Hedges or Thickets: Protecting Investors from Hedge Fund Managers' Conflicts of Interest

Ryan Sklar
HEDGES OR THICKETS:
PROTECTING INVESTORS FROM HEDGE FUND MANAGERS’ CONFLICTS OF INTEREST

Ryan Sklar*

This Note examines the conflicts of interest that hedge fund managers face and the negative effects that these conflicts can have on hedge fund investors. Taking a bifurcated approach, this Note analyzes the regulation of hedge funds at both the federal and state level, focusing specifically on the regulation of conflict transactions. With an emphasis on the retailization of the hedge fund industry, this Note demonstrates the inadequacy of the safeguards from such conflicts of interest that the law currently affords investors. Given the public interest in protecting the growing number of “ordinary” investors who indirectly invest in hedge funds, this Note suggests that Congress take action to protect investors from hedge fund managers’ conflicts of interest, either through enhanced disclosure obligations or the imposition of federally mandated fiduciary responsibilities.

INTRODUCTION

On August 31, 2006, Amaranth Advisors LLC (Amaranth), at the time one of the nation’s largest hedge funds, managed approximately $9.2 billion in assets.1 On September 18, 2006, Amaranth’s President and CEO, Nick Maounis, informed the fund’s investors that the hedge fund had lost half its capital in less than a month, with $560 million disappearing on September 14 alone.2 Despite “work[ing] around the clock” to stem the tide,3 Amaranth’s losses increased, eventually totaling more than $6 billion by the

---

* J.D. Candidate, 2010, Fordham University School of Law. I would like to thank Professor Caroline Gentile for her invaluable insight and guidance. I would also like to thank my family and friends for their constant support and eternal patience throughout the note-writing process.


2. See Til, supra note 1, at 4.

end of September. By September 29, the collapse was complete; Amaranth’s founder notified investors that the fund was suspending all requests to withdraw funds so that it could liquidate in an orderly fashion.

Prior to September 2006, Amaranth had traded heavily, and often successfully, in the energy sector. Although initially founded as a multistrategy hedge fund, by 2006 Amaranth was generating nearly eighty percent of its profits from energy-related trades. In particular, the fund had purchased many natural gas futures, swaps, and options—essentially, bets on the direction that the commodity’s price was likely to move in the future. Although the price of natural gas generally tends to rise in September, in September 2006 “the natural gas futures market behaved entirely differently than it had historically.” Rather than rise, as Amaranth expected, natural gas prices decreased dramatically, dropping ten percent in response to cooling weather and increased inventories. As a result of the price decreases, the hedge fund was left “scrambl[ing] to explain to investors how [its] risk controls went awry” and how it lost billions of dollars of their capital in such a short period of time.

Although not greatly disrupting the market as a whole, the ensuing collapse harmed significantly the fund’s investors. Unlike hedge funds of

4. See Hedge Fund Manager Amaranth to Liquidate, L.A. TIMES, Sept. 30, 2006, at C2. This loss corresponded to a sixty-five to seventy percent decline in the fund’s net asset value (NAV). Id.
7. See Ludwig B. Chincarini, The Amaranth Debacle: A Failure of Risk Measures or a Failure of Risk Management?, J. ALTERNATIVE INVESTMENTS, Winter 2007, at 91, 92; see also Katherine Burton & Jenny Strasburg, Human Frailty and Huge Losses, HOUS. CHRON., Dec. 10, 2006, at D2 (quoting a potential investor in the fund who, after investigation, thought that “the Amaranth multistrategy fund was a pure energy bet . . . . [as a]most all of their profits came from their energy portfolio’’); Morgenson & Anderson, supra note 6 (stating that “‘multistrategy’ seems to have been a misnomer at the fund”).
9. See Chincarini, supra note 8, at 154.
10. See Chincarini, supra note 7, at 99.
11. See Davis, supra note 8.
12. See Burton & Strasburg, supra note 7.
14. See Chincarini, supra note 7, at 102 (“[T]he Amaranth collapse did not significantly impact broader markets.”).
15. See Tina Seeley, Amaranth Tried to Manipulate Gas Prices, CFTC Says, BLOOMBERG, July 25, 2007, http://www.bloomberg.com/apps/news;?pid=20601087&sid=ascmHXF169AY&refer=home. Amaranth’s capital contributions included: approximately sixty percent from funds of funds, seven percent from insurance companies, six percent from retirement and benefit programs, six percent from high-net-worth individuals, five percent
a prior time, which only accepted funds from wealthy individuals who could better handle investment losses, Amaranth was not only investing the funds of sophisticated investors. The hedge fund had accepted investments by pension funds, endowments, and funds of funds, and, as a result, the effects of its collapse were felt across the country by more "ordinary" investors and even by municipal governments. Among others, public employees of San Diego County, California and the State of New Jersey, as well as employees of 3M, lost pension dollars in the wake of Amaranth's meltdown.

More recently, the Bernard Madoff scandal drew renewed focus on the risks associated with hedge funds. In December 2008, Madoff, the owner of Bernard L. Madoff Investment Securities LLC (Madoff Investment Securities), was arrested for perpetrating a "'stunning fraud . . . of epic proportions.'" In addition to running Madoff Investment Securities, a broker dealer service, Madoff also operated an investment advisory business which, according to Securities and Exchange Commission (SEC) filings, had more than seventeen billion dollars under management. It now appears that the investment advisory business consisted of nothing but "a giant Ponzi scheme" that resulted in the loss of billions of dollars. In

from financial institutions, two percent from endowments, and three percent from people affiliated with the hedge fund. See Chincarini, supra note 7, at 92.

16. A sophisticated investor is "'[a]n investor who has sufficient knowledge and experience of financial matters to be capable of evaluating a security's qualities" and who does "not require the full protection of securities laws." BLACK'S LAW DICTIONARY 846 (8th ed. 2004).


19. See Leslie Wolf Branscomb, Pension Loss Estimated at $105 Million: County System Invested in Amaranth Hedge Fund, SAN DIEGO UNION-TRIB., Oct. 5, 2006, at B1 (stating that San Diego County's employee-retirement fund lost at least $105 million of its $175 million dollar investment in the fund); Amaranth Fund Details Losses, supra note 18 (stating that New Jersey's pension fund, which was invested in Amaranth through a Goldman Sachs fund of funds, stood to lose $16 million of its $25 million investment, and that 3M had about one percent of its $9.2 billion investment portfolio invested in the hedge fund).


actuality, "Madoff deceived investors by operating a securities business in which he traded and lost investor money, and then paid certain investors purported returns on investments with the principal received from other, different investors." According to the complaint filed in the U.S. District Court for the Southern District of New York, Madoff became worried in early December 2008 that he could not "obtain the liquidity necessary to meet" the recent requests of investors to withdraw seven billion dollars from the fund. It was at this point that Madoff admitted to his sons that "he had 'absolutely nothing'" and that his seemingly extraordinarily successful hedge fund was "'all just one big lie.'"

Up to this point, the media has given much publicity to the fact that the "list of victims who lost money in . . . Madoff's alleged $50 billion Ponzi scheme reads like a who's who of the financially savvy." Significant capital, however, was also contributed by more "ordinary" investors who became indirectly exposed to the fraud by investing in hedge funds and funds of funds that invested with Madoff due to the "remarkably steady returns" his asset management business had reported over a long period of time. Additionally, numerous schools, pension plans, and charitable foundations had invested with Madoff. As a result, ordinary investors, including "[p]ensioners, municipal workers, students on scholarship and middle-class Americans . . . are likely to be burned by [Madoff's] spectacular flare-out." In fact, many investors who stand to be harmed by

ponzi.htm (last visited Mar. 29, 2009), the person in charge of the scheme uses the money that new investors contribute to either repay or pay interest to earlier investors, often times "without any operation or revenue-producing activity other than the continual raising of new funds." BLACK'S LAW DICTIONARY, supra note 16, at 1198.

23. Madoff Complaint, supra note 21, at 1–2.
24. See id. at 3.
25. See id. at 4.
30. See Stern, supra note 29.
Madoff's fraud may not have even been aware that their money was invested with Madoff.\(^\text{31}\)

While stories such as Amaranth and Madoff can be labeled atypical, either because of the size of their collapse or the level of malfeasance associated with the fraud, they help to highlight why both the government and the public in general need to pay greater attention to the hedge fund industry.\(^\text{32}\)

Historically, only the wealthy invested in hedge funds.\(^\text{33}\) Consequently, ordinary investors had little reason to be concerned with the investment vehicles' risks. However, as hedge funds continue to become more accessible to retail investors, there is a growing awareness of the deleterious effects that hedge funds and their accompanying risks can effect on ordinary investors and the general public.\(^\text{34}\) One such risk involves the conflicts of interest for those in charge of managing the funds, many of which can harm those who contribute capital, either directly or indirectly, to the investment vehicles. This Note focuses on the conflicts of interest that hedge fund managers face, and the regulatory measures necessary to better protect hedge fund investors. Part I provides general background information about hedge funds. It then discusses the numerous conflicts of interest that inhere in the management of hedge funds, and makes the case that hedge fund investors are poorly protected from the injurious effects of these conflicts by both state and federal law. Part II then presents different proposals for decreasing and mitigating conflicts of interest in hedge funds. Finally, Part III recommends how hedge fund investors can be better protected from conflicts of interest.

1. THE TANGLED HEDGE: HEDGE FUNDS, THE ASSOCIATED CONFLICTS, AND A LACK OF INVESTOR PROTECTION

Much has been written about hedge funds in the press, yet many in the public still have a very limited understanding of these influential investment vehicles.\(^\text{35}\) The first part of this Note provides background information

---

31. See id.
about these lightly regulated pools of capital and explains how, despite their ability to achieve lofty gains, hedge funds have the ability to experience sudden, stunning losses. Part I.B presents important operational details regarding the funds, including how they are organized, who contributes capital to the investment vehicles, and how hedge fund managers are compensated. Part I.C introduces the many conflicts of interest affecting hedge fund investors, and Part I.D presents the argument that neither federal nor state law protects hedge fund investors from these conflicts.

A. Live Big, Die Fast

1. Defining the Hedge

To this day, the term hedge fund defies discrete definition. Because hedge funds encompass many diverse business types employing various trading strategies, any attempt at a blanket definition must necessarily be blurry at the edges. Despite their amorphous nature, however, the term “generally is used to refer to an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which [are] not registered as an investment company under the Investment Company Act.”

2. The History of the Hedge

Alfred Winslow Jones is credited with establishing the first hedge fund in 1949. The fund, created as a limited partnership, sought to protect its portfolio against the overall volatility in the equity markets by using

http://business.timesonline.co.uk/tol/business/movers_and_shakers/article3196956.ece (stating that many still have little understanding of who and what hedge funds are, despite the vast amounts of wealth they control).

36. See Christopher Rowland, How a Hedge Fund Star Lost It All, INT’L HERALD TRIB. (London), Aug. 16, 2007 (describing a hedge fund that lost $1.6 billion of investors’ money, including that of Harvard University, the Massachusetts employees pension fund, and the philanthropic Boston Foundation, in approximately one week’s time).

37. STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (2003) [hereinafter STAFF REPORT].

38. STUART A. MCCRARY, HOW TO CREATE AND MANAGE A HEDGE FUND: A PROFESSIONAL’S GUIDE 7 (2002). Some commentators have eschewed any attempt at a concrete definition, instead referring to hedge funds as “eclectic investment pools.” BARRY EICHENGREEN & DONALD MATHIESON, HEDGE FUNDS: WHAT DO WE REALLY KNOW? 2 (1999); see Thierry Olivier Desmet, Understanding Hedge Fund Adviser Regulation, 4 HASTINGS BUS. L. J. 1, 4 (2008) (stating that “the hedge fund industry is far from monolithic, [as] hedge funds . . . vary enormously, not only in structure and investment style, but also in management”).

39. STAFF REPORT, supra note 37, at 3.

40. MCCRARY, supra note 38, at 1.
leverage in combination with long and short positions in common stocks. Jones’s novel combination of leverage and short selling proved successful both in achieving long-term gains and in weathering rough times in the market, and for a short time he was the only known hedge fund in operation. Although some competitors attempted to replicate Jones’s success, hedge funds remained essentially a secret to those outside select circles until the press became aware of these mysterious pools of capital in the late 1980s and early 1990s.

Since that time, both the number of hedge funds and the assets under their management have grown exponentially. Hedge funds now account for forty to fifty percent of trading on the world’s stock markets and are a significant player in the debt markets. Being such active traders, hedge

41. Leverage refers to an investor’s use of borrowed money to buy more stock (or other financial instruments) than she could purchase with her own money. See Jaeger, supra note 37, at 4. Using leverage magnifies a hedge fund’s gains and losses, and increases the risk associated with a position taken by the hedge fund manager. Id. at 134–35.

42. Short selling can refer to two practices: traditional short selling and naked short selling. See James W. Christian et al., Naked Short Selling: How Exposed Are Investors?, 43 Hous. L. Rev. 1033, 1038 (2006). A trader engages in traditional short selling when she sells shares that she does not own but has borrowed with the requirement that she purchase comparable shares and return them to the lender of the original shares at some point in the future. Id. The trader stands to make a profit if the share price drops between the time she sold the original shares and the time of the purchase of the replacement shares. Id. Conversely, naked short selling is an illusory practice that involves selling shares that have not been borrowed, will not be borrowed, and might not even exist. Id. Recently, traders engaging in short selling have “been accused of playing a key role in the current crisis, helping to force Lehman Bros. into bankruptcy and pushing other companies to the brink of financial ruin by driving down their stock prices.” David Baker, Short Sellers Get Some of the Blame, S.F. Chron., Sept. 20, 2008, at C1.


44. Jones is credited with being the first to demonstrate how long-employed investment tools could be combined to limit market risk. See Eichengreen & Mathieson, supra note 38, at 4.

45. In 1961 Jones created a second fund, having compounded his investors’ money in his first fund at a twenty-one percent annual rate. See Loomis, supra note 43, at 100.

46. See id.

47. See McCrory, supra note 38, at 1.


Funds have come to occupy a prominent place in the financial industry, conferring significant benefits on the debt and equity markets.51

3. The Propensity to Lose Capital Quickly

Hedge funds have also, however, demonstrated a propensity for rapid demise,52 destroying investors’ wealth and theoretically injecting systemic risk into the financial system.53 Long-Term Capital Management (LTCM) funds are also a major trader of some of the debt instruments that have recently caused significant market turmoil, including mortgage-backed securities, collateralized debt obligations, and asset-backed securities. See id.

51. See Staff Report, supra note 37, at 4–5. Timothy Geithner, then president and CEO of the Federal Reserve Bank of New York listed some of the benefits of hedge funds: Hedge funds play a valuable arbitrage role in reducing or eliminating mispricing in financial markets. They are an important source of liquidity, both in periods of calm and stress. They add depth and breadth to our capital markets. By taking risks that would otherwise have remained on the balance sheets of other financial institutions, they provide an important source of risk transfer and diversification.


53. While systemic risk has no universally accepted definition, Professor Steven L. Schwarcz of Duke University School of Law defines systemic risk as the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.

famously demonstrated the meteoric speed at which large, “safe” hedge funds can fail.\textsuperscript{54} Founded in 1993 by John Meriwether, a well-known former bond trader at Salomon Brothers,\textsuperscript{55} LTCM was comprised of brainy academics and two future Nobel laureates.\textsuperscript{56} In little time, LTCM became the “envy of Wall Street”\textsuperscript{57} as it relied on large loans from the major investment banks to finance its convergence trades\textsuperscript{58} and dynamic hedging strategies.\textsuperscript{59}

The good times, however, were not to last. In early August 1998, LTCM had $3.6 billion in capital, of which sixty percent belonged to the fund’s investors.\textsuperscript{60} At the same time, LTCM’s significant leverage made it susceptible to unfavorable shifts in the market.\textsuperscript{61} That unfavorable shift came when Russia unexpectedly defaulted on part of its debt.\textsuperscript{62} While many of the former communist countries found the transition from socialism to capitalism difficult, “Russia found it harder than most.”\textsuperscript{63} In 1998, these troubles reached epic proportions when the Russian currency was sharply devalued,\textsuperscript{64} in turn, triggering a “flight to quality,”\textsuperscript{65} as panicked investors sold risky investments for the relative safety of U.S. Treasury bonds.\textsuperscript{66} The resulting upheaval in the international bond markets

\begin{itemize}
\item \textsuperscript{54} See President’s Working Group on Fin. Mkts., Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management 10–14 (1999) [hereinafter PWG Report].
\item \textsuperscript{55} See Michael Siconolfi et al., All Bets Are Off: How the Salesmanship and Brainpower Failed at Long-Term Capital—Investors Clamored to Get In, While Partners Debated Their Ever-Greater Risks—On the Payroll, 25 Ph.D.s, WALL ST. J., Nov. 16, 1998, at A1.
\item \textsuperscript{56} The brainpower behind Long Term Capital Management (LTCM) impressed investors, some of whom viewed LTCM as “probably the best academic finance department in the world.” Id. (quoting William Sharpe, a professor at Stanford University and a Nobel laureate in economics).
\item \textsuperscript{57} Lowenstein, supra note 56, at xix.
\item \textsuperscript{58} Convergence trading involves purchasing two securities (bonds, for example) with similar but not identical characteristics that are priced differently in the hopes that the current price gap subsequently narrows. See PWG Report, supra note 54, at 10 n.13.
\item \textsuperscript{59} See PWG Report, supra note 54, at 10.
\item \textsuperscript{60} Lowenstein, supra note 56, at 143.
\item \textsuperscript{61} See PWG Report, supra note 54, at 11–12 (stating that, in January 1998, LTCM had a balance sheet leverage ratio of more than 25-to-1).
\item \textsuperscript{62} See Lowenstein, supra note 56, at 144 (stating that Russia “decided it would rather use its rubles to pay Russian workers than Western bondholders”).
\item \textsuperscript{63} See Krugman, supra note 52, at 132.
\item \textsuperscript{64} See id. at 133.
\item \textsuperscript{65} “Flight to quality” is defined as a “flow of funds from riskier to safer investments in times of marketplace uncertainty or fear.” Flight to Quality Definition, http://www.investorwords.com/2010/flight_to_quality.html (last visited Mar. 29, 2009). As Nobel Laureate Paul Krugman notes, “U.S. government debt is as safe as anything on the planet, not because the United States is the most responsible nation on earth but because a world in which the U.S. government collapses would be one in which pretty much everything else collapses too.” See Krugman, supra note 52, at 171–72.
\item \textsuperscript{66} See Lowenstein, supra note 56, at 144–45. U.S. Treasury bills are short-term debt obligations issued by the U.S. government that generally mature in one year or less. See TreasuryDirect, http://www.treasurysdirect.gov/indiv/products/products.htm (last visited Mar. 29, 2009). Because U.S. Treasury bills are backed by the full faith and credit of the federal government, they are considered very secure investments.
\end{itemize}
markets, in which LTCM had made large bets, forced LTCM to sell many of the assets in its portfolio at a steep loss. In August alone the hedge fund lost $1.8 billion—forty-four percent of the value of the hedge fund’s holdings.

In the first half of September, as LTCM continued to hemorrhage money and the losses mounted, those within the financial markets grew increasingly concerned about the effects that an LTCM collapse could effectuate on financial markets. Concluding that the risk was too much to bear, the president of the Federal Reserve Bank of New York “summoned . . . the heads of every major Wall Street bank” for a private sector bailout of the troubled hedge fund. In the end, about a dozen firms agreed to contribute $300 million to avert the possibility of an international financial crisis. The fund’s principals and investors were not as lucky, however, losing almost all of their equity stakes in the fund.

Whereas LTCM’s losses were confined to sophisticated investors, the Bernard Madoff scandal has demonstrated that investors of all backgrounds with money in hedge funds may be at risk. Even in those cases where fraudulent activity is not alleged, hedge funds remain prone to losing copious amounts of their investors’ wealth shockingly fast, a fact that has been well-demonstrated during the current economic crisis as hedge fund collapses have increased in frequency. This is problematic because, unlike in the past, hedge fund health increasingly affects the livelihood of government and only become worthless if the federal government itself goes bankrupt, they are considered the safest securities for investors. See U.S. Treasury Bill Definition, http://www.investorwords.com/5197/US_Treasury_Bill.html (last visited Mar. 29, 2009).

67. See KRUGMAN, supra note 52, at 134–36. The difficulty that LTCM experienced in trying to sell its many illiquid assets caused the hedge fund to lose millions by the minute. See LOWENSTEIN, supra note 56, at 145.

68. See SICONOLFI et al., supra note 55.

69. See PWG REPORT, supra note 54, at 13. According to Peter Fisher, the then second in command at the New York Federal Reserve Bank, “the systemic market risk posed by LTCM going into default was ‘very real.’” SICONOLFI et al., supra note 55.

70. See LOWENSTEIN, supra note 56, at xviii.

71. See SICONOLFI et al., supra note 55. The participating banks were willing to contribute because they had all lent to LTCM. In essence, the bailout “can be seen as an out-of-court bankruptcy-type reorganization in which LTCM’s major creditors became its new owners, hoping to salvage as much value as possible.” EICHENGREEN & MATHIESON, supra note 38, at 15.

72. See PWG REPORT, supra note 54, at 14.

73. See supra notes 26–31 and accompanying text.

74. The recent financial crisis is taking its toll on hedge funds. See Kardos, supra note 48. Through the first nine months of 2008, 693 hedge funds were liquidated, with 344 hedge funds liquidating in the third quarter alone. See Ben Rooney, Hedge Fund Graveyard: 693 and Counting, CNNMONEY.COM, Dec. 18, 2008, http://money.cnn.com/2008/12/18/news/economy/hedge_fund_liquidations/. As of November 2008, the hedge fund industry was cumulatively down 18.5% after an unprecedented six-month string of losses. See Nakashima, supra note 51. The monumental losses have caused investors to redeem their investments in hedge funds, see Rooney, supra, contributing to a significant contraction in the overall amount of capital under hedge fund management, see Nakashima, supra note 51. Indeed, the financial landscape currently looks so dire that some hedge fund managers predict a 75% reduction in the industry’s working capital. See id.
ordinary investors. Believing that the risks associated with hedge funds affect only wealthy investors, "'[m]ost people don't understand the relationship [the hedge fund industry] has to the working family on the street and the relationship to pensions and endowments.'"75 In fact, in 2007, pension funds and endowments had approximately $76.3 billion and $75 billion, respectively, invested in hedge funds.76 Thus, "'[w]hat happens at hedge funds . . . matters to just about every investor in America.'"77

B. Peering Behind the Hedge: Hedge Fund Practices

1. Hedge Fund Organization

Domestic hedge funds are typically organized as limited partnerships78 with the hedge fund manager serving as the general partner and having overall responsibility for managing the fund, including managing the fund’s investment portfolio.79 The limited partnership form, characterized by its flexibility of governance,80 provides the general partner with complete control over the hedge fund’s activities, subject only to the express provisions of the limited partnership agreement and principles of fiduciary duty.81 The general partner—the hedge fund manager—can either be a natural person or separate legal entity82 and typically will invest in the


76. See id.; see also NARAYAN NAIK, EUROPEAN PARLIAMENT’S COMM. ON ECON. AND MONETARY AFFAIRS, HEDGE FUNDS: TRANSPARENCY AND CONFLICTS OF INTEREST 7 (2007) (stating that a large number of investors are indirectly exposed to hedge funds through their investment in pension funds that invest a portion of their assets in hedge funds).


