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Public Interest Comment on
The Securities and Exchange Commission's Request for Comment on

The Definition of Accredited Investor in Certain Private Investment Vehicles[1]

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The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing scholarship from law, economics, and related disciplines to assess rulemaking proposals from the perspective of the public interest. This Public Interest Comment ("Comment") on proposed rules 509 and 216 by the Securities and Exchange Commission (the "Commission") defining a new category of accredited investor for certain private investment pools does not represent the views of any particular affected party or special interest group, but is designed to evaluate the effect of the proposed rules on overall consumer welfare.

Section I explains the proposed rules. Section II provides important facts about the hedge fund industry, especially as they bear upon the rationales and impact of the rules. Section III responds to several of the proposed rules' specific requests for comment with suggestions for how the Commission could revise the rules and conduct further study to best fulfill its statutory obligation to promote investor protection, competition, efficiency and capital formation. Section IV concludes. The Appendix evaluates the Commission's rulemaking against widely-applied criteria for regulatory analysis.

I. Introduction to Proposed Rules 509 and 216

A. Purpose and Scope of the Proposed Rules

On December 27, 2006, the Commission proposed new rules 509 and 216, raising the level of personal wealth required for individuals to qualify to purchase securities offered by certain private investment funds.[2] Currently, investment pools can offer and sell their

[1] Prepared by Houman B. Shadab, J.D., senior research fellow, Regulatory Studies Program. This comment is one in a series of Public Interest Comments from the Mercatus Center's Regulatory Studies Program and does not represent an official position of George Mason University. References to Internet sources are omitted because nearly every citation is available by searching by author and/o publication title.

[2] The proposed rules are applicable to "private investment vehicles" relying on the exclusion from the definition of investment company provided by section 3(c)(1) of the Investment Company Act (''3(c)(1) Pools'') of 1940 (the "Company Act") and on the private placement exemptions pursuant to Regulation D

securities only to "accredited investors"—individuals with a net worth of $1 million, or $200,000 annual income if single ($300,000 if married).[3] The proposed rules add the requirement that individuals purchasing securities from such private investment funds must also qualify as an "accredited natural person," which requires owning at least $2.5 million in investments.[4] These "investments" do not include the value of personal real estate or land held in connection with a place of business, but do include real estate held for investment purposes.[5]

The new accredited natural person requirement will, by the Commission's own estimates, reduce the number of individuals (or "households") able to invest in certain private investment pools from approximately 8.47 percent of the population to 1.3 percent,[6] an 85 percent reduction.

Although the proposed rules apply to various types of private investment funds, the Commission's release reflects a primary concern with private investment funds commonly known as "hedge funds."[7] Therefore, this Comment focuses on the private investment funds commonly described as hedge funds.

The proposed rules stem from the Commission's concern that substantially more persons are now qualified to invest in hedge funds than when the definition of accredited investor was first established in 1982.[8] According to the Commission, these investors "may find it difficult to appreciate the unique risks of these pools," because, among other factors, hedge funds "have become increasingly complex and involve risks not associated with many other issuers of securities" and "minimal information about them is available in the public domain."[9]

The proposed rules seek to ensure that individuals who invest in hedge funds "have a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools."[10] In particular, the $2.5 million in investments qualification "is consistent with [the Commission'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

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or section 4(6) of the Securities Act of 1933 (the "Securities Act"). Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 403-05 (proposed December 27, 2006) [hereinafter Accredited Investors in Certain Private Investment Vehicles].

[3] *See* Rules 501(a)(5) and 501(a)(6) of Regulation D.

[4] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 405.

[5] *Id*. at 415, 416.

[6] *Id*. at 406

[7] The Commission several times relies upon the 2003 Commission Study Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission. *See id.* at 400 n.3, 404 n.42, 404 n.43.

[8] *Id*. at 404.

[9] *Id*.

[10] *Id*. at 409, 412.

investment, or to hire someone who can."[11]

B. Summary of Findings

The hedge fund industry has become more mainstream and institutionalized due in large part to its recent growth. The industry manages nearly $1.5 trillion in assets across 13,000 funds. Institutional investors are increasingly supplying new capital to the new industry. Large financial institutions such as investment banks serve as both hedge fund managers and service providers. Along with such growth has come increased accountability and constraints on the funds' activities.

As a group, hedge funds earn positive returns in both up and down markets. The general impact of adding hedge funds to a portfolio of stock, bonds, and other common securities (a "traditional portfolio") is to reduce the portfolio's overall risk. Nonetheless, there are limits to how well hedge funds can diversify a portfolio, in part because hedge funds have their own unique risk characteristics. Hedge funds may also fail to maximize portfolio gains relative to other investments and after tax consequences are considered.

Hedge funds have become more complicated over the last decade. Yet increasing complexity has allowed hedge funds to better manage risk, and risk management more generally has substantially improved. Accordingly, hedge funds are at least in some important ways less risky than prior years. Hedge funds nonetheless face significant risk management challenges, and there are some signs suggesting new risks have arisen as a consequence of the industry's rapid growth.

Notwithstanding hedge funds' status as private investment vehicles, and despite their increased complexity, sufficient information is available in the public domain for a substantial portion of nonaccredited investors to make informed investment decisions with respect to the funds. Vast and detailed information about hedge funds exists in the public domain, including information about their unique risks, types of potential conflicts of interest and fee structures. Hedge funds disclose even more information to investors legally qualified to invest in hedge funds.

Finally, the risks and complexity involved with hedge funds are no more than those of numerous other investments not subject to any qualifications based upon personal wealth. Hedged mutual funds and computer-generated hedge fund "clones" are becoming more widespread and open to investors not meeting the definition of accredited investor. These funds are able to replicate some of the return and risk properties of hedge funds and are just as complicated. They have thus far been unable to outperform the best hedge funds.

C. Summary of Comments

Hedge funds are an important tool for reducing the overall risk of an investment portfolio. By limiting investors' ability to purchase hedge fund securities, the proposed rules undermine investor protection by reducing investors' ability to decrease their risk of

[11] *Id.* at 405.

loss. The proposed rules will not protect nonaccredited investors from the complexity and risks involved with hedge funds, but only prohibit such investors from benefiting from the best hedge funds. The proposed rules could also deprive accredited investors of access to significantly better hedge fund returns. For these reasons, the Commission should:

- revise the proposed rules to substantially reduce any net worth, income and/or value of investments required to purchase the securities of hedge funds;

- amend applicable rules to permit nonaccredited investors to purchase the securities of hedge funds registered with the Commission or some other regulatory body; and

- study how the policies of other countries that allow investors greater access to hedge funds affect investor protection, competition, efficiency, and capital formation.

II. Background: The Hedge Fund Industry

The Commission suggests that hedge funds are generally riskier than other investments, that the risk of such pools has increased, and that the public information available about the funds "may" make it difficult for the overwhelming majority of investors to appreciate their risks.[12] In reality, hedge funds are not generally riskier than equity securities, hedge funds' risks likely have not increased, and sufficient information is in the public domain for most investors appreciate their risks (notwithstanding that the funds are not subject to registration and disclosure under the federal securities laws). In addition, the Commission's claims and assumptions are further undermined by the existence of investments sharing the complexity and risks involved with hedge funds but not subject to any investor wealth qualifications.

The very term "hedge fund," after all, implies that the fund is trying to hedge against various types of risks prevalent in financial markets. Understood properly, hedge funds are a tool for risk management and risk reduction, not an attempt to earn abnormally high returns through excessive risk-taking.

A. The Hedge Fund Industry is Mainstream, Institutionalized and Growing

An outstanding feature of the hedge fund industry is the extent to which it has recently become an established part of the capital markets. This is the result of rapid growth in total assets under management, the institutionalization of both the supply and demand side of hedge funds, and the increased sophistication of hedge funds and involvement of third party service providers (especially prime brokers). These developments have important implications for individual investors and the Commission's proposed rules.

[12] *Id*. at 404.

