Brian J.M. Sano
1727 Massachusetts Avenue, NW
Apartment 615
Washington, D.C. 20036

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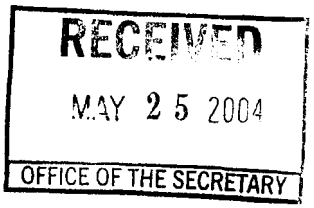
May 21, 2004

Re: Public Comment to the Staff's Report, *"Implications on the Growth of Hedge Funds"*

Mr. Paul F. Roye, Esq.
U.S. Securities and Exchange Commission
Director, Division of Investment Management
450 Fifth Street, NW
Washington, DC 20549



Mr. Roye:

It was nice to meet you recently at Chairman Donaldson's testimony April 8th before the U.S. Senate Committee on Banking, Housing and Urban Affairs. As I mentioned, I am a graduating third year student at American University, Washington College of Law and have recently studied and written extensively on the hedge fund industry. As we discussed, I am enclosing and submitting for public comment my recent paper, *"Alternatives to the Increased Regulation of Hedge Funds"* in response to the Staff's Report, *"Implications on the Growth of Hedge Funds."* The ideas discussed in this comment come from my previous article, *"Do hedge fund investors need more protection under the federal securities laws?"* which was also submitted as a public comment.

Overall, in addition to, or as an alternative to the Staff's recommendation to register hedge fund managers as investment advisers, I suggest that hedge funds and their mangers should *file notice of the exemptions* they rely on to avoid the regulation of the Investment Company Act, and registration under the Investment Advisers Act, respectively. Hedge funds also could be required to file any offering memorandum they use with the SEC. I believe such filings could provide investors and the SEC with additional disclosure and information on the hedge fund industry to help bridge the "information gap" that currently exists. Indeed, hedge funds already make similar filings with the CFTC and with the SEC, e.g. Form D of the Securities Act of 1933. Further, I have already discussed these ideas with the Senate Banking Committee. Please feel free to contact me with any questions at bsano@hotmail.com, or 202-320-5718. Thank you for your time and consideration.

Very Truly Yours,

Brian J.M. Sano

Cc: Jonathan G. Katz, Douglas J. Scheidt, Robert E. Plaze, Gerald J. Laporte (Corporation Finance), Leilani Sanders Hall (OCIE)

ALTERNATIVES TO THE INCREASED REGULATION OF HEDGE FUNDS

By Brian J.M. Sano[1]

"The issues surrounding hedge funds are an excellent example of how the [SEC] can be proactive and work to enhance enforcement in problem areas before they spread...[yet], under the current rules, the [SEC] is limited in its ability to gather information that could provide answers to these questions, and could help protect millions of investors."[2]

On September 29, 2003, after a yearlong investigation, the SEC's Staff released its report regarding the "implications of the growth of the hedge funds," including an analysis of whether there is a need for more regulation of the hedge fund industry.[3] Overall, the concerns of the SEC include: 1) there is an "information gap" regarding hedge funds;[4] 2) the SEC lacks the examination power over hedge funds and their managers that it has over registered investment advisers or registered investment

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[1] The author is a 2004 J.D. candidate at American University, Washington College of Law. The ideas discussed herein are extracted from the author's paper entitled, *"Do hedge fund investors need more protection under the federal securities laws?"* which received the first prize award for the Association of the Securities and Exchange Commission Alumni, Inc.'s 2003 writing competition. It was also filed as a public comment with the SEC in response to its Staff's Report, *"Implications of the Growth of Hedge Funds,"* Staff Report to the U.S. Securities and Exchange Commission, September 2003 ("Staff Report") (available at www.sec.gov/cpotlight/hedgefunds). While the author's previous paper focuses on assessing whether hedge fund investors are sophisticated and have access to material information allowing them to fend for themselves, as law suggests they should, this paper focuses more on the SEC's current enforcement of the federal securities laws relating to hedge funds and how it can better detect and deter fraud in the hedge fund industry. The author welcomes any comments and may be reached at: bsano@hotmail.com, or at 202-320-5718.

[2] Testimony of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs, *Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry* (April 8, 2004) ("Donaldson Testimony").

[3] *See Staff Report, supra* note 1.

[4] *See Staff Report, supra* note 1, at note 164 ("The lack of information on hedge funds is explained in part, of course, by the fact that we have no registration data to refer to because of claimed exemptions or exceptions by the funds from the registration requirements of the federal securities laws."). Moreover, the SEC's Staff has expressed concern that this has lead to an "information gap," that prevents them from knowing how many hedge funds are out there, who their advisers are, who manages them, what their power and clout is as institutional investors, the relations they have with mutual funds, either as hedge fund managers co-managing them, and whether they invest in mutual funds. *Id* at vii. *See also* Donaldson Testimony, *supra*, note 2.

companies; 3) the SEC is uncertain that it can detect or prevent fraud against investors *in hedge funds,* conducted by the hedge fund manager, portfolio manager, etc.,[5] and that it cannot find fraud or protect other investors, e.g. mutual fund shareholders, *from hedge funds* acting as investors themselves.[6]

These concerns arise mostly because there is no statutory or uniform definition of "hedge fund."[7] The SEC's Staff explained, "the term [hedge fund] generally is used to refer to an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment

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5 *See Staff Report, supra,* note 1. Recent examples of such fraud cases include: In the Matter of Robert T. Littell and Wilfred Meckel, Investment Advisers Act Rel. No. IA-2203 (Dec. 15, 2003) (available at http://www.sec.gov/news/press/2003-172.htm) (portfolio manager of hedge fund made misrepresentations to investors and potential investors concerning performance, management oversight, and risk management practices); *SEC v. Berger*, 322 F.3d 187 (2d Cir. 2003) (manager falsified the hedge fund information that he provided to the administrator and auditor to conceal the fund's losses); *SEC v. Beacon Hill Asset Mgmt. LLC et al.*, 2002 U.S. Securities and Exchange Commission Litigation Release No.17831, 2002 SEC LEXIS 2828, November 7 2002; *SEC v. Edward J. Strafaci* U.S. Securities and Exchange Commission Litigation Release No. 18432, 2003 SEC LEXIS 2580, October 29, 2003 (hedge fund manager engaged in fraudulent valuation of securities).

6 For example of recent cases see: *See State of New York v. Canary Capital Partners, LLC* (N.Y. Sup. Ct., complaint filed Sept. 3, 2003, available at: www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf) and the cases that followed, including: *In the Matter of Markovitz*, Investment Company Act Release No. IC-26201, 2003 SEC LEXIS 2341 (Oct. 2, 2003) (finding that a former hedge fund trader violated the federal securities laws and defrauded investors by engaging in late trading of mutual fund shares). *See also* NORA JORDAN, HEDGE FUNDS: HOT REGULATORY ISSUES, AT 117, Practicing Law Institute (2003) SUBMISSION BY SCHULTE ROTH ZABEL LLP, COMMENTS OF PAUL N. ROTH (giving an overview of recent SEC enforcement cases involving hedge funds). *See also* Donaldson Testimony, *supra* note 2.

7 *See* Testimony of John G. Gaine, President, Managed Funds Association, Before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives, *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk* (May 22, 2003) (the absence of a legal or widely accepted definition of "hedge fund" has lead to misconceptions, misunderstanding, and problems of the hedge fund industry); Testimony of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, Before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives, *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk* (May 22, 2003) ("There are no precise figures available regarding the number, size and assets of hedge funds. This is due, in part, to the fact that there is no industry-wide definition of hedge fund...."). *See also Staff Report, supra* note 1, at 77-79; Testimony of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, *Investor Protection Implications of Hedge Funds* (April 10, 2003) (discussing this problem further).

company under the Investment Company Act [of 1940]" ("Investment Company Act").[8] Specifically, although hedge funds would come under the definition of an "investment company" in § 3(a) of the Investment Company Act,[9] they are structured to come within an exemption from such definition set forth in either § 3(c)(1) or § 3(c)(7) of the Investment Company Act.[10]

Hedge funds also avoid registration of their securities[11] by use of the private offering exemptions, either under § 4(2) or Rule 506 of Regulation D of the Securities

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[8] *See Staff Report, supra* note 1, at 3.

[9] *See* 15 U.S.C. § 80a-3(a)(1) (An investment company is most often legally defined as being any issuer of securities that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities," or any issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."); *See also, Moses v. Black, et al.,* 1981 Fed. Sec. L.Rep. (CCH) ¶97,866; *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), aff'd, 435 F.2d 510 (2d Cir. 1970).

[10] *See* 15 U.S.C § 80a-3(c)(1) (limiting the number of investors in the fund to 100; prohibiting public offerings of the fund's securities); 15 U.S.C. § 80a-3(c)(7) (limiting the type of investors to persons who qualify as "qualified purchasers," i.e. high net worth individuals with investments worth at least $5 million and certain institutions and companies with $25 million in investments). *See* 15 U.S.C. § 2(a)(51); 17 C.F.R. § 270.2a51-1 (discussing "qualified purchaser"). Thus, hedge funds are often referred to as either "3(c)(1) funds" or "3(c)(7) funds" depending on which exemption they use. *See Staff Report, supra* note 1; *Hedge Fund Roundtable Transcripts* ("*Roundtable Transcripts*") May 14, 15 2003, www.sec.gov/cpotlight/hedgefunds/hedge1trans.txt., (noting that some hedge funds do register with SEC to attract certain investors). These exemptions significantly allow hedge funds to avoid the regulation of the Investment Company Act, e.g. reporting and registration requirements (15 U.S.C. § 80a-8, 30), 15 U.S.C. § 80a-12 (limiting functions and activities), certain prohibited transactions (15 U.S.C. § 80a-17), etc.

