NO DIRECTION: THE OBAMA ADMINISTRATION'S FINANCIAL REFORM PROPOSAL AND PENDING LEGISLATION PROPOSING THE REGISTRATION AND FURTHER REGULATION OF HEDGE FUNDS AND PRIVATE POOLS OF EQUITY ARE OVERBROAD AND FAIL TO ADDRESS THE ACTUAL RISKS THAT THESE FUNDS POSE TO THE FINANCIAL SYSTEM

ROBERT G. FRUCHT, ESQ. AND TASNEEM S. NOVAK, ESQ.*

I. Introduction

In the wake of the financial collapse that peaked roughly around the time that Lehman Brothers Holdings, Inc. ("Lehman Brothers") declared bankruptcy in the fall of 2008, regulators, political figures, and portions of the investing public have advocated for a wide-spread reform of all aspects of the financial industry. Even before being formally sworn in, President Barack Obama and his advisers were hard at work on a plan of comprehensive reform across the entire financial system in order to revamp and stabilize the economy in the wake of the financial crisis, increase government oversight and provide new protections for investors and consumers. The Obama administration's proposal for reform of the national financial system (the "Reform Proposal") was formally disseminated to the public on June 17, 2009 in an eighty-page white-paper which promotes legislation aimed at closing gaps between existing agencies, the creation of new regulatory bodies and an overall increase in oversight and regulation industry-wide.[1] The administration's view has been echoed by financial experts, but also criticized by many within the industry and the general public.[2] As of the date of

---

* The authors are, respectively, a partner and an associate in the Corporate and Securities practice in the New York office of the international law firm, Crowell & Moring LLP, www.crowell.com.

[1] *See generally* DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009) [hereinafter FINANCIAL REGULATORY REFORM PROPOSAL].

[2] *See generally* GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009); COMM. ON CAPITAL MARKETS REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (2009). Donald C. Langevoort, a former attorney for the Securities and Exchange

this writing, just over a year since the collapse of Lehman Brothers, it remains unclear exactly how the administration's Reform Proposal will manifest itself in new legislation; however, the text clearly indicates that none of the players in the nation's financial system should expect to enjoy the status quo.

The Reform Proposal that is the subject of this article would impose registration requirements and reporting requirements on "hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold."[3] Hedge funds in particular have been arguably ripe for regulation for the past several years. This is in part because hedge funds can be highly leveraged with little transparency concerning their trading practices, while at the same time the funds can generally structure themselves to qualify for current exemptions to federal securities laws.[4] The leading exemption for hedge funds is the "private adviser exemption" pursuant to § 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"),[5] which is discussed more fully in Part IV of this article. Over the past decade, sporadic attempts have been made to require hedge funds to register under federal securities laws. However, regulators have failed to adopt a consistent policy rationale

---

Commission ("SEC") and a professor at Georgetown University Law Center, stated:

> "This is going to be no honeymoon . . . People like Bob Rubin and others are well aware that we live in a global economy, and if you regulate too hard, you accomplish nothing and just watch economic activity move somewhere else. It's going to take a lot of political skill to navigate that clash."

Heidi Przybyla, *Obama Embrace of Wall Street Insiders Points to Politic Reforms*, BLOOMBERG, Nov. 19, 2008, http://www.bloomberg.com/apps/news?pid=20601109&sid=aWSz2kUxdTiU&refer=home (quoting Donald C. Langevoort).

3 FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 12.

4 *See* Sean M. Donahue, *Hedge Fund Regulation: The Amended Investment Advisers Act Does Not Protect Investors From Problems Created By Hedge Funds*, 55 CLEV. ST. L. REV. 235, 247 (2007); Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 686-87 (2000).

5 STAFF, U.S. SEC. AND EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 12-13 (Sept. 2003).

for such regulation,[6] and opinions among industry participants differ regarding the pros and cons of increased oversight, registration and reporting requirements for hedge funds.[7] Hedge funds have served as a scapegoat for government and private industry participants who support increased regulation. While it is true that some have abused the benefits of hedge funds' shape-shifting structure,[8] it is not evident that hedge funds in fact contribute a greater risk to the financial system than large investment banks and financial institutions.[9]

In addition to the anticipated regulation of hedge funds, the Reform Proposal seeks to include "other private pools of capital" within the grasp of its new regulatory scheme.[10] As Part II of this article discusses, hedge funds differ in significant ways from venture capital funds and other private equity investments.[11] Wide-sweeping regulation across all pools of private equity under the ambit of the Reform Proposal will have similarly broad implications within the

---

[6] *See generally* Joseph Lanzkron, *The Hedge Fund Holdup: The SEC's Repeated Unnecessary Attacks On The Hedge Fund Industry*, 73 BROOK. L. REV. 1509 (2008).