79. See SHARTSIS FRIESE, supra note 78, at 91–92. For more discussion on the roles, rights, and obligations of general and limited partners in a limited partnership, see infra notes 177–82 and accompanying text.

80. See SHARTSIS FRIESE, supra note 78, at 90.

81. See id. Depending on the limited partnership agreement, the general partner may owe fiduciary duties and other rights to the limited partners. See id. at 92.

82. See id. at 91. Natural persons acting as the general partner typically will manage the hedge fund as a sole proprietorship, which, while tax efficient, does not provide the protection of limited liability. See id. at 93. Hedge fund managers organized as a separate legal entity often take the form of a limited liability corporation. See id. This provides the owners of the hedge fund with both a flexible governance structure and the protection of limited liability. See id.; see also Levy & Barton, supra note 78, at 18 (stating that using a liability-limiting entity as the general partner is typically favored).
When organized as a limited partnership, the hedge fund manager will have unlimited liability for any of the hedge fund’s debts and obligations that the hedge fund itself cannot satisfy. Ordinarily, the hedge fund manager will have exclusive authority to manage the business and affairs of the hedge fund, including managing its portfolio of assets. Accordingly, the hedge fund manager will generally be the hedge fund’s investment adviser; however, in some situations it may be advantageous to structure the investment adviser as an individual entity with its own rights and obligations.

The hedge fund’s investors constitute the limited partners. While the limited partnership form offers hedge fund investors benefits, it provides them with only minimal rights and protections. In the hedge fund context, limited partners remain passive investors who take no active role in the fund’s management. The limited partners, who share in the partnership’s income, gains, and losses, are generally only liable to the extent of their investment.

In addition to the limited partnership form, some domestic hedge funds incorporate as a limited liability company (LLC). Though not as prevalent as the limited partnership, LLCs have become more popular as a hedge fund vehicle. Like limited partnerships, LLCs offer investors the benefit of limited liability and flow-through taxation. Where the limited partnership will have a general partner, however, the LLC will have one or more managing members, which unlike a general partner, enjoys limited liability.

83. See Shartsis Friese, supra note 78, at 92. It is thought that a hedge fund manager can better align its interests with the interests of its investors by personally investing its capital alongside investor funds. See Hedge Funds and the Financial Market: Hearing Before the H. Comm. on Oversight and Government Reform, 110th Cong. 5 (2008) (testimony of Professor Houman B. Shadab) [hereinafter Shadab Testimony].

84. See Shartsis Friese, supra note 78, at 92.

85. See id. at 91. The hedge fund manager is generally responsible for negotiating the fund’s arrangement with various service providers, maintaining relations with the fund’s investors, and, when the hedge fund is first becoming established, marketing and distributing its securities to investors. See Staff Report, supra note 37, at 52–53.

86. See Shartsis Friese, supra note 78, at 94.

87. See id. at 95.

88. See id. at 90; see also infra notes 180–82 and accompanying text.

89. See Lins, supra note 78, at 98.

90. Id. In addition to limited liability, organizing as a limited partnership affords the fund’s investors the benefit of “flow-through” tax treatment. Id. As compared to being organized as a corporation, which is subjected to “double taxation,” the limited partnership proves a more tax-efficient investment vehicle for most investors. Id.

91. See id. at 99.

92. Id.

93. Id.

94. Id.
Domestic hedge funds are typically organized in Delaware. In addition to being drawn to the state by the Delaware Court of Chancery’s reputation and the manner in which Delaware handles bankruptcy proceedings, filing in Delaware allows hedge funds to take advantage of the Delaware Revised Uniform Limited Partnership Act (DRULPA), widely considered one of the most “state of the art” and “flexible” limited partnership statutes in the United States. Delaware also has the benefit of a hedge-fund-friendly tax structure. The state also attracts hedge fund managers because of its recognition of side letters—the ancillary agreements with limited partners that allow hedge fund managers to give certain preferred investors individual benefits that are not shared by all the fund’s investors.

2. Nature of Investors

Historically, hedge fund investors were high net worth individuals seeking large returns for which they accepted the higher risk associated with hedge funds. In recent years, however, there has been a dramatic shift in hedge funds’ investor base. Although wealthy individuals still compose a large percentage of hedge fund investors, institutional investors, funds of hedge funds (or funds of funds), endowments,

95. See McCrary, supra note 38, at 103; Ron S. Geffner, Delaware—The Hedge Fund Jurisdiction of Choice in the US, COMPLINET, Feb. 11, 2008, http://www.hedgefundworld.com/documents/Delawarerev.pdf (detailing why Delaware is the jurisdiction of choice for domestic hedge funds); Levy & Barton, supra note 78, at 18 (stating that Delaware is the most recommended state for hedge fund organization by attorneys specializing in hedge fund representation).

96. The Delaware Court of Chancery, which many believe to be the nation’s most important court in matters of corporate law, is a primary reason that nearly half of the Fortune 500 companies, as well as many alternative business entities, are located in Delaware. See Maureen Milford, New Home for Delaware’s Noted Chancery Court, N.Y. TIMES, Feb. 4, 2001, § 11, at 7; see also Omari Scott Simmons, Branding the Small Wonder: Delaware’s Dominance and the Market for Corporate Law, 42 U. RICH. L. REV. 1129, 1163 (2008) (noting the Delaware Court of Chancery’s “national reputation for its sophistication and expertise in handling corporate cases”).

97. See McCrary, supra note 38, at 103.

98. Geffner, supra note 95.

99. See Levy & Barton, supra note 78, at 18 (stating that Delaware, in addition to Nevada and Wyoming, has beneficial tax structures).

100. See Geffner, supra note 95. For a more detailed discussion of side letters, see infra notes 157–61.

101. See Shartsis Friese, supra note 78, at 95; Bandopadhyaya & Grant, supra note 33, at 6.

102. See Shartsis Friese, supra note 78, at 95.

103. See Bandopadhyaya & Grant, supra note 33, at 6.

104. Institutional investors are entities—as compared to natural persons—such as insurance companies, banks, and corporations. See Jaeger, supra note 37, at 34. According to the Philadelphia Inquirer, “Pennsylvania is among the leading institutional investors in hedge funds.” See Joseph N. DiStefano, Hedge Fund’s Bad Bet to Hurt Pa., N.J. Pensions, PHILA. INQUIRER, Sept. 21, 2006, at C1.

105. Funds of funds provide an indirect way to invest in hedge funds. See Jaeger, supra note 37, at 37. Funds of funds, which are investment companies that specialize in investing
private foundations, and governmental and private pension funds are increasingly investing in hedge funds.\textsuperscript{106} This process, by which hedge funds are being made available to a growing investor base, either directly or indirectly, has come to be known as retailization.\textsuperscript{107} And while many commentators see benefits in the retailization phenomenon, the SEC particularly has expressed concern, as it sees hedge funds as "generally risky ventures that simply don't make sense for most retail investors."\textsuperscript{108} Accordingly, the SEC does not view hedge funds as appropriate "investments for Mom and Pop."\textsuperscript{109} Others, however, find it permissible that retail investors indirectly can access hedge funds as investment vehicles, though some proponents of opening the hedge fund market to retail investors realize that problems arise when investors are made "to accept high risk with no accountability or transparency."\textsuperscript{110}
3. Hedge Fund Managers/Advisers

Typically, hedge funds are founded by experienced financial professionals—former traders and analysts—who are lured by the entrepreneurial aspect of starting their own business, the opportunity to employ more flexible trading strategies, and the outsized compensation earned by successful hedge fund managers.\textsuperscript{111} Hedge fund managers differ markedly. Some are large, sophisticated entities managing billions of dollars and employing a team of financial personnel.\textsuperscript{112} Others are smaller, typically new entities that may have one person operating in numerous capacities and following “few, if any, formal procedures.”\textsuperscript{113} Yet, a common thread noted among those who start hedge funds is a belief that they can exploit their unique understanding of the financial system to earn gains for themselves and their investors.\textsuperscript{114}

4. Compensation Structure

Practically speaking, most hedge funds are unregulated in their fee structures.\textsuperscript{115} In general, hedge fund managers charge two forms of fees, a management fee—typically one percent of the assets under management, though this number is subject to minor variation—and performance fees.\textsuperscript{116} The management fee is fixed as a percentage of the amount of assets under management.\textsuperscript{117} By contrast, the performance fee will fluctuate according to the fund’s performance.\textsuperscript{118} A hedge fund’s performance fees, one of the investment vehicle’s defining features,\textsuperscript{119} generally consists of twenty

\textsuperscript{111} See STAFF REPORT, supra note 37, at 52. Indeed, “[y]oung, ambitious talent is fleeing Wall Street in search of hedge funds’ overnight riches.” Jenny Anderson & Riva D. Atlas, If I Only Had a Hedge Fund, N.Y. TIMES, Mar. 27, 2005, at C1. These advisers, sometimes referred to as “investment cowboys,” see JAEGGER, supra note 37, at vii, are typically “stars” of the investment world before starting their hedge fund. Id. at 7.

\textsuperscript{112} See id.

\textsuperscript{113} See STAFF REPORT, supra note 37, at 53.

\textsuperscript{114} See Shadab Testimony, supra note 83, at 4.

\textsuperscript{115} See McCRARY, supra note 38, at 13.

\textsuperscript{116} See JAEGGER, supra note 37, at 11. The management fee provides the hedge fund manager with the cash flow necessary to operate the fund. See STAFF REPORT, supra note 37, at 61. The management fee, which applies to the hedge fund’s NAV, is generally due regardless of whether the fund makes money. See McCRARY, supra note 38, at 14.

\textsuperscript{117} See id.

\textsuperscript{118} See Shartsis Frieze, supra note 78, at 326. It is the presence of performance fees, also called incentive fees, that makes possible the astronomical fees achieved by some of the top hedge fund advisers. See Jenny Anderson, Wall Street Winners Hit a New Jackpot: Billion-Dollar Paydays, N.Y. TIMES, Apr. 16, 2008, at A1 (reporting that in 2007, one hedge fund manager made $3.7 billion, and at least two others made nearly $3 billion); Anderson & Atlas, supra note 111 (reporting that in 2003, the twenty-five highest-paid hedge fund managers on average took home more than $200 million). Until recently, it was commonly believed that hedge fund fees would not come down from their lofty levels. See Anderson & Atlas, supra note 111. The recent economic upheaval, and the toll it is taking on hedge funds, is causing some funds to consider the once unthinkable. In an effort to keep investors from withdrawing their money from the fund, some advisers have begun offering sliding
percent of the appreciation of the fund’s assets over a given period of time.\footnote{120}

Performance fees may create incentives for the hedge fund manager to make risky investments, as they create a situation in which the manager shares proportionately in the fund’s profits “but is not liable for losses.”\footnote{121} In an effort to better align their respective interests, many investors require the fund manager to invest significant sums of its own capital in the fund.\footnote{122} This investment, however, fails to mitigate fully the divergence in the two parties’ respective willingness to bear risk.\footnote{123} As a result, performance fees, and the related valuation of portfolio assets on which performance fees are based, create one of the more prominent conflicts of interest facing hedge fund managers.\footnote{124}

\section*{C. A Thorny Thicket: Conflicts of Interest in Hedge Funds}

In many ways, hedge funds can be characterized by the myriad conflicts of interest growing out of an essentially unregulated agency relationship.\footnote{125} An inherent problem in such cooperative efforts is that the agent will not always act in the principal’s best interests.\footnote{126} Consequently, both agent and principal will expend costs to limit these divergences in interests.\footnote{127} And while these problems manifest in all agency relationships, they become

\begin{footnotesize}
\footnote{120. See \textit{Staff Report}, \textit{supra} note 37, at 61. In the case of limited partnerships, each limited partner is charged a performance fee based on her specific investment. See \textit{Hedge Funds: Strategies, Risk Assessment, and Returns} 348 (Greg N. Gregoriou et al. eds., 2004). It is necessary to calculate the performance fee on an individual level because the time at which a limited partner invests in the fund can drastically affect its level of profit or loss. See \textit{Jae ger}, \textit{supra} note 37, at 195. Performance fees are based on periodic, as compared to daily, valuation of the hedge fund’s portfolio’s assets. See \textit{Mc Crary}, \textit{supra} note 38, at 8. While it is common for hedge funds to charge a performance fee of twenty percent, highly successful hedge funds may charge higher fees. See \textit{Shartsis Friese}, \textit{supra} note 78, at 328.}

\footnote{121. \textit{Id.} at 308–10; Davis et al., \textit{supra} note 3 (quoting Louis Garicano, a professor at the University of Chicago’s business school, stating that “[performance fees] result[] in a huge incentive for taking risk[: ... when the bet goes well, the hedge-fund manager collects a lot, while when it goes badly the worst that can happen to the loser is he gets zero”).}

\footnote{122. See \textit{Mc Crary}, \textit{supra} note 38, at 310.}

\footnote{123. See \textit{id.} In situations where a fund is far from meeting its high-water mark, a manager may throw a “Hail Mary,” where investors would rather that the fund manager take a more conservative approach and try to limit losses. See Houman B. Shadab, \textit{The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection}, 6 BERKELEY BUS. L.J. (forthcoming 2009) (manuscript at 38–39, on file with the Berkeley Business Law Journal).}

\footnote{124. See \textit{infra} notes 131–41 and accompanying text.}

\footnote{125. In general, an agency relationship is a contract under which a principal delegates decision-making authority to an agent who performs some service on the principal’s behalf. See Michael C. Jensen & William H. Meckling, \textit{Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure}, 3 J. FIN. ECON. 305, 308 (1976).}

\footnote{126. \textit{Id.}}

\footnote{127. See \textit{id.} at 308–10.}
\end{footnotesize}
especially acute in relationships that involve separation of ownership and control. It should come as no surprise, then, that in the context of hedge funds, where the limited partnership form facilitates the complete separation of control and ownership over invested funds, conflicts of interest arise inevitably between hedge fund managers and their investors. But despite the commonality in hedge funds, investors are afforded few legal protections against such conflicts.

Part I.C.1 presents aspects of hedge fund management in which the interests of the hedge fund manager conflict with the those of the fund and its investors. Part I.C.2 then discusses conflicts that arise by way of a hedge fund manager operating more than one fund and having to decide how to allocate investment opportunities amongst the various pools of capital. Finally, Part I.C.3 addresses the conflicts of interest that arise when a hedge fund manager enters into side letters with certain preferred investors.

1. Conflicts Between a Hedge Fund Manager and its Fund(s)

a. Valuation Methods

The methods by which a hedge fund manager values the complex instruments in the fund’s portfolio create a significant conflict of interest. The valuation process drives nearly every decision that hedge fund managers make, from risk management to how they will compensate themselves, which, in turn, will affect many aspects of the relationship

128. See id.

129. See Asset Managers’ Comm., Best Practices for the Hedge Fund Industry: Report of the Asset Managers’ Committee to the President’s Working Group on Financial Markets 47 (2008) [hereinafter Asset Managers’ Comm. Report to PWG] (stating that “[c]onflicts of interest are inherent in the asset management business”); Douglas Cumming & Sofia Johan, Hedge Fund Forum Shopping, 10 U. PA. J. BUS. & EMP. L. 783, 794 (2008); see also Coffee Testimony, supra note 110, at 9 (stating that hedge fund managers face far greater conflicts of interest than the directors of public corporations). In addition to the deleterious effects of these conflicts of interest, hedge fund managers face other conflicts of interest that actually may benefit hedge fund investors. Where a hedge fund manager oversees both hedge funds and mutual funds, the fund manager may direct favorable investment opportunities to the hedge fund as compared to the mutual fund, which has a less favorable compensation structure for the fund manager. See Pearson & Pearson, supra note 35, at 39. In this case, the negative effect of the hedge fund manager’s conflict of interest is borne by the mutual fund shareholders. See id.

130. See Investors’ Comm., Principles and Best Practices for Hedge Fund Investors: Report of the Investors’ Committee to the President’s Working Group on Financial Markets 36 (2008) [hereinafter Investors’ Comm. Report to PWG]. Theoretically, investors are protected against conflicts of interest by the hedge fund’s partnership agreement. See id. (noting that investors may find some protections against conflicts of interest in a hedge fund’s investment agreement). Hedge fund managers, however, typically structure their limited partnership agreements in a way that leaves investors with few protections. See infra notes 164–66 and accompanying text.

between hedge fund managers and investors.\textsuperscript{132} In addition to determining the size of the management fee and the performance fee,\textsuperscript{133} hedge fund investors decide whether to remain invested in the fund or withdraw their money based, in part, on the hedge fund's performance.\textsuperscript{134}

Despite the importance of accurately valuing the assets in a hedge fund's portfolio, no uniform standards exist for doing so.\textsuperscript{135} Indeed, the valuation models are often developed by the hedge fund manager itself.\textsuperscript{136} While most hedge funds' offering documents contain clauses regarding how the hedge fund manager will value the fund's assets and calculate its net asset value (NAV), these provisions are deliberately kept vague and lack the specificity needed for investors to adequately police the valuation process.\textsuperscript{137} Moreover, the typical offering documents will grant the hedge fund manager the liberty of deviating from the stated valuation policies and procedures when it is deemed necessary, thereby further obfuscating the

\begin{footnotesize}
\begin{enumerate}
\item The management fee is calculated as a percentage of the fund's NAV, and the performance fee is calculated as a percentage of the fund's profits—the appreciation of the NAV. See INVESTORS' COMM. REPORT TO PWG, supra note 130, at 40. NAV is calculated based on the assets in the hedge fund's portfolio. In most cases, a hedge fund manager both will value the assets in the hedge fund's portfolio and calculate the NAV, a practice which gives rise to a conflict of interest as a hedge fund manager has a strong incentive to see an increase in the fund's NAV in order to receive performance fees. See STAFF REPORT, supra note 37, at 79.
\item See INVESTORS' COMM. REPORT TO PWG, supra note 130, at 40. An investor gauges hedge fund performance by changes in its NAV, which, in turn, is based upon changes in the fund's portfolio's value. \textit{id.}
\item See Pearson & Pearson, supra note 35, at 41–42 (noting that "there are no standards for hedge fund valuations" and a lack of uniformity in the valuation of complex assets). Where a hedge fund investment adviser typically has complete discretion in how she values the securities the fund holds, the valuation of a SEC-registered investment company's securities will be independently overseen by the board of directors of a registered investment company. See STAFF REPORT, supra note 37, at 64. This broad discretion exacerbates the conflicts of interest present in the valuation process. Hedge fund managers need only value their fund's assets in a manner consistent with the often vague policies and guidelines disclosed to investors in the fund's offering documents. See \textit{id}. at 80. This leads to great inconsistency in the valuation process, as there are currently few ways to ensure that the hedge fund manager's valuation policies and methodology accurately assess the value of the assets in the fund's portfolio. See \textit{id}. Concern over the inadequacy of current valuation processes is further heightened by hedge funds often investing in inherently hard to value illiquid assets for which there exists no readily ascertainable market price. See \textit{id}.
\item See FSA DISCUSSION PAPER, supra note 131, at 48.
\end{enumerate}
\end{footnotesize}
valuation process and making the potential conflicts of interest more pronounced.\textsuperscript{138}

A system by which each hedge fund manager values the assets in its fund according to a model that it developed can expose investors to the risk that the performance fee is, in part, determined by a model that overvalues the fund’s assets.\textsuperscript{139} Additionally, efforts to earn the performance fee may result in excessive investment risks, unbeknownst to the fund’s investors.\textsuperscript{140} Furthermore, the manager’s control over the fund’s investment strategies may allow it to shelter its investment from risks to which the investor remains exposed.\textsuperscript{141}

b. Prime Brokers

A potential conflict also arises out of the nature of the services that prime brokers provide hedge fund managers.\textsuperscript{142} A hedge fund’s prime broker is a brokerage firm that holds the hedge fund’s assets, clears the fund’s trades, and provides the fund with detailed financial reports, such as transaction and position reports.\textsuperscript{143} The prime broker, which is typically a large Wall Street firm, also finances the hedge fund’s long positions and lends securities to the fund to finance its short positions.\textsuperscript{144} Additionally, prime brokers act as marketing agents for the fund, raising capital for the fund by introducing the fund managers to some of the brokerage’s more important clients.\textsuperscript{145} Hedge funds compensate prime brokers based on the services rendered.\textsuperscript{146}

While prime brokers’ services are essential to the operation of a hedge fund, they have the potential to cause hedge fund managers’ interests to diverge from those of their investors. For example, a conflict may arise if the hedge fund manager utilizes fund assets to pay for services such as capital introduction and marketing that benefit the fund manager as compared to the investors.\textsuperscript{147} Additional conflicts may arise as a result of the prime brokers’ provision of “seed capital” investments to the fund.\textsuperscript{148} By accepting seed capital investments, a hedge fund manager may lose

\textsuperscript{138} See id. ("To add salt to the wound, every prospectus we have ever read includes a final caveat along the lines of ‘notwithstanding the above policies, the general partner . . . may elect any “alternative method” of fair valuation.").

\textsuperscript{139} See Cumming & Johan, supra note 129, at 796.

\textsuperscript{140} See id. Although performance fees are thought to align the interests of the hedge fund manager with those of the investor, the incentives of the hedge fund manager can change if the fund’s performance suffers. See Ted Seides, A Matter of Trust: The Issue of Risk Transparency, in HEDGE FUND STRATEGIES: A GLOBAL OUTLOOK, supra note 78, at 106.

\textsuperscript{141} See STAFF REPORT, supra note 37, at 85.

\textsuperscript{142} See JAEGERT, supra note 37, at 48

\textsuperscript{143} See id. at 48–49.

