LAS VEGAS STYLE INVESTING: IN THE ABSENCE OF REGULATION, RISKY HEDGE FUND BETS CAN WIN BIG AND LOSE EVEN MORE

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I. INTRODUCTION

The hedge fund industry has grown considerably in recent years, largely due to enormous profits derived from risky investment activities. As highly complex investment vehicles with unique strategies, hedge funds have become the center of much debate between investors, who hope to receive high returns, and regulators, who hope to bring the industry under their authority. While hedge funds offer many benefits, the wide variety of financial products and strategies are oftentimes inherently risky. Many hedge fund managers make high stakes bets on uncertain investments, which may yield serious consequences for world markets if a wager goes sour. Although the financial sector has survived two major hedge fund collapses—Long-Term Capital Management ("LTCM") and Amaranth Advisors ("Amaranth")—the potential for disaster remains. Without regulatory oversight, the hedge fund industry is free to roll the dice in large market segments and make Las Vegas style bets using billions of investor dollars.

This Article explores the nature of the hedge fund industry and the consequences of the high risk/high return strategy utilized by many funds. In addition, this Article illustrates the large amount of risk involved in hedge fund investments and the need for regulatory scrutiny. Section II begins with an overview of the hedge fund industry, describing the key players and the growth of investments. Section III details the types of strategies used by many hedge funds and the high returns offered under dangerous conditions. Section IV highlights the results of high-risk investing and the various market consequences. Section V provides an overview of the current regulatory framework governing the hedge fund industry and explains a recent United States Securities and Exchange Commission ("SEC") attempt to bring hedge funds within its regulatory authority. Section VI illustrates the potential for disaster and describes the downfall of LTCM and Amaranth. Finally, Section VII provides possible solutions to current regulatory loopholes and proposes that congressional legislation may change the future of the hedge fund industry.

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II. AN OVERVIEW OF THE PLAYING FIELD

A. The Hedge Fund Game

The term "hedge fund" was coined in 1949 when it was used to describe a private partnership managed by Alfred Winslow Jones.[1] Fearing poor returns during market slumps, Jones created a "hedging" strategy that would neutralize the effect of market factors on his portfolio's performance.[2] He invested in both long and short positions in common stocks, while using a modest amount of leverage[3] to hedge his bets, so that changes in equity markets would affect only half of his investment portfolio.[4] In this way, Jones sought to balance market risk and produce a net return that depended on his ability to select "the *relative* best and worst" investments.[5]

Today, hedge funds trade in a wide variety of financial instruments and employ a number of strategies[6] that may not reflect the traditional hedging and arbitrage strategies Jones developed.[7] The term "hedge fund" has become illusive because "many 'hedge funds' are not actually hedged."[8] Thus, there is no universal definition to describe the various types of hedge funds;[9] they include "any pooled

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[1] ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 25 (2000) [hereinafter LOWENSTEIN].

[2] *Id.*

[3] STUART A. MCCRARY, HOW TO CREATE & MANAGE A HEDGE FUND: A PROFESSIONAL'S GUIDE 1 (2002) [hereinafter MCCRARY].

[4] LOWENSTEIN, *supra* note 1, at 25 ("The term 'hedge fund' is a colloquialism derived from the expression 'to hedge one's bets,' meaning to limit the possibility of loss on a speculation by betting on the other side.").

[5] *Id.*

[6] STAFF OF THE SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 3 (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgfunds0903.pdf [hereinafter SEC STAFF REPORT].

[7] *See Testimony Concerning Investor Protection Implications of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs* (2003) (statement of William H. Donaldson, Former Chairman, Securities and Exchange Commission), http://www.sec.gov/news/testimony/041003tswhd.htm [hereinafter *Investor Protection Testimony*].

[8] *Id.*; *see* Section III, *infra*.

[9] *Id.*

investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[10] Essentially, the term is a catchall classification for a number of privately-managed pools of capital that are not registered under the Investment Company Act.[11]

B. The Dealers

Hedge funds usually are created "by former traders, analysts or portfolio managers"[12] and are organized as limited partnerships or limited liability companies.[13] The limited partnership form is the most common, wherein a general partner has exclusive responsibility and authority for the management of the fund; the limited partners divest control in exchange for limited liability.[14] The general partner, who is either a natural person or a separate legal entity, is typically considered the fund manager or "investment adviser," and is responsible for portfolio management and fund operations.[15] Based largely on the agreement of the limited partnership, the duties of hedge fund managers vary and may include marketing the fund, soliciting investors, and developing investment strategies.[16] Managers typically receive lucrative fees for their services, including a standard management fee of one to two percent per year of the assets under management.[17] In addition, hedge fund managers have a stake in the game, and generally receive an

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10 THE PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999) [hereinafter PRESIDENT'S WORKING GROUP].

11 *Investor Protection Testimony*, *supra* note 7; SEC STAFF REPORT, *supra* note 6, at viii.

12 SEC STAFF REPORT, *supra* note 6, at 52.

13 *See* DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS 88 (2005) [hereinafter DOUGLAS L. HAMMER ET AL.].

14 *Id.* at 88-91.

15 *Id.* at 91-92. Because general partners face several tax and liability issues, they are commonly organized as limited liability companies or corporations. *Id.* at 92. For the purposes of this Article, "hedge fund manager" will refer to the general partner of a hedge fund who is vested with the responsibility for the operation and control of the fund, as well as the fund's investment strategy.

16 SEC STAFF REPORT, *supra* note 6, at 52-53; *see* DOUGLAS L. HAMMER ET AL., *supra* note 13, at 90.

17 MCCRARY, *supra* note 3, at 13.

incentive fee if the fund performs well.[18] Incentive fees are typically twenty percent of the fund's net return.[19]

C. The Players & the Buy-in

Hedge fund investors are the limited partners of the limited partnership and are not liable for the fund's debts beyond the amount of their investment (and any undistributed profits).[20] Investors purchase an "interest" in the hedge fund and essentially contribute their money to a "pool of assets," which is then invested under the direction of the fund manager.[21] In this sense, investors have little involvement with their investment once they have purchased an interest in the fund. Rather, investors place large amounts of money in the hands of an "investment adviser," who they hope will invest wisely. Through this type of investment, hedge fund investors generally hope to achieve portfolio diversification, reduce overall portfolio risk, and garner a larger return than with traditional assets.[22] Investors, therefore, make high stakes bets with hedge funds, in which they hope to win big but often stand to lose even more.

The nature of investors and the manner in which they are solicited is largely determined by efforts to avoid regulation under the federal securities laws.[23] In general, however, hedge funds traditionally attract wealthy individuals and families who have the financial backing and stability to support alternative investment strategies.[24] Increasingly, however, funds are attracting institutional investors who are able to meet "private offering standards."[25] Hedge funds now attract

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[18] *Id.* at 14.

[19] *Id.*

[20] DOUGLAS L. HAMMER ET AL., *supra* note 13, at 88.

[21] *Id.* at 1-3.

[22] MCCRARY, *supra* note 3, at 3.

[23] *See* Section IV, *infra*.

[24] *See* LARS JAEGER, MANAGING RISK IN ALTERNATIVE INVESTMENT STRATEGIES: SUCCESSFUL INVESTING IN HEDGE FUNDS AND MANAGED FUTURES 3-4 (2002) [hereinafter JAEGER].

