In contrast to the Court's holding that section 17(a)(1) requires a showing of scienter, the Court found that section 17(a)(3) does not require that the misconduct be knowing or intentional:

The language of § 17(a)(3), under which it is unlawful for any person "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit," . . . quite plainly focuses

333. Id. (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)).
334. Id. (quoting Hochfelder, 425 U.S. at 199).
335. Id.
336. Id.
337. Id. (citing SEC v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992)).
338. Steadman, 967 F.2d at 647 (citing Aaron v. SEC, 446 U.S. 680 (1980)).
340. Id. at 696.
341. Id. (footnote omitted).
342. Id. "In addition, the Court in Hochfelder noted that the term 'to employ,' which appears in both § 10(b) and § 17(a)(1), is 'supportive of the view that Congress did not intend § 10b to embrace negligent conduct.' Id. at 696 n.14 (quoting Hochfelder, 425 U.S. at 199 n.20).
upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible.343

In Steadman, the court compared the language of section 206(4) to the language of sections 17(a)(1) and 17(a)(3) under the Securities Act.344 The court found that the language of 206(4) more closely resembled the language of section 17(a)(3) than it did the language of section 17(a)(1), which, as the Supreme Court found in Aaron, would require scienter.345 The court distinguished section 17(a)(3)’s use of the terms “device, scheme, or artifice,” which the “Aaron Court believed connoted so strongly a knowledge or intent requirement,”346 from the adjectives “fraudulent, deceptive, or manipulative” used in section 206(4).347 The Steadman court found that “the more neutral ‘act, practice, or course of business’ language” of section 206(4) was “similar to section 17(a)(3)’s ‘transaction, practice, or course of business’” language.348 The court concluded that, similar to section 17(a)(3), section 206(4) focused on the “effect of particular conduct . . . rather than upon the culpability of the person responsible.”349 Therefore, in accordance with the Supreme Court’s holding in Aaron, the court held that “scienter is not required under section 206(4).”350

Commissioner Atkins, along with several of those who wrote comment letters, found several points of contention with the Steadman court’s analysis and decision. One issue raised by both Atkins and the ABA was with the application of the comparison of the wording of sections 206(2) and 17(a)(3) to a comparison of the wording of sections 206(4) and 17(a)(3). In short, the ABA concluded that they “are not comparable.”351 In Aaron, the Supreme Court “placed considerable weight on the terms ‘operate’ or ‘would operate,’ neither of which appears in section 206(4).”352 According to the ABA, the absence of the “operates as” language means that it does not “focus on the effect of conduct.”353 Instead, section 206(4) “uses the affirmative word ‘is,’ which would seem to de-emphasize

343. Id. at 696–97. “This reading follows directly from Capital Gains, which attributed to a similarly worded provision in § 206(2) of the Investment Advisers Act of 1940 a meaning that does not require a ‘showing [of] deliberate dishonesty as a condition precedent to protecting investors.’” Id. at 697 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 200 (1963)).
344. Id.
345. Steadman, 967 F.2d at 641, 647.
346. Id.
347. Id.
348. See id.
349. Id. (quoting Aaron, 446 U.S. at 697).
350. Id.
351. ABA Letter, supra note 313, at 4.
353. ABA Letter, supra note 313, at 4 (“Section 206(4) prohibits conduct that ‘is fraudulent, deceptive, or manipulative’ . . . , and focuses on whether the investment adviser is culpable on the basis of engaging in conduct that is ‘fraudulent, deceptive or manipulative.’”).
The ABA also argued that "the fact that a practice or course of business ‘operates’ as a fraud is distinguishable from a practice or course of business that ‘is’ itself a fraud." Review of these differences led to the conclusion that the "conduct must be accompanied by a culpable mental state" to be "fraudulent, deceptive, or manipulative."

Commissioner Atkins also pointed out that, "while Section 17(a)(3) speaks of only ‘fraud’ and ‘deceit,’ Section 206(4) also includes [the term] ‘manipulative.’" In its comment letter, the ABA suggested that the inclusion of the term "manipulative" in section 206(4), and lack of the term in section 17(a)(3), is significant because Congress's use of the term denotes its "desire to punish conduct that is designed to deceive or defraud." In support of this argument, it pointed to several occasions on which the Supreme Court has read the term "manipulative" to indicate that the actor must act with intent or knowledge.

Commissioner Atkins also drew attention to the similarities between section 206(4) and section 14(e) under the Exchange Act. Section 206(4) "was modeled on Section 15(c)(2) under the [Exchange Act]." Section 14(e) also follows the pattern of section 15(c)(2). In addition, section 14(e), which relates to tender offers, is similar to section 206(4) in that it includes "both a proscription against ‘engag[ing] in any fraudulent, deceptive, or manipulative acts or practices,’" in addition to "a directive that the SEC ‘by rules and regulations define[] and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative.’" Due to the similarities between these two rules, Commissioner Atkins found it "useful to look at the Supreme Court’s interpretation of Section 14(e)."

He first addressed the Supreme Court’s decision in Schreiber v. Burlington Northern, Inc., in which the Court held that "the term ‘manipulative’ as used in § 14(e) requires misrepresentation or nondisclosure." The Supreme Court looked to the "textual similarity

354. Id.
355. Id. (explaining that a practice or course of business that "operates" as a fraud is much more inclusive because the practice or course of business may not necessarily itself be a fraud).
356. Id.
358. Id.
359. Id. (citing Schreiber v. Burlington N., Inc. 472 U.S. 1 (1985); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)). In Hochfelder, 425 U.S. at 199, the Supreme Court stressed that the "[u]se of the word ‘manipulative’ is especially significant."
360. SEC Release: Antifraud Rule, supra note 38, at 44,762. "Section 15(c)(2) makes it unlawful for brokers and dealers to effect transactions in or induce the purchase or sale of securities in connection with which they ‘engage[] in any fraudulent, deceptive, or manipulative act or practices, or make[] any fictitious quotation.’" Id. (alterations in original) (quoting 15 U.S.C. § 78o(c)(2) (2006)).
361. Id.
362. Id. (quoting 15 U.S.C. § 78n(e)).
363. Id.
between Section 14(e) of the Exchange Act (which requires a showing of scienter) and Section 206, and held that the term "manipulative" as used in Section 14(e) 'connotes conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.'\textsuperscript{365} The \textit{Schreiber} Court also pointed out that, despite the addition of the rulemaking authority under section 14(e), this provision does not "suggest[] any change in the meaning of 'manipulative' itself."\textsuperscript{366} Atkins then looked to \textit{United States v. O’Hagan}, another case in which the Supreme Court reviewed section 14(e).\textsuperscript{367} In dealing with rule 14e-3(a), the Court held that it "was within the SEC’s authority under Section 14(e) because Section 14(e) allows the SEC to ‘prohibit acts, not themselves fraudulent under the common law or § 10(b), if the prohibition is reasonably designed to prevent . . . acts and practices [that] are fraudulent."\textsuperscript{368} What Commissioner Atkins inferred from these cases is that "the SEC cannot effect a change in the meaning of specific statutory terms under its comparable Section 206(4) rulemaking authority."\textsuperscript{369}

