FENDING FOR THEMSELVES: CREATING A U.S. HEDGE FUND MARKET FOR RETAIL INVESTORS

*Houman B. Shadab**

TABLE OF CONTENTS

* Senior Research Fellow, Regulatory Studies Program, Mercatus Center at George Mason University. B.A. 1998, University of California at Berkeley; J.D. 2002, University of Southern California. I would like to thank Jerry Ellig and Steven M. Davidoff for their invaluable comments and Christopher White for his research assistance. All errors are my own.

> "[T]he experience and background of these investors were such that they were in a position to make an informed investment decision, i.e., they could fend for themselves."[1]

Introduction

Time and time again, hedge funds have preserved investor wealth while broader markets experienced losses. A "hedge fund" is a type of private investment pool that actively trades securities (and perhaps other assets) and is not subject to the full range of disclosure obligations and limitations on investment activities imposed by the federal securities laws.[2] Although the U.S. hedge fund market is the largest in the world, among developed nations, it is one of the least accessible.[3] Only about 8.5% of U.S. households legally qualify to invest in hedge funds because retail investors, that is, nonwealthy individuals, are not

1. SEC v. Cont'l Tobacco Co., 463 F.2d 137, 157 (5th Cir. 1972).

2. There is no legal or universally accepted definition of "hedge fund." *See* SEC, Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission 3 (2003) [hereinafter SEC Staff Report]. Certain distinguishing characteristics of hedge funds are discussed *infra* in Parts I.A. and II.B.

3. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 406 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230 & 275) [hereinafter Accredited Natural Person Rule]; *see* PriceWaterhouseCoopers, Under the Spotlight: The Regulation, Taxation and Distribution of Hedge Funds Around the Globe 5 (2007) (noting that "hedge funds will continue to penetrate the retail market" around the globe).

permitted to invest in the funds.[4] By contrast, Australia, Switzerland, Hong Kong, Singapore, and Ireland have successfully permitted retail investors to invest in hedge funds, and other foreign jurisdictions such as the United Kingdom are in the process of expanding access. Although the Securities and Exchange Commission (SEC) has expressed interest in broadening access to investment strategies of the kind employed by the funds, it has yet to offer any concrete reform proposals. Indeed, the SEC is taking steps to even further limit access to hedge funds.[5] This Article proposes specific regulatory reforms to allow financially sophisticated retail investors to have access to and potentially benefit from hedge funds.[6] The reforms proposed here further the goal of investor protection and also create a framework for certain hedge funds to find it profitable to market and sell shares to retail investors.

The federal securities laws are based upon the premise that the primary danger to investors is from predation by unscrupulous promoters. However, existing regulation fails to adequately recognize that one of the greatest risks to ordinary retail investors is from market disturbances having nothing to do with fraud or human malfeasance.[7]

---

4. *Id.* For the purposes of this Article, a retail investor is an individual not meeting any of the wealth-based standards hedge funds typically rely upon to qualify for exemptions from significant aspects of the securities laws. These exemptions are discussed in detail in Part II.B *infra*. A retail investor is distinguishable from a "high net worth" individual. *See* Investopedia, http://www.investopedia.com/terms/h/hnwi.asp (last visited Nov. 26, 2007). *See also* Brian G. Cartwright, Gen. Counsel, U.S. SEC, Address at the University of Pennsylvania Law School Institute for Law and Economics n.1 (Oct. 24, 2007), *available at* http://www.sec.gov/news/speech/2007/spch102407bgc.htm ("By 'retail investor' I mean those investors who lack the sophistication or net worth to gain access to institutional markets; in other words, most individual investors. With this definition, however, some high net worth families and individuals don't qualify as retail investors.").

5. *See infra* notes 192–195 and accompanying text.

6. Financial sophistication means that an investor "either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." 17 C.F.R. § 230.506(b)(2)(ii) (2007) (crafting an exemption for offers and sales that are otherwise available only to accredited investors). *See also* Accredited Natural Person Rule, *supra* note 3, at 405 (noting that in the context of purchasing shares of private investment pools such as hedge funds "sufficient knowledge and financial sophistication . . . enable that purchaser to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment").

7. *See* Stephen G. Cecchetti & Lianfa Li, Monetary Policy and Capital Regulation: Is There a Conflict? 21 (Oct. 6, 2006) (conference draft for XIX Moneda y Crédito Symposium, *Monetary and Financial Stability: Harmony or Conflict*), *available at* http://www.fundacion.gruposantander.com/files/Moneda_y_Credito/cechetti.pdf (discussing the risks posed by financial imbalances and central banks' responses).

Due to the explosive growth and integration of global financial markets and rapid financial innovation, ordinary investors saving for their retirements by investing in a home mortgage, stocks, and bonds are nonetheless exposed to substantial investment risks. As demonstrated by losses in the subprime mortgage market spreading to the rest of the economy beginning in the summer of 2007, macroeconomic shocks can reduce the wealth of ordinary investors in even the most conservative investments.[8] Furthermore, "do-it-yourself" retail investors, at little cost, can now bear risks associated with the most complex trading strategies by investing in short-sales, leveraged trades, and all types of esoteric securities such as those based upon the value of foreign currencies, interest rate fluctuations, and intangible assets like intellectual property.[9] Hedge fund-like products are also rapidly proliferating in the retail marketplace.[10] Although these products do not perform as well as genuine hedge funds, they expose retail investors to the same kind of risks and investment complexity.[11]

The SEC is mandated by law to protect investors from suffering undue investment losses.[12] Investment losses harm investors whether the source of losses is fraud or investment risk. Accordingly, investors are protected not only when fraud is prohibited and prevented but also when investors are permitted to reduce the risk of loss to their portfolios by making investments commensurate with their level of financial sophistication. Retail investors seeking to invest in hedge funds likely have, either alone or with the assistance of a financial adviser, sufficient sophistication to make investment decisions that reduce the overall risk of their portfolios. Unsophisticated retail inves-

---

8. Subprime lending losses led to a substantial decline in stock prices and are expected to lead to a decrease in housing prices and increase in mortgage rates even for home owners not involved in subprime borrowing. *See* Karyn McCormack, *Stocks Tumble as Credit Fears Mount*, BUS. WEEK ONLINE, Aug. 15, 2007, *available at* http://www.businessweek.com/investor/content/aug2007/pi20070815_487622.htm; Lynn Asinof, *What You Need to Know About the Mortgage Industry's Woes*, BOSTON GLOBE, Mar. 18, 2007, at D1; Gerri Willis, *How the Subprime Fallout Affects You*, CNNMONEY.COM, Mar. 22, 2007, http://money.cnn.com/2007/03/22/pf/saving/toptips/index.htm.

9. *See infra* note 132 and accompanying text.

10. *See* discussion *infra* Part I.D.2.

11. *See infra* Part I.D.2.

12. *See, e.g.*, Securities Act § 2(b), 15 U.S.C. § 77b(b) (2000) ("Whenever pursuant to this subchapter the [Securities and Exchange] Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall . . . consider . . . the protection of investors . . . ."); Securities Exchange Act § 6(f), 15 U.S.C. 78f(a) (2000) ("[T]he Commission . . . may prescribe as necessary or appropriate in the public interest or for the protection of investors."); Investment Company Act § 2(c), 15 U.S.C. 80a-2c (2000) ("[T]he Commission shall . . . consider . . . the protection of investors. . . .").

tors, by contrast, invest very little as it is and would likely have no desire to invest in hedge funds.[13] Permitting sophisticated retail investors to invest in hedge funds therefore advances investor protection while continuing to prohibit them from doing so undermines it.

With the reforms proposed in this Article, neither the SEC nor Congress need eviscerate the federal securities regime or sacrifice investor protection. Part I finds that the defining features of hedge funds benefit investors. Modern portfolio economics, a body of knowledge rarely consulted by legal scholars recommending regulatory reform, makes clear that retail investors stand to gain the most from investing in genuine hedge funds as opposed to the hedge fund-like products currently available in the marketplace. In Part II, the two-tiered regulatory structure limiting hedge funds almost exclusively to the wealthy is examined in depth, and in Part III its rationales are found wanting. Compared to hedge funds not registered under the federal securities laws, registered investment vehicles employing hedge fund-like strategies are not uniformly safer, less complicated, or even more transparent in ways important to retail investors. Part IV proposes a novel approach to establishing a regulatory framework for sophisticated retail investors to have access to hedge funds and for the funds to find it attractive to sell to retail investors. Unlike previous reform proposals and how foreign markets enable retail access to hedge funds, this Article recommends utilization of one of the most cutting edge innovations in financial markets: the establishment by large financial institutions of electronic trading platforms for shares of privately placed securities similar to those issued by hedge funds.

I.
Hedge Funds and Retail Investing

Hedge funds are a unique type of investment fund and their superior risk-adjusted performance owes much to their distinguishing characteristics and operations. Overall trends in the hedge fund industry have made them more institutionalized, sophisticated, and accountable. Although retail investors currently have no direct access to hedge funds, a retail fund should retain the distinguishing characteristics of hedge funds to provide the most value to investors.

A. Distinguishing Structure and Operation of Hedge Funds

"Hedge fund" is a term for a diverse class of private investment companies that pool together capital from several investors into a

13. *See infra* Part III.B.1.

fund. What unifies hedge funds is not their employment of a particular investment strategy or class of assets, or even that they all "hedge" their investments (they do not). Rather, hedge funds are distinct from other investment funds by their status under federal securities law,[14] their internal structure and relationship with investors, and their wide range of investment practices.[15]

Hedge funds are usually structured as a limited partnership, but sometimes as a limited liability company, and each investor in the fund is a limited partner.[16] The general partner of the fund is typically a limited liability company or a corporation.[17] The general partner is typically also the investment adviser or manager of the fund, giving the general partner wide latitude in activities such as managing the fund's investment portfolio and structuring compensation.[18] In accordance with partnership law, the general partnership has unlimited liability for debts not able to be satisfied by the limited partnership's funds.[19]

The other characteristic features of hedge funds have by and large been found by financial economists to improve the welfare of investors. Although not required by state partnership statutes, the general partnership or individual general partners (managers) often co-invest a significant portion of their liquid net worth directly in the fund as limited partners.[20] Direct participation in gains and losses by

---

14. The unique posture of hedge funds under the federal securities laws is examined in detail Part II.B. For clarity, only general references to such laws are made in this Part.

15. Although hedge funds share the same legal posture and much of the same internal structure as other investment funds such as private equity funds, hedge funds' investment activities make them unique. Thus, while hedge funds typically make short-term trades in publicly traded securities, private equity funds make long-term investments in illiquid private assets and often engage in buyouts, turnarounds, and active management of under-performing companies in their portfolio. *See* SEC STAFF REPORT, *supra* note 2, at 7–8; Jonathan Bevilacqua, Comment, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 BUFF. L. REV. 251, 260 (2006). A notable trend in the financial markets is the extent to which hedge funds are engaging in activities traditionally performed by private equity firms. *See generally id.*

16. DOUGLAS L. HAMMER ET AL., SHARTSIS FRIESE LLP, U.S. REGULATION OF HEDGE FUNDS 3 (2005).

17. *Id.* at 91–93. Organizing as a general partnership is crucial to the fund and the general partner for tax efficiency purposes. As partnerships, neither the fund nor the general partner is taxed at the entity level; all income, gains, losses, and deductions "pass through" to the partners who report such items on their own personal income tax returns. *Id.* at 88–89.

18. *Id.* at 90–91.

19. *Id.* at 92.

20. *Id.* at 92; SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 2:2.2 (2007). Using a comprehensive database of hedge funds from 1994 to 2002, Agarwal et al. found

managers likely helps to align the incentives between managers and investors—by curtailing excessive risk-taking, for example—and thereby leads to higher performance.[21]

Compensation for the general partner-manager comes from two sources. Hedge fund managers, similar to other asset managers, charge investors an annual management fee typically ranging from 1–2% of total assets under management.[22] In addition, the manager charges a performance-based (incentive) fee usually around 15–20% of gains.[23] Charging a performance fee is a defining feature of hedge funds and is generally prohibited for investment fund managers registered under the federal securities laws.[24] Another distinguishing feature of hedge fund compensation is the use of high water marks and hurdle rates. A high water mark limits the manager's performance fee to only a portion of gains in a given investor's account, meaning that an investor will not be charged a performance fee until any previous losses are recouped.[25] A hurdle rate is the minimum rate of return a fund must achieve before a performance fee can be charged, but this is a relatively uncommon feature among the funds.[26] Empirically, most studies find a positive correlation between the level of incentive fees and performance.[27] Looking at the combined incentives facing hedge

---

the average investment by managers to be 7.1%, with the median manager owning 2.4% of fund assets. Vikas Agarwal et al., Role of Managerial Incentives and Discretion in Hedge Fund Performance 35 (Mar. 1, 2007) (unpublished article, *available at* http://ssrn.com/abstract=889008).

21. The empirical data isolating the impact of fund manager ownership is sparse. One paper found a significant positive correlation between managerial ownership and performance such that a one standard deviation increase in ownership increases returns by about 1.5%. Agarwal et al., *supra* note 20, at 5, 17. *See also* Cécile Le Moigne & Patrick Savaria, *Relative Importance of Hedge Fund Characteristics*, 20 FIN. MARKETS PORTFOLIO MGMT. 419, 424 (2006) (compiling statistics from hedge funds that show that personal investment positively correlates with returns).

22. *See* HAMMER ET AL., *supra* note 16, at 327.

23. JAMES R. BARTH ET AL., MILKEN INST., HEDGE FUNDS: RISKS AND RETURNS IN GLOBAL CAPITAL MARKETS 32–33 (2006).

24. LEDERMAN, *supra* note 20, § 2:2.3 ("[T]he assessment of performance based fees or profit allocations . . . has been a significant distinguishing characteristic [of hedge funds] from traditional money management."). The inability of registered investment funds to charge performance-based fees is discussed *infra* in notes 176–178, 217 and accompanying text.

25. HAMMER ET AL., *supra* note 16, at 329.

26. *Id.* at 330–31 (noting that a hurdle rate may be structured only to enable the manager to charge a fee on gains above the hurdle rate or to allow a performance fee to be charged on the entire gains so long as the hurdle is exceeded).

27. *See* Bing Liang, *On the Performance of Hedge Funds,* 55 FIN. ANALYSTS J. 72, 78 (1999) (finding that "a high incentive fee is able to align the manager's incentive with fund performance"); Franklin R. Edwards & Mustafa O. Caglayan, *Hedge Fund Performance and Manager Skill*, 21 J. FUTURES MKTS. 1003, 1014 (2001) (finding

fund managers, hedge funds perform better in the presence of higher performance fees, more managerial co-investment into the fund, and higher high water marks.[28] The evidence is somewhat mixed regarding the impact of performance fees and high water marks on the chances of hedge fund failure, although no study has found that funds with both higher incentive fees and high water marks have an increased probability of failure.[29] Career concerns have also been found to constrain hedge fund managers who might otherwise take on too much risk to earn performance fees.[30]

Finally, hedge funds generally limit the ability of investors to redeem their shares. Most hedge funds allow investors to redeem shares on a quarterly or other periodic basis.[31] A fund may also implement a "lockup" period of anywhere from six months to two years, during which withdrawals of an initial investment are prohibited, require prior notice before funds can be removed, and limit how much capital can be withdrawn on a given date.[32] Greater managerial discretion in the form of longer lockup, and notice periods, and less frequent redemption periods has been correlated with higher performance. Longer capital commitments can benefit investors as a whole where the fund invests in illiquid assets that may expose the fund to the risk of investors overreacting to a short-term asset price decline by seeking

---

that "successful hedge funds appear to pay much higher incentives fees" based upon a sample of hedge funds from January 1990 to August 1998); Hung-Gay Fung et al., *Global Hedge Funds: Risk, Return, and Market Timing*, 58 FIN. ANALYSTS J. 19, 25–26, 28 (2002) (finding that incentive fees have a significant positive impact on a hedge fund's risk-adjusted return). *But see* BARTH ET AL., *supra* note 23, at 60 (finding that higher performance fees have no impact on fund performance); WALTER GÉHIN, EDHEC RISK & ASSET MGMT. RESEARCH CTR., A SURVEY OF THE LITERATURE ON HEDGE FUND PERFORMANCE § 2.1.4 (2004) (discussing mixed findings on the relation between performance fees and fund performance).

28. Agarwal et al., *supra* note 20, at 5; Liang, *supra* note 27, at 74 (finding that funds with high water marks outperformed funds without).

29. *See* BARTH ET AL., *supra* note 23, at 63–64 (funds with higher management and performance fees are less likely to fail); Naohiko Baba & Hiromichi Goko, *Survival Analysis of Hedge Funds* 27 (Bank of Japan, Working Paper No. 06-E-05, 2006) (finding funds with higher incentive fees are less likely to survive while funds with high water marks are more likely to survive). *But see* Guillermo Baquero et al., *Survival, Look-Ahead Bias, and Persistence in Hedge Fund Performance*, 40 J. FIN. & QUANTITATIVE ANALYSIS 493, 504 (2005) ("[T]he higher the incentive fee, ceteris paribus, the more likely it is that the fund will liquidate in the next quarter.").

30. Stephen J. Brown et al., *Careers and Survival: Competition and Risk in the Hedge Fund and CTA Industry*, 56 J. FIN. 1869, 1884–85 (2001).

31. HAMMER ET AL., *supra* note 16, § 1.2.

32. LEDERMAN, *supra* note 20, § 2:3.3, at 2-16–17; BARTH ET AL., *supra* note 23, at 38 (showing that a majority of hedge funds have a lockup period of less than one quarter).

to redeem shares all at once.[33] Greater discretion allows managers to be more flexible or capture the gains from investing in illiquid assets without investors prematurely withdrawing funds.[34] Studies have also found that funds with longer lockup periods and less frequent redemption policies are less likely to fail.[35] High water marks may also be used to get investors to agree to make long-term capital commitments through lockup and notice periods.

Another defining characteristic of hedge funds is the use of unique investment and trading strategies to earn returns. Traditional investment strategies typified by publicly registered mutual funds are long-only strategies that purchase stocks and bonds and seek to earn returns relative to how the overall market, or some sector of it, is performing.[36] By contrast, hedge funds pursue absolute return strategies, seeking gains regardless of the relative direction of the market.[37] The funds pursue absolute returns through the employment of specific investment strategies or a combination of strategies. Some of the more common distinct strategies employed by hedge funds include long/short equity, corporate-event driven, and market-neutral funds (accounting for 17, 10, and 8% of hedge fund assets under management, respectively).[38] Funds of hedge funds (FOHFs) are hedge funds that invest in a portfolio of underlying hedge funds, and they comprise the largest portion of the industry, accounting for approximately 30% of assets.[39] Unlike mutual funds, which must typically stick to a particular investment strategy, hedge funds are relatively flexible and may

33. *See* George O. Aragon & Jun "QJ" Qian, Liquidation Risk and High-Water Marks 24 (Mar. 2006) (draft article, *available at* http://www.mfrc.mcgill.ca/documents/QianJun.pdf).

34. Agarwal et al., *supra* note 20, at 9–10, 17. *See also* Liang, *supra* note 27, at 78 (finding that hedge fund performance increases with longer lockup periods).

35. BARTH ET AL., *supra* note 23, at 63–64; Baba & Goko, *supra* note 29, at 27–28 ("[F]unds with a longer redemption notice period and a lower redemption frequency have higher survival probabilities.").

36. *See* LEDERMAN, *supra* note 20, § 1:3 (noting that traditional investment strategies consist of stock, bond, and other fixed-income investments); Liang, *supra* note 27, at 78–81 (contrasting hedge funds with mutual funds and other traditional investment vehicles). *See infra* Part II.A (defining and discussing the legal posture of mutual funds).

37. LEDERMAN, *supra* note 20, § 1:3.

38. BARTH ET AL., *supra* note 23, at 18. Long/short equity funds seek gains by buying certain stocks long and selling others short. *See id.* at 16. Corporate event driven funds seek returns on events like mergers or bankruptcies. *See id.* Market-neutral funds seek returns by using arbitrage to take advantage of price discrepancies. *See id.* For a definition of a short-sale, *see infra* note 42.

39. *See* BARTH ET AL., *supra* note 23, at 20. FOHFs are discussed in detail in Part I.D.1 *infra*. The term "hedge funds" as used in this Article refers to both hedge funds not invested in other funds and FOHFs, unless otherwise distinguished.

switch strategies and the types of assets in which they invest over time.[40] Investment flexibility likely benefits investors by allowing managers to adapt to changing market conditions. Indeed, one study found that poorly performing funds generally perform better after switching styles.[41]

Another defining characteristic of hedge funds is the utilization of non-traditional investments involving short sales, derivatives, and significant amounts of leverage.[42] Leverage is a means of magnifying gains or losses and includes not only borrowing capital or securities but also purchasing derivatives and short-selling securities.[43] Derivatives trading allows hedge funds to manage risk.[44] These unique trading strategies provide a value to investors that traditional investments do not.[45]

B. Trends in the Hedge Fund Industry

By nearly every measure, the hedge fund industry has grown in economic significance and is expected to continue doing so. From 1999 to 2004, the global hedge fund industry nearly doubled in size, growing from an estimated $456 billion in assets under management to $973 billion, with the number of funds (including FOHFs) also approximately doubling to 7436 from 3617.[46] By the first quarter of

---

40. LEDERMAN, *supra* note 20, § 1:2.3. Being a registered investment company may limit the ability of a fund to change its strategy over time. *See id.* § 5:2.7.

41. *See* Ramin Baghai-Wadji & Stefan Klocker, Performance and Style Shifts in the Hedge Fund Industry 33–34, 36–37 (Feb. 27, 2007) (unpublished article, *available at* http://ssrn.com/abstract=920444).