[25] DOUGLAS L. HAMMER ET AL., *supra* note 13, at 1.

endowments, private foundations, pension plans, and funds of hedge funds.[26] As of January 2005, individuals and families still accounted for the largest share of hedge fund capital, owning 44 percent of the total amount invested.[27] In the aggregate, institutional investors own approximately 56 percent of the total amount invested in hedge funds: funds of hedge funds own up to 28 percent; corporations own up to 14 percent; pension funds own up to seven percent; and foundations and endowments own up to seven percent.[28]

D. The Pot is Increasing

Due to increasing attention from several large market segments, the hedge fund industry has experienced tremendous growth in both size and scope.[29] The number of funds has increased significantly from 530 in 1990[30] to approximately 8,800 as of July 2006.[31] The SEC estimates that 2,000 new hedge funds were created in 2005 alone.[32] Total assets under management topped 1.2 trillion dollars in 2006, a three thousand percent increase from thirty billion dollars in 1990.[33] Most notably, endowments have continued to increase their exposure to hedge funds.[34] In 2005, the average endowment allocated 8.7 percent of its portfolio assets to hedge funds, a

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26 *Id.* at 95. A fund of hedge funds "is a hedge fund that utilizes a multi-manager, multi-strategy approach by investing all, or a significant portion, of its assets in hedge funds." SEC STAFF REPORT, *supra* note 6, at 67.

27 Deborah Solomon, *Congress May Let Hedge Funds Manage More Pension Money*, WALL ST. J., July 28, 2006, at A1 (citing Hennessee Group LLC).

28 *Id.*

29 It is important to note that many hedge funds do not disclose information, so the statistics presented in this paper reflect the views and opinions of analysts and are, at best, an estimate of hedge fund volume.

30 CTR. FOR INT'L SEC. & DERIVATIVES MKTS. RESEARCH DEP'T, THE BENEFITS OF HEDGE FUNDS: 2006 UPDATE 5 (May 2006) [hereinafter CISDM].

31 *Testimony Concerning the Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs* (2006) (statement of Christopher Cox, Chairman, Securities and Exchange Commission), http://www.sec.gov/news/testimony/2006/ts072506cc.htm [hereinafter *Regulation Testimony*].

32 *Id.*

33 *Id.,* CISDM, *supra* note 30, at 4.

34 CISDM, *supra* note 30, at 4-5.

1.4 percent increase from 2004.[35] Overall, hedge funds currently account for approximately thirty percent of all U.S. equity trading volume, which poses considerable implications for financial markets.[36]

III. RISKY GAMES: THE UNIQUE STRATEGIES OF HEDGE FUNDS

As mentioned previously, hedge funds employ a number of investment strategies. While some hedge funds still utilize the traditional "hedging" strategy developed by Alfred Winslow Jones, the industry now encompasses a wide variety of investment styles.[37] Hedge fund managers usually devise strategies based on their investment expertise; thus, the activities of hedge funds are extremely diverse.[38] For instance, "some hedge funds invest only in securities and only for the long term."[39] Other funds never actually invest in the traditional sense, and rather, continuously "trade to profit from market and security depreciation."[40] Some hedge funds stick to fundamental strategies, "others rely on technical analysis," and at least one hedge fund claims to base its trading decisions on astrological charts.[41]

Thus, hedge funds are unique investment vehicles utilizing various investment products,[42] strategies,[43] performance levels, and degrees of risk.[44] Many hedge funds employ a combination of investment products and strategies that

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[35] *Id.*

[36] *Regulation Testimony*, *supra* note 31; *see* Section IV, *infra*.

[37] *See* SEC STAFF REPORT, *supra* note 6, at 34.

[38] *See id.* at 34, 52.

[39] DOUGLAS L. HAMMER ET AL., *supra* note 13, at 1.

[40] *Id.*

[41] *Id.*

[42] Hedge Funds trade in a number of investment products, including "fixed income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options and other non-securities investments." SEC STAFF REPORT, *supra* note 6, at 3.

[43] Common hedge fund strategies include market trend, event-driven, and arbitrage. *Id.* at 34-36.

[44] *See id.* at 34.

change frequently based on market conditions.[45] This flexibility allows funds to pursue an absolute return approach that is "profitable in both rising and declining markets."[46] As a result, hedge funds generally outperform standard benchmarks, but involve greater risk in doing so.[47]

A. Big Wins from High Returns

The high returns associated with hedge funds are derived from the fund manager's skill and the underlying investment strategy.[48] Hedge funds are actively traded; hence, a manager's ability to identify changes in market factors and current trends is extremely important to a fund's performance.[49] These unique strategies and skills have enabled hedge funds to achieve greater returns when compared to traditional assets, drawing increased interest from the financial community.[50]

In a performance comparison study conducted by the Center for International Securities and Derivatives Markets ("CISDM"),[51] analysts found that, over the past 16 years, hedge funds have provided significant standalone performance and portfolio diversification as compared to traditional investment vehicles.[52] From 1990 to 2005, the CISDM Equal Weighted Hedge Fund Index[53]

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45 *See id.* at 33.

46 *Id.* at 36. In contrast, most registered investment companies pursue a relative return strategy that "seek[s] positive returns compared to the performance of a particular asset class or index." *Id.* These strategies focus on outperforming a "benchmark," regardless of profitability. *Id.*

47 PRESIDENT'S WORKING GROUP, *supra* note 10, at 3.

48 CISDM, *supra* note 30, at 7.

49 *Id.*

50 *See* PRESIDENT'S WORKING GROUP, *supra* note 10, at 3.

51 CISDM "is a non-profit academic research center which focuses on security and investment fund performance in both U.S. and international asset markets" located at the Isenberg School of Management of the University of Massachusetts Amherst. CISDM, About Us, http://cisdm.som.umass.edu/aboutus/aboutus.shtml. CISDM funds research in traditional and alternative financial markets and provides educational material to financial firms, non-financial firms, and the general public. *Id.* CISDM has produced a series of papers, updated annually, that analyze the risk and return benefits of hedge funds and other alternative investment products when considered as a part of an investor's overall portfolio. CISDM, "Benefits of" Series, http://cisdm.som.umass.edu/research/benefits.shtml.

52 CISDM, *supra* note 30, at 14.

yielded a 15.13 percent annualized return, compared to the 10.55 percent return of the Standard & Poor's 500 ("S&P 500")[54] and the 4.15 percent return on a three-month Treasury bill.[55] CISDM's study also illustrates the growth of a one hundred dollar investment made in 1990 in various asset types, including the CISDM Equal Weighted Hedge Fund Index, the S&P 500, the Lehman U.S. Aggregate, and the MSCI World.[56] The Equal Weighted Hedge Fund Index had superior performance over the 16-year period; the initial one hundred dollar investment would have been worth nine hundred dollars by July 2005, as compared to five hundred dollars if invested in the S&P 500, the asset class with the second-highest returns.[57] While the returns of individual hedge funds vary, CISDM found that the hedge fund industry as a whole consistently outperforms traditional equity and bond investments.[58]

B. But, a Big Gamble

The hefty returns and diversification benefits of hedge funds do not come without a price. In order to achieve absolute returns, hedge fund managers employ a number of inherently risky techniques and strategies. Thus, while hedge funds theoretically offer less portfolio risk for investors, many fund managers often make risky bets on financial products and take chances in volatile industries that they believe are headed for success. In financial terminology, risk is "related to the volatility of the future value of a position due to market changes."[59] Hedge fund

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[53] The CISDM Equal Weighted Hedge Fund Index reflects "the overall composition of the hedge fund universe." *Id.* at 3. It depicts "the average performance of hedge fund managers reporting to the CISDM Hedge Fund/CTA Database. Its objective is to provide an estimate of the rate of return to an equally weighted portfolio of hedge fund managers who trade a wide variety of hedge fund strategies which are based on a wide variety of trading models." CISDM, Equal Weighted Hedge Fund Index, http://cisdm.som.umass.edu/indices/hedge/hedgefundweighted.asp.

[54] CISDM, *supra* note 30, at 15. The S&P 500 Index reflects the equity performance of five hundred leading U.S. companies in several industries, and is regarded as the best gauge of the U.S. equities market. *See* S&P Indices, http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/Page/IndicesIndexGroupPg&r=1&l=EN&b=4&s=6&ig=51&f=1.