[11] Because hedge funds are structured as limited partnerships or limited liability companies, their interests are generally "investment contracts" and thus "securities" that must be registered as per § 5 of the Securities Act of 1933, 15 U.S.C. § 77e. *See Walther v. Maricopa Int'l Inv. Corp.*, 1998 U.S. Dist. Lexis 5475 (1998) (holding that hedge fund interests are investment contracts because all the Howey test factors apply; specifically, commonality exists because of the hedge fund manager's use of performance fees and the investors reliance on the efforts of a third party, i.e. the hedge fund manager, for profit). *See also SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (the test used to determine if an investment contract exists assesses whether "the person invests his own money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party"); *SEC v. Glenn W. Turner*, 474 F.2d 476 (9th Cir. 1973) (efforts "solely" by a third party include "undeniably significant ones"); *Goodman v. Epstein*, 582 F.2d 388 (7th Cir. 1978) (limited partnership interests are generally securities when limited partners are not allowed to participate in management); *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), *Koch v. Hankins*, 928 F.2d 1471 (9th Cir. 1991) (general partnership interests are generally not securities unless the general partner is not actively involved in management); *SEC v. Shreveport Wireless*, 1998 WL 892948 (D.D.C. 1998), *Great*

Act of 1933 ("Securities Act").[12] Most hedge funds limit their number of investors to avoid reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act").[13]

Because the entity that manages and/or administers the fund's assets, usually its general partner/managing member, comes within the definition of an "investment adviser" in the Investment Advisers Act of 1940 ("Advisers Act"), such "hedge fund managers" must register with the SEC unless they qualify for an exemption from such registration.[14] Hedge fund managers do usually avoid registering with the SEC by relying

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Lakes Chemical Corp v. Monsanto Co., 96 F.Supp 2d 376 (D. Del 2000) (limited liability company interests are usually securities if the member is not actively participating in the business or management).

[12] *See* 15 U.S.C. § 77d(2); 17 C.F.R. § 230.501, 506. Hedge funds tend to rely on the safe-harbor in Rule 506 of Regulation D, not those in Rules 504, 505 and § 4(6) because unlike the others, Rule 506 does not impose a limit on the amount, or size, of the offering. *See* 17 C.F.R. § 230.504 (offers and sales may not exceed $1,000,000), 15 U.S.C. § 77d(6), 17 C.F.R. § 230.505 (offers and sales may not exceed $5,000,000). Because hedge funds typically have an average minimum investment per investor of $1 million, the average 3(c)(1) fund with 100 investors could have an offering of $100 million or higher, while a 3(c)(7) fund with 499 investors could have an offering of $499 million or higher, depending on how high the fund's minimum investment is. Hedge funds unregistered under the Investment Company Act are prohibited from publicly offering their securities via general solicitation of investors. 15 U.S.C §§ 80a-3(c)(1), (7). Some hedge funds rely on the private offering exemption in § 4(2) of the Securities Act, 15 U.S.C. § 77d(2) if they do not qualify for Regulation D or choose not to.

[13] Under §12(g) of the Securities Exchange Act of 1934 ("Exchange Act"), every issuer of securities that has 500 or more shareholders and has more than $10 million in assets under management must register its securities with the SEC, thereby subjecting it to further reporting requirements. *See* 15 U.S.C. §§ 78*l*, 78m, 78*o*(d); 17 C.F.R. §§ 240.12g-1, 15d-1 et seq. Note, this is only applies to 3(c)(7) funds because 3(c)(1) funds cannot have more than 100 investors anyway. Thus, because most 3(c)(7) hedge funds have over $10 million under management, they limit the number of investors in a fund to 499 to avoid these requirements.

[14] *See* 15 U.S.C. § 80b-2(a)(11) (investment advisers are generally persons in the business of providing personalized investment advice about securities to others while receiving compensation for such services). For more descriptions of investment advisors *see*: SEC Division of Investment Management: Staff Legal Bulletin No. 11 Sept 19, 2000; *Lowe v. SEC*, 472 U.S. 181 (1985); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). *See also Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1976) (court noted that Congress' intended notion of an investment adviser meant to include persons who maintain, manage and have discretion of a fund's portfolio, not just those who give investment advice, concluding that hedge fund managers would be within the statutory definition of investment advisers). Because they are exempt from registration, hedge fund managers avoid various reporting and filing requirements. *See* 15 U.S.C. § 80b-3, 17 C.F.R. § 275.203-1 (registered investment advisers must file Form ADV, 17 C.F.R. § 279.1, with the SEC); 17 C.F.R. § 275.204-2 (registered investment advisers must make and keep certain records available for the SEC's inspection); 17 C.F.R. § 275.204-3 (registered investment advisers must furnish each advisory client and prospective advisory client with a written disclosure statement); 15 U.S.C. § 80b-6(4), 17 C.F.R. § 275.206(4)-4 (advisers must disclose financial and disciplinary information to clients).

on the "*de minimus*" exemption in § 203(b) of the Advisers Act.[15] The SEC is mainly concerned that these exemptions limit the information it has on hedge funds, possibly allowing fraud to go undetected.

SEC Proposal

Thus, the SEC's Staff recommended requiring hedge fund managers to register with the SEC as "investment advisers."[16] The Staff believes this would provide more information to investors and the SEC, helping it *uncover* fraud more easily.[17]

However, it is uncertain whether the Staff's Proposal is sufficient or necessary to resolve the illustrated problems. First, requiring such registration *may not* provide adequate or additional information on hedge funds or their managers. Specifically,

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[15] *See* 15 U.S.C. § 80b-3(b)(3) (exempting from registration investment advisers, including most hedge fund managers, that have fewer than 15 clients in the past 12 months). *See Staff Report*, *supra* note 1, at 89. While there is no legislative history explaining the reasons for this exemption, Congress seemed to exempt such advisers whose advisory business is so limited it does not warrant federal attention. *See Lowe v. SEC*, 472 U.S. 181; *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180. For purposes of this safe harbor, the individual investors in a limited partnership or a limited liability company, e.g. a hedge fund, are not counted towards the number of clients, but rather, the entity itself counts as one client. *See* 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i). The SEC may change this to prevent hedge funds from relying on such exemption. *See Staff Report, supra* note 1.

[16] *See Staff Report*, *supra* note 1; *Id.* This would be done mainly by changing the "look through" provision of Rule 203(b)(3)-1 that currently allows advisers with fewer than 15 clients to avoid registration. Currently, a hedge fund is counted as one "client," rather than counting all of the investors in the fund as clients. *See* 15 U.S.C. § 80b-3(b)(3); 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i). This rule would be changed to allow an unregistered adviser only to have one fund with 14 investors to. Thus, most hedge fund managers could not rely on the § 203(b)(3) exemption to avoid registration.

[17] *See Staff Report*, *supra* note 1, at 88 ("[M]andating federal registration of hedge fund investment advisers would mean that hedge fund investors would receive important information regarding the funds and their advisers."). Specifically, such information would be filed with the SEC and available to investors. *See* 15 U.S.C. § 80b-3, 17 C.F.R. § 275.203-1 (registered investment advisers must file Form ADV, 17 C.F.R. § 279.1, with the SEC); 17 C.F.R. § 275.204-2 (registered investment advisers must make and keep certain records available for the SEC's inspection); 17 C.F.R. § 275.204-3 (registered investment advisers must furnish each advisory client and prospective advisory client with a written disclosure statement); 15 U.S.C. § 80b-6(4), 17 C.F.R. § 275.206(4)-4 (advisers must disclose financial and disciplinary information to clients). Such registration would allow the SEC to conduct periodic examinations and inspections of hedge fund managers. *See* 15 U.S.C. § 80b-4, 17 C.F.R. § 275.204-2. This would subject hedge fund managers to more antifraud provisions as well. *See* 15 U.S.C. § 80b-7 (it is unlawful for any person to make untrue statements, misrepresentations, omissions in such documents); 17 C.F.R. § 275.206(4)-1.

because no definition exists, it is unclear how the SEC will determine if a registered investment adviser even manages a "hedge fund."[18] In addition, hedge fund managers still might be able to avoid registering with the SEC by restructuring hedge funds and their operations to rely on the intra-state exemption in § 203(b)(1) of the Advisers Act.[19] Significantly, this might even allow managers of master-feeder hedge fund structures or funds of hedge funds to remain unregistered.[20] Moreover, a hedge fund manager could still avoid registration by running a hedge fund if it had 14 individual persons as clients.[21]