42. A derivative is a security whose price is derived from the value of some other asset. STEPHEN G. CECCHETTI, MONEY, BANKING AND FINANCIAL MARKETS 202–03 (2006). A short-sale is a way to profit from a price decline. *See id.* at 204. It requires the short-seller to borrow securities, sell them, repurchase them at a lower price, and return the securities to the lender. *Id.* If successful, the short-seller profits by the amount of the price minus the cost to borrow the shares. *See id.*; LEDERMAN, *supra* note 20, §1:1, 1–3.

43. LEDERMAN, *supra* note 20, §1:1, 1–4.

44. Yong Chen, Derivatives Use and Risk Taking: Evidence from the Hedge Fund Industry 2 (Sept. 12, 2006) (unpublished article, *available at* http://www.fma.org/SLC/DSS/Deriv-FMA.pdf) (finding hedge funds that use derivatives exhibit lower risk than nonusers). However, accurately pricing complex and illiquid derivatives remains a significant challenge. *See* ALTERNATIVE INV. MGMT. ASS'N, ASSET PRICING AND FUND VALUATION PRACTICES IN THE HEDGE FUND INDUSTRY 6 (2005) (finding that pricing illiquid and complex derivatives were identified by hedge fund managers to be their most significant valuation challenge) [hereinafter AIMA 2005 SURVEY].

45. *See* discussion *infra* Part I.C.

46. COUNTERPARTY RISK MGMT. POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE app. at B-10 (2005) [hereinafter CRMPG STUDY].

2007, hedge funds managed about $1.5 trillion in assets globally, spread across more than 13,000 funds.[47] They will likely surpass $2 trillion in assets before the end of the decade[48] and may even reach $6 trillion by 2015.[49] The U.S. market accounts for over $1 trillion of the global industry.[50] As a proportion of total investment into hedge funds, individuals' direct investment (i.e., not through FOHFs, pension plans, or other institutions) is decreasing and projected to continue decreasing while that of institutional investors, especially pensions, is on the rise.[51] In non-U.S. jurisdictions, retail investors are expected to increase their investments into hedge funds.[52]

Large financial institutions are increasingly providing hedge fund-adviser (management) services. Two of the largest hedge fund managers in the United States are Goldman Sachs and JPMorgan Asset Management;[53] other large investment banks are making inroads into the sector through acquisitions of single-manager funds.[54] Prime brokerage services (e.g., lending, trade clearing, and risk management) are typically carried out by established investment banks and securities broker-dealer firms registered with the SEC.[55] As hedge funds have become larger, more sophisticated, and employ more complex

---

47. *See* Press Release, HedgeFund Intelligence, Global Hedge Fund Assets Surge to $1.5 Trillion According to HedgeFund Intelligence Research (Mar. 27, 2006), *available at* http://www.hedgefundintelligence.com/images/590/globalhedgefundassets-asiahedge.pdf; Ken Schachter, *Hedge Funds Grow Like Kudzu*, RED HERRING, Feb. 26, 2007, *available at* http://www.redherring.com/Home/21446.

48. *See*, *e.g.*, Denise Valentine, *The Hedge Fund Marketplace Today*, BUILDING AN EDGE (IBM), Mar. 22, 2005, at 7.

49. GEORGE P. VAN, VAN HEDGE FUND ADVISORS INT'L, HEDGE FUND DEMAND AND CAPACITY 2005–2015, at 6 (2005).

50. Alex Akesson, *Survey Shows US Hedge Funds to Hold $1,200 Billion In Assets*, HEDGECO.NET, Mar. 6, 2007, http://www.hedgeco.net/news/03/2007/survey-shows-us-hedge-funds-to-hold-billions-in-assets.html.

51. BANK OF N.Y. & CASEY, QUIRK & ASSOCS., INSTITUTIONAL DEMAND FOR HEDGE FUNDS 2, at 14 (2006) (predicting that retirement plans will constitute 65% of asset flows to hedge funds through 2010).

52. PRICEWATERHOUSECOOPERS, *supra* note 3, at 5.

53. Shaheen Pasha, *Banks' Love Affair With Hedge Funds*, CNNMONEY.COM, Oct. 6, 2006, http://money.cnn.com/2006/10/05/news/companies/banks_hedgefunds/index.htm?postversion=2006100607.

54. *See* William Hutchings, *Banks Place Big Bets on Growth*, FIN. NEWS ONLINE, Nov. 22, 2006, http://www.efinancialnews.com/homepage/peoplemoves/content/1046676662/restricted; *Morgan Stanley: A Big Bet on Hedge Funds*, BUSINESSWEEK.COM, Nov. 1, 2006, http://www.businessweek.com/investor/content/nov2006/pi20061101_517314.htm?chan=top+news+index_businessweek+exclusives.

55. *Regulation of the Hedge Fund Industry: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs,* 108th Cong. (2004) (statement of Charles J. Gradante, Managing Principal of The Hennessee Group LLC), *available at* http://banking.senate.gov/_files/gradante.pdf ("The top 10 Prime Brokers [of all hedge funds] are registered broker dealers and regulated by the SEC.") [hereinafter Gradante

trading strategies, prime brokers face increasing pressures to deliver more sophisticated, integrated, and customized services to remain competitive.[56] Greater sophistication and the ability to provide customized services places the hedge fund industry in a better position to provide standardized and low-cost services to retail investors.

Although hedge fund operations have increased in complexity during the past decade, there is no empirical basis to conclude that such complexity has increased their risk to investors. To the contrary, in important ways, hedge funds have become less risky than in prior years.[57] Generally, as financial markets have become more complex, those markets have also become more stable.[58] Hedge funds have likewise increased their stability, or decreased some of their risks to investors, in part *because of* their increasingly complex transactions and trading strategies, not in spite of it.[59]

Lower risk to investors is also the result of improved industry-wide risk management practices.[60] The hedge fund industry has substantially improved its risk management practices since the massive contraction of hedge fund Long Term Capital Management (LTCM) in 1998.[61] In response to LTCM, twelve major commercial and in-

---

Testimony]; BARTH ET AL., *supra* note 23, at 45 (implying that of the funds reporting which prime broker they utilized, 69% utilized large and well-known financial firms).

56. *See, e.g.*, *Cutthroat Competition*, MARHEDGE, Dec. 5, 2005, at 17; Paul Allen, *Prime Time for Primes*, WALL STREET & TECH., Mar. 2006, at 35, 35; *Prime Brokerage Debate: The Race to Keep Up With the Clients*, EUROMONEY, Nov. 2006, http://www.euromoney.com/article.asp?PositionID=5056&ArticleID=1083644; *Service Provider Battle Shifts to the Middle Office*, HEDGEWEEK, Jan. 8, 2007, http://www.hedgeweek.com/articles/pdf_page.jsp?content_id=44845.

57. "Risk" is the chance of economic loss. *See* discussion *infra* Part I.C.

58. *See* CRMPG STUDY, *supra* note 46, at app. B-10.

59. For example, the development of derivatives transactions known as "credit default swaps" allows hedge funds and other financial entities to manage exposures to the risks involved with lending. *See* STACEY FACTER, JPMORGANCHASE, CREDIT DEFAULT SWAPS AND TRADE: A USEFUL TOOL FOR DISTRIBUTING RISK, http://www.jpmorgan.com/cm/ContentServer?c=TS_Content&pagename=jpmorgan%2Fts%2FTS_Content%2FGeneral&cid=1136555202065 (last visited Feb. 5, 2008); CRAIG M. VARRELMAN & LEWIS TATANANNI, GE ASSET MGMT., CREDIT DEFAULT SWAPS—INTO THE MAINSTREAM (2005), *available at* http://www.geam.com/common/newsdocs/wp_credit_default.pdf.

60. Press Release, Mercer Oliver Wyman, New Study Reveals Strengthened Global Hedge Fund Industry Risk Management Practices and Highlights Areas for Improvement 1 (June 20, 2006), *available at* http://www.oliverwyman.com/ow/pdf_files/Global_Hedge_Fund_RM_MOW_0606.pdf.

61. *See* PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT viii (1999), *available at* http://treas.gov/press/releases/reports/hedgfund.pdf (reporting findings of U.S. financial market regulators after the collapse of LTCM). *But see* Fin. Economists Roundtable, *Statement on Long-Term Capital Management and the Report of the President's Working Group on Financial Markets*, FINANCIER, Summer 1999, at 6, 6–7 (criticiz-

vestment banks formed the Counterparty Risk Management Policy Group. This group issued two detailed reports, one in June of 1999 and another in July of 2005, explaining how the financial sector could improve risk management practices.[62] Hedge funds have largely followed such recommendations by continuing to standardize procedures, employing more sophisticated controls, and committing significant resources to risk personnel, operations, and external monitoring.[63] For example, the use of "stress testing" to observe responses to extreme price movements is now pervasive throughout the industry.[64]

These improvements are driven by the underlying economics of the industry, indicating that hedge funds and counterparties[65] will have the incentive and the means to continue toward greater stability. First, the rising involvement of large investment banks and other institutions as fund managers and prime brokers[66] increases the funds' and counterparties' ability to bear and monitor risk because such parties have more resources and likely have more sophisticated management systems and expertise than stand-alone funds. Second, hedge funds are seeking to improve and disclose more information about their risk management practices to attract capital from large institutional investors.[67] This would benefit retail investors without substantial bargaining power as such practices become standardized across the industry.

ing findings and policy recommendations of President's Working Group regarding LTCM).

62. *See* CRMPG STUDY, *supra* note 46, at 1. Other groups have also since released hedge fund best practice guidelines. *See generally* MANAGED FUNDS ASSOC., SOUND PRACTICES FOR HEDGE FUND MANAGERS (2005); AIMA 2005 SURVEY, *supra* note 44.

63. *See* Press Release, Mercer Oliver Wyman, *supra* note 60, at 1.

64. *Id.* at 5.

65. A "counterparty" is simply the other party taking part in a financial transaction. *See, e.g.*, Investopedia, http://www.investopedia.com/terms/c/counterparty.asp (last visited Feb. 5, 2008).

66. *See* Pasha, *supra* note 53 (describing banks' increasing involvement with hedge funds).

67. *See* BANK OF N.Y. & CASEY, QUIRK & ASSOCS., *supra* note 51, at 8–10; Lauren Keyson, *Top Five Hedge Fund Trends For 2007*, FORBES.COM, Jan. 18, 2007, http://www.forbes.com/2007/01/19/hedge-funds-snl-pf-ied-in_lk_0118soapbox_inl.html; Allen, *supra* note 56, at 35 ("Market maturity—specifically the institutionalization of the investor universe and heightened regulation—means hedge funds are facing demands for better risk analysis, performance measurement and reporting; more robust operational infrastructures; and greater transparency."); BARRY KOLATCH & LYNN CONNOLLY, DELOITTE RESEARCH, PRECAUTIONS THAT PAY OFF: RISK MANAGEMENT AND VALUATION PRACTICES IN THE GLOBAL HEDGE FUND INDUSTRY 2 (2007) ("[Hedge funds] that will thrive in this new competitive environment will be those that pay particular attention to risk management and valuation so that they can attract institutional funds. . . .").

Several indicators suggest that improved risk management practices have, indeed, reduced risks to investors and will continue to do so. Hedge fund failure rates have decreased during the past several years and are expected to keep decreasing.[68] The more careful studies distinguishing between hedge funds that stop reporting to databases from those that cannot continue to operate find failure rates somewhere between 3–5%, with no trend of increasing failure.[69] As opposed to failures from poor investment decisions, operational issues (e.g., fraud, trade processing, and accounting) are the primary reasons why hedge funds fail,[70] suggesting that failure rates may decrease due to the improvements being made in operational management. Managers close hedge funds more often due to failing to meet performance expectations rather than being forced to cease operations due to poor investment choices.[71] Importantly, larger funds, and those with more experienced managers, tend to have lower failure rates, suggesting the industry may be less prone to failure as the average fund size grows and industry experience becomes more widespread.[72] In addition, one study found that as of March 2003, only 4% of hedge funds, represent-

68. *Hedge Fund Attrition Rate Continues to Decline, Says Hennessee*, HEDGEWEEK, Feb. 1, 2007, http://www.hedgeweek.com/articles/detail.jsp?content_id=47820.

69. Fabrice Rouah, Competing Risks in Hedge Fund Survival 26 (Jan. 2006) (unpublished article, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=840505) (finding failure rate to be 3–5% with no trend of increasing); Hyuna Park, Risk Measures for Hedge Funds and a Survival Analysis 27 (Sept. 2006) (unpublished article, *available at* http://www.isenberg.umass.edu/doctoral/uploads/listWidget/15052/Ch2_Survival_HyunaPark.pdf) (finding the "real failure" rate for hedge funds at 3.1% and lower than the attrition (closure) rate of 8.7%).

70. *See* THE CAPITAL MKTS. CO., UNDERSTANDING AND MITIGATING OPERATIONAL RISK IN HEDGE FUND INVESTMENTS: A CAPCO WHITE PAPER 5 (2005), *available at* http://www.capco.com/assets/DFA90A4A-E6DD-4F62-9466-ACD1A05A25FF.pdf (finding that "54% of failed funds had identifiable operational issues and half of all failures could be attributed to operational risk alone"); Interview with Jean-René Giraud, CEO of EDHEC-Risk Advisory, Jan. 18, 2006, http://www.edhec-risk.com/site_edhecrisk/public/Interview/RISKArticle.2006-01-18.3323 ("[M]ore than 60% of hedge fund failures can be directly related to operational issues that have nothing to do with the financial performances and risks of the investment . . . [w]ith two-thirds of these operational failures being directly related to different forms of fraud. . . ."); CORENTIN CHRISTORY ET AL., EDHEC RISK & ASSET MGMT. RESEARCH CTR., QUANTIFICATION OF HEDGE FUND DEFAULT RISK 4 (2007) ("[I]n the case of blow-ups, operational risk greatly exceeds the risk related to the investment strategy. . . .").

71. *See* THE CAPITAL MKTS. CO., *supra* note 70, at 4 ("[D]iscretionary fund closures . . . are much more frequent and are often driven by the business or market expectations of the fund manager."); Park, *supra* note 69, at 27.

72. *See, e.g.*, Nicholas Chan et al., *Systemic Risk and Hedge Funds* 71 (MIT Sloan Sch. of Mgmt., Working Paper No. 4535-05, 2005), *available at* http://ssrn.com/abstract=671443 (finding that age, assets under management, cumulative returns, and fund flows have a significantly negative impact on liquidation probability); Baba &

ing 1% of assets, are "undercapitalized," meaning that they do not have enough equity relative to the risk of their underlying investments.[73]

Hedge funds, nonetheless, still face significant risk management challenges, in particular from valuation of illiquid assets and operational risks associated with private, over-the-counter derivatives trading.[74] There are also some indications that new risks have emerged, largely due to the recent growth in the number of hedge funds. First, as more funds enter an increasingly crowded market, some funds may find it more difficult to earn returns without taking on added risk, and consequently, a greater absolute number of firms may fail.[75] Second, hedge funds' returns may be increasingly correlated to general market trends as the industry grows, implying a greater vulnerability to market risk factors.[76] Nonetheless, these new risks do not seem to have substantially diminished the value of hedge funds to investors given the continued and projected increases in hedge fund investments.[77]

In sum, joining the mainstream of financial markets has made hedge funds more accountable, more transparent, and provided important institutional constraints on funds' activities. When publicly traded financial firms offer hedge funds and act as prime brokers that finance trades and lend securities to the funds, they put their own capital and reputations on the line and hence have strong incentives to manage risk and monitor fund investments.[78] There is practically no

---

Goko, *supra* note 29, at 27 (finding funds with greater assets under management have higher survival probability).

73. Anurag Gupta & Bing Liang, *Do Hedge Funds Have Enough Capital? A Value-at-Risk Approach*, 77 J. FIN. ECON. 219, 248 (2005).

74. KOLATCH & CONNOLLY, *supra* note 67, at 2, 8, 12–13 (noting deficiencies in hedge fund practices such as insufficient utilization of independent third-parties for valuation and insufficient use of stress testing); Benjamin S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Hedge Funds and Systemic Risk, Remarks at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006), (transcript available at http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm) (noting potential problems with settling over-the-counter trades in credit derivatives); AIMA 2005 SURVEY, *supra* note 44, at 6.

75. Baba & Goko, *supra* note 29, at 28 (finding that as the number of total hedge funds becomes larger the survival probability significantly falls); Justin Lahart, *Ahead of the Tape*, WALL ST. J., Feb. 12, 2007, at C1.

76. *See, e.g.*, BARTH ET AL., *supra* note 23, at 54 (noting increased correlations between hedge fund returns and equity returns such that "rather than being a good hedge to stock returns, hedge fund returns have recently tended to move more closely in line with them").

77. *See supra* notes 48–49 and accompanying text.

78. As the consequences of the summer 2007 collapse of two Bear Stearns hedge funds illustrate, potential losses from failing to appropriately manage risk include a substantial drop in stock price, legal liability, accounting losses, job losses, and a loss

risk that an established financial firm would sponsor a retail hedge fund to dupe unwary unsophisticated investors into buying its shares based on a false promise of exorbitant returns. Unlike unestablished companies that may attempt to profit from bilking investors out of their money and then disappearing,[79] established financial firms have a long-term presence and other lines of business to protect and therefore have substantial economic incentives to make truthful and accurate representations to hedge fund investors. Because established financial firms would likely be the primary providers of hedge funds to retail investors if such a market existed,[80] retail investors would benefit from the institutional safeguards that go along with their services.

C. *Retail Investing: Risk, Return, and Portfolio Diversification*

To get the most benefit from investing, investors should seek to maximize returns for the level of risk they are willing to bear—so-called risk-adjusted returns.[81] Risk is simply "the chance that . . . the

---

in hedge fund and prime brokerage clientele. *See* Grace Wong, *Pink Slips Hit Wall St.; Bear Stearns Pares 240*, CNNMONEY.COM, Aug. 17, 2007, http://money.cnn.com/2007/08/16/markets/wall_street_bonuses_jobs/ (reporting that Bear Stearns fired approximately 240 employees, including its co-president, subsequent to large hedge fund losses); Vikas Bajaj, *Bear Stearns Shakes Up Funds Unit*, N.Y. TIMES, June 30, 2007, at C1 (reporting that Bear Stearns fired the executive in charge of two collapsed hedge funds); Dan Wilchins & Dane Hamilton, *Bear Rivals Say Courting Prime Broker Clients*, REUTERS, Aug. 24, 2007 (reporting that Bear Stearns may lose prime brokerage business and be less able to extend credit due to losses in its hedge funds business); Mark Pittman, *Bear Stearns Fund Collapse Sends Shock Through CDOs*, BLOOMBERG.COM, June 21, 2007, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=ahWfhEJ7dra4 (reporting that Bear Stearns' hedge "funds had borrowed at least $6 billion from the biggest names on Wall Street"); James Herron, *Fund Investors Launch Bear Claims*, USATODAY.COM, Aug. 1, 2007, http://www.usatoday.com/money/economy/2007-08-01-4138637345_x.htm (describing an arbitration claim filed against Bear Stearns by investors in its failed hedge funds).

79. *See, e.g.,* Matt Apuzzo, *Ex-Student's Phony Fund Attracted Millions*, CHI. TRIB., June 7, 2006, at 4 (reporting that a man fraudulently posed as a hedge fund representative and "forged multimillion-dollar checks and passed them quickly through banks in Greenwich, New York and Switzerland, hoping to cash out before they caught on").

80. *See* Gail Marks Jarvis, *Taking All Ego Out of Investing in Hedge Funds*, CHI. TRIB., Oct. 29, 2006, at 5.

81. Risk-adjusted return is a measure of an investment's return compared to how risky the investment is. *See* LEDERMAN, *supra* note 20, § 1:3. The standard measure of risk-adjusted returns is the Sharpe ratio. *Id.* A Sharpe ratio is calculated by dividing an investment's return in excess of the return to a hypothetical "risk-free" investment (typically proxied by the return on the ninety-day U.S. Treasury bill) by the standard deviation of the returns (i.e., how dispersed the investment's returns are around its average). *Id.*

securities you hold will fall in price."[82] The fundamental and well-documented relationship between a security's risk and return characteristics is that they rise and fall together: to receive a higher rate of return, an investor must bear more risk.[83] Modern finance has one overriding lesson: investors can minimize risk by placing their capital into a diverse portfolio of securities from numerous different issuers and different types of assets (e.g., stocks, bonds, commodities, real estate, etc.).[84] Diversification reduces risk to the extent the performance of the securities in a portfolio are not related to each other.[85] That way, if some securities perform poorly, others may perform well, and the net effect is to insulate a portfolio from overall losses. As Nobel prize-winning economist James Tobin aptly summarized, diversification means "don't put all your eggs in one basket."[86]

Because the performance of a company's securities depends on, or is correlated with, various external market factors separate from how the company itself is performing (e.g., interest rates, consumer spending, the value of the dollar), in practice, diversification requires creating a portfolio of securities whose returns are not correlated with the same external market factors.[87] However, it is impossible to completely eliminate risk through diversification. This is because the returns of most securities have at least some correlation to external market movements, and thus, to some extent, move up and down in tandem.[88] This market-correlation risk, which cannot completely be diversified away, is identified by economists as "systematic" risk.[89] Thus, when choosing to add new securities to an already-existing portfolio, an investor's basic choice is whether to increase or decrease overall risk and expected returns by creating a portfolio more or less correlated with general market factors.[90] For instance, an investor can almost completely eliminate risk by investing in low-yield U.S. gov-

82. Burton G. Malkiel, *A Random Walk Down Wall Street, in* FOUNDATIONS OF CORPORATE LAW 29, 29 (Roberta Romano ed., 1993).

83. *Id.* at 30.

84. *Id.* at 32.

85. *See id.* at 32–33.

86. James Tobin, Nobel Economists Lecture Series at Trinity University (Apr. 30, 1985) (transcript available at http://www.trinity.edu/nobel/Tobin_files/Tobin%20web%20quotes.htm).