[7] *The Future of Hedge Fund Regulation: Q&A With Ezra Zask and Gaurav Jetley of Analysis Group*, FINALTERNATIVES.COM, Sept. 14, 2009, http://www.finalternatives.com/node/9070 (discussing the view among industry experts that regulations may benefit the hedge fund industry by making funds less secretive, thereby attracting investors who might otherwise be hesitant to invest in hedge funds); Carol E. Curtis, *Advisers May Find Themselves Targets in Hedge Fund Regulation*, SECURITIES INDUSTRY NEWS, July 20, 2009, http://www.securitiesindustry.com/issues/19_100/-23703-1.html (discussing the hedge fund industry's support for adviser registration at a July 15th hearing on the subject); Przybyla, *supra* note 2 (statement of Donald Langevoort).

[8] *See, e.g.*, Donahue, *supra* note 4, at 236-40 (discussing fraud perpetuated by the Bayou Hedge Fund); Laszlo Ladi, *Hedge Funds: The Case Against Increased Global Regulation in Light of the Subprime Mortgage Crisis*, 5 INT'L. L. & MGMT. REV. 99, 122 (discussing fraud in hedge funds).

[9] *Id.* at 130 ("Hedge funds are increasingly seen as the vanguard of market developments because they are able to quickly respond to market changes.").

[10] FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 12 ("All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold should be required to register with the SEC under the Investment Advisers Act.").

[11] Mark K. Thomas & Peter J. Young, *Key Differences Between Hedge Funds and Private Equity Funds*, 62 THE SECURED LENDER 26, 26 (2006).

nation's financial system and abroad. A major criticism of this type of increased regulation, therefore, is that it could inhibit economic activity within the United States and force investment funds to set up shop in jurisdictions with laws that are more favorable to their activities.[12]

The Obama administration has stated that "[i]nnovation is essential to the growth of our financial system and the prosperity of our country," and has specifically noted the importance of matching financial products to consumer preference.[13] With approximately 1,700 U.S. domiciled hedge funds currently in existence and hedge fund assets under management at the end of 2008 exceeding $1.6 trillion, hedge funds clearly continue to maintain the interest of individual and institutional investors.[14] Hedge fund investors are sophisticated. They include accredited investors, qualified purchasers (each as defined in Part IV of this article) and qualified clients (as defined in Part III of this article). Such investors often seem to prefer the diversity in investment strategies provided by hedge funds, and they are willing to take on higher risk in order to proportionately increase their return. Why, then, should the government advance proposed regulations which could hinder hedge funds and private equity from utilizing those very strategies?

This article analyzes the Reform Proposal and pending legislation regarding hedge fund and other private equity pools. It argues that the insufficiency in the proposed law reforms results from (i) inadequately addressing the risks that hedge funds and other private pools of equity pose to the financial system and (ii) failing to protect the benefits that these investment funds bring to the national economy. Part II of this article provides background by discussing the structural differences of, and the diverse investment strategies utilized by, hedge funds, venture capital funds and the other private

---

[12] Ladi, *supra* note 8, at 126-27.

[13] Press Release, U.S. Dep't. of the Treasury, Secretary Timothy F. Geithner Written Testimony, House Financial Services Committee, Financial Regulatory Reform (Sept. 23, 2009) (available at http://www.treas.gov/press/releases/tg296.htm).