[55] CISDM, *supra* note 30, at 15.

[56] *Id.* at 9-10.

[57] *Id.* at 10.

[58] *Id.* at 9.

[59] DIMISTRIS N. CHORAFAS, ALTERNATIVE INVESTMENTS AND THE MISMANAGEMENT OF RISK 5 (2003).

managers attempt to predict future market changes, but as one analyst remarked: "Foretelling these changes is an art, not a science, and forecasters often fail in their assumptions."[60] Although many fund managers are experts in their field, they are not clairvoyant.[61] Thus, while uncertain odds and strategies may pay off, managers often take dangerous chances at the peril of the fund, as in the case of LTCM and Amaranth.

One risky component of many hedge fund strategies is the use of leverage to increase the fund's value and return.[62] Leverage was traditionally obtained through the use of borrowed money, but many hedge funds now purchase securities using "futures, options and other derivative contracts."[63] Unlike investment companies, hedge funds are not restricted in their ability to use leverage, and thus employ this tool much more aggressively than other investment vehicles.[64] While leverage can significantly enhance investment returns, it can also magnify investment losses.[65] Highly-leveraged entities face enormous potential losses that can destroy the fund's net worth.[66] The chance that a highly-leveraged entity will fail increases in a volatile market.[67]

Most hedge funds actively trade securities to take advantage of short-term price changes and to maintain a desired risk-return profile when market prices fluctuate.[68] Thus, unlike traditional investments, hedge funds change positions frequently to seek higher returns or other arbitrage opportunities.[69] In addition,

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[60] *Id.*

[61] *Id.*

[62] SEC STAFF REPORT, *supra* note 6, at 37.

[63] *Id.*

[64] *Id.* at 37-38. The Investment Company Act of 1940 limits investment companies' use of leverage. *Id.* at 38.

[65] *Id.* at 37.

[66] PRESIDENT'S WORKING GROUP, *supra* note 10, at 23.

[67] *Id.*

[68] *Id.* at 5.

[69] *Id.* at 5, A-2.

hedge funds engage heavily in short-selling, in which the fund buys "higher expected-return securities and sell[s] short lower-expected-return securities," or buys securities in a target company and simultaneously sells short the securities of the acquiring company.[70] The intended result of short-selling is to gain a profit "from an expected downward price movement, to provide liquidity in response to unanticipated demand or to hedge the risk of a long position in the same or a related security."[71] Although these practices provide market liquidity and pricing efficiency, they may also manipulate stock prices.[72]

In addition to dangerous strategies, hedge fund risk is also related to the fund manager's talent. Although many funds are owned and operated by top traders and financial experts, many less experienced managers are breaking into the field and starting their own funds.[73] This growing trend is due in large part to low entry barriers and light industry regulation.[74] As one fund manager, a thirty-year-old college dropout, remarked: "Opening a hedge fund is easy: It's just paperwork."[75] Rather than waiting through long apprenticeships, which used to last at least ten years, some recent college graduates and other average traders are starting their own funds after very little training.[76] This trend is fueled by organizations such as Hedge Fund Dynamics LLC,[77] Hedge Fund Launch, LLC,[78] and Green & Company, Inc.,[79] which offer a wide range of services to create and manage funds. Even though young managers may have difficulty raising capital, they often use their own money

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[70] SEC STAFF REPORT, *supra* note 6, at 42.

[71] *Id.* at 40.

[72] *Id.*

[73] *See* Roben Farzad, *Hedge Fund Toddlers: Why wait for that big break when you and a few buds can manage millions now?*, BUS. WK., July 3, 2006, at 37.

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] *See* Hedge Fund Dynamics, Start a Hedge Fund, http://www.hedgefunddynamics.com.

[78] *See* Hedge Fund Launch: Matching startup hedge funds with seed capital providers, http://www.hedgefundlaunch.com.

[79] *See* Green Trader Tax, Hedge Funds, http://www.greencompany.com/HedgeFunds/index.shtml.

for initial investments to demonstrate their financial prowess.[80] Thus, while many investors will steer clear of amateur fund managers, such managers still have a stake in the game if they have adequate financial resources to launch a fund and enter the marketplace.

IV. THE IMPACT OF HIGH-STAKES GAMBLING

Although hedge funds traditionally aim to eliminate risk and create portfolio diversification, risky bets by fund managers have far-reaching implications for both investors and financial markets. As unregulated investment vehicles, hedge funds pose significant problems; the SEC has struggled to bring funds within the scope of their authority.[81] Without regulatory oversight, hedge funds raise a number of important policy concerns, including the potential for fraud, retailization, and serious market disruptions.[82]

A. Fraud: Scams and Illegal Trading

Chief among the criticisms of hedge funds is the increasing level of hedge fund fraud. The SEC has noted that the growth in the number of hedge funds has brought a similar increase in fraud enforcement cases.[83] From 2000 to 2004, the SEC brought 51 cases alleging that hedge fund managers defrauded investors and others for an aggregate amount of 1.1 billion dollars.[84] These cases involved "misappropriation of assets; misrepresentation of portfolio performance; falsification of experience, credentials and past returns; misleading disclosure regarding claimed trading strategies; and improper valuation of assets."[85]

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[80] Hannah M. Terhune, *How to Set Up Your Own Hedge Fund*, HEDGE FUND CENTER, http://www.hedgefundcenter.com/wrapper.cfm?article_type=legal&content_id=849&content_type=articles.

[81] *See* Section V, *infra*.

[82] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Sec. & Exch. Comm'n Release No. IA-2333, 69 Fed. Reg. 72,054, 72,056 (Dec. 10, 2004).

[83] *Id.* Although most hedge funds are not currently subject to registration requirements under federal securities laws, they are all subject to antifraud statutes. SEC STAFF REPORT, *supra* note 6, at 72.

[84] SEC Release No. IA-2333, 69 Fed. Reg. at 72,056 (2004).

[85] SEC STAFF REPORT, *supra* note 6, at 73-74.

While most fraud cases involve situations where fund managers defraud their own investors, the SEC asserts that "hedge funds have been used to defraud other market participants."[86] Late trading and market timing of mutual fund shares has become a concern, as "hedge fund advisers have been key participants in . . . recent scandals."[87] The SEC estimates that as of 2004, approximately four hundred hedge funds and 87 fund managers have been involved in exploiting mutual fund investors for their own gain.[88] These managers allegedly entered into arrangements with mutual fund advisers in which restrictions on market timing were waived in return for the fund manager's promise to place other assets with the mutual fund adviser.[89] In addition, some hedge fund managers purportedly sought to avoid detection by concealing the identity of their fund.[90]

Similarly, critics argue that hedge funds have benefited from their large asset pool by receiving market "tips" from securities firms seeking commissions from heavy hedge fund trading.[91] Securities firms allegedly "court…funds by feeding them steady streams of trading ideas and information about stocks, bonds and what other financial-market participants are up to."[92] While the sharing of such information is not necessarily illegal, regulators are concerned that it gives funds an unfair advantage and may amount to insider trading.[93] Further, it is not unusual for hedge funds to receive calls from underwriters before a securities offering, often to the detriment of the issuing company.[94] One such case involves the London hedge fund firm Marshall Wace, LLP, which manages seven billion dollars in three funds.[95]

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[86] SEC Release No. IA-2333, 69 Fed. Reg. at 72,056.

[87] *Id.*

[88] *Id.* at 72,057.

[89] *Id.* at 72,056-57.

[90] *Id.* at 72,057.

[91] *See, e.g.,* Henny Sender & Anita Raghavan, *Worry Amid Hedge Fund Boom: Privileged Access to Information*, WALL ST. J., July 27, 2006, at A1.