\textsuperscript{144} See id. at 50.

\textsuperscript{145} See STAFF REPORT, supra note 37, at 55.

\textsuperscript{146} See id. at 85.

\textsuperscript{147} See id.
leverage in negotiating a prime brokerage fee more agreeable to the fund, which would benefit the investors.149 Hedge funds, however, rarely disclose the nature of these services to their investors, nor do they disclose how prime brokers are compensated.150

2. Conflicts Between Funds Managed by the Same Manager

A hedge fund manager's self-interest may also conflict with the interest of investors when the hedge fund manager operates multiple hedge funds.151 If the different funds have varying fee structures, or the hedge fund manager's proprietary investment in the funds are different, the conflict becomes more apparent and even more problematic.152 These discrepancies may cause a hedge fund manager to direct preferential investment opportunities, liquidity preferences, and other preferential allocations to its favored fund, denying them to the investors in the other fund.153 Additionally, conflicts of interest may be triggered, or exacerbated, where a hedge fund manager employs offsetting trading strategies between two funds.154 For example, a hedge fund manager may use one fund to invest long in stock, and use another fund to short the same stock. Regardless of the direction in which the stock moves, the hedge fund manager will collect management fees on both funds and a performance fee on one of the funds.155 The investors in one of the funds will suffer losses, as the hedge fund manager's gains will come at that fund's expense.156

3. Conflicts Between Investors

Interestingly, hedge fund investors can also be harmed by conflicts that develop between the investors themselves. At times, hedge fund managers give preferential treatment to certain fund investors, typically those who they want to invest in any new hedge funds the manager may be opening.157 By entering into a "side letter" agreement, a hedge fund manager can agree to provide a favored investor with specified preferences that are not

149. See id.
150. See id.
151. See INVESTORS' COMM. REPORT TO PWG, supra note 130, at 36; Cumming & Johan, supra note 129, at 796.
153. See Cumming & Johan, supra note 129, at 796.
154. See id. at 800.
155. See id.; see also Douglas Cumming, A Law and Finance Analysis of Hedge Funds 4 (Apr. 5, 2008) (unpublished manuscript, on file with York University, Schulich School of Business), available at http://ssrn.com/abstract=946298 (noting that, in such a situation, "half of the investors of these two hedge funds will lose, while the hedge fund manager[] reap[s] the profits").
156. See Cumming & Johan, supra note 129, at 800.
157. See id. at 795.
available to all the hedge fund’s investors.\textsuperscript{158} Preferential treatment may take the form of superior investment opportunities and more favorable redemption terms.\textsuperscript{159} Although side letters can help hedge fund managers attract large investors to the fund—thereby benefiting all the fund’s investors—they also have the propensity to work disadvantages on those investors not receiving preferential treatment.\textsuperscript{160} Hedge fund managers may be reluctant to disclose their presence, however, fearing that their nonpreferred investors would discontinue their investment in the fund upon knowledge of these preferential arrangements.\textsuperscript{161}

\section*{D. Lack of Investor Protection from the Thorns}

Despite the prevalence of conflicts of interest that hedge fund managers face and the harmful effect they can have,\textsuperscript{162} there are few legal protections in place to shield investors from their potential harm. Part I.D.1 next discusses the lack of hedge fund investors’ protection from conflicts of

\begin{footnotesize}
\begin{enumerate}
\item[158.] See Asset Managers’ Comm. Report to PWG, supra note 129, at 10.
\item[159.] See Cumming & Johan, supra note 129, at 795.
\item[160.] See Asset Managers’ Comm. Report to PWG, supra note 129, at 10; Hedge Fund Side Letters: What You Don’t Know Could Hurt You (June 2008), http://www.lplegal.com/smartbusiness_070108/ (noting that not being aware of the side letters a hedge fund manager has entered into can hurt an investor).
\item[161.] See NAIK, supra note 76, at 33.
\item[162.] During the period between the Hedge Fund Rule becoming effective, see infra notes 246–72 and accompanying text, and the U.S. Court of Appeals for the District of Columbia Circuit’s abrogation of the rule, see infra notes 273–96 and accompanying text, many hedge funds registered as investment advisers with the SEC and filed Form ADVs. The Investment Advisers Act of 1940 (Advisers Act) requires most investment advisers to fill out Form ADV disclosing basic information about the adviser to advisory clients and prospective advisory clients. See infra notes 237–39 and accompanying text. A group of social scientists used the information contained in those disclosures to analyze whether such disclosures have value as a public good or are “simply costly and redundant.” Stephen Brown et al., Mandatory Disclosure and Operational Risk: Evidence from Hedge Fund Registration 1 (Yale Int’l Ctr. for Fin., Working Paper No. 06-15, 2008), available at http://ssrn.com/abstract=918461. In addition to finding “a strong positive association between [a hedge fund manager’s] potential conflicts identified in the Form ADV filing and past legal and regulatory problems,” id. at 4, the study identified a strong correlation between operational risk indicators and conflict of interest variables, see id. at 1. In other words, “as potential conflicts of interests between manager and investor increase, operational risk increases as well.” Id. at 7. Operational risk is “[t]he risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.” DRAFT SUPERVISORY GUIDANCE ON OPERATIONAL RISK ADVANCED MEASUREMENT APPROACHES FOR REGULATORY CAPITAL 5 (2003). Operational risk includes the risk of loss for failure to comply with laws, ethical standards, and contractual obligations, and also includes an institution’s exposure to liability stemming from its actions. See id. Unlike other types of risk, operational risk does not provide investors with potentially increased returns. See Reiko Nahum & David Aldrich, Hedge Fund Operational Risk: Meeting the Demand for Higher Transparency and Best Practice, CAPCO INST., 2006, at 104, available at http://www.capco.com/files/pdf/62/02_PART%202/02_Hedge%20fund%20operational%20risk%20meeting%20the%20demand%20for%20higher%20transparency%20and%20best%20practice%20(Opinion).pdf. Described as “a potential ‘time bomb,’” for hedge fund investors, id. at 107, “operational risk is particularly relevant in the hedge fund industry as the type and quality of fund management . . . varies widely,” id. at 104.
\end{enumerate}
\end{footnotesize}
interest at state law, focusing particularly on the laws of Delaware, the state
in which most domestic hedge funds are organized. Next, Part I.D.2
highlights the lack of investors’ protection from conflicts of interest at
state law. In doing so this part discusses the federal securities laws,
including the exemptions that hedge fund managers use to avoid their
application, the SEC’s ill-fated attempt to bring hedge fund managers under
the umbrella of regulation, and the SEC’s new anti-fraud rule.

1. Lack of Investor Protection at State Law

Common-law fiduciary duties protect hedge fund investors against the
fund manager’s conflicts of interest.\textsuperscript{163} Hedge fund limited partnership
agreements, however, often contractually “‘limit[] the liability of, and
reduce[] or eliminate[] the duties (including fiduciary duties) owed by [the]
general partner to [the limited partners] and restrict[] the remedies available
to [limited partners] for actions that might otherwise constitute breaches of
[the] general partner’s duties.”\textsuperscript{164} Consequently, hedge fund investors,
particularly those investing in the fund indirectly, are left with few
common-law protections and “weak to nonexistent corporate governance”
stuctures to guard against the myriad conflicts of interest despite an overall
lack of transparency and accountability.\textsuperscript{165} The situation is especially
problematic in Delaware, where the limited partnership statute, in
“[g]iv[ing] maximum effect to the principle of freedom of contract and to
the enforceability of partnership agreements,” allows for the complete
elimination of fiduciary duties.\textsuperscript{166}

\textsuperscript{163} In the absence of contractual modification, a hedge fund manager owes the
limited partnership and its investors the traditional fiduciary duties of loyalty and care. See TIMOTHY
W. MUNGOVEN ET AL., LESSONS FROM LEHMAN: HEDGE FUNDS AND REDEMPTION RISK 3
Investment_Lit_Alert_10_10_2008_.pdf.

\textsuperscript{164} Coffee Testimony, supra note 110, at 3 (quoting the Blackstone Group Prospectus,
Form 424 B4, filed June 25, 2007, at 197). For those hedge funds organized as limited
partnerships, the limited partnership agreement sets forth the rights and responsibilities of
the hedge fund manager and the investors. See Staff Report, supra note 37, at 49.

\textsuperscript{165} Coffee Testimony, supra note 110, at 11.

\textsuperscript{166} DEL. CODE ANN. tit. 6, § 17-1101(c) (2005). Pillsbury Winthropshaw Pittman, LLP
stated in a client alert notice that

most hedge funds are structured as Delaware limited partnerships in large part so
that the general partner may avail itself of the protection against fiduciary liability
Delaware offers general partners of hedge funds. In fact, the private placement
memoranda . . . of most hedge funds contain a section typically entitled “Conflicts
of Interest” in which the hedge fund manager will describe any number of
activities that could be construed as placing the interest of the general partner over
that of the hedge fund and its investors. The partnership agreement indicates that
the limited partner, by signing the partnership agreement, has read the [private
placement memorandum] and agrees that none of the activities in which the
general partner may engage will give rise to a cause of action by the limited
partner.

JAY B. GOULD & ROBERT B. ROBBINS, CLIENT ALERT: CONCEPT CLASH—DIFFERING DUTIES
UNDER INVESTMENT ADVISERS ACT AND DELAWARE PARTNERSHIP LAW (2006), available at
The following part demonstrates that investors lack legal protections from conflicts of interest at state law. Specifically, Part I.D.1.a provides a brief overview of fiduciary duties, particularly the common-law obligations that historically have governed agency relationships. Part I.D.1.b discusses the default understanding of fiduciary duties as they relate to limited partnerships and how, theoretically, fiduciary duties could protect hedge fund investors from conflicts of interest at state law. Part I.D.1.c demonstrates how Delaware has statutorily allowed for the complete elimination of fiduciary duties in limited partnerships, thereby removing an investor's primary protections from conflicts of interest at state law.

a. Nature of Fiduciary Duties

"'Fiduciary' is a vague term, [that] has been pressed into service for a number of ends."\textsuperscript{167} Despite the term's ambiguity, however, certain generalizations can be drawn about the nature of the relationships that involve a fiduciary. A fiduciary relationship is predicated on trust and generally arises where one person gives another person discretionary authority over his or her property or a critical resource.\textsuperscript{168} Indeed, a defining characteristic of the relationship is the separation of ownership and control.\textsuperscript{169}

In an optimal situation, the fiduciary's interests would align perfectly with those of the entrustor (the person entrusting her property or critical resource to the fiduciary),\textsuperscript{170} thereby removing all incentives for the fiduciary to harm the entrustor. In reality, the same delegated power that enables the fiduciary to benefit the entrustor in this situation makes it...


\textsuperscript{168} See Andrew S. Gold, On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms, 41 Wake Forest L. Rev. 123, 130 (2006); see also Melvin Aron Eisenberg, The Limits of Cognition and the Limits of Contract, 47 Stan. L. Rev. 211, 249 (1995) ("If an actor has a significant degree of managerial or other control over assets that belong in whole or in part to others, the relationship between the actor and the others normally is deemed a fiduciary relationship and imposes upon the actor certain fiduciary obligations.").


possible for the fiduciary to injure that person.\textsuperscript{171} The nature of the relationship allows the fiduciary to harm the entrustor in two primary ways: the fiduciary may misappropriate the entrustor’s assets, and the fiduciary may neglect to manage the entrustor’s assets.\textsuperscript{172} As a result, the law imposes a rigorous standard of behavior on fiduciaries, forcing fiduciaries to subordinate their own self-interest to the interests of the entrustor at all times.\textsuperscript{173} The law requires that fiduciaries “carry on their dealings with beneficiaries at a level high above ordinary commercial standards. . . . By comparison, non-fiduciaries who contract with each other can engage in ‘conduct permissible in a workaday world for those acting at arm’s length.’”\textsuperscript{174} Thus, the fiduciary may not receive gain from the relationship beyond that compensation agreed to by the parties.\textsuperscript{175} And though the wisdom of doing so is open to debate, many still view morality as a central tenet of the fiduciary relationship.\textsuperscript{176}

b. Fiduciary Duties in Limited Partnerships

Under both the common law and uniform partnership laws of most states, the general partner in a limited partnership owes fiduciary duties to the limited partners.\textsuperscript{177} And though court determinations have not always been congruent as to the nature of those duties, it is commonly recognized that general partners owe the partnership and limited partners the fiduciary

\textsuperscript{171} See id. One reason for this inherent vulnerability of the entrustor is that the power delegated to the fiduciary is narrower than the fiduciary’s capacity to utilize that which has been entrusted to it. See id. at 810.

\textsuperscript{172} See Cooter & Freedman, supra note 167, at 1047.

\textsuperscript{173} Gold, supra note 168, at 134–35.


\textsuperscript{175} Id. at 9.

\textsuperscript{176} See Frankel, supra note 170, at 830. But see Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 J.L. & ECON. 425, 427 (1993) (“Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings.”). The emphasis on morality is not surprising given the origins of the fiduciary relationship. Fiduciary duties are obligations imposed on modern-day business entities that grew out of ancient notions of trust and agency law. Paul M. Altman & Srinivas M. Raju, Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law, 60 BUS. LAW. 1469, 1470 (2005). Indeed, “the genealogy of fiduciary duties can be traced to the English Court of Chancery, the ecclesiastical courts, and ‘Roman conceptions, as modified and molded by Christian ethics.’” Mary Szto, Limited Liability Company Morality: Fiduciary Duties in Historical Context, 23 QUINNIPIAC L. REV. 61, 86 (2004) (quoting ARTHUR TAYLOR VON MEHREN & JAMES RUSSELL GOODLEY, The Civil Law System 13 (2d ed. 1977)).

\textsuperscript{177} See David Rosenberg, Venture Capital Limited Partnerships: A Study in Freedom of Contract, 2002 COLUM. BUS. L. REV. 363, 388–89. Although neither the 1916 Uniform Limited Partnership Act (ULPA) nor the Revised Limited Partnership Act (RULPA) explicitly state that general partners owe fiduciary duties to the limited partners in a limited partnership, the relationship “has long been part of the common law of partnerships.” CRAIG B. SMITH & ROGER D. ANDERSON, LIMITED PARTNERSHIPS: LEGAL ASPECTS OF ORGANIZATION, OPERATION, AND DISSOLUTION § VI.C (2006).
duties of loyalty, good faith, candor, and fairness. In general, the nature of fiduciary duties and liability stemming from breaches of those duties will be determined by the state in which a limited partnership is formed.

In general, one's status as a limited partner does not impose upon him fiduciary obligations. In certain circumstances, however, courts may impose fiduciary duties on a limited partner who takes part in the control of the limited partnership. By imposing fiduciary obligations on those limited partners who take an active role in the management of the limited partnership, this “control” rule provides incentive to limited partners to remain passive participants in the partnership.

c. Delaware and the Freedom of Contract

Delaware, the state where most domestic hedge funds are organized, takes a progressive view of limited partnership governance. Rejecting the notion that parties’ obligations are dictated by their status as partners, Delaware adopts what is known as the contractarian position—that

178. See Smith & Anderson, supra note 177, § VI.C; see also Turner v. Ferguson, 149 F.3d 821, 823 (8th Cir. 1998) (stating that a general partner owes a fiduciary duty to the limited partner under Missouri law); 7547 Partners v. Fistek, Nos. 94-20930, 95-20230, 1997 WL 255562, at *5 (5th Cir. Apr. 29, 1997) (stating that under Texas law, “when a corporation serves as a general partner it owes fiduciary duties to the partnership and the limited partners”); Int’l Equity Invs., Inc. v. Opportunity Equity Partners, Ltd., 475 F. Supp. 2d 456, 462 (S.D.N.Y. 2007) (applying New York law and stating that general partners owe fiduciary duties to limited partners); Golden Tee, Inc. v. Venture Golf Sch., Inc., 969 S.W.2d 625, 631 (Ark. 1998) (stating that, under Arkansas law, a general partner owes a fiduciary duty to a limited partner); Louis G. Hering et al., A Review of Delaware Limited Partnership Cases: The Development of a Limited Partnership Jurisprudence, 1 Del. L. Rev. 89, 90-91 (1998) (stating that, under the common law of partnerships, a general partner in a limited partnership owes fiduciary duties to the limited partnership and its limited partners).

179. See Spitzer v. Shanley Corp., 870 F. Supp. 565, 570 (S.D.N.Y. 1994) (applying Oklahoma law to a claim of breach of fiduciary duty where limited partnership was organized in Oklahoma, even though the general partner was a Texas corporation whose parent was a Delaware corporation); Maywalt v. Parker & Parsley Petroleum Co., 808 F. Supp. 1037, 1059 (S.D.N.Y. 1992) (noting that, under both Pennsylvania and Texas law, a fiduciary relationship exists between general partners and limited partners).

180. See Ribstein, supra note 174, at 37.

181. See id. The fiduciary duties that have been imposed on limited partners in those situations where the limited partners exert significant control over the partnership resemble the fiduciary duties imposed on controlling shareholders in the corporate context. See Kenneth M. Jacobson, Fiduciary Duty Considerations in Choosing Between Limited Partnerships and Limited Liability Companies, 36 Real Prop. Prob. & Tr. J. 1, 8–9 (2001); see also Bond Purchase, L.L.C. v. Patriot Tax Credit Props., L.P., 746 A.2d 842, 863–64 (Del. Ch. 1999) (stating that in deciding whether a limited partner to a Delaware limited partnership owes fiduciary duties to the general partner, the court looks to whether the limited partnership agreement gives the limited partner power to engage in the governance of the limited partnership); KE Mgmt. Inc. v. 275 Madison Mgmt. Corp., Civ. A. No. 12683, 1993 WL 285900, at *9 (Del. Ch. July 27, 1993) (“[T]o the extent that a partnership agreement empowers a limited partner discretion to take actions affecting the governance of the limited partnership, the limited partner may be subject to the obligations of a fiduciary . . . .”).

182. See Ribstein, supra note 174, at 38–39.

183. See notes 95–100, 166 and accompanying text.
partnership is a contractual relationship formed in arm’s length transactions between sophisticated parties who are free to define the nature of their relationship and the obligations governing their dealings. Accordingly, Delaware allows the general partner and limited partners to subordinate fiduciary duties through private contracting. As discussed below, this offers investors few state law protections against a general partner’s potential conflicts of interest. In large measure, Delaware’s limited partnership law “reflects the doctrine of caveat emptor,” as investors who desire fiduciary protections may choose other investment opportunities that offer less risk and more security.

Pursuant to section 17-1101(d)(2) of DRULPA, parties entering into a limited partnership in Delaware are free to expand, restrict, or eliminate the fiduciary duties the general partner owes to the limited partnership and the limited partners, provided that the partnership agreement does not eliminate the contractual covenant of good faith and fair dealing. Delaware courts will give effect to limited partnership agreements that replace a general partner’s fiduciary duties with contractual standards such as gross negligence, willful misconduct, or sole discretion. Additionally, Delaware courts will honor provisions allowing the general partner to compete directly with the limited partnership, to engage in self-dealing, and to appropriate the business opportunities of the partnership for itself.

184. See Hynes, supra note 167, at 452.
185. See Rosenberg, supra note 177, at 370-75; see also Smith & Anderson, supra note 177, § VI.C(6) (stating that Delaware “has been relatively generous in elevating contractual provisions over the statutory default rules relating to fiduciary duties”). When its courts are faced with a situation where contract provisions come into conflict with fiduciary duties, “Delaware law resolves th[e] conflict in favor of contract law, rendering fiduciary duties default rules. Consequently, parties to a limited partnership can enter into a contract which diminishes the general partner’s fiduciary duties.” Cont’l Ins. Co. v. Rutledge & Co., 750 A.2d 1219, 1235 (Del. Ch. 2000). Because obligations spelled out in the limited partnership agreement provide the primary form of protection to investors from the conflicts of interest common to hedge fund management, see INVESTORS’ COMM. REPORT TO PWG, supra note 130, at 36, Delaware’s contractarian approach leaves hedge fund investors with few state law protections against a hedge fund manager’s conflicts of interest.
To the extent that ... a partner ... has duties (including fiduciary duties) to a limited partnership or to another partner ... the partner’s ... duties ... may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
Id.; see also In re Marriott Hotel Props. II Ltd. P’ship Unitholders Litig., No. 14961, 1996 WL 342040, at *5 (Del. Ch. June 12, 1996) (“[W]here the parties have a more or less elaborated statement of their respective rights and duties, absent fraud, those rights and duties, where they apply by their terms, and not the vague language of a default fiduciary duty, will form the metric for determining breach of duty.”).
189. See id.; see also Seaford Funding Ltd. P’ship v. M & M Assocs. II, L.P., 672 A.2d 66, 72 (Del. Ch. 1995) (stating that a limited partner’s acceptance of a conflict of interest
The courts, however, will only give this level of deference to those limited partnership agreements whose provisions purporting to supplant common-law fiduciary duties of loyalty and care are written clearly and unambiguously.¹⁹⁰

By adopting such a deferential posture toward limited partnership agreements, and statutorily permitting the complete elimination of a general partner’s fiduciary obligations, Delaware has removed the primary protections from conflicts that state law affords hedge fund investors. As Part I.D.2 of this Note demonstrates, federal law also fails to offer hedge fund investors meaningful protections from a hedge fund manager’s conflicts of interest.

2. Lack of Investor Protection at Federal Law

Hedge fund investors are also not well-protected from conflicts of interest at federal law. Although potentially subject to numerous federal rules and regulations, hedge funds are typically structured in a way that exempts them from most federal requirements. This part discusses the primary federal regulations that apply to hedge funds and the exemptions that hedge funds utilize to remain outside their purview. Part I.D.2.b focuses on the SEC’s attempt to make hedge fund managers register with the agency under the Investment Advisers Act, and the U.S. Court of Appeals for the District of Columbia Circuit’s subsequent abrogation of the newly promulgated rule. Finally, Part I.D.2.c briefly discusses the Investment Advisers Act’s new anti-fraud rule.

a. Federal Securities Laws

According to one commentator, “[t]he most accurate definition of a hedge fund is a fund that is not registered under a list of specific federal statutes.”¹⁹¹ Under the current regulatory framework, if structured properly, hedge funds are in large part exempt from regulation under 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).