Commissioner Atkins also explained his disagreement with the SEC’s contention that "use of a negligence standard is an appropriate method reasonably designed to prevent fraud."\textsuperscript{370} Although the SEC defended its adoption of a negligence standard as a means reasonably designed to prevent fraud by citing \textit{O’Hagan}, Commissioner Atkins found that the present rule "differs markedly from the rules at issue in \textit{O’Hagan} and \textit{Steadman}.”\textsuperscript{371} The rules in those cases were "narrowly targeted rules that covered clearly-defined behavior. They were designed to prohibit conduct, that, although outside of the ‘core activity prohibited’ by the statute, were designed to ‘assure the efficacy’ of the statute.”\textsuperscript{372} Unlike those rules, rule 206(4)-8(a)(2) is broadly phrased and “essentially repeats the statutory prohibition.”\textsuperscript{373} Therefore, he maintained that lowering that standard of care could not logically be the “type of ‘means reasonably designed to prevent’ within the contemplation of the regulatory mandate within Section 206(4).”\textsuperscript{374} He even suggested that lowering the standard of care is "an attempt to rewrite the statute by assigning new definitions to the words of

\textsuperscript{365} ABA Letter, supra note 313, at 4 (internal quotation marks omitted) (quoting \textit{Schreiber}, 472 U.S. at 11–12).

\textsuperscript{366} SEC Release: Antifraud Rule, supra note 38, at 44,762 (quoting \textit{Schreiber}, 474 U.S. at 11 n.11).

\textsuperscript{367} Id. As Atkins noted, in \textit{O’Hagan}, the Court “considered whether Rule 14e-3(a), which prohibits trading on undisclosed information in connection with a tender offer, exceeds the SEC’s authority under Section 14(e) given that the prohibition applies regardless of whether there is a duty to disclose.”

\textsuperscript{368} Id. at 44,763 (alterations in original) (quoting \textit{United States v. O’Hagan}, 521 U.S. 642, 672–73 (1997)) (internal quotation marks omitted).

\textsuperscript{369} Id.

\textsuperscript{370} Id.

\textsuperscript{371} Id.

\textsuperscript{372} Id. (quoting \textit{O’Hagan}, 521 U.S. at 673–74).

\textsuperscript{373} Id.

\textsuperscript{374} Id.
the statute.”\(^{375}\) This change in mental state may then be considered contrary to the statute itself, which could then interfere with the SEC’s ability to use the rule effectively.\(^{376}\)

The ABA also challenged the Commission’s authority by arguing that section 206(4) does not expand the Commission’s authority to “define” fraud.\(^{377}\) It argued that the original meaning of fraud is “not negligent conduct, but instead, conduct that has some element of scienter or deliberateness.”\(^{378}\) Therefore, although the Commission has power to prescribe rules to prevent fraud, section 206(4) does not give it authority to create the New Antifraud Rule because that would expand the concept of fraud itself beyond its original meaning.\(^{379}\)

The comment letters also looked to the scienter requirements in rule 10b-5 and other prominent securities fraud laws in support of requiring scienter for rule 206(4)-8. The Proposal Release explained that the wording of the New Antifraud Rule is similar to other antifraud laws and rules, including rule 10b-5.\(^{380}\) However, unlike the current rule, rule 10b-5 requires that the adviser act with scienter.\(^{381}\) The MFA claimed that “it is inapposite and fraught with the potential for adverse impacts to adopt wording from a different rule that requires a finding of scienter in order for a violation to have occurred, into a rule that is intended to require a finding of only simple negligence.”\(^{382}\)

One serious concern raised in the comment letters was the unintended consequences this rule might have. A rule without a scienter requirement could undercut the Commission’s desire to enhance hedge fund transparency. The ABA suggested that classifying undefined, unintentional material omissions or misstatements as fraudulent within the adviser-investor relationship would “chill” communication.\(^{383}\) Similarly, in its comment letter, Davis Polk & Wardwell LLP warned that this rule would create a high risk of reduced disclosure to, and communication with, investors because the advisers will have to worry that, “despite no intent to mislead investors or knowledge of any misstatements, they will be held to have violated Rule 206 under the Advisers Act.”\(^{384}\)

In the comment letter submitted by Dechert LLP, the firm explained that, without a scienter requirement, “the proposed rule would have the effect of

\(^{375}\) Id.

\(^{376}\) Id.

\(^{377}\) ABA Letter, supra note 313, at 3.

\(^{378}\) Id.

\(^{379}\) Id.

\(^{380}\) SEC Release: Antifraud Rule, supra note 38, at 44,759.

\(^{381}\) Id.

\(^{382}\) MFA Letter, supra note 75, at 10.

\(^{383}\) ABA Letter, supra note 313, at 3.

creating both uncertainty on the part of hedge fund advisers as well as the possibility of strict liability . . . for innocent or minor violations of the strictures of Rule 206(4)-8.”385 This possibility for liability would result in hedge fund advisers choosing to “provide more limited information to investors, which would have the effect of limiting the frequency and quality of communications between the adviser and a fund’s investors.”386 Limiting communication would have damaging effects; specifically, it would “result in diminishing an investor’s understanding of and ability to evaluate potential investments and to discourage meaningful, candid and informative discourse between fund advisers and investors.”387 Therefore, the commenters urged the Commission that, in order to avoid such adverse consequences, the rule must include a scienter requirement.

B. Support for the New Antifraud Rule

This section discusses the support offered in the comment letters for the new rule. Supporters of the rule found that efforts to clarify and strengthen existing safeguards for investors in investment adviser fraud were necessary and suggested that the proposed rule “achieve[d] a reasonable balance of providing important benefits to investors at an acceptable cost to the industry.”388 This section also tracks the SEC’s reaction to the commenters that disagreed with the adoption of the rule.