By nearly every measure, the hedge fund industry has grown in economic significance and is expected to continue to do 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 funds of hedge funds) also approximately doubling to 7,436 from 3,617.[13] Today, hedge funds manage about $1.5 trillion in assets globally spread across over 13,000 funds,[14] will likely surpass $2 trillion in before the end of the decade,[15] and may even reach $6 trillion by 2015.[16] The United States market accounts for over $1 trillion of the global industry.[17] 2006 was a record year for global hedge fund capital inflows, which tripled 2005 inflows to reach $126.5 billion.[18]

As a proportion of total capital inflows, individual investors' direct investment into hedge funds (i.e., not through funds of hedge funds, pension plans, or other intermediaries) is decreasing and projected to continue decreasing.[19] Individuals already account for a minority of hedge fund investors.[20] Institutional investors, on the other hand, are leading the growth of new capital inflows into hedge funds.[21] By one estimate, pension plans will account for a majority of new institutional flows into hedge funds through 2010.[22]

As a result of the growth in hedge funds, investors seeking to participate in popular hedge funds are finding their investments rejected because competition and increased flows to funds have reduced the market inefficiencies typically corrected by fund investment

[13] *Toward Greater Financial Stability: A Private Sector Perspective, The Report of the Counterparty Risk Management Policy Group II*, Appendix B-10 (2005).
[14] *See Global Hedge Fund Assets Surge to $1.5 Trillion According to HedgeFund Intelligence Research*, HEDGEFUND INTELLIGENCE, March 27, 2006; Ken Schachter, *Hedge Funds Grow Like Kudzu*, RED HERRING, February 26, 2007.
[15] *See*, *e.g.*, Denise Valentine, *The Hedge Fund Marketplace Today*, IBM, 6 BUILDING AN EDGE—THE FINANCIAL SERVICES NEWSLETTER, March 22, 2005.
[16] George P. Van, *Hedge Fund Demand and Capacity 2005-2015* 6, VAN HEDGE FUND ADVISERS, INT'L, LLC (2005).
[17] Alex Akesson, *Survey Shows US Hedge funds to Hold $1,200 Billion In Assets*, HEDGECO.NET, March 6, 2007.
[18] *See* Grace Wong, *Hedge Funds Rake in $126.5 Billion in New Money in '06*, CNNMONEY.COM, January 18, 2007.
[19] *Institutional Demand for Hedge Funds 2,* THE BANK OF NEW YORK, CASEY, QUIRK & ASSOCIATES, 3, 13 (2006) [hereinafter *Institutional Demand for Hedge Funds 2*]; *Hedge Funds and Their Implications for Financial Stability* (European Central Bank Occasional Paper Series No. 34, 19, August 2005). *See also Hedge Funds Fall Out Of Favor With The U.S. Rich*, REUTERS, January 25, 2007 (households with a net worth of $25 million or more decreased allocations to hedge funds in 2006 to 27 percent from 38 percent in 2005).
[20] *See*, *e.g.*, *Hennessee Group LLC Releases 12th Annual Hedge Fund Manager Survey*, HENNESSEE GROUP, December 5, 2006 (finding that individual investors account for 40 percent of hedge fund sources of capital).
[21] *See generally Institutional Demand for Hedge Funds 2*, *supra* note 19; *2006 Alternative Investment Survey*, DEUTSCHE BANK (2007); *Institutional Investors' Perspective on Hedge Funds*, MANAGED FUNDS ASSOCIATION 1-2, 12 (2006).
[22] *Institutional Demand for Hedge Funds 2*, *supra* note 19, at 14 (retirement plans will constitute 65 percent of asset flows to hedge funds through 2010).

strategies.[23] Since hedge funds have some discretion in choosing their investors, they can keep out investors who lack the appropriate sophistication or wealth. Funds often view such investors as less desirable. Competition has also made it possible for hedge funds to include easily understood provisions requiring long term commitments by investors, providing a clear warning to investors for whom the investment is inappropriate.

On the supply side, large financial institutions increasingly provide hedge fund advisor (management) services. The two largest hedge fund managers in the United States are Goldman Sachs and JPMorgan Asset Management,[24] and other large investment banks are making inroads into the sector through acquisitions of single-manager funds.[25] Prime brokerage services (e.g., lending, trade clearing, and risk management) are usually offered by established investment banks and securities broker-dealer firms. As hedge funds have become larger, more sophisticated and employ more complex trading strategies, prime brokers face increasing pressures to deliver more sophisticated, integrated, and customized services to remain competitive.[26]

Joining the mainstream of financial markets has made hedge funds more accountable, more transparent, and provided important institutional constraints on funds' activities. When major financial firms offer hedge funds, they put their own reputations on the line, and hence have strong incentives to closely monitor fund managers.

B. Investing in Hedge Funds Generally Reduces the Overall Risk of a Portfolio of Traditional Investments

The Commission claims that "higher risk . . . may accompany [hedge funds'] anticipated returns" and that the funds "involve risks not generally associated with many other issuers of securities." [27] However, the Commission cites no empirical studies supporting its claim that hedge funds are generally riskier than securities of other issuers, nor does it explain who the "other issuers" are. The Commission likewise fails to define or describe financial risk as it relates to hedge funds and how hedge fund risk is unique, thereby ignoring a significant body of recent academic literature dedicated to examining that very topic.[28] Indeed, a fundamental shortcoming of the proposed rules is the Commission's

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[23] *See, e.g.*, Fung et al., *Hedge Funds: Performance, Risk and Capital Formation* 19 (AFA 2007 Chicago Meetings Working Paper, July 19, 2006).

[24] Shaheen Pasha, *Banks' Love Affair With Hedge Funds*, CNNMONEY.COM, October 6, 2006.

[25] *See* William Hutchings, *Banks Place Big Bets on Growth*, FINANCIAL NEWS ONLINE US, November 22, 2006. *See also Morgan Stanley: A Big Bet on Hedge Funds*, BUSINESSWEEK.COM , November 1, 2006.

[26] *See*, *e.g.*, *Cutthroat Competition*, MARHEDGE , December 5, 2005; Paul Allen, *Prime Time for Primes*, INFORMATIONWEEK, February 14, 2006; *Prime Brokerage Debate: The Race to Keep Up With the Clients*, EUROMONEY, November 2006; *Service Provider Battle shifts to the Middle Office*, HEDGEWEEK, January 8, 2007.

[27] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 400, 404.

[28] *See*, *e.g.*, Hilary Till, *Risk Considerations Unique to Hedge Funds*, QUANTITATIVE FIN. 409-11 (2002); Natalya Lyzanets & Maksym Senchyna, *Comparing Different Value-at-Risk Models for Hedge Funds*, University of Lausanne Working Paper, October 2005 (comparing "performance of the six main VaR models for a generic hedge fund and for an 'average' hedge fund belonging to a particular strategy in an attempt to identify the best performing model."); Daniel Giamouridis & Ntoula Ioanna, *A Comparison of Alternative Approaches for Determining the Downside Risk of Hedge Fund Strategies* (Cass Business

failure to cite any academic literature on hedge funds whatsoever, thereby preventing the affected public and commenters from understanding or evaluating how the Commission arrived at its conclusions.

Most importantly, the Commission fails to recognize that hedge funds' risk must be evaluated in the context of their contribution to the overall risk of an investment portfolio, rather than as a stand-alone risk. The Commission correctly observes that hedge funds "involve risks not generally associated with many other issuers of securities."[29] However, there is a fundamental difference between having *unique* risk properties and *being riskier* to investors. According to mainstream finance scholarship, the risks of hedge funds when considered in isolation, no matter how unique, do not adequately reflect the risks hedge funds pose to investors. Rather, risk is the impact that *the addition* of hedge funds to a traditional portfolio has on the likelihood of the portfolio experiencing losses. Hedge funds' unique risks are mostly beneficial to a traditional portfolio because investments with "risks not generally associated with many other issuers of securities" allow the investor to reduce portfolio risk through diversification.

1. *Modern Portfolio Theory*

Modern finance defines risk as "the chance that . . . the securities you hold will fall in price."[30] Risk is most commonly measured by calculating the "standard deviation" of a security's return, a way of quantifying how actual returns may differ from average historical returns.[31] Thus, the higher a security's standard deviation the more likely it is that its actual return will differ from its expected return and hence the higher its risk (and vice versa).

The fundamental and well-documented relationship between a security's risk and return characteristics is that they rise and fall together: on average, for investors to receive higher rates of return, they must bear more risk.[32] For example, stocks with higher gains also have higher standard deviations.

Modern portfolio theory demonstrates that investors can minimize risk by investing in a diversified portfolio of securities from multiple issuers or asset classes.[33] A portfolio is diversified, and risk is minimized, to the extent returns from the various securities in a portfolio are unrelated to each other, or better still move in offsetting directions. But because security returns depend upon, or are correlated with, various market factors apart

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School Research Paper, October 2006) ("compar[ing] a number of different approaches for determining the Value at Risk (VaR) and Expected Shortfall (ES) of hedge fund investment strategies"); Martin Eling, *Performance Measurement of Hedge Funds Using Data Envelopment Analysis*, 20 FIN. MARKETS PORTFOLIO MANAGEMENT 4 (2006) (finding that "performance measures should be supplemented with [data envelope analysis] . . . to fully capture hedge fund risk and return characteristics").

[29] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 400, 404.

[30] Burton G. Malkiel, *A Random Walk Down Wall Street, in* FOUNDATIONS OF CORPORATE LAW 29 (1999 Romano ed.).

[31] *Id.* at 29-30.