¹⁹⁰. See Brickell Partners v. Wise, 794 A.2d 1, 3–4 (Del. Ch. 2001) (“[T]his court has noted many times . . . ‘principles of contract preemp fiduciary principles where the parties to a limited partnership have made their intentions to do so plain.’ Here, the plain and unambiguous language of [the provision] of the Partnership Agreement displaces traditional fiduciary duty principles.” (quoting Sonet v. Timber Co., 722 A.2d 319, 322 (Del. Ch. 1998))); Lubaroff & Altman, supra note 188, at 11–26.12–20; see also Miller v. Am. Real Estate Partners, L.P., No. CIV.A.16788, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) (cautioning that “[a] topic as important [as the restriction of fiduciary duties] should not be addressed coyly”).

i. Securities Act of 1933

The Securities Act,\footnote{192} which primarily regulates the initial distribution of securities,\footnote{193} seeks to ensure transparency in securities transactions.\footnote{194} To accomplish this goal, section 5 of the Securities Act requires that any entity offering securities to the public register those securities with the SEC\footnote{195} and make available to purchasers a prospectus containing information about the issuer and offered securities.\footnote{196}

The interest hedge funds offer in limited partnerships and LLCs falls within the Securities Act’s broad definition\footnote{197} of “securities.”\footnote{198} In order “to meet the countless and variable schemes devised by those who seek the use of the money of others,” the term “security” is necessarily defined to include investment contracts, which “for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”\footnote{199} However, the Securities Act has a number of provisions that exempt certain securities from filing and disclosure requirements. Hedge funds rely on these provisions regularly.\footnote{200}

Section 4(2) of the Securities Act provides that the registration and prospectus requirements do not apply to any “transactions by an issuer not involving a public offering.”\footnote{201} This exemption is often referred to as the “private offering” or “private placement” exemption and can be utilized without notice, filing, or regulatory approval.\footnote{202} In order to utilize this exemption, a hedge fund manager may satisfy the requirements of rule 506 of regulation D (rule 506), a safe harbor that, broadly speaking, allows an investment product that will be sold to a limited number of sophisticated investors and that is not publicly advertised to avoid the registration requirements of the Securities Act.\footnote{203} This requirement is flexible, though,
as hedge fund managers need not count "accredited investors" toward rule 506's cap on the number of investors. Hedge funds utilizing this exception, however, are prohibited from engaging in general solicitation or advertising.

ii. Securities Exchange Act of 1934

The Exchange Act employs a "philosophy of continuous disclosure" to regulate the postdistribution trading of securities. Among other things, the Exchange Act requires securities dealers to register with the SEC. By structuring themselves to qualify as "traders" and not meet the Exchange Act's definition of a "dealer," hedge funds generally avoid many of the Exchange Act's substantive requirements.

A subset of the Exchange Act's registration and reporting requirements may apply to hedge funds. Section 12(g) and rule 12g-1 of the Exchange Act require an issuer having 500 holders of record of a class of equity securities and assets in excess of $10 million at the end of its most recently ended fiscal year to register the equity security with the SEC. By doing so, an issuer becomes subject to section 13's periodic reporting requirements and section 14's proxy requirements, as well as short swing profit provisions and insider trading regulations housed in section 16.

---

204. See id. § 230.506(b)(2)(ii). Pursuant to rule 501(a), the "accredited investor" category includes individuals having a net worth (or a joint net worth with their spouse) above $1,000,000, or making more than $200,000 (or joint income with their spouse exceeding $300,000) in the last two years with a reasonable expectation of reaching the same income level in the current year. Id. § 230.501(a). Additionally, certain institutional investors with more than $5,000,000 in assets and many employee benefit plans and trusts with more than $5,000,000 in assets qualify as accredited investors. Id. The SEC does not mandate that an issuer furnish any specific information when selling securities solely to accredited investors. See Loss & Seligman, supra note 193, at 408.

205. See 17 C.F.R. § 230.502(c); Staff Report, supra note 37, at 16-17.


207. Loss & Seligman, supra note 193, at 46-47. The Exchange Act's disclosure scheme, unlike the "transaction oriented" scheme of the Securities Act, mandates the filing of periodic reports and compliance with federal proxy rules, Williams Act provisions regulating tender offers and certain controls on insider trading practices. See id. at 471.


209. A "trader" is defined as "a person that buys and sells securities, either individually or in a trustee capacity, but not as part of a regular business." Staff Report, supra note 37, at 18. Those who buy and sell securities for investment, such as hedge funds, are generally considered traders. Id. Whereas traders need not register with the SEC, dealers fall within the purview of the Exchange Act's registration requirements. Id.

210. A "dealer" is defined as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." 15 U.S.C. § 78c-(a)(5); see Desmet, supra note 38, at 15.

211. See Staff Report, supra note 37, at 18.

212. See id.; Oppold, supra note 48, at 847.


214. See Staff Report, supra note 37, at 18.
practice, however, most hedge funds will structure themselves to have no more than 499 holders of record in order to avoid these requirements. 215

Hedge funds may also fall under the purview of the beneficial ownership rules in sections 13(d) and 13(g), whose integrated disclosure requirement is triggered by beneficial ownership of five percent of a company’s stock. 216 Beneficial ownership is defined to include the power to vote or dispose of any equity securities, or to direct the voting or disposition of any such securities. 217 Hedge fund advisers, all of which have essentially sole discretion over the voting and investment power of the fund’s portfolio, generally fall within the broad definition of beneficial ownership. 218 Consequently, the hedge funds must file schedule 13D or schedule 13G beneficial ownership statements with the SEC. 219

Finally, depending on the fund’s holdings, hedge fund managers may come within the purview of section 13(f)’s quarterly filing obligation for institutional investment managers holding more than an aggregated fair market value of $100,000,000 in equity securities. 220

iii. Investment Company Act of 1940

Of all the regulatory exemptions employed by hedge funds, the most important are found in the Company Act, 221 for it is freedom from the Company Act that affords a hedge fund its noted “flexibility.” The Company Act, in part a congressional response to late-1930’s government findings of pervasive self-dealing among those in the investment fund industry, 222 is the primary federal statute governing investment companies. 223 The Company Act defines an investment company to include a company that issues securities and whose business is primarily comprised of investing in securities. 224

215. See id. at 19.
216. See 17 C.F.R. § 240.13d-1; STAFF REPORT, supra note 37, at 19. Though section 13(d) is an alarm mechanism designed to disclose “‘creeping tender offers,’” its disclosure requirements apply even in the absence of a contemplated acquisition. See LOSS & SELIGMAN, supra note 193, at 620.
217. See 17 C.F.R. § 240.13d-3(a).
218. See STAFF REPORT, supra note 37, at 19.
219. See 17 C.F.R. § 240.13d-1. Only under certain circumstances may a beneficial owner file a schedule 13G statement in lieu of a section 13D statement. See id. § 240.13d-1(b).
220. See id. § 240.13f-1.
221. 15 U.S.C. §§ 80a-1 to 80a-64 (2006); see Oesterle, supra note 191, at 5.
224. See 15 U.S.C. § 80a-3(a)(1) (defining “investment company” as any issuer that “is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities . . . is engaged . . . in the business of issuing face-amount certificates of
substantive regulations are designed to enable unsophisticated investors to make informed investment decisions and to guard against investment companies engaging in self-interested behaviors at the expense of their investors.\textsuperscript{225} For those falling within its ambit, the Company Act regulates virtually all aspects of operations.\textsuperscript{226} This includes substantive regulations affecting a fund's governance and structure, limits on leverage utilization, the nature of a fund's investments, the sale and redemption of its shares, and its dealings with affiliates.\textsuperscript{227} The Company Act also limits discretion in the valuation of an investment company's assets.\textsuperscript{228} Most hedge funds invest heavily in securities; however, they typically avoid meeting the Company Act's definition of investment company\textsuperscript{229}—and the Company Act's regulatory provisions—by relying on one of two statutory exclusions.\textsuperscript{230} Section 3(c)(1) enables a hedge fund to avoid registering as an investment company by having less than 100 investors and selling their securities only through a private sale.\textsuperscript{231} Additionally, hedge funds can avoid the Company Act's mandates by allowing only "qualified purchasers" to invest in the fund,\textsuperscript{232} which the statute defines to include as

---

the installment type, or . . . is engaged . . . in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis").

\textsuperscript{225} See Shadab, supra note 123, at 9–10.

\textsuperscript{226} See MacHarg, supra note 223, at 61.

\textsuperscript{227} See id. Being subjected to such stringent requirements would drastically affect hedge funds' operations, and would, in many cases, preclude them from employing their primary trading strategies. See Oppold, supra note 48, at 847; see also Houman B. Shadab, Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors, 11 N.Y.U. J. LEGIS. & PUB. POL'Y 251, 311 (2008) (stating that Investment Company Act regulation is ill-suited to hedge fund operations). Hedge funds would be significantly constrained in their ability to use leverage and invest in illiquid assets. See 15 U.S.C. § 80a-18(f); Willia E. Gibson, Is Hedge Fund Regulation Necessary?, 73 TEMP. L. REV. 681, 694 n.99 (2000) ("Classification as an investment company limits the hedge fund's ability to engage in leveraged transactions and to execute many of its trading strategies."); see also Oesterle, supra note 191, at 5 (opining that the most important freedom gained by not being a registered investment company is the ability to engage in short selling). Additionally, the Investment Company Act of 1940 (Company Act) obligates an investment company to have a board of directors that must approve all investment advisory contracts, custodial arrangements, and other business affairs concerning fund operations. See Sunil Sharma, Regulation of Hedge Funds, in HEDGE FUNDS AND FINANCIAL MARKET DYNAMICS 62, 64 (1998).

\textsuperscript{228} See GORDON ALTMAI BUTOWSKI WEITZEN SHALOV & WEIN, A PRACTICAL GUIDE TO THE INVESTMENT COMPANY ACT 30–31 (1993). The Company Act mandates daily valuation of the fund's portfolio securities at market value, or fair market if market value is not readily available. See id.

\textsuperscript{229} Section 3(c)(1) of the Act exempts from the definition of an investment company any issuer whose outstanding securities are owned by less than 100 investors and does not make public offerings of its securities. See 15 U.S.C. § 80a-3(c)(1).

\textsuperscript{230} See STAFF REPORT, supra note 37, at 11.

\textsuperscript{231} 15 U.S.C. § 80a-3(c)(1).

\textsuperscript{232} Section 3(c)(7) of the Act excludes from the definition of investment company issuers whose outstanding securities are owned exclusively by "qualified purchasers." Id. §80a-3(c)(7).
an individual who owns over $5 million in investments, institutional investors who own $25 million investments, and a family-owned company that owns $5 million in investments. The Company Act does not limit the number of qualified purchasers that may be in a fund: though most will accept no more than 499 investors in order to avoid the Exchange Act’s registration and reporting requirements.

iv. The Investment Advisers Act of 1940

The Advisers Act regulates the activity of investment advisers by creating a “mechanism to monitor and oversee money managers.” The Advisers Act defines an investment adviser as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.” In addition to registering with the SEC, the Advisers Act requires most investment advisers to complete Form ADV disclosing basic information about the adviser to advisory clients and prospective advisory clients. Among the required disclosures, Form ADV requires information regarding the adviser’s basic fee structure, the nature of the adviser’s services, client base, and broker discretion, its basic fee structure and whether it is negotiable, and the adviser’s business activities that may engender conflicts of interest. The Advisers Act also generally prohibits performance-based compensation.

233. See id. § 80a-2a(51)(A).
234. See STAFF REPORT, supra note 37, at 13.
235. McCrary, supra note 38, at 181. Congress passed the Advisers Act in response to an SEC report concluding that investment advisers could not fulfill their obligations to clients unless “conflicts of interest between the investment counsel and the client were removed,” SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 187 (1963) (quoting SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 76-477, at 28 (1939)), recognizing that “conflicts of interest . . . might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.” Id. at 191–92.
236. 15 U.S.C. § 80b-2(a)(11). The definition is purposely broad and encompasses all persons who are compensated for advising others regarding securities. LOSS & SELIGMAN, supra note 193, at 884.
238. See 17 C.F.R. § 275.204-3(a) (2008).
239. TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 85–87 (2d ed. 2003). Primarily, the Advisers Act imposes a duty of disclosure on an investment adviser related to the adviser’s business practices and disciplinary history. See STAFF REPORT, supra note 37, at 21. The Act also prohibits investment advisers from defrauding their clients. See id.
240. See 15 U.S.C. § 80b-5(a)(1). This prohibition is malleable. A registered adviser may charge a performance fee if they advise a fund meeting the requirements of the Company Act section 3(c)(7) or if all the fund’s investors are qualified clients. See Shadab, supra note 123, at 11–12. Qualified clients are defined as a natural person with either $750,000 managed by the adviser or a net worth exceeding $1,500,000. 17 C.F.R. § 275.205-3(d)(1).
Virtually all hedge fund advisers meet the definition of investment advisers under the Advisers Act. Most hedge fund advisers, however, avoid registering with the SEC by structuring their fund to qualify for the private adviser exemption found in section 203(b)(3) of the Investment Advisers Act, which removes from the purview of the Act "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public... nor acts as an investment adviser" to a registered investment company or business development company. Because the Advisers's Act does not statutorily define the term "client," in the context of investment funds organized as limited partnerships, it was initially unclear, for purposes of section 203(b)(3), whether a general partner should count each limited partner as a separate client. In 1985, the SEC moved to clarify the issue by creating a safe harbor that allows advisers to count as clients specified limited partnerships, as compared to the limited partners investing in the fund. Thus, a hedge fund adviser may manage up to fourteen hedge funds without being required to register with the SEC under the Investment Advisers Act, provided that it does not hold itself out to the general public as an investment adviser.
b. An Attempt at Regulation

i. The Hedge Fund Rule

In 2004 the SEC attempted to bring hedge fund advisers into the regulatory fold by adopting section 203(b)(3)-2 (the Hedge Fund Rule).246 The Hedge Fund Rule, which took effect in early 2005, reinterpreted the word "client" for purposes of the Advisers Act's private adviser exemption.247 Rather than counting individual hedge funds as a client, the Hedge Fund Rule required hedge fund advisers to "look through" the limited partnerships they advised and count as clients the limited partners who had invested in their funds.248 Whereas the private adviser exemption previously exempted most hedge fund advisers managing less than fifteen separate funds, the new interpretation required the registration of any adviser who, in the preceding twelve months, had advised any funds comprised of more than fourteen investors.249 Changing the manner in which hedge fund advisers counted their clients for purposes of section 203(b)(3) had the effect of bringing most hedge fund advisers under the Advisers Act's umbrella of regulation.250


249. See id. In promulgating the Hedge Fund Rule, "the [SEC] noted that Congress did not appear to have addressed whether an adviser must count an investor in a pooled investment vehicle as a client for purposes of Section 203(b)(3). The [SEC] concluded that [this interpretation] was consistent with the broad remedial purposes of the Advisers Act." Desmet, supra note 38, at 17 (citing Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,067).

250. Advisers of hedge funds whose securities portfolios totaled less than $25 million in assets did not have to register with the SEC. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,070.
The SEC passed the Hedge Fund Rule partly in response to its "significant concern" regarding "the growing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds." According to the SEC, hedge funds' expanding investor base was caused primarily by three developments: hedge funds attracting a new, more diverse investor base through expanded marketing activities, funds of funds making the hedge fund industry more broadly available to retail investors, and the increase in hedge fund investment by pension funds, foundations, universities, endowments, and other charitable organizations. In light of these developments, and the investor-related risks that they posed, the SEC viewed as inadequate its reliance on ex post enforcement actions brought after investor assets had disappeared. Accordingly, the SEC passed the Hedge Fund Rule in order to gain better oversight "to provide the protections afforded by the Advisers Act to investors in hedge funds."

The Hedge Fund Rule required hedge fund advisers to complete and file Form ADV with the SEC. The form provides for the identification of the individuals associated with the advisers as well as for the disclosure of information about the number of hedge funds they manage, the amount of assets held in the funds, the number of persons employed by the advisers, other business activities they conduct, and the identity of persons that controlled or were affiliated with the firms. Registration also subjected hedge fund managers to the Advisers Act's section 206 prohibition of fraudulent, deceptive, and manipulative practices. In SEC v. Capital Gains Research Bureau, Inc., the U.S. Supreme Court considered whether under the Advisers Act, the SEC may require a registered investment adviser to disclose to her clients certain manipulative trading practices designed to enrich the investment adviser.

---

252. See id. at 72,057-58. The SEC recognized the third development as "perhaps [the] most significant["], noting that losses associated with hedge fund investing could encumber these "entities' ability to satisfy their obligations to their beneficiaries or pursue other intended purposes." Id.
253. See id. at 72,059.
254. Id. at 72,054. Theoretically, the rule could increase the SEC's understanding and oversight of the hedge fund industry and enable earlier identification of potential fraudulent practices. See Desmet, supra note 38, at 21; Jill E. Fisch, Does Analyst Independence Sell Investors Short?, 55 UCLA L. REV. 39, 86 n.266 (2007). Because of their secretive nature, "little concrete information is available about the extent of hedge funds' activities." EICHENGREEN & MATHIESON, supra note 38, at 1.
258. Id. at 181. The practice before the Court is called scalping, and involves an investment adviser purchasing shares of a security for his own account shortly before recommending that his client make a long-term investment in the same security. Id. The investment adviser then sells his shares at a profit caused by the rise in market price following the client's purchase of the securities. Id.
Goldberg, writing for eight Justices, construed section 206 as imposing upon investment advisers a fiduciary obligation to manage their clients' portfolios in their clients' best interests.\(^{259}\) The Supreme Court's opinion made clear that a duty to disclose material conflicts the adviser has with its clients is part and parcel of an investment adviser's fiduciary duty.\(^{260}\)

Additionally, registration required hedge fund managers to "[a]dopt and implement written policies and procedures" designed to prevent violations of the Advisers Act\(^ {261}\) and mandated that hedge fund managers designate a chief compliance officer who would be responsible for implementing the adopted policies.\(^ {262}\) According to the SEC, compliance officers ensure compliance with securities regulations and guard against conflicts of interest\(^ {263}\).

The Hedge Fund Rule did not, however, require hedge fund advisers to provide the SEC with performance statistics or to meet diversification requirements, nor did it provide a means to police hedge fund trading strategies.\(^ {264}\) And while the Advisers Act prohibits investment advisers from receiving compensation based on "a share of capital gains... or capital appreciation of the funds or any portion of the funds of the client,"\(^ {265}\) registered hedge funds could still charge performance fees by meeting one of several exceptions.\(^ {266}\)

\(^{259}\) Id. at 191–94; see Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471, n.11 (1977)) (stating that section 206 establishes federal fiduciary standards that govern investment adviser conduct); Loss & Seligman, supra note 193, at 1108–10 (summarizing the Court's opinion in Capital Gains); John A. Gray, Reforms to Improve Client Protection and Compensation Against Personal Financial Planners' Unethical Business Practices, 32 AM. Bus. L.J. 245, 252 n.30 (1994).

\(^{260}\) See Capital Gains, 375 U.S. at 191–94; Shartsis Friese, supra note 78, at 318 (citing Capital Gains, 375 U.S. at 191–92) (stating that an investment adviser has a fiduciary duty to disclose all "potential and actual conflicts of interest to its clients").

\(^{261}\) 17 C.F.R. § 275.206(4)-7(a) (2008).

\(^{262}\) Id. § 275.206(4)-7(c).


\(^{264}\) See Desmet, supra note 38, at 20.


\(^{266}\) See Loss & Seligman, supra note 193, at 897–98. Because of the exceptions, specifically the qualified client exception, the SEC thought that section 205(a)(1) may have the "salutary effect" of limiting hedge fund retailization, speculating that many hedge fund advisers would only accept clients capable of having $750,000 in assets under management or having a net worth of $1.5 million. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,064.
Not surprisingly, opposition to the Hedge Fund Rule was strong. Many opponents argued that hiring a compliance officer would increase operating costs and that regulation in general would cause domestic hedge funds to relocate in offshore jurisdictions with fewer regulatory burdens. They also argued that the Hedge Fund Rule’s requirements were overly burdensome and would increase administrative workloads. Opponents also posited that, by creating a moral hazard, the Hedge Fund Rule would have the indirect effect of attracting less savvy investors to offshore jurisdictions.

---

267. The SEC received 161 letters in regard to the Hedge Fund Rule, 83 of which expressed forceful opposition to the proposal. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,058–59; see also Oppold, supra note 48, at 872 (stating that seventy-three percent of the letters the SEC received during the comment period voiced opposition to the Hedge Fund Rule). Some commentators urged that adoption of the Hedge Fund Rule would create a moral hazard as registration would cause hedge fund investors to rely on governmental oversight in place of conducting proper due diligence before investing in a hedge fund. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,065.

268. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,063; see also Gregory Zuckerman & Ian McDonald, Hedge Funds Avoid SEC Registration Rule, WALL ST. J., Nov. 10, 2005, at Cl (stating that some hedge funds were “wary of the cost of complying with the SEC’s registration requirement, which could cost more than $500,000 for many funds”).

269. See Desmet, supra note 38, at 26. It is debatable, however, whether the prospect of increased regulation would drive domestic hedge funds offshore. Overregulation can increase a firm’s costs of doing business, thereby putting the firm at a disadvantage to those firms operating in less regulated jurisdictions, but so too can regulatory gaps make a business less competitive “by eroding the trust necessary to make the financial markets work properly.” Elizabeth F. Brown, The Tyranny of the Multitude is a Multiplied Tyranny: Is the United States Financial Regulatory Structure Undermining U.S. Competitiveness?, 2 BROOK. J. CORP. FIN. & COM. L. 369, 376 (2008). Indeed, many international public companies are attracted to more stringent regulation—specifically, increased disclosure requirements—rather than being repelled by it. See John C. Coffee, Jr., Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance, 102 COLUM. L. REV. 1757, 1762–63 (2002). Understanding that investors value the protection that regulation provides, numerous offshore companies “migrate to U.S. exchanges because by voluntarily subjecting themselves to the United States’s higher disclosure standards and greater threat of enforcement . . . they partially compensate for weak protection of minority investors under their own jurisdictions’ laws.” Id. at 1757. The primary impetus for this noted migration, it would seem, is the opportunity to enhance share price. Coffee, supra, at 1763. Where investors view regulation as being too restrictive, however, the premium they are willing to pay may decrease. See generally Kate Litvak, Sarbanes-Oxley and the Cross-Listing Premium, 105 MICH. L. REV. 1857 (2007) (finding that after the enactment of the Sarbanes-Oxley Act, the premium that investors were willing to pay for shares of foreign companies subject to U.S. regulation decreased).