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[18] *See* FORM ADV, Part 1A, Item 5.D.4, item 7b; 17 C.F.R. § 279.1 (although Form ADV does require registered investment advisers to indicate whether they advise or manage "investment pools, e.g. hedge funds" and limited partnerships (LPs) or limited liability companies (LLCs), because there is no standard or statutory definition a "hedge fund," unless Form ADV is changed, or the term "hedge fund" is defined, there is no *objective* way for the SEC to distinguish whether an adviser manages a hedge fund versus another "investment pool," LP, or LLC without making a *subjective* conclusion by examining the fee structures, strategies, and data of each fund the adviser manages and drawing the conclusion that such a fund seems to be a "hedge fund" based on how it operates. Not only is this subjective, it is very time consuming. While some hedge funds and their advisers *do* currently register with the SEC, it is still unclear how the SEC would know whether an adviser manages a "hedge fund" versus another investment pool. *See Staff Report*, *supra* note 1, at 95, note 109. The Staff implied that it can tell if an adviser manages a hedge fund by looking at Part 1A, Item 5.D.4 of Form ADV because that requires the adviser to list each pooled vehicle on Schedule D (section 7B) and disclose the amount of assets in the fund and the minimum amount of capital contribution per investor. Although hedge funds do typically have high amounts of assets and investment minimums, this would still not distinguish a hedge fund from any other pooled vehicle with similar characteristics, e.g. private equity pools, commodity pools, etc. *See infra*, regarding discussion of defining "hedge fund" versus other 3(c)(1) or 3(c)(7) funds. Further, it is not clear where one would draw the line as to what amount of assets under management, or what level of investment minimum, would qualify an investment pool as a "hedge fund." Thus, any such test is completely subjective and arbitrary.

[19] *See* 15 U.S.C. §§ 80b-3(b)(1) (exempting registration of advisers whose clients are residents in the state the adviser conducts business, if such adviser refrains from giving clients advise about securities listed on a national securities exchange); 15 U.S.C. 80b-2(a)(9), (15), 15 U.S.C. § 78f (defining "National Securities Exchange"). Significantly, many of the activities hedge fund managers already engage in would not qualify as activities in securities listed on a national exchange, including investing in: global macro strategies (including investments in: currencies, foreign securities, emerging market investments, etc.), interest rates, real estate, futures trading governed by the CFTC, but not the SEC, other alternative investments (including other Regulation D offerings, other unregistered or registered investment pools, funds of hedge funds), and perhaps even securities listed on the NASDAQ or other exchanges that may not be deemed "National Securities Exchanges." The clients may not even be residents in that state if they invest in a hedge fund through another entity such as a corporation, trust, partnership, LLC, etc. that is registered in the state the adviser is in because there is apparently no "look-through" provision in the federal securities laws relevant here. In fact, the SEC has noted that many hedge fund investors already reside in concentrated areas. *See Staff Report*, *supra* note 1. Moreover, advisers could even avoid state regulation in many circumstances. *Id. See also*, § 203A of the Advisers Act, 15 U.S.C. 80b-3a.

Besides, some have debated whether the *opportunity* for more examinations of the hedge fund industry will actually *uncover* more fraud.[22] Indeed, the recent market timing scandals within the investment management industry indicate this problem.[23] Moreover, it is unclear whether hedge funds should receive special treatment from the SEC.[24]

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[20] *See id.* For example, in master-feeder funds, one fund is set up to sell its securities to investors (the feeder fund). It invests solely in one fund (the master), which creates a portfolio by investing in other securities and investments. One could argue that the adviser managing the feeder fund could rely on the exemption in § 203(b)(1), 15 U.S.C. § 80b-3(b)(1) if it only advised the feeder fund, if such fund existed in the same state as the adviser. Moreover, because no "look-through" provisions apply to § 203(b)(1), 15 U.S.C. § 80b-3(b)(1), the adviser would be deemed to manage one client only (compare to § 203(b)(3); 15 U.S.C. § 80b-3(b)(3) and 17 C.F.R. § 275.203(b)(3)-1, the "look-through" client provision). Further, the feeder-adviser would arguably not be giving advice about securities listed on an exchange. Indeed, the adviser for the master fund could argue it falls within the § 203(b)(1) exemption if it does not "furnish advice" about securities listed on a national exchange if the feeder fund existed in the same state it did. In addition, one could make this argument for funds of hedge funds structured this way, because they invest in other hedge funds, not in securities listed on an exchange. *Compare*, note 14, *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1976) (giving "advice" about securities seems to include that hedge fund managers that manage hedge funds, bringing them within the statutory definition of investment advisers). Notably, § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) includes the language "advising others," while § 203(b)(1), 15 U.S.C. § 80b-3(b)(1), includes the language "furnish advice." This distinction may suggest the court's reasoning in *Abrahamson v. Fleschner*, would not apply here. Yet, the SEC might contend that such structuring violates § 208(d), 15 U.S.C. §§ 80b-8(d), (prohibiting any person from doing indirectly what is cannot do directly under the Advisers Act). In any case, the SEC should look into this argument.

[21] Indeed, even if the SEC changes the look-through rules regarding § 203(b)(3), 15 U.S.C. § 80b-3(b)(3), an adviser could still manage a hedge fund with 14 extremely wealth investors that could potentially have billions of dollars in assets under management and still remain exempt under § 203(b)(3), 15 U.S.C. § 80b-3(b)(3), as revised. Such a fund could still pose systemic risks or engage in suspicious, fraudulent activity, including placing sticky assets and market-timing, while still avoiding registration with the SEC.

[22] Interestingly, the SEC's Office of Compliance, Inspections, and Examinations (OCIE) currently examines every registered investment advisers at least once every five years. *See* Lori Richards, Director of OCIE, *"The Evolution of the SEC's Inspection Program for Advisers and Funds: Keeping Apace of a Changing Industry,"* October 30, 2002 (available at www.sec.gov). However, because hedge funds have short life spans, typically 5.5 years, managers conducting fraud may be able to avoid getting caught if they close down operations before they are examined. Because investigation is not frequent, some managers may try to get away with fraud anyway. Indeed, academics have mentioned that originally, the Advisers Act was "little more than a census of investment advisers." Yet, "even today, the regulation of investment advisers has not been rigorous." TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS (Second Ed. Aspen Publishers, 2004); TAMAR FRANKEL, CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION, (Carolina Academic Press, 1998).

23 In fact, the recent mutual-fund scandal indicated that registered investment advisers could still conduct fraud and go undetected. *See State of New York v. Canary Capital Partners, LLC* (N.Y. Sup. Ct., complaint filed Sept. 3, 2003, available at: www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf); and the cases that followed. *See SEC v. Scott and Kamshad*, Civil Action No.03-12082-EFH (D. Mass. Filed Oct. 28, 2003); *In the matter of Alliance Capital Mgmt., L.P.*, Investment Advisers Act Release No. IA-2205, 2003 SEC LEXIS 2997, December 18, 2003; *SEC v. Invesco Funds Group, Inc., and Cunningham*, Civil Action No. 03-N-2421 (PAC Filed Dec. 2, 2003). This suggests that subjecting hedge fund managers

The Staff's recommendation may even be unnecessary. Particularly, many of the federal securities laws, including the various antifraud provisions, still apply to hedge funds and their advisers whether registered or not.[25] Further, the SEC *already has* investigation and subpoena power over the hedge fund industry.[26] Interestingly, hedge funds and their managers *already do* file various documents with the SEC.[27] Yet, these filings may go unnoticed because it is not obvious that such filers are "hedge funds" or

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to open their books and records to the SEC may not even result in a finding of more fraud, even if such fraud exists. Many of the investment advisers involved in the scandal were registered with the SEC. This suggests that subjecting hedge fund managers to open their books and records to the SEC may not even result in a finding of more fraud, even if such fraud exists.

[24] Securities and Exchange Commissioners Paul Atkins and Cynthia Glassman have expressed concern that registering hedge fund managers, subjecting them to more inspections, is unnecessary and would take up OCIE's time from investigating other investment advisers that do not cater to wealthy or highly sophisticated investors as hedge funds do. *See* Gregory Zuckerman and Deborah Solomon, *Now, the Hedge-Fund Business May Exhale,* THE WALL STREET JOURNAL, Sept. 30, 2003, at C5. Indeed, registering hedge fund managers while not forcing the hedge funds they manage to register creates an inconsistency in the laissez-faire policy of hedge fund regulation created by Congress in the Investment Company Act and Advisers Act. *See also Roundtable Transcripts, supra* note 10, May 15, Comments of Stephen M. Cutler (Although there have been an increasing number of fraud cases along with the incline of the number of hedge funds forming and the number of investors and assets going into these pooled vehicles, "fraud is not more prevalent in the hedge fund industry."). *See also Staff Report, supra* note 1, at 72 ("There is no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity.").