[92] *Id.*

[93] *Id.*

[94] *Id.*

[95] *Id.*

Marshall Wace allegedly received two phone calls from an official at Deutsche Bank AG alerting the firm of a new issuance of securities by the French company, Alcatel.[96] As a result, Marshall Wace made a 672,000 dollar profit on a large sale of Alcatel shares made minutes before the firm unveiled its new securities offering.[97] Though Marshall Wace denies any wrongdoing, the allegations are currently being investigated by French securities regulators.[98]

B. Retailization: Small Investors Have a Hand at the Table

Another major concern regarding the growth of hedge funds is the increasing exposure of smaller, less sophisticated investors to the hedge fund world.[99] Although many hedge funds have high minimum investment requirements, the SEC has noted that these minimum qualifications have decreased as funds compete for investors.[100] For instance, in 2003, the Oppenheimer Tremont funds began accepting investments of as little as 25,000 dollars from "affluent individuals."[101] Critics argue that these low investment barriers will attract individuals who meet the monetary requirement, but who do "not possess the understanding or market power" to make an informed investment decision.[102] In addition, the SEC has raised concerns that U.S. hedge funds will begin to emulate foreign funds that seek out smaller investors.[103] However, hedge fund managers continue to argue that they do not intend to solicit "retail investors" because such investors are not suited for the

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[96] *Id.*

[97] *Id.*

[98] *Id.*

[99] SEC Release No. IA-2333, 69 Fed. Reg. at 72,057.

[100] *Id.*; SEC STAFF REPORT, *supra* note 6, at 81.

[101] *Hedge Fund Milestones*, WALL ST. J. ONLINE, *available at* http://online.wsj.com/article/SB115394214778218146-search.html?KEYWORDS=hedge+fund+milestones&COLLECTION=wsjie/6month [hereinafter *Hedge Fund Milestones*].

[102] SEC STAFF REPORT, *supra* note 6, at 81.

[103] SEC Release No. IA-2333, 69 Fed. Reg. at 72,057.

inherent risks of hedge funds, and "the effort required to ensure . . . suitability often outweighs the benefit of any investments."[104]

In addition, the fear of the "retailization" of hedge funds stems from the growing number of public and private pension funds, universities, endowments, foundations and other charitable organizations that are investing in hedge funds.[105] As mentioned previously, these groups compose a considerable amount of the total capital invested in hedge funds. Although the institutions themselves meet the criteria for investment, they do so by exposing the collective assets of their less sophisticated participants or beneficiaries to the hedge fund.[106] For example, if a pension plan experiences substantial losses, it may be unable to meet its obligations to millions of beneficiaries,[107] such as in the case of Amaranth.[108] The SEC estimates that institutional investments in hedge funds may increase to three hundred billion dollars by 2008.T[109]

C. Market Implications: Systemic Loss

Perhaps the most significant concern regarding the hedge fund boom is the exposure of banks and other financial institutions to hedge fund risk, and the potential large-scale market impact of hedge funds.[110] As will be addressed in Section VI, *infra*, the fall of LTCM and, more recently, Amaranth, has sparked major concerns throughout the financial sector, as analysts worry about how the demise of major hedge funds will affect banks, institutions, and the entire economy. Although, as of July 2006, hedge funds account for only five percent of all U.S. assets under management, such funds compose approximately thirty percent of all U.S. equity trading volume.[111] In fact, a 2003 article asserted that one hedge fund adviser alone

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104 SEC STAFF REPORT, *supra* note 6, at 80-81.

105 *See* SEC Release No. IA-2333, 69 Fed. Reg. at 72,057-58.

106 SEC STAFF REPORT, *supra* note 6, at 82.

107 *Id.*

108 *See* Section VI, *infra*.

109 SEC Release No. IA-2333, 69 Fed. Reg. at 72,058.

110 *See* PRESIDENT'S WORKING GROUP, *supra* note 10, at 29.

111 *Regulation Testimony*, *supra* note 31.

was "responsible for an average of five percent of the daily trading volume of the New York Stock Exchange."[112] Thus, hedge funds exert an enormous influence in the marketplace; experts have become increasingly concerned about the stability of financial markets as a result.

Despite their relatively small market share, the impact of hedge funds is amplified by their active trading strategies and aggressive use of leverage.[113] Many analysts are concerned that these practices may cause widespread systemic losses to other firms, which will disrupt global financial markets.[114] In addition, hedge funds have significant positions in many market segments so that if a fund collapses, the market segment may also falter.[115] The consequences could be devastating, and the fall of a single hedge fund could bring about an economic catastrophe.

V. MONITORING THE BETS AND THE PLAYING FIELD

Despite the many policy concerns, hedge funds remain largely unregulated; the majority of hedge funds fall within exceptions to securities law, and thereby avoid registration requirements.[116] However, the expansive growth of the industry has attracted increasing attention from the SEC and other regulatory agencies.[117] Recent scandals have contributed to this focus as investors, financial services entities, and businesses express concern over this highly unregulated industry. The SEC, therefore, has taken steps to bring hedge funds within the scope of its authority. The following Sections provide an overview of the applicability of federal securities laws to hedge funds, and explain the SEC's best attempt at regulation so far, which was recently overturned in *Goldstein v. SEC*.

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[112] SEC Release No. IA-2333, 69 Fed. Reg. at 72,056 (citing Marcia Vickers, *The Most Powerful Trader on Wall Street You've Never Heard Of*, BUS. WK., July 21, 2003, at 66).

[113] PRESIDENT'S WORKING GROUP, *supra* note 10, at 2.

[114] *See, e.g.,* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 704 (2000).

[115] *Id.* at 704-05.

[116] *See* SEC STAFF REPORT, *supra* note 6, at 11.

[117] DOUGLAS L. HAMMER ET AL., *supra* note 13, at 4.

A. Regulatory Loopholes

1. The Investment Company Act of 1940

The Investment Company Act of 1940 ("Company Act")[118] requires all "investment companies" to register with the SEC before they offer or sell securities.[119] Upon registration, an "investment company is subject to technical, complex and extensive substantive regulation of its activities."[120] Most hedge funds fall within the definition of "investment company" under the Company Act.[121] Hedge funds, however, usually rely on the "100-Owner Limit" exception or the "Qualified Purchaser" exception to avoid registration. The "100-Owner Limit" exception "excludes any pooled investment vehicle" that "does not have more than 100 beneficial owners of its outstanding securities . . . and does not make or propose

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[118] 15 U.S.C.A. §§ 80a-1 to 80a-64 (2007).

[119] *Id.* § 80a-7(a)(1). This statute provides,

> No investment company organized or otherwise created under the laws of the United States or of a State and having a board of directors, unless registered under section 80a-8 of this title, shall directly or indirectly . . . offer for sale, sell, or deliver after sale, by the use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person; or offer for sale, sell, or deliver after sale any such security or interest, having reason to believe that such security or interest will be made the subject of a public offering by use of the mails or any means or instrumentality of interstate commerce . . . .

Id.

[120] DOUGLAS L. HAMMER ET AL., *supra* note 13, at 61.

[121] SEC STAFF REPORT, *supra* note 6, at 11. Two definitions of "investment company" apply to most hedge funds.

> When used in this title, "investment company" means any issuer which (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities . . . ; or (C) is engaged or proposes to engage 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.

15 U.S.C.A. § 80a-3(a)(1).

to make a public offering of its securities."[122] The "Qualified Purchaser" exception excludes issuers whose "beneficial owners of outstanding securities" are "qualified purchasers," as defined under the Company Act, provided that the issuer "does not make or propose to make a public offering of its securities."[123] Although there are a number of specific requirements to claim either exception, the vast majority of hedge funds generally meet these requirements. Thus, the Company Act does not regulate these entities adequately.