[14] Morningstar Hedge Fund Data, MORNINGSTAR, Oct. 2008, http://hedgefunds.datamanager.morningstar.com/hfsecure/docs/press/HF_Data_FactSheet.pdf; *HFN Releases Hedge Fund Administrator Survey, February Asset Flow and Performance Estimates*, REUTERS, Mar. 10, 2009, http://www.reuters.com/article/pressRelease/idUS116297+10-Mar-2009+BW20090310 (discussing the Q4 2008 HFN Hedge Fund Administrator Survey results).

equity funds that would be subject to new regulation under the Reform Proposals. Part III walks through the federal securities law provisions that currently afford exemptions from registration to these investment vehicles. Part IV illustrates the problems with the government's earlier attempt to require hedge funds to register under federal securities laws—under an amendment to the Investment Advisers Act of 1940, as amended (the "Advisers Act"),[15] commonly referred to as the "Hedge Fund Rule"—which was successfully challenged in *Goldstein v. SEC* in the United States Court of Appeals for the District of Columbia Circuit.[16] Part V briefly discusses the recent collapse of major national financial institutions, which provides the backdrop for the Obama administration's imminent Reform Proposal to tighten regulation across all facets of the financial industry. Part VI analyzes the Reform Proposal's treatment of hedge funds and other private equity pools and (A) argues that the Reform Proposal does not significantly advance regulation beyond the now defunct Hedge Fund Rule because it fails to recognize an exception for venture capital funds and other private equity funds (which are in many ways dissimilar to hedge funds and therefore should not be governed by one blanket regulation); (B) analyzes certain ambiguities that need to be addressed by pending legislation; and (C) argues that the Reform Proposal does not address the risks actually posed to the market by hedge funds and private equity, and similarly, does not appreciate certain benefits that hedge funds and private equity bring to the market. Part VII of this article analyzes pending legislation in this area vis-à-vis the Reform Proposal. Part VIII concludes the article.

II. Structural Differences and Different Objectives of Hedge Funds, Venture Capital Funds, and More Common Types of Private Equity

Hedge funds, venture capital funds and other private pools of equity can be grouped together because they all share the common feature of exemption from registration under the federal securities laws. As discussed in Part III, however, there are significant differences between them. Section 5 of the Securities Act of 1933

---

[15] Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1-80b-18a (2006).

[16] Registration of Certain Hedge Fund Advisers, Exchange Act Release No. IA-2333, 17 C.F.R. §§ 275, 279 (Feb. 10, 2005); Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 874 (D.C. Cir. 2006).

(the "Securities Act")[17] prohibits companies from offering or selling securities prior to filing a registration statement with the United States Securities and Exchange Commission (the "SEC").[18] Limited partnership interests in hedge funds, venture capital funds and other types of private equity are typically viewed as securities under federal securities law. However, pursuant to the non-public offering exemptions under § 4(2) of the Securities Act and the rules thereunder,[19] these investment vehicles may raise capital via private offerings and generally do not register with the SEC.

The definition for hedge funds given on the SEC's website compares hedge funds to mutual funds (a highly regulated and generally lower risk investment type), in that they "pool investors' money and invest those funds in financial instruments in an effort to make a positive return."[20] However, hedge funds differ from mutual funds in various ways, including that they "typically issue securities in 'private offerings' that are not registered with the SEC under the Securities Act . . . [and they are] not required to make periodic reports" under the Securities Exchange Act of 1934, as amended (the "Exchange Act").[21] While hedge funds are subject to fraud prohibitions as are mutual funds,[22] and while hedge fund managers owe a fiduciary duty to their clients as do registered and exempt investment advisers, hedge funds are extremely opaque to the public regarding their investment practices, and often pursue high amounts of leveraging and speculative investments that may increase their risk.[23] No longer a new and unfamiliar investment structure amongst industry participants, hedge funds are monitored by the use of a variety of reputable hedge fund indices,[24] and hold a significant place

---

[17] Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2006).
[18] 15 U.S.C. § 77(e) (2006).
[19] 15 U.S.C. § 77(d) (2006).
[20] U.S. Sec. and Exch. Comm'n, *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, http://www.sec.gov/answers/hedge.htm (last visited Nov. 12, 2009).
[21] *Id.*; Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78oo (2006).
[22] 15 U.S.C. § 80b-6(1) (2006) (prohibiting investment advisers from using "any device, scheme or artifice to defraud any client or prospective client"); 15 U.S.C. § 80b-6(2) (prohibiting investment advisers from partaking "in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client").
[23] FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 5.
[24] Barclay Hedge Fund Indices, http://www.barclayhedge.com/research/hedge-funds-indices.html (last visited Nov. 12, 2009); Credit Suisse/

in the national economy, accounting for approximately 18-22% of all trading on the New York Stock Exchange.[25]