[25] The antifraud provisions of § 206 of the Advisers Act and the Rules promulgated there under still apply to hedge fund managers, whether they are registered or not, because they come under the definition of "investment adviser." *See* 15 U.S.C. § 80b-6 ("it shall be unlawful for *any* (emphasis added) investment adviser...to employ any device, scheme, or artifice to defraud any client or prospective client."); 17 C.F.R. § 275.206(3)(1) et seq. *See supra,* note 14 (explaining that hedge fund managers are "investment advisers"). Other antifraud provisions of the federal securities laws that may apply to hedge fund managers include: §17(a) of the Securities Act, 15 U.S.C. § 77q, § 10(b) of the Exchange Act and the Rules promulgated thereafter, 15 U.S.C. § 78j(b), 17 C.F.R. § 240.10A-1 et seq., and § 208 of the Advisers Act, 15 U.S.C. § 80b-8 (particularly 208(d), 15 U.S.C. § 80b-8(d)). *See also, SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180; *Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11 (1979) (Section 206 of the Advisers Act establishes a *fiduciary duty* for investment advisers, e.g. hedge fund managers, to act in the best interest of their clients).

[26] *See* 15 U.S.C. 77t; 15 U.S.C. 78u; 15 U.S.C. § 80a-41(a); 15 U.S.C. § 80b-9 (provisions of Securities Act, Exchange Act, Investment Company Act, and Advisers Act, respectively, that give such authority).

[27] Such forms include: Form D, 17 C.F.R. § 239.500 (*see* 17 C.F.R. § 230.503: requiring notice of sale of securities pursuant to Regulation D of the Securities Act by use of Form D), Schedules 13D, 13G, 17 C.F.R. 240.13d-1(filing notice of beneficial ownership of securities under the Exchange Act), and Form 13F, 17 C.F.R. 240.13f-1 (filing by institutional investment managers under the Exchange Act).

hedge fund mangers.[28] Other regulators oversee hedge funds also.[29] Indeed, the SEC has brought many fraud cases against hedge funds and their advisers.[30] Thus, because hedge funds and their managers are "unregistered," does not mean they are "unregulated."

Interestingly, the policy of the federal securities laws regarding hedge funds could be described as "laissez-faire" because hedge fund investors are supposed to be sophisticated enough and have access to material information to fend for themselves.[31] Thus, the hedge fund industry is seen as being "self-regulating." Yet, it is debatable whether hedge fund investors can actually "fend for themselves" in practice.[32] Although the Staff's Proposal does suggest requiring hedge fund managers to give investors

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[28] For example, currently, anyone can look up information filed by well-known hedge funds, e.g. Caxton, Citadel, Moore Capital, etc. in the SEC's EDGAR and IARD (Investment Adviser Registration Depository) databases. But, the lesser well-known funds go un-noticed because even though they may file the same documents with the SEC, no one, including the SEC, has specific notification that they are hedge funds. *See supra,* note 4 (explaining the problem of the "information gap" regarding hedge funds).

[29] For example, hedge funds advisers may be subject to ERISA (Employee Retirement Income Security Act, 29 U.S.C.§ 1001 et seq.), imposing additional fiduciary duties and prohibiting them from certain transactions if they have discretion or control over "plan assets." Further, the Commodity and Futures Trading Commission ("CFTC") and its self-regulatory organization, the National Futures Association ("NFA") may have jurisdiction over a hedge fund and its managers if they are deemed to be a "commodity pool operator" ("CPO"), a "commodity trade adviser" ("CTA"), or a "futures commission merchant." *See* 7 U.S.C. § 1a(5), 1a(6)(A), 1a(20). State contract, corporate, and partnership law will apply to hedge funds as well. NASD may have jurisdiction over the marketing of hedge funds, or regarding the actions of their prime brokers. *See also* MFA Sound Practices For Hedge Fund Managers 2003, (available at www.mfainfo.org); MFA Sound Practices for Hedge Fund Managers 2000, (available at www.mfainfo.org) (giving a list and explanation of the regulations that apply to hedge funds and their managers).

[30] *See supra*, notes 5, 6, 24.

[31] *See SEC v. Ralston Purina, Inc.*, 346 U.S. 119 (1953) (establishing the standard qualifications for reliance on the private offering exemptions in the Securities Act, stating that such investors do not need the "protection of the [Securities Act]" where they are sophisticated and have access to information they would have received if the issuer were registered); *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977) (explaining this concept further). *See also* Louis Loss and Joel Seligman, *Securities Regulation*, 3d, (2001), at Chapter 3-C-7 (discussion of *SEC v. Ralston Purina* and its progeny); *See supra* note 1, *"Do hedge fund investors need more protections under the federal securities laws?"* (regarding the author's discussion of this topic relating to hedge funds and their investors).

[32] *See supra* note 1, *"Do hedge fund investors need more protections under the federal securities laws?"* (questioning whether hedge fund investors actually have sophistication and access to material information).

standard information via a "brochure,"[33] this may not give investors access to all the material information they need,[34] including insight into the funds' strategies and operations,[35] or about the fund manager.[36] While the Staff did not give explicit details

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[33] *See Staff Report*, *supra* note 1.

[34] *See Staff Report*, *supra* note 1, at 98 ("The information contained in Form ADV would not, we recognize, give investors in hedge funds the information that they may need or want...Because the form is designed to provide information about investment advisers, there would be limitations on the information about specific hedge funds.").

[35] Although registered investment advisers are required to disclose some of the strategies they use in Form ADV, Part II, item 3, regarding types of investments, and Item 4.C, regarding investment strategies, an adviser could theoretically check all the boxes and comply with the legal requirements, giving it broad discretion. *See* Form ADV, 17 C.F.R. § 279.1. Yet, in practice, advisers may not do so in fear of lawsuits from clients claiming the adviser conducted a misrepresentation if it did not engage in a one of those listed strategies. Advisers doing so may be violating §§ 206(1), (2), 207 of the Advisers Act, 15 U.S.C. §§ 80b-6(1), (2), (general fraud provisions) 15 U.S.C. § 80b-7 (fraudulent misrepresentation in a filed document), as well as other antifraud provisions. *See supra*, note 25. *See* Advisers Act Rel. No. IA–1862 (2000) ("In some cases, an adviser's response to a question may be accurate but paint an inaccurate picture of its practices. For example, an adviser may truthfully respond to current Item 4.C by indicating it uses all of the strategies listed by the item, but a client may not appreciate that the adviser's principal strategy involves, for example, risky options trading."). Moreover, if an adviser manages more than one fund, Form ADV does not indicate the particular activities or strategies of each fund. *See also Staff Report*, *supra* note 1, at 98 ("Because [Form ADV] is designed to provide information about investment advisers, there would be limitations on information about specific hedge funds."). Interestingly, in some cases, investment advisers can incorporate by reference to the disclosure documents, e.g. Form N1-A, 17 C.F.R. § 274.11A, or Form N-2, 17 C.F.R. § 274.11a-1 of a registered fund it manages. *See* 17 C.F.R. § 275.0-6(a), (d), (e). However, the SEC can refuse such reference if they determine such disclosure to be too confusing or incomplete. Yet, a fund cannot, vice-versa incorporate by reference to Form ADV.

[36] Specifically, Form ADV does not inform investors about a manager's reputation, or historical experience, which is essential information in hedge funds because so much of the fund's success depends on the manager. Significantly, the SEC has noted that these disclosure problems exist regarding all investment advisers. *See Staff Report*, *supra* note 1, at 98 ("Form ADV cannot provide investors with sufficient information to evaluate the character of the hedge fund adviser or its employees."); *See also Roundtable Transcripts, supra* note 10, May 14, Comments of David Swensen ("[W]hat we really care about when we're making an investment decision is, first and foremost, the quality of the people [at a fund], and there's no way that you can look at somebody's disclosure document and figure out if the people that you're invested with have the character, the intelligence, the integrity, the creativity, and market savvy that you want to have in a partner in this arena or any other investment arena, for that matter."); May 15, Comments of Pamela Parizek ("While there is a great deal of information that's available in the public domain,...things like reputation and integrity [are] not generally going to be available and frequently we are called upon to get that type of information for many of our investors."); Advisers Act Rel. No. IA–1862 (2000) ("because the information in Part II [of Form ADV] concerns the advisory *firm*, clients may not receive information they want and need about the firm's employees with whom they have contact and on whom they rely for investment advice."). For example, Form ADV may not even indicate a manager's prior experience in managing hedge funds or the performance of prior funds under its control. Yet, new hedge fund manager brochures might give information about the key employees of the fund as well as its adviser. *See Staff Report*, *supra* note 1 at 98; Advisers Act Rel. No. IA–1862 (2000). Besides, because hedge funds tend to last about five years, or due to the fact that when a fund experiences losses and/or falls

about the brochure, it noted that some information disclosed in this brochure might overlap with a fund's offering memorandum.[37] More significantly, the Staff refused to address the issues of sophistication or suitability of investors adequately at this time.[38]

Alternative ways to increase the regulation of the hedge fund industry

Alternatively, or in addition to the Staff's Proposal, the SEC could require hedge funds and their managers to file notice of the exemptions they rely on from the federal securities laws with the SEC. Similar filings are actually already made by hedge funds.[39] Additionally, regulators could create new laws, or restructure current ones to hold the

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below its hurdle rate, and/or the high water mark becomes too high to make back, its manager may not want to waste time trying to make up such losses, and instead may close and liquidate one fund only to set up a new fund. While some of the previous investors in the former fund may invest in the second one, additional investors may come into the new fund as well. However, they may not know of the reasons why the first fund closed, or even if the manager ran the first fund at all. Further, NASD and the SEC have not agreed in the past about whether an adviser should be required, or even allowed to list past performance results of its other funds, because such information may be misleading to investors. *See* NASD NtM 97-47 (the SEC allows it, while the NASD prohibits it); SR-NASD-98-11. NASD proposed rules in 1998 to allow the presentation of such performance information. These rules have not yet been adopted, but have received more attention recently due to the increased scrutiny of the hedge fund and mutual fund industries. *See also* Rules 204-2(a)(11) and 206(4)-1 of the Advisers Act, 17 C.F.R. §§ 275.204-2(a)(11), 275.206(4)-1 (discussing advertising by investment advisers). Advisers Act Rel. No. IA–1862 (2000) (the SEC proposed, but never adopted rules mandating this additional disclosure for all investment advisers, not just hedge fund managers).