[32] *Id*. at 30.

[33] *Id.* at 32.

from how the issuer performs (e.g., interest rates, consumer spending, the value of the dollar), diversification amounts to creating a portfolio of securities whose returns are not correlated with the same market factors.[34] As Nobel prize-winning economist James Tobin aptly summarized, diversification means "[d]on't put all your eggs in one basket."[35]

However, it is impossible to completely eliminate risk through diversification. This is because security returns have at least some correlation with general market movements, and thus to some extent move up and down in tandem.[36] This market-correlation risk, which cannot completely be diversified away, is identified by economists as "systematic" risk.[37] By contrast, the risks that arise from issuer-specific characteristics or actions (e.g., poor business judgment, employee retention, financial misstatements) is "unsystematic" risk and can be substantially reduced through diversification because such risks are not correlated with general market trends and the returns of other issuers.[38]

The market only rewards investors with higher returns for bearing more systematic risk.[39] Thus, what matters most to investors is the systematic risk that a security may add to a portfolio. Investors' basic choice is whether to increase or decrease expected returns by creating a portfolio more or less correlated with general market trends.[40]

Under the modern portfolio approach, then, risk is the likelihood a portfolio will lose value in response to systematic risks—general market trends. A portfolio totally unresponsive to market trends (e.g., made up completely of government bonds) has no (systematic) risk and earns a low return.

2. *Hedge Funds and Modern Portfolio Theory*

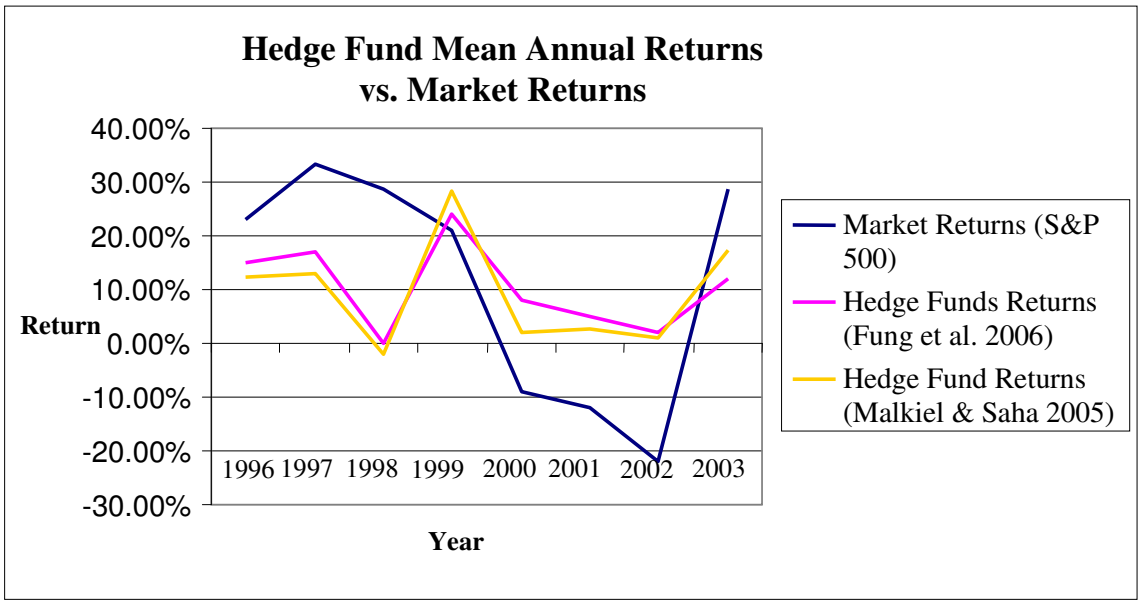
With mainstream finance as background, the value of hedge funds becomes evident. In contrast to publicly offered investment pools such as mutual funds, the goal of most hedge funds is to deliver positive (or "absolute") returns regardless of the direction of general markets, not to earn higher returns than the general market. The empirical evidence bears out the fact that hedge fund managers, despite significant differences by type and over time, have been successful in obtaining positive returns through various market conditions.[41]

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

[34] *Id*. at 34.
[35] James Tobin, Lecture at Trinity University (April 30, 1985).
[36] Malkiel, *supra* note 30, at 34.
[37] *Id.*
[38] *Id*.
[39] *Id*. at 35.
[40] *Id*. at 35-6.
[41] *See, e.g.*, Roger Ibbotson & Peng Chen, *The A,B,Cs of Hedge Funds: Alphas, Betas, and Costs* 16 (Yale ICF Working Paper No. 06-10 September 2006) (finding the compounded annual return to hedge funds at nine percent from 1995 to April 2006).

Index) from 1996-2003.[42] As Figure 1 illustrates, hedge fund returns, while not always higher than market returns, almost always produced gains regardless of the direction of the general market. It also shows that hedge fund returns are more consistent than those of the market. Nonetheless, Figure 1 does not illustrate that different hedge fund types have substantial differences in returns.[43]

Figure 1



Another way to evaluate absolute return strategies is to isolate hedge fund returns when the general market is negative. By looking at the experience of vehicles investing in hedge funds (i.e., returns to funds of hedge funds), Figure 2 demonstrates that most hedge funds had either no losses or gains during those months when the market experienced losses from January 1990-June 2004.[44] In particular, during the 2000 to 2002 bear market, the S&P 500 had an average annual loss of 15.5 percent, and the NASDAQ Composite Index likewise lost 10.6 percent annually, but the average annual return for hedge funds was about 2.5 percent.[45] More recently, while the S&P 500 lost 2 percent of its value in February 2007, hedge funds returns as a whole ranged from a loss of only 0.21 percent to a gain of 0.65 percent, depending on the measure used.[46]

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[42] The academic studies upon which the annual hedge fund returns in Figure 1 are based explicitly control for biases in hedge fund data that would otherwise tend to exaggerate their gains. *See* Burton G. Malkiel & Atanu Saha, *Hedge Funds: Risk and Return*, 61 FIN. ANALYSTS J. 80, 83 (2005); Fung et al., *Hedge Funds: Performance, Risk and Capital Formation* 25 (AFA 2007 Chicago Meetings Paper July 19, 2006).

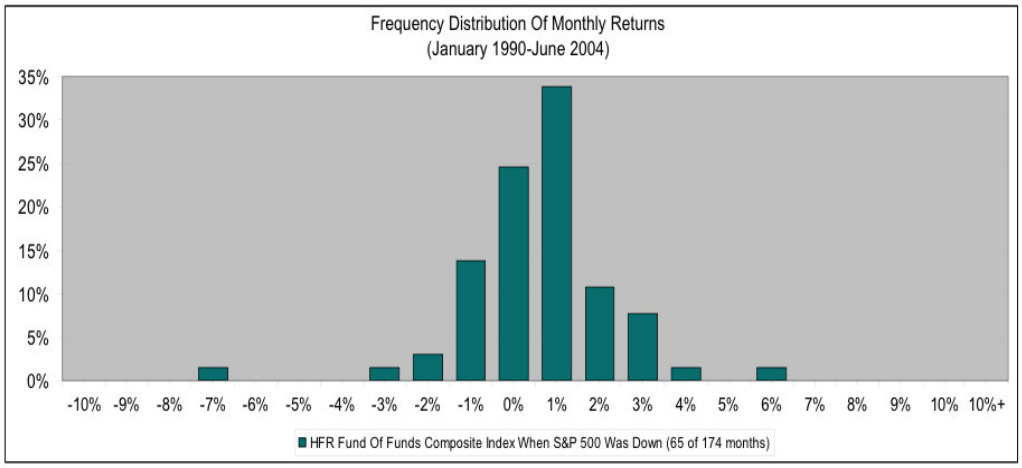
[43] For example, from 1995-2003 equity market neutral hedge funds returned 5.56 percent while emerging markets funds returned 14.19 percent. *See* Malkiel & Saha, *supra* note 42, at 81.

[44] Presentation, *Perspectives on Hedge Fund Investing*, CRESTMONT RESEARCH 18, 2002-05.

[45] The average annual hedge fund returns are based upon the average of those in Malkiel & Saha, *supra* note 42, Fung & Hsieh, *supra* note 42.

[46] *HFR: Hedge Funds Down in February*, FIN*ALTERNATIVES*, March 7, 2007; Alistair Barr, *Hedge Funds Tracked by HFR Returned 0.65percent in February*, MARKETWATCH, March 7, 2007.