87. Malkiel, *supra* note 82, at 33–34.

88. *Id.* at 33.

89. *Id.* at 34. By contrast, the risks that arise from company-specific characteristics or actions (e.g., poor business judgment, employee retention, financial misstatements) are "unsystematic" or idiosyncratic risks and can be substantially reduced through diversification because such risks are not correlated with general market trends and the returns of other issuers. *Id.* at 35.

90. *Id.* at 36.

ernment bonds because their returns are practically guaranteed and thus have no correlation with external market trends.[91]

When portfolio diversification is the goal of investing, the value of hedge funds becomes evident. Hedge funds' pursuit of absolute returns is just another way of stating that they pursue returns uncorrelated with general market factors, or returns with low systematic risk.[92] The empirical evidence shows that hedge funds, despite significant differences by type and over time, have been successful in obtaining positive returns throughout various market conditions.[93] While hedge fund returns are not always greater than those of traditional investments, due to manager skill, they have generally achieved superior risk-adjusted returns—so-called "alpha."[94]

Figure 1 compares average yearly hedge fund returns (as measured by two separate academic studies) to those of the general market (as measured by returns to the S&P 500 Index) from 1996 to 2003.[95]

---

91. Economists typically use the rate of return on a short-term U.S. Treasury bill as a measure of a "risk-free" rate because the federal government is unlikely to default on its loans. *See, e.g.*, RICHARD A. BREALY ET AL., PRINCIPLES OF CORPORATE FINANCE 188 (8th ed. 2006).

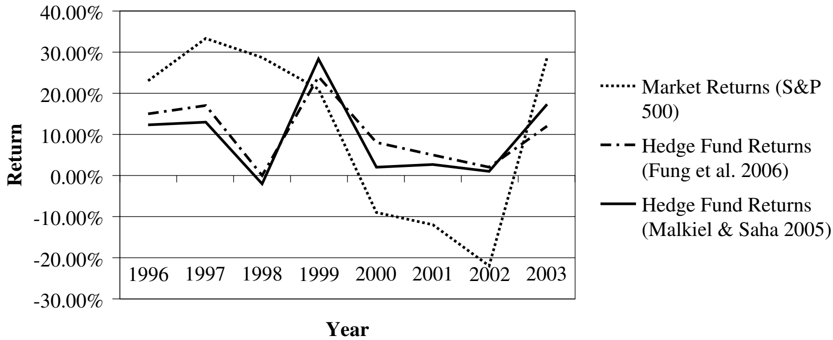
92. *See* Liang, *supra* note 27, at 78 (noting that "hedge funds are absolute performers . . . [with no] relative benchmark" and finding empirically that "the low beta value for . . . hedge fund groups indicate that hedge funds have low systematic risk . . . ").

93. *See* Roger Ibbotson & Peng Chen, *The A,B,Cs of Hedge Funds: Alphas, Betas, and Costs* 16 (Yale Int'l Ctr. for Fin., Working Paper No. 06-10, 2006), *available at* http://ssrn.com/abstract=733264 (finding the compounded annual return for hedge funds from 1995 to April 2006 to be 9%); Harry M. Kat & Joëlle Miffre, *The Impact of Non-Normality Risks and Tactical Trading on Hedge Fund Alphas* 7–8 (Cass Bus. Sch., City Univ. London, Faculty of Fin. Working Paper Series WP-FF-21-2005, 2006), *available at* http://www.cass.city.ac.uk/facfin/papers/WP2005/WP-FF-21-2005_Miffre_Kat.pdf (finding an annualized average return from hedge funds of 12% from January 1985 to August 2004).

94. *See* Robert Kosowski et al., *Do Hedge Funds Deliver Alpha? A Bayesian and Bootstrap Analysis*, 84 J. FIN. ECON. 229, 262–63 (2007); Bill Ding & Hany A. Shawky, *The Performance of Hedge Fund Strategies and the Asymmetry of Return Distributions*, 13 EUR. FIN. MGMT. 309, 329 (2007) (finding that from 1990 to 2003, all hedge fund categories achieved above average performance when measured against an aggregate equity market index); Ibbotson & Chen, *supra* note 93, at 14 (finding that "when combined with stock, bond, and cash portfolios, hedge funds add positive alpha and excellent diversification"); Kat & Miffre, *supra* note 93, at 16–17 (finding the representative hedge fund manager to have superior trading skills but noting that previous studies and their own may overstate alpha); Daniel Capocci & Georges Hübner, *Analysis of Hedge Fund Performance*, 11 J. EMPIRICAL FIN. 55, 77 (2004) (finding that hedge funds as a whole "[d]eliver significant excess returns").

95. The academic studies upon which the annual hedge fund returns in Figure 1 are based explicitly on control for biases in hedge fund data that might exaggerate their gains. *See* Burton G. Malkiel & Atanu Saha, *Hedge Funds: Risk and Return*, 61 FIN. ANALYSTS J. 80, 81–84 (2005); William Fung et al., Hedge Funds: Performance, Risk and Capital Formation 2–3, 25 tbl. 1 (July 19, 2006) (unpublished paper presented at the AFA 2007 Chicago Meetings, *available at* http://ssrn.com/abstract=778124).

As Figure 1 illustrates, hedge fund returns, while not always greater than market returns, almost always produced gains regardless of the direction of the general market. It also shows that hedge fund returns are more steady (i.e., less volatile) than those of the market.[96]



Another way to evaluate absolute return strategies is to isolate hedge fund returns when the general market is negative. The experience of funds investing in hedge funds (i.e., returns to FOHFs) from January 1990 to December 2006 illustrates that most hedge funds had either no losses or had gains during those months when the general market experienced losses.[97] In particular, during the 2000–2002 bear market, the S&P 500 had an average annual loss of 15.5%, and the NASDAQ Composite Index likewise lost 30.6% annually, but the average annual return for hedge funds was a gain of approximately 3.46%.[98] And in the summer months of 2007, while losses from the subprime mortgage market led to a 3.7% decrease in the S&P 500, hedge fund returns as a whole decreased by approximately 0.24% during that time period.[99] This means that investors would have gener-

96. However, Figure 1 does not illustrate that different hedge fund types have substantial differences in returns. *See* Malkiel & Saha, *supra* note 95, at 81.

97. CRESTMONT RESEARCH, PERSPECTIVES ON HEDGE FUND INVESTING 18 (2007), *available at* http://www.crestmontresearch.com/pdfs/HF%20Industry%20Presentation.pdf.

98. WALL ST. JOURNAL, ECONSTATS, MAJOR INDICES, http://www.econstats.com/eqty/index.htm (last visited Feb. 22, 2008) (detailing S&P 500 and NASDAQ Composite Index returns). Hedge fund annual returns are based upon the average of those in: Malkiel & Saha, *supra* note 95, at 83 tbl. 3 panel B; and Fung et al., *supra* note 95, at 2–3, 25 tbl. 1.

99. The S&P 500 opened the month of June 2007 at 1530.62 and closed August 2007 at 1473.96. *See* WALL ST. JOURNAL, ECONSTATS, S&P 500 (LARGE CAP) INDEX AND CORRELATIONS WITH SP500, http://www.econstats.com/eqty/eqem_mi_1.htm (last visited Feb. 22, 2008). For June, July, and August 2007, the HFRI Fund Weighted Composite Index reports returns of 0.73, 0.08, and −1.53, respectively. *See* HEDGE FUND RESEARCH, HFRI FUND WEIGHTED COMPOSITE INDEX, https://

ally been better off with a diversified portfolio of hedge funds than with a diversified portfolio of stocks.

Producing positive returns in various market conditions and helping to diversify a portfolio requires hedge fund returns to have a relatively low correlation to general market factors. This aspect of hedge fund returns has been well-documented in academic literature for at least a decade.[100] Figure 2 illustrates this relatively low correlation by using the statistical property known as R^2.[101] In this context, a distribution of R^2 closer to 100% (the right-hand part of the chart) simply means that the issuer's returns are better explained by, or more correlated to, the general market factors (and vice versa). As the figure strikingly demonstrates, hedge fund returns are substantially less correlated to general market movements than traditional buy-and-hold mutual funds.

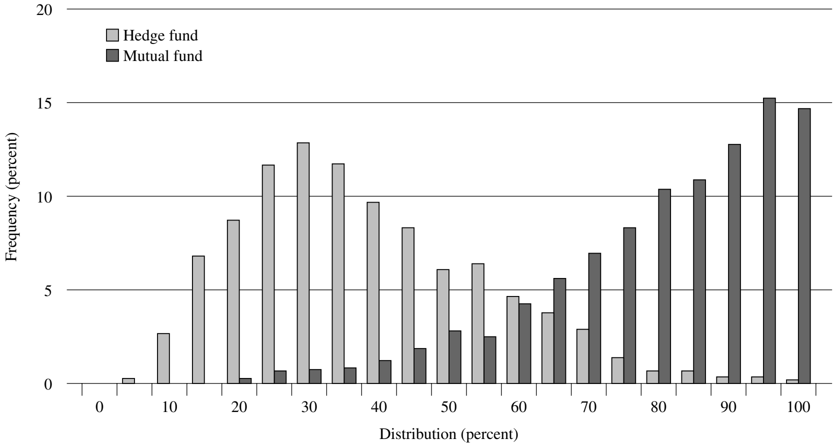
---

www.hedgefundresearch.com (requires free registration; on file with the *New York University Journal of Legislation and Public Policy*). The HFRI Index states that it is constructed so as to correct for biases which may exaggerate the performance of hedge funds. *See* HEDGE FUND RESEARCH, HFR INDICES – BASIC METHODOLOGY AND FAQ 4 (2007), https://www.hedgefundresearch.com/pdf/HFRI-HFRX_FAQ.pdf. However, even if the highest estimated upward biases in hedge fund returns were applicable to HFR's summer 2007 return figures, the funds would have still substantially outperformed the market. *See* Ibbotsen & Chen, *supra* note 93, at 6–8 (finding that backfill and survivorship biases exaggerated hedge fund returns annually by 5.68% and 5.01%, respectively, or monthly by approximately 0.47% and 0.42%).

100. *See, e.g.*, William Fung & David A. Hsieh, *Empirical Characteristics of Dynamic Trading Strategies: The Case of Hedge Funds*, 10 REV. FIN. STUDIES 275, 279–82 (1997); William K.H. Fung & David A. Hsieh, *Hedge Funds: An Industry in Its Adolescence*, ECON. REV., Fourth Quarter 2006, at 1, 7–8, *available at* http://www.frbatlanta.org/publ.cfm [hereinafter Fung & Hsieh, *Hedge Funds*] (demonstrating the relatively low correlation of hedge fund returns to general market factors, such as North American equity returns, emerging market equities, bonds, and the value of the dollar).

101. *See* Fung & Hsieh, *Hedge Funds*, *supra* note 100, at 8. The Federal Reserve Bank of Atlanta is the publisher of Fung and Hsieh's article in the *Economic Review*. On its website, the bank grants permission to reproduce from its publications for not-for-profit uses and requests a copy of the publication with the abstracted materials, http://www.frbatlanta.org/publ.cfm (follow Disclaimers and Terms of Use).

FIGURE 2: DISTRIBUTION OF R^2 VERSUS EIGHT ASSET CLASSES



Source: CISDM, HFR, TASS, Morningstar, Datastream

Because hedge fund returns have relatively low correlation to general market trends, they can diversify a traditional portfolio and reduce systematic risk or the correlation of a portfolio's returns to market factors.[102] Accordingly, adding hedge funds to a traditional portfolio will generally *reduce the portfolio's risk of loss*, because including the funds will reduce the vulnerability of the portfolio to market downturns.[103] As with all other securities, how and to what extent adding those of hedge funds to a portfolio will reduce systematic risk depends on several factors, such as which assets the portfolio is already composed of and which particular funds are added.[104]

Likewise, there are limits to how much hedge funds can help diversify a portfolio. This is because hedge funds have their own systematic risk factors—risks that cannot be diversified away. First, though less so than traditional investments, hedge fund returns typically have some correlation to general market factors,[105] which limits the funds' ability to completely diversify away market-correlation risk when added to a portfolio. A second limitation on how well hedge funds can reduce overall portfolio risk is the funds' own unique risk

102. *See, e.g.*, Jean-François Bacmann & Gregor Gawron, *Fat-Tail Risk in Portfolio of Hedge Funds and Traditional Investments*, *in* HEDGE FUNDS: INSIGHTS IN PERFORMANCE MEASUREMENT, RISK ANALYSIS, AND PORTFOLIO ALLOCATION 491, 491–513 (Greg N. Gregoriou et al. eds., 2005) (demonstrating that "the risk of a traditional portfolio is reduced when hedge funds are added").

103. *See infra* text accompanying note 111.

104. *See, e.g.*, Bacmann & Gowran, *supra* note 103, at 512 ("[T]he benefits of the inclusion of hedge funds in a traditional portfolio depend on the initial composition of the portfolio and on the type of hedge fund added to the portfolio.").

105. *See, e.g.*, Fung et al., *supra* note 95, at 13.

properties. One property is the potential to have relatively extreme losses.[106] Another is a possibility that hedge fund returns may become more correlated to general market trends during downturns, notwithstanding their typically low correlation to market movements.[107] Yet another is the potential for poor performance in some hedge funds to spill over to different types of funds.[108] Diversifying one's hedge fund holdings may reduce such risks, but increasing allocations to hedge funds may also increase them.[109]

However, though hedge funds do share some risks of traditional investments and have unique risks of their own, a large and sophisticated body of academic and practitioner research finds that adding hedge funds to a traditional portfolio benefits investors.[110] At least

106. This is because hedge fund returns are asymmetric, or do not follow a "normal" bell curve shaped pattern. Hedge fund returns often exhibit so-called "higher moment" statistical properties known as "negative skew" and excess "kurtosis." *See, e.g.*, Chris Brooks & Harry M. Kat, *The Statistical Properties of Hedge Fund Index Returns and Their Implications for Investors*, 5 J. ALTERNATIVE INVS. 26, 42–43 (2002); Malkiel & Saha, *supra* note 95, at 80.

107. Monica Billio et al., *Phase-Locking and Switching Volatility in Hedge Funds* 38 (Dep't of Econ., Ca' Foscari Univ. of Venice, Working Paper No. 54, 2006) (finding "that exposures [to market factors] can be strongly different in the down-market . . . regimes compared to normal times[,] suggesting that risk exposures of hedge funds in the down-market regimes are quite different than those faced during normal regimes"); Javier Mencía, Testing Dependence Between Financial Returns, An Application to the Hedge Fund Industry 3 (Jan. 2006) (unpublished paper, *available at* http://ssrn.com/abstract=870000) (finding that "when strong shocks to the market occur . . . diversification benefits [of hedge funds] seem to deteriorate due to non-linear dependence"). *But see* Nicole M. Boyson et al., Is There Hedge Fund Contagion? 26, 30 (Mar. 2007) (unpublished paper, *available at* http://ssrn.com/abstract=884202) (finding no evidence that extreme losses in currency, fixed income, and equity markets are correlated to extreme losses in the hedge fund indices).

108. *See* Boyson et al., *supra* note 107, at 26–27 (finding strong evidence of contagion across hedge funds of different styles).

109. *See, e.g.*, Harry M. Kat, *Integrating Hedge Funds into the Traditional Portfolio*, *in* HEDGE FUNDS, *supra* note 102, at 3, 6.

110. *See, e.g.*, R. McFall Lamm, Jr., *Asymmetric Returns and Optimal Hedge Fund Portfolios*, J. ALTERNATIVE INVESTMENTS, Fall 2003, at 9 ("[O]ptimal hedge fund portfolios should have up to a 30% smaller allocation to distressed debt than symmetric return models indicate . . . offset by larger allocations to equity market neutral, rotational, and systematic macro strategies, which produce more positively skewed portfolios."); Jan-Hein Cremers et al., *Optimal Hedge Fund Allocations: Do Higher Moments Matter?*, 32 J. PORTFOLIO MGMT. 70, 70 (2005) (finding that "higher moments of hedge funds do not meaningfully compromise the efficacy of mean-variance optimization" where investors are generally risk-averse); Niclas Hagelin et al., *Hedge Fund Allocation Under Higher Moments and Illiquidity*, *in* HEDGE FUNDS, *supra* note 102, at 105–28 (finding that "gains from allocating into hedge funds occur even when possible effects of deviations from normality in the hedge fund data are taken into account"); Jean Brunel, *Revisiting the Role of Hedge Funds in Diversified Portfolios*, *in* HEDGE FUNDS, *supra* note 102, at 129–49 (concluding that despite hedge funds' unique risks, "there is indeed a role for nontraditional, hedge fund-type strategies in

one study found that a diversified portfolio of hedge funds is less risky and generally preferable to a diversified portfolio of stocks.[111] None of the foregoing implies that all investors should add hedge funds to their portfolios; nor does it imply that hedge funds are risk-free or always less risky than traditional investments. After considering tax consequences and the widening array of financial products available, investors may find hedge funds to be less attractive.[112] Nevertheless, hedge funds have been proven to decrease the volatility of investment portfolios and present an attractive investment opportunity for sophisticated retail investors.

D. The Retail Fund of Hedge Funds

Retail investors would need access to the unique characteristics and operations of genuine hedge funds in order to fully benefit from the funds' ability to diversify a portfolio. For retail investors, this access would most likely take the form of a FOHF. Although they can purchase investments resembling or related to hedge funds, no option currently available to retail investors fully captures the benefits of hedge funds.

1. Characteristics and Operation of a Retail Hedge Fund

To obtain the most benefits from hedge fund investing, retail investors must have access to funds that are able to charge a performance fee, undertake a wide variety of investment strategies, and limit redemptions by investors. In order for retail investors to make in-

---

diversified portfolios"); Bacmann & Gawron, *supra* note 102, at 491 (finding the optimal allocation of hedge funds to an initial portfolio consisting primarily of bonds to be approximately 50%); Ivilina Popova et al., Optimal Hedge Fund Allocation with Asymmetric Preferences and Distributions 2 (May 1, 2006) (unpublished paper, *available at* http://ssrn.com/abstract=900012) (showing "that conditional on the investor's objective, a substantial allocation to hedge funds is justified even with consideration for the highly unusual skewness and kurtosis").

111. *See* Todd Brulhart & Peter Klein, *Faulty Hypotheses and Hedge Funds*, CANADIAN INVESTMENT REV., Summer 2005, at 6, 10–11, *available at* http://www.aima-canada.org/doc_bin/SUMMER2005_aimawinner.pdf (finding large allocations to hedge funds appropriate because hedge fund indices have lower overall risk than equity indices).

112. Hedge funds are typically structured as limited partnerships or limited liability companies and for that reason short-term gains are taxed as ordinary income tax, whereas gains from investing in other investments, such as mutual funds, may be taxed at the lower long-term capital gains rate. *See* HAMMER ET AL., *supra* note 16, at 89; Henry Blodget, *The Wall Street Self-Defense Manual: Please Do Not Buy Hedge Funds*, SLATE.COM, Jan. 2, 2007, http://www.slate.com/id/2155871/entry/2156310. For alternatives to hedge funds that capture some of their benefits, *see infra* Part I.D.2.

formed investment decisions and to reduce the incidence of fraud, a retail hedge fund should disclose basic information including information about its management company, fees and redemption policy, and risks and returns.[113] Another important feature of hedge funds is economically significant co-investment by the hedge fund manager, which aligns incentives between managers and investors.[114]

As is typical in foreign jurisdictions, hedge funds selling shares to retail investors in the U.S. would probably take the form of a FOHF operated by a large financial firm. First, hedge fund managers seem to have little interest in managing capital from retail investors directly.[115] This may be in part due to a perception that retail investors are less sophisticated or more risk-averse than institutional or wealthy individuals and therefore are more likely to move their capital in and out of funds—a practice hedge fund managers find very undesirable.[116] Hedge funds may also find retail investors undesirable because their substantially smaller investments likely increase a fund's transaction costs in raising, managing, and redeeming capital, and providing individualized services to investors.[117] Second, a FOHF's value is generally greatest to investors, such as retail investors, for whom investing in several separate, single-strategy hedge funds would be too costly, time-consuming, or complicated.[118] Furthermore, large financial firms already running hedge funds for institutional investors, such as

---

113. For a discussion of the information likely required by sophisticated retail investors to make an informed investment choice, *see infra* Part III.B.1. Because all statements made to investors are subject to prohibitions on fraud, a hedge fund making basic disclosures of information is less likely to engage in fraudulent activity than a fund not making such disclosures. *See infra* Part III.B.2 (discussing federal anti-fraud law applicable to hedge funds).

114. *See* Agarwal et al., *supra* note 20, at 28–29.

115. Gradante Testimony, *supra* note 55, at 8 (noting that "Hennessee [Group LLC] research indicates that hedge fund managers do not want to manager [sic] retail assets"); FIN. SERVS. AUTH., HEDGE FUNDS AND THE FSA: FEEDBACK STATEMENT ON DP16, at 4 (2003), *available at* http://www.abanet.org/intlaw/hubs/programs/Annual0313.02.pdf (noting that responses to the U.K.'s inquiry regarding retail hedge funds "have not suggested that there is a great desire among product providers or retail investment advisers to produce and sell retail hedge fund products").

116. Helen Avery, *The Funds of Hedge Funds That Are Too Hot to Handle*, EUROMONEY, Nov. 2006, at 1 (reporting that hedge funds are turning away FOHFs who move capital in and out of funds relatively quickly).

117. *See* Email from Bruce Gibney & Alda Leu, Clarium Capital Management LLC, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Mar. 9, 2007), http://www.sec.gov/comments/s7-25-06/s72506-566.pdf (stating that "hedge funds are generally available for open and frank discussion with investors at any time").