[37] *See Staff Report, supra* note 1, at 98.

[38] *See Staff Report, supra*, note 1. Interestingly, this seems most important issue because if hedge fund investors were indeed sophisticated and had access to material information, they arguably would not invest in funds conducting fraud against them. They may also not want to invest in a fund that defrauds other investors for fear of liability themselves. Indeed, if sophistication is guaranteed, the market will regulate itself. Although this is theoretically occurring and reflects the current theory and policy regarding hedge funds, it is questionable whether all hedge fund investors are sophisticated and have access to material information in practice. Arguably because sophistication is currently only tested by wealth and not actual knowledge and understanding of how hedge funds operate, all hedge fund investors may not be sophisticated. *See supra*, notes 1, 31, 32.

[39] *See* 17 C.F.R. §§ 4.5, 4.6, 4.13(b)(1), 4.14(a)(8)(iii)(A) (the CFTC and NFA require filing similar notice of exemptions from registration under the Commodity Exchange Act, 7 U.S.C. § 6k, used by CPOs and CTA's, including hedge funds). In fact, the SEC already requires issuers of securities, *including most hedge funds*, that rely on several of the private offering exemptions in the Securities Act to file notice of such exemption on Form D. *See* 17 C.F.R. § 230.503; 17 C.F.R. § 239.500 (Form D). *See supra*, note 12. *See also* 31 C.F.R. § 103 (proposed rules of the Patriot Act) (requiring unregistered investment companies, including hedge funds, to file notice of exemption from the Patriot Act's anti-money laundering rules).

filers of such documents liable for material misstatements or omissions in such documents.[40]

First, regulators could create "Form HF." Specifically, either Congress, by amendment to the current statute, or the SEC, by promulgation of new rules, could create new laws under the Investment Company Act to require all investment pools that rely on the §3(c)(1) or § 3(c)(7) exemptions to file notice of such reliance with the SEC. Arguably, the SEC has the authority do so under §§ 6(b), 6(c), 38(a), 3(c)(1), and 3(c)(7) of the Investment Company Act.[41]

Form HF could be structured to contain useful information for investors and regulators including: which exemption the fund relies on, i.e. § 3(c)(1), or § 3(c)(7), the legal structure of the fund, which state it legally exists in, its principal place of business, who manages the fund and whether they are invested in the fund,[42] when the fund was formed, the minimum investment requirement, assets of the fund,[43] the number of investors,[44] number of institutional investors,[45] other hedge funds invested in the fund,[46]

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[40] *See* 15 U.S.C. § 80a-34(b), 15 U.S.C. § 80b-7. Notably, other antifraud provision may already apply to such misrepresentations. *See supra*, note 5, 6, 25.

[41] *See* Investment Company Act Release No. IC-22597, 62 FR 17512, April 9, 1997 (the SEC claimed and was granted such authority to promulgate rules under § 3(c)(1), § 3(c)(5)).

[42] This should include investment advisers and portfolio managers. *See* Investment Company Rel. No. IC-26383, 69 FR 12752, March 17, 2004 (proposed rule discussing similar disclosure). If the amount of such investment is disclosed, as perhaps it should be, the SEC could decide whether to disclose such information in a range, percentage, or in dollars depending on the privacy concerns of individuals involved.

[43] *See id.* Presenting such information by using a range could be helpful to hedge funds because, as assets are often in flux, such exact filing would cause burdensome amendments to hedge funds.

[44] This could include the number of accredited investors, and non-accredited but sophisticated investors including the number of "qualified purchasers" invested in § 3(c)(1) funds. This could ensure fair access to material information and equal treatment in the funds. This may not currently be the case because a fund may accept investors who barely meet accreditation standards (or who may not at all if they are "sophisticated") along with large institutions who arguably have the opportunity to receive special treatment from hedge fund managers due to their economic clout and their potential to invest more in the

how the fund is marketed,[47] who the funds prime brokers are,[48] the fund's investment policy,[49] if it invests in mutual funds, variable annuities, or other hedge funds,[50] if it uses

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fund. Arguably, such favorable treatment and disclosure exists now and possibly even constitutes a violation of the hedge fund manager's fiduciary duties under § 206 of the Advisers Act. 15 U.S.C. § 80b-6. *See supra,* note 2, *"Do hedge fund investors need more protection under the federal securities laws?"* (discussing the concerns of ensuring equal access to material information among hedge fund investors).

[45] This could include filers of Form 13F, 17 C.F.R. 249.325, as required in the Exchange Act, 17 C.F.R. 240.13f-1, or as otherwise defined. Such disclosure could assist in inequalities of investors within hedge funds as well assist in the protection of retail investors invested indirectly in hedge funds via pension funds. *See id. See also supra,* note 2, Donaldson Testimony (noting the need of such protections).

[46] This could provide information on master-feeder funds and funds of hedge funds. *See supra,* note 20.

[47] Such information could involve which private offering exemption under the Securities Act the fund relies on to issue its securities, e.g. § 4(2) or Regulation D (maybe the SEC could thus allow cross reference to Form D), the use of consultants/finders, "capital introductions," etc. This could also help the SEC monitor use of the internet, whether the fund uses a password-protected website, what such address is, etc. *See* Lamp Technologies, Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 638 (publ. avail. May 29, 1997) (The SEC's Staff stated that posting of generic information about hedge funds on a third party website would not involve a "general solicitation" or "general advertising" and would thus not constitute a public offering of securities by the participating fund under the federal securities laws so long as the information was password protected and only available to potential investors who completed a questionnaire that allowed the issuing hedge funds to reasonably believe such investors were indeed "accredited investors." Further, the SEC's Staff also mentioned that an investment adviser exempt from registration under the Advisers Act would not be deemed to be "holding itself out to the public" here in violation of such exemption.) However, whether such use of the Internet constitutes a public offering will be determined by the specific facts of each case. *See also* IPONET SEC No-Action Letter, [1996-1997 *Transfer Binder*] *Fed. Sec. L. Rep. (CCH) ¶ 77,252* (1996) (posting of the notice of a private offering on a password-protected website did not involve a general solicitation within the meaning of Rule 502(c) of Regulation D). In capital introductions a hedge fund's broker-dealer acts as an intermediary between prospective investors and the fund or its manager. For more on capital introductions *see*: NASD NtM 03-07, *supra* note 14; *Roundtable Transcripts, supra* note 10, May 14, Comments of Richard Lindsey; Hal Lux, *Who wants to be a billionaire?*, INSTITUTIONAL INVESTOR, June 2002, Henry Sender and Gregory Zuckerman, *Are Hedge Funds and Brokers too Interlocked?* THE WALL STREET JOURNAL, May 15, 2003, at C1; *Staff Report, supra* note 1 at 53-55 (discussing how hedge funds are in practice marketed); Donaldson Testimony, *supra* note 7; *supra*, note 1, *"Do hedge fund investors need more protection under the federal securities laws?"*

[48] This may help detect fraud and ensure brokerage "Chinese walls" remain in tact. *See* Henry Sender and Gregory Zuckerman, *Are Hedge Funds and Brokers too Interlocked?* THE WALL STREET JOURNAL, May 15, 2003, at C1; Hal Lux, *Who wants to be a billionaire?*, INSTITUTIONAL INVESTOR, June 2002 (explaining prime brokerage). Perhaps this should be disclosed only to the SEC to maintain hedge funds' privacy rights and prevent predatory practices in the industry.

[49] This could include long/short equity trading, event-driven, and global macro strategies, whether the fund focuses on investing in start up companies for control purposes (to determine if it's a private equity fund, *see infra* notes 55, 57). This could include whether the fund invests in IPOs as well. *See supra,* note 2, Donaldson Testimony (discussing the concerns of hedge funds activities and trading strategies).

leverage,[51] if it subscribes to various hedge fund indices,[52] what conflicts of interest may arise within the fund, its manager, and third parties.[53] This information could be filed with the SEC on its EDGAR database ("EDGAR") to be publicly available to investors.[54]

However, it still may be difficult for the SEC to determine if a filer of Form HF is actually a "hedge fund" rather than a private equity, e.g. venture capital fund, absent some additional clarification.[55] One way to resolve the problem would be to define

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[50] This might assist the SEC prevent, deter, and detect late-trading, market-timing, and the issues concerning "sticky assets." *See supra,* note 2, Donaldson Testimony (discussing the concerns of hedge funds' activities and trading strategies in mutual funds).