Figure 2

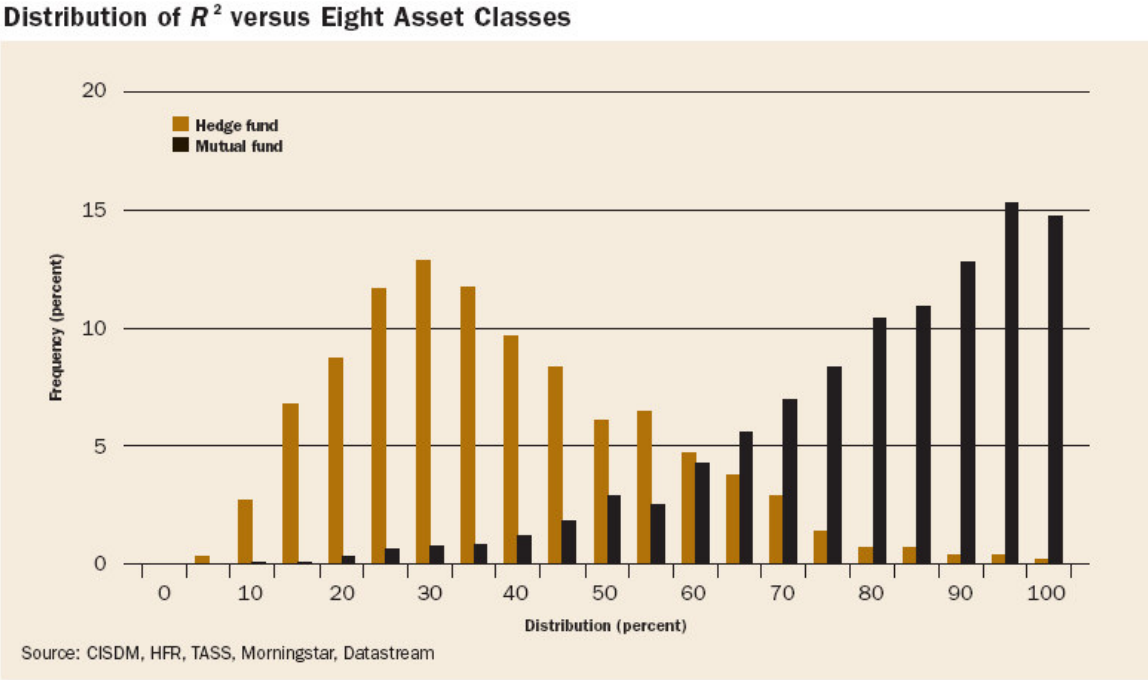


Source: *Perspectives on Hedge Fund Investing*, Crestmont Research (2000-05).

To produce positive returns in various market conditions, hedge fund returns must have a relatively low correlation to general market factors. This aspect of hedge fund returns has been well documented in the academic literature for at least a decade.[47] A 2006 study by William Fung and David Hsieh demonstrates 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).[48] Figure 3 below, reproduced from Fung and Hsieh's paper, illustrates this relatively low correlation by using the statistical property known as R^2. In this context, a distribution of R^2 closer to 100 percent (the right-hand part of the chart) simply means 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.

[47] *See* William Fung & David A. Hsieh, *Empirical Characteristics of Dynamic Trading Strategies: The Case of Hedge Funds*, 10 REV. OF FIN. STUDIES 279-82 (1997).
[48] William K.H. Fung & David A. Hsieh, *Hedge Funds: An Industry in Its Adolescence*, FEDERAL RESERVE BANK OF ATLANTA ECON. REV. 7-8 (2006).

Figure 3



Source: Fung and Hsieh, *Hedge Funds: An Industry in Its Adolescence* (2006)

Because hedge fund returns have relatively low correlation with general market trends, they can diversify a traditional portfolio and reduce (systematic) risk, or the correlation of a portfolio's returns with market factors.[49] Viewed from the perspective of what type of investment to add to an already existing portfolio of traditional investments, adding hedge funds is therefore generally *less* risky than further investing in stocks, because including the funds will likely reduce the vulnerability of the portfolio to market downturns. Just like any securities, how and to what extent adding those of hedge funds to a portfolio will reduce (systematic) risk depends on several factors, such as what assets the portfolio is already composed of and the investor's tolerance for risk.[50]

Unsurprisingly, just like every other security in the investment universe, there are limits to how much hedge funds can help diversify a portfolio. This is because hedge funds have their own systematic risk factors or risks that cannot be diversified away. First, although generally lower than traditional investments, hedge fund returns are at least somewhat correlated with general market factors.[51] This limits the funds' ability to

[49] *E.g.*, Jean-François Bacmann & Gregor Gawron, *Fat-Tail Risk in Portfolio of Hedge Funds and Traditional Investment*, *in* HEDGE FUNDS: INSIGHTS IN PERFORMANCE MEASUREMENT, RISK ANALYSIS AND PORTFOLIO ALLOCATION 491, 491-513 (Greg N. Gregoriou et al. eds., 2005) [hereinafter HEDGE FUNDS] (demonstrating that "the risk of a traditional portfolio is reduced when hedge funds are added.").
[50] *See, e.g.*, Bacmann & Gawron, *supra* note 54 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.").
[51] *See, e.g.*, Fung & Hsieh, *supra* note 48, at 16-26.

diversify, because an investor who adds hedge funds to a portfolio is adding at least some of the same market-correlation risks that already exist in that portfolio.

A second limitation on how well hedge funds can reduce overall portfolio risk is the funds' own unique risk properties. One property is a potential tendency to have relatively extreme losses.[52] Another is a tendency to become more correlated to general market trends during downturns, notwithstanding their typically low correlation to market movements.[53] Yet another is a potential for poor performance in some hedge funds to spill over to different types of funds.[54] Diversifying one's hedge fund holdings may reduce such risks, but adding more hedge funds may also increase them.[55]

Notwithstanding that hedge funds share some risks of traditional investments and have some risks of their own, their net contribution to a portfolio is generally to make it safer by reducing overall risk (so long as, like any other investment, the allocation to hedge funds is of the appropriate size and type).[56] While including hedge funds may fail to

[52] This is because hedge fund returns are asymmetric or "nonnormal" such that they have the "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 INVESTMENTS 26 (2002); Malkiel & Saha, *supra* note 42, at 80.

[53] Monica Billio Mila Getmansky & Loriana Pelizzon, *Phase-Locking and Switching Volatility in Hedge Funds* (Department of Economics, Ca' Foscari University of Venice Working Paper, 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"); Harry M. Kat, *Integrating Hedge Funds into the Traditional Portfolio*, J. OF WEALTH MANAGEMENT (Spring 2005); Javier Mencía, *Testing Dependence Between Financial Returns, An Application to the Hedge Fund Industry* (Working Paper, January 2006) (finding that "when strong shocks to the market occur, [hedge funds'] diversification benefits seem to deteriorate due to non-linear dependence"). *But see* Nicole M. Boyson, Christof W. Stahel & Rene M. Stulz, *Is There Hedge Fund Contagion?* (National Bureau of Economic Research Working Paper, 2006) (undermining the "phase-locking" hypothesis by finding no evidence that extreme losses in currency and equity markets are correlated to extreme losses in the hedge fund sector).

[54] *See* Nicole M. Boyson, Christof W. Stahel & Rene M. Stulz, *Is There Hedge Fund Contagion?* (National Bureau of Economic Research Working Paper, 2006) (finding "strong evidence of contagion across hedge fund styles, so that hedge fund styles tend to have poor coincident returns").

[55] Harry M. Kat, *Integrating Hedge Funds into the Traditional Portfolio*, *in* HEDGE FUNDS, *supra* note 49, at 3-15.

[56] *See* R. McFall Lamm Jr., *Asymmetric Returns and Optimal Hedge Fund Portfolios*, J. ALT. INVESTMENTS 6, 9-21 (2003) ("[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."); Kat, *supra* note 55 (investors can mitigate negative skewness and kurtosis of hedge funds by investing in put options, managed futures, and/or favoring some hedge fund types to others); Vikas Agarwal & Narayan Y. Naik, 17 *Risks and Portfolio Decisions Involving Hedge Funds*, REV. FIN. STUDIES 63 (2004); Jan-Hein Cremers, Mark Kritzman & Sebastien Page, *Optimal Hedge Fund Allocations: Do Higher Moments Matter?* (Revere Street Working Paper No. 272-13, September 3, 2004) (finding that "higher moments of hedge funds do not meaningfully compromise the efficacy of mean-variance optimization if investors have power utility . . . . that mean-variance optimization is not particularly effective for identifying optimal hedge fund allocations if preferences are bilinear or S-shaped . . . . [and] . . . investors with bilinear utility dislike kurtosis and that, contrary to conventional wisdom, investors with S-shaped preferences are attracted to kurtosis as well as negative skewness."); Niclas Hagelin, Bengt Pramborg & Fredrik Stenberg, *Hedge Fund Allocation under Higher Moments and Illiquidity*, *in* HEDGE FUNDS, *supra* note 49, at 105-128 (finding that "gains from allocating into hedge funds occur even when possible effects of deviations from normality"); Jean Brunel,

maximize a portfolio's potential gains, it will generally decrease its potential losses.

