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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]

March 9, 2007

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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.

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[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

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[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*

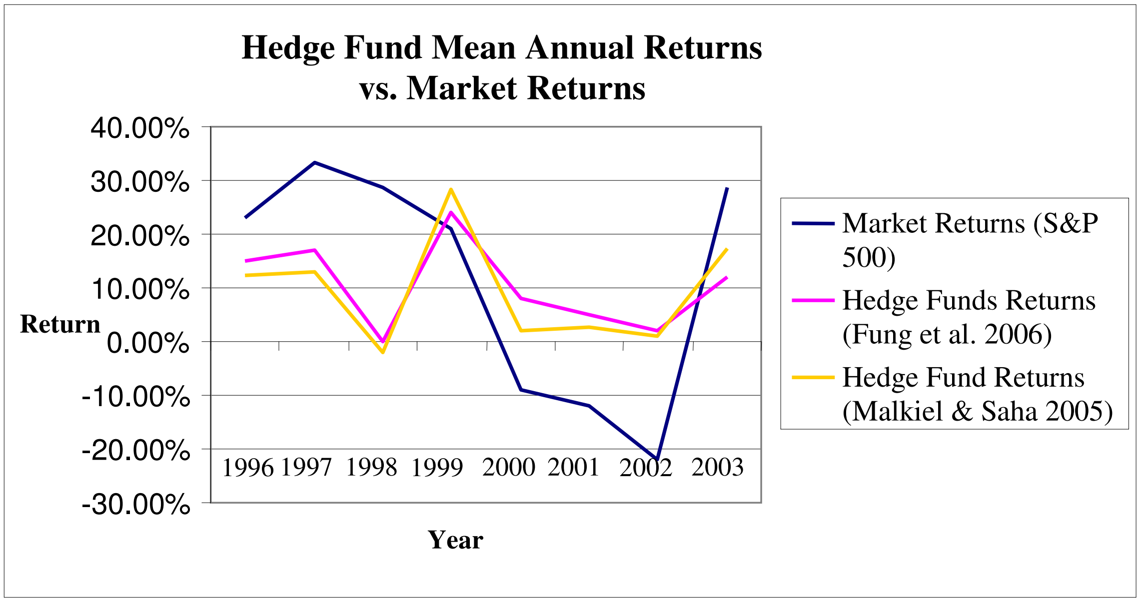
With mainstream finance as background, the value of hedge funds becomes evident. In contrast to publicly offered investment pools such as mutual funds, the goal of most hedge funds is to deliver positive (or "absolute") returns regardless of the direction of general markets, not to earn higher returns 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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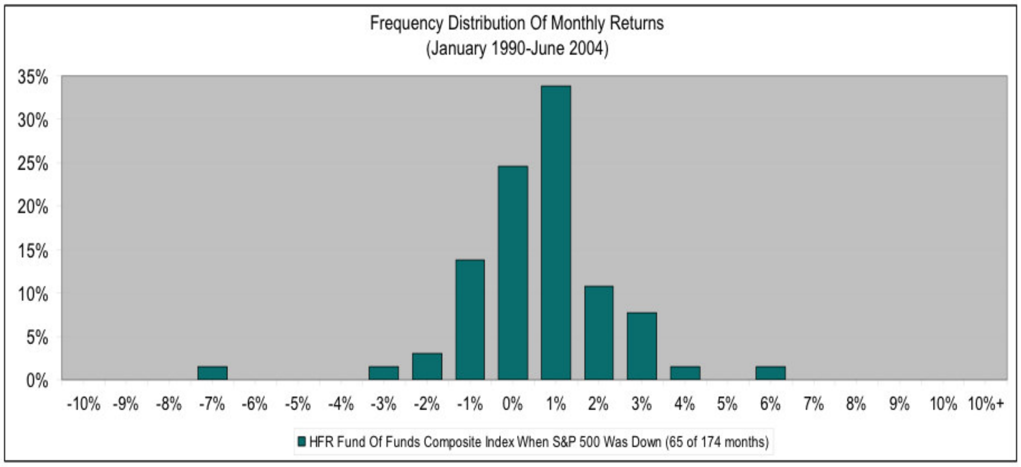
[42] The academic studies upon which the annual hedge fund returns in Figure 1 are based explicitly control for biases in hedge fund data that would otherwise tend to exaggerate their gains. *See* Burton G. Malkiel & Atanu Saha, *Hedge Funds: Risk and Return*, 61 FIN. ANALYSTS J. 80, 83 (2005); Fung 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

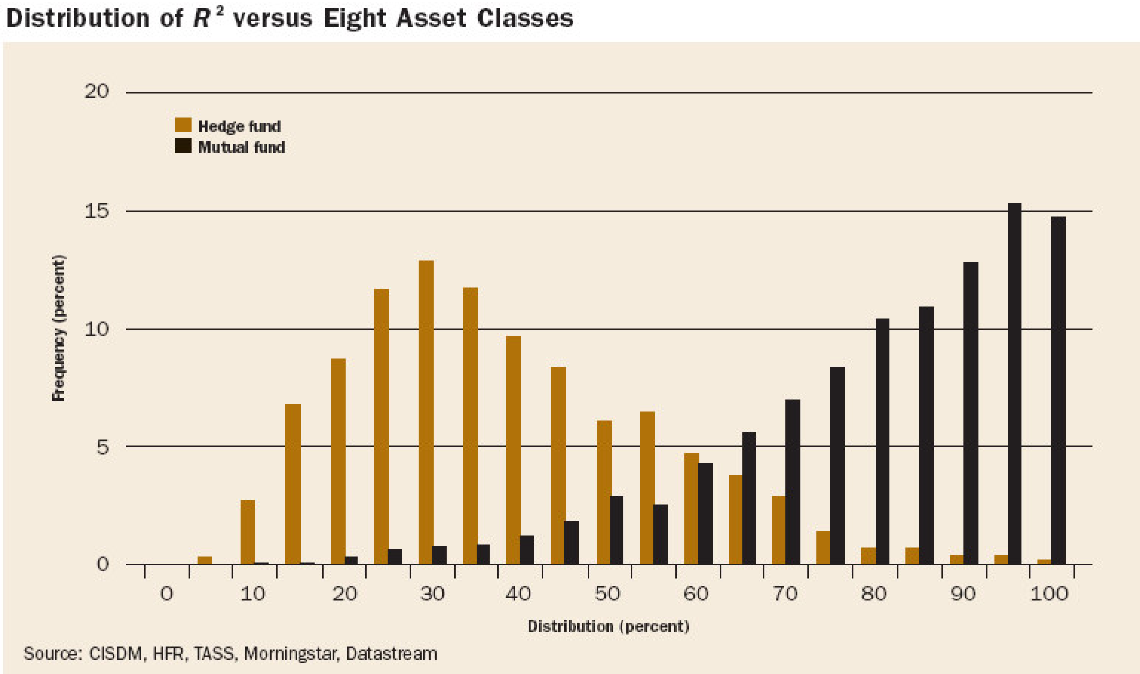


Source: *Perspectives on Hedge Fund Investing*, Crestmont Research (2000-05).

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.

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.