Hedge funds are normally structured as a limited partnership, with the general partner being an investment manager (or in some cases, an off-shore corporation) and each investor being a limited partner.[26] Larger funds, commonly called "funds of funds" within the industry, adopt a master-feeder structure, by which a diverse group of individual investors can invest into a variety of feeder funds with different domiciles and differing tax treatments. Each of these feeder funds' assets, however, falls under the umbrella of a master fund structure managed by the investment manager.[27] In addition to differing in structure from mutual funds,[28] hedge funds also employ a diverse range of trading strategies, which make the funds even more difficult to classify into a cohesive and homogenous grouping. For example, these strategies can be made up of a composite of different investment styles (whether these be event-driven based on certain events impacting the market, or trades based on market direction or

---

Tremont Hedge Fund Index, http://www.hedgeindex.com/hedgeindex/en/default.aspx?cy=USD (last visited Nov. 12, 2009); Dow Jones Hedge Fund Indexes, http://www.djhedgefundindexes.com/ (last visited Nov. 12, 2009); Hedge Funds Consistency Index, http://www.hedgefund-index.com/ (last visited Nov. 12, 2009); Standard & Poor's Hedge Fund Index, http://www.sp-hedgefundindex.com/ (last visited Nov. 12, 2009).

[25] *Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 9 (July 22, 2009) (statement by Mary L. Shapiro, Chairman, Sec. and Exch. Comm'n) ("Hedge Funds reportedly account for 18-22 percent of all trading on the New York Stock Exchange."); Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 100 (2008) ("Today, it is estimated that hedge funds account for over half of the daily trading volume of the New York Stock Exchange . . . ."); Stephen M. Davidoff, *Do Retail Investors Matter Anymore?*, N.Y. TIMES, Jan. 17, 2008, http://dealbook.blogs.nytimes.com/2008/01/17/do-retail-investors-matter-anymore/ (estimating that hedge fund trading may exceed 60% of the daily trading volume on the New York Stock Exchange and Nasdaq).

[26] Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. OF ECON. PERSPECTIVES 189, 190 (1999).

[27] THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT B-1-B-2 (Apr. 1999).

[28] MARK JICKLING, CONGRESSIONAL RESEARCH SERVICE, HEDGE FUNDS: SHOULD THEY BE REGULATED? 1 (July 2009).

relative value (arbitrage)), which commonly include some type of long and short position in shares traded on public stock exchanges.[29]

Hedge funds differ from other investment funds in that they generally pay a performance fee to their investment managers in addition to a management fee, which is typically paid to the manager in the other types of funds discussed in this article.[30] The management fee is usually a percentage of the fund's "net asset value" ("NAV"), and can range from anywhere between 1% and 4% of the fund's NAV per annum.[31] Recent economic pressure, however, has caused some to question whether the industry will reduce its typical 2% management fee and 20% performance fee structure (a "2 and 20" structure) to a "1 and 10" fee structure, for example, if driven to do so by client demand and economic factors.[32] The management fee is meant to cover operating costs of the manager and can sometimes constitute a large portion of the investment manager's profit.[33] Performance fees on the other hand, are calculated by taking a percentage of a hedge fund's annual profits, as opposed to its NAV.[34] Performance fees can count both realized and unrealized profits[35] and are meant to link the interests of the investment manager more closely to the interests of the hedge fund, thereby creating an incentive for the hedge fund manager to generate returns for the fund.[36] Hedge fund performance fees are generally about 20% of the fund's annual profits, but can be more for funds that are considered to be high-performance, managed by experienced and sought-after managers.[37] As discussed earlier in this paragraph,

---

[29] THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at 2-3; Gibson, *supra* note 4, at 684.

[30] THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at A-1.

[31] U.S. Sec. and Exch. Comm'n, *supra* note 20.

[32] *Finance and Economics: One-and-Ten; Hedge Funds*, 390 ECONOMIST 82, 82 (2009).

[33] STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at 61.

[34] *Hedge Fund Performance Fees*, HEDGEFUNDEXCHANGE.NET, Nov. 9, 2008, http://www.hedgefundexchange.net/exchange/content/view/121/9/.

[35] Hannah M. Terhune, *Hedge Fund Management and Performance Fees*, HEDGE FUND ASSOCIATION ASIA, Dec. 11, 2007, http://www.asiahfa.com (follow "articles" hyperlink; then follow "Hedge Fund Management and Performance Fees" hyperlink).