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 even always less risky than traditional investments. After considering tax issues and the widening array of financial products available to investors, hedge funds may lose some of their attractiveness. Nevertheless, the recent and projected growth of hedge funds demonstrates that investors have thus far been largely satisfied.

C. Despite Increasingly Complexity, Hedge Funds are in Important Ways Less Risky than Prior Years

The Commission notes the "increasing complexity of financial products, in general, and hedge funds, in particular."[57] On this basis, the Commission concludes that it is appropriate for the proposed rules to actually *decrease* the percentage of households able to invest in hedge funds from the 1982 level, when the minimum net worth requirements were first established.[58] Although the Commission correctly observes the increased complexity of hedge funds over the last decade, there is no empirical basis to conclude that such complexity has increased their risk so that fewer individuals are qualified to invest in them. To the contrary, in important ways hedge funds have become less risky than in prior years.

Revisiting the Role of Hedge Funds in Diversified Portfolios, *in* HEDGE FUNDS, *supra* note 49, at 129-49 (concluding that despite hedge funds' unique risks, "there is indeed a role for nontraditional, hedge fund-type strategies in diversified portfolios"); Jean-François Bacmann & Gregor Gawron, *Fat-Tail Risk in Portfolio of Hedge Funds and Traditional Investment*, *in* HEDGE FUNDS, *supra* note 49, at 491-514 (finding the optimal allocation of hedge funds to a portfolio consisting primarily of bonds to be approximately 50 percent and that consisting primarily of stocks to be substantial); Mark S. Shore, *Skewing Your Diversification*, *in* HEDGE FUNDS, *supra* note 49, at 515-25 (finding that "[h]edge funds show greater S-ratio volatility and negative skewness, but may enhance the returns of a traditional portfolio when allocated properly with managed futures"); David P. Morton, Elmira Popova, & Ivilina Popova, *Efficient Fund of Hedge Funds Construction Under Downside Risk Measures*, 30 JOURNAL OF BANKING & FINANCE 2, 503-18 (2005) (constructing a model for optimal hedge fund allocation to despite nonnormal returns); Ivilina Popova, et al., *Optimal Hedge Fund Allocation with Asymmetric Preferences and Distributions* (Working Paper 2006) (showing that "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"); Todd Brulhard & Peter Klein, *Are Extreme Hedge Fund Returns Problematic?* (Working Paper March 9, 2005) (finding that "the true magnitude of extreme returns is less severe for hedge fund indices than for equity indices . . . [and] that hedge fund indices are preferable to equity indices, even after taking into account the risk of extreme returns."); Todd Brulhard & Peter Klein, *Faulty Hypotheses and Hedge Funds*, CANADIAN INVESTMENT REV. 6-13 (2005) (finding that investing in hedge fund indices is no riskier than equity indices despite hedge funds' returns possessing negative skew and high kurtosis); Jefferson Duarte, Francis A. Longstaff & Fan Yu, *Risk and Return in Fixed Income Arbitrage: Nickels in Front of a Steamroller?*, REV. OF FIN. STUDIES (2006) (finding that "[i]n contrast with other hedge fund strategies, many of the fixed income arbitrage strategies produce positively skewed returns."); Daniel Giamouridis & Ioannis D.Vrontos, *Hedge Fund Portfolio Construction: A Comparison of Static and Dynamic Approaches*, 31 JOURNAL OF BANKING AND FIN. 199 (January 2007) (finding that "dynamic covariance/correlation prediction models" allow investors to optimize portfolio allocations with lower risks and higher returns).

[57] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 400, 406.

[58] *Id*.

Because of their increased complexity over the past decade, the risk of hedge funds has likely not increased and probably decreased overall. Generally, as financial markets have become more complex, they have also become more stable.[59] Hedge funds have likewise increased their stability, or decreased some of their risks to investors, in part *because of* their increasing complexity, not in spite of it.[60] Lower risk to investors is also the result of substantially improved industry-wide risk management practices.

The hedge fund industry has substantially improved its risk management practices since the massive contraction of Long Term Capital Management in 1998. In response to this crisis, in January 1999 12 major commercial and investment 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. In August 2005, the Managed Funds Association released its most recent report detailing best practices for internal control, investor protection, and other aspects of hedge fund risk management.

Hedge funds and the "counterparties" on the other side of their transactions have acted in accordance with such recommendations. Such improvements include continuing to standardize procedures, employing more sophisticated controls, and committing significant resources to risk personnel, operations, and external monitoring.[61] For example, testing funds to observe responses to unexpected price movements is now pervasive throughout the industry.[62]

These improvements are driven by the underlying economics of the industry, indicating that hedge funds and counterparties will have the incentive and the means to continue towards greater stability. First, the rising involvement of investment banks as fund managers and as prime brokers,[63] for example, increases capabilities to bear and monitor risk because such parties tend to have the most sophisticated management systems, expertise, and resources. Second, hedge funds increasingly disclose information about their risk management practices to attract capital from large institutional investors.[64] This can benefit individual investors with less clout, as disclosures require funds to improve and standardize practices. Finally, third parties such as Standard and Poor's and Moody's recently began to facilitate risk management by rating aspects of hedge fund risk.

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[59] COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, *Toward Greater Financial Stability: A Private Sector Perspective, The Report of the Counterparty Risk Management Policy Group II* Appendix B-10 (2005).

[60] The development of complicated derivatives, such as "credit default swaps" for example, allows hedge funds to manage exposures to the risks involved with lending.

[61] MERCER OLIVER WYMAN, *New Study Reveals Strengthened Global Hedge Fund Industry Risk Management Practices* (2006).

[62] *Id*.

[63] *See* Shaheen Pasha, *Banks' Love Affair with Hedge Funds*, CNNMONEY.COM (October 6, 2006).

[64] *See Institutional Demand for Hedge Funds 2*. *supra* note 19, at 8-10; Lauren Keyson, *Top Five Hedge Fund Trends For 2007*, FORBES.COM (January 18, 2007); Paul Allen, *Prime Time For Primes*, FINANCETECH (February 14, 2006) ("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.").

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 over the past several years and are expected to keep decreasing.[65] 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 to 5 percent, with no trend of increasing failure.[66] 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,[67] suggesting that failure rates may decrease due to the strides 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.[68]

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.[69] In addition, a recent study found that only 4 percent of hedge funds, representing 1 percent of assets, are "undercapitalized," meaning they do not have enough equity relative to the risk of their underlying investments.[70]

The spectacular collapse of Amaranth Advisors LLC in September of 2006 illustrates the resilience of hedge funds to large market swings. Amaranth was the largest collapse in hedge fund history, losing about $6.6 billion on natural gas trades in a few weeks, substantially larger losses than Long Term Capital Management suffered. Nonetheless, Amaranth's investors ultimately recovered one-third of their investments,[71] making them

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[65] *Hedge Fund Attrition Rate Continues to Decline, Says Hennessee*, HENNESSEE GROUP, February 1, 2007.
[66] Fabrice Rouah, *Competing Risks in Hedge Fund Survival* 26 (Working Paper, January 2006) (finding failure rate to be three to five percent with no trend of increasing); Hyuna Park, *Risk Measures for Hedge Funds and a Survival Analysis* 27 (Isenberg School of Management, University of Massachusetts, Working Paper, September 2006) (finding the "real failure" for hedge funds at three percent and lower than the rate of attrition (closure) rate of 8.7 percent).
[67] Stuart Feffer & Christopher Kundro, *Understanding and Mitigating Operational Risk in Hedge Fund Investments*, THE CAPITAL MARKETS COMPANY LTD. (2003) ("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, January 18, 2006 ("more 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"); Jean-René Giraud, *Managing Hedge Fund Operational Risks* (EDHEC Risk and Asset Management Research Centre, Working Paper, 2003) (same). *See also* Corentin Christory et al., *Quantification of Hedge Fund Default Risk* 4 (EDHEC Risk and Asset Management Research Centre Working Paper, 2007).
[68] Feffer & Kundro, *supra* note 67, at 4 ("discretionary fund closures . . . are much more frequent and are often driven by the business or market expectations of the fund manager."); Park, *supra* note 66.
[69] *See, e.g.*, Nicolas T. Chan et al., *Systemic Risk and Hedge Funds* 71 (MIT Sloan Research Paper No. 4535-05, February 22, 2005) (finding that age, assets under management, cumulative returns, and fund flows have a significantly negative impact on the liquidation probability); Naohiko Baba & Hiromichi Goko, *Survival Analysis of Hedge Funds* (Bank of Japan Working Paper, March 2006) (finding funds with greater assets under management have higher survival probability).
[70] Anurag Gupta & Bing Liang, *Do Hedge Funds Have Enough Capital? A Value-at-Risk Approach*, 77 J. FIN. ECON. 219 (2005) (finding that as of March 2003, less than 4 percent of operating hedge funds, constituting only 1.2 percent of total assets, were undercapitalized).
[71] John Carney, *The Cost of Amaranth*, DEALBREAKER.COM, November 30, 2006.

much better off than millions of stock market investors after the collapse of the Internet price bubble.