270. See Zuckerman & McDonald, supra note 268 (“Some . . . say they are wary of registration because they fear an SEC audit will tie up traders and senior management for weeks . . . .”).
invest in hedge funds. Finally, critics argued that the SEC lacked the authority to change the interpretation of the word “client.”

ii. Goldstein v. SEC

Philip Goldstein, an investment adviser, challenged the Hedge Fund Rule in the D.C. Circuit. Specifically, Goldstein argued that, in promulgating the Hedge Fund Rule, the SEC misinterpreted the word “client” and exceeded its regulatory authority. A unanimous panel agreed, invalidating what it considered to be an “arbitrary rule.”

In Goldstein v. SEC, the SEC argued that the failure of the Advisers Act to define the term “client” rendered the statute “ambiguous as to a method for counting clients.” Therefore, the SEC argued, the Agency’s statutory interpretation should be afforded the deferential standard of review articulated by the Supreme Court in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.* The court disagreed, stating that “[t]he lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous,” and even if a word could mean various things, an agency does not have carte blanche “to choose any one of those meanings.” Denying the SEC Chevron deference, the court found the SEC’s new understanding of the term “client” unreasonable. In light of a hedge fund investor’s “completely passive” role, the court found the Advisers Act’s definition of investment adviser as “any person who, for

271. Myron Scholes, a co-creator of the Black-Scholes option pricing model, and a partner at LTCM, highlighted the risk that the Hedge Fund Rule could lead to a false sense of security among unsophisticated investors who believe that the SEC’s regulatory action eliminates the risk associated with hedge funds and guaranteed their performance. See Desmet, supra note 38, at 27 & n.226.

272. See id. at 26.


275. Goldstein, 451 F.3d at 884.

276. 451 F.3d 873.

277. Id. at 878 (citing Brief of Sec. & Exch. Comm’n at 21, Goldstein, 451 F.3d 873 (No. 04-1434), 2005 WL 1636146).

278. Id.; see Brief of Sec. & Exch. Comm’n, supra note 277, at 20–21 (stating that part of the ambiguity as to the meaning of “client” stems from the fact that, because “hedge funds did not exist until 1949[,] . . . it is difficult to surmise whether Congress would have viewed a hedge fund rather than the fund’s investors as the client for purposes of this exemption”).

279. 467 U.S. 837 (1984). Whether an administrative agency is entitled to Chevron deference rests on a two-pronged inquiry: first, has Congress “directly spoken to the precise question at issue,” or has Congress left a gap to fill, and second, “if the statute is silent or ambiguous with respect to the specific issue,” is the agency’s interpretation “based on a permissible construction of the statute.” Id. at 842–43.

280. Goldstein, 451 F.3d at 878.

281. See id. at 879–81.
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... securities' to indicate that "the person or entity controlling the fund is not an 'investment adviser' to each individual investor."\(^{282}\)

The court's determination that the SEC's interpretation was unreasonable focused heavily on the nature of the relationship between investment advisers and clients. Viewing the presence of an advisory relationship as determined by the character of the advice rendered,\(^ {283}\) the court found guidance in *Lowe v. SEC*,\(^ {284}\) a 1985 case in which the Supreme Court had to decide whether a previously registered investment adviser convicted of misappropriating client funds, who was no longer registered with the SEC, could be permanently enjoined from publishing securities newsletters.\(^ {285}\) Reversing the U.S. Court of Appeals for the Second Circuit, and denying a permanent injunction, the Court held that publishers of financial newsletters are not investment advisers for purposes of the Advisers Act.\(^ {286}\) In *Lowe*, Justice John Paul Stevens stated that "'[t]he mere fact that a publication contains advice and comment about specific securities does not give it the personalized character that identifies a professional investment adviser.'"\(^ {287}\) By not offering "individualized advice attuned to any specific portfolio or to any client's particular needs,"\(^ {288}\) publishers of financial newsletters did not "develop... the kind of fiduciary, person-to-person relationships... that are characteristic of investment adviser-client relationships."\(^ {289}\) Applying this logic to hedge funds, the D.C. Circuit found the type of direct relationship referenced in *Lowe* to exist between a hedge fund adviser and the fund itself, while finding it lacking as between the adviser and hedge fund investors.\(^ {290}\) The lack of a person-to-person relationship between a hedge fund adviser and the fund’s investors led the court also to conclude that "'[t]he adviser owes fiduciary duties only to the fund, not to the fund’s investors.'"\(^ {291}\)

The court further believed the Hedge Fund Rule to be arbitrary given the SEC's inability to explain adequately why it was moving away from its 1985 position that for purposes of section 203(b)(3), the limited partnership, not the individual partners, are to be considered "clients."\(^ {292}\) The court stated that, given the incongruence between the new interpretation of

\(^{282}\) Id. at 879–80 (citing 15 U.S.C. § 80b-2(11) (2006)).

\(^{283}\) Id. at 880.


\(^{285}\) Id. at 183.

\(^{286}\) Id. at 211.

\(^{287}\) Id. at 208.

\(^{288}\) Id.

\(^{289}\) Id. at 210.

\(^{290}\) See Goldstein v. SEC, 451 F.3d 873, 880 (D.C. Cir. 2006) ("The adviser is concerned with the fund’s performance, not with each investor’s financial condition.").

\(^{291}\) Id. at 881.

\(^{292}\) Id. at 880.
“client” and the 1985 amendment, the SEC had “not adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter.”293 The court also observed a policy disconnect, finding that the SEC’s new interpretation of section 203(b)(3) bore little relationship to the Advisers Act’s intention to regulate investment advisory activities that are national in scope.294 Accordingly, the D.C. Circuit abrogated the Hedge Fund Rule, finding the SEC’s construction of “client” to be arbitrary and in conflict with the congressional purposes underlying the statute.295 The court’s ruling made clear that the SEC would be unable to compel hedge fund advisers to register with the Agency short of congressional action.296

c. The Anti-fraud Rule

The SEC decided not to appeal the Goldstein decision,297 leaving the hedge fund industry in “a regulatory vacuum.”298 In August 2007 the SEC moved to fill this void, adopting a new anti-fraud rule to the Advisers Act that “prohibits advisers to pooled investment vehicles from making false or misleading statements to . . . investors or prospective investors in those pooled vehicles.”299 Unlike rule 10b-5 under the Exchange Act, which similarly prohibits fraudulent conduct, there is no requirement that the SEC demonstrate that an investment adviser allegedly in violation of the new anti-fraud provision acted with scienter.300 Instead, the SEC adopted a

293. Id. at 882 (citing Shays v. FEC, 414 F.3d 76, 96–97 (D.C. Cir. 2005)). The court felt that “without any evidence that the role of fund advisers with respect to investors had undergone a transformation, there is a disconnect between the factors the Commission cited and the rule it promulgated.” Id.
294. Id. at 883.
295. See id. at 884.
296. See Floyd Norris, Court’s Decision Setback for SEC: Regulation of Hedge Funds Is Stripped Away, HOUS. CHRON., June 24, 2006, at 1.
297. See Judith Burns, SEC to Redo Hedge-Fund Rules Instead of Appealing Rejection, WALL ST. J., Aug. 8, 2006, at A8 (stating that lawyers at the SEC concluded that appealing the Goldstein decision would be “futile”).
298. SEC Won’t Challenge Hedge-Rule Overturn, CHI. TRIB., Aug. 8, 2006, at 3.
300. See Prohibition of Fraud, supra note 299, at 12. In the context of securities fraud, the term scienter denotes “[a] mental state consisting in an intent to deceive, manipulate, or defraud.” BLACK’S LAW DICTIONARY, supra note 16, at 1373. In Ernst & Ernst v. Hochfelder, the Supreme Court held that a plaintiff bringing a rule 10b-5 claim who fails to establish scienter is precluded from recovering damages. 425 U.S. 185, 193 (1976). The lack of scienter is one aspect of the new provision that has engendered significant controversy. See Margaret A. Bancroft, The SEC Adopts a Broad Antifraud Rule Under the Advisers Act and Denies Need to Demonstrate Scienter, INSIGHTS, Sept. 2007, at 2, 3–4 (2007).
negligence standard under the belief that the more permissive standard would better discourage reckless deception.\(^{301}\)

Specifically, section 206(4)-8 prohibits investment advisers of pooled investment vehicles from making misleading statements of material fact or otherwise engaging in any act that is fraudulent, deceptive, or manipulative as to investors in pooled investment vehicles.\(^{302}\) In light of \textit{Goldstein}, the SEC deemed the new rule necessary to make clear the Agency's authority to bring actions for fraud against both registered and unregistered investment advisers to hedge funds.\(^{303}\) The SEC has expressly stated that the new rule creates neither a private right of action in investors nor a fiduciary duty to investors.\(^{304}\)

Thus, as it now stands, federal law provides hedge fund investors with few protections against those conflicts of interest commonly related to the management of hedge funds. Because of the numerous exemptions of which hedge funds take advantage, the federal securities laws provide investors with few safeguards. Additionally, the \textit{Goldstein} decision made clear that federal fiduciary protections do not extend to hedge fund investors—a notion that the SEC's new anti-fraud rule reinforces. Likewise, Delaware's adoption of the contractarian position, thereby allowing parties to a limited partnership to modify and even eliminate fiduciary duties, removes the main form of protection available to hedge fund investors at state law. Whereas Part I explained why hedge fund investors have few protections against conflicts of interest, Part II provides proposals as to how those conflicts either can be eliminated or their effects mitigated.

\section*{II. VARIOUS WAYS TO PROTECT INVESTORS FROM HEDGE FUND MANAGERS' CONFLICTS OF INTEREST}

Hedge funds house numerous conflicts of interest that can work harms on their investors.\(^{305}\) In addition, hedge funds typically elude the regulatory devices at both state and federal law that offer investors the most security.\(^{306}\) This may be best highlighted by the current fiduciary vacuum

\begin{itemize}
\item \(^{301}\) Prohibition of Fraud, \textit{supra} note 299, at 12.
\item \(^{302}\) \textit{See} 17 C.F.R. § 275.206(4)-8 (2008). As compared to the Hedge Fund Rule, which only applied to hedge funds and purposefully sought to exclude other pooled investment vehicles, the new anti-fraud provision applies to all pooled investment vehicles. \textit{See} Prohibition of Fraud, \textit{supra} note 299, at 7–8.
\item \(^{303}\) Prior to \textit{Goldstein v. SEC}, 451 F.3d 873 (D.C. Cir. 2006), the SEC prosecuted enforcement actions against investment advisers who allegedly made misleading or fraudulent statements to investors pursuant to sections 206(1) and (2) of the Advisers Act. \textit{See} Prohibition of Fraud, \textit{supra} note 299, at 9. The D.C. Circuit drew into question the SEC's authority to do so by concluding that for purposes of both sections, the adviser's client is the fund itself, as compared to the investor. \textit{See id}. By distinguishing section 206(4) in \textit{Goldstein}, the D.C. Circuit left open the door for the SEC to clarify the scope of its enforcement authority. \textit{See id}. at 2–3.
\item \(^{304}\) \textit{See id}. at 13–14.
\item \(^{305}\) \textit{See supra} notes 131–61 and accompanying text.
\item \(^{306}\) \textit{See supra} Part I.D.
in which hedge funds operate. Pursuant to Goldstein, hedge fund managers do not owe fiduciary duties to hedge fund investors under section 206 of the Advisers Act,307 and, their funds being organized in Delaware, hedge fund managers will contract away their fiduciary duties at state law.308

While many in the public may not find this situation overly problematic—given the common perception that only the sophisticated invest in hedge funds—retailization of the industry has created a situation in which common investors who are indirectly tied to the hedge fund industry can be harmed by conflicts of interest. As compared to the possible systemic risk that hedge funds may cause, however, the problems caused by these conflicts receive little attention.309

Part II of this Note assesses potential ways to address many of the conflicts of interest common to hedge funds. Part II.A presents policies and procedures that could limit the many conflicts of interest that inhere in hedge fund valuation processes. Part II.B discusses different governance mechanisms to deal with conflicts of interest. Part II.C addresses how disclosure practices, the theoretical underpinning of federal securities laws, can be improved upon to better protect hedge fund investors from their managers' conflicts of interest.

A. Proposals to Improve the Valuation Process

In general, financial markets are in need of better practices to value complex financial assets.310 So, too, many commentators and industry groups have recognized the need for better hedge fund valuation policies and procedures in order to minimize the many conflicts of interest that flow from the difficulty in valuing their portfolio's complex, often illiquid assets.311 Highlighting the issue's importance, many of these groups have released valuation principles and proposals in an effort to promote

308. See supra note 163–66.
309. See JOHN KIMELMAN, EVALUATING THE HEDGE FUND PROPOSITION (n.d.), available at http://morningbull.blog.tdg.ch/media/01/02/1211890550.pdf (stating that Ferenc Sanderson, a senior hedge fund analyst with Thomson Reuters Lipper unit, believes that conflicts of interest in hedge funds is an area "which certainly could get a lot more attention").
uniformity across the industry and reduce the conflicts of interest that the valuation process currently creates.  

One such group, the International Organization of Securities Commission (IOSCO), has formulated a prominent set of valuation principles "to ensure that the hedge fund’s financial instruments are appropriately valued and, in particular, that these values are not distorted to the disadvantage of fund investors." IOSCO seeks to promote consistency in the valuation process, and to inject independence and transparency into what has generally been an opaque process. In articulating its industry guidance, IOSCO recognizes that ultimate accountability for the valuation techniques that the hedge fund employs lies with the fund’s governing body, and while the identity of the governing body will depend on the fund’s organizational structure, the document’s nine principles were intended to be generally applicable.  

1. Valuation Policies, Procedures, and Methodology

IOSCO highlights the necessity for hedge fund governing bodies to establish documented policies and procedures in an effort “to ensure integrity in the valuation process.” Among other things, these policies and procedures should address, “the competence and independence of personnel who are responsible for valuing the financial instruments, . . . the specific investment strategies of the hedge fund and the financial instruments in the investment portfolio, . . . the controls over the selection of valuation inputs, sources and methodologies,” and “the appropriate time for closing the books for valuation purposes.” IOSCO highlights that each governing body should disclose the methodologies used for valuing the various financial instruments in the fund’s portfolio, along with information indicating how the chosen valuation models will be checked for

312. See, e.g., ALTERNATIVE INV. MGMT. ASS’N, AIMA’S GUIDE TO SOUND PRACTICES FOR HEDGE FUND VALUATION 10 (2007) [hereinafter AIMA SOUND PRACTICES], available at www.aima.org/download.cfm/docid/CB1B1807-35ED-452E-9FEB4BD31D6BA06; HFWG REPORT, supra note 310, at 46–53; IOSCO REPORT, supra note 132; MANAGED FUNDS ASS’N, SOUND PRACTICES FOR HEDGE FUND MANAGERS § 3 (2007) [hereinafter MFA SOUND PRACTICES].

313. IOSCO REPORT, supra note 132, at 5. The International Organization of Securities Commission (IOSCO) is an international organization comprised of securities regulators from around the world who “cooperate together” to “maintain just, efficient and sound markets . . . to promote the development of domestic markets . . . [and] to establish standards and an effective surveillance of international securities transactions.” International Organization of Securities Commissions, About IOSCO, http://www.iosco.org/about/ (last visited Mar. 30, 2009).

314. See IOSCO REPORT, supra note 132, at 5.

315. See id. at 9.


317. IOSCO REPORT, supra note 132, at 13.

318. Id.
IOSCO does not, however, indicate whether any valuation methods are more likely than others to assess accurately the value of a hedge fund’s assets. The Alternative Investment Management Association (AIMA), a global trade association, has made a similar proposal. AIMA advises all hedge funds to create a valuation policy document (VPD), which should be approved by the hedge fund’s governing body and include a summary of the fund’s valuation practices, procedures, and controls.

Although the IOSCO principles do not specify a chosen valuation methodology, the report stresses that the methodology be consistently implemented, and suggests that the hedge fund manager create a monitoring system to ensure that the party responsible for asset valuation is in fact following policies and procedures. And because hedge funds are dynamic investment vehicles, often times characterized by their flexible trading strategies, IOSCO suggests that the policies and procedures governing their asset valuation techniques not be static. They suggest, then, that hedge funds’ valuation methodology be periodically examined to determine whether, given market conditions at that time, the valuation technique remains valid and accurate.

2. Independence in the Valuation Process

Of all the problems associated with hedge fund valuation creating conflicts of interest, arguably none is more cited than the lack of independence currently characterizing the process. Hedge fund

---

319. See id. at 11–12.
320. McVea, supra note 316, at 22.
321. According to its website, Alternative Investment Management Association (AIMA) is “the hedge fund industry’s global, not-for-profit trade association with over 1,200 corporate members worldwide.” AIMA, http://www.aima.org/ (last visited on Mar. 30, 2009).
322. AIMA Sound Practices, supra note 312, at 10. The policies provided for in the valuation policy document (VPD) should be capable of practical implementation and should specify the role of each party in the valuation process. See id.
323. Because of the variety of assets in which hedge funds invest, “[a] ‘one size fits all’ approach to the valuation of hedge funds would . . . be unwise and unworkable.” Id. at 6.
324. See IOSCO Report, supra note 132, at 14.
325. See id. at 14–15.
326. See id.
327. Institutional investors curious as to how hedge funds value their holdings are increasingly looking for assurances from hedge fund managers that valuations of the fund’s portfolio’s assets are being provided by independent third parties. See The State of Valuation: Risk Management Expert Mangiero Stresses the Importance of Process, SEC. INDUSTRY NEWS, June 4, 2007, available at http://www.fwa.org/pdf/SRpt_Valuation_060407.pdf, see also Kris Devasabai, Hedge Fund Valuations ‘Problematic’ Say Investors, INT’L CUSTODY & FUND ADMIN. NEWSL., Apr. 11, 2007, http://icfamagazine.com/public/showPage.html?page=icfa_display_news&tempPagId=467713 (stating that, of the sixty-four percent of institutional investors claiming that hedge fund valuation is problematic, more than half expressed concern that the hedge fund manager was solely responsible for asset valuation, while forty-seven percent would like to see an independent administrator value the assets). Institutional investors’ desire for increased
managers, whose performance fees are based on the value of the holdings in the fund’s portfolio, have a clear interest in overstating asset values, thereby creating the opportunity to assess performance fees on illusory profits.\textsuperscript{328} Thus it is not surprising that many suggestions for improving hedge fund asset valuation focus on the need for independence to “be embedded into the processes adopted for valuation.”\textsuperscript{329} For example, AIMA counsels that a hedge fund manager delegate the task of calculating the fund’s NAV to an independent party—a valuation service provider.\textsuperscript{330} Where independent calculation of NAV is not feasible and the determination must be made in-house, AIMA suggests that a hedge fund manager establish “robust controls over conflicts of interest.”\textsuperscript{331} IOSCO similarly proposes that conflicts of interest can be decreased by a hedge fund manager’s use of an independent, qualified third party to value the assets in the fund’s portfolio.\textsuperscript{332} AIMA, however, additionally advocates for the disclosure of a hedge fund manager’s material involvement in the valuation process to hedge fund investors.\textsuperscript{333}

IOSCO advances two additional proposals that hedge fund managers can implement to further achieve valuation independence. First, in hedge funds where different entities are responsible for investment and valuation decisions, IOSCO suggests that these people should maintain independent reporting lines.\textsuperscript{334} This would require that fund employees report to

\textsuperscript{328} See McVea, supra note 316, at 2.

\textsuperscript{329} See IOSCO REPORT, supra note 132, at 15; accord HFWG REPORT, supra note 310, at 21 (“[T]he ideal way to avoid . . . conflicts is for the [hedge fund manager] to appoint an independent and competent third party when that is feasible. In circumstances where the only way to ensure competent asset valuation is for the hedge fund manager to determine asset values, conflicts need to be managed by ensuring that the in-house valuation function is segregated from the portfolio management function.”). According to the Managed Funds Association (MFA), in the context of hedge fund asset valuation “independence is paramount given the potential for conflicts of interest.” Letter from John G. Gaine, President, MFA, to Pamela Vulpes, Gen. Secretariat, Int’l Org. of Sec. Comm’ns 4 (June 21, 2007) [hereinafter MFA Comment Letter], available at http://www.managedfunds.org/downloads/IOSCO%20Valuation%20Letter%20June%2021%2007.pdf.

\textsuperscript{330} AIMA SOUND PRACTICES, supra note 312, at 10. According to AIMA, independent valuation service providers are most capable of managing the conflicts of interest in the valuation of hedge fund assets. See id. at 6.

\textsuperscript{331} Id. at 10.

\textsuperscript{332} See IOSCO REPORT, supra note 132, at 15. It is important that the hedge fund manager do the necessary due diligence to ensure that the independent third party employ personnel with the knowledge, experience, and training necessary to accurately value the hedge fund’s assets. See id. at 19.

\textsuperscript{333} AIMA SOUND PRACTICES, supra note 312, at 6.

\textsuperscript{334} See IOSCO REPORT, supra note 132, at 16. This suggestion is applicable where the hedge fund’s structure demands that the hedge fund manager actively participate in the valuation of the fund’s assets. Id.
different personnel when making investment decisions as compared to valuation decisions. Second, IOSCO supports the establishment of valuation committees. A valuation committee composed of persons within the hedge fund with knowledge of the financial instruments being traded would be in charge of regularly reviewing the hedge fund’s valuation policies and procedures and overseeing the application of those policies. IOSCO points out that the appointment of independent persons unconnected with the specific hedge fund to valuation committees could help to protect the interests of investors. The President’s Working Group on Financial Markets (PWG) empaneled two private-sector committees, which both issued reports to the PWG recommending establishment of valuation committees as a way to reduce the conflicts of interest that asset valuation creates. In its report, the Asset Managers’ Committee (AMC) suggests that hedge funds establish valuation committees to review and provide oversight of the hedge funds’ valuation policies and procedures. These committees should be comprised of key members of the hedge fund manager’s senior management and “should be structured to provide an appropriate measure of independence from the portfolio management function.” According to the AMC, the valuation committee should review the hedge fund’s valuation policies and procedures no less than once

335. See id.

336. See id. Some who responded to the IOSCO proposals expressed concern that establishing valuation committees, hiring independent third party valuation agents, and creating independent reporting lines will be difficult for smaller hedge funds. See Letter from Various Participants of the London Buy Side Forum to the Technical Comm., Int’l Org. of Sec. Comm’ns (June 18, 2007), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD250.pdf. Smaller funds are worried that they do not have the monetary or logistical resources necessary to implement these proposals. See Letter from Gary Palmer, Irish Funds Indus. Ass’n, to Pamela Vulpes, Gen. Secretariat, Int’l Org. of Sec. Comm’ns, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD250.pdf. Other commentators, however, believe that, despite the cost implementation of these proposals may impose on smaller hedge funds, the “internal valuation of illiquid assets leaves too much scope for less-than-independent calculations.” HEDGE FUND STANDARDS: CONSULTATION PAPER FROM THE HEDGE FUNDS WORKING GROUP: A RESPONSE BY CFA SOCIETY OF THE UK 3 (2007) [hereinafter CFA CONSULTATION PAPER], available at http://www.cfauk.org/assets/66/Response_Final.pdf. Accordingly, they suggest that funds that cannot afford to hire independent valuers and must do their asset valuation in-house should have their internal valuations reviewed by independent third-party valuers. See id.