1. Breadth of the Commission’s Authority

Although the comment letters suggested that the authority granted by Congress under section 206(4) is not broad enough to withstand challenge of their authority in promulgating the new rule, the Commission adopted rule 206(4)-8 as it was originally released. The Commission acknowledged the commenters’ interpretation that its power is limited to adopting “prophylactic rules that explicitly identify conduct that would be fraudulent under the new rule.”389 It believed, however, that its authority under section 206(4) is broader than the commenters suggested. The Commission asserted that Congress expected that it would use the authority provided by section 206(4) to “promulgate general antifraud rules capable of flexibility.”390

386. Id.
387. Id.
389. SEC Release: Antifraud Rule, supra note 38, at 44,759 (citing ABA Letter, supra note 313; ICI Letter, supra note 312; Schulte Letter, supra note 315; Sullivan & Cromwell Letter, supra note 311).
390. Id. at 44,757 (quoting S. REP. NO. 86-1760, at 4 (1960)).
The Commission stated that the terms "material false statements or omissions and ‘acts, practices, and courses of business as are fraudulent, deceptive, or manipulative’" are consistent with the "well-developed body of law under the antifraud provisions of the federal securities laws." It concluded that the "legal authorities identifying the types of acts, practices, and courses of business that are fraudulent, deceptive, or manipulative under the federal securities laws are numerous," and therefore, that the conduct prohibited by the rule is "sufficiently clear and well understood.

The Commission rejected the call for more detailed rules describing specific forms of fraudulent conduct by suggesting that such detailed rules could provide a roadmap for those wishing to engage in fraudulent conduct. The Commission refused to adopt such an approach, claiming that it would be inconsistent with "historical application of the federal securities laws under which broad prohibitions have been applied against specific harmful activity."

2. Lack of a Scienter Requirement

Although commenters argued that lack of a scienter requirement was not consistent with the Commission’s authority or would "expand the concept of fraud itself beyond its original meaning," the Commission insisted that the language of section 206(4) is not limited to knowing or deliberate conduct. As noted in Commissioner Atkins’s concurrence, the Commission cited the language of section 206(4) as encompassing "acts, practices, and courses of business as are . . . deceptive," which it interpreted to reach conduct that is negligently deceptive as well as reckless or deliberate.

The Commission relied heavily on Steadman. As previously discussed, the Steadman court analogized the wording of section 206(4) of the Advisers Act to the language used in section 17(a)(3) of the Securities Act. Through this analogy, and with reference to the Supreme Court decision in Aaron, which held that section 17(a)(3) does not require a showing of scienter to establish liability, the Steadman court concluded that "scienter is not required under section 206(4)."

The Commission also cited O'Hagan to support its belief that a negligence standard is appropriate as a method reasonably designed to

392. Id.
393. Id. at 44,759.
394. Id.
395. Id. (citing ABA Letter, supra note 313, at 3).
396. Id. (citing ABA Letter, supra note 313, at 3).
397. See SEC v. Steadman, 967 F.2d 636 (D.C. Cir. 1992) (holding that scienter is not required under section 206(4)).
398. See supra Part II.A.2.
399. Steadman, 967 F.2d at 647.
prevent fraud. The Commission quoted the Court in *O'Hagan*, noting that "'[a] prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited.'" The Commission believed that if advisers take sufficient care to avoid negligent conduct, they "will be more likely to avoid reckless deception." It follows that, since the Commission is able to "prescribe conduct that goes beyond fraud as a means reasonably designed to prevent fraud," then "prohibiting deceptive conduct done negligently is a way to accomplish this objective."

C. Alternatives to Regulation by the SEC

This section discusses alternatives to regulation by the SEC that may be effective in protecting hedge fund investors from fraud. Part II.C.1 discusses some of the problems that may arise as a result of regulation. Part II.C.2 explores the possibility of the hedge fund industry regulating itself. Part II.C.3 discusses establishing an organization of institutional investors to certify hedge funds. Part II.C.4 then discusses the SEC’s establishment of an SRO to regulate the industry and considers the effectiveness of such an approach.

1. Problems with Regulation

In determining how to effectively regulate the hedge fund industry, it is important to balance several relevant issues. One issue that must be considered is that the imposition of constraints on domestic hedge funds’ management may result in substantial migration of the industry to offshore jurisdictions without similar constraints. If funds migrate to offshore jurisdictions, oversight is "reduced for the industry and eliminated altogether for the migrating hedge funds." Therefore, imposing overly constraining regulation on the domestic hedge fund industry could have the effect of limiting regulation of these funds by encouraging them "to migrate to more lax jurisdictions without substantially reducing their investor base."

In addition, the rapid expansion of hedge fund investments is an obstacle posed for government regulation because it is transforming the price discovery functions of the securities markets. Although this transformation yields positive results in creating more efficient valuation and robust flows of capital, these innovative strategies morph rapidly and operationally, which poses a problem for government regulators who are notoriously slow.

401. *Id.* (quoting *O'Hagan*, 521 U.S. at 672-73).
402. *Id.* at 44,759–60.
403. *Id.* at 7.
405. *Id.*
Another consideration is whether regulation by the SEC would make a difference, based on critics questioning "whether the SEC can anticipate hedge fund malfeasance if it could not anticipate such problems through its oversight of mutual funds." 408

Increased disclosure requirements may be helpful for some investors in tracking the funds' investments, but "[i]n order for disclosure to be an effective regulatory mechanism, investors will have to be able to monitor the impact of manager decisions on the portfolio." 409 Harvey Westbrook, Jr., a financial economist in the SEC's Office of Economic Analysis, asserted that, in a hedge fund environment, "where investment strategies are dynamic and involve complicated long-short strategies, illiquid holdings, and derivative arbitrage strategies, 'snapshot' portfolio composition information" is not very informative to investors. 410 He also pointed out that, due to the absence of a secondary market for hedge fund shares, there is no clear way for them to "attach value to hedge fund management if the manager concentrates the portfolio in illiquid assets." 411 Therefore, due to often varied and complex investment strategies, even the most sophisticated investors "are not likely to possess the expertise to consistently monitor hedge fund managers." 412

2. Self-Regulation

One possibility besides regulation by the SEC is to follow the suggestion of the PWG and let the private market regulate itself through encouragement and support from the government oversight body. 413 The PWG Principles suggest that hedge fund managers "should have information, valuation, and risk management systems that meet sound industry practices and enable them to provide accurate information to creditors, counterparties, and investors with appropriate frequency, breadth, and detail." 414 The Best Practices for Investors, the Hedge Fund Industry Report, and MFA's Sound Practices provide guidelines for hedge fund managers to comply with this requirement.

The successful development and implementation of such guidelines would set standards within the industry. This approach may only be

407. See Verret, supra note 151, at 800, 818 (following the arguments supporting use of SROs in our capital markets); see also generally Paul G. Mahoney, The Exchange as Regulator, 83 VA. L. REV. 1453 (1997) (arguing that exchanges serve as more effective regulators than government institutions due to their inability to respond to rapid market innovation).
408. Verret, supra note 151, at 826.
409. Westbrook, supra note 404, at 22.
410. Id.
411. Id. at 23.
412. Id. at 24–25.
413. Id.
414. Verret, supra note 151, at 835 n.182 (quoting PWG PRINCIPLES AND GUIDELINES, supra note 192, at 5).
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successful, however, if the guidelines are adopted and adhered to by those within the industry. For self-regulation to work, there must be market and investor confidence that is adequate and consistently employed.