Hedge funds still face significant risk challenges, in particular from valuation difficulties and operational risks associated with private, over-the-counter derivatives trading. There are also some indications that hedge funds have become riskier, but not in ways related to their increased complexity. First, as more funds enter an increasingly crowded market, some funds may find it more difficult to earn returns, especially without taking on added risk, and as a consequence a greater absolute number of firms may fail.[72] In addition, hedge funds returns may be increasingly correlated to general market trends as the industry grows, implying a greater vulnerability to market risk factors.[73] Although popular writers often assert the existence of a hedge fund "bubble," no academic study has confirmed such a claim and at least one found to the contrary.[74] While the net effects of such trends upon risk are unknown, such risks are of the same type already faced by investors not meeting the definition of accredited investor.

D. Sufficient Information About Hedge Funds Exists in the Public Domain Such that a Substantial Portion of Nonaccredited Investors are Able to Appreciate the Funds' Merits and Risks

The Commission asserts that investors "may find it difficult to appreciate the unique risks of" hedge funds because of their "complicated investment strategies" and because "there is minimal information available about [hedge funds] in the public domain" such that "investors do not have access to the kind of information provided through our system of securities registration."[75] While it is true that hedge funds are not required to publicly disclose important information pursuant to the Commission's system of registration and disclosure, the Commission's claim that "there is minimal information available about [hedge funds] in the public domain" is incorrect. The amount of publicly available information about all aspects of the hedge fund industry is overwhelming, and much of it is available at no cost over the Internet or through public libraries. This information is sufficient for a substantial portion of investors not meeting the definition of accredited investor to appreciate the funds' merits and risks.

Information about hedge funds includes book length treatments and articles; academic, industry, and government studies; and pieces in popular publications, such as magazines, newspapers, and blogs. An Amazon.com search for "hedge funds" in its Business & Investing category retrieves nearly 3000 results. Several hundred studies are freely

[72] Baba & Goko, *supra* note 69 (finding that as the number of total hedge funds is becoming larger, the survival probability significantly falls.); Justin Lahart, *Hedge Funds Start to Look Like Risky Bets*, WALL ST. J., Page C1, February 12, 2007.
[73] *See, e.g.*, James R. Barth et al., *Hedge Funds: Risks and Returns in Global Capital Markets*, MILKEN INSTITUTE 54 (2006).
[74] *See* Jan Loeys & Nikolaos Panigirtzoglou, *Are Alternatives the Next Bubble?*, J. ALTERNATIVE INVESTMENTS 54 (2006) (finding that hedge funds do not demonstrate much evidence of being a bubble).
[75] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 412.

available online.[76] Many of these books and articles are written in a style accessible to general audiences, and hedge fund investors in particular, and many explain in detail the funds' underlying investment strategies.[77] Several news services, blogs, and data collection websites track, in near real-time, news and analysis of the industry. Indeed, this Comment was produced based solely on publicly available information.

Substantial and detailed public information is available regarding the potential sources of conflicts of interest, complex fee structures and higher risks for which the Commission expressed particular concern.[78] For example, the following information is freely available through the Internet: the distribution of hedge funds by the types and levels of fees they charged from 1981-2006;[79] publications discussing the sources and impact of potential conflicts of interest;[80] several different measures of hedge fund risk; and risk-adjusted performance by type of hedge fund from 2004-06 and 1997-2006.[81]

Furthermore, most hedge funds are registered with some regulatory agency,[82] providing basic information about the fund and manager.[83] And because a substantial portion of hedge funds own more than $100,000,000 in publicly traded stock, they are required to quarterly disclose to the Commission their equity holdings on Form 13F.[84] Form 13F filers are likely to increase as the size of hedge funds increases. In addition, hedge funds must disclose any acquisition of a public company's equity securities above five percent.[85]

Although minimal information exists about the proprietary aspects of trading strategies and what hedge funds are involved with what counterparties, it strains credibility to hold that the amount of publicly available information about hedge funds is so "minimal" that nonaccredited investors are unlikely to understand the funds' merits and risks. Investors do not need to know the day-to-day mechanics of a fund's investment strategies to make sufficiently informed investment decisions.

Finally, the relative lack of information available to investors is a function of the definition of accredited investor. Hedge funds seeking exemption from the 1934 Act cannot disclose information to nonaccredited investors under pain of violating

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[76] *E.g.*, a Google Scholar search for publications with "hedge fund" in the title retrieved nearly 800 results, most of which are available for free on-line, http://scholar.google.com/.
[77] *See, e.g.*, Ann C. Logue, HEDGE FUNDS FOR DUMMIES (2006);
[78] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 404.
[79] Barth et al., *supra* note 73, at 26-37.
[80] *See, e.g.*, Chester S. Spatt, *Conflicts of Interest in Asset Management*, Keynote Address at Hedge Fund Compliance and Regulation Conference, May 12, 2005; Tom Nohel, Zhi Jay Wang & Lu Zheng, *Side-By-Side Management of Hedge Funds and Mutual Funds*, Working Paper, November 21, 2006.
[81] Veronique Le Sourd, *Hedge Fund Performance in 2006: A Vintage Year for Hedge Funds?* (EDHEC Risk and Asset Management Research Centre Working Paper, March 2007).
[82] *Hennessee Group LLC Releases 12th Annual Hedge Fund Manager Survey*, HENNESSEE GROUP, December 5, 2006.
[83] Shartsis Friesse LLP, U.S. REGULATION OF HEDGE FUNDS 22-25 (2005).
[84] Securities and Exchange Act of 1934 ("Exchange Act") Rule 13f-1(b), 17 C.F.R. § 240.13f-1(b).
[85] *See* Exchange Act § 13(d), 15 U.S.C. § 78m(d); Exchange Act Rules 13d-1(a), 17 C.F.R. § 240.13d-1(a).

prohibitions against general solicitation and advertising.[86] Those qualified to invest in hedge funds, by contrast, can receive and inquire about more detailed information. If more investors could get into hedge funds, the funds themselves would likely make information more widely available.

E. Investors Not Meeting the Definition of Accredited Natural Person Are Directly Exposed to the Risk and Complexity of Hedge Funds

According to the Commission's own projections, the proposed rules will decrease the proportion of households able to purchase hedge funds—by 85 percent. Yet regardless of how much wealth is required to qualify as an accredited investor, the Commission will be unable to prevent investors from purchasing securities exposed to the same type and complexity of risks associated with hedge funds.

While hedge funds' strategies are certainly more complicated than those of traditional stock and bond investing, traditional investment strategies are also complicated because of the complexity of issuers' business operations in an increasingly global and information based economy. For example, investors in registered information technology, financial services, and healthcare provider companies (e.g., Cisco Systems, Goldman Sachs, and Medtronic) may have little understanding of the complex technological, financial, and scientific expertise underlying their securities' values or the risks such companies are exposed to through inflation, foreign exchange fluctuations, patent acquisitions and regulatory developments.

In addition, numerous securities currently available to nonaccredited investors also employ "complicated investment strategies," due in large part to the development of exchange traded funds (ETFs). 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 even investing in ETFs whose value is tied to intangible assets like innovation and customer loyalty.[87] The Commission fails to explain in what relevant sense hedge fund investing is more complicated than such investments.

Two relatively recent market developments are investment vehicles known as "hedged mutual funds" and hedge fund "clones" (or synthetic hedge funds). Hedged mutual funds are registered investment pools (mutual funds) that mimic hedge fund strategies and only require an average minimum investment of $5,000,[88] with some as low as $500.[89] Synthetic hedge funds are passively managed index-based securities, which also attempt

[86] *See supra* note 83, at 213-220.
[87] *See, e.g.*, Rob Wherry, *These ETFs Bring Hedge-Fund Tactics to the Mainstream*, SMARTMONEY.COM, January 31, 2007 (noting that "[w]ith these new ETFs . . . the ordinary investor can treat a part of their portfolio in a 'hedge fund' like manner.").
[88] *See* Vikas Agarwal et al., *Hedge Funds for Retail Investors? An Examination of Hedged Mutual Funds* 1 (EFA 2006 Zurich Meetings Working Paper, January 26. 2007).
[89] *Adam* Shell, *Investors Add a Bit of Hedge Fund to Portfolio Mix*, USA TODAY (December 8, 2006).

to replicate hedge fund risk and returns properties through complex trading algorithms.[90] Although most synthetic hedge funds are available only to high net worth investors, more will likely be available to nonaccredited investors in a few years.[91]

These hedge-fund-like alternatives arose in response to investor demand for absolute return (or low market-correlation) strategies without features such as high manager fees, low liquidity, and substantial minimum investment requirements.[92] These alternatives expose investors to the same types of risks and complicated strategies as real hedge funds.[93] However, neither has matched the performance of the best hedge funds (which rely more directly on human skill).[94] Thus, under the proposed rules nonaccredited natural persons can still be exposed to the risk and complexity of hedge funds, but will be unable to benefit from the best performing funds.