2. The Securities Act of 1933

The Securities Act of 1933 ("1933 Act")[124] makes it unlawful to sell a security unless it is registered with the SEC.[125] The interests in limited partnerships and limited liability companies that are typically offered by hedge funds fall within the definition of "securities."[126] Thus, hedge funds are required to register under the

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[122] DOUGLAS L. HAMMER ET AL., *supra* note 13, at 62. The Company Act and SEC rules thereunder determine how to calculate the number of "beneficial owners" and the standards for "looking-through" an investing entity to include its shareholders in the calculation. *Id.* at 62-63; 15 U.S.C.A. § 80a-3(c)(1).

[123] DOUGLAS L. HAMMER ET AL., *supra* note 13, at 74-75. The Company Act and the SEC rules thereunder determine how to calculate a "qualified purchaser" and layout the other requirements to claim the exception. 15 U.S.C.A. §§ 80a-3(c)(7), 80a-2(a)(51).

[124] *Id.* §§ 77a to 77aa.

[125] *Id.* § 77e(c). This statute provides,

> It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

Id.

[126] Limited partnerships and limited liability companies fall within the catch-all category of "investment contracts" under the 1933 Act's definition of securities. DOUGLAS L. HAMMER ET AL., *supra* note 13, at 111. "An 'investment contract' is an arrangement where individuals are 'led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves.'" *Id.* (citing Sec. Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293 (1945)).

1933 Act unless they are exempt from registration.[127] Most hedge funds fall under the "private placement" exemption, which excludes "transactions by an issuer not involving any public offering."[128] However, the standards to qualify under this provision are somewhat subjective.[129] Therefore, hedge funds often seek exemption under Rule 506 of Regulation D, which operates as a "safe harbor" for private offerings.[130] Rule 506 provides an issuer with certainty that transactions meeting the specific requirements of the rule will be deemed not to "involv[e] any public offering."[131] Hedge funds typically meet these requirements by selling interests in the fund only to "accredited investors," such as wealthy individuals and institutions.[132] Thus, the registration requirement of the 1933 Act does not apply to many hedge funds.

3. The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 ("1934 Act")[133] has several provisions that might apply to a hedge fund. First, the 1934 Act requires any broker or dealer

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127 SEC STAFF REPORT, *supra* note 6, at 13-14.

128 *Id.* at 14; 15 U.S.C.A. § 77d(2).

129 DOUGLAS L. HAMMER ET AL., *supra* note 13, at 113. *See generally* Sec. Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119 (1953) ("An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering."); Sec. Exch. Comm'n v. Murphy, 626 F.2d 633 (9th Cir. 1980) ("If an offering is small and is made directly to the offerees 'rather than through the facilities of public distribution such as investment bankers or the securities exchanges,' a court is more likely to find that it is private." (quoting Hill York Corp. v. Am. Int'l Franchises, Inc., 448 F.2d 680, 689 (5th Cir. 1971)); Gen. Life of Missouri Inv. Co. v. Shamburger, 546 F.2d 774 (8th Cir. 1976) ("Many courts have applied the Supreme Court's 'focus of inquiry' in determining whether a given transaction involves a public offering within the meaning of § 4(2) of the Act and have based their decisions on the presence or absence of the offerees' need for the protections afforded by registration, i.e., whether the offerees were shown to have access to the kind of information the registration . . . would disclose.").

130 SEC STAFF REPORT, *supra* note 6, at 14.

131 Mark v. FSC Sec. Corp., 870 F.2d 331, 334 (6th Cir. 1989); 17 C.F.R. § 230.506(a) (2007) ("Exemption. Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act.").

132 SEC STAFF REPORT, *supra* note 6, at 14-16; 17 C.F.R. § 230.506(b)(2)(ii).

133 15.U.S.C.A. §§ 78a to 77nn.

who offers or sells securities to register with the SEC.[134] Hedge fund companies may fall within the definition of "dealer" under the 1934 Act[135] because most funds buy and sell securities for their own accounts.[136] However, many hedge funds are excluded from this definition because of the partnership structure and other activities they engage in.[137] In addition, although some fund managers fit within the definition of "broker,"[138] many qualify for a safe harbor exemption as an "associated person of an issuer."[139] Under Section 12 of the 1934 Act, hedge fund companies might be

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[134] *Id.* § 78o(a)(1). This statute provides,

> It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

Id.

[135] Dealer is defined in the 1934 Act as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." *Id.* § 78c(a)(5).

[136] DOUGLAS L. HAMMER ET AL., *supra* note 13, at 246.

[137] *See id.* at 246-47. In several No-Action letters, the SEC has identified factors to consider when identifying a "dealer." *Id.* Namely,

> whether the person purchases or sells securities as principal to or from customers, runs a book of repurchase and reverse repurchase agreements, uses an interdealer broker for securities transactions, issues or originates any securities, or guarantees contract performance or indemnifies the parties for any loss or liability from the failure of the transaction to be successfully consummated.

Id. Although hedge funds generally "issue or originate securities" (i.e., the interests in the hedge fund), the typical fund does not engage in any of the other mentioned activities. *Id.*

[138] "Broker" is defined as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C.A. § 78c(a)(4)(A).

[139] *See* DOUGLAS L. HAMMER ET AL., *supra* note 13, at 241-42; 17 C.F.R. § 240.3a4-1 (2007). "'Associated person of an issuer' includes any general partner of an issuer and any natural person who is an employee, officer, director or partner of a corporate general partner of a limited partnership that is the issuer." DOUGLAS L. HAMMER ET AL., *supra* note 13, at 241. Provided that they meet certain requirements, hedge fund managers may qualify for this exception. *Id.* at 241-42. In addition, hedge

required to register classes of equity securities with five hundred or more holders of record and assets in excess of ten million dollars at the end of the fiscal year.[140] However, because registration of a class of equity securities subjects the registrant to a number of reporting requirements, most funds avoid the registration requirement by having fewer than five hundred holders of record.[141] Finally, hedge funds may be subject to several "beneficial ownership" filing requirements if they beneficially own greater than five percent of a class of equity securities that are registered with the SEC under Section 12.[142] Many hedge funds can easily avoid this requirement as well.

B. Attempted Regulation

1. The Investment Advisers Act of 1940

Perhaps the most relevant federal securities statute for hedge funds, however, is the Investment Advisers Act of 1940 ("Advisers Act").[143] A companion statute to the Company Act, the Advisers Act was created "to 'substitute a philosophy of full disclosure for the philosophy of *caveat emptor*' in the investment advisory profession."[144] In this regard, all "investment advisers" must register with the SEC unless they are exempt from registration.[145] Registration under the Advisers Act can

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funds can avoid registration if they are not in the business of selling securities, which depends on the extent of their securities activities. *Id.* at 243.

140 SEC STAFF REPORT, *supra* note 6, at 18.

141 *Id.* at 18-19.

142 *Id.* at 19-20. "Beneficial owners" under Sections 13 and 16 of the 1934 Act are required to disclose the amount of equity securities beneficially owned and other material information regarding the reporting person. *Id.*

143 15 U.S.C.A. §§ 80b-1 to 80b-21 (2007).

144 Goldstein v. Sec. Exch. Comm'n, 451 F.3d 873, 876 (D.C. Cir. 2006) (quoting Sec. Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)).