118. Andrew Ang et al., Do Funds-of-Funds Deserve Their Fees-on-Fees? 2–3 (Nov. 20, 2005) (unpublished paper, *available at* http://ssrn.com/abstract=687274) ("For unskilled investors, funds-of-funds add value, even if their after-fee returns are lower than the returns of hedge funds.").

mutual fund complexes and investment banks, would be likely to create retail FOHFs because they possess the necessary infrastructure and marketing abilities to make selling shares to retail investors economical.[119]

Like hedge funds, FOHFs charge their own layer of management and performance fees (averaging about 1.5% and 10% respectively), employ high water marks and lockups, and may have managerial co-investment.[120] FOHFs typically have greater access to hedge funds, lower minimum investments, and provide investors with a portfolio manager having expertise in the funds.[121] FOHFs do not typically engage in derivatives trading or short-selling, but they do sometimes employ leverage.[122] Although research finds that FOHFs are, in some ways, less preferable to hedge funds because of their second layer of fees, studies also find that FOHFs are better at diversifying portfolios and, unlike hedge funds, may decrease their fees in response to competitive pressures.[123]

---

119. *See* Donald E. Lacey, Jr., Democratizing the Hedge Fund: Considering the Advent of Retail Hedge Funds 67–68 (Apr. 2003) (unpublished paper, *available at* http://www.law.harvard.edu/programs/pifs/pdfs/donald_lacey.pdf). Indeed, in July of 2006, the U.S.-based investment bank Goldman Sachs launched Goldman Sachs Dynamic Opportunities Limited, a FOHF listed on the London Stock Exchange for retail investors. *See* Goldman Sachs homepage, http://www2.goldmansachs.com/client_services/asset_management/closed_ended_investment_companies/resident.html (detailing terms of fund).

120. *See* Ang et al., *supra* note 118, at 1, 15 (summarizing FOHF's fee structure and use of high watermarks); HEWITT INV. GROUP, IN BRIEF: HEDGE FUND-OF-FUNDS—PART ONE: STRATEGIC ALLOCATIONS 2 (2005), *available at* http://www.hewittinvestmentgroup.com/pdf/InBrief_Fund_of_Funds.pdf; Brett Duval Fromson, *SOS for FOFs: Funds of Hedge Funds Under Fire for Fees, Risks and Low Returns; Can Managers Survive a Dry Spell?* WALL ST. J. ONLINE, Jan. 27, 2007, http://online.wsj.com/article/SB116982933420289117.html (noting that because of managerial co-investment FOHF "managers likely have a piece of the action via the general partnership").

121. DEUTSCHE BANK, FUNDS OF HEDGE FUNDS: AN INTRODUCTION TO MULTI-MANAGER FUNDS 15, 18 (2000), *available at* http://www.opalesque.com/files/FundsofHedgeFundsAnIntroductiontoMultiManagerFunds.pdf.

122. *See*, *e.g.*, *id.* at 50–51 (finding that the Permal European Holdings FOHF uses up to 20% leverage); HEWITT INV. GROUP, *supra* note 120, at 4.

123. Emily Denvir & Elaine Hutson, *The Performance and Diversification Benefits of Funds of Hedge Funds*, 16 J. INT'L FIN. MARKETS, INSTITUTIONS & MONEY 4, 5–6 (2006) (finding that FOHFs are better portfolio diversifiers than single-strategy hedge funds); Maher Kooli, *The Diversification Benefits of Hedge Funds and Funds of Hedge Funds*, 12 DERIVATIVES USE, TRADING & REG. 290, 299 (2007) (finding that FOHFs provide added diversification); Christopher Holt, *Hedge Fund Fees Show Signs of Heading South*, SEEKINGALPHA.COM, July 5, 2007, http://seekingalpha.com/article/40106-hedge-fund-fees-show-signs-of-heading-south (citing research showing that fees are decreasing for FOHFs).

2. *Retail Access to Hedge Fund-Like Investments*

Several hedge fund-like alternatives have emerged in response to investor demand for absolute return (or low market-correlation) strategies without features such as low liquidity and substantial minimum investment requirements. One development is public offerings of alternative asset managers who sponsor hedge funds (and other investment vehicles such as private equity and real estate funds). On February 8, 2007, Fortress Investment Group ("Fortress") was the first U.S.-listed alternative asset management company to go public, raising $634 million in an initial public offering.[124] Fortress is a registered investment adviser providing asset management services to its underlying funds, which primarily include private equity funds, hedge funds, and two publicly traded real estate investment vehicles. The income of the public adviser entity comes from management fees, performance fees, and investment income from the capital Fortress itself invests into its funds.[125] Another hedge fund manager to allow retail investors to share in its gains and losses is Och-Ziff Capital Management Group, a registered investment adviser primarily managing hedge funds. On July 2, 2007, Och-Ziff filed a registration statement with the SEC as is required to publicly raise capital.[126]

Another development is the growth of synthetic hedge funds (or hedge fund "clones"), which are passively managed index-based securities that attempt to replicate hedge fund returns through complex trading algorithms.[127] Although most synthetic hedge funds are available only to high net worth investors, some will likely be available to retail investors in a few years.[128] Yet another trend is the growth of

---

124. Alex Halperin, *Investors Storm Fortress IPO*, BUSINESSWEEK.COM, Feb. 9, 2007, http://www.businessweek.com/investor/content/feb2007/pi20070209_895342.htm?chan=top+news_top+.

125. Fortress Inv. Group, Registration Statement (Form S-1), at 29 (Nov. 8, 2006).

126. Gregory Zuckerman, *A Bustle Grows on Hedge Row: The IPO Allure*, WALL ST. J., July 3, 2007, at C1.

127. *See* Marc Hogan, *Hedge Funds: Attack of the Clones*, BUSINESSWEEK.COM, Dec. 4, 2006, http://www.businessweek.com/investor/content/dec2006/pi20061204_627321.htm?chan=search; Harry M. Kat & Helder P. Palaro, *Hedge Fund Returns: You Can Make Them Yourself!* 4–5 (City Univ. of London, Cass Bus. Sch., Alternative Inv. Research Ctr., Working Paper No. 0023, 2005) (suggesting how to create a clone using a "general procedure that allows us to design simple trading strategies in stock index, bond, currency and interest rate futures that generate returns with statistical properties that are very similar to those of hedge funds").

128. Jarvis, *supra* note 80, at 5 (reporting that "individual investors may find [synthetic hedge fund clones] available in the retail market within three to five years"); Hogan, *supra* note 127 (noting that the Merrill Lynch synthetic "Factor index is currently unavailable in the retail market, though Merrill executives say they are considering wider distribution").

hedged mutual funds, which are publicly registered investment companies that mimic hedge fund strategies and only require an average minimum investment of $5000, with some as low as $500.[129] Hedge fund clones and hedged mutual funds expose retail investors to the same kinds of risks and complicated strategies as real hedge funds,[130] which means that increasing access to hedge funds will not expose retail investors to entirely new types of risk or investment complexity. In addition, some FOHFs have become more like mutual funds and are publicly registered as investment companies.[131] Finally, with the development of sophisticated at-home trading tools and publicly registered exchange traded funds (ETFs), retail investors can implement hedge fund trading strategies on their own, at low cost. These complicated strategies include: short-selling; trading options, futures, and other derivatives; investing in gold, silver, and other commodities; trading securities tied to foreign exchange rates and emerging markets; and investing in ETFs whose value is tied to intangible assets such as good will or innovation.[132] In addition, an ETF attempting to mimic returns of a hedge fund clone is being planned by Stonebrook Structured Products and similar products are likely to follow.[133]

None of these alternatives possess all the characteristics of real hedge funds, which likely explains why none have been able to capture the full benefits of hedge fund investing. Investing in shares of publicly traded alternative asset managers may provide returns that are less correlated with market returns, liquid shares, and substantial transparency because such issuers must make disclosures mandated by

---

129. Vikas Agarwal et al., Hedge Funds for Retail Investors? An Examination of Hedged Mutual Funds 1 (June 4, 2007) (unpublished paper, *available at* http://www.fma.org/Orlando/Papers/HMF_January11_fma.pdf); Adam Shell, *Investors Add a Bit of Hedge Fund to Portfolio Mix*, USA TODAY, Dec. 8, 2006, at B1.

130. *See* Kat & Palaro, *supra* note 127, at 8 (noting that all of "the statistical [risk and return] properties of [George Soros's Quantum hedge fund] . . . have been quite successfully replicated" by the authors' own synthetic hedge fund); Agarwal et al., *supra* note 129, at 13–14 (finding that hedged mutual funds open to retail investors exhibit more extreme returns ("kurtosis") than traditional mutual funds); Shell, *supra* note 129 ("While these new [hedged mutual] funds are sold under the guise of mutual funds, *it does not mean that the investment strategies they use are any less confusing than a hedge fund*.") (emphasis added).

131. Franklin R. Edwards, *Hedge Funds and Investor Protection Regulation*, ECON. REV., Fourth Quarter 2006, at 35, 44–45.

132. *See* Rob Wherry, *These ETFs Bring Hedge-Fund Tactics to the Mainstream*, SMARTMONEY.COM, Jan. 31, 2007, http://www.smartmoney.com/etffocus/index.cfm?story=20070131; Eleanor Laise et al., *Over Their Heads: Small Investors, Too, Get Nailed by Arcane Trades*, WALL ST. J., Aug. 14, 2007, at A1.

133. Eleanor Laise, *The Hedge-Fund 'Clones,'* WALL ST. J., July 21, 2007, at B1.

the securities laws.[134] However, retail investors do not gain the full benefits of hedge fund investing by purchasing shares of publicly traded fund managers. The shares of these investment advisers represent gains not to any particular hedge fund strategy, but to the entire portfolio of investments and activities of the manager, which also include other alternative investments such as private equity and real estate funds.[135] Accordingly, investing in a public hedge fund manager may dilute the gains from particular underlying funds.[136] In addition, the disclosures made by a public hedge fund manager state investment strategies in very general terms but do not reveal information about any particular fund.[137]

The drawback of synthetic hedge funds is that they are not really hedge funds in the sense of being portfolios of actively managed investments. Rather, they are computer simulations that mimic the previous performance of real hedge funds and, as such, are vulnerable to failing to adjust to market developments as needed.[138] While clones may outperform a large cross-section of hedge funds, they are generally unable to outperform the best hedge funds.[139] And while hedged

---

134. The registration statement of Och-Ziff, for example, details the value of operating company's equity and debt holdings and its short sales by sector and geographic region. It also lists the value of its derivatives holdings and other assets and liabilities. Och-Ziff Capital Mgmt. Group, Registration Statement, Amendment No. 6 (Form S-1), at 110–12 (Oct. 25, 2007).

135. PRICEWATERHOUSECOOPERS, *supra* note 52, at 3 (noting that "[t]he underlying earnings from these managers [such as Fortress] are not purely from hedge funds and the securitisation of the earnings represents more an alternative assets earnings stream").

136. *See* Steven M. Davidoff, *Black Market Capital* 45–46 (Wayne State Univ. Law Sch., Legal Studies Research Paper Series No. 07-26, 2007), *available at* http://ssrn.com/abstract=1012042 (arguing that the derivative nature of public hedge fund managers make them "more risky on an individualized basis than the hedge fund and private equity investments they substitute for").

137. For example, Och-Ziff's registration statement states only that one of its main investment strategies includes "[c]redit and distressed credit investments, which involves high-yield debt investments at a favorable price in distressed businesses . . . ." *See* Och-Ziff Capital Mgmt. Group, *supra* note 134, at 170.

138. During the recent market losses stemming from the subprime market, hedge funds heavily dependent upon automated quantitative trading techniques experienced substantial losses. Katherine Burton & Jenny Strasburg, *Highbridge, Goldman 'Quant' Hedge Funds Lose Money*, BLOOMBERG.COM, Aug. 9, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aEPgend5RgPk&refer=home,
("Hedge funds' quantitative, or 'quant,' models have been confounded by wider credit spreads stemming from losses in the subprime loan market.").

139. *See* Jasmina Hasanhodzic & Andrew W. Lo, *Can Hedge-Fund Returns Be Replicated?: The Linear Case*, 5 J. OF INVESTMENT MGMT. 5, 5, 19–20 (2007) (finding that "the performance of linear clones is often inferior to their hedge-fund counterparts . . ." and "61% of the average total return is attributable to manager-specific alpha [i.e., skill], implying that on average, the remaining 39% is due to" general

mutual funds may outperform regular mutual funds, hedged mutual funds have likewise been unable to match the performance of the best hedge funds in part because of the substantially higher regulatory burdens placed on publicly registered investment funds.[140] Additionally, FOHFs publicly registered as investment companies do not market to retail investors because current law prohibits managers of such funds from charging performance fees if they accept capital from retail investors.[141] Both hedged mutual funds and registered FOHFs are indicative of the inherent deficiencies in using registered public company structure to broaden access to hedge funds.[142] In sum, the sophisticated retail investor seeking the full benefits of professionally managed hedge fund products lacks direct access to genuine hedge funds and their superior risk-adjusted returns.

II.
Regulation of Investment Funds: Retail vs. Non-Retail

The legal structure of the U.S. market for investment funds creates two tiers, within which retail investors have virtually no access to hedge funds. The securities in one tier of investment funds are open to all investors able to afford to purchase their shares. Securities of funds in the other tier are only available for purchase by individuals and institutions qualified based primarily upon net worth or some other indicator of financial sophistication. U.S. securities laws and regulations place no direct limitations on the ability of individual investors to invest in hedge funds. Hedge funds, on the other hand, can only accept funds from limited numbers of wealthy investors in order to qualify for exemptions from certain mandatory disclosure rules and other laws restricting their conduct. Because hedge funds typically find such exemptions beneficial, the funds almost exclusively sell their securities to wealthy individuals and are inaccessible to retail

market movements); Hogan, *supra* note 127 ("Merrill [Lynch] doesn't claim the [hedge fund] index can match the market-beating returns of the best-performing hedge funds.").

140. *See generally* Agarwal et al., *supra* note 129, at 25–26 (finding that hedged mutual funds underperform as compared to hedge funds but outperform traditional mutual funds due to less regulatory constraints including investment flexibility).

141. For example, although the Oppenheimer Tremont Market Neutral Fund is a registered investment fund which in 2002 had an investment minimum of $25,000; it requires investors to have a net worth of $1.5 million so that it may utilize performance fees. Edwards, *supra* note 131, at 44–45. For discussion on prohibition of performance fees, see *infra* notes 176–78, 217, and accompanying text.

142. The limitations placed upon registered investment companies that conflict with hedge fund operations are discussed *infra* notes 161–67 and accompanying text.

investors. The choices hedge funds make in response to regulation thus creates a two-tiered market.

A. *Structure of the U.S. Market for Retail Investment Funds*

The Securities Act of 1933 (the "Securities Act") and the Securities and Exchange Act of 1934 (the "Exchange Act") subject companies that raise capital from the public (i.e., issuers of securities) and have their securities widely traded to an extensive system of registration, disclosure, and reporting requirements. The Investment Company Act of 1940 (the "Company Act") and the Investment Advisers Act of 1940 (the "Advisers Act") subject investment companies and investment advisers—those in the business of facilitating investment in issuers—to an additional regime of registration, disclosure, and limitations on activities such as investment strategies and fee structures.[143] Publicly traded pools of capital commonly referred to as "mutual funds" are open to retail and non-retail investors and are therefore required to comply with aspects of the four federal securities laws.[144] These statutes each have their own provisions exempting various entities from registration and from most (but not all) disclosure requirements, and it is within these exemptions that hedge funds are typically structured and operate.[145]

143. *See* Company Act § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (2000) (defining an investment company as an issuer that, among other things, "is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading securities"); Advisers Act § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2000) (defining an investment adviser as any person "in the business of advising others," including investment companies, about whether to purchase or sell certain securities).

144. *See* SEC, Invest Wisely: An Introduction to Mutual Funds (2007), http://www.sec.gov/investor/pubs/inwsmf.htm. A mutual fund is a registered investment company "that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments." Mutual funds are classified under the Company Act as open-end management companies. *See id.* ("Legally known as an 'open-end company,' a mutual fund is one of three basic types of investment companies."); Company Act § 4(3), 15 U.S.C. § 80a-4(3) (2000) (defining "management company"); Company Act § 5(a)(1), 15 U.S.C. § 80a-5(a)(1) (2000) (defining a management company as "open-end" if it "is offering for sale or has outstanding any redeemable security of which it is the issuer").

145. *See* SEC Staff Report, *supra* note 2, at 3, 18–19, 21 (noting that a hedge fund is a type of fund whose "interests are not sold in a registered public offering [under the Securities Act] and which is not registered as an investment company under the Investment Company Act," that the funds are not necessarily regulated as broker-dealers or otherwise registered under the Exchange Act, and that "[m]any hedge fund advisers . . . avoid registering with the Commission by relying on the Advisers Act's *de minimis* exemption under Part 203(b) of that Act").

The Securities Act requires all companies publicly raising capital to register with the SEC and disclose information to investors.[146] Section 5 of the Securities Act requires all interstate issuers of securities to file a registration statement.[147] Registration statements typically relied upon by hedge funds generally consist of a prospectus to be delivered to investors before or accompanying a sale, other information to be filed with the SEC, and a third category of information to be made available to investors upon request.[148] The SEC has adopted several different registration statements tailored to different types of issuers such as investment companies, certain real estate companies, and foreign issuers. Form S-1 is the general form for use by issuers of standard U.S. securities, or those not qualifying to use any particularized form, and requires disclosure of extensive financial and non-financial information.[149] Form S-1 requires the delivery of a prospectus containing information such as a description of the issuer's business, the offering, important risk factors affecting the issuer, financial statements, and numerous items relating to the financial condition of the issuer.[150]

The Exchange Act also requires companies to file a registration statement and to periodically disclose financial and other information. Section 12 of the Exchange Act requires registration of securities traded on a national exchange.[151] The Exchange Act also requires registration of large shareholdings of securities.[152] Form 10 is the basic registration form to be filed under the Exchange Act and requires disclosure of information similar to that required under Securities Act registration forms.[153] Section 13(a) requires Exchange Act registered

---

146. Securities Act § 5(a), 15 U.S.C. § 77e (2000).

147. *Id.*

148. HAMMER ET AL., *supra* note 16, at 145–57 (describing the components of disclosure for registration statement on Form N-1A and Form S-1).

149. Form S-1 General Instruction I, http://www.sec.gov/about/forms/secforms.htm (last visited Nov. 29, 2007). None of the Securities Act registration forms are codified in the Code of Federal Regulations, but they can all be obtained from the SEC's website.

150. *Id.*

151. Exchange Act § 12(a), 15 U.S.C. § 78*l*(a) (2000) ("It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange . . . .").

152. *See infra* Part III.B.2.

153. *See* Form 10, http://www.sec.gov/about/forms/form10.pdf (last visited Jan. 12, 2008) (listing the types of information required to be disclosed in an Exchange Act registration statement); LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES LAW 110 (1998) (noting that "Exchange Act registration forms have much in common with Securities Act registration forms, because there is great sameness in the general disclosures required for registration under each Act").

companies to comply with a panoply of periodic reporting requirements, including filing annual and quarterly reports on Forms 10-K, 10-Q, and occasional reports on Form 8-K.[154]

In addition to the Securities Act and the Exchange Act, investment fund business activities also implicate the Company Act and the Advisers Act. The Company Act requires registration by all investment companies, defined as any issuer that, among other things, "is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities."[155] Registered investment companies are subject to their own extensive disclosure and reporting requirements including disclosure of audited financial statements and the value and amount of the securities it owns.[156] Open-end registered investment companies like mutual funds must quarterly disclose portfolio holdings to the SEC[157] and semiannually to investors.[158] Mutual funds must also daily calculate net asset value and allow investors to redeem shares within seven days at that value.[159] Furthermore, a registered investment company must have a board of directors, 40% of whom are independent.[160]

A registered investment company is significantly limited in the use of the investment strategies that distinguish hedge funds from

---

154. *See* Exchange Act § 13(a), 15 U.S.C. § 78m (2000); Exchange Act Regulation 13A, 17 C.F.R. § 240.13a-1 (2006) (covering the periodic filings required to be filed under the Exchange Act); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 474–75 (4th ed. 2001) (describing disclosures on Forms 10-K, 10-Q, and 8-K).

155. Company Act § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (2000).

156. *See* LEDERMAN, *supra* note 20, § 5:2.5.

157. *See* Company Act § 30(a)–(b), 15 U.S.C. § 80a-29(a)–(b) (2000); Company Act Rules 30(a)–(b), 17 C.F.R. § 270.30a–b (2007) (requiring registered investment companies to file annual reports as required by the Exchange Act, and requiring registered investment companies to file semiannual or quarterly reports); Company Act Rule 30b1-1, 17 C.F.R. § 270.30b1-1 (2007) (requiring registered management investment companies to file annual and semi-annual reports on Form N-SAR within sixty days after the close of the second quarter and fiscal year); Company Act Rule 30b1-5, 17 C.F.R. §270.30b1-5 (2007) (requiring registered management investment companies to file a complete portfolio schedule on Form N-Q within sixty days after its first and third quarters).

158. *See* Company Act § 30(e), 15 U.S.C. § 80a-29(e) (2000); Company Act Rule 30e-1, 17 C.F.R. §270.30e-1 (2007).

159. Company Act § 22(e), 15 U.S.C. § 80a-22(e) (2000); Company Act Rule 22c-1(a), 17 C.F.R. § 270.22c-1(a) (2007) (requiring registered investment companies to sell, redeem, or repurchase shares at net asset value); Company Act Rule 22c-1(b), 17 C.F.R. § 270.22c-1(b) (2007) (requiring registered investment companies to calculate net asset value at least daily).