3. Hedge Fund Certification

Another common issue in looking at the future of hedge funds is that institutional investors, including pension funds and university endowments, "are beginning to aggressively invest in the hedge fund industry and are a potential source of substantial investment growth in the future." Therefore, it is possible that these increasingly influential institutional investors may be in a better position to influence transparency and develop best practices, as opposed to regulation by the SEC. After discussing several other regulatory alternatives, Westbrook concluded that hedge fund certification is the best solution to regulate the hedge fund industry.

In his analysis, Westbrook looked at the problem of regulating the hedge fund industry as a monitoring problem which he stated as follows: "How does a regulator encourage sophisticated investors to use their market power to require hedge funds to establish and follow minimal standards of operational practice?" He found that institutional investors are likely to gain market power "from being a primary source of future growth for the hedge fund industry." Under this framework, institutional investors would reduce their own operational risk monitoring costs by pooling their expenses to establish standards for "fund 'certification' by creating a 'certification body' to enact industry standards." "Through the certification body, institutions could establish the minimal operational and

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416. Id.

417. Westbrook, supra note 404, at 25; see also supra notes 31–34 and accompanying text.

418. Id. at 18–27. Some of the regulatory approaches that Harvey Westbrook explores are "restrictions on the number (or type) of investors, investment management restrictions, disclosure based regulations (requiring some disclosure of holdings to fund investors), [and] risk management based regulations (requiring specified risk management procedures to be followed)." Id. at 18–19.

419. Id. at 25.

420. Id.

421. Id. Westbrook describes operational risk as "the fund specific risk of a particular hedge fund's business operations." Id. at 9. It can be decomposed into several different categories, such as "money transfer risk, valuation risk, systems risk, clearance risk, regulatory risk, [and] human factor risk." Id. Due to "the idiosyncratic nature of operational risk, and its variability across the hedge fund industry, operational risk can not be adequately measured by standard risk measures, but is appropriately evaluated only through fundamental bottoms-up analysis and due diligence." Id.
qualifications standards hedge funds must satisfy on an ongoing basis in order to qualify for institutional investments."

Hedge funds that met the certification requirements "could choose whether or not to obtain certification." If "certified," a fund could use their certification "as a signal of the quality of its operations and possibly the qualifications of management." An investment in a certified fund could also "serve as a signal to pension beneficiaries that their hedge fund exposure meets appropriate operation standards." Although Westbrook acknowledged that this approach does not account for "the incentive differences between institutional investors and small investors," he concluded that "institutional investors are best suited to establish certification standards and, indirectly, the baseline for industry-wide best practices."

4. Creation of an SRO

Another alternative proposed to provide enhanced protection for hedge fund investors is to establish a new SRO. Although SEC enforcement actions such as those brought under the New Antifraud Rule are beneficial, it is suggested that these should be viewed as a "residual mechanism." The creation of an SRO could provide greater investor protection because it would focus on preventing the fraudulent conduct from occurring in the first place.

A recent article by J.W. Verret explores the SEC's previous efforts to combat hedge fund fraud and—anticipating future regulatory efforts—seeks to craft a regulatory regime that would more effectively achieve that goal. According to Verret, the benefits provided by hedge funds and the risks associated with unnecessarily tight constraints require that any regulation be "narrowly tailored to abusive practices" and that the costs of such regulation are weighed to "ensure that [they] do not outweigh the

422. *Id.* at 26.
423. *Id.*
424. *Id.*
425. *Id.* In order for this approach to effectively reduce operational risk, "institutions must limit, at least to some degree, their investments to certified hedge funds." *Id.* Limitations to investing in these certified funds would be necessary because "[i]f the certification signal does not attract sufficient investment, institutional or otherwise, hedge funds will have no reason to subject themselves to additional due diligence requirements." *Id.* In addition, in order for other investors to take the certification process seriously, the institutions themselves must take it seriously. *Id.*
426. *Id.* at 27.
428. See Seligman, supra note 299, at 1126.
429. *Id.*
430. See generally Verret, supra note 151 (reviewing the Hedge Fund Rule promulgated by the SEC, which was struck down in 2006 by the D.C. Circuit in Goldstein).
He proposes a self-regulatory model that could utilize the "inherent advantage of firms regulating each other," and, if crafted correctly, could "help to overcome the severe disadvantage that bureaucratic regulators face in this field." Verret suggests that this new model could be effectuated through the creation of a new self-regulatory organization for hedge funds, or it could encourage more action by self-regulatory mechanisms already in place "through the form of safe harbors from adviser registration."

Verret explores the comparison of costs to benefits that are associated with regulation or reform of the hedge fund industry. Self-regulation, Verret contends, would be more likely than government regulation to minimize the cost impact because an SRO, made up of industry representatives, would be more sensitive to the effect of compliance costs on the industry. He suggests that government regulators, as opposed to industry participants, face "no penalty for over-regulation, and indeed may have political or turf-guarding incentives to overregulate." Therefore, if an SRO had incentives to properly regulate, "it would be more likely to seek cost-effective strategies."

In his analysis, Verret compares the relationship between an investor and the investment adviser who manages the investor's money to a principal/agent relationship. In this model, the investor is the principal, who "contracts with the investment adviser, as agent, to manage the assets of the investor diligently and for a specified fee or a specified percentage of the amount by which the adviser can make the investment grow." Therefore, a principal/investor hires the agent/adviser to perform a service that requires delegation of authority. Typically, principals seek to "create incentives for agents to limit aberrant activities," while the agent "frequently expend[s] bonding costs to ensure principal interest and maintain a profitable relationship." However, if information asymmetries exist between the parties and the agents/advisers are able to take advantage of those asymmetries "to engage in profitable aberration at

431. Id. at 815–16.
432. Id. at 800.
433. Id. at 811.
434. Id. at 816. Verret measures costs as "(1) compliance costs of hedge funds, (2) [the] opportunity cost of trades not undertaken due to an artificial dampening of risk appetite, (3) legal costs of private and governmental compliance, and (4) enforcement costs." Id. at 815 (citations omitted). Benefits are "measured as investment appreciation due to fraud prevention, less any appreciation realized as a result of fraud that is never ultimately discovered by the market." Id.
435. Id.
436. Id.
437. Id.
438. Id.
439. See id.
440. Id.
the principals’ expense and without the principals’ knowledge, it may be rational for [them] to do so.”

In viewing the investment management situation this way, the information asymmetry that minimizes monitoring by principals or investors is the “lack of disclosure of hedge funds to their investors.”

The social harm caused from the agent/adviser’s aberrant behavior “might be market instability or investor losses due to fraud.” One possibility for correcting this harm would be the government’s imposition of a penalty for fraud. However, this would add an additional social cost “as social resources are used to conduct compliance audits.”