III. Proposals In Response to Request for Detailed Comments and Explanation on Proposed Rules

The Commission requests "comment on the rules proposed in this Release, suggestions for additions to the rules, whether any changes are necessary or appropriate to implement the objectives of our proposed rules and what those changes might be . . . ."[95] This Comment makes proposals widely applicable to the proposed rules, but most applicable to the following specific requests:

- "[W]hether retaining the existing definition of accredited investor as it relates to natural persons and adding an additional requirement for that term that uses the amount and type of a natural person's investments (individually, or jointly with

[90] Harry M. Kat & Helder P. Palaro, *Hedge Fund Returns: You Can Make Them Yourself!* (AIRC Working Paper No. 0023, Cass Business School Research Paper, June 8, 2005) (constructing "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"); Wherry, *supra* note 87; Marc Hogan, *Hedge Funds: Attack of the Clones*, BUSINESS WEEK, December 4, 2006.

[91] Gail Marks Jarvis, *Taking All Ego Out of Investing in Hedge Funds*, CHICAGO TRIBUNE, October 29, 2006 (reporting that "individual investors may find [synthetic hedge fund clones] available in the retail market within three to five years."); Hogan, *supra* note 90 (noting that the Merrill Lynch synthetic "Factor index is currently unavailable in the retail market, though Merrill executives say they are considering wider distribution.").

[92] Hogan, *supra* note 90; Agarwal et al., *supra* note 88, at 1.

[93] Kat & Palero, *supra* note 90, at 8 (noting that all of the "the statistical [risk and return] properties of [George Soros's Quantum hedge fund] . . . have been quite successfully replicated"); Agarwal et al., *supra* note 88 (noting that hedge mutual funds exhibit significant skewness and kurtosis); Shell, *supra* note 88 ("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).

[94] *See generally* Agarwal et al., *supra* note 88 (finding hedged mutual funds underperform hedge funds but outperform traditional mutual funds); Jasmina Hasanhodzic & Andrew W. Lo, *Can Hedge-Fund Returns Be Replicated?: The Linear Case* (Working Paper, August 16, 2006) (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 market movements); Hogan, *supra* note 90 ("Merrill [Lynch] doesn't claim the [hedge fund] index can match the market-beating returns of the best-performing hedge funds").

[95] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 408.

the person's spouse) is an appropriate standard by which to measure whether that person is likely to have sufficient knowledge and financial sophistication to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment."[96]

- "[W]hether the proposed rules, if adopted, would promote efficiency, competition and capital formation."[97]

- "[W]hether we should increase (or decrease) the amounts specified for the net worth and income criteria applicable to natural persons under the Regulation D definition of accredited investor."[98]

- "[W]hy their suggestions would address our interest in providing an objective and clear standard for ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and financial sophistication to 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."[99]

- "We also solicit comment on our proposal to use $2.5 million as the level of investments that an accredited natural person must own. Should we use another level that is higher or lower than proposed?"[100]

A. Substantially Reduce Any Net Worth, Income or Level of Investments Required to Purchase the Securities of Hedge Funds

Pursuant to any act of rulemaking, the Commission is required by federal law to consider "in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation."[101] Based upon these goals, the Commission should revise the proposed rules to substantially reduce any net worth, income, and/or value of investments required to purchase the securities of issuers of hedge funds. Such a reduction would take into account the fact that a substantial portion of nonaccredited investors could benefit from hedge fund investing.

1. The Proposed Rules May Harm Nonaccredited Investors

The proposed rules narrowly construe investor protection as 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

[96] *Id*. at 405.
[97] *Id*. at 414.
[98] *Id*. at 405.
[99] *Id*. at 406.
[100] *Id*.
[101] National Securities Markets Improvement Act of 1996, Public Law 104-290, October 11, 1996, 110 Stat. 3424 (1996), Sections 106(a), (b) and (c) (amending the Securities Act, the Exchange Act and the Company Act).

matters to enable that purchaser to evaluate the merits and risks of a prospective investment or to hire someone who can."[102] By requiring $2.5 million in investments and thereby limiting those able to invest in hedge funds to 1.3 percent of households, the proposed rules would achieve the Commission's goal of investor protection, so construed.

However, investor protection also includes enabling investors to reduce the risk of economic loss, not merely preventing investors from purchasing securities without sufficient knowledge. The addition of hedge funds to a portfolio generally reduces the overall risk of loss. Furthermore, sufficient public information exists about hedge funds such that substantially more than 1.3 percent of investors can evaluate their merits and risks to successfully add them to a portfolio. Relative to the complexity and risks of other securities nonaccredited investors currently purchase, including those that underperform hedge funds (i.e., hedged mutual funds), hedge funds are no more complicated. Therefore, by limiting the ability of investors to purchase hedge fund securities, the proposed rules undermine investor protection by reducing investors' ability to decrease their risk of loss.

It is true that the development of hedged mutual funds (and similar investments) available to nonaccredited investors makes hedge fund-like risks and returns available to a broader class of investors. However, hedged mutual funds have not matched the performance of the best hedge funds.[103] Thus, under the proposed rules, nonaccredited natural persons can still be exposed to the risk and complexity of hedge funds, but will be unable to benefit from the best performing funds.

2. The Proposed Rules Undermine Capital Formation

In addition, the proposed rules conflict with the goal of promoting capital formation by investors. Capital formation means investment in productive assets today that will allow us to enjoy a higher standard of living in the future. Capital formation is promoted when rules allow investors to purchase securities reducing portfolio risk. Just as fire insurance makes people more willing to invest in houses, hedge funds and other forms of portfolio diversification make people more willing to invest in stocks, bonds, and other productive assets.

Hedge funds generally reduce portfolio risk. Substantially more investors than those allowed by the proposed rules could benefit from investing in hedge funds. By making them more vulnerable to general market risks, the proposed rules on net increase the risk of investors' portfolios. Because the ability to invest in hedge funds generally preserves investor savings in the event of a market downturn, the proposed rules increase investors' exposure to a substantial risk of loss (such as that experienced in the recent 2000-2002 bear market). This increased risk, in turn, would likely make at least some investors less willing to invest, thus reducing capital formation.

[102] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 400, 405.
[103] *See supra* note 94.

3. The Proposed Rules Undermine Economic Efficiency

Finally, the proposed rules also undermine economic efficiency. Efficiency is "that allocation of resources in which value is maximized" to the public.[104] A policy that maximizes economic efficiency is a policy that allows consumers to satisfy as many of their most highly-valued wants as possible, where the consumer's own judgment establishes which wants are most important. Efficiency increases when consumers are able to engage in mutually beneficial transactions.[105] A rule that prevents a reasonably well-informed investor from adding hedge funds to his or her portfolio reduces economic efficiency, because it prohibits a transaction the investor might view as beneficial. The proposed rules deny a substantial portion of informed (but "nonaccredited") investors the ability to reduce the risk of their portfolios by investing in hedge funds. Accordingly, the proposed rules also decrease overall economic efficiency.

In a telling admission, Commission recognized that the proposed rules may "result in some sponsors of 3(c)(1) Pools not offering new 3(c)(1) Pools or some potential sponsors of such pools not entering the business."[106] However, younger hedge funds often outperform older funds.[107] Furthermore, the hedge fund industry as a whole increases overall market efficiency and promotes capital formation by mitigating price downturns, bearing risks that others will not, and making securities more liquid.[108] As a result, the proposed rules are likely to deprive accredited investors of an important source of superior returns and may even reduce the benefits of hedge funds to the global economy to the extent the reduction in new funds undermines growth of the entire industry.

4. Lower Accredited Investor Limits Are Consistent With Investor Protection

A substantial reduction in the amount of wealth required to invest in hedge funds would not undermine the Commission's goal to "ensure that only investors that are capable of evaluating the merits and risks of investments in certain 3(c)(1) Pools may invest in such pools."[109] Investors genuinely unable to appreciate the merits and risks of hedge funds are likely not to purchase the funds' securities or a significant amount of them. Investors tend not to purchase securities with which they are relatively unfamiliar.[110]

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[104] Richard A. Posner, ECONOMIC ANALYSIS OF LAW 13 (1998).

