Section 2) Rationale for regulation

2.1) Rationale for regulation: "Investor Protection"

Under the Securities Act of 1982, the Securities Exchange Commission limited public participation in private investment pools such as hedge funds, by establishing minimum net worth and/or income levels for potential investors. To be more specific, the SEC decreed that hedge funds could only solicit and receive funds from "accredited investors", and defined an accredited investor "to include a natural person whose individual net worth, or joint net worth with the person's spouse, exceeds $1,000,000 at the time of the purchase, or whose individual income exceeds $200,000 (or joint income with the person's spouse exceeds $300,000) in each of the two most recent years and who has reasonable expectation of reaching the same income level in the year of investment." The SEC adopted these standards in 1982, based on their view "that these tests would provide appropriate and objective standards to meet [their] goal of ensuring that only such persons who are capable of evaluating the merits of an investment in private offerings may invest in one." According to the Office of Economic Analysis's (OEA) calculations, these standards limited participation in such pools to 1.87% of US households when the original standards were enacted (1982).

In late 2006, the SEC published a proposed revision of these standards, which would change and raise the minimum standard to "$2.5 million in investments", and exclude housing values from eligible investments for the purposes of the calculation. The SEC is proposing these amendments because it feels that the proposed amendment "is consistent with [their] goal of providing an objective and clear standard to use in ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and experience in financial and business matters to enable that purchaser to evaluate the merits and risks of a prospective investment, or to hire someone who can." It also notes that "our staff's observation in its 2003 Staff Study that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard." Based on analysis conducted by our Office of Economic Analysis ("OEA"), we also note that the increase in investor wealth is due in part to the increase in the values of personal residences since 1982. Accordingly, many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments. Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities. Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns.

The Commission is also proposing that "this dollar amount would be adjusted for inflation on April 1, 2012, and every five years thereafter, to reflect any changes in the value the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, from December 31, 2006." Additionally, the SEC argues that the "OEA estimates that the levels used in those rules [the standards established in 1982], adjusted for inflation, would have been approximately $1.9 million (net worth), $388,000 (individual income) and $582,000 (joint income) as of July 1, 2006." Also, the OEA "estimates that by 2003, [the percentage of eligible households] increased by 350% to approximately 8.47% of households. By incorporating the proposed requirement for $2.5 million of investments owned by the [investor] at the time of purchase, that percentage would decrease to 1.3% of households that would qualify for [accredited investor status], a percentage below 1982 levels." The SEC then argues that it "believes that this result is appropriate given the increasing complexity of financial products, in general, and hedge funds, in particular, over the last decade."

Additionally, the “proposed rules would not grandfather current accredited investors who would not meet the new accredited natural person standard so that they could make future investments in private investment pools, even those in which they currently are invested,” yet it does not specifically address the reason why it chose to pursue this path.

When examining the economic costs and benefits of the proposed rule changes, the Commission argues the following:

> “We believe that the proposed rules would benefit those investors who are currently accredited investors and would meet the proposed accredited [investor] standard. The revised eligibility standard may benefit those accredited investors who would meet the definition of accredited [investors] by increasing the competition among [hedge funds] for their investment money. Such competition may result in lower fees.”

The Commission also argues that:

> “The proposed rules may impose certain costs on affected [hedge funds]. These costs may include administrative compliance costs, such as the costs related to amending investor questionnaires and other administrative documents and procedures. These costs also could include expenses for computer time, legal and accounting fees, and information technology staff. Under the proposed rules, sponsors of an affected [hedge fund] would need to prepare and review new administrative documents and procedures, and implement such new procedures, in order to determine if prospective investors in the [hedge fund] would meet the revised accredited investor standards we propose for natural persons in connection with the offer or sale of securities issued by those pools. We expect the costs involved in complying with these proposed requirements would be minimal based on our understanding that many sponsors of [hedge funds] also sponsor [other private investment pools with similar requirements].”

The Commission then states:

> "The proposed rules would shrink the pool of accredited investors eligible to invest in [hedge funds]. Such a decrease in the investor base may increase competition among [hedge funds] which could lower profits and thereby possibly result in some sponsors of [hedge funds] not offering new [hedge funds] or some potential sponsors of such pools not entering the business. While we recognize that there are costs associated with such a decrease in the investor pool and potential new pools, we believe that these costs would be justified by the potential benefits of investor protection, and possibly lower fees resulting from increased competition."

Lastly, the Commission argues that:

> "It is possible that the proposed rules could result in a diminishment of the universe of [hedge funds] available to investors. We believe, however, that such a diminishment, were it to take place, may result in increased competition among [hedge funds] which, in turn, may result in lower fees for investors."