In addition, as previously discussed, government regulation would be ineffective because “government regulators are severely constrained in their ability to regulate rapidly innovating markets.” Therefore, a better alternative may be to “let the private market regulate itself through encouragement and support from the government oversight body.”

The advantages of self-regulation, as discussed above, may address the difficulties faced by the government due to “rapid functional change.” Verret argues that “[o]rganizations composed of financial institutions have some interest in ensuring the viability of a market for a profitable activity, such as hedge fund investing, that is harmed by those members who violate best practices.” Therefore, an SRO, as a group, might “have many interests that coincide with those of market regulators.”

As discussed above in Part I.C.3, national securities regulation has always utilized some form of self-regulation coupled with SEC oversight authority. The two justifications offered for self-regulation were “that business would have a more specialized knowledge of current and abusive strategies and that the task was ultimately beyond the SEC’s resources to oversee.” The benefits of adopting a self-regulatory model are typically associated with supplemental government oversight to aid in eliminating cases of market failure and establishing “a forum for firms to compete with each other in policing themselves.”

Verret uses strategic behavior game theory to demonstrate how the SEC’s mandate of the creation of an SRO for hedge funds could be an “effective solution to the free rider problem of industry reputability” and also could “help foster a healthy Nash equilibrium to deter fraud in the

441. Id.
442. Id. at 817.
443. Id.
444. Id.
445. Id.
446. Id. at 817–18.
447. Id. at 818.
448. Id.
449. Id.
450. See supra Part I.C.3.
452. Id. at 819.
hedge fund management industry."

Before exploring the two models that Verret proposes, it is important to understand the situations he creates and the theories underlying his models. First, Verret uses the term “Nash equilibrium,” which is a central solution concept in game theory that is based on the principle that

the combination of strategies that players are likely to choose is one in which no player could do better by choosing a different strategy given the [strategy] the other choose[s]. A pair of strategies will form a Nash equilibrium if each strategy is one that cannot be improved upon given the other strategy.

Thus, “[t]he strategy of each player must be a best response to the strategies of the other.”

Another important concept that Verret uses is that of “signaling,” which is defined as “[s]trategy choices by those who possess nonverifiable information that convey information.” A problem arises in game theory when one party possesses “private, nonverifiable information that neither the other party nor a third party can acquire directly.” Therefore, even if the party with private information is forced to disclose, there is no way of telling whether their disclosure is truthful. The best solution available to uninformed parties is to “draw inferences from the actions that the informed party takes.” However, a court or government entity could have an important impact under these situations “by limiting the actions that parties can take or attaching consequences” to certain actions but not others. These actions by courts or government authorities could therefore “affect not only what actions are taken, but what inferences can be drawn from those actions.” This concept explains why the SEC’s involvement would be necessary. The SEC would have to establish and maintain the SRO because creation of “a regulatory regime that could effectively signal fiduciary duty violations to investors would require government authority.”

As previously discussed, hedge funds are highly secretive about their activities and, without government involvement, the funds would not have any incentive to join the SRO or follow its guidelines. The SEC’s role would be “to make membership in the SRO mandatory, or at

453. Id. at 820. “Strategic behavior arises when two or more individuals interact and each individual’s decision turns on what that individual expects the others to do.” DOUGLAS G. BAIRD, ROBERT H. GERTNER & RANDEL C. PICKER, GAME THEORY AND THE LAW 1 (1994). The theories addressing this strategic behavior can “offer insights into how legal rules affect the way people behave.” Id.
454. BAIRD ET AL., supra note 453, at 310 (emphasis omitted).
455. Id. at 21 (emphasis omitted).
456. Id.
457. Id.
458. Id.
459. Id.
460. Id.
461. Verret, supra note 151, at 819.
least desirable, because only in that event will the equilibrium forces come into effect."\textsuperscript{462}

For the purposes of the model situations, Verret defines "fiduciary duty violations" (FDV) as "investment managers profiting at the expense of investors absent contractual agreement (i.e., not fees)."\textsuperscript{463} The cost that Verret highlights is the cost to a firm's reputation, although he points out that there may not necessarily be a direct correlation between firms that engage in fraudulent activity and reputation costs.

In the first and most basic model, Verret assumes that there are no information asymmetries between the investors and the managers. Without an SRO, "[a] single firm may find it profitable to engage in fraudulent behavior, where the profit . . . exceeds its allocation of industry reputation cost."\textsuperscript{464} If an SRO were limited to deciding between whether to allow FDV or to stop FDV, the SRO would allow fraud where the sum of the firm's profit was greater than the sum of the firm's costs. However, "where fraud allows managers to profit at the expense of investors, reputation costs have to at least equal profits from fraud. In such an instance, it would not be profitable for an SRO to allow fraud."\textsuperscript{465} Under this model, no regulation would be required; but it is not a realistic example.\textsuperscript{466} Information asymmetries do exist; the hedge fund industry is notorious for being highly secretive and disclosing very little to investors about investment activities. Therefore, the second model is necessary to understanding how the creation of an SRO would alter the landscape of the hedge fund industry.

The second model addresses a situation in which the sum of profits from FDV is not correlated with the sum of the firm's costs. One situation that could give rise to this situation is an information asymmetry between managers and investors. In this scenario, "investors may not be aware of fraud if it occurs," which would result in the total profits being greater than the total costs, and therefore an SRO would likely want to allow FDV.\textsuperscript{467} In this model, the creation of an SRO could still lead to a Nash equilibrium, or optimal outcome, "where firms would not violate individually where they might all profit from allowing fraud together."\textsuperscript{468} This model separates the outcomes so that "the funds making up the SRO are divided into two halves and are allowed to make independent decisions of whether or not to vote to allow FDV in the hedge fund market."\textsuperscript{469} It is further assumed that "half of firms voting for no FDV will result in creation of a self-regulatory regime in which investors will be able to determine whether or not a firm is conforming to established best practices and thus whether or

\textsuperscript{462} Id. at 820.
\textsuperscript{463} Id.
\textsuperscript{464} Id.
\textsuperscript{465} Id. at 820–21.
\textsuperscript{466} Id. at 821.
\textsuperscript{467} Id.
\textsuperscript{468} Id.
\textsuperscript{469} Id.
not the fund is engaging in FDV."470 Once the funds decide whether or not to engage in FDV, they are ready to vote. In this situation,

[i]f either group of firms decides not to engage in FDV, and votes accordingly, it will benefit because it will expose the other firms and thus profit from the additional investments it can now secure from investors. Further, if one group of firms votes not to allow FDV, then the other must not engage in FDV and will vote to create the signal as well. Thus, the dominant strategy for both groups of firms will be not to engage in FDV and not vote to allow FDV.471