160. Company Act § 10(a), 15 U.S.C. § 80a-10(a) (2000) ("No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.").

other investment companies, such as the use of leverage, derivatives, and short-selling.[161] Under Section 18(f) of the Company Act, a registered investment company must cover bank borrowings by assets equivalent to at least 300% of the borrowings and cannot issue any class of securities senior to those held by shareholders.[162] SEC staff interpretations of the Company Act also require a registered company engaging in a short-sale and certain derivatives transactions to take an offsetting long position in a segregated account.[163] Registered investment companies are also prohibited from investing greater than 15% of the net value of their assets in illiquid securities,[164] which conflicts with investment practices of some hedge funds.[165] Furthermore, hedge fund lockup periods conflict with the general prohibition against registered investment companies suspending redemption of shares.[166] Limitations imposed by the Company Act on leverage and investing in illiquid securities may also conflict with practices of a FOHF if registered as an investment company.[167]

The Advisers Act requires the registration of certain investment advisers, defined as any person in the business of advising others, including investment companies, about whether to purchase or sell certain securities.[168] Investment advisers are required to register under circumstances such as when the adviser holds himself out to the public, has a registered investment company as a client, or has more than fifteen clients.[169] Fund managers registered under the Advisers Act must disclose information on Form ADV, either to investors or the

---

161. *See generally* Audrey C. Talley & James L. Love, *Restrictions on Investments*, *in* MUTUAL FUND REGULATION § 8:1, (Clifford E. Kirsch ed., 2d ed. 2005).

162. Company Act § 18(f), 15 U.S.C. § 80a-18(f) (2000).

163. *See* Emerald Mgmt. Co., SEC No-Action Letter, 1978 SEC No-Act. LEXIS 502, at *2 (Jan. 21, 1978); LEDERMAN, *supra* note 20, § 5:2.7. Although the SEC has authority under Part 12(a) of the Company Act to prohibit registered investment companies from undertaking short-sales or purchasing securities on the "margin" (which is a form of borrowing), it has not exercised that authority.

164. *See* Talley & Love, *supra* note 161, § 8:3.6. The SEC defines "illiquid" securities as those that cannot be sold at or near their net asset value within seven days. *Id.*

165. SEC STAFF REPORT, *supra* note 2, at 4 (noting that hedge funds engage in a wide variety of investment strategies which may involve investing in illiquid securities).

166. *See* Company Act § 22(e), 15 U.S.C. § 80a-22(e) (2000).

167. It should be noted that diversification requirements for registered investment companies that could potentially be applicable to a registered fund of funds are only applicable to investments in an "investment company" for which hedge funds do not qualify. Company Act § 12(d)(1), 15 U.S.C. § 80a-12(d)(1).

168. Advisers Act § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2000).

169. *See* Advisers Act § 203(b)(3), 15 U.S.C. § 80b-3(b) (2000). A "client" for the purposes of the Advisers Act is each individual fund, not each investor in the fund.

SEC.[170] The items listed on Part II of Form ADV require a fund manager to deliver to investors or prospective investors a brochure containing several items about itself, including information about its investment strategies, the background of its personnel, and its interest in client transactions and brokerage arrangements.[171] Fund managers registered under the Advisers Act must typically also disclose to investors material facts about the financial condition of the management company potentially impairing its ability "to meet contractual commitment to clients."[172] In addition, investors or potential investors must be made aware of facts relating to any legal or disciplinary event relevant to the manager's integrity or ability to meet client commitments.[173] The items listed on Part IA of Form ADV must be electronically filed with the SEC and consist of basic information such as persons who control the manager and potential conflicts of interest.[174] Fund managers registered with a state regulator also typically complete and deliver Form ADV, and some states also require registered managers to file Part II.[175]

Generally, a registered investment adviser cannot charge a performance fee to investment companies it advises.[176] However, registered advisers may charge performance fees to a fund if all investors in the fund meet the definition of "qualified client," which, in the case of natural persons, means having a net worth of at least $1.5 million.[177] Determination of whether a client is qualified for the purposes

170. Advisers Act Rule 204-3(a), 17 C.F.R. § 275.204-3(a) (2007) (requiring investment advisers registered or required to be registered under the Advisers Act to "furnish each advisory client and prospective advisory client with a written disclosure statement which may be either a copy of Part II of its form ADV which complies with [Rule 204-1(b)] under the Act or a written document containing at least the information then so required by Part II of Form ADV").

171. Form ADV, Part II, http://www.sec.gov/about/forms/formadv.pdf (last visited Jan. 12, 2008).

172. Advisers Act Rule 206(4)-4(a)(1), 17 C.F.R. § 275.206(4)-4(a)(1) (2007).

173. Advisers Act Rule 206(4)-4(a)(2), 17 C.F.R. § 275.206(4)-4(a)(2) (2007).

174. Advisers Act Rule 203-1(b), 17 C.F.R. § 275.203-1(b) (2007); Form ADV, *supra* note 171.

175. HAMMER ET AL., *supra* note 16, at 24.

176. *See* Advisers Act § 205(a)(1), 15 U.S.C. § 80b-5(a)(1) (2000). A registered investment adviser may, however, charge a "fulcrum fee" based upon assets under management which is increased or decreased according to a relevant benchmark of performance. *See* 15 U.S.C. § 80b-5(b)(2). These fee arrangements are only utilized by a small minority of mutual funds. *See id.*; Sophia Grene, *A Cautious Embrace of Performance Fees*, FIN. TIMES, Jan. 7, 2008, at 9 ("According to Lipper research, just over 2 per cent of US mutual funds have such a [fulcrum] fee structure . . . .").

177. Advisers Act Rule 205-3, 17 C.F.R. § 275.205-3 (2007). To avoid this limitation on charging performance fees, registered FOHFs do not accept capital from retail investors. *See* Edwards, *supra* note 131, at 44–45.

of charging a performance fee requires the adviser to "look-through" to each individual equity owner in the advised fund.[178]

B. *Structure of the U.S. Market for Non-Retail Investment Funds*

Hedge funds qualify for exemptions from the four federal securities laws listed above by limiting sales to only a certain number of wealthy investors, not advertising or otherwise holding their services out to the public, and also limiting resale of their securities.

1. *Exemptions from the Securities Act*

Section 4(2) of the Securities Act specifically exempts nonpublic offerings of securities by an issuer from the requirements of Section 5.[179] These sales are widely referred to as "private placements" or "private offerings."[180] However, the Securities Act does not define the meaning of "public offering" or provide any criteria by which to distinguish private from public offerings. The seminal case on the definition of "public offering" is the 1953 U.S. Supreme Court decision in *SEC v. Ralston Purina Co.*, which held the company's offer and sale of unregistered stock to a broad range of employees to be a public offering.[181] Under *Ralston*, an offering is nonpublic if offerees are "able to fend for themselves," and such is the case where offerees have access to "the same kind of information the Act would make available in the form of a registration statement."[182] Following *Ralston*, federal courts have taken varying approaches and found several elements inherent in or indicative of a section 4(2) nonpublic offering. These elements include that the offerees have access to or receipt of registration statement-like information, are financially sophisticated, and have the ability to bear economic risk.[183]

Notwithstanding substantial case law on point, a statutory section 4(2) nonpublic offering lacks a precise and widely-accepted judicial definition. To decrease the uncertainty involved with section 4(2) offerings and thereby expand the market for private placements, the SEC

178. *See* Advisers Act Rule 205-3(b), 17 C.F.R. § 275.205-3(b) (2007); SEC STAFF REPORT, *supra* note 2, at 61 n.212.

179. Securities Act § 4(2), 15 U.S.C. § 77d(2) (2000) (exempting from Part 5 of the Securities Act any "transaction not involving a public offering").

180. SEC STAFF REPORT, *supra* note 2, at 14.

181. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125–27 (1953).

182. *Id.* at 125–26.

183. *See* HAMMER ET AL., *supra* note 16, at 116–20. An offering is also less likely to be deemed "public" if the offering is personally made to potential investors, raises a low amount of capital, and involves a small group of offerees and limited number of shares. *Id.*

engaged in a series of rulemakings culminating in Regulation D.[184] Rule 506 of Regulation D is a nonexclusive safe harbor providing objective criteria by which an issuer can assure itself of exemption from the registration requirements of section 5 of the Securities Act.[185] To avoid the uncertainty involved in making a statutory section 4(2) private placement and to minimize liability in connection with making a nonpublic offering, hedge funds usually make private offerings under the requirements of Rule 506 *and* according to the judicially-defined statutory section 4(2) exemption.[186] This means that nominally private hedge funds disclose to investors information of the type disclosed in a Securities Act registration statement.[187]

Pursuant to Rule 506, a fund may sell an unlimited number of securities to accredited investors and not be subject to the registration and prospectus delivery requirements of section 5.[188] An "accredited investor" is a qualified financial institution or natural person, or one the fund reasonably believes is qualified.[189] Rule 506 itself imposes no affirmative disclosure obligations upon a hedge fund making an offering solely to accredited investors. For a natural person to qualify as an accredited investor, the sole criterion is possession of the requisite level of wealth. A natural person whose net worth (or whose joint net worth with a spouse) exceeds $1,000,000 qualifies as an accredited investor.[190] A natural person can also qualify as an accredited investor if the investor has an annual income for the last two years of $200,000 (or $300,000 in joint spousal income if married) with a rea-

---

184. *See* Accredited Natural Person Rule, *supra* note 3, at 403–04.

185. *Id.* at 404.

186. Hammer et al., *supra* note 16, at 120 ("Hedge funds typically rely on the safe harbor of Regulation D Rule 506 . . . in addition to relying on the statutory section 4(2) exemption, in offering and selling their interests."); Lederman, *supra* note 20, § 4:2.1 (noting that hedge funds typically raise capital "pursuant to a private placement exempted from registration under section 4(2) of the Securities Act and Rule 506 of Regulation D"); Soderquist & Gabaldon, *supra* note 153, at 73 (noting the importance of the section 4(2) private placement exemption even in light of Rule 506 because, among other reasons, it minimizes liability for making an unregistered public offering).

187. The disclosures typically made by hedge funds are discussed in detail in Part III.B.2.

188. *See* Rule 506 of Regulation D, 17 C.F.R. § 230.506 (2007) (stating offers and sales under certain conditions "shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the [Securities] Act."). Although Rule 506(b)(2)(i) limits the number of "purchasers" allowed to thirty-five, that limitation has no effect because accredited investors are not included in the definition of "purchaser" under Regulation D. 17 C.F.R. § 230.501(e)(1)(iv) (2007).

189. Regulation D, 17 C.F.R. § 230.501(a) (2007).

190. *Id.* § 230.501(a)(5).

sonable expectation of reaching the same in the current year.[191] On December 27, 2006, the SEC proposed new rule 509, raising the level of personal wealth required for individuals to qualify to purchase securities offered by certain hedge funds and other private investment funds (such as private equity funds).[192] The proposed rule is applicable only to investment funds relying on exclusion from the definition of investment company provided by section 3(c)(1) of the Company Act[193] and, for that reason, do not impact the reforms proposed in this Article.[194] The proposed rule adds the requirement that individuals purchasing securities from 3(c)(1) funds must, in addition to being accredited, *also* qualify as an "accredited natural person," which requires owning at least $2.5 million in investments.[195]

Rule 506 does allow sale to up to thirty-five nonaccredited investors so long as the investor is financially sophisticated or the hedge fund believes the investor to be so.[196] Financial sophistication means that an investor, either alone or with the assistance of a purchaser representative, possesses "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."[197] However, a sale to *any* nonaccredited investors requires the fund, at a reasonable time before the sale, to furnish financial and non-financial information to investors "material to an understanding of the issuer, its business and the securities being offered."[198] A hedge fund selling to accredited and nonaccredited investors must make the same disclosures to both groups to avoid violation of the anti-fraud provisions of the Securities Act and other federal securities laws.[199]

---

191. *Id.* § 230.501(a)(6).
192. *See* Accredited Natural Person Rule, *supra* note 3, at 405.
193. *Id.* The SEC also proposed rule 216 applicable to section 3(c)(1) funds seeking exemption from section 4(6) of the Securities Act. *Id.* Since hedge funds typically do not raise capital pursuant to section 4(6), rule 216 is not discussed in this Article.
194. *See infra* Part IV.A–B.
195. Accredited Natural Person Rule, *supra* note 3, at 405.
196. Regulation D, Rule 506(b)(2)(i)–(ii), 17 C.F.R. § 230.506(b)(2)(i)–(ii) (2007).
197. 17 C.F.R. § 230.506(b)(2)(ii) (2007).
198. Regulation D, 17 C.F.R. § 230.502(b)(2) (2007). This information is similar to the type required in Part I of a registration statement, must be more extensive the larger the offering, and requires employment of an independent auditor for offerings over $2,000,000. *See id.*
199. Regulation D, 17 C.F.R. § 230.502(b)(1) (2007) ("When an issuer provides information to [nonaccredited] investors pursuant to paragraph (b)(1), it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws."); SEC, Rule 506 of Regulation D, http://www.sec.gov/answers/rule506.htm (last visited Nov. 28, 2007) ("If a company provides information to accredited investors, it must make this information available to non-accredited investors as well.").

To qualify for an exemption under Rule 506, a hedge fund is also prohibited from offering or selling its securities using "general solicitation or general advertising."[200] Rule 502(c) of Regulation D lists any advertising in print or broadcast media and any invitation to a seminar or meeting by such methods as constituting general solicitation or advertising.[201] Hedge funds should have a reasonable basis for believing potential investors are accredited or otherwise financially sophisticated.[202] For example, the SEC found that a broker-dealer made a general solicitation when it sent out a mass email about privately raising capital for an Internet startup, without first verifying whether the potential investors were accredited or otherwise sophisticated.[203]

Hedge funds that seek to fall within the safe harbor provision of Rule 506 must also take steps to prevent the resale of their securities. Securities purchased pursuant to a Rule 506 private placement cannot be resold by the purchaser without registration or qualification for another exemption.[204] The hedge fund must exercise reasonable care to prevent resales, which may be demonstrated by inquiring as to whether the purchaser is an underwriter with the intent to resell and making clear in writing to investors of their inability to resell without registering under the Securities Act.[205]

2. *Exemptions from the Exchange Act, Company Act, and Advisers Act*

In addition to the Securities Act, hedge funds also operate so as to be exempt from the disclosure and reporting provisions of the Exchange Act. A hedge fund does not have to register its securities under section 12 of the Exchange Act and be subject to the periodic reporting requirements of section 13, so long as it has fewer than 500 investors or no more than $10 million in assets as of the end of its

200. Regulation D, Rule 506, 17 C.F.R. §§ 230.502(c) & 506(b)(1) (2007).

201. Regulation D, 17 C.F.R. § 230.502(c)(1) (2007).

202. *See* Regulation D, 17 C.F.R. § 230.506(b)(2)(ii); HAMMER ET AL., *supra* note 16, at 122–23.

203. *See* In re CGI Capital, Inc., Securities Act Release No. 7904 (Sept. 29, 2000).

204. Regulation D, 17 C.F.R. § 230.502(d) (2007) (stating that "securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under section 4(2) of the [Securities] Act and cannot be resold without registration under the Act or an exemption therefrom").

205. *Id.* Exercising reasonable care to prevent resale is meant "to assure that the purchasers of the securities are not underwriters within the meaning of section [2(a)(11)] of the [Securities] Act." *Id.*

most recent fiscal year.[206] However, all hedge funds are subject to certain reporting requirements under the Exchange Act relating to disclosure of significant holdings.[207]

Because hedge funds are in the business of investing in or trading securities, they would fall within the definition of "investment company" under the Company Act if not for the fact that they typically rely upon one of two exclusions from the definition of investment company. Under section 3(c)(1) of the Company Act, hedge funds are excluded from the definition of investment company as long as they have no more than 100 investors and sell their securities only through a private placement.[208] Under section 3(c)(7) of the Company Act, hedge funds are excluded from the definition of investment company as long as they only sell securities to "qualified purchasers" through a private placement.[209] A natural person satisfies the definition of "qualified purchaser" under the Company Act if they own at least $5 million in investments.[210] Section 3(c)(7) funds may sell to an unlimited number of qualified purchasers without falling within the definition of an investment company but limit their sales to 499 investors so as not to be required to register under section 12 of the Exchange Act.[211] The latter two provisions are the subject of the regulatory reforms proposal below.[212]

Finally, hedge fund managers meet the definition of "investment adviser" under the Advisers Act.[213] However, most fund managers are exempt from registration because they qualify as small advisers. To qualify as a small adviser, hedge fund managers must, among other things, only provide investment advisory services to fewer than fifteen clients, not hold themselves out to the public as advisers, and not provide advisory services to a registered investment company.[214] A "client" includes a legal organization, thereby allowing hedge fund

206. *See* Exchange Act § 12(g), 15 U.S.C § 78*l*(g) (2000); Exchange Act Rule 12g-1, 17 C.F.R. § 240.12g-1 (2007). Hedge funds also typically do not need to register as broker-dealers under the Exchange Act. SEC STAFF REPORT, *supra* note 2, at 18.

207. *See infra* Part III.B.2.

208. Company Act § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (2000).

209. Company Act § 3(c)(1), 15 U.S.C. § 80a-3(c)(7) (2000). Nonpublic offerings for the purposes of being exempted from the Company Act are generally interpreted to be the same as those under section 4(2) of the Securities Act. SEC STAFF REPORT, *supra* note 2, at 12 n.36.

210. Company Act § 2(a), 15 U.S.C. § 80a-2(a)(51)(A)(i) (2000); Company Act Rule 2a51-1, 17 C.F.R. § 270.2a51-1(g)(2) (2007) (explaining how to calculate a natural person's level of investments for the purposes of being a qualified purchaser).

211. *See* Exchange Act § 12(g), 15 U.S.C § 78*l*(g) (2000).

212. *See infra* Part IV.A–B.

213. *See* Advisers Act § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2000).

214. Advisers Act § 203(b)(3), 15 U.S.C. § 80b-3(b)(3) (2000).

managers to count each separate fund as a client and not each separate investor in each fund.[215] Unregistered managers are generally not subject to any limitations on charging performance fees.[216] In addition, even registered investment advisers to section 3(c)(7) funds are not subject to limitations on charging a performance fee.[217]

III.
How Wealth-Based Qualifications Harm Investors

Predicating exemptions from the Securities Act and Company Act upon the wealth of investors is intended to further the goal of investor protection. However, this approach actually undermines investor protection. Wealth-based qualifications effectively prohibit sophisticated retail investors from using hedge funds to reduce their risk of loss and do not protect unsophisticated investors from bearing the risks or investment complexity associated with hedge fund investing.

A. Rationales for Limiting Hedge Funds Only to Wealthy Investors

The rationales for limiting hedge funds to wealthy investors stem from the fundamental purpose of securities law, which is to protect investors from being fleeced by companies issuing securities and securities traders. The legislative history of the Securities Act and the Exchange Act demonstrates that Congress was concerned with ordinary investors being subjected to inadequate disclosure, fraud, and manipulation of stock prices.[218] Nearly every provision in the Securities Act and the Exchange Act has the goal of protecting individual investors from unscrupulous issuers.[219] The securities laws seek to protect investors by mandating a wide-ranging and detailed regime of disclosure and reporting on issuers and holding issuers liable for fraud in connection with such disclosures. The Securities Act seeks "to provide full and fair disclosure of the character of securities" sold by issuers to raise capital.[220] The Exchange Act mandates disclosure and

215. Advisers Act Rule 203(b)(3)-1(a), 17 C.F.R. § 275.203(b)(3)-1(a) (2007).
216. *See* Hammer et al., *supra* note 16, at 333.
217. Advisers Act § 205(b)(4), 15 U.S.C. § 80b-5(b)(4) (2000) (exempting Company Act 3(c)(7) funds from limiting performance fees for registered investment advisers only to qualified clients).
218. C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 6 Duke L. J. 1081, 1133 (1988).
219. *See id.* at 1134.
220. *See* Securities Act, Preamble, 48 Stat. 74, 73d Cong. (1933). There is little controversy over the purposes of the federal securities laws. *See, e.g.*, S. Rep. No. 73-47, at 1 (1933) (noting that the "basic policy [of the Securities Act] is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresenta-

periodic reporting to prevent abusive trading practices and facilitate accurate valuation of securities through secondary markets.[221] The Company Act and Advisers Act likewise employ disclosure to protect investors.[222]

Because the disclosure system seeks to protect investors from being misled by issuers, exemptions from the system are allowed when mandatory disclosure is unnecessary for investors to make informed investment choices. This approach is evident in the context of exemptions from the Securities Act, which are allowed when an issuer is offering securities to investors who do not need the protections of mandatory disclosure because they can "fend for themselves."[223] Fending for oneself means possessing enough knowledge about the issuer and financial sophistication to make an informed investment decision.[224] Thus, registration and disclosure under the Securities Act is unnecessary when potential investors have access to or are furnished with the same kind of information made available under a re-

---

tion."); *Ralston Purina Co.*, 346 U.S. at 124 ("The design of the [Securities Act] is protect investors by promoting full disclosure of information thought necessary to informed investment decisions.").

221. *See* Phillip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 226 (1959) (arguing that periodic reporting under the Exchange Act "is an essential part of the effort to remedy abuses in exchange trading" because "the absence of public disclosure of the facts facilitates manipulation, speculation on inside information, and other improper practices"); John E. Tracy & Alfred Brunson MacChesney, *The Securities and Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1048 (1934) (noting that the Exchange Act disclosure requirements facilitate "evaluation of prices of securities"). In addition to disclosure and fraud liability, the Exchange Act also expressly prohibits manipulative and abusive trading practices by insiders, speculators, and others. *See* Exchange Act §§ 8–11, 16, 15 U.S.C. §§ 78h–j, 78p (2000).

222. *See* Company Act § 1(b)(1), 15 U.S.C. § 80a-1(b)(1) (2000); Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (explaining that the purpose of the Advisers Act is to "'substitute a philosophy of full disclosure for the philosophy of *caveat emptor*' in the investment advisory profession") (quoting SEC. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)); Loomis, *supra* note 221, at 245 (noting the registration and disclosure requirements of the Advisers Act sought to provide "a compulsory census of investment advisers and which would provide in a small degree for the regulation of some of their activities") (internal quotations omitted).