[105] This applies in the absence of "externalities" —effects on third parties that the transacting parties fail to take into account. However, the Commission has offered no externality-based rationale for its proposed rules, justifying them instead as necessary to protect investors who might invest in hedge funds.

[106] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 411-12.

[107] *See* Walter Géhin, *The Challenge of Hedge Fund Performance Measurement: A Toolbox Rather Than a Pandora's Box* 17-18 (EDHEC Risk and Asset Management Research Centre Working Paper, October 2004).

[108] *See, e.g.*, Sebastian Mallaby, *Hands Off Hedge Funds*, FOREIGN AFFAIRS (2007).

[109] Accredited Investors in Certain Private Investment Vehicles, *supra* note 2, at 413.

[110] See H. Hencry Cao et al., *Fear of he Unknown: The Effects of Familiarity on Financial Decisions*, (Duke University Working Paper, September 16, 2003) (finding "evidence indicates that individuals prefer proximate and familiar investments"); Warren Bailey et al., *Home Bias of U.S. Individual Investors: Causes and Consequences* (Working Paper April 22, 2006) (less sophisticated and wealthy investors display bias towards home country stocks despite the benefits of international diversification).

Hedge funds' own business practices and their institutionalization also provide an important check on the ability of investors lacking sufficient sophistication or capital to invest in the funds.[111] First, such investors are generally the least likely to be seen as desirable investors by hedge funds, because dealing with such investors increases the funds' transaction costs and liability risk. Second, the funds' desire to avoid becoming too large to generate high returns also leads them to reject potential investors, a practice becoming increasingly widespread as funds grow and opportunities for higher returns likewise diminish.

In sum, a substantial reduction in any net worth, income, and/or value of investments required to purchase hedge fund securities would further the Commission's goals of investor protection, capital formation and efficiency. Although the combination of specific levels of income, net worth, and/or investments consistent with this standard is relatively flexible, a reasonable amount might be to require a minimum level of investible assets around $50,000. Financial research suggests that putting about 10 percent of one's portfolio in assets such as hedge funds is in the range of an optimal overall risk-reduction strategy. On average, hedged mutual funds require a minimum investment of $5000, and hedge funds serving smaller investors may require a similar minimum investment average. An individual who makes that minimum investment should thus have a portfolio of about $50,000 to result in a 10 percent allocation to hedge funds. Since Commission regulation permits any nonaccredited investor to take on this kind of risk in hedged mutual funds, it seems reasonable to let an investor into hedge funds if he or she has a portfolio large enough to make a beneficial investment in hedged mutual funds.

B. Allow Nonaccredited Investors to Purchase Securities of Hedge Funds Registered with the Commission or with the Commodity Futures and Trading Commission (CFTC)

A second-best course of action for the Commission is to allow nonaccredited investors to purchase hedge fund securities from funds registered with a regulatory agency. To accomplish this goal, the Commission could by rulemaking exempt hedge funds registered with a federal or state regulatory body, or a recognized self-regulatory organization from rules requiring them to sell their securities exclusively (or primarily) to accredited investors.[112]

C. Study Policies of Other Nations that Make Hedge Funds More Widely Available

Other industrial nations, such as Australia, allow retail investors full access to hedge fund investments so long as such funds are registered with the Australian Securities &

[111] *See* Alex Akesson, *Higher Standards may be Welcomed by Hedge Funds*, HEDGECO.NET, December 22, 2006 (reporting that because the hedge fund industry "is much more dominated by institutional money, rather than individuals . . . . [i]t is just fewer and fewer funds relying on individual investors").
[112] The Commission could accomplish this goal by amending Regulation D of the Securities Act.

Investments Commission.[113] In this regard, the Commission should study the impact on retail investors' experiences in with hedge funds, not only in Australia, but in other nations with substantially less barriers to purchasing the funds' securities such as the Ireland, Germany and Switzerland.[114]

IV. Conclusion

The very term "hedge fund" implies that the fund is trying to hedge against various types of risks prevalent in financial markets. Used properly, hedge funds are a tool for risk management and risk reduction. Based upon the publicly available information about hedge funds, a substantial portion of nonaccredited investors are able to properly use and benefit from the funds. By limiting investors' ability to purchase hedge fund securities, the proposed rules undermine investor protection by reducing investors' ability to decrease their risk of loss.

The proposed rules will not protect nonaccredited investors from the complexity and risks involved with hedge funds, but only prohibit such investors from benefiting from the best hedge funds. On the other hand, a substantial reduction in any net worth, income and/or value of investments required to purchase hedge fund securities would more effectively advance the Commission's goals of investor protection, efficiency, competition, and capital formation.

A second-best option would be to allow any hedge fund that registers with a regulatory agency to sell securities to nonaccredited investors. At the very least, the Commission should evaluate the experience of countries that make hedge funds more widely available to investors before deciding whether they should be more, or less, widely available to American investors.

[113] Scott McNally, Mark Chambers & Chris Thompson, *The Australian Hedge Fund Industry*, FIN. STABILITY REV. 57, 58-59 (2004) ("if a hedge fund is marketed to retail investors then it must be registered with ASIC, and is subject to certain operational and disclosure requirements designed to protect investors' interests.").

[114] *See* Rhea Wessel, *German Hedge Fund Market to be Established by January 1st*, FIN. ENGINEERING NEWS, November/December 2003.

APPENDIX I
RSP Checklist

SEC Proposed Rules Regarding the Definition of Accredited Investor for Certain Private Investment Pools

Element	Agency Approach	RSP Comments
1. Has the Commission identified a significant market failure?	The Commission expressed concern that substantially more persons are currently qualified to invest in hedge funds than when the definition of accredited investor was first established in 1982. Raising the threshold required to invest in hedge funds would ensure that individuals who invest in hedge funds have a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools. **Grade: D**	The proposed rule limiting investors' abilities to purchase hedge fund securities undermines investor protection by reducing investors' abilities to decrease their risk of loss. The proposed rules will not protect nonaccredited investors from the complexity and risks involved with hedge funds, but only prohibit such investors from benefiting from the best hedge funds. The proposed rules could also deprive accredited investors of access to significantly higher returns. The proposed rules do not evaluate or consider these possibilities.
2. Has the Commission identified an appropriate federal role?	The Commission claims authority to impose a wide variety of regulations to protect investors and amend the definition of accredited investor under the Securities Act. **Grade: A**	The Commission presents a convincing case that it has legal authority to implement its proposed rules. The vast majority of securities transactions are clearly interstate if not international in nature.

Element	Agency Approach	RSP Comments
3. Has the Commission examined alternative approaches?	The Commission considered no substantial alternatives to the proposed rules. **Grade: D**	Increasing the portion of investors able to invest in hedge funds could further the Commission's goals of investor protection, capital formation, and economic efficiency. Other nations make hedge funds more widely available by adopting less restrictive alternative forms of regulation. The Commission should consider the experiences of other jurisdictions allowing investors greater access to hedge funds.
4. Does the Commission attempt to maximize net benefits?	The Commission did not consider the net benefits of hedge fund investing. **Grade: D**	Benefits to investors from hedge fund investing would be maximized by substantially increasing the portion of nonaccredited investors able to invest in the funds. The proposed rules fail to maximize the benefits to investors by depriving nonaccredited investors of a significant source of risk reduction.
5. Do the proposed rules have a strong scientific or technical basis?	The Commission failed to any academic literature whatsoever and likewise failed to perform any detailed analysis of the current state of the hedge fund industry and the publicly available information about it. The Commission is unclear about the precise basis for its proposed rules. **Grade: F**	Economic research demonstrates that hedge funds generally reduce portfolio risk. An analysis of the industry indicates that important risks have decreased and that substantial information about hedge funds is publicly available.

Element	Agency Approach	RSP Comments
6. Are distributional effects properly understood?	The Commission noted that the proposed rules will result in an 85 percent reduction in households able to invest in hedge funds, briefly discussed the impact of the proposed rules on new hedge funds, but failed to analyze the impact of raising the required threshold to invest in hedge funds on wealth distribution. **Grade: D**	Depriving a substantial portion of nonaccredited investors the potential benefits of hedge fund investing may increase wealth disparities between accredited natural persons and nonaccredited investors. Undermining the incentive to start new hedge funds may deprive accredited investors of a significant source of better returns and undermine economy-wide efficiency.
7. Are individual choices and property impacts understood?	The Commission failed to adequately consider the ability of nonaccredited investors to make informed decision regarding hedge fund investing. **Grade: D**	Notwithstanding hedge funds' status as private investment vehicles, and despite their increased complexity, sufficient information is available in the public domain for a substantial portion of nonaccredited investors to make informed investment decisions with respect to the funds.