The Nash equilibrium model, according to Verret, is really about damage control, which, in this case, results in both firms voting not to allow FDV.472 The signaling mechanism is what enables the SRO to create a Nash equilibrium because it gives firms the opportunity to overcome the information asymmetry.473 This theory suggests that "[a] hedge fund SRO would have an interest in creating signals to the general market of investors that the operational risk of fraud in hedge funds is minimal," because the signal "would give them a competitive edge in acquiring investment capital flows over the other asset classes with which it competes."474

After showing how a self- regulatory model could be effective, Verret examines alternative regulatory strategies and structures that the SEC may use to regulate hedge funds.475 He suggests three entities that could be used by the SEC to advance his self-regulatory thesis as a form of governance over the hedge fund industry: the NFA, the MFA, or the NASD.476 According to Verret, if the SEC creates an SRO, it should consider granting it authority to license members and extend an exemption for registrants with the SRO from any future registration requirement.477 The SEC could use the MFA or start a new SRO, but nonetheless, it would need to take an

470. Id.
471. Id. at 822. "The result is an equilibrium of compliance that could exceed the level of transparency that would exist without the collective action, thus giving more sharpness and binding effect to any best practices that may exist in the industry and providing a more cost effective enforcement avenue for those best practices." Posting of Holger Spamann to Harvard Law School Corporate Governance Blog, http://blogs.law.harvard.edu/corpgov/2008/01/24/a-self-regulation-proposal-for-the-hedge-fund-industry (Jan. 24, 2008, 11:02 EST).
472. Verret, supra note 151, at 822. Even if the firms individually would have initially chosen to vote for FDV, "each firm would anticipate that the other firm would vote to create the signal, because it could profit by taking market share." Id.
473. Id.
474. Id. at 823 ("In effect, not only will individual fund managers want a signal about their low operational risk vis-à-vis their internal competition for capital, they will have an added incentive to create such a signal to aid in their external competition for capital with other asset classes.").
475. Id. at 833.
476. Id.
477. Id. at 836. "[S]tatutory self-regulation subject to SEC supervision generally has been effective in major applications only when the Commission has been willing to threaten or actually use its regulatory authority to create incentives for securities industry regulation." Seligman, supra note 299, at 1119.
active role in the process of creating the SRO.478 "The five basic functions of this SRO would be registration, standards of practice, inspection, investigations and discipline, and budgetary and operational decision making."479

Verret proposes that, in order to establish a new SRO and overcome the collective action problem faced by the majority of individual hedge funds in coming together to form the SRO, the SEC would have to take the following four steps.480 The first necessary step would be to obtain the SEC’s encouragement to establish the necessity for such an SRO.481 If the SEC were to provide these funds with a motive to submit to regulation, then the Nash equilibrium would take effect.482 One way to accomplish this motivation would be to allow funds “to avoid more onerous regulation by the SEC by taking advantage of a registration exemption for SRO members.”483 The next step the SEC would have to take is to design the SRO’s charter so that it defines the rulemaking process.484 Similar to the charters creating SROs like the NYSE, NASD, NFA, and the Financial Accounting Standards Board, the SEC would need to require that no amendments may be made to the charter without SEC approval.485 The third requirement is that the SEC must approve the representatives of the rulemaking body to ensure that they encompass “a representative sample of the hedge fund industry” and “representatives that engage in a variety of fund strategies.”486 Lastly, “the SEC would need to establish in the SRO’s charter that, though the rulemaking body could be composed of individuals with industry ties, a separate body within the organization would need independent authority to enforce violations of the SRO’s rules.”487 In the hedge fund SRO, the decision-making body would be composed “of individuals with a working knowledge of the hedge fund world, but independent of industry ties.”488 This result could be achieved through the SEC obtaining a veto power “over appointments to the SRO’s regulatory wing.”489 Also, consistent with a reform that NYSE adopted in 2003, there should be a chief regulatory officer reporting directly to the rulemaking body.490

478. Verret, supra note 151, at 836.
479. Id. (citing Seligman, supra note 299, at 1124).
480. Id.
481. Id.
482. Id.
483. Id.
484. Id.
485. Id. at 836–37.
486. Id. at 837. The need for SEC approval “would also ensure that, as the landscape of the hedge fund industry changed, the SRO rulemaking body membership continued to represent the disparate players well.” Id.
487. Id. This requirement was established in the NASD settlement.
488. Id.
489. Id.
490. Id.
III. THE FUTURE AND EFFECTIVENESS OF THE NEW ANTIFRAUD RULE

This part argues that the New Antifraud Rule is an ineffective way to protect investors in hedge funds. Part III.A predicts that the overly broad language of the rule and the Commission’s lack of a scienter requirement will likely lead to it being successfully challenged. Part III.B suggests that, even if the rule were to withstand judicial scrutiny, the rule lacks a reporting requirement that prevents it from addressing the original problem posed: that fraud in hedge funds can only be detected after investors have lost their money. For these reasons, the protection offered by this new rule is ineffective. Part III.C highlights the various problems with SEC regulation of hedge fund fraud. Finally, Part III.D argues that, without additional regulatory power, the best protection for investors will come through self-regulation, whether it be through internally adopted best practices—such as those offered by Best Practices for Investors, the Hedge Fund Industry Report, or the MFA’s Sound Practices—or through the creation of an SRO by the SEC for the hedge fund industry.

A. Validity of the New Antifraud Rule

If challenged, the new Antifraud Rule is likely to face a similar fate as the SEC’s Hedge Fund Rule did in Goldstein. As previously explained, the SEC adopted rule 206(4)-8 under section 206(4), which directs the Commission to adopt rules and regulations that “define[] and prescribe means reasonably designed to prevent[] such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.”\(^1\) In the Adopting Release of rule 206(4)-8, the SEC supported the broad scope of the rule by stating that “Congress expected that [the SEC] would use the authority provided by section 206(4) to ‘promulgate general antifraud rules capable of flexibility.’”\(^2\)

Despite the legislative history cited by the SEC, the language under section 206(4) clearly requires that the Commission “define[] and prescribe means reasonably designed to prevent[] such acts, practices and courses of business as are fraudulent, deceptive, or manipulative.”\(^3\) The first part of the rule, 206(4)-8(a)(1), could reasonably be interpreted by a court to adequately define what constitutes fraud under section 206(4). However, the second part of the rule, 206(4)-8(a)(2) does not define or prescribe what conduct would be fraudulent under the rule, and therefore may be susceptible to challenge on the grounds that the Commission’s authority under section 206(4) is not broad enough to create such a provision.