[36] U.S. Sec. and Exch. Comm'n, *supra* note 20.

[37] *Finance and Economics: One-and-Ten; Hedge Funds*, *supra* note 32. (speculating that ten percent performance fees may become prevalent in the

both management fees and performance fees may face downward pressure if investors demand fee reductions. It is unclear, however, whether highly-profitable funds will reduce their fees so long as the interests of investors and managers are aligned.[38]

One criticism of performance fees is that they allow managers to share in profits, but do not sufficiently penalize managers by requiring them to share in the loss when the fund underperforms and does not increase value for its investors.[39] This apparent inequity is sometimes addressed by the imposition of a "high water mark" or "loss-carryforward provision" on profits, meaning that the percentage performance fee is only applied to the amount of profits which exceed the NAV of the fund for the highest NAV it has previously achieved.[40] Limiting profits in this manner links the performance fee to the manager's ability to increase the NAV of the hedge fund, thus rewarding the manager only when the fund's profits exceed the high water mark.[41] In fact, the imposition of a high water mark can have the effect of penalizing a hedge fund manager even when the fund profits; for example, if the fund starts the year below the high water mark, and the manager is able to

---

hedge fund industry if the industry continues to suffer losses as it did in 2008); David Walker, *Hedge Fund Fees Too High?*, WALL ST. J., Jan. 19, 2009, http://online.wsj.com/article/SB123233781410094455.html; U.S. Sec. and Exch. Comm'n, *supra* note 20; *see also* Sam Jones & Kate Burgess, *Pressure To Reduce '2 and 20' Hedge Fund Fees*, FIN. TIMES, Aug. 2, 2009, http://www.ft.com/cms/s/0/0f547a3c-7f81-11de-85dc-00144feabdc0.html (discussing the 3 and 50 fund structure of SAC, a hedge fund group run by Steven Cohen).

38 Jones & Burgess, *supra* note 37 ("Instead the real focus is on the 'alignment' of interests between managers and their clients.").

39 *Hedging Their Bets: How Hedge Funds Can Curb Critics and Avoid Regulation*, KNOWLEDGE@WHARTON, Nov. 12, 2008, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2088 ("Even when a hedge fund loses money, the manager still keeps 2% of invested assets, about double the fee charged by a mutual fund.").

40 THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at A-1; Eliot D. Raffkind, *Frequently Asked Questions Concerning Investment Limited Partnerships (Hedge Funds)*, Mar. 2006, at 2, http://www.akingump.com/ (follow "publications" hyperlink; then search "Frequently Asked Questions Concerning Investment Limited Partnerships").

41 William N. Goetzmann, Jonathan E. Ingersoll Jr. Jr. & Stephen A. Ross, *High Water Marks And Hedge Fund Management Contracts* 1 (Yale Sch. of Mgmt.—Int'l Cent. for Fin., Working Paper No. 00-34, 2001).

greatly increase the fund's profit (but not enough to exceed the high water mark), the fund manager earns no performance fee although the fund's value increased substantially. Alternatively, other firms impose a "hurdle" amount, which the fund must achieve before a performance fee will be charged to investors.[42] Generally, this hurdle amount is equivalent to an accepted benchmark rate in a lower risk investment, so any fee earned on the profits of the fund would require the fund to over-perform such benchmark.[43]

Note that the Advisers Act places certain limitations on the imposition of performance fees, specifically, to those investors who do not meet the requirements of the definition of "qualified client" under Rule 205-3, which provides an exemption from the compensation prohibition of § 205(a)(1) for investment advisers.[44] The term qualified client is defined as:

> (1). A natural person who or a company that immediately after entering into the contract has at least $ 750,000 under the management of the investment adviser; (2). A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:
>
> (A). Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $ 1,500,000 at the time the contract is entered into; or
>
> (B). Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 at the time the contract is entered into; or
>
> (3). A natural person who immediately prior to entering into the contract is:
>
> (A). An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or
>
> (B). An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his

[42] Terhune, *supra* note 35, at 4.
[43] *Id.*
[44] 17 C.F.R. § 275.205-3(a) (2009).