223. *See Ralston Purina Co.*, 346 U.S. at 125–27 ("An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.' . . . The focus of inquiry should be on the need of the offerees for the protections afforded by registration.").

224. *Id.* at 124–26 (holding that "the exemption [from the Securities Act] question turns on the knowledge of the offerees"); *SEC v. Manus*, et al., 1981 WL 1683 (S.D.N.Y.), Fed. Sec. L. Rep. P98,307, at *6 (noting that under *Ralston,* the offerees in a private offering should have the ability to evaluate the merits of the issue and be disclosed information about the issuer like that disclosed in a registration statement).

gistration statement.[225] Consistent with this approach is the carve-out for nonaccredited investors under Rule 506, which allows sale to up to thirty-five sophisticated nonaccredited investors, provided that material information about the company and the securities is provided before the sale.[226]

In contrast to exemptions based upon *actual* investor knowledge and sophistication, the two most important exemptions relied upon by hedge funds use investor wealth as the sole criterion to be exempt from mandatory disclosure.[227] Rule 506 enables a hedge fund to be exempt from the Securities Act and not have to disclose any information to prospective investors as long as they are accredited investors. Similarly, under section 3(c)(7) of the Company Act, investment companies are not required to register or disclose information as long as they limit their sales to qualified purchasers.[228] Both of these exemptions are based upon the assumption that wealth is an indication of the ability to make informed investment choices.[229]

In proposing to increase the level of wealth required to qualify as an accredited investor under Regulation D, SEC staff articulated how wealth-based qualifications specifically apply to hedge fund investing.[230] After recognizing that substantially more investors became qualified to invest in hedge funds since the definition of accredited investor was first established in 1982, the SEC expressed concern that

---

225. *See Ralston Purina Co.,* 346 U.S. at 125–26.

226. *See* Regulation D, 17 C.F.R. §§ 230.502(b)(1), 230.506(b)(2) (2007). *See supra* text accompanying note 198.

227. Fletcher, *supra* note 218, at 1123 ("Rule 506 thus departs from the *Ralston Purina* line of cases. Whereas before, private placement purchasers had to be smart, now they need only be rich.").

228. Rule 506 and Company Act section 3(c)(7) do not require disclosure, but hedge funds operating pursuant to such provisions nonetheless make comprehensive disclosures to investors pursuant to other provisions of the federal securities laws. *See infra* Part III.B.2.

229. Accredited Natural Person Rule, *supra* note 3, at 404 (noting that the level of wealth or income required to qualify as an accredited investor under Rule 506 is based on the SEC's view that such levels meet the "goal of ensuring that only such persons who are capable of evaluating the merits and risks of an investment in private offerings may invest in one"); S. REP. NO. 104-293, at 10 (1996) (''The qualified purchaser pool [for 3(c)(7) funds] reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections. Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.'').

230. Although the proposed rules apply to various types of private investment funds, the SEC's accompanying release reflects a primary concern with hedge funds. *See* Accredited Natural Person Rule, *supra* note 3, at 400 n.3, 404 n.42, 404 n.43.

more recently qualified investors "may find it difficult to appreciate the unique risks" of hedge funds.[231] The SEC claimed that hedge funds use "complicated investment strategies," and "minimal information about [the funds is] available in the public domain" such that "investors may not have access to the kind of information provided through our system of securities registration."[232] From the SEC's point of view, hedge funds "have become increasingly complex and involve risks not generally associated with many other issuers of securities."[233] As a result of the SEC's beliefs regarding minimal information, increased complexity, and unique risks being associated with hedge funds, it concluded that investors may fail to appreciate the risks of hedge funds relating to issues such as "undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns."[234] Accordingly, the SEC proposed Rule 509 to increase the net worth required to invest in hedge funds and ensure that each individual hedge fund investor "has a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools."[235] In particular, the $2.5 million in investments qualification is supposed to be

> consistent with [the SEC's] goal of providing an objective and clear standard to use in ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and experience in financial and business matters to enable that purchaser to evaluate the merits and risks of a prospective investment, or to hire someone who can.[236]

Under the federal securities laws, therefore, wealthy investors are deemed able to make informed choices about hedge funds because, even if they do not, in fact, possess sufficient financial acumen, they are able to purchase the services of those with financial sophistication, or at least bear the losses from poor investment choices.

---

231. *Id.* at 404.
232. *Id.*
233. *Id.*
234. *Id.*
235. *Id.* It should be noted that proposed Rule 509 only applies to investments in hedge funds exempt from the Company Act under section 3(c)(1) and not 3(c)(7). The SEC's rationale was that natural persons investing in 3(c)(7) funds were already required to own $5 million in investable assets to be a qualified purchaser to invest and hence did not need the added protections of Rule 509. *Id.*
236. *Id.* at 405.

B. Deficiencies in Limiting Hedge Funds Only to Wealthy Investors

The financial acumen of retail investors likely to invest in hedge funds and the disclosure practices typical of the funds indicate that such investors are well-positioned to benefit from hedge fund investing. Broadening access would almost certainly not lead unsophisticated retail investors to begin investing in the funds. In any case, all retail investors can already expose themselves to risks and complexities similar to that of hedge funds merely by investing in registered investment companies and other public companies with complex business operations. Limiting hedge funds to wealthy investors therefore prohibits sophisticated retail investors from earning the highest returns on investment risks the law already permits them to bear.

1. Sophistication of Likely Retail Hedge Fund Investors

In determining whether retail investors possess sufficient investment sophistication to make informed choices about hedge funds, the relevant group to focus on is retail investors already investing in traditional investments and likely to express a demand for and willingness to undertake the steps to invest in the funds. The relevant group is not the entire population of potential retail investors in the United States, half of whom make no or little investments in stocks of any kind.[237] Unsophisticated retail investors are highly unlikely to express a demand for hedge funds, much less undertake the effort to invest in the funds. This is because research finds that retail investors are typically risk averse, fail to properly diversify their portfolios, and biased towards investing in companies they are familiar with, even when doing so undermines their economic interests.[238] The difficulty of retail hedge funds in attracting investors in foreign jurisdictions such as Singapore and Hong Kong also provides some indication that unsophisticated investors would not make substantial investments into hedge

237. SECURITIES INDUSTRY ASSOCIATION, 2000 INDUSTRY FACT BOOK 64 (finding that nearly 50% of U.S. households have invested in stocks).

238. *See* H. Henry Cao et al., Fear of the Unknown: The Effects of Familiarity on Financial Decisions 6–7, 33–34 (Sept. 16, 2003) (unpublished paper, *available at* http://faculty.fuqua.duke.edu/areas/finance/papers/familiarity09-08-03.pdf) (finding evidence indicating that individuals prefer familiar investments); Warren Bailey et al., Home Bias of U.S. Individual Investors: Causes and Consequences 18 (Apr. 22, 2006) (unpublished paper, *available at* http://ssrn.com/abstract=633902) (finding that less sophisticated and wealthy investors display bias towards home country stocks despite the benefits of international diversification).

funds.[239] Accordingly, increased access to hedge funds is highly unlikely to induce retail investors to invest in funds they know little about when they currently fail to utilize the vast array of widely publicized and low-cost opportunities (e.g., mutual funds, ETFs) already open to them.

Retail hedge funds would likely be operated by major financial institutions that have little incentive to market or sell their shares with promises of exorbitant returns to appeal to uninformed investors.[240] Although there is the possibility that unsophisticated investors might invest in hedge funds, because of the risk and complexity of many public companies, the availability of hedge fund-like investments, and the ability of retail investors to engage in numerous complex trading strategies on their own, retail hedge funds would not meaningfully add to retail investors' already limitless opportunities to take on risks above their level of financial sophistication.[241]

By contrast, retail investors undertaking steps to invest in hedge funds are likely to possess the requisite sophistication. Surveys of retail investors find that 72% understand the tradeoff between risk and return and 80% seek to diversify their portfolios.[242] And because obtaining the services of a sophisticated purchaser representative will likely lead an investor to make informed investment choices, retail investors interested in hedge funds can likely purchase the requisite sophistication due to the widespread availability of retail investment advisers through firms such as John Hancock, Charles Schwab, and Morgan Stanley.[243] Accordingly, a substantial portion of retail inves-

239. *See* Michael Ferguson, Ernst & Young, *Hedge Funds Entering the "Mass-Market" Arena*: *Funds Europe*, Feb. 2004, at 1 (on file with the *New York University Journal of Legislation and Public Policy*) (predicting based upon the experience of Singapore and Hong Kong the demand for retail hedge funds in Europe will be "disappointing"); *Hedge Funds Flock to Hong Kong*, TDCTRADE.COM, Dec. 2005, *available at* http://banking.tdctrade.com/suc-e481.htm (reporting that Sally Wong, Executive Director of the Hong Kong Investment Funds Association "thinks it will take some time for retail investors to warm to hedge funds").

240. *See supra* notes 78–80 and accompanying text.

241. On the risk and complexity of registered public companies, *see infra* Part III.B.4. On the availability and complexity of hedge fund-like investments, *see supra* Part I.D.2. Because the reforms proposed here require the operator of a trading platform for retail hedge funds to permit only sophisticated investors to trade, the potential for unsophisticated investors to invest in the funds is negligible.

242. APPLIED RESEARCH & CONSULTING LLC, NASD INVESTOR LITERACY RESEARCH 8 (2003) (finding that 72% of surveyed investors "knew that riskier investments yield higher returns over time than less risky investments"); *Hartford Survey Finds Eight Out of Ten Americans Keen on Asset Allocation*, PR NEWSWIRE, July 8, 2004 (finding 80% of investors sought to diversify their portfolios).

243. Such firms typically charge investors a fee totaling a percentage of the investor's assets. *See*, *e.g.*, Charles Schwab, Representatives' Compensation, http://

tors are in a position to benefit from hedge fund investing, far greater than the estimated 8.47% of U.S. households (which includes single and married individuals) currently permitted to invest due to wealth-based qualifications.[244] Furthermore, wealthy individuals and institutional investors are hesitant to invest in hedge funds until they have a sufficient understanding of the funds' investment strategies and associated risks.[245] This suggests that retail investors are likewise unlikely to purchase hedge fund securities until and unless they have sufficient familiarity with the funds' strategies and risks to make an informed investment decision.[246]

Financial sophistication is not merely a matter of an investor's business acumen in the abstract. As Regulation D correctly recognizes, an investor is financially sophisticated when the investor, either alone or with the assistance of a purchaser representative, has "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment" under consideration.[247] Sophistication is therefore also a function of the *quality* of information disclosed about the issuer, either by the issuer itself or a third party information provider. The more understandable and relevant information is disclosed, the more "capable of evaluating" is the investor.

The law recognizes that investors with relatively little financial expertise can be "sophisticated." Rule 506 recognizes that employment of a sophisticated purchaser representative deems an otherwise unsophisticated investor qualified for the purposes of taking part in a private placement.[248] Furthermore, in *Bayoud v. Ballard*, the court found physicians who successfully operated and sold their own medical clinic to be financially sophisticated for the purposes of a private placement under Section 4(2) of the Securities Act where "the factual

---

www.aboutschwab.com/about/overview/compensation.html (last visited Jan. 13, 2008).

244. Accredited Natural Person Rule, *supra* note 3, at 406.

245. *See* Joseph Finora, *Hedge Funds Don't Sell Themselves*, FINANCIAL-PLANNING.COM, http://www.financial-planning.com/pubs/wealth_adviser/20050310101.html (last visited Feb. 12, 2008) (reporting that one hedge fund manager found that in marketing to wealthy individuals "the greatest challenges facing those trying to market hedge funds is providing a basic explanation of what's behind the product"); BANK OF N.Y. & CASEY, QUIRK & ASSOCS., *supra* note 51, at 4 (finding that increased allocations to hedge funds by institutions is the result of increased comfort with their trading strategies).

246. *See* Cao et al., *supra* note 238, at 6–7, 33–34 (finding that individuals avoid investments that are unfamiliar).

247. Regulation D, 17 C.F.R. § 230.506(b)(2)(ii) (2007).

248. *See id.*; Regulation D, 17 C.F.R. § 230.501(h) (2007) (defining "purchaser representative").

equivalency of a prospectus" was disclosed to them.[249] The law affords greater weight to disclosure for the purposes of purchasing unregistered securities, likely in part because financial sophistication is a relatively vague concept. The court in *Doran v. Petroleum Mgmt. Corp.* held that so long as information material to making an informed investment decision is provided to offerees, it may not even be necessary to inquire into financial sophistication to establish a private placement exemption.[250]

Financial sophistication is therefore measured by a sliding scale, consisting of an investor's financial acumen and the quality of information provided about the issuer: the higher the quality of information about the issuer, the less knowledge and experience in financial and business matters an investor needs to be sophisticated; and vice versa. Figure 3 provides an illustration of this approach. On the vertical axis is the quality of disclosures made about the issuer. "Quality" refers not only to how much and how often information about the issuer is disclosed, but also how easy it is to understand, how relevant it is to investment choice, and how accurate it is from an accounting point of view. On the horizontal axis is an investor's level of technical knowledge and experience in business and financial matters. Each point along curve S_1 represents a different type of sophisticated investor, reflecting the combination of financial acumen and quality of disclosure required to make an informed investment choice. A retail investor interested in hedge funds likely understands the risk/return tradeoff and the benefits of portfolio diversification, and to make an informed investment choice requires relatively high quality disclosures in terms of being easily understandable and material to the risks involved with the issuer and its securities.

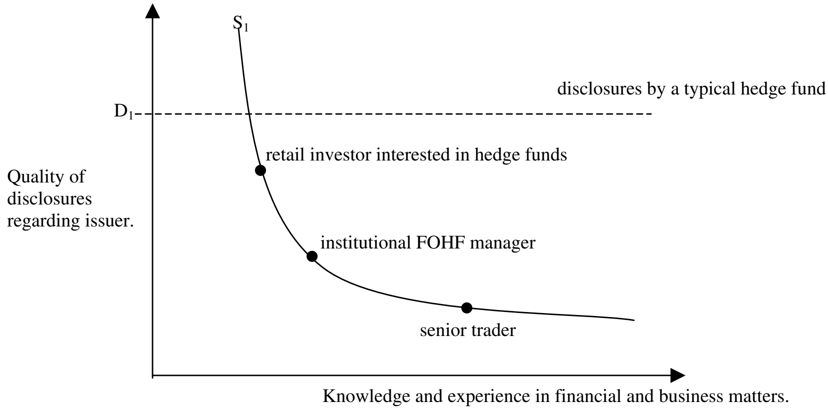
Figure 3 also illustrates an institutional FOHF manager, who possesses investment skills superior to a retail investor and can make informed investment choices without standardized and easily readable information about the issuer. Finally, a trader employed by a hedge

249. Bayoud v. Ballard, 404 F. Supp. 417, 423–24 (N.D. Tex. 1975).

250. *See* Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 902–03, 902 n.10 (5th Cir. 1977) ("We do not intimate that evidence of the offerees' sophistication is required in all cases to establish a private offering exemption under § 4(2)" of the Securities Act, which solely requires a "sufficient basis of accurate information upon which the sophisticated investor may exercise his skills."). Indeed, post-*Ralston* jurisprudence correctly recognizes that even the most astute investor cannot make an informed choice if the issuer fails to disclose sufficient information about itself. *Id.* at 902 (finding that investor "[s]ophistication is not a substitute for access to the information that registration would disclose"); Lawler v. Gilliam, 569 F.2d 1283, 1290 (4th Cir. 1978) ("In short, there must be sufficient basis of accurate information upon which the sophisticated investor may exercise his skills.").

fund likely requires the lowest quality information about issuers to make informed investment choices. A hedge fund trader may, for instance, apply complex financial models to large bodies of risk and return data to form their own proprietary knowledge about an issuer.[251]

FIGURE 3: THE RANGE OF SOPHISTICATED INVESTORS



Based on the goal and analysis of portfolio diversification presented in Part I.C, a retail investor needs to have the following information presented in an accessible manner to be able to fend for himself in purchasing or selling a security.[252] First, a retail investor should know how the security performed historically and the absolute level of risk or volatility of the security. These two pieces of information let the investor know how good an indicator past returns are of future returns and thereby form an estimate of expected future returns. Second, the investor should know how the security's returns are related to market trends and to what specific market risk factors the security may be exposed. These items allow the investor to diversify his or her portfolio. Finally, the investor should know the price at which the security can be sold on a timely basis. All things being equal, the greater the liquidity of the security—the ability to trade on a short-term basis at net asset value—the better off is the investor.

251. For example, a common type of trading strategy known as "statistical arbitrage" uses quantitative models in deciding what stocks to buy or sell-short. *See* ARMELLE GUIZOT, THE HEDGE FUND COMPLIANCE AND RISK MANAGEMENT GUIDE 11 (2007).

252. A similar standard for investors in private pools such as hedge funds was enunciated by the President's Working Group on Financial Markets. *See* AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL 2 (2007), *available at* http://www.treasury.gov/press/releases/reports/hp272_principles.pdf.

In the context of retail investors making informed choices about hedge fund issuers, a substantial majority of retail investors taking the necessary steps to invest in hedge funds would likely be sufficiently sophisticated. First, a retail investor interested in hedge funds is likely to understand that higher expected returns tend to come with higher risk and will likely attempt to further diversify his or her portfolio.[253] Second, as discussed in detail in the next two subsections, the disclosure practices currently utilized by hedge funds and third parties are sufficient to allow such an investor to make an informed choice. These disclosures are at a level illustrated by D_1 in Figure 3.

Importantly, to be sufficiently sophisticated to make informed investment choices, it is not necessary to precisely understand the mechanics of a company's day-to-day operations. Just as it is not necessary to understand the intricacies of modern finance or medical equipment innovation to make informed investment decisions regarding publicly traded companies like Goldman Sachs or Medtronic, respectively, it is not necessary for retail investors to have anything beyond a basic understanding of derivatives, short-sales, and hedge fund investing strategies to make informed choices about purchasing the securities of the funds. Indeed, too much disclosure about hedge fund operations may mislead and confuse investors who are unable to properly interpret the information.[254] Sophisticated institutional investors, for instance, rarely desire hedge funds to disclose information about their specific positions and instead are able to make informed decisions so long as risk factors and information of the type mentioned above are disclosed.[255] Similarly, sophisticated retail investors should be able to make informed investment choices without possessing in-depth and detailed knowledge of the activities of the funds they invest in.

253. *See* APPLIED RESEARCH & CONSULTING LLC, *supra* note 242, at 8.

254. *See* Bernanke, *supra* note 74 (rejecting the notion that regulators should attempt to create a real-time database to track hedge fund investments because of the impracticability of regulators gathering and interpreting vast amounts of financial data).

255. *See* EDHEC-Risk Asset Mgmt. Research, *What Institutions Really Want from Hedge Funds/Funds of Funds*, May 31, 2007, http://www.edhec-risk.com/latest_news/featured_analysis/RISKArticle.2007-05-31.2202 (noting that only a small proportion of institutions desire transparency at the position level); BANK OF N.Y. & CASEY, QUIRK & ASSOCS., *supra* note 51, at 10.

2. *Hedge Fund Disclosure Practices*

Hedge funds are widely regarded as highly opaque investment vehicles.[256] This is a misunderstanding. Although hedge funds are not subject to all of the registration and reporting requirements of the federal securities laws and benefit from proprietary trading strategies, as a matter of law and practice the funds make substantial and detailed disclosures. As the industry becomes more prominent and institutionalized and competition for investors grows, hedge funds are likely to further expand and standardize disclosures to avoid liability and to meet investor demand. The involvement of retail investors with hedge funds would likely intensify such trends because the potential value of their business would increase the value of expanding and standardizing disclosures.

Mandatory disclosure by hedge funds arises from the requirement that all investment funds must comply with the anti-fraud provisions of the federal securities laws. Funds engaging in a private placement pursuant to section 4(2) and Regulation D are subject to liability for fraud under the Securities Act, the Exchange Act, and the Advisers Act.[257] These statutes prohibit specific material misstatements, fraudulent conduct more generally (i.e., conduct not involving "statements"), and also material omissions. Under section 17(a) of the Securities Act, it is unlawful for a fund making an offering pursuant to Regulation D to make any untrue statement of material fact or to omit any fact so as to render any other statement made misleading.[258] Rule 10b-5 promulgated pursuant to section 10(b) of the Exchange Act likewise prohibits making material omissions in connection with the sale of any security.[259] In addition, the Advisers Act prohibits material misstatements, misleading omissions, and other fraudulent practices to investors or prospective investors by any registered or unregistered hedge fund advisor.[260] The Advisers Act prohibits any fund manager from making false or misleading statements regarding investment strategies, experience and credentials, risks associated with

---

256. *See, e.g.*, Bernanke, *supra* note 74 (noting that "[i]t is commonly observed that hedge funds are 'opaque'—that is, information about their portfolios is typically limited and infrequently provided").

257. Regulation D, Preliminary Notes 1, 17 C.F.R. § 230.501 (2007) (noting that transactions pursuant to Regulation D "are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws").

258. Securities Act § 17(a), 15 U.S.C. § 77q(a) (2000) (applying its provisions to "the offer or sale of any securities").

259. Exchange Act § 10(b), 15 U.S.C. § 78j (2000); Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007).

260. Advisers Act §§ 206(4)–(8), 15 U.S.C. §§ 80b-4–8 (2000).

the fund, and valuation of the fund's assets.[261] Furthermore, under the Securities Act and the Advisers Act, fraudulent or misleading statements or omissions do not require willful wrongdoing to be unlawful, which means that hedge funds and their advisers may be prosecuted by the SEC for mere negligence.[262] Thus, if a fund makes *any* disclosures to potential investors, it is required to make *additional* disclosures to ensure no statements are misleading.[263] The anti-fraud provisions are an *implied* disclosure rule requiring true, accurate, and comprehensive disclosures in connection with hedge fund offerings.[264]

In addition, to qualify for a statutory private offering pursuant to Section 4(2) of the Securities Act, as hedge funds typically seek to do, a fund must provide potential investors with access to the same type of information as would be provided in a registration filed pursuant to section 5 of the Securities Act.[265] No amount of financial sophistication on the part of the offerees extinguishes the need to provide access to information material to the decision whether to invest.[266] As a matter of business practice, and to comply with their legal duties under the anti-fraud laws and section 4(2), hedge funds typically take the additional step of directly furnishing to potential investors a private placement memorandum ("PPM").[267] A PPM contains the type of information that would be provided by a registration statement pub-

261. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,759 (Aug. 9, 2007) (to be codified at 17 C.F.R. pt. 275).