Rule 206(4)-8(a)(1) prohibits any investment adviser to a pooled investment vehicle from “mak[ing] any untrue statement of a material fact,” or from “omit[ting] to state a material fact necessary to make the statements

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3. 15 U.S.C. § 80b-6 (emphasis added); see supra Part I.C.2.
made . . . not misleading[] to any investor or prospective investor in the pooled investment vehicle.\textsuperscript{494} The issue before a court reviewing this part of the rule would seem to be whether the rule's prohibition on "[m]ak[ing] any untrue statement of a material fact or omit[ting] to state a material fact" is an adequate definition to specify conduct that is "fraudulent, deceptive, or manipulative."\textsuperscript{495} In the New Antifraud Rule's Adopting Release, the Commission noted that rule 206(4)-8(a)(1) is very similar to those in many of the antifraud laws and rules under the securities laws.\textsuperscript{496} Also, the Commission provides advisers with examples of what the new rule prohibits.\textsuperscript{497} Although the language of this rule, in comparison to other valid and long-standing laws, would suggest that it is within the Commission's authority, the fact that it does not require a showing of scienter for a violation may influence a court to decide otherwise.

The second part of the rule, 206(4)-8(a)(2) prohibits advisers to pooled investment vehicles from "[o]therwise engag[ing] in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."\textsuperscript{498} As noted by Commissioner Atkins, the provision is almost as broad as the statute giving the Commission authority to make rules to define fraud.\textsuperscript{499} Although the SEC should not have to provide "prophylactic rules that explicitly identify conduct that would be fraudulent under the new rule," a rule created through the authority of an enabling provision should be different in some material aspect to justify its creation.\textsuperscript{500} Under this part of the rule, the SEC did not provide a single example of what would constitute fraudulent, deceptive, or manipulative conduct. The Commission argued that providing examples of what conduct would be fraudulent under the rule "could provide a roadmap for those wishing to engage in fraudulent conduct."\textsuperscript{501} This argument is inconsistent with the release as a whole because the Commission provided examples of what would be prohibited under the first part of the rule and also gave examples in a different part of the release to demonstrate the rule's applicability to both current and prospective investors.\textsuperscript{502} Therefore, it is unclear how providing examples for one part of the rule would create a "roadmap" for violators, while providing examples for another part would not.

\textsuperscript{495} Id.; see also ABA Letter, supra note 313, at 3.
\textsuperscript{496} SEC Release: Antifraud Rule, supra note 38, at 44,759 (listing various antifraud laws and rules, including rule 10b-5 under the Exchange Act).
\textsuperscript{497} Id.
\textsuperscript{498} 17 C.F.R. § 275.206(4)-8(a)(2).
\textsuperscript{499} See supra note 373 and accompanying text.
\textsuperscript{500} SEC Release: Antifraud Rule, supra note 38, at 44,759 (citing ABA Letter, supra note 313; ICI Letter, supra note 312; Schulte Letter, supra note 315; Sullivan & Cromwell Letter, supra note 311).
\textsuperscript{501} Id.
\textsuperscript{502} Id. at 44,758–59.
Since the New Antifraud Rule is so broadly phrased, it fails to identify "the types of acts, practices, and courses of business that are fraudulent, deceptive, or manipulative." As pointed out by the comment letters, this could lead to confusion in its application and result in unintended and adverse consequences, such as decreased transparency. If advisers are unclear as to what is prohibited, they may be generally fearful of misspeaking to investors and prospective investors if that communication is not necessary. This fear also is raised by the lack of a scienter requirement. The Commission enacted the rule to protect investors; however, if it creates uncertainty for hedge fund advisers, legitimate communications will decrease. The costs of leaving out the scienter requirement, even if determined to be consistent with the case law, may outweigh the benefits, yielding severe unintended consequences.

In addition to the challenges posed by the sweeping breadth of the new rule, it is likely to be successfully challenged due to its lack of a scienter requirement. The Commission justifies its decision to include negligent conduct based on the wording "acts, practices, and courses of business as are . . . deceptive." However, as Commissioner Atkins contended, the separation of terms is not consistent with the principles of statutory construction according to the Supreme Court.

The Commission's interpretation of the term "manipulative" in a way that differs from the Supreme Court's interpretation should also call into question the validity of the rule. The Court stated in Hochfelder that the term "manipulative" is "virtually a term of art" that "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." The applicability of this language to the interpretation of rule 206(4)-8 is particularly persuasive since both rules are antifraud provisions of the federal securities laws. The Commission's interpretation of the rule suggests that its fate may be similar to that of the original Hedge Fund Rule that was struck down in Goldstein. The court in Goldstein made it very clear that the SEC cannot interpret words of a statute however it wishes.

Although Steadman held that "scienter is not required under section 206(4)," a showing of intent should be required for rule 206(4)-8. First,
it should be noted that the Steadman decision is from the D.C. Circuit court and therefore is not binding on other jurisdictions and has not been affirmed by the Supreme Court. Commissioner Atkins and those who wrote comment letters correctly pointed out several potential problems with the Steadman court’s analysis. For example, the Supreme Court emphasized the terms ‘operate’ or ‘would operate’ in its Aaron decision. However, neither of these words appear in section 206(4), which instead uses the affirmative word “is.” The difference in word choice should distinguish a course of conduct that “operates” as a fraud from a course of business that is itself a fraud. Fraud is defined as a “knowing misrepresentation of the truth or concealment of a material fact.”

Therefore, it seems that conduct that is itself fraudulent would require a “knowing misrepresentation . . . or concealment.”

Also, as discussed, the term “manipulative” has a definite meaning within the federal securities laws, and the fact that the term is used in section 206(4) and not used in section 17(a)(3) should distinguish the two statutes.

As the law currently stands, the SEC cannot force disclosure by hedge fund managers to their investors. Although the general idea of preventing and punishing fraudulent communications with, and conduct toward, investors is a valid one, the broad language and lack of a scienter requirement may only serve to discourage communications between investors and their advisers. This would negate the underlying purpose for the rule.

B. The SEC’s Need for More Power from Congress

If the New Antifraud Rule does withstand judicial scrutiny, it still does not provide strong protection for investors in hedge funds. The fraud problems raised by the SEC’s Staff Report are not addressed by this new rule. As previously discussed, the report found that the major difficulty in protecting investors in hedge funds was that the Commission was only able to take action after it received relevant information from third parties—such as investors—and only after they had already suffered significant losses. Therefore, the New Antifraud Rule, although it reaffirms the Commission’s power to bring such actions, does not create any substantial protections for these investors.

Arguably, in order to be able to detect misconduct at an earlier stage, the Commission would need access to information it currently cannot access. In the wake of Goldstein, it seems that federal legislation requiring hedge fund registration may be the only way for the Commission to have the

513. Id.
514. See supra notes 332–35 and accompanying text.
515. See supra Part I.A.2.
516. See supra notes 108–15 and accompanying text.
517. See Part I.B.2.
ability to police and detect hedge fund fraud. Congress could amend the
Advisers Act to expand the regulatory power of the SEC, although it has
deprecated to do so.\textsuperscript{518}

\textbf{C. Problems with SEC Regulation}

Further, even if hedge funds were required to register with the SEC, it is
questionable whether SEC regulation would be able to protect investors
from fraud. Some argue that the availability of such information would not
increase protection.\textsuperscript{519} Commissioner Atkins has stated that the SEC does
not even have the resources to regulate the mutual fund industry, an
industry that the SEC should currently be regulating.\textsuperscript{520} Moreover, the
Commission also suffers from inadequate staffing. This suggests that the
SEC may not have the capacity to regulate these funds, and investors
believing that the industry is adequately regulated may operate under a false
sense of security that could harm them more than protect them.