And:

> "Our proposed definition may also result in costs to previously accredited investors who would not meet the proposed accredited natural person standards. Since the proposed definition of accredited natural person is not precisely correlated with actual investment sophistication, to the extent that a sophisticated investor would no longer be considered accredited, his or her investment opportunities would decrease. We believe, that to the extent that our proposed definition captures financial sophistication for investors in

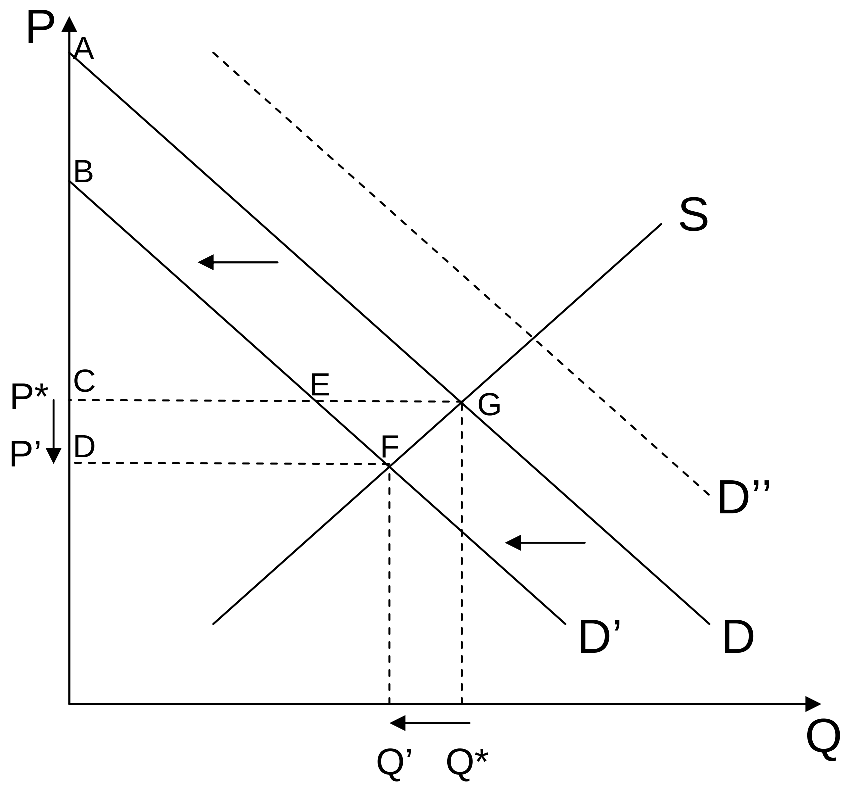
> [hedge funds] better than the accredited investor definition alone, the benefits would still justify the costs."

Let's examine each and every one of these arguments closely.

The first assumption the SEC makes in its proposal is that owning $2.5 million in investments equals, or is the best proxy for, investment sophistication and knowledge of risks. While it is difficult to prove or disprove this assertion (given the complexity of defining and measuring "investment sophistication and knowledge or risks"), it is easy to see that this "blunt instrument" is imperfect since there are plenty of individuals who have "investment sophistication and knowledge of risks" but do not meet the $2.5 million investment threshold, and vice-versa.
The SEC then argues that it needs to protect people from themselves, and from potentially "poor" decisions that they may make with their own money at stake. It argues that people may not have the proper knowledge, or access to information, to adequately access the risks that are involved in investing in a hedge fund, and/or similar private investment pools, so the government should intervene to protect them for these kinds of potential mistakes. For starters, it is difficult to argue that there is any sort of externality in a transaction between a willing investor, and a willing investment vehicle (defining an externality as "costs or benefits that are imposed unto others and not on the decision-makers), and this implies that the costs of any "poor" decisions are borne directly the investor. The fact that all costs (and benefits) are borne by the individual investor leads us to the conclusion that the welfare maximizing equilibrium is one where investors are free to pursue any and all investment opportunities of their choosing, and investment vehicles are allowed to pursue investors freely, without the need for [hedge fund management] Demand restrictions.

Figure X, and the accompanying description, conceptually illustrates the economic efficient outcome for this market, the distortions generated by the new restriction on

Demand, and the effect of the original restriction (passed in 1982, and currently in place).



If we assume that given the current "accredited investor" standards, then the current D curve for private investment vehicles, such as hedge funds (HFs), is illustrated by D, and the supply of HFs is illustrated by S. By raising the qualification standards for investors, the SEC would essentially lower demand, and shift demand inwards, illustrated by D'. By examining the figure above after this intervention, we can clearly see that general welfare to society has dropped by the quadrilateral A-B-F-G, while producers (HFs) have lost C-D-F-G, and buyers (investors) have lost A-B-F-G, though this last group receives, from suppliers, the area of C-D-E-F in a transfer. This last transfer is received only by investors who are currently accredited, and would remain accredited given the new standards (i.e. the richest of the current pool of investors) in the form of lower pricing for HF management services. While market prices for HF services drops, quantity demanded drops as well, and the magnitudes of each of these changes (surplus transfers, deadweight losses, price and quantity demanded drops) will depend on the relative elasticities of the Supply and Demand curves. That said, regardless of the relative elasticities in play, the fact that remains that raising the accredited investor standards will create a deadweight loss to society, as potential gains from trade are proverbially ‘left on the table’ due to trades not being executed. Going even further, it can be seen by Figure X that the current restrictions are already distortionary and run counter to economic efficiency due to the fact that without them, demand for HF services would be best represented by D’’. If we believe that demand for HF services would be greater, absent the current restrictions, our current equilibrium (point G), is in effect a distorted equilibrium, which already includes all of the aforementioned costs to society.