145 15 U.S.C.A. § 80b-3(a). This statute provides,

> Except as provided in subsection (b) of this section and section 80b-3a of this title, it shall be unlawful for any investment adviser, unless registered under this section, to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser.

be burdensome on advisers, as they are subjected to significant SEC scrutiny. For instance, registered advisers are required to provide both the SEC and investors with current information about their business practices, disciplinary history, and other pertinent data.[146] Investment advisers must provide a disclosure statement and maintain an updated Form ADV with the SEC.[147] In addition, "[r]egistered advisers must maintain required books and records and submit to periodic examinations."[148] Advisers also owe a fiduciary obligation to their clients; they must safeguard clients' assets, disclose material conflicts, and seek the best execution for client transactions.[149] Overall, investment adviser registration allows the SEC to keep a census of advisers so it can "respond to, initiate, and take remedial action on complaints against fraudulent advisers."[150]

Under the Advisers Act, an "investment adviser" is "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who . . . issues or promulgates analyses or reports regarding securities."[151] Nearly every hedge fund manager meets this definition,[152] and, as the Second Circuit Court of Appeals pointed out in *Abrahamson v. Fleschner,* hedge fund general partners are "investment advisers."[153] As a result, essentially all hedge funds fall within the regulatory scope of the Advisers Act, and managers hope to avoid registration under an exemption. More specifically, most managers are exempt from registration under a provision that excludes investment advisers who have "fewer than 15 clients during the preceding 12 months, do not hold themselves out generally to the public as an investment adviser and are not an investment adviser to a registered investment

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Id.

146 SEC STAFF REPORT, *supra* note 6, at 20-21.

147 *Id.*

148 *Id.*

149 SEC Release No. IA-2333, 69 Fed. Reg. at 72,054.

150 *Goldstein*, 451 F.3d at 876.

151 15 U.S.C.A. § 80b-2(11) (2007).

152 SEC STAFF REPORT, *supra* note 6, at 20.

153 Abrahamson v. Fleschner, 568 F.2d 862, 869-70 (2nd Cir. 1977).

company."[154] Traditional SEC rules provided that investment advisers may count a "legal organization" as a single client.[155] Therefore, institutions, pension plans, and other hedge funds were each counted as one client, even though they had hundreds of investors or beneficiaries.[156] Although a majority of hedge fund advisers were excluded from registration under this provision, they were still required to comply with the Adviser Act's antifraud provisions.[157]

2. SEC Rule 203(b)(3)-2

In light of the thousands of hedge funds advisers claiming the "private issuer exemption," the SEC felt that the current regulatory framework did not effectuate Congress' intent to exempt only those advisers with a small number of clients whose activities were "unlikely to affect national securities markets."[158] Rather, hedge fund advisers were taking advantage of the "exemption to operate large investment advisory firms without being registered."[159] The SEC argued that hedge funds and other advisers were pooling client assets and creating limited partnerships, business trusts, and corporations in order to count these entities as a single client and avoid registration.[160] Advisers were misusing the private issuer exemption to manage large amounts of client assets, and indirectly, maintain a large number of clients.[161] In addition, the SEC argued that the private issuer exemption did not adequately address growing problems within the industry.[162] With so many hedge fund advisers excluded from any type of registration, the SEC argued that there was no effective

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154 SEC STAFF REPORT, *supra* note 6, at 21; 15 U.S.C.A. § 80b-3(b)(3).

155 SEC STAFF REPORT, *supra* note 6, at 21.

156 *Id.*

157 *Id.*

158 SEC Release No. IA-2333, 69 Fed. Reg. at 72,054.

159 *Id.*

160 *Id.*

161 *Id.*

162 *See id.* at 72,059.

program in place to deter or detect fraud, to gather basic information about the hedge fund industry, and to protect investors.[163]

To combat these problems, the SEC adopted Rule 203(b)(3)-2[164] in December 2004, which effectively closed the private issuer loophole. This rule required that advisers "count as clients the shareholders, limited partners, members, or beneficiaries . . . of a private fund."[165] As a result, advisers would have to "look through" the advised entity and consider the surrounding circumstances of the advisory arrangement.[166] The SEC asserted that the new rule was consistent with the purpose of the Advisers Act, and argued that the private issuer "exemption does not require a rigid approach to counting clients without consideration of the surrounding circumstances."[167] By adopting Rule 203(b)(3)-2, and effectively changing the requirements of the private issuer exemption, the SEC hoped to bring a majority of investment advisers, and the hedge funds they manage, under regulatory control.[168] Advisers were required to register under the new rule by February 1, 2006.[169]

The SEC argued that registration under the Advisers Act would provide extensive benefits to the securities markets, although many critics disagreed.[170] Specifically, the SEC argued that registration would help identify harmful practices at an early stage, thereby deterring fraud and protecting investors.[171] In addition, the SEC emphasized that registration would require hedge funds to adopt compliance programs and submit to routine examinations.[172] But perhaps most importantly,

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[163] *See id.*

[164] 17 C.F.R. § 275.203(b)(3)-2 (repealed 2006).

[165] *Id.*

[166] SEC Release No. IA-2333, 69 Fed. Reg. at 72,067-68.

[167] *Id.* at 72,068.

[168] *Id.* at 72,054.

[169] *Id.*

[170] *See id.* at 72,062.

[171] *Id.* at 72,061.

[172] *Id.* at 72,063.

registration would provide the SEC "with the ability to collect important information" regarding the hedge fund industry, fund strategies, and fund advisers.[173] Such information would provide investors and other market participants with disclosure,[174] and is necessary for determining the impact of hedge funds on national financial markets, the potential for "retailization," and other industry trends.T[175]

3. Goldstein v. SEC

Rule 203(b)(3)-2 quickly came under attack by hedge fund advisers, trade associations, and other critics who were concerned about compliance costs and inefficiencies.[176] Opponents asserted that the new proposal would not achieve the desired results and that hedge funds would be forced to increase their management fees.[177] Despite this opposition, the SEC was successful in getting a total of 2,423 fund managers registered under the Advisers Act by April 2006.[178] Although some of these hedge fund advisers had registered voluntarily before Rule 203(b)(3)-2 was enacted,[179] more than 1,000 new hedge fund advisers registered between April 2005 and April 2006.[180]

The SEC's registration success, however, came to a crashing halt on June 23, 2006, when the United States Court of Appeals for the District of Columbia vacated

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[173] *Id.* at 72,061. As stated in the SEC Release adopting the new rule, "Currently, neither we nor any other government agency has any reliable data on even the number of hedge funds or the amount of their assets. We must rely on third-party surveys and reports, which often conflict and may be unreliable." *Id.*

[174] *See* SEC STAFF REPORT, *supra* note 6, at 83.

[175] *See* SEC Release No. IA-2333, 69 Fed. Reg. at 72,061.

[176] *Id.* at 72,059.

[177] *Id.* The SEC's counterarguments are presented in a Cost-Benefit analysis in Release No. IA-2333.

[178] INV. ADVISER ASS'N & NAT'L REGULATORY SERVS., EVOLUTION REVOLUTION 2006: A PROFILE OF THE INVESTMENT ADVISER PROFESSION 3 (2006), *available at* http://www.icaa.org/public/evolution_revolution-2006.pdf [hereinafter EVOLUTION REVOLUTION].

[179] Some advisers register voluntarily because investors demand that they do or for competitive reasons. SEC STAFF REPORT, *supra* note 6, at 22.

[180] EVOLUTION REVOLUTION, *supra* note 178, at 4.

Rule 203(b)(3)-2.[181] In *Goldstein v. SEC*, the D.C. Circuit Court held that the SEC's interpretation of "client" under the new rule was unreasonable.[182] The Court's analysis focused on the definition of "investment adviser" under the Advisers Act, noting that an adviser is defined as "any person who, for compensation, engages in the business of advising others, either *directly* or through publications or writings."[183] The court stated that hedge fund investors do not receive advice directly from the fund's manager.[184] Rather, the fund manager collects the investor's money and then decides what investment strategy to pursue.[185] In this sense, the hedge fund adviser owes a fiduciary obligation "only to the fund, not to the fund's investors."[186] The *Goldstein* court further held that, "[i]f the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest."[187] Therefore, "client" cannot mean one thing when determining to whom fiduciary obligations are owed, and another when determining who is required to register under the Adviser's Act.[188] Thus, the court held that the SEC's interpretation of "client" came "close to violating the plain language of the statute," and struck down Rule 203(b)(3)-2.[189] The court explained, "That the [SEC] wanted a hook on which to hang more comprehensive regulation of hedge funds may be understandable. But the [SEC] may not accomplish its objective by a manipulation of meaning."[190]

Goldstein is a major victory for hedge fund advisers who fought registration under the Advisers Act. Although the SEC can appeal this decision, Chairman

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[181] Goldstein v. Sec. Exch. Comm'n, 451 F.3d 873, 884 (D.C. Cir. 2006).