[51] This may help detect systemic risk concerns, and the concerns the SEC has over the power and influence of hedge funds acting as institutional investors in the equity markets. *See supra,* note 2, Donaldson Testimony. Yet it may be difficult or disadvantageous to define the term "leverage." *See infra,* note 56.

[52] This would also give the SEC more oversight as to what hedge funds are out there, their activities, as well as the operations of the indices, including how the funds, managers, and indices themselves calculate the statistics used in reporting such data.

[53] *See supra*, note 2, Donaldson Testimony, (expressing concern about such conflicts of interest that currently go undisclosed); note 1, *"Do hedge fund investors need more protection under the federal securities laws?"* In addition, failure to disclose such information may be a breach of the hedge fund manager's fiduciary duties as per § 206 of the Advisers Act, 15 U.S.C. § 80b-6.. *See supra,* note 16. (discussing fiduciary duties of investment advisers). *See also In the Matter of Chancellor Capital Management*, Advisers Act Rel. No. IA-1447, 57 SEC Docket 2204 (October 18, 1994); *In the Matter of Joan Conan*, Advisers Act Rel. No. IA-1466, 57 SEC Docket 2239 (September 30, 1994); *In the Matter of Ronald V. Speaker and Janus Capital Corp.*, Advisers Act. Rel. No. IA-1605, 1997 SEC LEXIS 85, January 13, 1997.

[54] *See* www.sec.gov/edgar.shtml

[55] Indeed, this is a problem with the definitions proposed recently by Congress in the Baker and "Markey/Dorgan" Bills. *See* H.R. 2924; H.R. 3483 106th Congress (2000). The "Baker Bill" defined term, "*unregulated* hedge fund" as, "any pooled investment vehicle, or any group or family of pooled investment vehicles under the control of the same person, that had, as of the last business day of any of the most 4 most recent calendar quarters, either...aggregate total assets of $3,000,000,000 or more; or aggregate net asset value of $1,000,000,000 or more." H.R. 2924. The Markey/Dorgan Bill defined the term, "*unregistered* hedge fund" as, "any pooled investment vehicle, or group or family of pooled investment vehicles, that...has total assets under management of $1,000,000,000 or more; and...is excepted from the definition of investment company by section 3(c)(1) or 3(c)(7)." *See* H.R. 3483. Notably, the former definition uses the improper term, "unregulated" hedge fund, whereas the latter uses the more appropriate term, "unregistered" hedge fund. Further, due to the large dollar amounts used to define these terms, most investment pools thought of as hedge funds would be excluded from such definition. This emphasizes the point that such Bills were made to prevent systemic risk threats caused by hedge funds and highly leveraged institutions, not the prevention of hedge fund fraud. However, it is uncertain whether distinctions need to be made between private funds. Arguably, fraud may also exist in the private equity industry as well. Also, the SEC might benefit from such oversight as well. Thus, the SEC may not need to,

"hedge fund." Yet, because hedge funds are very entrepreneurial and vary in strategies, operations, structure, etc., defining such a term narrowly would be difficult and may not encompass all hedge funds. Further, having a strict definition would be disadvantageous because hedge funds could be structured to easily avoid such a definition.[56]

Alternatively, the SEC could define "private equity fund" and then make a rule stating that a "hedge fund" is any filer of Form HF that does not fit in this definition.[57] Otherwise, the SEC could reserve the right to determine or classify whether a Form HF filer is a hedge fund or a private equity fund after reviewing its investment policies as stated in the documents it files with the SEC.[58] Similarly, Form HF could require the

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or want to, distinguish between private funds, unless statistics show that "hedge funds" i.e. unregistered non-private equity funds, engage in significantly more fraud than other unregistered private funds.

[56] Indeed, although many of the statutes and rules within the federal securities laws relate to the terms "insider trading" and "tender offer," these terms are undefined. A definition of the term "tender offer" was excluded from the Williams Act because "the term is to be interpreted flexibly," in light of their "dynamic nature." *See* Exch. Act Rel No. 12,676 (1976); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 Duke L.J. 1081, at 1128. *See also* Rules 10b-5(1), 10b-5(2), 14e-3 of the Exchange Act, 17 C.F.R. §§ 240.10b-5(1), 240.10b-5(2), 240.14e-3 (regarding insider trading; 143-4 deals with insider trading in tender offers) and Regulation 14D, Rule 14d-1 et seq., Regulation 14E, Schedule TO, Rule 14e-1 et seq. 17 C.F.R. §§ 240.14d-1 et seq, 240.14e-1 et seq. (regarding tender offers). Rather, such terms have been defined through caselaw. *See Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983); *United States v. O'Hagan*, 117 S.Ct. 2199 (1997); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) (discussing insider trading); *Hanson Trust PLC v. SCM Corp.* 774 F.2d 47 (2d Cir. 1985); *Wellman v. Dickenson*, 475 F.Supp. 783 (S.D.N.Y.), aff'd on other grounds, 682 F.2d 355 (2d Cir. 1982), cert. denied, 460 U.S. 1069 (1983) (discussing the "8 factor test" often used in determining the existence of a "tender offer").

[57] This is a better option because most private equity funds share similar characteristics, specifically regarding long lock-up periods, continual capital contributions from investors, and strategies in buying large amounts of equities in start up companies for control purposes. *See* 31 C.F.R. § 103 (proposed rule) (definition of "unregistered investment company" specifically included 3(c)(1) and 3(c)(7) funds with $1,000,000 or more in total assets, that had short lock-up periods that gave investors the right to redeem their shares within two years after the day they were purchased). This definition would include most investment pools thought of as "hedge funds." This policy was created for the purposes of the Patriot Act because investment companies with lengthy lock-up periods are more attractive to money launderers. Such funds would thus not be exempt from the proposed rules, unlike hedge funds. However, creating such objective definitions may be dangerous because hedge funds could easily avoid such regulation by restructuring the way they exist or operate. *See also, Staff Report, supra,* note 1 (discussing these issues).

[58] This approach is more practical and deals with the true differences between these types of private funds. Specifically, hedge funds are typically passive investors that invest large amounts in short-term trades and

filer to make a statement whether it would classify itself as a private equity fund and why.[59] Yet, such distinctions may be unnecessary because fraud may exist in all Form HF filers.

In addition to filing Form HF, funds required to do so could also be required to file their offering memorandum with the SEC. Although the federal securities laws currently do not require hedge funds to disclose *any* information to "accredited investors,"[60] most hedge funds do typically give investors an offering memorandum.[61]

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are highly leveraged to make fast, absolute gains, while private equity funds are active investors that tend to invest in start-up, developing, or struggling companies for control purposes, with long-term objectives. However, because there are no requirements that either set of private funds operate or invest in a certain way, such classifications, although typical, are still subjective. *See Staff Report*, *supra* note 1, at vii, 5 ("there are other unregistered pools of investments, including venture capital funds, private equity funds and commodity pools that generally are not categorized as hedge funds."). Yet, within the closed-end fund universe itself, some pooled unregistered investment companies may consider themselves to be hedge funds based on the investment strategies they use, whereas the industry as a whole may not necessarily consider them so, and vice versa. *See Roundtable Transcripts*, *supra* note 10, May 14. Unlike hedge funds, which typically last 5.5 years, private equity funds usually operate for longer periods of time. Thus, investors in these other investment pools remain invested in such funds for a lengthy period of time and constantly contribute capital to the fund. *See Id; Staff Report*, *supra* note 1, at 7-9.

[59] This would allow the SEC to review and determine for itself, putting it on alert whether such funds may need greater scrutiny than others. *See supra,* note 55 (debating whether such distinctions need to be made).

[60] Unregistered hedge funds that offer their securities by use of Rule 506 of Regulation D, 17 C.F.R. § 230.506 are not required to disclose *any* information to offerees or purchasers of their securities if such persons are "accredited investors." *See* Rules 502(b)(1), (2), 17 C.F.R. §§ 230.502(b)(1), (2) (some disclosure is required if securities are sold via Rule 506(b) to sophisticated investors who are not "accredited"). Interestingly, if a hedge fund issues its securities under Rule 506 to both accredited and non-accredited but sophisticated investors, although the SEC *suggests* this disclosure be made universally, the Rule only requires such disclosure be made to the non-accredited investors. *See* Rule 502(b), 17 C.F.R. §§ 230.502(b). *See also* FRANCOIS-SERGE LHABITANT, HEDGE FUND MYTHS AND LIMITS (John Wiley & Sons Ltd. 2002), at 26 ("A private offering does not mean an undocumented one...this confidential document presents a general overview of the fund and should contain key elements needed to make an investment decision."); *Staff Report*, *supra* note 1, at 46-48 (an offering memorandum will qualify as a "brochure" and meet a registered investment adviser's disclosure requirements under Part II of Form ADV). Some academics have noted that disclosure in the private offering context has created a legal paradox. *See* Fletcher, *supra* note 56, at 1119; at 1125, note 277 (1988) ("The scheme requires registration of securities offered to *unsophisticated* investors, thus ensuring that people who do not read prospectuses receive copies of them, but exempts securities offered to *sophisticated* investors who would read and benefit from prospectuses if they received them. A legal structure that creates such anomaly demands reconsideration.").