262. *Id.* at 44,759–60 (noting that negligent misstatements are prohibited under the Advisers Act); Aaron v. SEC, 446 U.S. 680, 701–02 (1980) (holding that because a violation of either section 17(a)(2) or 17(a)(3) of the Securities Act does not require scienter, only a showing of negligence is required). Scienter is a "mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

263. *See* First Virginia Bankshares v. Benson, 559 F.2d 1307, 1317 (5th Cir. 1977) (noting that "a duty to speak the full truth arises when a defendant undertakes to say anything").

264. LEDERMAN, *supra* note 20, § 4:2.2 (noting that "in light of various federal and state anti-fraud provisions, a well advised hedge fund prepares a comprehensive offering memorandum, even if the offering is directed solely to accredited investors, to ensure that all material information is conveyed"); HAMMER ET AL., *supra* note 16, at 4 (noting that hedge funds generally make comprehensive disclosures to investors, even though an SEC staff comment indicates that they are not required to do so).

265. *See supra* Part II.B.1.

266. *See* Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 902 (1977); Lawler v. Gilliam, 569 F.3d 1283, 1290 (1978).

267. SEC STAFF REPORT, *supra* note 2, at 46 ("Most hedge funds provide written information to their investors in the form of a private offering memorandum or private placement memorandum ('PPM')."); HAMMER ET AL., *supra* note 16, at 118 ("Instead of merely providing access to information, the issuer may furnish directly the information that would be provided by a registration statement, as in a private offering memorandum that fully discloses such information.").

licly filed under Section 5 of the Securities Act.[268] A hedge fund's disclosures in a PPM contain information similar to that required to be disclosed on Form N-1A or Form S-1, in addition to the unique facts and circumstances of the fund.[269] Accordingly, hedge funds typically disclose the following information in connection with a private placement: a basic description of the fund including its investment objectives, strategies, and the types of securities the fund purchases; risks pertaining to its investment strategy and regulatory and tax issues; a description of how advisory fees are calculated and conflicts of interest by the managers or other principals; a summary of the terms of the fund, how it is managed and organized, and how investors can redeem shares; and financial statements including net asset value and how it is calculated.[270]

Hedge funds often make substantially greater and more intelligible disclosures than those found in a registration statement or made by registered investment companies under the Company Act. These disclosures include detailed monthly or quarterly summaries of relevant market conditions and trading strategies, relative performance data compared to benchmarks such as hedge fund indices, equity indices, and Treasury yields, and descriptions of what losses were attributable to what strategies or investment group.[271] Hedge fund disclosures may also simplify the choices made by investors relative to investing in mutual funds by providing Sharpe and Sortino ratios, which are two ways of measuring the risk-adjusted performance of a fund.[272] As institutional investors become increasingly involved with hedge funds and continue to demand substantial disclosures, comprehensive and intelligible disclosures of these kinds will likely become ubiquitous.[273] In sum, hedge funds typically disclose to offerees and investors the

268. SEC Staff Report, *supra* note 2, at 47–49 (describing the information typically disclosed in a PPM); Hammer et al., *supra* note 16, at 118 ("A hedge fund's private offering memorandum should contain all of the information required in a registration statement . . . .").

269. Lederman*, supra* note 20, § 4:2.2.

270. SEC Staff Report, *supra* note 2, at 47–49; Lederman*, supra* note 20, § 4:2.2; Hammer et al., *supra* note 16, at 144–59.

271. *See* Gibney & Leu, *supra* note 117, at 5.

272. *Id*. A Sortino ratio measures risk-adjusted performance using only extreme downside movements to measure risk. *See* HedgeCo.Net, Sharpe Vs Sortino Ratio, http://www.hedgeco.net/sharpe-ratio-sortino-ratio.htm (last visited Oct. 17, 2007).

273. *See* Bank of N.Y. & Casey, Quirk & Assocs., *supra* note 51, at 11–12 (indicating trend toward greater transparency); Christine Williamson, *Demand by Clients Gives Firms Offering Details on Portfolios a Competitive Edge*, Pensions & Investments, Nov. 6, 2007, http://www.pionline.com/apps/pbcs.dll/article?AID=/20071015/PRINTSUB/71012043/1031/toc (reporting that because of "institutional investor demand, both the level of portfolio transparency and the number of hedge fund manag-

same type of information required to be disclosed under section 5 of the Securities Act, and many make disclosures of a higher quality than those made by registered investment companies.[274]

The foregoing analysis covers those disclosures typically made by hedge funds to be legally operational and competitively situated among their peer firms. However, many hedge funds either choose to or are legally required to make significant additional disclosures. For instance, it is estimated that 50% of hedge fund managers voluntarily register under the Advisers Act and submit to its disclosure requirements, and some portion of those do so to signal quality and accountability to investors.[275] As of July 2007, about 1977 hedge fund managers were registered with the SEC,[276] and a 2007 fund manager survey found that 87% of all managers registered either with the SEC, Commodities Future Trading Commission ("CFTC"), National Association of Securities Dealers, or a state regulatory authority.[277] Registration of a substantial portion of hedge fund advisers with a regulatory authority indicates that many of the funds are willing to increase their transparency to demonstrate accountability and attract investors.

Under the Exchange Act, all hedge funds and their managers are required to publicly disclose any large shareholdings of public companies to the SEC. Under sections 13(d) and 13(g), hedge funds or their advisers must disclose beneficial ownership of greater than 5% in a class of voting shares of securities registered under section 12 of the Exchange Act and whether the purpose of such ownership is to acquire or influence the issuer.[278] Section 16(a) requires hedge funds to disclose ownership of 10% or more in any class of voting equity se-

---

ers willing to provide that transparency have increased dramatically during the past two years").

274. *See* Gibney & Leu *supra* note 117, at 5.

275. HAMMER ET AL., *supra* note 16, at 17 (noting that "some investment advisers choose to register with the SEC to gain whatever marketing cachet SEC registration might afford or to avoid potentially more burdensome or less predictable state registration"); SEC STAFF REPORT, *supra* note 2, at 22 n.76; Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 45,172, 45,181 n.98 (July 28, 2004) (estimating that 30 to 50% of hedge fund managers voluntarily register); *The Hedge Fund 100*, INSTITUTIONAL INVESTOR, June 2002, at 43 (finding that disclosure among the largest 100 hedge fund managers is becoming more common).

276. Siobhan Hughes, *Fund Advisers Deregister*, WALL ST. J., July 9, 2007, at A4.

277. Press Release, Hennessee Group LLC, HENNESSEE GROUP LLC RELEASES 13TH ANNUAL HEDGE FUND MANAGER SURVEY (May 1, 2007), *available at* http://www.hennesseegroup.com/releases/release20070501.html.

278. Exchange Act § 13(d), 15 U.S.C. § 78m(d) (2000); Exchange Act § 13(g), 15 U.S.C. § 78m(g) (2000); Exchange Act Rule 13d-1(a), 17 C.F.R. § 240.13d-1(a) (2007).

curities registered pursuant to the Exchange Act, including any subsequent changes in ownership of such securities.[279] In addition, under section 13(f), hedge funds owning more than $100 million in stock traded on a national exchange or on the NASDAQ are required to quarterly disclose to the SEC their equity holdings on Form 13F,[280] a disclosure more likely to be made as the median size of hedge funds increases. Certain hedge funds investing in commodities must register and make substantial additional disclosures under the Commodities and Exchange Act and are subject to inspection and regulation by the CFTC.[281]

3. *Transparency Through Third Party Information Providers*

In its proposed rule increasing the net worth required to be an accredited investor in hedge funds, the SEC asserted that "minimal" information about hedge funds exists in the public domain.[282] Although hedge funds are not subject to all aspects of the federal system of registration and disclosure,[283] the SEC's claim that minimal information about the funds is in the public domain fails to account for the overwhelming and growing amount of publicly available information about all aspects of the hedge fund industry, much of which is available at no cost over the Internet or through public libraries.

Information about hedge funds in the public domain, much of which is accessible to a general audience, includes: book-length treatments;[284] academic, industry, and government studies;[285] and coverage in the popular press.[286] News services, blogs, and other sources of information provide, in near real-time, news and analysis of the indus-

---

279. Exchange Act § 16(a)(3)(B), 15 U.S.C. §78p(a)(1) (2000); Exchange Act Rule 16a-1, 17 C.F.R. § 240.16a-1–2 (2007).

280. Exchange Act Rule 13f-1(a), 17 C.F.R. § 240.13f-1(a)(1) (2007).

281. *See* HAMMER ET AL., *supra* note 16, at 170–79.

282. Accredited Natural Person Rule, *supra* note 3, at 412.

283. Ultimately, the relative lack of publicly available information about hedge funds is due in substantial part to the prohibitions against general solicitation and advertising under Regulation D and can and should be remedied for the reasons detailed in Part IV.A.3 *infra*.

284. *See, e.g.*, BARTON BIGGS, HEDGEHOGGING (2006); RICHARD M. BOOKSTABER, A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION (2007).

285. *See, e.g.*, CTR. FOR INT'L SEC. & DERIVATIVES MKTS., THE BENEFITS OF HEDGE FUNDS: 2006 UPDATE (2006), *available at* http://cisdm.som.umass.edu/research/pdffiles/benefitsofhedgefunds.pdf; BERNSTEIN GLOBAL WEALTH MGMT., HEDGE FUNDS: TOO MUCH OF A GOOD THING? (2006), *available at* https://www.bernstein.com/CmsObjectPC/pdfs/B32267_HF_TooMuchGoodThing.pdf.

286. *See, e.g.*, *Behind the Hedge*, N.Y. MAGAZINE, Apr. 9, 2007, http://nymag.com/news/features/hedgefunds/.

try.[287] Indeed, this Article was authored entirely based on publicly available information. The following is just a small indication of the kind of information freely available through the Internet: the distribution of hedge funds by the types and levels of fees they charged from 1981 to 2006,[288] publications discussing the sources and impact of potential conflicts of interest,[289] and several different measures of hedge fund risk and risk-adjusted performance by type of hedge fund from 1997 to 2006.[290]

Beyond general information about hedge funds, third parties also provide fund-specific information in a way that increases the overall quality of disclosures about hedge funds. Thus, in determining whether retail investors are sufficiently sophisticated to make informed investment choices regarding hedge funds, disclosures by third parties must be taken into consideration. Even if hedge fund issuers fail to make disclosures regarding particular items of information, third parties may make such disclosures and add to the overall quality of disclosures about a fund.

For instance, in 2005, Morningstar, an established provider of information and ratings of mutual funds, began to offer detailed reports on separate hedge fund issuers.[291] It currently rates more than 6000 separate funds (nearly 60% of the U.S. market) and has plans to ex-

287. *See*, *e.g.*, New York Times, Dealbook: Hedge Funds, http://dealbook.blogs.nytimes.com/category/hedge-funds; Seeking Alpha, Hedge Funds, http://seekingalpha.com/tag/hedge-funds. The role of hedge funds in the summer 2007 credit-market losses were immediately analyzed by no less than two academic studies. *See* NOËL AMENC, THREE EARLY LESSONS FROM THE SUBPRIME LENDING CRISIS: A FRENCH ANSWER TO PRESIDENT SARKOZY (2007), *available at* http://docs.edhec-risk.com/mrk/071008_subprime/EDHEC_Subprime_Crisis_Study.pdf; Amir E. Khandani & Andrew W. Lo, What Happened to the Quants in August 2007? (Nov. 4, 2007) (unpublished paper, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1015987).

288. BARTH ET AL., *supra* note 23, at 26–37.

289. *See, e.g*., Chester S. Spatt, Chief Economist and Dir., Office of Econ. Analysis, SEC, Conflicts of Interest in Asset Management, Keynote Address at Hedge Fund Compliance and Regulation Conference (May 12, 2005), *available at* http://www.sec.gov/news/speech/spch051205css.htm; Tom Nohel et al., Side-By-Side Management of Hedge Funds and Mutual Funds (Dec. 2006) (unpublished paper, *available at* http://ssrn.com/abstract=891867).

290. *See* VÉRONIQUE LE SOURD, EDHEC RISK & ASSET MGMT. RESEARCH CTR., HEDGE FUND PERFORMANCE IN 2006: A VINTAGE YEAR FOR HEDGE FUNDS? (2007), *available at* http://www.edhec-risk.com/edhec_publications/RISKReview.2007-03-19.5712/attachments/EDHEC%20Publi%20Hedge%20Fund%20Performance%20in%202006.pdf.

291. Svea Herbst-Bayliss, *Morningstar Expands Hedge Funds Survey, Eyes More*, REUTERS.COM, Apr. 30, 2007, http://www.reuters.com/article/fundsFundsNews/idUSN3042541320070430.

pand.[292] These reports provide all of the information identified above as required by retail investors to make informed investment choices.[293] Although Morningstar hedge fund reports are currently only available to qualified institutional buyers, a retail hedge fund market would very likely give the incentive for such reports to become available at low or no cost to retail investors. Morningstar, BusinessWeek, and numerous other institutions provide free online ratings of mutual funds and highly readable presentations of the funds' risk, correlation to the market, historical returns, and the identity of the fund manager.[294] To continue to serve retail clientele, such organizations would likely provide the same information about hedge funds for free or at low cost, providing further assurance that retail investors would have the ability to make informed investment decisions.

In sum, hedge funds make substantial and comprehensive disclosures to comply with anti-fraud laws, section 4(2) of the Securities Act, and other federal laws and also make additional important disclosures to attract investors and comply with industry norms. Third-party providers are also beginning to furnish all of the information required by a sophisticated retail investor to make informed investment decisions. These disclosures demonstrate that sophisticated retail investors do not need the protections of the Securities Act and Company Act when investing in hedge funds. Exemptions should therefore be provided for hedge fund securities sold to sophisticated retail investors.

4. *The Risk and Complexity of Hedge Funds*

The SEC takes the view that investing in hedge funds is fundamentally riskier and more complicated than investing in issuers registered under the securities laws.[295] However, the SEC's approach to hedge fund risk fails to recognize that the funds' risk must be evaluated in the context of their contribution to the overall risk of an invest-

---

292. *Id.*

293. For example, Morningstar Direct hedge fund reports provide information about historical return by year and across numerous monthly time frames, fees, several measures of correlation with the market, several measures of risk including the worst months, and how many negative months the hedge fund experienced. *See* Morningstar Hedge Fund Data, http://corporate.morningstar.com/US/documents/HedgeFund/HF_OneSheet.pdf (last visited Nov. 29, 2007); Morningstar Hedge Fund Data Points List, http://corporate.morningstar.com/US/documents/HedgeFund/HedgeFundDataPointList.pdf (last visited Nov. 29, 2007).

294. *See* Morningstar, Mutual Fund Performance and Ratings, http://www.morningstar.com/cover/funds.aspx (last visited Nov. 29, 2007); BusinessWeek, Mutual Fund Scoreboard, http://bwnt.businessweek.com/mutual_fund/ (last visited Nov. 29, 2007).

295. Accredited Natural Person Rule, *supra* note 3, at 404.

ment portfolio, rather than as a stand-alone risk.[296] The SEC correctly observes that hedge funds "involve risks not generally associated with many other issuers of securities."[297] However, there is a fundamental difference between having *unique* risks and being *riskier* to investors. According to mainstream finance scholarship, the risks of hedge funds, when considered in isolation, do not accurately reflect the risks hedge funds pose to investors. Rather, risk is the impact that *adding* hedge funds to a traditional portfolio has on the likelihood of the portfolio experiencing losses. As detailed above, hedge funds' unique risks are mostly beneficial to a traditional portfolio precisely *because* investments with "risks not generally associated with many other issuers of securities" allow investors to reduce overall portfolio risk through diversification.[298]

Additionally, in today's investment marketplace, retail investors cannot avoid highly complex investment risk. Even simple investment strategies are complicated because of the complexity of issuers' business operations in a global and information-based economy. For example, retail investors in registered information technology, financial services, and health care provider companies (e.g., Cisco Systems, Citigroup, and Medtronic, respectively) likely have little understanding of the complex technological, financial, and scientific expertise underlying their securities' values or the risks to which such companies are exposed through inflation, foreign exchange fluctuations, patent acquisitions, and regulatory developments.[299] Furthermore, as detailed above, a wide variety of highly complicated investment strategies with the same general risks associated with hedge funds are (or will soon be) available to retail investors through publicly traded alternative asset managers, hedged mutual funds, hedge fund clones, ETFs, and low-cost at-home trading platforms.[300] Even though these securities are registered and make periodic disclosures pursuant to the federal securities laws, they are not less complicated or less risky than unregistered hedge funds.

---

296. *See supra* Part I.C.

297. Accredited Natural Person Rule, *supra* note 3, at 404.

298. *See supra* Part I.C.

299. *See* APPLIED RESEARCH AND CONSULTING LLC, *supra* note 242, at 6–10 (finding that 65% of surveyed investors failed a basic market literacy survey); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 185 (2006) (arguing that ordinary investors often lack the skills to properly interpret "the structure and operations of business organizations today [which] are more complex than ever").

300. *See supra* Part I.D.2.

C. *The Impact of Wealth-Based Investor Qualifications*

Permitting only wealthy investors to have access to hedge funds conflicts with the SEC's duty to advance the public interest and protect investors.[301] Sophisticated retail investors are harmed when the law does not permit them to invest in hedge funds and reduce economic losses to their portfolios. Unsophisticated retail investors are not harmed by increasing access because such investors would be very unlikely to express any desire for and undertake the steps necessary to invest in the funds. Even if unsophisticated investors purchased hedge fund shares, the funds are not more prone to fraud or investor abuse than registered investment vehicles[302] and are also not more complicated or risky than a wide range of investments available to all retail investors. Wealth-based qualifications, therefore, do not protect retail investors from bearing the risks associated with hedge funds and do not prevent investors from undertaking investments which may be too complicated for their level of financial sophistication. The impact of wealth-based qualifications is to deprive retail investors of access to the full range of investment opportunities commensurate with their level of financial sophistication.

Although the SEC and other financial markets regulators are generally content with preserving wealth-based criteria for qualifying to invest in hedge funds,[303] the SEC has expressed a desire to increase access to hedge funds while maintaining investor protection.[304] The

---

301. *See* Securities Act § 2(b), 15 U.S.C. § 77b(b) (2000).

302. SEC STAFF REPORT, *supra* note 2, at 73 ("There is no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."); *Regulation of the Hedge Fund Industry: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs,* 108th Cong. (2004) (statement of Patrick J. McCarty, Gen. Counsel to the CFTC), *available at* http://banking.senate.gov/_files/mccarty.pdf (stating that from 1999 to 2004 less than 3% of total CFTC and SEC enforcement actions were against hedge funds or hedge fund managers).

303. *See Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2006) (statement of Christopher Cox, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/2006/ts072506cc.htm (stating that hedge funds "are not investments for Mom and Pop. They are generally risky ventures that simply don't make sense for most retail investors" and that retail investors having access to hedge funds would be a development to be "viewed with alarm"); Anthony Ryan, Assistant Sec'y for Fin. Mkts., U.S. Dept. of the Treasury, Remarks at World Hedge Fund Forum (Mar. 6, 2007), *available at* http://www.ustreas.gov/press/releases/hp296.htm.

304. SEC STAFF REPORT, *supra* note 2, at 103–04 (recommending that the SEC examine wide use of hedge fund strategies by publicly registered investment companies); *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 23 (2003) (statement of William H. Donaldson, Chairman, SEC) ("I think there is a definite need

reforms proposed below explain how to accomplish that goal. Several foreign jurisdictions have successfully permitted retail investors to invest in hedge funds, and other foreign jurisdictions are in the process of expanding access.[305] Given the capabilities of U.S. financial markets, wealth-based qualifications deny to U.S. investors the benefits of hedge funds enjoyed by their peers around the world.

IV.
Reforms to Create a U.S. Market for Retail Hedge Funds

There are several ways to reform the existing two-tiered regulatory structure to allow sophisticated retail investors to have access to hedge funds without compromising investor protection. This Part proposes several reforms that preserve the characteristics and beneficial features of hedge funds, maintain investor protection, and make the business of providing retail hedge funds profitable and otherwise attractive to large financial firms. Indeed, the nature of hedge fund business and the experience of retail funds in foreign jurisdictions demonstrate that the primary concern regarding any reform proposal is not whether unsophisticated investors will begin to invest in hedge funds to their detriment. Rather, the issue is whether retail investors will choose to invest in hedge funds and whether the new structure will provide an attractive environment for funds to market and sell to retail investors.[306]

To address such concerns, the reforms proposed here seek to create a retail FOHF that raises capital through a private placement to an underwriter (or syndicate of underwriters) who, in turn, lists the securities of the retail FOHF on a trading platform accessible only by so-

---

to examine how hedge funds, properly run and properly disclosed, can be allowed to be purchased by retail investors. . . .").

305. *See generally* PriceWaterhouseCoopers, The Regulation, Taxation and Distribution of Hedge Funds in Europe: Changes and Challenges (4th ed. 2006) (reviewing retail access to hedge funds in Europe); AXISS Australian, The Hedge Funds Industry in Australia (2006–07) (examination by the Australian Government's Financial Services Division of the substantial involvement with hedge funds by Australian retail investors and applicable regulations); Janine Canham & Manoj Ramachandran, *Hedge Funds: Asia Leads the Retail Market*, Asia L. & Prac., Dec. 2003 (noting that in Asia, hedge funds "have become an increasingly important element of a well-balanced portfolio investment strategy"); James Daley, *FSA All-Clear for Retail Investors to Put Money into Hedge Funds*, The Independent (London), Mar. 28, 2007.