> or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.[45]

In essence, the qualified client term is largely the same as the "accredited investor" term (discussed below in Part III), however, it imposes a higher net worth requirement.[46] In addition to performance fees and management fees, hedge funds also generally charge investors a withdrawal fee or penalty for redeeming their investment before a certain time period (however, certain hedge funds have recently decided to waive such fees in an effort to respond to investor need).[47]

Hedge funds generally adopt a wider range of trading activities than other investment funds, and as their name suggests, sometimes "hedge" the risks involved in their investments by short-selling or investing in derivatives of the other elements in their portfolio in order to reduce their overall risk.[48] However, many hedge funds no longer hedge their investments and instead use the fact that they are not regulated, or very lightly regulated, as an opportunity to increase risk in order to increase the potential return on their investment.[49] Hedge funds are often heavily leveraged, meaning that the funds often borrow money for investment purposes in far greater amounts than the initial buy-in capital they receive from investors.[50] This can increase the funds' gains and losses by large magnitudes. In part to balance this risk and largely to qualify for certain exemptions under federal securities laws, hedge funds generally only receive

---

[45] 17 C.F.R. § 275.205-3(d) (2009).

[46] *What is a qualified client? Qualified client definition*, HEDGE FUND LAW BLOG, Sept. 17, 2008, http://www.hedgefundlawblog.com/what-is-a-qualified-client-qualified-client-definition.html.

[47] *Hedge Fund Platform Scraps Redemption Fees*, HEDGE FUNDS REVIEW, Apr. 8, 2009, http://www.hedgefundsreview.com/public/showPage.html?page=851592.

[48] ALEXANDER INEICHEN & KURT SILBERSTEIN, AIMA's ROADMAP TO HEDGE FUNDS 53, 132 (Nov. 2008).

[49] *See id.* at 25.

[50] THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at A-1-A-2.

investments from a limited set of "qualified clients" or "qualified purchasers" (as defined in Parts II and III, respectively, of this article) who are deemed financially fit to assess and understand the risks posed by such investments.[51]

Venture capital funds differ from hedge funds mainly in the type of assets that make up the fund's portfolio and the lack of a performance fee. Venture capital funds also differ from hedge funds in that they do not employ long-term leverage; instead, they utilize short-term leverage to fulfill capital needs and generally do not take on loans with a duration of over 90 days.[52] Venture capital funds usually provide companies with liquidity in exchange for an equity interest in an emerging or start-up company that the fund manager has determine has high growth potential.[53] An investment is realized after the target company either makes an initial public offering of shares of the company's stock pursuant to the rules set forth in the Securities Act (an "IPO") or is sold to another company. Venture capital funds typically avoid registration by maintaining institutional investors or financially sophisticated individual investors who fall under the definition of "qualified investors" or "accredited investors" under federal securities laws.[54] Like hedge funds, venture capital funds typically charge a management fee, which is paid to the fund's managers as consideration for managing the company.[55] Venture capital funds generally take some role in managing the companies they invest in, and such management can be more or less active depending on the fund and the investment.[56] Venture capitalists can mitigate their risk by pooling with other funds.[57] Furthermore, the

---

[51] STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at 12, 61.

[52] National Venture Capital Association, *Venture Capital Funds and Systemic Risk: An Analysis*, June 17, 2009, at 2, http://www.nvca.org/ (follow tab hyperlink "Research"; then follow "VC Industry Statistics Archive"; then follow "Search Documents"; then search "Systemic Risk").

[53] Bob Zider, *How Venture Capital Works*, 76 HARV. BUS. REV. 131, 133-34 (1998).

[54] *See generally* National Venture Capital Association, *Venture Capital Funds and SEC Disclosure: An Overview*, June 17, 2009, http://www.nvca.org/ (follow tab hyperlink "Research"; then follow "VC Industry Statistics Archive"; then follow "Search Documents"; then search "SEC Disclosure").

[55] Zider, *supra* note 53, at 135.

[56] *Id.* at 136 (explaining that venture capitalists' equity interests give them the flexibility to make management changes).