[61] *See supra,* note 31 (discussing the judicial requirement that hedge fund investors must be sophisticated and have access to material information). Most hedge funds do currently distribute such documents to avoid liability under § 206 of the Advisers Act, 15 U.S.C. § 80b-6 and other fraud provisions regarding misrepresentation and omissions. See supra, note 25.

Moreover, this requirement could essentially indirectly force hedge funds to give all investors a disclosure document because funds and their managers would not want to appear suspicious to the SEC and because they may fear losing investors to funds that do disburse such information.[62] Otherwise, the SEC could make filers explain in Form HF if they do not have such a document and why they do not. To abide by the current policy regarding hedge funds, the industry should have the flexibility to determine what to include in such documents.[63] Yet, the SEC could suggest using Form N-2 as guidance.[64]

Regulators could require such filing in various ways. First, the SEC could amend Form D of the Securities Act[65] to state that filers of Form HF that issue securities as per Regulation D are required to file any offering memorandum they issue as a schedule to Form D, called, "Schedule HF." However, this may not encompass all hedge funds because some rely on § 4(2) of the Securities Act, not Regulation D to offer their

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[62] In fact, the SEC used similar reasoning in creating the going private rules, Rule 13e-3 of the Exchange Act. *See* Schedule 13E-3, Rule 13e-3, 17 C.F.R. § 240.13e-3. Instead of mandating that issuers give disadvantaged, minority shareholders fair value in going private transactions, the SEC adopted rules that required the issuer to state whether it reasonably believed the transaction was fair to minority shareholders. *See also "Comment, Regulating Going Private Transactions: SEC Rule 13e-3,"* 80 Colum. L. Rev. 782 (1980); Securities Act Rel. No. 33-5567 (1975) (proposed rules, suggesting specific regulation of substantive fairness); Exch. Act. Rel. No. 34-14185 (1977) (re-proposed rule, deleting substantive fairness provision, proposing subjective disclosure to mandate transactions be fair).

[63] Compare the author's previous views of creating a uniform disclosure document, requiring all filers of Form HF to attach a new "Schedule PPM" with uniform disclosures. *See supra,* note 1 (*"Do hedge fund investors need more protection under the federal securities laws?"*). However, due to the entrepreneurial nature of the hedge fund industry, requiring such a uniform disclosure document may be difficult to administer and may actually impede upon the practices of hedge funds which often seek flexibility in their policies and strategies to obtain absolute performance in all market conditions.

[64] *See* 15 U.S.C. §§ 80a-4, 80a-5, 80a-8(b); Form N-2, 17 C.F.R. § 274.11a-1 (because hedge funds classify as closed-end management investment companies they would file Form N-2 if registered under the Investment Company Act). Most reputable law firms with hedge fund clients base their offering memorandum off of Form N-2 now anyway. Particularly, Form HF could incorporate by reference to this document instead of stating all the strategies, marketing activities, etc. Such offering documents, e.g. the private placement memorandum, may give insight into the funds strategies, risk assessment, valuation policies of the funds NAV, trading or brokerage transactions, etc.

[65] *See* 17 C.F.R. § 230.503; 17 C.F.R. § 239.500 (Form D). *See supra,* note 40 (discussing filing Form D).

interests.[66] Thus, the SEC could create new rules to § 4(2) to require all Form HF filers relying on the § 4(2) exemption to file notice of such exemption and file its offering memorandum, if it has one, with the SEC.[67] Coherently, Form HF could also say if the fund relies on § 4(2) or Regulation D to privately offer its securities.[68] Arguably, §§ 19(a), 19(c), 4(2), 4(6) of the Securities Act give the SEC authority to make such laws.[69]

In addition, hedge fund managers could be required to file notice with the SEC of their reliance on exemption from registration under § 203 of the Advisers Act[70] on a newly created form, Form ADV-X (for exempt adviser). This could be filed on EDGAR as well. Although debatable, arguably, the SEC has the authority to create such a requirement by rule promulgation under §§ 211, 203 and 206(4) of the Advisers Act.[71]

The SEC could either require all "investment advisers," as per § 202(a)(11), that rely on the § 203(b)(3) registration exemption,[72] all investment advisers who manage/advise[73] a filer of form HF, those who manage "hedge funds" if such a definition

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[66] *See supra,* note 12 (discussing how hedge fund interests are sold); 15 U.S.C. § 77d(2). Form D could also be amended to include Form HF filers that issue securities as per § 4(2), 15 U.S.C. § 77d(2).

[67] Again, if such filers do not have such memorandum, they could be required to explain that they do not have one and why. *See supra,* note 62 (such a law would result in indirect regulation requiring such filing).

[68] The SEC could alternatively create a new "Regulation HF" to the Securities Act, requiring Form HF filers to disclose whether they use § 4(2) or Regulation D to sell their securities. *See supra,* note 12 (discussing how hedge fund interests are sold).

[69] *See* Securities Act. Rel. No. 33-6389, 47 FR 11251, March 16, 1982 (for example, the SEC relied on and was granted such authority when it created Regulation D, particularly Form D and Rule 506).

[70] *See supra*, note 14; 15 U.S.C. § 80b-3 (requiring all "investment advisers" must register with SEC).

[71] For instance, the SEC claimed and was granted such authority in promulgating rule 203-1 amending the registration requirements, particularly concerning the creating of Form ADV-H regarding wrap fees. *See* Adviers Act. Rel. No. IA-1897, 65 FR 57438, Sept. 20, 2000.

[72] 15 U.S.C. §§ 80b-2(a)(11), 80b-3(b)(3).

[73] However, this could be difficult due to the lack of any statutory definitions of "advice" or derivations of such word. *See supra,* note 14 (discussing caselaw on this subject).

is made, or any adviser who relies on any § 203(b) exemption to file such form. Arguably, it would be more beneficial for the SEC to create a broad rule that covers all advisers exempt from registration by reliance on § 203.[74] This could help the SEC detect more fraud as well. Moreover, this filing could be free and not be too detailed to be burdensome on advisers if it only has to be filed once without amendments.

Further, if any new rule were restricted to advisers relying on § 203(b)(3), lawyers might structure the way hedge fund managers or hedge funds exist or operate to avoid such laws. First, because "advice" is not defined, one may argue that hedge fund managers do not come under the definition of "investment advisers."[75] Second, debatably hedge fund managers still may be able to rely on § 203(b)(1) to avoid registration.[76]

In any event, the SEC could require various disclosures to be made on Form ADV-X, including: if the adviser is a general partner/managing member in a limited partnership or limited liability company that would be deemed a hedge fund (i.e. as defined, or a filer of Form HF), if it invests its own assets in such hedge fund(s)[77] or in other hedge funds, if it invests in mutual funds, whether it jointly manages other hedge

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[74] *See supra*, note 55 (discussion of limiting Form HF filers to hedge funds or whether the SEC should include private equity funds too). Because information gaps exist regarding all unregistered investment advisers and because such advisers can conduct fraud as well, it is unclear why the SEC should single out unregistered hedge fund managers.

[75] This probably would not work though because courts have declared that hedge fund managers give "advice" regarding securities. *See supra*, note 14. *See also, supra*, note 20.

[76] *See supra,* note 20 (discussing this possibility).

[77] Investment by the adviser in the fund it manages is often seen as a good sign because, arguably, it would not defraud investors in the fund if it has its own money at risk, and because it has its own assets at risk it may potentially lose its money along with other investors. Conversely, one may argue that such an adviser may have incentive to boost fund performance because it gets high fees, so it will try to defraud other investors by use of illegal or improper schemes, e.g. market timing, later-trading, etc.

funds/filers of Form HF or mutual funds,[78] if it was subject to prior regulatory or legal sanctions,[79] amount of assets under management,[80] number of clients (including how many are not living persons),[81] the key employees of the adviser managing the fund, their experience, history, etc. (e.g. portfolio managers), any "knowledgeable employees" invested in the fund, etc.[82]

Interestingly, one may argue that filing Form HF, the offering memorandum, and/or Form ADV-X would constitute a "general solicitation" of the interests of the filing hedge fund in question if such documents were made publicly available on EDGAR. As a result, this might violate the prohibitions against publicly offering hedge fund interests in § 4(2) and Rule 502(c) of Regulation D of the Securities Act and §§ 3(c)(1), 3(c)(7) of the Investment Company Act.[83] Thus, the SEC could make rules or issue a policy statement explaining that such filings would not constitute a breach of such provisions.[84]

However, this raises another important issue addressed in the Staff's Proposal: whether hedge funds should be *allowed* to conduct general solicitations. In fact, it is unclear why such advertising is forbidden anyway.[85] Moreover, the prohibition is

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[78] This also helps deal with sticky assets, market-timing, and late-trading issues.

[79] This could be addressed in similar fashion to registered adviser regulation. *See* 15 U.S.C. § 80b-6(4), 17 C.F.R. § 275.206(4)-4 (advisers must disclose financial and disciplinary information to clients).

[80] *See supra,* note 42 (this could be done it a range to ease amendments to such documents).