[182] *Id.* at 880-81.

[183] *Id.* at 879 (quoting 15 U.S.C. § 80b-2(11)).

[184] *Id.*

[185] *Id.* at 879-80.

[186] *Id.* at 881.

[187] *Id.*

[188] *Id.* at 882.

[189] *Id.* at 881.

[190] *Id.* at 882.

Christopher Cox announced that he would not seek a U.S. Supreme Court review of the case.[191] The impact that this decision will have on the number of registered hedge fund managers is largely unknown, but 101 hedge fund advisers have already de-registered as of October 2006, and that figure is expected to increase.[192] As a result, the future of hedge fund regulation is uncertain, but several alternative solutions have recently emerged.[193]

VI. LOSING BETS: WHEN THE TABLE FOLDS

Almost immediately after *Goldstein*, the financial industry once again witnessed the downfall of a major hedge fund and the enormous consequences that followed. As the largest collapse in hedge fund history, the downfall of Amaranth came as a harsh blow to regulators. It is clear that while hedge fund investors stand to gain enormously from investments, often earning thirty percent or more annual returns,[194] they also stand to lose—sometimes even more than they win. Amaranth illustrates the risky bets advisers often make and the stinging results of a bad choice.

The hedge fund industry has suffered several devastating losses over the years, which have far-reaching impacts. By employing risky strategies and making dangerous bets, funds often find themselves in dire positions with overextended investments and falling prices. Such is the case with the fall of LTCM in 1998, and, more recently, Amaranth. Although LTCM and Amaranth avoided large-scale market disruption because of buyouts from other financial institutions, their demise demonstrates the devastating impact that unregulated hedge funds have on both investors and the market. Increasing concern for regulation now mounts as many funds produce low returns in the wake of Amaranth's downfall, and speculators keep a lookout for the next big "loser."

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[191] Ron Orol, *SEC Not Appealing Hedge Fund Ruling*, THE DEAL, Aug. 8, 2006, *available at* http://www.law.com/jsp/pc/LawArticleCorp.jsp?id=1154960917659&rss=pc.

[192] Julie Fishman-Lapin, *Registration Reconsidered,* THE STAMFORD ADVOCATE, Oct. 13, 2006.

[193] *See* Section VII, *infra*.

[194] *See Hedge Fund Milestones*, *supra* note 101.

A. Pre-Amaranth: Long Term Capital Management

Although several hedge funds suffered significant loses and were forced to shut down,[195] LTCM has received the most attention because of the financial crisis that almost resulted. Once considered the "Dream Team" with returns of forty percent, LTCM used a variety of trading strategies including "shorted" Treasury bond futures and high yielding "mortgage-backed or corporate debt securities."[196] LTCM held large positions in various markets and was extensively leveraged, with a balance sheet ratio of twenty-five to one; this exposed the fund to major market risks.[197] In 1998, the fund began experiencing devastating financial hardships, with a loss of over fifty percent of its equity.[198] With losses mounting, LTCM could not continue to meet its cash flow obligations to creditors because of its size and the leverage involved.[199] Market participants became concerned about the possibility that LTCM would collapse and bring severe consequences to fragile world markets.[200] In addition, major banks and other creditors who enabled LTCM to build up its leveraged positions were concerned about the effect of a default on their operations.[201] As a result, the banks involved and the Federal Reserve Bank of New York came to an agreement with LTCM in which they would invest 3.6 billion dollars to bail out the fund, in exchange for a ninety percent equity stake in

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195 For instance, Michael Steinhardt was forced to shut down his $2.6 billion investment partnerships in 1995 after using aggressive, short-term trading and risky market bets since he started the fund in 1967. *Id.* In 1998, Everest Capital Ltd. lost nearly half of its $2.7 billion under management, effecting the endowments of both Yale and Brown universities. *Id.* And, in 2000, Tiger Management LLC, closed down most of its operations and liquidated $6 billion in investments due to the market rush to Internet stocks. *Id.*

196 *Hedge Fund Gets Help*, CNN MONEY, Sept. 23, 1998, http://money.cnn.com/1998/09/23/investing/longterm; PRESIDENT'S WORKING GROUP, *supra* note 10, at 10-11.

197 PRESIDENT'S WORKING GROUP, *supra* note 10, at 11-12.

198 *Id.* at 12.

199 *Id.* at 12-13.

200 *Id.* at 13.

201 *Id.*

LTCM.[202] Although investors were seriously harmed, LTCM avoided a major world financial crisis largely due to the assistance of other financial institutions.[203]

B. Amaranth Advisors, LLC

While the financial industry was still talking about the fall of LTCM, and in the wake of the D.C. Circuit Court's decision in *Goldstein*, another major hedge fund suffered serious losses and was forced to close its doors. Amaranth, a Connecticut based hedge fund with approximately nine billion dollars in assets, lost approximately five billion dollars in one week.[204] Amaranth's assets under management fell to roughly 4.5 billion dollars during the first week of September 2006, as the result of risky bets in natural gas made by 32-year-old trader Brian Hunter.[205] Amaranth's demise came in less than a month and was the largest collapse in hedge fund history.[206]

Amaranth's failure is linked to Hunter's aggressive trading in natural gas futures.[207] Hunter employed a trading strategy focused on exploiting futures contracts for natural gas, while relying heavily on "borrowed money to double-down on his bets."[208] With generous lines of credit from banks, Hunter leveraged aggressively[209] and increased his exposure in an extremely volatile commodities

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[202] *Id.* at 14.

[203] For more information on the fall of LTCM, see LOWENSTEIN, *supra* note 1; NICHOLAS DUNBAR, INVENTING MONEY: THE STORY OF LONG-TERM CAPITAL MANAGEMENT AND THE LEGENDS BEHIND IT (2000); Jonathan H. Gatsik, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591 (2001).

[204] Ann Davis, *Blue Flameout: How Giant Bets on Natural Gas Sank Brash Hedge-Fund Trader*, WALL ST. J., Sept. 19, 2006, at A1 [hereinafter Davis].

[205] *See id.*

[206] Katherine Burton, *Amaranth to Get Advice From Fortress Investment on Asset Sales*, BLOOMBERG, Oct. 2, 2006, http://www.bloomberg.com/apps/news?pid=20601087&sid=aPz3nvmZNWP4&refer=home.

[207] Davis, *supra* note 204.

[208] Ann Davis et al., *What Went Wrong at Amaranth – Mistakes at the Hedge Fund Include Key Trader's Confusing Paper Gains With Cash Profits*, WALL ST. J., Sept. 20, 2006, at C1 [hereinafter Davis et al.].