[57] *Id.* at 135.

institutional investors who invest in venture capital funds typically place only a "small percentage of their total funds into high-risk investments."[58] Venture capital funds make up a smaller percentage of the overall class of investment vehicles discussed in this article, and are currently on the decline.[59] These firms do not provide investors with a great amount of detail about the companies in which they invest. They do, however, conduct extensive diligence on their targets prior to adding a new company to their portfolio.[60]

President Obama's Reform Proposal also states the administration's intent to regulate "other private pools of capital, including private equity funds."[61] This catch-all clause includes a wide strata of private equity investments including but not limited to leveraged buyouts, growth capital, distressed investments, mezzanine capital and the afore-mentioned venture capital funding.[62] In effect, the administration's addition of this general and broad language sweeps up all private equity investment vehicles that are otherwise unregulated by the Reform Proposal into its reach. Private equity investments, as a class, share certain common characteristics. These investments usually consist of securities purchased from existing and operating companies that are not publicly traded and therefore generally exempt from registration under federal securities laws.[63] Like venture capital investments, other private equity investments often involve investments in existing companies. Unlike venture

---

[58] *Id.* at 133.

[59] *Venture Capital Fund Raising Drops 71 Percent in Q4,* REUTERS, Jan. 19, 2009, http://www.reuters.com/article/marketsNews/idUSN1937592920090120; Keenan Skelly, *Venture Capital Fund-Raising Plunges in First Half*, WALL STREET JOURNAL, July 8, 2009, http://blogs.wsj.com/venturecapital/2009/07/08/venture-capital-fund-raising-plunges-in-first-half/.

[60] Hal Nelson, *Note on Due Diligence in Venture Capital,* TUCK SCH. OF BUS. AT DARTMOUTH, Dec. 5, 2004, http://mba.tuck.dartmouth.edu/pecenter/research/pdfs/due_diligence.pdf. (discussing, generally, due diligence).

[61] FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 12.

[62] *See generally Private Equity Seminar Why Should You Care?*, ALEXANDER HUTTON, Feb. 19, 2009, AlexanderHutton.com (follow "News" hyperlink; then follow "02/19/09: Managing Director Conducts Private Equity Seminar" hyperlink; then follow "Private Equity Seminar Sampling" hyperlink) (listing common private equity transaction structures).

[63] *See, e.g.*, THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at B-1 n.3.

capital funds, however, private equity investments (leveraged buyouts, for example) generally involve the purchase of a majority stake in such companies and typically only invest in mature companies versus start-up companies.[64] As discussed below, the Reform Proposal does not appear to suggest the adoption of substantially different regulatory treatment of these three broad categories of investments (hedge funds, venture capital funds, and private equity) despite their various significant differences.

III. Exemptions from Registration for Hedge Funds, Venture Capital Funds, and Other Common Types of Private Equity under Federal Securities Laws

The Investment Company Act regulates the practices of statutorily defined "investment companies," the most common of these being mutual funds.[65] Under the Investment Company Act, investment companies are required to register with the SEC. Although technically varieties of investment companies under the Investment Company Act, each of the investment fund structures discussed in this article are currently exempt from registration with, and from obligatory reporting to, the SEC because of certain exemptions available under the federal securities laws that generally apply to them.[66] The application of these exemptions can greatly impact the kinds of investment activities and the structures available to these investment funds. Mutual funds, for example, are a common form of registered investment company, which are subject to limitations on short-selling, leveraging and whose managers generally are prohibited from charging performance and incentive fees.[67] Because they are subject to the Investment Company Act,

---

[64] Thomas & Young, *supra* note 11, at 28.

[65] Goldstein v. U.S. Sec. & Exch. Comm'n v. Advance Growth Capital Corp., 470 F.2d 40, 42 (7th Cir. 1972).

[66] *See* THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at B-1-B-4.

[67] *Id.* at A-1 (discussing the prohibition on leverage); U.S. Sec. and Exch. Comm'n, *Mutual Fund Fees and Expenses*, SEC.GOV, Aug. 8, 2007, http://www.sec.gov/answers/mffees.htm (explaining accepted mutual fund fees).

mutual funds are prohibited from engaging in many of the practices that are common to hedge funds.[68]

As discussed above, hedge funds, venture capital funds and other types of private equity can usually seek exemption from registration under the Investment Company Act, pursuant to §§ 3(c)1 and 3(c)7 of the same, which both create exceptions to the definition of an "investment company" for purposes of the statute.[69] Section 3(c)1 of the Investment Company Act exempts from registration an issuer who has less than 100 beneficial owners if such issuer has not made a public offering.[70] Section 3(c)7 of the Investment Company Act exempts from registration an issuer who is offering and selling only to "qualified purchasers" under § 2(a)51-A of the Investment Company Act (defined in the next paragraph) and has not made a public offering.[71]