[81] *See supra,* note 44 (discussing dangers of inequalities among hedge fund investors).

[82] *Id. See also* 17 C.F.R. 270.3c-5; *supra* note 1, *"Do hedge fund investors need more protection under the federal securities laws?"* (discussing "knowledgeable employees").

[83] 15 U.S.C. § 77(d)(2), 17 C.F.R. 230.502(c), 15 U.S.C. §§ 80a-3(c)(1), (7).

[84] Arguably, the SEC would have the authority to do so. *See supra,* notes 41, 69.

[85] Notably, the legislative histories of such provisions do not explain why such prohibitions exist. *See* Pub L. 104-290 (Oct. 11, 1996) (regarding § 3(c)(7), 15 U.S.C. §§ 80a-3(c)(7)); Aug. 22, 1940, ch 686, Title I,

unnecessary because hedge fund managers must perform due diligence on all potential investors, to ensure they are "sophisticated" and that a "pre-existing relationship" exists in order to comply with the private offering exemptions.[86] Indeed, this raises the question whether the current laws really do ensure that investors in hedge funds are sophisticated or whether a specific hedge fund investment is suitable for each specific investor in that fund.[87] Although some may argue that it is unfair for hedge funds to advertise publicly to non-accredited investors, there is no danger in doing so as long as hedge fund managers assure their investors are sophisticated, as they are legally required to.[88] Thus, arguably, it should not matter *how* a hedge fund *originally* attracts investors.

Allowing such advertising will result in better benefits for various parties. It will allow the SEC and NASD to better regulate the marketing of hedge funds and detect fraud, increasing the protection of hedge fund investors. It will also give investors more information on what funds exist, their characteristics, strategies, etc., allowing them to

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§ 3, 54 Stat. 797 (regarding § 3(c)(1), 15 U.S.C. §§ 80a-3(c)(1)); Securities Act Rel. No. 33-638947, FR 11262, Mar. 16, 1982 (regarding Regulation D, 17 C.F.R. 230.502(c)); May 27, 1933, ch 38, Title I, § 4, 48 Stat. 77 (regarding § 4(2), 15 U.S.C. § 77d(2)).

[86] *See supra,* notes, 1, 31 (discussing the need to determine sophistication of hedge fund investors). *See also* H.B. Shaine & Co., Inc. No-Action Letter, 1987 SEC No-Act. LEXIS 2004 (publ. avail. May 1, 1987). In determining what constitutes a general solicitation, a questionnaire requesting specific information about an investor's employment history, business experience, business or professional education, investment experience, income, and net worth, that also asked investors to express their own opinion as to their ability to evaluate the merits and risks of venture capital investments may be sufficient to establish a pre-existing relationship. Thus, it seems that a suitability requirement may quasi-exists under Rule 502(c), 17 C.F.R. § 230.502(c). Interestingly, the SEC's Director of Corporate Finance, Alan Beller, noted at the Hedge Fund Roundtable that a hedge fund could not place an advertisement on a billboard in Times Square, saying, "we have a new hedge fund but please understand that unless you are an accredited investor, don't call...there is a school of thought that so long as you restrict the sales to accredited investors and are adequate about policing the people to whom you sell, it shouldn't matter if you put a billboard up in Times Square. That is not the law today." *See Roundtable Transcripts, supra* note 8, May 14, Comments of Alan Beller.

[87] *See supra* note 1, *"Do hedge fund investors need more protection under the federal securities laws?"*

[88] *See supra,* notes 1, 31.

make more suitable and wise investment decisions in hedge funds. This will also create competition in the industry encouraging better self-regulation, as current policy suggests.

However, some may argue that if general solicitation is allowed hedge funds will have more incentive to, and will in fact, lie about performance and other statistics to seem more attractive. In order to combat such concerns, regulators could limit the amount of information allowed in such ads. For example, hedge funds could only be allowed to conduct such advertising publicly via tombstone ads.[89] Such ads could also be required to refer to the documents the fund and its manager file with SEC (e.g. Form HF, Form ADV-X, offering memorandum). One may also argue that if publicly advertised, hedge funds will be more attractive and enticing to retail or less sophisticated investors. Even though this may seem dangerous, especially if funds of hedge funds now have investment minimums as low as $25,000,[90] all hedge fund investors must still be "sophisticated."[91] Again, the real issue here is whether the sophistication and suitability tests are adequate.[92]

Indeed, the SEC's Staff recently proposed allowing general solicitation for hedge funds, but suggested limiting such use to § 3(c)(7) funds.[93] This suggestion erroneously implies that "qualified purchasers," due to their wealthy status, are more sophisticated

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[89] Recently, the MFA (Managed Funds Association), the main trade organization for hedge funds and their managers, lobbied that hedge funds should be allowed to convey general information about a fund by use of "tombstone" ads if they solicited accredited investors via public means. *See* www.mfainfo.org (providing list of articles on the subject). Laws were never enacted regarding this issue. If such ads were allowed, hedge funds could be prohibited from reporting performance results in ads. Perhaps, rules could even be structured to parallel mutual funds advertising rules.

[90] Notably, the SEC's Staff noted that the "retailization" of hedge funds has *not occurred* significantly as was previously thought. *See Staff Report,* note 1.

[91] *See supra*, note 31 (discussing sophistication requirements).

[92] *See supra* note 1, "*Do hedge fund investors need more protection under the federal securities laws?*"

[93] *See Staff Report*, *supra* note 1, at 100.

than other hedge fund investors, i.e. accredited investors that are not qualified purchasers, and sophisticated, but non-accredited ones.[94] Generally, hedge fund investors must be sophisticated enough to understand the risks and merits of investing in hedge funds and to determine if a particular hedge fund is a suitable investment for it.[95] Yet, it is incorrect to imply that qualified purchasers, i.e. § 3(c)(7) fund investors, need to be more sophisticated, or that such funds always involve more complex strategies.[96] Moreover, the SEC indicated that wealth is not necessarily indicative of hedge fund sophistication by adopting Rule 3c-5 of the Investment Company Act, allowing "knowledgeable employees" to invest in either § 3(c)(1) *or* § 3(c)(7) funds they work in, regardless of their wealth or economic status.[97]

Conclusion

Overall, filing these document benefits all parties, without imposing heavy burdens on the private fund industry. Having such additional information on hedge funds will allow the SEC to conduct more efficient, targeted investigations of hedge fund operations. Publicly filing these documents, and allowing general solicitation will help

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[94] It is unclear whether this is because they have more economic clout, or can afford to lose their investments. Either way, such reasoning if flawed because money alone does not equal sophistication and is a poor proxy of it. *See supra* note 1, *"Do hedge fund investors need more protection under the federal securities laws?" See supra*, note 10 (explaining "qualified purchasers.")

[95] *See supra*, note 31 (discussing sophistication requirements); *See supra* note 1, *"Do hedge fund investors need more protection under the federal securities laws?"*

[96] *See supra* note 1, *"Do hedge fund investors need more protection under the federal securities laws?"* For example, a 3(c)(1) fund can engage in the same strategies, or even more risky and complex strategies than a 3(c)(7) fund. Thus, one could even argue that some investors in the former may need to be more sophisticated than those in the latter in some instances. Technically, the major difference between these two types of funds is not necessarily the sophistication of their investors, but rather it is the number of investors in the fund (100 vs. 499). *See supra,* note 13 (discussing Exchange Act exemption). Although qualified purchasers can be in either fund, accredited or non-accredited sophisticated investors cannot be invested in a 3(c)(7) fund.

[97] *See* 15 U.S.C. §§ 3(c)(7); 17 C.F.R. § 270.3c-5.

deter fraud in the hedge fund industry, including helping the SEC detect fraud involving hedge funds transactions.[98] This also helps the hedge fund industry itself because it will help promote competition without leading to predatory practices that might result from full transparency of a particular fund's investment activities. It also helps hedge fund investors by allowing them to compare data of various hedge funds more easily. These benefits will not necessarily result from the Staff's Proposal. Thus, the SEC should consider these ideas either in addition to or as an alternative to the Staff's Proposal.

[98] This could particularly help detect and deter hedge fund fraud involving mutual funds, including detecting hedge fund's investment activity in mutual funds as well as determining if an adviser is jointly managing registered investment companies, e.g. mutual funds, and unregistered ones, e.g. hedge funds, resolving current problems of the mutual fund scandal. Such disclosures would also aid the newly created, Office of Risk Assessment as well as the SEC's Task Force on Enhanced Mutual Fund Surveillance. Further, establishing these new regulations regarding hedge funds and their managers could better satisfy the recently expressed goals of Chairman Donaldson. *See supra,* note 2 Donaldson Testimony ("I have asked the staff to move forward with a rulemaking proposal that would enhance the [SEC's] ability to prevent, detect and deter abusive fraudulent conduct in the hedge fund segment of the investment management industry...we could consider both a form of registration for hedge fund managers and an oversight regime different from that which we use for other, more heavily regulated industries, like mutual funds. They could be specifically tailored to the unique dynamics of these types of managers. We could thus better target our inquiries on those hedge fund managers where there is some reasonable concern that they may be violating the securities laws."