The counter-argument for these new standards, despite the economic inefficiencies they entail, is that the decision is less about economic efficiency, and more about protecting vulnerable individuals from being taken advantage of by individuals that exploit potential ‘gray areas’ when it comes to aggressive solicitations (which may be difficult to separate from misrepresentations, omissions, and/or deceitful practices, that are already forbidden by law at the federal, state, and local level across the USA). While it is plain to see that many individuals do fit this description in reality, it is not so clear to see how limiting their access to hedge fund investments will prevent them from making poor decisions with their investments going forward. To take the argument to an extreme scenario, albeit a plausible one, any individual, as of today, can legally go to his or her nearest casino, and lose their entire net worth on a single bet at any given time.

If regulators are concerned about fraud, misrepresentations, deceitful practices, etc, laws already exist, in most if not all jurisdictions, to prevent and/or punish these behaviors. The SEC, in the very document it published explaining and defending the proposed amendments to the regulations, admitted that:

> "Investment advisers to pooled investment vehicles should not be making untrue statements or omitting material facts or otherwise be engaged in fraud with respect to investors or prospective investors in pooled investment vehicles today, because federal authorities, state authorities and private litigants often can, and do, seek redress from the adviser for the untrue statements or omissions, or other frauds. In most cases, the conduct that the rule would prohibit as well as state law is already prohibited by federal securities statutes, other federal statutes (including federal wire fraud statutes), as well as state law."

So then the question becomes; does the HF industry provide additional risk to the pool of investors the regulations is trying to protect (as opposed to MFs which they would understandably resort to)?

It is common knowledge that individuals, with as little as $1000, can either open brokerage accounts, and/or invest in securities and/or mutual funds (or other investment vehicles that are in fact regulated by the SEC and other federal and/or state agencies) with relative ease. Mutual funds (MF), and all other regulated entities, can lose much of their value just like hedge funds, and these occurrences exist in reality and not just in theory. An example of a mutual fund which lost a substantial portion of its value is pictured below, where the Munder Internet fund lost over 90% of its value from late 2000 to late 2002 due to its specialization in internet stocks at the turn of the decade, which depreciated rapidly after the stock market bubble burst in late 2000.

This phenomenon is not limited to a select few funds either, as a cursory search of poorly performing mutual funds (on any financial website) and attest to the fact that many funds not only under-perform the market, but generate negative returns overall. Figure X, included below, cites contemporary examples of currently available mutual funds (regulated) which have had negative 5-year annualized returns in the 5 years preceding February 28, 2007. While 1.7% of *currently* available MFs have generated negative 5-year returns (this number obviously underestimates the percentage of MFs that generated negative returns since extinct funds are not included in the calculation), the number of *currently* available MFs that have generated negative 1-yr returns exceeds 4.8% of the total number of *currently* available MFs.[1]

[1] www.finance.yahoo.com as of 2/27/2007

Figure X:

Symbol	Fund Name	Return YTD(%)	1 Yr Return(%)	Annualized 3 Yr Return(%)	Annualized 5 Yr Return(%)
AIVTX	Ameritor Investment	0	-85.71	-69.13	-56.2
AHEGX	American Heritage Growth	-4.76	-26.65	-27.89	-21.4
DXRSX	Direxion Small Cap Bear 2.5X Inv	-3.38	-21.5	-20.83	-19.76
SMPSX	ProFunds Semiconductor UltraSector Svc	0	-17.87	-15.39	-17.08
SMPIX	ProFunds Semiconductor UltraSector Inv	0.11	-16.96	-14.55	-16.23
RYCBX	Rydex Inverse Dynamic S&P 500 C	-2	-15.92	-14.29	-14.81
URPSX	ProFunds UltraBear Svc	-2.02	-15.97	-14.27	-14.77
RYTPX	Rydex Inverse Dynamic S&P 500 H	-1.91	-15.24	-13.6	-14.14
URPIX	ProFunds UltraBear Inv	-1.95	-15.13	-13.51	-14.01
AHERX	American Heritage	-2.78	-18.03	-11.21	-12.94
GRZZX	Grizzly Short	-1.93	-12.22	-10.25	-10.73

Besides the fact that the admittedly simplistic examples shown above hint at the fact that limiting access to HFs does not eliminate the possibility of individuals making poor choices even if they stick to MF investments, the central point that the proponents of these regulations do not contemplate in their analysis is that given HFs' wider array of investment options, they can achieve more favorable Sharpe ratios and/or Sortino ratios than MFs. Higher Sharpe and Sortino ratios simply imply better returns for equal risk, equal returns with less risk, or a combination of both. This critical distinction between HFs (unregulated) and MFs (regulated) lie in the strategies, techniques, and instruments they are legally allowed to engage in and/or hold in their investment portfolios. While MFs are required to cover their use of options, futures, forward contracts and short-selling, HFs are not, and this allows HFs to leverage their positions far easier, and it allows them to hold portfolios, with favorable Sharpe and/or Sortino ratios, that MFs can not reach due to the burden of the regulations brought upon them.