337. See IOSCO REPORT, supra note 132, at 16.

338. See id. IOSCO stops short of calling for mandatory appointment of independent persons unconnected with the hedge fund to the valuation committee. See McVea, supra note 316, at 18. Even with independent members, an internal valuation committee appointed by the hedge fund manager’s governing body and primarily comprised of fund-insiders may find that it lacks the necessary level of autonomy to resolve conflicts of interest that arise. See CFA CONSULTATION PAPER, supra note 336, at 3.


340. ASSET MANAGERS’ COMM. REPORT TO PWG, supra note 129, at 14.
a year or "upon the occurrence of certain material events," such as a change in the fund's investment strategies or market conditions.\textsuperscript{341} Unlike IOSCO, however, the AMC does not suggest that the valuation committee include an independent person not affiliated with the hedge fund.\textsuperscript{342} Likewise, the Investors' Committee (IC) notes that hedge funds that trade harder to value assets may establish a valuation committee, but unlike the AMC, agrees with IOSCO that the committee may benefit from the inclusion of independent members with experience valuing the relevant assets who are not employed by the hedge fund manager.\textsuperscript{343} The IC suggests that the valuation committee meet regularly and that its decisions be documented in writing and made available to investors.\textsuperscript{344}

3. Valuation Related Disclosure

Finally, IOSCO advocates for dissemination to investors of the policies, procedures, and methodologies that hedge funds employ in valuing their assets.\textsuperscript{345} In order for investors to make rational decisions, IOSCO proposes that hedge funds disclose, among other things, the fund's valuation policies and a "description of the roles, skills, and experience" of those taking part in the valuation process, as well as a "description of any material conflicts of interest" that those participants may have.\textsuperscript{346} Additionally, it is becoming increasingly apparent that, if hedge funds want Employee Retirement Income Security Act (ERISA)\textsuperscript{347} qualified pension plans to

\begin{itemize}
\item \textsuperscript{341} Id. at 15.
\item \textsuperscript{342} See id. at 14-16.
\item \textsuperscript{343} See INVESTORS' COMM. REPORT TO PWG, supra note 130, at 45-46.
\item \textsuperscript{344} See id. at 46. The Investors Committee (IC) also puts significant responsibility on investors to confirm that within the valuation process, there is "adequate segregation" of duties and that those performing the valuation tasks are "suitably independent, competent, and experienced." Id. Like IOSCO, the IC recognizes that having a third-party administrator produce the hedge fund's NAV provides for better segregation of valuation duties, thereby reducing conflicts of interest. Id. at 48. If the hedge fund adopts this suggestion, the IC recommends that investors obtain NAV reports directly from the administrator. See id. The IC also suggests that investors verify that hedge fund managers have established a written statement of valuation policies and procedures stating that the fund's portfolio is valued under general accepted accounting principles (GAAP) and that, in order to avoid conflicts of interest, separate and distinct resources are being used for portfolio valuation and portfolio management responsibilities. See id. at 45, 48. GAAP refers to the "conventions, rules, and procedures that define approved accounting practices at a particular time." BLACK'S LAW DICTIONARY, supra note 16, at 705. These principles, which include not only broad guidelines, but also detailed policies and procedures, are issued by the Financial Accounting Standards Board. See id.
\item \textsuperscript{345} See IOSCO REPORT, supra note 132, at 19.
\item \textsuperscript{346} See id.
\item \textsuperscript{347} The U.S. Department of Labor describes the Employee Retirement Income Security Act as "a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans." U.S. Dep't of Labor, Employee Retirement Income Act—ERISA, http://www.dol.gov/dol/topic/health-plans/erisa.htm (last visited Mar. 31, 2009). Among other things, the law mandates that pension plans provide its participants with various disclosures and imposes fiduciary obligations on those who manage and control the plans assets. See id.
continue to invest in their funds, hedge fund managers must provide more robust disclosure regarding their valuation practices.  

4. Criticisms

Overall, IOSCO’s articulated principles for hedge fund valuation have been well-received. Yet, the principles are not without their limitations. The principles do not address audit or accounting standards that should be applied to hedge funds and their assets. Nor do they address the timeliness and methods by which a hedge fund communicates valuation information to its investors. While IOSCO calls for the disclosure of the models and inputs the hedge fund uses to value its assets, it does not call for the hedge fund to disclose and explain the nature and underlying structure of the often times complex assets being valued. Additionally, IOSCO’s principles leave discretion with hedge funds as to how they may better achieve independence in the valuation process and minimize conflicts of interest with investors, and they stop short of mandating that hedge funds

348. Castle Hall Alternatives, a hedge fund operational due diligence provider, recently reported that the Boston office of the U.S. Department of Labor issued a letter to a qualified pension plan under the Employee Retirement Income Security Act (ERISA) stating that in order to adhere to ERISA’s requirements when investing in hedge funds

"it is incumbent on the Plan Administrator to establish a process to evaluate the fair market value of any hard to value assets held by the Plan. Such a process would include a complete understanding of the underlying investments and the fund’s investment strategy. In addition, the Plan Administrator must have a thorough knowledge of the general partner’s valuation methodology to ensure that it comports with the fund’s written valuation provisions and reflects fair market value. A process which merely uses the general partner’s established value for all funds without additional analysis may not insure that the alternative investments are valued at fair market value.”

See ERISA vs. The Hedge Fund Industry, supra note 137 (quoting the U.S. Department of Labor).


350. See McVea, supra note 316, at 21. In their 2007 Sound Practices, the MFA takes the position that, at least for purposes of NAV, hedge fund managers should value their assets according to U.S. GAAP or international accounting standards (IAS). See MFA SOUND PRACTICES, supra note 312, § 3.6.

351. See McVea, supra note 316, at 21. The MFA’s 2007 Sound Practices only states that the manner in which hedge funds communicate valuation information to investors should remain consistent from period-to-period, but does not specify a favored method of communicating this information or the frequency with which it should be communicated. See MFA SOUND PRACTICES, supra note 312, § 3.14.

352. See McVea, supra note 316, at 22.
have their assets valued by an independent administrator. Finally, IOSCO’s principles do not provide explicit direction as to when, in relation to assessing performance fees, hedge fund managers should value hard-to-value assets. One possible way to reduce the conflicts of interest in this situation is to require that performance fees on these complex and often illiquid assets be assessed only after the asset has been liquidated.

B. Regulating the Conflicts

Other ways to reduce conflicts of interest in hedge funds involve governing the conflicts themselves. Such governance mechanisms can be permissive, heavy-handed, or even internally administered. Part II.B.1 addresses Delaware’s permissive governance mechanism, the implied contractual covenant of good faith, which acts as a legal backstop after a general partner’s fiduciary duties have been eliminated. Part II.B.2 presents a counterapproach used in Washington State, which has an inflexible prohibition of the modification of fiduciary duties by investment advisers. Part II.B.3 then discusses internal governance of a hedge fund manager’s conflicts of interest through the establishment of in-house conflicts committees.

1. Contractual Covenant of Good Faith

Delaware limited partnership law provides a prime example of a permissive means by which to govern the conflicts of interest that arise in hedge funds. Since 2004, DRULPA has allowed for the expansion, restriction, and elimination of fiduciary duties, mandating only the contractual covenant of good faith and fair dealing as the baseline below which a partner’s duties cannot be contractually lowered. This makes fiduciary duties merely default duties, as only the contractual covenant of good faith and fair dealing inheres in all limited partnership agreements. It also allows for the contracting parties to reduce substantially judicial oversight of the parties’ actions. Despite its seemingly limited application, the proponents of this statutory scheme argue that the implied covenant of good faith sufficiently protects parties to limited partnership

353. See id.
354. See id. at 23. Note too that the current financial crisis and the “resulting loss of liquidity in many markets” have made valuing illiquid instruments a difficult proposition. Hedge Funds Review, Industry Tackles Valuation Anxieties, VALUATION RISK.NET, Jan. 12, 2009, http://www.valuationrisk.net/index2.php?option=com_content&do_pdf=1&id=126 [hereinafter Valuation Anxieties]. Valuing derivatives becomes particularly problematic when, as now, during the current credit crunch, there is limited trading of these instruments. See id.
355. DEL. CODE ANN. tit. 6, § 17-1101(d) (2005).
356. See supra notes 184–90 and accompanying text.
357. See Gold, supra note 168, at 128. This is significant in the context of limited partnerships, where fiduciary duties act to constrain the conflicts of interest between the general and limited partners. See Larry E. Ribstein, Fiduciary Duties and Limited Partnership Agreements, 37 SUFFOLK U. L. REV. 927, 939 (2004).
agreements in which fiduciary duties have been eliminated. The question, then, is whether the contractual covenant of good faith adequately protects hedge fund investors from hedge fund managers' conflicts of interest.

In Delaware, the contractual covenant of good faith and fair dealing is implied into every contract "to prevent one [contracting] party from unfairly taking advantage of the other party." Unlike fiduciary duties, which can act as a means to enforce a mandatory business norm, the implied covenant of good faith and fair dealing acts as a means by which courts can enforce parties' actual agreements. The implied covenant of good faith does not impose obligations on the parties, but rather acts as an interpretive doctrine that courts employ to enforce the reasonable expectations of contracting parties based on the text of their agreement. Accordingly, a court's interpretation of the parties' expectations, and thus, what actions constitute good faith, will be dictated by the parties' agreement. In business arrangements in which the parties cannot foresee all the circumstances to that their agreement will apply, good faith acts as a contractual gap filler, supplying implied terms where the contracting parties remained "silent as to

358. The implied contractual covenant of good faith and fair dealing must be distinguished from the fiduciary duty of good faith. See generally Hillary A. Sale, Delaware's Good Faith, 89 CORNELL L. REV. 456 (2004) (providing a detailed discussion regarding Delaware's emerging doctrine of the fiduciary duty of good faith). The fiduciary duty of good faith remains ambiguously defined but may "address[] those outrageous and egregious abdications of fiduciary behavior that are not simply the results of bad process or conflicts." Id. at 494; see In re The Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005) ("The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty . . . but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders."). Or, as Professor Sean Griffith argues, the duty of good faith may be "best understood as a rhetorical device rather than as a substantive standard," the purpose and effect of which is "to loosen the doctrinal constraints on the Delaware judiciary and to enable its judges to shift the authority/accountability balance in response to a change in the set of pressures and constraints . . . operating upon them." Sean J. Griffith, Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence, 55 DUKE L.J. 1, 6, 8 (2005).


360. See Gold, supra note 168, at 146. See generally Mariana Pargendler, Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered, 82 TUL. L. REV. 1315 (2008) (referring to fiduciary duties as more general "untailored" gap fillers applicable to general contracts, and the implied covenant of good faith as a "tailored" gap filler applicable to the parties' specific contract).


But where the parties' contract addresses the contingency at issue, contractual freedom will take precedent, and the implied covenant of good faith will be of little import.\(^3\)

Delaware courts, however, are generally reluctant to use the implied covenant of good faith to infer obligations into a contract, except in those narrow circumstances where fairness dictates the necessity.\(^4\) By and large, inferring obligations is a "cautious enterprise,"\(^5\) and breaches of good faith typically involve some semblance of "fraud, deceit or misrepresentation."\(^6\) Courts will determine whether a party has breached the implied covenant by deducing the essential meaning of the contract and inferring the terms that the parties would have included in the agreement had they predicted the exigency.\(^7\) Given the inherent variability in the process, it is not surprising that "[t]he type of conduct circumscribed by the duty [remains un]clear . . . and courts have no articulated standards that are much more than conclusory assessments of how the parties acted."\(^8\)

The uncertainty as to when the implied covenant will preclude conduct that would have otherwise been prohibited by fiduciary duties stems from the doctrine's fact-intensive nature and the vagaries of contractual interpretation.\(^9\) That parties to a limited partnership agreement often formulate novel obligations and duties using cryptic language only injects further uncertainty as to the behaviors that good faith proscribes.\(^10\) Nonetheless, it is clear that where a limited partnership agreement has waived fiduciary duties, the contractual duty of good faith and fair dealing


\(^{364}\) See Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., No. C.A. 15388, 1997 WL 525873, at *5 (Del. Ch. Aug. 13, 1997) (stating that Delaware courts "will not find an implied term when the contract expressly addresses the subject matter at issue"); Shenandoah Life Ins. Co. v. Valero Energy Corp., CIV. A. No. 9032, 1988 WL 63491, at *8 (Del. Ch. June 21, 1988) ("Where . . . a specific, negotiated provision directly treats the subject of the alleged wrong and has been found to have not been violated, it is quite unlikely that a court will find by implication a contractual obligation of a different kind that has been breached."); Gold, supra note 168, at 150.

\(^{365}\) See Altman & Raju, supra note 176, at 1479; see also Gold, supra note 168, at 144 (stating that, in Delaware, the coverage of the contractual duty of good faith is narrow).


\(^{367}\) Wilmington Trust Co. v. Keith, No. C.A. 00C-11-016, 2002 WL 1748622, at *2 (Del. Super. Ct. June 26, 2002) (citing Cincinnati SMSA Ltd. P'ship, 708 A.2d at 992). It has been suggested that, to prove breach of the implied covenant of good faith, the plaintiff must show that the defendant had a culpable mental state. See Altman & Raju, supra note 176, at 1477.

\(^{368}\) See Altman & Raju, supra note 176, at 1477.

\(^{369}\) Coca-Cola Bottling Co. of Elizabethtown, Inc. v. Coca-Cola Co., 668 F. Supp. 906, 918 (D. Del. 1987); see Gold, supra note 168, at 135 (stating that "[t]he content of contractual good faith has not been easy to define in the abstract").

\(^{370}\) See Gold, supra note 168, at 153–54.

\(^{371}\) See id. at 154–55 (stating that parties to limited partnerships "often draft reticulated, intricate terms" and "novel formulations of contractual obligations" to describe the parties' duties).
does not prevent partners from taking business opportunities that would have otherwise been available to the limited partnership or engaging in self-interested transactions.372

It is also certain that a contract term clearly granting discretion to a party who has negotiated away fiduciary duties must "be enforced to the letter."373 Where the objective meaning of the text cannot be understood to convey the disputed level of decision-making latitude, courts may find that discretion-granting terms leave room for interpretation,374 though this is unlikely, as contract law places few limitations on the level of discretion a nonfiduciary is allowed to exercise.375 For example, limited partnership agreements often provide general partners with "sole" or "absolute" discretion to make many, if not all, of the decisions regarding the governance and operation of the entity.376 A typical example of the

372. For example, in Kahn v. Icahn, limited partners in a Delaware limited partnership alleged that the general partner, controlled by Carl Icahn, usurped opportunities that rightfully belonged to the limited partnership. No. CIV. A. 15916, 1998 WL 832629, at *1 (Del. Ch. Nov. 12, 1998). In light of the fact that the limited partnership agreement "permitted the Icahn Defendants to make the investments without bringing them to the limited partners," the court found no breach of fiduciary duty or the contractual duty of good faith and fair dealing. Id. at *3.

373. See Ann E. Conaway, The Multi-Facets of Good Faith in Delaware: A Mistake in the Duty of Good Faith and Fair Dealing; a Different Partnership Duty of Care; Agency Good Faith and Damages; Good Faith and Trust Law, 10 DEL. L. REV. 89, 90 (2008) ("According to the law of contracts, action by a partner pursuant to a partnership agreement . . . unless partnership . . . default fiduciary duties have not been modified or eliminated, permits action in the partner[s] . . . own interest and not in the interest of the partnership . . . ."); Gold, supra note 168, at 135 (stating that, unlike fiduciary duties, contractual good faith duties are not breached by selfish behavior). Conversely, intentionally hindering another party's performance or fraudulently exercising one's discretion are clear examples of bad faith. See Gold, supra note 168, at 152–53.

374. See Gold, supra, note 168, at 140. Where contract terms are silent, good faith duties can be used to fill the gap, but where the contract addresses the issue, "[e]xisting contract terms control . . . such that implied good faith cannot be used to circumvent the parties' bargain, or to create a 'free-floating duty . . . unattached to the underlying legal document.'" Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 441 (Del. 2005) (quoting Glenfed Fin. Corp., Commercial Fin. Corp. v. Penick Corp., 647 A.2d 852, 858 (N.J. Super. Ct. App. Div. 1994)).

375. Cf. Gold, supra note 168, at 173–74 (stating that because "[a] broad grant of discretion is confined by a reasonable understanding of the text as a whole," an unreasonable result may prompt a court to interpret what otherwise appears to be a contract term granting a party absolute discretion).

376. See id. at 127–28.

377. See Schuss v. Penfield Partners, L.P., No. 3132-VCP, 2008 WL 2433842, at *2 (Del. Ch. June 13, 2008) (discussing a hedge fund's limited partnership agreement granting the general partner sole discretion to determine how a limited partner would be paid upon withdrawal from the fund); Albert v. Alex. Brown Mgmt. Servs., Inc., Nos. 762-N, 763-N, 2005 WL 5750601, at *6 (Del. Ch. June 29, 2005) (discussing an exchange fund's limited partnership agreement granting sole discretion to the general partner "to delay or deny redemptions, if such redemption requests imposed significant liquidity costs on the Funds"); Gelfman v. Weeden Investors, L.P., 792 A.2d 977, 985 (Del. Ch. 2001) (citing a limited partnership agreement that gave the general partner "sole discretion" to make decisions concerning the limited partnership and, in doing so, entitling the general partner "to consider only such interests and factors as it desires" and removing the general partner's obligation to
definition that a limited partnership provision gives to sole discretion provides,

Notwithstanding any other provision of this Agreement or otherwise applicable provision of law or equity, whenever in this Agreement, the General Partner is permitted or required to make a decision in its “sole discretion” or “discretion” or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires, including its own interests, and shall, to the fullest extent permitted by applicable law, have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership or the Limited Partner’s.378

By entering into a limited partnership agreement with a similar provision, a limited partner loses much of her enforcement rights against the general partner, who, in turn, has gained the right to act in a self-interested fashion.379 The court is likely to find that such a bargained-for exchange, at the time of contracting, would have factored into the parties’ reasonable expectations, leaving little room for the court to imply a term diminishing the general partner’s decision-making latitude.380 Short of truly egregious conduct, such as fraud or misappropriation of partnership assets, there seems little that a general partner could do in exercising its stated level of discretion that would constitute bad faith.381

At least one commentator does not view the implied covenant as a governance mechanism sufficiently stringent to police conflicts of interest in the limited partnership context, asserting the need for a more “robust version of the implied covenant” to apply when a limited partnership agreement restricts fiduciary duties.382 Professor Deborah A. DeMott is concerned that in the absence of a more forceful implied covenant of good faith, a “limited partnership agreement that completely abjured fiduciary obligation would . . . resemble a gift of [partners’] property to those in control of the enterprise who would be free to use the entity’s property as they saw fit.”383 In Professor’s DeMott’s opinion, a gift of their assets is not what limited partners have in mind when they invest in the partnership.384

Conversely, other commentators argue that the implied covenant is an adequate governance mechanism. Despite the general partner’s freedom to

378. See Altman & Raju, supra note 176, at 1484.
379. See Conaway, supra note 373, at 102–03.
380. See Altman & Raju, supra note 176, at 1484. Conversely, if the partnership agreement does not clearly define the scope of the general partner’s discretion, it would make sense for the court to infer that the parties intended for it to be exercised reasonably. See id. at 1485.
383. Id. at 1061.
384. Id.
eliminate fiduciary duties, these commentators argue that alternative remedies outside the judicial arena couple with the implied covenant to provide limited partners with sufficient protection. They point specifically to the importance of reputation as a limiting factor on a general partner's self-interested behavior. Looking to venture capital firms, which are often organized in Delaware as limited partnerships and take advantage of DRULPA to restrict the general partner's fiduciary obligations despite the apparent conflicts of interest, these commentators suggest that the need for future investment in the fund forces the general partner to maintain a reputation for fair dealing. Additionally, they cite an apparent lack of venture capital-related litigation in this context to indicate the possibility that extrajudicial limitations on general partners, such as reputational concerns, provide sufficient protection for passive investors. Importantly, a major proponent of this view acknowledges that, where the potential benefits associated with self-interested behavior might be such that self-opportunism trumps a general partner's reputational concerns, the benefits of supplementing the implied covenant of good faith with mandatory fiduciary obligations may outweigh the cost of decreased contractual flexibility.

2. Washington's Substantive Regulations

Where Delaware has opted to allow investors in limited partnerships the freedom to restrict or eliminate their fiduciary protections, other states have taken a more paternalistic position. The state of Washington's limited partnership law provides a good example of a governance mechanism designed to ensure that general partners always put their clients' interests before their own.

385. See Gold, supra note 168, at 163–64; Ribstein, supra note 169, at 233–35.
386. See Gold, supra note 168, at 163; Ribstein, supra note 169, at 233.
387. See Rosenberg, supra note 177, at 366–71. For example, like a hedge fund manager, the manager of a venture capital firm has an interest in maximizing the valuation of the firm's portfolio in order to encourage future investment in the fund. See D. Gordon Smith, Team Production in Venture Capital Investing, 24 J. CORP. L. 949, 970 (1999). This creates incentives for the manager of the venture capital firm to utilize methods to inflate artificially the value of the firm's portfolio. See id.
388. See Ribstein, supra note 169 at 233; Rosenberg, supra note 177, at 394–97.
389. See Gold, supra note 168, at 163. Alternatively, the lack of litigation in this context could be due to the fact that limited partners realize the futility of bringing a claim for self-dealing where their enforcement rights have been contracted away.
390. See Ribstein, supra note 169, at 234.
391. In light of recent scandals involving hedge funds, the notion that fiduciary roles need strengthening is gaining acceptance. See Bob Ivry, Saijel Kishan & Ian Katz, Hedge Funds Concede Oversight Inevitability in Wake of Madoff, BLOOMBERG, Dec. 22, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aJ43XHvSySeVª&refer=home (quoting Mehraj Mattoo, the global head of alternative investments at Commerzbank AG, as seeing a need for "greater oversight of the fiduciary roles where there are clear conflicts of interest").
In Washington, as they do under federal law, hedge fund managers meet the statutory definition of an investment adviser.\textsuperscript{392} As under federal law, a hedge fund manager in Washington "is a fiduciary [who] has a duty to act primarily for the benefit of [her] clients."\textsuperscript{393} This, however, is where Washington’s approach to hedge fund regulation diverges from that of the federal government. Unlike the federal law, Washington law does not recognize a private adviser exemption to its investment adviser registration requirement.\textsuperscript{394} Additionally, Washington has always taken the position that each investor in a hedge fund is counted as a client of the hedge fund manager, a position Washington has maintained even after the \textit{Goldstein} court’s abrogation of the Hedge Fund Rule.\textsuperscript{395} Thus, even a hedge fund manager with fourteen or fewer investors will be subjected to the mandates and obligations governing an investment adviser in the state of Washington.