306. *See* Ferguson, *supra* note 239, at 1 (noting that a U.K.-based survey "concluded that there was no great desire among product producers to produce and sell retail hedge funds and no great demand among investors for such products."); *Hedge Funds Flock to Hong Kong*, *supra* note 239.

phisticated investors. This way, hedge funds will not have to bear transaction costs in dealing with numerous individual investors and can continue to accept investments from FOHFs as they currently do. Furthermore, retail investors will be more likely to invest in hedge funds if their shares are listed on an easily accessible, Web-based trading platform as is currently in operation for other types of privately placed securities.[307] Before turning to the specific proposed regulatory reforms, it is worthwhile to first summarize their ultimate goal. The proposed reforms seek to create a retail hedge fund that:

- is an unregistered fund of hedge funds;
- is purchased only by sophisticated retail investors;
- is advised by a hedge fund manager registered with the SEC, the CFTC, a state regulatory authority, or a self-regulatory organization;
- is advised by a manager co-investing into the fund to align incentives with investors;
- discloses material information about the strategy pursued by the fund and the identity of the manager;
- discloses material information about the fund's return history, absolute risk, and correlation with general market risks;
- may engage in any manner of legal trading strategy including the use of leverage;
- may charge management and performance fees (with or without high water marks and hurdle rates);
- may place limitations on the ability of investors to redeem capital;
- has its shares traded on a private electronic trading platform; and
- may engage in general advertising and solicitation.

Allowing only registered investment advisers to sponsor and manage retail FOHFs is likely to ensure an adequate level of transparency about the fund manager, its investment strategy, and other important details due to the mandatory disclosures required to be made by registered advisers.[308] At the same time, given the large number of successfully operating hedge funds advised by a registered investment adviser, requiring an adviser to a retail FOHF to register likely would not infringe upon the fund's operations, require overly burdensome or redundant disclosures about a fund, or require the fund to disclose proprietary trading strategies. Indeed, the large financial

307. *See infra* notes 328–329 and accompanying text.
308. *See supra* notes 168–174 and accompanying text.

firms likely to sponsor retail FOHFs for U.S. investors, such as Goldman Sachs and Fidelity Investments, are already registered advisers in part because they advise registered investment companies such as mutual funds. The following specific reforms are likely to achieve a widely utilized and valuable retail hedge fund product with the foregoing characteristics and operations.

A. Increase Access to Unregistered Investment Companies

To provide the most benefits to investors, retail FOHFs must be able to charge performance fees, use substantial amounts of leverage, and also retain significant flexibility in trading strategies, among other characteristics. Registered investment company status is an unworkable regulatory posture through which to operate a genuine hedge fund because the Company Act severely limits or entirely prohibits registered funds from engaging in these activities commonplace among hedge funds and FOHFs.[309] Although the Company Act could theoretically be amended to allow hedge funds to operate with their characteristic properties, registered company status is so unsuited for hedge fund operations that only substantial legislative reforms to the Company Act would allow retail FOHFs to efficiently operate within its framework.[310]

Sophisticated retail investors therefore need to be able to purchase the securities of an investment fund not meeting the definition of investment company under the Company Act. An unregistered 3(c)(7) fund is the most suitable structure currently available for a retail FOHF because, unlike a 3(c)(1) fund, a 3(c)(7) fund may have an unlimited number of investors (so long as they are qualified) and is not subject to the Advisers Act's prohibition on being charged a performance fee by its manager.[311]

However, reforms must be made to enable a 3(c)(7) fund to accept capital from retail investors in a way consistent with achieving the desired features of retail hedge funds. The SEC is authorized under section 2(a)(51)(B) of the Company Act to amend the definition

309. *See supra* notes 162–169 and accompanying text.

310. Reforms seeking to expand retail access to hedge funds by amending the Company Act to allow mutual funds to engage in hedge fund-like strategies are deficient because they fail to allow hedge funds to operate with all of their defining characteristics which are likely to benefit investors. *See* Lacey, *supra* note 119, at 78–82 (proposing to reform the Company Act to allow greater utilization of hedge fund trading strategies yet without the ability to charge performance fees); SEC STAFF REPORT, *supra* note 2, at 103–04 (advocating broader access to hedge fund strategies "through the registered investment company structure").

311. *See* Advisers Act § 205(b)(4), 15 U.S.C. § 80b-5(b)(4) (2000).

of "qualified purchaser" as it determines is "necessary or appropriate in the public interest or for the protection of investors."[312] Because allowing retail investors to have access to hedge funds helps to protect sophisticated investors from economic loss and is highly unlikely to harm unsophisticated investors, the public interest would be advanced if the following reforms were made. The SEC should add a new category of natural person meeting the definition of qualified purchaser to include any natural person:

- sophisticated and otherwise qualified for the purposes of a private offering to nonaccredited investors pursuant to Rule 506 of Regulation D of the Securities Act;
- purchasing securities from an investment fund exempt from the definition of "investment company" under Section 3(c)(7) of this Act; and
- purchasing securities from such an investment fund advised by a registered investment adviser owning sufficient assets of the investment fund or acquired funds to align incentives with investors.

This new definition of qualified purchaser does not open 3(c)(7) funds to all retail investors. Although the new definition vastly widens the availability of 3(c)(7) funds by not necessarily requiring individuals to possess $5 million in investments, it only opens 3(c)(7) FOHFs to retail investors if the investor or his or her purchaser representative is sophisticated, and the fund is advised by a registered investment adviser with a significant co-investment in the fund.

By referring to the definition of investor sophistication under Regulation D, a sophisticated retail investor in a 3(c)(7) FOHF would still be required to be furnished with information "material to an understanding of the issuer, its business and the securities."[313] This practice would not only protect investors but would be unlikely to impose any additional costs upon the retail FOHF as hedge funds typically already disclose substantial information upon which a sophisticated investor can make an informed investment decision.[314]

B. *Enable a Secondary Market for Shares of Retail Hedge Funds*

The SEC should also enact reforms to allow the creation of a robust secondary market for shares of retail FOHFs. A secondary

312. Company Act § 2(a)(51)(B), 15 U.S.C. § 80a-2(a)(51)(B) (2000).

313. Regulation D, 17 C.F.R. § 230.502(b)(2) (2007). This information is similar to the type required in Part I of a registration statement, must be more extensive the larger the offering, and requires employment of an independent auditor for offerings over $2 million. *Id.*

314. *See supra* Part III.B.2.

market would increase the liquidity of hedge fund shares beyond the quarterly redemptions typically allowed by the funds.[315] The ability to sell shares on a short-term basis would make investors in the fund better off because they could exit the fund as they deemed appropriate. A liquid secondary market effectively serves the purpose of being able to daily redeem shares from the fund at net asset value, as is required by open-end registered mutual funds.[316] The SEC has already deemed a sufficiently liquid secondary market as an adequate substitute for direct redemption at net asset value.[317] FOHFs would probably also be more willing to sell shares to a retail clientele knowing they would be subject to fewer expenses and disruptions involved with redeeming shares to investors who would be able to exit by selling to other investors. Increased liquidity would also promote price discovery, meaning that the true value of a fund's underlying assets would be more accurately known by investors and other market participants as those values changed over time.[318]

To facilitate the liquidity and transparency of retail hedge fund securities through a secondary market mechanism, the SEC should extend to sophisticated retail investors exemptions *already in place* for private resales to certain institutional investors. In 1990, the SEC adopted Rule 144A under the Securities Act to allow resales to large institutional investors of privately placed securities.[319] Rule 144A was adopted to attract foreign issuers to U.S. markets by establishing "a more liquid and efficient institutional resale market for unregistered securities."[320] As then-SEC Chairman Richard C. Breedon noted, Rule 144A

---

315. *See* HAMMER ET AL., *supra* note 16, at 3.

316. *See* Company Act § 22(e), 15 U.S.C. § 80a-22(e) (2000).

317. Paul F. Roye, Dir., Div. of Investment Mgmt., SEC, Regulatory Issues Involving Exchange Traded Funds, Speech at the American Stock Exchange Symposium on Exchange Traded Funds (Jan. 14, 2002), *available at* http://www.sec.gov/news/speech/spch534.htm ("Because exchange traded fund shares are only redeemable in large creation units, the funds must obtain relief from the requirement that fund shares be individually redeemable . . . . Shares on the secondary market typically trade at or near NAV because of arbitrage opportunities. Thus, investors in exchange traded funds generally should be able to sell their shares in the secondary market for a price at, or near, NAV—even if they cannot redeem individual shares directly from the fund.").

318. Price discovery is a process where trading by buyers and sellers results in the "discovery" of a price reflecting the value market participants place on an asset. *See* Randall S. Kroszner, Member, Bd. of Governors of the Fed. Reserve Sys., Remarks at Institute of International Bankers Annual Breakfast Dialogue, Washington, D.C. (Oct. 22, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/kroszner20071022a.htm.

319. LOSS & SELIGMAN, *supra* note 154, at 391–96.

320. *Id*. at 391 (quoting Sec. Act Rel. 6862, 46 SEC Dock. 26, 28 (1990)).

> will bring enhanced market liquidity and efficiency for investors in the burgeoning private placement market, together with direct access to foreign issues in the U.S. institutional capital markets. [It will also] enhance the ability of issuers to raise capital and will expand the investment alternatives available to U.S. investors.[321]

Rule 144A provides a non-exclusive safe harbor for sales by dealers or other sellers of securities not registered pursuant to Section 5 of the Securities Act.[322] Rule 144A requires, among other conditions, that private sales are only made to "qualified institutional buyers" (QIB) having at least $100 million in assets.[323] Foreign issuers take advantage of Rule 144A to privately raise capital in U.S. markets by first privately placing securities with investment banks acting as underwriters who, in turn, sell to QIBs.[324] By the terms of Rule 144A, persons purchasing securities through a private placement under the Securities Act with the intent to resell to QIBs are not deemed underwriters and therefore able to sell without registering the securities.[325]

The benefits to QIBs under Rule 144A would apply equally as well to sophisticated retail investors. Allowing a resale market for hedge fund securities would bring enhanced liquidity, efficiency, and investment alternatives to retail investors through the burgeoning hedge fund market. Since its inception in 1990 through 2006, the total equity and debt raised in 144A transactions has gone from $4.9 billion to about $1 trillion.[326] Indeed, in 2006 the value of 144A equity is-

321. Robert A. Barron, *Control and Restricted Securities: Some Comments on SEC Rule 144A*, 18 SEC. REG. L. J. 400, 400–01 (1990).

322. Securities Act Rule 144A, 17 C.F.R. § 230.144A (2006) (providing that sales made in accordance with its provisions are not "distributions" under the Securities Act such that re-sellers are not deemed underwriters).

323. Securities Act Rule 144A(d), 17 C.F.R. § 230.144A(d) (2006); Luis F. Moreno Treviño, *Access to U.S. Capital Markets for Foreign Issuers: Rule 144A Private Placements*, 16 HOUSTON J. INT'L. L., 159, 175–76 (1993).

324. Letter from Keith F. Higgins, Chair, Comm. on Fed. Regulation of Sec., Am. Bar Assoc., to John W. White, Dir., Div. of Corp. Fin., SEC 16 (Mar. 22, 2007), *available at* http://www.abanet.org/buslaw/committees/CL410000pub/comments/20070322000000.pdf ("Investment banks (individually or in small or large syndicates) purchase securities from issuers in transactions exempt under § 4(2), pursuant to purchase agreements that look very much like underwriting agreements, and resell to QIBs in accordance with Rule 144A, using offering memoranda that look very much like prospectuses used in registered public offerings.").

325. Securities Act Rule 144A(b), 17 C.F.R. § 230.144A(b) ("Any person, other than the issuer or a dealer, who offers or sells securities in compliance with the conditions set forth in paragraph (d) of this section shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter of such securities . . . ."); Securities Act Rule 144A(c), 17 C.F.R. § 230.144A(c) (same as to dealers).

326. LOSS & SELIGMAN, *supra* note 154, at 396 n.52; Liz Moyer, *Barely Private Exchanges*, FORBES.COM, Aug. 14, 2007, http://www.forbes.com/business/2007/08/14/private-placement-exchanges-biz-cx_lm_0814private.html.

sues, for the first time, surpassed that raised on public U.S. exchanges and also brought the 144A market to nearly the same size as the U.S. hedge fund industry.[327] However, simply permitting retail investors to sell hedge fund shares to other sophisticated investors would not noticeably improve liquidity without an organized exchange through which the shares can be traded at low cost. Fortunately, recent innovations in financial markets demonstrate that such a market would be established and policed by large investment banks and other financial intermediaries.

In 2007, full-scale private trading of placed securities not registered under the Securities Act began to take place. Several large financial institutions established a private electronic exchange, creating a relatively liquid marketplace for trading 144A securities among QIBs. On May 21, 2007 the Goldman Sachs Tradable Unregistered Equity market became the first trading platform for 144A securities and sold $880 million of equity in alternative asset manager, Oaktree Capital Management.[328] On August 15, 2007, NASDAQ began trading on its own Web-based trading platform for 144A securities (named PORTAL) with 600 equity securities from companies such as Archer Daniels Midland Company and Korea-based Samsung.[329] Index funds and ETFs based upon the performance of shares on PORTAL are likely to be developed for retail investors,[330] suggesting that hedge funds privately traded on such platforms would also have widespread appeal. While other financial institutions such as Bear Sterns, Lehman Brothers, and Citigroup initially planned to establish their own 144A trading platforms, they ultimately agreed to join the other exchange providers to establish a single private exchange for 144A securities operated by NASDAQ.[331]

---

327. Moyer, *supra* note 326.

328. Kathleen M. McBride, *Going Private: Sea Change for Private Equity 144A Investing and Issuing*, INVESTMENT ADVISOR, July 2007, *available at* http://www.investmentadvisor.com/article.php?article=7904.

329. Moyer, *supra* note 326; Press Release, NASDAQ, NASDAQ's Electronic Trading Platform for the 144A Private Placement Market Is Approved by the SEC (Aug. 1, 2007), *available at* http://www.nasdaq.com/newsroom/news/newsroomnewsStory.aspx?textpath=pr2007%5ACQPMZ200708010800PRIMZONEFULLFEED125065.htm.

330. Interview by Mark Gongloff with John Jacobs, Executive Vice President of NASDAQ, by teleconference in New York (Aug. 15, 2007) (video available at http://video.msn.com/dw.aspx?mkt=en-us&from=truveo&vid=0c02fc81-3e4e-4af7-8391-1e1e56eafbf5).

331. Moyer, *supra* note 326; Lynn Cowan, *Banks to Share Platform for 144A Trades*, WALL ST. J., Nov. 12, 2007, at C3.

These developments strongly suggest that large financial institutions have the capabilities and incentives to establish a profitable trading platform for the shares of privately placed retail FOHFs securities. The trading platform for retail hedge fund shares could, at low cost, ensure investor protection by only allowing sophisticated retail investors to use the platform. The PORTAL system uses an application process requiring new users to verify they are QIBs, and a platform for retail hedge fund shares could do the same for sophisticated retail investors. Similarly, it is standard practice among issuers privately placing securities to nonaccredited investors pursuant to Rule 506 to require investors to sign a representation concerning their sophistication and complete a questionnaire regarding their experience.[332] It is thus extremely unlikely that an investor without a sufficient understanding of hedge fund investments would go through the trouble to register for a retail hedge fund trading platform. Numerous financial products and trading techniques, including hedge fund clones and "do-it-yourself" hedging strategies, are available for those desiring alternatives to traditional investments without having to be certified by a private exchange.

To avoid triggering Exchange Act registration and reporting requirements, proprietors of the retail hedge fund trading platform would have to keep track of the number of investors in an issuer to ensure the number does not exceed 499, just as the platforms currently do for 144A investors.[333] However, to protect investors through added liquidity, and to ensure that retail FOHFs are able to raise sufficient capital through a retail offering, the SEC should substantially increase from 499 the number of investors allowed before triggering the requirements of the Exchange Act. The SEC has express authority under section 12(h) of the Exchange Act to increase the number of investors allowed in an issuer not required to register so long as the amendment advances the public interest and investor protection.[334] The Exchange Act specifically contemplates the SEC amending its exemptions to "classify issuers and prescribe requirements appropriate for each such class."[335] In addition, a primary purpose of the Exchange Act is to facilitate accurate valuation of securities through secondary markets.[336] Accordingly, the SEC should amend the Exchange

332. *See* HAMMER ET AL., *supra* note 16, at 124.

333. Moyer, *supra* note 326 (reporting that private exchanges "offer investor tracking to make sure the issuer doesn't tip over the 499 maximum investor threshold.").

334. Exchange Act § 12(h), 15 U.S.C. § 78*l*(h) (2000).

335. *Id*.

336. *See* Tracy & MacChesney, *supra* note 221, at 1048.

Act to increase the number of investors permitted to own the securities of a retail FOHF as proposed here. The guiding principles for increasing the number of investors in an investment company not reporting under the Exchange Act are to increase the liquidity of hedge fund shares and thereby increase transparency and valuation accuracy of the fund and allow timely exits from retail hedge fund investments without disrupting fund operations. It is difficult to determine how many more investors than 499 are likely required to obtain a sufficient amount of liquidity and attract sponsors. However, given that 79% of new hedge funds (including FOHFs) have less than $50 million in assets and many European FOHFs have less than $100 million in assets,[337] the number of investors permitted into such funds would likely have to be substantially larger that 499 to permit a retail FOHF to raise enough funds to be sufficiently capitalized.

C. Permit General Solicitation and Advertising

To foster greater transparency among all hedge funds, including retail hedge funds, the SEC should amend Rule 502 of Regulation D to permit the funds to engage in general solicitation and advertising. The SEC's assessment that less information about hedge funds is available to the general public compared to information available about issuers registered under the securities laws is, to some extent, correct. However, the fact that less information is available about hedge funds is, in part, a result of the securities laws' prohibitions on advertising and solicitation. Allowing hedge funds to advertise and solicit investors would not enable unsophisticated retail investors to purchase the funds on private trading platforms (nor likely make them desire to invest in the funds), and it would promote greater and more accurate public awareness of hedge funds and also increase their transparency to investors, academics, industry researchers, and regulators.

The SEC has, at various times, questioned the ban on advertising and solicitation. In 1995, and again in 1996, the SEC requested public comment on whether it should amend the prohibition.[338] In its 2003 staff report on hedge funds, the SEC noted there was no compelling policy justification for limiting advertising and solicitation by 3(c)(7)

---

337. BARTH ET AL., *supra* note 23, at 9 tbl.7; Deutsche Bank, *supra* note 121, at 19.

338. CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS, § 7.07, 7-28 (4th ed. 2006); Exemption for Certain California Limited Issues, 60 Fed. Reg. 35,638 (July 10, 1995) (soliciting public comment "on whether the prohibition against general solicitation in certain Regulation D offerings should be reconsidered"); Securities Acts Concepts and Their Effects on Capital Formation, 61 Fed. Reg. 49,184 (Sept. 18, 1996) (extending comment period).

funds open only to sophisticated qualified purchasers.[339] Finally, in evaluating the impact of the Sarbanes-Oxley Act of 2002, the SEC Advisory Committee on Smaller Public Companies recommended that the ban on solicitation and advertising be eliminated for those investors not needing all the protections of the Securities Act's registration requirements, including sophisticated natural persons.[340] Fostering a transparent hedge fund market for sophisticated retail investors affords the SEC an opportunity to act upon recommendations.

Conclusion

Hedge funds have helped wealthy individuals diversify their portfolios and thereby reduce economic losses. The reforms proposed in this Article seek to extend the benefits of hedge funds to retail investors—nonwealthy individuals. Unfortunately, although having expressed interest in expanding access to hedge fund strategies, the SEC is more recently moving to ensure that only the wealthiest individuals in the United States have access to the funds. Currently, the SEC is attempting to increase the wealth required to invest in hedge funds to $2.5 million in investable assets. If successful, this increase will reduce the portion of the U.S. households able to invest in hedge funds and other private investment pools by 85%—to a mere 1.3%.[341] Although this Article finds that the goal of investor protection will be furthered by increasing access to hedge funds, and other nations offer retail investors access or are undertaking reforms to do so, the SEC is moving in the opposite direction to the detriment of U.S. retail investors.

A retail FOHF listed on a private trading platform and accessible only to sophisticated investors would further investor protection. Retail investors investing in such a product would likely possess enough financial acumen and be furnished with sufficiently high-quality disclosures to make informed choices. In remarking on the purpose of the Securities Act in 1977, the court in *Doran* observed that

> The Act is practical and pragmatic, not dogmatic and doctrinaire. It is designed to give a panoply of protection to the investor, but also to allow play in the marts of trade for offers of securities that do not require the oversight of the Securities and Exchange Commission.[342]

---

339. SEC Staff Report, *supra* note 2, at 100–01.

340. Advisory Comm. on Smaller Pub. Cos., Final Report to the United States Securities and Exchange Commission 76–78 (2006).

341. *See* Accredited Natural Person Rule, *supra* note 3, at 406.

342. Doran v. Petroleum Mgmt. Corop, 545 F.2d 893, 904 (1977).

In the modern financial marketplace, the securities of a FOHF open only to sophisticated retail investors are of the type not requiring the full scope of SEC oversight. Hedge funds not fully subject to the federal system of registration and disclosure are just as appropriate for sophisticated retail investors as are registered investment funds. Allowing sophisticated retail investors to have access to hedge funds will not increase the risks to which they are already exposed. Greater access to hedge funds will, however, help sophisticated retail investors fend for themselves.