One serious issue that should be considered before any regulations are
implemented is the effect these regulations may have on hedge funds
moving to other jurisdictions. Once these funds move out of the United
States’ jurisdiction, investors will either not be able to invest in them or will
be afforded no protection or remedies under the federal securities laws.
Therefore, the consequences of the regulations may defeat their original
purpose.

In addition, the rapid innovations within the hedge fund industry and the
need to retain secrecy of their investment strategies make it harder to
regulate than other areas.\textsuperscript{521} Given the potential problems that may result
from regulation, decreasing hedge fund fraud by implementing SEC
regulations is not the most effective means for protecting investors.

\textbf{D. Protecting Investors Through Self-Regulation}

Fraud, by its nature, is hard to detect and, as the case law and Staff
Report demonstrate, perpetrators of fraud in hedge funds go to great lengths
to conceal their fraudulent activities.\textsuperscript{522} As demonstrated by the Bayou
case, hedge fund managers who commit fraud create false documentation—
including false accounting statements and other reports to customers,
confirmations, and pricing sheets.\textsuperscript{523} Without the SEC having the ability to
require registration by hedge funds and gain access to their records, an
antifraud rule will not provide sufficient protection for investors.

Absent government regulation, the best protection for investors is likely
to result from self-regulation within the industry. One way to accomplish this is

\begin{itemize}
\item \textsuperscript{518} See Verret, \textit{supra} note 151, at 810.
\item \textsuperscript{519} See, e.g., \textit{id.}; \textit{supra} note 131.
\item \textsuperscript{520} \textit{id.}
\item \textsuperscript{521} \textit{id.}
\item \textsuperscript{522} \textit{STAFF REPORT ON THE GROWTH OF HEDGE FUNDS, supra} note 33, at 74.
\item \textsuperscript{523} \textit{id.}
\end{itemize}
for hedge funds to voluntarily follow a set of industry standards such as the PWG’s reports—Best Practices for Investors and the Hedge Fund Industry Report—or the MFA’s Sound Practices. The recommendations in these best practices are good examples of how firms could effectively structure themselves to make this type of self-regulation protect investors. The recommendations, if followed, would increase the amount of information investors receive from managers. Also, the Model Due Diligence Questionnaire could be helpful for investors looking to invest in a hedge fund. It would help them understand their investment, the strategies used, and the risks involved. Adoption of these recommendations would be a good starting point for protecting investors; however, this may not be enough. This form of self-regulation relies entirely on the fund’s accurate disclosure to investors in their due diligence. The recommendations do not require outside accountants or alternative means to verify that the information supplied by hedge funds to investors is accurate.

The benefit of this form of self-regulation seems to be dependent on the investors. If investors request or even require that funds adhere to the recommendations, funds that do not adopt the recommendations would be disadvantaged. Wealthy investors and institutional investors may have market power that would enable them to induce hedge funds to follow the recommendations and even to verify the accuracy of their disclosures. This market power is displayed by the fact that many hedge funds voluntarily register with the SEC. This is not because they are required by securities laws to register but rather because some institutional investors condition their investment on such registration. Therefore, investors with enough influence could certainly demand that hedge funds comply with these recommendations or provide independent audits. One drawback to this solution, however, is that it does not protect the less influential investors.

The most effective way to protect all hedge fund investors, while continuing to reap the market benefits that these funds provide, is through the creation of an SRO. An SRO for the hedge fund industry would be better suited to police the industry than the SEC because the SEC does not have the means or manpower to effectively regulate the industry. The creation of an SRO could address the concerns over risks associated with hedge funds having to disclose their investment strategies. An SRO could also require independent auditing to ensure that the information disclosed is accurate and that the funds are following the valuation procedures provided to investors.

The SEC would have to delegate its regulatory power to the SRO and either provide an incentive to join or make membership mandatory. As outlined by Verret, the SEC would need to take the necessary precautions to avoid the negative consequences that can flow from allowing an industry to regulate itself. Like the current SROs, the new hedge fund SRO would

524. See supra Part I.D.2.
525. See supra Part II.C.2.
be responsible for "registration, standards of practice, inspection, investigations and discipline, and budgetary and operational decision making."

The hedge fund SRO could follow the structure of the NFA, the SRO for the U.S. futures industry. The NFA mandates membership and operates at no cost to taxpayers because it is financed by membership dues. The NFA also has stringent screening requirements that firms must pass to register, including fingerprinting and background checks. This would help protect hedge fund investors from managers that defraud them by lying about their background and qualifications. The rules created for a hedge fund SRO would have to be industry specific and should include disclosure requirements such as those recommended by the MFA. In addition, these internal regulations should require regular independent audits and proper valuation procedures. Consistent with the NFA's practice, the hedge fund SRO would have to establish reporting requirements and perform its own random audits to monitor compliance with the established rules. In addition, this hedge fund SRO should adopt the NFA philosophy that "investor protection begins with investor education." Even with an SRO regulating the hedge fund industry, investors should be responsible for making informed decisions by performing their own due diligence, self-education, and monitoring of their investments.

If such a structure had been in place prior to the Bayou fraud, the investors would have been aware that the accounting firm Marino created was not a legitimate accounting firm and that the audits were neither independent nor accurate. In the case of Amaranth Advisers, SDCERA would have been on notice that the fund had altered its investment strategies if routine disclosure had been required. Ultimately, there is no guaranteed protection from fraud. However, an SRO could offer greater protection for hedge fund investors than regulation by the SEC.

CONCLUSION

Fraud is particularly difficult to uncover, whether in a registered or unregistered investment company. Whether additional regulation will be necessary to protect investors from their advisers is an ongoing controversy that the government will continue to investigate; the resolution may depend on the administration in office. Whether this new rule will withstand judicial scrutiny or protect investors is still uncertain. One way the hedge fund industry may be able to prevent government regulation would be to

526. Verret, supra note 151, at 836 (citing Seligman, supra note 299, at 1124); see also supra Part II.C.2.
528. Id.
529. Id.
530. Id.
531. Id.
establish a self-regulatory framework that instills confidence in the industry and provides protection to investors. Another alternative is for the SEC to get involved in a different capacity—by creating and supervising an SRO to police the hedge fund industry. Currently, with no regulations in place, the investors can best protect themselves by conducting their own due diligence and closely monitoring their investments.