One such mandate is that "[t]he fiduciary duties of an investment adviser [in Washington] may not be modified."\textsuperscript{396} Recognizing that the obligations imposed on fiduciaries is "generally higher than those owed to partners in a partnership" and because the obligations "to partners . . . under default provisions of state law [are] lower than the fiduciary duty of an investment adviser," Washington has deemed it prudent to prohibit contractual modification of those duties among partners.\textsuperscript{397} To ensure compliance with this requirement, Washington prohibits waivers of these protections in hedge fund agreements.\textsuperscript{398} Thus, any broadly crafted limitation on liability, the very same type that would remove fiduciary obligations under Delaware law, will be unenforceable under Washington law.\textsuperscript{399}

\section*{3. Conflicts Committee}

Internally regulating conflicts of interest provides a third possible governance mechanism. In its report to the PWG, the AMC suggests that hedge fund managers should self-regulate conflicts of interest by establishing conflicts committees.\textsuperscript{400} With the stated purpose of assessing new and potential conflicts of interest as they arise, it would be an in-house

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{392} Washington’s definition of investment adviser tracks that of the SEC. See WASH REV. CODE ANN. § 21.20.005(6) (West 2007); \textit{supra} note 236 and accompanying text.
\item \textsuperscript{394} \textit{See} State of Wash. Dep’t of Fin. Insts., Notice to Hedge Fund Managers (Sept. 22, 2005), \textit{available at} http://www.dfi.wa.gov/sd/pdf/hedgefundreg.pdf.
\item \textsuperscript{395} \textit{See id.}
\item \textsuperscript{397} \textit{Id.}
\item \textsuperscript{398} \textit{Id.}
\item \textsuperscript{399} \textit{See id.}
\item \textsuperscript{400} \textit{See} ASSET MANAGERS’ COMM. REPORT TO PWG, \textit{supra} note 129, at 48.
\end{itemize}
\end{footnotesize}
committee's charge to "determine whether amendments or new policies are necessary or appropriate" to deal with the conflicts of interest facing the hedge fund manager.\textsuperscript{401} The AMC recommends that a conflicts committee include the hedge fund manager's chief compliance officer,\textsuperscript{402} a person whom the AMC recommends oversee and ensure compliance with the framework set in place "to provide guidance to the [hedge fund manager] and its personnel in respect of ethical, regulatory compliance and conflict of interest situations."\textsuperscript{403} Additional recommendations include that, at a minimum, the conflicts committee annually review the effectiveness of its conflicts management practices and that it keep records of how it addressed past conflicts.\textsuperscript{404}

The AMC report makes no recommendation that a conflicts committee include an independent representative not affiliated with the hedge fund, nor does it suggest that the compliance officer be independent of the investment vehicle. There are at least two potential problems with this type of in-house solution: it assumes that the hedge fund's size will allow for the internal segregation of roles and responsibilities, and it assumes that those in charge of compliance and managing the hedge funds conflicts are not sufficiently under the patronage of the hedge fund manager as to be compromised in carrying out their duties.\textsuperscript{405} Specifically, a compliance scheme dependent on internal reporting, which the AMC recommends as one of the responsibilities of the compliance officer, may lack the independence necessary to effectively deal with the hedge fund's opportunities for self-interested behaviors.\textsuperscript{406}

C. Thinning the Hedge: Improving Disclosure and Making Funds More Transparent

As demonstrated above, substantive regulation directed at the elimination and governance of conflicts of interest has its limitations.\textsuperscript{407} It is where these limitations arise that both mandatory and voluntary disclosure can provide needed protection by shifting some of the responsibility for protecting investors to the investors themselves.\textsuperscript{408} Indeed, disclosure

\textsuperscript{401} Id. at 49.
\textsuperscript{402} See id.
\textsuperscript{403} Id. at 42. The compliance officer should have the resources necessary "to seek the advice of external experts on compliance matters" and have an allocation of responsibilities such that they have sufficient time to dedicate to fulfilling this function. Id. at 50. The AMC also suggests that all episodes of noncompliance with the best practice standards that the hedge fund adopts into its compliance framework be reported to the compliance officer, who will then provide senior management input as to appropriate disciplinary actions, if necessary. See id. at 51.
\textsuperscript{404} See id. at 49.
\textsuperscript{405} See Naik, supra note 76, at 14.
\textsuperscript{406} See id. at 15.
\textsuperscript{407} It has been noted that "[s]ubstantive regulation has its limits. But '[t]he truth shall make you free.'" Loss & Seligman, supra note 193, at 8.
\textsuperscript{408} Richard Frederick, Principal Adm'r, Org. for Econ. Co-operation & Dev., Address at the Third Meeting of the Russian Corporate Governance Roundtable: Disclosure: A
PROTECTING INVESTORS

provides the foundation for the federal securities laws and many other regulatory schemes. In regard to securities regulation specifically, reducing the informational incongruities among investors, issuers, and their intermediaries is thought essential to prudent investing and market efficiency. Disclosure schemes are also employed to remedy the conflicts of interest faced by professional advisors under the assumption that disclosing advisors' conflicts of interest allows their clients to account for biases that may taint the advice they receive. Less focused on regulating the outcome of investors' decisions, disclosure regimes are intended to enhance the process by which investors arrive at those conclusions.


409. See Basic Inc. v. Levinson, 485 U.S. 224, 258 (1988) (White, J., concurring in part and dissenting in part) (stating that the federal securities laws demonstrate a strong congressional preference for "widespread public disclosure and distribution to investors of material information concerning securities"); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) ("A fundamental purpose [of the securities laws] was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." (citing H.R. Rep. No. 73-85, at 2 (1933)); see also Loss & Seligman, supra note 193, at 8 (stating that disclosure is a recurrent theme throughout the federal securities statutes).


411. See Paul M. Healy & Krishna G. Palepu, Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature, 31 J. ACCT. & ECON. 405, 412 (2001); see also Brown et al., supra note 162, at 1 ("Mandatory disclosure is an important regulatory tool intended to allow market participants to assess manager risks without unnecessarily constraining manager actions."); Joel Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. CORP. L. 1, 9 (1983) (stating that in the absence of mandatory corporate disclosure, investors would be deprived of material information).

412. See Daylian M. Cain et al., The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest, 34 J. LEGAL STUD. 1, 2–3 (2005).

413. See Dalley, supra note 410, at 1110. Justice Louis Brandeis, an early proponent of the disclosure philosophy that permeates securities regulation, did not think that disclosure laws should prevent investors from making bad bargains. See Loss & Seligman, supra note 193, at 36. Rather, he saw disclosure as a method of informing investors of the nature of their bargains. See id.
1. The Inadequacy of Current Disclosure Practices

Much of the hedge fund industry’s current disclosure practices are less than forthcoming. Even some within the industry acknowledge that hedge funds’ “disclosure documents (offering memoranda and the like) tend to give them carte blanche and are therefore useless, and their lack of transparency plays into the hands of the worst participants in the business.” It is therefore not surprising then that many commentators and industry groups have asserted the need for greater transparency and increased disclosure as a way to mitigate the conflicts of interest that hedge fund managers face. It is generally thought that investors can make better, more informed decisions when provided with clear disclosure, as this provides investors with the tools necessary to assess and understand the risks associated with fund investments. While numerous disclosure-related recommendations apply to operational risk factors, many are geared toward conflicts of interest.

2. Proposals to Improve Disclosure of Conflicts of Interest

Various entities have published reports and submitted proposals directed toward improving the quality and increasing the quantity of disclosure regarding conflicts of interest to hedge fund investors. For example, the


416. See id. at 2–3.

417. See Pearson & Pearson, supra note 35, at 72. Hedge fund transparency benefits others, in addition to individual investors. It is believed that from transparency flows greater investor participation, which in turn promotes “better market disciplining of product providers, greater informational efficiency in markets and the more rapid spread of financial innovations.” NAIK, supra note 76, at 6.

Managed Funds Association (MFA) suggests that each hedge fund manager should develop specific policies and procedures to assess and disclose its material conflicts of interests to investors. These include, among others, the hedge fund manager's relationship with prime brokers, conflicts caused by the fund's fee arrangements, the personal trading activities of the hedge fund manager and its employees, as well as conflicts that ensue from overseeing numerous funds. The MFA also recommends that hedge fund managers should disclose to investors side letters granted to preferred investors that have a material impact on other investors. The MFA does not recommend how often hedge fund managers should make these disclosures, stating only that a hedge fund manager should attempt to prepare disclosures for dissemination to investors on a timely basis.

As compared to the MFA, both the AMC's and the IC's reports to the PWG present voluntary disclosure requirements "in more ambitious terms." And though both reports are written in a horatory fashion, merely prescribing best practices as compared to mandating them, at least one commentator believes that, as compared to the MFA's prescriptive standards, the AMC's and the IC's recommendations "raise the bar" on hedge fund managers. The AMC report, recognizing that "[a] robust disclosure framework is critical to the protection of investors' interests," recommends that hedge fund managers put a framework in place that allows for the disclosure of material information regarding financial and risk information and potential conflicts of interest "with sufficient frequency and detail." Such disclosure allows investors to make informed

---

419. See MFA SOUND PRACTICES, supra note 312, § 2.3.
420. In relation to prime brokers, the MFA suggests that hedge fund managers should disclose to investors those relations that involve potential material conflicts of interest. See id. § 2.12.
421. See id.
422. See id. § 2.6. The SEC distinguishes side letters that materially impact other investors and those that do not. Side letters granting certain investors the ability to make additional investments or limiting the fees they pay the hedge fund manager are not considered material. See Testimony Concerning Hedge Funds: Hearing Before the Subcomm. on Securities and Investment of the S. Comm. on Banking, Housing, and Urban Affairs, 109th Cong. (2006) (testimony of Susan Ferris Wyderko, Director of the Office of Investor Education and Assistance at the SEC). Conversely, material conflicts of interest are created by side letters conferring upon select investors liquidity preferences or increased access to portfolio information. See id. In the United Kingdom, the SEC's counterpart, the FSA, already requires hedge fund managers to disclose to investors the presence of certain side letters. See SCHULTE ROTH & ZABEL INT'L LLP, ALERT: GUIDANCE ON DISCLOSURE OF SIDE LETTERS, available at http://www.srz.com/files/News/e630fc1e-3c05-4b48-a1d6-8fba427d00b2/Presentation/NewsAttachment/b94fbf39-7a31-4c83-a39b-cbfa53fa1da7/files/filesAlert%20-%20October%204,%202006%20-%20%20Guidance%20on%20Disclosure.pdf.
423. See MFA SOUND PRACTICES, supra note 312, § 2.2. Some insight into the frequency with which such disclosure should be made may be provided by the MFA's suggestion that hedge fund managers provide investors with annual audited financial statements. See id. § 2.8.
425. Id. (quoting ASSET MANAGERS' COMM. REPORT TO PWG, supra note 129, at 1).
426. ASSET MANAGERS' COMM. REPORT TO PWG, supra note 129, at 1.
decisions about initial investment in the fund, and facilitates monitoring and management of the risks associated with remaining in the fund.427

In the context of hedge funds, disclosure can take a variety of forms, the first of which typically is private placement memoranda (PPM).428 Among other things, the AMC recommends that the PPM disclose the fund’s legal structure, including the jurisdiction in which it is organized,429 as well as the fund’s valuation framework.430 Moreover, information being disclosed should include the fund’s accounting standards,431 the role of third parties in the valuation process; the hedge fund manager’s valuation policy and the manner in which the hedge fund manager oversees its implementation; the methodologies that both internal and external valuation agents use to price the fund’s assets; and ways in which the hedge fund manager works to mitigate the conflicts of interest inherent in the valuation process.432 Finally, the PPM should disclose the risks associated with investing in the hedge fund, including valuation of illiquid assets to which the market does not give a readily ascertainable value, the degree to which the fund’s operations are overseen by regulators, and potential conflicts of interest of those managing the hedge fund.433

Realizing that providing initial disclosure through the PPM does not obviate the need for transparency, the AMC stresses the importance of “provid[ing] all investors with a consistent level of information.”434 In so doing, the AMC report arguably provides more detailed guidance as to when hedge fund managers should make disclosures to their investors. While many of the AMC’s disclosure recommendations pertain to performance-related risks, the report counsels hedge fund managers to disclose material changes to the fund’s valuation policies and key investment personnel, and entry into side letters promptly after the occurrence.435 Additionally, in an effort to make conflicts of interest more

427. See id.
428. See id. The private placement memorandum (PPM) is the fund’s offering document and should provide a broad overview of the hedge fund, including strategies and products the fund employs, as well as significant risks associated with investment in the fund. See id.
429. See id. at 2.
430. See id. at 3.
431. The AMC states that valuations and NAV should be calculated using fair value accounting in accordance with GAAP or with standards substantially similar to GAAP. See id.
432. See id. at 3–4.
433. See id. at 4–5.
434. Id. at 9.
435. See id. With respect to side letters, it appears that the AMC took a less deferential view as to when disclosure of the arrangement is necessary. Where the MFA recommends disclosure only where side letters would have a material impact on other investors, the AMC recommends disclosure when entry into the preferential agreements “may adversely impact other investors in the fund.” Id. at 10. The AMC’s recommendation may be categorized as more investor-protective. Moreover, in a letter dated June 13, 2008, the MFA points out that the AMC’s suggestion regarding disclosure of side letters is more stringent than that of the IC, which, according to the MFA, suggests only that a hedge fund manager provide disclosure of side letters upon request from investors. Letter from Richard H. Baker, President and CEO, Managed Funds Ass’n, to Eric Mindich, Chair, Asset Managers’ Comm.
apparent to investors, other commentators have called for hedge fund advisers to disclose the securities they own personally.\textsuperscript{436}

3. Disclosure Regimes' Costs and Limitations

The use of disclosure as a form of regulation may not always be desirable.\textsuperscript{437} It can be costly to "create, compile, and publish the relevant information," and some opponents of increased transparency may argue that such costs outweigh the benefits from such disclosure.\textsuperscript{438} Even where costs do not outweigh benefits, disclosure regimes may prove ineffectual nonetheless if the information disclosed is not considered salient by its target audience and provided in an easily utilized form.\textsuperscript{439} Additionally, requiring disclosure can lead those with propriety over the information to "game" the system in an effort to avoid reporting negative information about themselves.\textsuperscript{440}

More specifically, the generally secretive nature of the hedge fund industry imposes a steep obstacle to the implementation of increased hedge fund transparency.\textsuperscript{441} Seeing increased transparency as nothing more than a negotiating tool, many hedge fund managers may resist implementing greater disclosure measures, unless the benefits to them—such as increased investment in their funds—are clear.\textsuperscript{442} And when coupled with the fact that these disclosure measures are merely voluntary suggestions drafted by

\textsuperscript{436} See Pearson & Pearson, supra note 35, at 75–76.
\textsuperscript{437} See Cass R. Sunstein, Informational Regulation and Informational Standing: Akins and Beyond, 147 U. PA. L. REV. 613, 626 (1999); see also Geoffrey A. Manne, The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure, 58 ALA. L. REV. 473, 474, 478 (2007) (arguing that, in some situations, mandatory disclosure can have "undesirable consequences," including "substitut[ing] federal regulator and enforcer biases for the limitations of market enforcement" and "induc[ing] too much participation by investors in corporate governance," thereby imperiling their "competitive governance schemes").
\textsuperscript{438} See Dalley, supra note 410, at 1127 (citing Sage, supra note 410, at 1721–22).
\textsuperscript{439} See Sunstein, supra note 437, at 626–28.
\textsuperscript{441} Oppold, supra note 48, at 849 ("Disclosure requirements particularly trouble hedge funds, many of which emphasize secrecy within their investment process to create a competitive advantage"); see Linda Chatman Thomsen et al., Hedge Funds: An Enforcement Perspective, 39 RUTGERS L.J. 541, 556, 598 (2008) (noting hedge funds' desire to maintain the level of secrecy they currently enjoy as a result of being unregistered under the federal securities laws). Many hedge funds fear that by disclosing proprietary information, such as trading positions, imitators will be able to capitalize on the strategies of more successful funds. Chatman, supra, at 598.
\textsuperscript{442} See NAIK, supra note 76, at 7.
private-sector committees without regulatory power,\textsuperscript{443} it is unlikely that hedge funds will widely implement them.\textsuperscript{444} A limitation of voluntary codes, or in this case recommended best practices, is that, the more the proposals meet the needs of investors, the more that hedge fund managers will limit their implementation of the suggestions.\textsuperscript{445}

To be effective, an industry-wide body is likely required to not only draft the voluntary hedge fund disclosure standards, but also monitor hedge funds’ adherence to them and impose sanctions for eventual breaches.\textsuperscript{446} An industry-wide body may also find it beneficial to provide hedge fund managers with a stake in the success of a disclosure regime, so that they receive some benefit from the disclosure.\textsuperscript{447} Additionally, suggestions that hedge funds delegate responsibility for ensuring and reporting compliance with voluntary best practices to in-house personnel is likely to further undermine implementation and effectiveness of the measures.\textsuperscript{448} Rather, effectiveness may be increased by having hedge funds report in their periodic disclosures to investors the results of independent audits of the funds’ compliance with voluntary best practices.\textsuperscript{449}

Like the disclosure-related proposals, many of the suggestions that industry-wide bodies have advanced and state governments have adopted to protect hedge fund investors from conflicts of interest are limited by the issue’s multifaceted nature. Thus, effectively protecting investors will likely be realized by synthesizing the previously mentioned conflict-mitigating measures into a workable proposal that allows hedge funds to retain many of their defining traits, and does not preclude the investment vehicles from continuing to confer significant benefits on the market. Part III of this Note suggests ways that this may be achieved.

III. INCREASING TRANSPARENCY AND REGULATING VALUATION PRACTICES TO PROTECT INVESTORS

Though not ideal, the level of protection from conflicts of interest afforded to hedge fund investors is not entirely deficient. This is evinced

\textsuperscript{443} See Hunt, supra note 247, at 6.
\textsuperscript{445} See NAiK, supra note 76, at 14.
\textsuperscript{446} See id. at 15.
\textsuperscript{447} See Dalley, supra note 410, at 1129.
\textsuperscript{448} See id. (opining that “[d]isclosure systems are less likely to work where disclosers are required to report negative information about themselves”).
\textsuperscript{449} See NAiK, supra note 76, at 16.
by the fact that, even in the face of recent hedge fund scandals, and an increase in redemption requests, many investors continue to invest, or remain invested, in hedge funds. Yet, in light of the ongoing retailization of the hedge fund industry and the growing exposure of ordinary investors to the risks of hedge fund investment, measures should be taken to better protect hedge fund investors from the numerous conflicts of interest associated with hedge fund management. In particular, efforts should be made to protect those who are indirectly invested in hedge funds. As compared to sophisticated investors, whom the federal securities laws presume to require little protection, ordinary investors—many of whom are unaware of their hedge fund involvement—remain particularly vulnerable to investment losses. However, regulatory steps should not deprive hedge funds of their characteristic traits. Due to their unique structure and flexibility, which has been shown to confer significant benefits on the market, it is imperative that regulations enacted to protect investors from conflicts of interest do not overly restrain the liveness of the investment vehicles.

Part III addresses regulatory measures that can be taken to better protect investors from the conflicts of interest associated with hedge fund management. Part III.A discusses ways in which hedge funds can be made more transparent to investors and regulators alike without compromising their characteristic flexibility and trading strategies. Part III.B then presents measures to reduce the conflicts of interest affecting the hedge fund valuation process.

450. See Dan Molinski, Some Pension Funds Don’t Flee, WALL ST. J., Dec. 26, 2008, at C3 (“Chief investment officers for pension funds note that despite some worrisome drawbacks, hedge funds continue to outperform stocks, and by a good margin . . . . That pension funds remain committed to hedge funds may be a surprise given the industry’s recent problems . . . .”). But see Craig Karmin, Once Burned, Twice Shy: Pension Funds, WALL ST. J., Jan. 3–4, 2009, at B3 (reporting that, after incurring sizable losses in 2008, some large pension funds are rethinking their current exposure to hedge funds).

451. Congress’s motivation in designing the securities laws was not to “protect investors capable of protecting themselves.” C. Edward Fletcher, III, Sophisticated Investors Under the Federal Securities Laws, 1988 DUKE L.J. 1081, 1133. Rather, in establishing the regulatory framework, Congress sought to address the vulnerabilities of individual, ordinary investors. See id. at 1133–34.

452. See supra notes 101–10 and accompanying text.

453. Hedge funds’ noted flexibility results from their ability to avoid registration under the Company Act, see infra notes 221–34 and accompanying text, which limits significantly the types of transactions into which a registered investment company can enter. See Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006); see also JAEGER, supra note 37, at 4 (“[M]utual funds operate under specific rules defined by the [SEC] . . . . and these rules limit the manager’s freedom of movement. . . . In contrast, the hedge fund manager can do almost anything she wants to do.”).