[209] *Id.* "Funds like Amaranth are able to borrow three to eight times their initial capital to make bets thousands of times over. Mr. Hunter sometimes held 100,000 positions in a single contract, say traders familiar with his bets." *Id.*

market.[210] Hunter's strategy involved making complex wagers on natural gas by analyzing weather conditions and other factors in an attempt to predict how prices would fare at some point in the future.[211] Based on his analysis, Hunter would bet against market prices and attempt to take advantage of large price swings from both declines and surges.[212]

Hunter's bets often paid off, and at the end of April 2006, he was up by two billion dollars for the year.[213] By September 2006, however, the market quickly changed and gas prices fell drastically.[214] Hunter's brash bets fell with market volatility, which is "proof of how quickly fortunes can reverse in gyrating commodities markets."[215] Although much about Amaranth's trading strategy is unknown, some analysts speculate that Hunter's positions were so large that he could not get out of them when the market turned.[216] As a result, the net asset value of Amaranth funds dropped sixty-five to seventy percent by October 2006, which sent investors scrambling.[217]

In an attempt at recovery, Amaranth quickly sold its energy portfolio to J.P. Morgan Chase & Co. ("J.P. Morgan") and the hedge fund Citadel Investment Group, LLC ("Citadel").[218] Despite limited interest in the large and complicated holdings, J.P. Morgan and Citadel believed that the investments would be more valuable than the market assumed, and that they could balance the risk of the trades

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210 Davis, *supra* note 204.

211 *Id.*

212 *Id.*

213 *Id.*

214 Davis, *supra* note 204; Davis et al., *supra* note 208.

215 Davis, *supra* note 204.

216 *Id.*

217 Alistair Barr, *Amaranth to sell all remaining positions: Hedge fund suspends redemptions to try to boost proceeds from asset sales*, MARKETWATCH, Sept. 29, 2006, http://www.marketwatch.com/News/Story/Story.aspx?guid={59B167B2-2D4D-4C80-9BFC-996F997C20DD}&dist=rss&siteid=mktw [hereinafter Barr].

218 Gregory Zuckerman, *How the Wreck from Amaranth was Contained*, WALL ST. J., Oct. 5, 2006, at C3.

with other investments.[219] This smooth transaction eased concerns about broad market turmoil and "ripple effects" from the hedge fund's failure.[220] In addition, with the aide of Fortress Investment Group LLC, Amaranth suspended client redemptions in order to liquidate three billion dollars that remained in investments.[221] It is unclear how much investors will actually receive from the sale, as it will take time to maximize proceeds.[222] Major investors that were affected by Amaranth's collapse include the pension fund of 3M Co., funds of hedge funds run by Goldman Sachs and Morgan Stanley, and the San Diego County Employees Retirement Association, which invested 175 million dollars with Amaranth.[223]

Although Amaranth has thus far avoided widespread market implications (largely due to the help of J.P. Morgan and Citadel), the hedge fund's collapse has caused major repercussions for investors; the fund is certainly not out of "hot water" yet. Some investors, including the San Diego pension fund, are considering legal recourse for their losses, including a potential class action lawsuit.[224] In addition, Amaranth has raised increased concerns regarding the trading practices of funds and the need for regulation to ensure that a similar incident does not happen in the future. As the largest failure in hedge fund history, some experts argue that Amaranth will spark the beginning of a trend in the industry and are anticipating a "'fire or ice' shakeout."[225] Meaning, the industry will either experience "a wave of collapsing funds" ("fire"), or significant diminishing returns because too many funds will pursue the same investment strategies ("ice").[226] Either way, Amaranth's failure could be a turning point in the industry, as investors become increasingly concerned with disclosure, regulation, and the impact of risky hedge fund bets.

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219 *Id.*

220 *Id.*

221 Katherine Burton, *Amaranth Hires Fortress Investment to Sell Assets*, BLOOMBERG, Oct. 1, 2006, http://www.bloomberg.com/apps/news?pid=20601014&sid=ajdgTUeNTeSU&refer=funds.

222 *See* Barr, *supra* note 217.

223 *Id.*; Davis et al., *supra* note 208.

224 Josh Gerstein, *Lawyers Circle After Failure of Hedge Fund*, N.Y. SUN, Oct. 20, 2006, Business Section at 1, *available at* http://www.nysun.com/article/41922.

225 *Id.*

226 *Id.*

VII. SOLUTIONS: IS RECOVERY IN SIGHT?

The holding in the *Goldstein* case effectively blocked a recent attempt by the SEC to bring the hedge fund industry within its regulatory scope. The Amaranth disaster that followed demonstrates the degree to which unregulated advisers can gamble with billions of investor dollars in a playing field with little to no oversight. Although Amaranth and LTCM avoided serious damage to the financial markets, future hedge funds may not be so lucky. Without the assistance of major financial institutions to "bail out" these failing entities, one must wonder how the cards would have played out. In many ways, it is unfair to allow hedge funds and their managers to operate in this manner and to make extremely risky bets without some degree of accountability. In the absence of regulatory control, hedge fund managers are free to play the market and gamble with investors' money, much like high-rollers at the roulette wheel. Although hedge funds stand to win big when they "double-down" with leveraged positions, they can also lose their bank roll, and bring devastating consequences to the entire market. As a result, industry experts are proposing solutions to "regulate the table" in an effort to avoid future pitfalls from the Las Vegas style investing techniques of many hedge fund advisers.

Although several hedge funds have risk management systems in place, these vary by firm in the absence of industry-wide standards.[227] Therefore, one potential solution is industry self-regulation, in which hedge funds would launch an overarching organization. Such an entity could model itself after the National Association of Securities Dealers ("NASD") or the National Futures Association, and would set standards for disclosure and other principles, as well as punish member firms for violations.[228] However, many critics of this proposition argue that the industry cannot be trusted to police itself; others argue that many funds may not join such an organization.[229]

Similarly, another solution is the potential for "risk ratings" of hedge funds by companies like Moody's and Morningstar, Inc.[230] Moody's recently published its

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[227] SEC STAFF REPORT, *supra* note 6, at 67.

[228] David Enrich & Arden Dale, *Hedge Fund, Regulate Thyself – Could Self-Policing Help Avoid More Government Oversight?*, WALL ST. J., Oct. 14, 2006, at B4.

[229] *Id.*

[230] *See* Serena Ng, *Moody's Offers Glimpse Inside a Hedge Fund – Sorin-Run Vehicle is the First to be Publicly Graded Based on Firm's 'Operational Risks,'* WALL ST. J., Sept. 5, 2006, at C1.

first operational risk rating of Sorin Capital Management, LLC, and hopes to conduct similar reviews in the future.[231] However, these ratings are voluntary and there is concern within the industry about releasing information regarding investment strategies and internal operations.[232] Thus, while ratings would offer significant information to investors, many funds may prefer to maintain their privacy. Much like the self-regulatory organization solution, fund ratings may have little effect on the problem of regulation or on the industry as a whole.

The best solution to achieve oversight of the hedge fund industry appears to be future congressional legislation. Almost immediately after the court's decision in *Goldstein*, a bill was introduced in the House to restore SEC Rule 203(b)(3)-2.[233] On June 29, 2006, Representative Barney Frank (D-MA) introduced a bill to "amend the Investment Advisers Act of 1940 to authorize the Commission to require the registration of hedge fund advisers under that Act."[234] If enacted, this bill would "authorize the . . . (SEC) to: (1) limit the availability of this exemption; and (2) require the registration of any investment adviser by requiring that certain shareholders, partners, and beneficial owners of, or investors in, clients of the adviser be counted as clients themselves."[235] The bill was referred to the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises on July 18, 2006 and awaits further congressional action in the next session.[236] Even if the bill is not adopted, it is clear that lawmakers realize the impact of hedge funds on financial markets and are taking steps toward industry regulation. Hedge fund critics hope that, even if this bill is not passed, a similar one will be proposed in the near future to regulate the reckless behavior of many funds and their advisers.

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[231] *Id.*

[232] *Id.*

[233] Securities and Exchange Commission Authority Restoration Act of 2006, H.R. 5712, 109th Cong. (2006).

[234] *Id.*

[235] *Id.*

[236] The Library of Congress, THOMAS, http://thomas.loc.gov/cgi-bin/bdquery/z?d109:HR05712:@@@L&summ2=m&.