454. See supra note 51 and accompanying text.

455. See supra notes 106–07 and accompanying text.
A. Increased Transparency Regarding Conflicts of Interest

Protecting investors from a hedge fund manager’s conflicts of interest does not mean only minimizing the actual conflicts. Investor protection also requires informing investors of the conflicts’ presence, prevalence, and pervasiveness. Currently, however, hedge funds are, to a large degree, characterized by the shroud of secrecy under which they act.456 In general, hedge fund managers disclose little regarding their conflicts of interest, and what information they do provide is often opaque and has little value to investors.457

The Goldstein court’s ruling notwithstanding,458 the Hedge Fund Rule had the potential to confer significant benefits on hedge fund investors, specifically the retail investors whose growing involvement in the hedge fund industry played a key role in the rule’s promulgation.459 By federally mandating that hedge fund managers disclose their conflicts of interest,460 thereby providing investors with increased transparency, the Hedge Fund Rule could have facilitated investors of all backgrounds in making more informed investment decisions. Since the abrogation of the Hedge Fund Rule, however, little has been done to meaningfully address the resulting lack of disclosure and overall opacity of hedge funds’ informational documents. Therefore, this Note argues, in order to protect ordinary investors who are indirectly invested in hedge funds, it is essential that the federal government make mandatory the meaningful disclosure of a hedge fund manager’s conflicts of interest.

Continued reliance on a voluntary disclosure regime—which is what the abundance of “best practice” guidelines essentially amount to—is unlikely to suffice.462 Thus far, market pressures alone have failed to generate the necessary level of transparency,463 a market failure that can be attributed to hedge fund managers’ desire to keep their funds’ proprietary information secret,464 despite investors’ growing calls for increased access

456. See supra note 441 and accompanying text.
457. See supra notes 414–18 and accompanying text.
458. See supra notes 277–96 and accompanying text.
459. See supra notes 251–54 and accompanying text.
460. See supra notes 256–60 and accompanying text.
461. See supra notes 419–36 and accompanying text.
462. According to the CFA Institute Centre,

        [T]he right approach is to create a comprehensive set of ethical and professional industry standards that hedge fund managers will adopt in entirety, and to which they can then claim compliance. We are concerned that without a comprehensive code, created with strong investor protection provisions that require full adoption, these kinds of flexible best practice guidelines create only the veneer of self-regulation.


464. See supra notes 254, 441–42 and accompanying text.
to information. Consequently, governmental action is necessary to stimulate greater transparency regarding a hedge fund manager's conflicts of interest.

The first part of this section argues that by imposing federal fiduciary obligations on hedge fund managers, Congress can improve hedge fund transparency, protect investors against conflicts of interest, and provide the SEC with needed understanding of this currently opaque industry. The second part then presents more specific regulatory measures that Congress can enact to facilitate improved disclosure regarding a hedge fund manager's conflicts of interest.

1. Imposing Federal Fiduciary Duties on Hedge Fund Managers

The federal government could protect hedge fund investors from conflicts of interest by enacting legislation imposing upon hedge fund managers a federal fiduciary obligation akin to the duty that Justice Goldberg identified in SEC v. Capital Gains Research Bureau, Inc. Unlike the SEC, whose interpretation of the word "client" the D.C. Circuit found to be in conflict with the congressional purposes underlying the Advisors Act, Congress, by taking direct action, can clearly articulate its intent to protect investors and how that objective should apply to hedge fund managers. A federal fiduciary duty would not only require hedge fund managers to manage assets in their clients' best interests, it would also compel the disclosure of a hedge fund manager's material conflicts of interest. Without substantively regulating trading strategies or changing compensation structures, establishing a fiduciary relationship between hedge fund managers and investors would enable regulators and investors alike to gain a level of understanding regarding the hedge fund industry that, at current, is conspicuously lacking.

It is important that fiduciary duties be made mandatory at the federal level, as compared to the state level. Individual state legislatures imposing fiduciary obligations on hedge fund managers in the absence of federal action—which Washington State has done—is unlikely to confer significant benefits. Unless all states adopted similarly strict regulations, hedge funds would likely locate in those jurisdictions with more relaxed standards. The competition between states for corporations, however, demonstrates the unlikelihood of such coordinated action. A more likely scenario involves the persistence of the current fragmented regime in which

465. See supra notes 256–60 and accompanying text.
466. See supra notes 283–95 and accompanying text.
467. See supra note 260 and accompanying text.
468. See supra notes 264–66.
469. See supra note 254.
470. See supra notes 391–99 and accompanying text.
hedge funds continue to organize in those jurisdictions making the fewest regulatory demands. Federal legislation, then, is necessary to avoid the inevitable jurisdiction shopping that a state-by-state approach would produce.472

Empirical research demonstrating that a hedge fund manager's potential conflicts of interest are positively associated with past legal and regulatory problems473 supports the notion that imposing fiduciary obligations can help to fill the current regulatory vacuum. The disclosure of such conflicts could facilitate investment decisions that direct funds into more suitable investment vehicles, and the mandate that investment advisers manage their clients' portfolios in their clients' best interests475 would reduce a hedge fund manager's liberty to engage in self-interested behavior. So, too, current practices of hedge fund managers evince the capacity of mandatory fiduciary obligations to provide added protection to hedge fund investors. It is because they confer a recognized benefit upon investors that hedge fund managers have worked in the past to eliminate fiduciary duties through the funds' limited partnership agreements.476

In the past, opponents of federal regulation have argued that rigorous federal oversight would effectuate a migration of domestic hedge funds to offshore jurisdictions with few regulatory burdens.477 This contingency seems improbable. Rather, the industry's highly publicized recent troubles

472. This argument is predicated on a race-to-the-bottom theory, which, applied to the hedge fund context, holds that hedge fund managers are motivated to organize their funds in states offering business organization rules that benefit managers at the expense of investors. See Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1435, 1438 (1992); see also William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 YALE L.J. 663, 666 (1974) (noting that the race to the bottom involves "water[ing] the rights of shareholders vis-à-vis management down to a thin gruel"). Proponents of this view believe that federal regulation of corporate governance is necessary to guarantee that shareholders receive the essential safeguards that state law rarely affords. See Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 NW. U. L. REV. 913, 914 (1982). The topic of state competition, however, is hotly debated. Supporters of state competition for corporations and other business entities view it as a race to the top, in which state competition results in the maximization of shareholder value. See ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 16 (1993) (finding empirical evidence to demonstrate that "managerial discretion to choose among alternative corporation codes by changing a firm's state of incorporation . . . benefits rather than harms shareholders"); Roberta Romano, Competition for Corporate Charters and the Lesson of Takeover Statutes, 61 FORDHAM L. REV. 843, 847 (1993) ("While state competition is an imperfect public policy instrument, on balance it benefits investors."); Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching, 150 U. PA. L. REV. 1795, 1797–98 (2002).

473. See supra note 162.

474. In regard to the suitability of hedge funds, risk, in and of itself, is not necessarily bad. But risk is problematic when investors are left unaware of it, due to a lack of transparency, or unknowingly bear risk for which they are not compensated.

475. See supra note 259 and accompanying text.

476. See supra notes 164–66 and accompanying text.

477. See supra note 269 and accompanying text.
are likely to mitigate a widespread relocation of hedge funds to offshore jurisdictions. In light of the recent Madoff scandal\(^{478}\) and the industry’s large losses,\(^{479}\) investors may prefer to invest in funds that are more highly regulated, even if doing so leads hedge fund managers to charge a higher management fee to offset the increased compliance costs.\(^{480}\) A substantial body of evidence demonstrates that investors value the benefits of greater regulation and are willing to pay a premium for the increased protection it provides.\(^{481}\) Indeed, investors may see the premium as costing less than investing in a more opaque fund whose associated risk remains unknown.

2. Disclosure-Specific Regulations

The mandatory imposition of fiduciary duties on hedge fund managers would allow Congress to take advantage of the inherent flexibility of the fiduciary relationship.\(^{482}\) This fluidity could allow Congress to work around the abundant uncertainty that characterizes the asset management business and provide investors with essential protections without having to promulgate many specific laws that, after time, may prove limited in scope and application.\(^{483}\) Thus, in making hedge fund managers fiduciaries to their investors, Congress could establish the framework of the hedge fund manager–investor relationship without having to promulgate individual rules to govern unforeseen exigencies.\(^{484}\)

Fiduciary duties’ indeterminate nature,\(^{485}\) however, could also prove to be a disadvantage. While the ambiguity regarding the behaviors that fiduciary obligations proscribe may deter some hedge fund managers from engaging in self-interested behaviors, it also may encourage others to act opportunistically.\(^{486}\) Likewise, the indeterminacy of fiduciary duties can prove problematic for investors. By making it more difficult to assess the likely outcome of litigation, the ambiguity of fiduciary duties could dissuade investors from initiating meritorious suits seeking to enforce a hedge fund manager’s fiduciary duties.\(^{487}\) Moreover, because the specific

---

478. See supra notes 20–32.
479. See supra note 74.
480. See supra note 268 and accompanying text.
481. See supra note 269.
482. See supra 167–76 and accompanying text.
484. Because “[a] precise, detailed, explication of their duties will make it difficult for the fiduciaries to respond to the dynamics of the commercial environment,” it is beneficial to define the permissible limits of hedge fund manager behavior in an “open-ended” fashion. Id.
485. See supra notes 167–69 and accompanying text.
487. See id.
contours of fiduciary duties are gleaned over time through litigation, this approach to protecting hedge fund investors will, by necessity, develop gradually, and may prove ill-suited to provide critical investor protection in the near term.

In an effort, then, to provide more immediate safeguards for hedge fund investors, Congress should enact legislation mandating that hedge fund managers disclose specified conflicts of interest. In addition to regulating the timing and frequency of conflicts disclosure, such legislation should establish the types of conflicts that must be disclosed in hedge funds’ offering documents and periodically thereafter. The MFA suggests that hedge fund managers disclose to their investors “material” conflicts of interest, but fails to define adequately what this constitutes. By leaving that determination up to individual hedge fund managers, the MFA vests too much discretion in an industry not known for being forthright with investors. Rather, Congress should either enumerate specific conflicts of interest that must be disclosed to investors, or provide a discrete definition of which conflicts qualify as material, and therefore, must be disclosed. So, too, Congress should go beyond the AMC’s suggestion that hedge fund managers disclose conflicts of interest “with sufficient frequency.”

Rather than permitting hedge fund managers to make this determination, Congress should articulate both the frequency with which hedge fund managers should make such disclosures, and the changes in conditions that necessitate further disclosure.

The disclosure itself should include elements of the hedge fund’s valuation framework and be sufficiently detailed to permit independent verification of the value of the hedge fund’s assets. In order to minimize an obvious area of conflict between the hedge fund manager and investors, Congress should also require hedge fund managers to disclose the securities they own personally.

Additionally, like the Financial Services Authority (FSA) in Great Britain, Congress should require hedge fund managers to disclose the presence of certain side letters, specifically those, as the AMC suggests, that have an adverse impact on other investors in the fund. The hedge fund industry’s recent liquidity issues demonstrate well why such disclosures are necessary if investors are to make informed investment decisions. As

---

488. See id. ("Fiduciary duties are not self-executing. Their enforcement mechanism is litigation, a reactive process that is expensive, slow, and uncertain in result.").
489. See supra note 419 and accompanying text.
490. See supra notes 419–22 and accompanying text.
491. See supra notes 441–44 and accompanying text.
492. See supra notes 426–27 and accompanying text.
493. See supra note 436 and accompanying text.
494. See supra note 422.
495. See supra note 435 and accompanying text.
496. See Lawrence C. Strauss, Hedge Funds Meet Their Match, BARRON’S, Jan. 5, 2009, at 18, 19 (”With their liquidity squeezed, some funds have put restrictions on redemptions, in a practice known as ‘gating.’”).
one astute observer succinctly explained, "'Nobody could seriously object to the idea of another guest at the same hotel getting a cheaper room deal. They would however, have legitimate cause for concern if others had negotiated priority access to the exits in case of an emergency.'" 497

Making these specific disclosures mandatory would allow Congress to regulate the hedge fund industry in an incremental fashion, which could prove beneficial, given the industry's complexity and the lack of uniformity among funds. 498 It would also provide Congress regulatory flexibility. The incremental enactment of targeted disclosure policies would provide regulators with critical guidance as to those disclosures that prove most helpful to investors. By utilizing the information gleaned to both alter previously enacted disclosure rules and tailor subsequent investor protections, Congress could use specific disclosure regulations to responsively protect hedge fund investors.

B. Valuation Improvements

Improving how hedge fund managers value the fund's portfolio will help alleviate significant conflicts of interest from which investors currently receive little protection. 499 The SEC does not directly regulate hedge fund valuation practices, 500 and though such practices are theoretically constrained by federal and state fiduciary duties, 501 as this Note has demonstrated, neither set of fiduciary obligations generally apply to hedge fund managers. 502 Moreover, the Advisers Act's anti-fraud rule, which may protect investors from some of the more egregious valuation abuses, does little to safeguard investors from many of the more subtle biases present in the valuation process. 503 And though the conflicts related to asset valuation are not so egregious as to completely dissuade hedge fund investment, it has become clear that, moving forward, valuation requires modification so as to better protect investors from the myriad related conflicts of interest. 504

First, it is imperative that the valuation process be made more independent of the hedge fund manager. In most hedge funds, the hedge fund manager is the party responsible for valuing the fund's assets, 505 a situation that creates "a clear conflict of interest." 506 The conflict is then compounded by a uniform process to value hedge funds' often illiquid assets, which makes it is nearly impossible for hedge fund investors to

498. See supra notes 78–110 and accompanying text.
499. See supra notes 135–41 and accompanying text.
500. See supra note 135.
501. See Lahiri & Rutkowski, supra note 327, at 92.
502. See supra notes 166, 183–90, and 273–96 and accompanying text.
503. See supra notes 297–304 and accompanying text.
504. See supra notes 132–41, 311–12 and accompanying text.
505. See supra note 136 and accompanying text.
506. Valuation Anxieties, supra note 354.
gauge whether or not the valuation process is performed adequately. 507

Not surprisingly, "[i]nvestors are increasingly wary of funds where the valuation process is entirely in the hands of the investment manager." 508

Partially extricating the hedge fund manager from the valuation process will help to alleviate the concerns of investors and regulators alike who feel that hedge fund managers' current role facilitates a dangerous bias. 509

While failure to do so is unlikely to cause investors to pull their money out of hedge funds en masse, making the valuation process more independent appears essential to instilling needed confidence in an industry that is currently reeling as a result of scandal and huge recent losses 510—some of which are due to improper valuation of assets. 511

To engender the necessary increase in independence, the government should pass legislation mandating the delegation of the valuation of the fund's assets and calculation of its NAV to an independent valuation service provider. 512

Doing so would immediately help to reduce the bias that currently taints the valuation process, and, in turn, the hedge fund manager's compensation. 513

To avoid potential cronyism, however, hedge funds should utilize independent valuation service providers who apply for and receive SEC certification. Such approval should follow rigorous SEC investigation of the valuation service providers' valuation methodologies and procedures, as well as the valuation service providers' own conflicts of interest. In addition to ensuring the unbiased calculation of a hedge fund's NAV, subjecting independent valuation service providers to a regulatory approval process would have the ancillary benefit of introducing a degree of uniformity to the valuation of illiquid and other hard-to-value assets that is currently wanting. 514

Undoubtedly, mandating the use of independent valuation service providers will be costly, a cost that will fall disproportionately on "smaller hedge fund[s which] often lack the resources to establish and install adequate pricing systems." 515

To address this valid concern, Congress should craft an opt-out provision permitting smaller funds meeting statutory

507. See supra notes 135–39 and accompanying text.
508. Valuation Anxieties, supra note 354.
509. See supra note 327 and accompanying text.
510. See supra note 74.
512. See supra note 330 and accompanying text. According to Jeff Gooch, executive vice president of valuations and processing and co-head of trade processing at Markit, an independent valuation service provider, Markit has "a team of independent, unbiased people who do not take direction from traders and have access to the right data sources." Valuation Anxieties, supra note 354.
513. See supra notes 115–20 and accompanying text.
514. See CFA CONSULTATION PAPER, supra note 336 ("The increase in the number of independent third party valuers who use standardised approaches should alleviate the difficulty for outsiders to value illiquid assets.").
515. STAFF REPORT, supra note 37, at 80.
size constraints to forego independent valuation of their assets and calculation of NAV. Instead, Congress should permit these smaller funds to conduct in-house valuation functions using the same policies and procedures that certified independent valuation service providers employ and require that in-house valuations undergo periodic SEC inspection and validation.\footnote{516}{Those funds that qualify for the statutory opt-out provision and perform in-house valuations should have to reimburse the SEC for what essentially amounts to a government-conducted audit. And, because funds conducting in-house valuations would still have to utilize SEC-approved valuation methodology, uniformity in the valuation process would not be compromised.}

Compared to valuation committees,\footnote{517}{See supra notes 336–44 and accompanying text.} which essentially amount to a purely in-house solution, the combination of independent valuation service providers and SEC oversight of in-house valuations seems more capable of introducing a level of independence to the valuation process that even those within hedge funds recognize as necessary.\footnote{518}{See supra note 311.} First, a valuation committee comprised of members of the hedge fund manager’s senior management, as the AMC suggests,\footnote{519}{See supra note 340 and accompanying text.} could easily be dominated by those running the fund, thereby compromising its intended function of introducing an element of independence into the valuation process. So, too, a valuation committee that includes independent entities unconnected with the specific hedge fund, as both IOSCO and the IC suggest,\footnote{520}{See supra note 338, 343–44 and accompanying text.} is susceptible to similar domination, especially if employees of the hedge fund comprise a majority of the committee’s members.

Second, it is unlikely that smaller hedge funds will have the personnel or resources necessary to form a sufficiently independent valuation committee that does not include employees who are also responsible for the fund’s trading strategies, as the AMC suggests.\footnote{521}{See supra note 340 and accompanying text.} As a result, small funds will likely prove unable to constitute a valuation committee with the segregation of functions necessary to mitigate the bias currently tainting the valuation process. Thus, requiring that hedge funds utilize independent valuation service providers or, in the case of smaller funds, mandating SEC validation of their valuation procedures and methodologies, are routes by which independence, and associated valuation accuracy and uniformity, prove more readily achievable.\footnote{522}{Hedge funds may well pass along to their investors those costs associated with making the valuation process more independent. These costs, however, pale in comparison to those associated with funds that fail, partially or wholly, as a result of inaccurate asset valuation.}

Making independence a fixture of the valuation process, however, is not alone sufficient to achieve the accuracy and uniformity that asset valuation requires. It is also necessary that hedge funds increase the level of transparency associated with the valuation process. Currently, most hedge
funds only provide valuation information through their offering documents, which tend to be deliberately vague with regards to valuation of the fund's assets and calculation of the NAV.\textsuperscript{523} Moreover, hedge fund agreements, which give hedge fund managers wide discretion in making decisions regarding the fund, often allow the manager to employ alternative methods of valuation rather than those disclosed in the offering documents.\textsuperscript{524} Consequently, hedge fund investors remain predominantly uninformed as to how and when assets in the fund's portfolio are valued.

However, in light of the recent credit crunch, hedge fund scandals, and numerous hedge fund collapses, "investors will be more rigorous and systematic in their hedge fund selection and due diligence process" as it no longer "possible to rely primarily on manager reputation and historical track record."\textsuperscript{525} Investors now desire that hedge fund offering documents provide greater specificity regarding the fund's valuation models, procedures, and policies.\textsuperscript{526} Yet, up to this point, market pressures alone have proved incapable of effectuating investors' desired level of transparency. In response to this market failure, Congress should require hedge funds to disclose to investors in their initial offering documents the name of the independent valuation service provider the fund utilizes, as well as the valuation methodology the independent entity employs. Additionally, the valuation service provider should provide investors with sufficient information regarding the valuation models so that they can independently verify the NAV calculations and the portfolio's values. Accordingly, direct disclosure from independent valuation service providers to investors is necessary to ensure that a hedge fund manager is not using discretion granted to them in the hedge fund offering documents to override the independently performed valuation calculations.

In addition to the federal government effectuating improvements quickly in valuation transparency through legislation, markets can prove beneficial in protecting investors. Institutional investors, specifically, are becoming increasingly active in pressuring hedge funds to increase their transparency, especially as it relates to valuation issues.\textsuperscript{527} Oftentimes fiduciaries themselves, institutional investors have the incentive to agitate for increased transparency and independence in the valuation process, and, as an ever-growing percentage of overall hedge fund investment, collectively, they

\textsuperscript{523} See supra note 137.
\textsuperscript{524} See supra note 138.
\textsuperscript{525} CASTLE HALL ALTERNATIVES, HEDGE FUND INVESTING IN A NEW WORLD: FIVE QUESTIONS FOR INVESTORS AND MANAGERS 2 (2008).
\textsuperscript{526} See KPMG, Hedge Funds Under Pressure on Illiquid Assets, http://www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Hedgefundasssetvaluation.aspx (last visited Mar. 26, 2009) ("Large institutional investors, particularly pension funds, have . . . started to make noises about a lack of guidance on valuing 'hard-to-value assets,' . . . and are seeking ever greater assurance on the principles around valuations.").
\textsuperscript{527} See supra note 327 and accompanying text.
have the capability to effect such a change.\textsuperscript{528} In bringing about imperative valuation reforms, institutional investors can improve the protections for not only direct hedge fund investors, but more importantly, to the indirect investors who can less afford the current level of risk associated with hedge fund investment. Yet, congressional action remains essential to ensure that increased protection extends to all indirect hedge fund investors. Relying on institutional investors alone, which has thus far not proven successful, will likely be insufficient to produce the uniform level of transparency necessary.

CONCLUSION

No longer are hedge funds solely the domain of the sophisticated investor. As pension plans, endowments, charitable organizations, and other institutional investors continue to invest in hedge funds, "ordinary" investors are becoming increasingly exposed to these lightly regulated investment vehicles. Consequently, ordinary investors are subjected to the myriad conflicts of interests associated with hedge fund management. In addition to explicating many of these conflicts, this Note has demonstrated the risks that they pose to hedge fund investors, specifically indirect investors who oftentimes remain unaware of their hedge fund investment.

Hedge fund investors, specifically institutional investors, have been intensifying their demands for better safeguards. So too, many within the hedge fund industry have come to recognize that improved investor protection from conflicts of interest is imperative. The increased attention on the issue has led numerous industry-wide bodies to recently release hedge fund "best practices" documents that make a multitude of suggestions that, if effectuated, could enhance greatly the level of protection afforded to investors. Best practices, however, are essentially voluntary suggestions that, thus far, hedge fund managers have demonstrated little likelihood of adopting and implementing.

Thus, it is necessary that Congress take action to ensure that hedge fund investors—a group comprised of an increasingly large segment of the population—receive adequate protection from the funds' many conflicts of interest. By introducing increased transparency to hedge fund investment and standardizing the valuation process, Congress can protect investors without eliminating the characteristic flexibility that permits hedge funds to confer significant benefits on the markets.

\textsuperscript{528} See Lahiri & Rutkowski, \textit{supra} note 327, at 97.