Unlike funds who seek the § 3(c)1 exemption, 3(c)7 exempt funds may have an unlimited number of investors so long as they each meet the criteria for a "qualified purchaser" under the Investment Company Act.[72] Section 2(a)51-A of the Investment Company Act defines a "qualified purchaser" as either: (i) a natural person who owns not less than $5,000,000 in investments, as defined by the SEC; (ii) a company that owns not less than $5,000,000 in investments and which company is "directly or indirectly [owned] by or for" at least two "natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;"[73] (iii) certain trusts that are not covered by clause "(ii)"; and (iv) "any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments."[74]

---

[68] JICKLING, *supra* note 28, at 1 ("Hedge funds are essentially unregulated mutual funds.").

[69] 15 U.S.C. §§ 80a-3(c)1, 3(c)7 (2006); THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at B-1-B-4.

[70] 15 U.S.C. § 80a-3(c)1; THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at B-1-B-4.

[71] 15 U.S.C. § 80a-3(c)7.

[72] 15 U.S.C. §§ 80a-3(c)1, 3(c)7.

[73] 15 U.S.C. § 80a-2(a)51-A (2006).

[74] *Id.*

The Securities Act and the Exchange Act also operate to regulate the actions of hedge funds and other private equity investment vehicles in the event that certain exemptions do not apply. Section 5 of the Securities Act prohibits companies from offering or selling securities[75] prior to filing a registration statement with the SEC.[76] Pursuant to the Securities Act, only companies that raise funds from the general public must comply with the Securities Act's disclosure requirements.[77] Therefore, hedge funds and other private equity funds that raise capital through private offerings do not have to disclose anything about their financial strength, balance sheet or trading activities to the SEC. The non-public offering exemptions under Section 4(2) of the Securities Act and the rules thereunder (which dictate certain requirements for structuring a private offering in compliance with federal securities laws) were created to balance the costs of registration for smaller issuers who would be offering a limited number of securities to the public with the benefits to the

---

[75] Section 2(a)(1) of The Securities Act states:

> 1. The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
>
> 2. 15 U.S.C. § 77b (2006); Marine Bank v. Weaver, 455 U.S. 551, 555-56 (1982); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847-48 (1975).

[76] *See* § 5 of the Securities Act, 15 U.S.C. § 77e (2006).

[77] *See* § 4(2)2 of the Securities Act, 15 U.S.C. § 77d (2) (2006).

investing public from such registration, a benefit which the government concluded was not large enough to impose registration requirements on private issuers.[78]

Regulation D contains the rules and exemptions to the Securities Act by which private companies can avoid registration if they meet certain requirements.[79] The Regulation D safe-harbor is well-known in the industry for requiring companies to sell their securities to only those investors who qualify as "accredited investors" pursuant to the regulation.[80] Under Rule 506 of Regulation D, there is no limit on the number of accredited investors who may purchase securities.[81] The definition of accredited investor under Regulation D includes a variety of different categories of investors determined sophisticated enough to understand the risks of purchasing unregistered securities. Federal securities laws define the term accredited investor in Rule 501 of Regulation D as: (i) a bank, insurance company, registered investment company, business development company or small business investment company; (ii) an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million; (iii) a charitable organization, corporation or partnership with assets exceeding $5 million; (iv) a director, executive officer or general partner of the company selling the securities; (v) a business in which all the equity owners are accredited investors; (vi) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase; (vii) a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or (viii) a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.[82] Moreover, any entity "in which all of

---

[78] Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 689 (2000).

[79] 17 C.F.R. §§ 230.501-508 (2009).

[80] 17 C.F.R. § 230.502(b) (2009).

[81] 17 C.F.R. § 230.506 (2009).

[82] 17 C.F.R. § 230.501(a) (2009).

the equity owners are accredited investors" also qualifies as an accredited investor under Rule 501.[83] When combined with the exemptions in the Investment Company Act (both section 3(c)1 and 3(c)7 prohibit securities from being sold in a public offering), Regulation D effectively requires hedge funds, venture capital funds and other types of private equity seeking exemption from registration to enter into private offerings solely with accredited investors.[84]

The Exchange Act regulates all aspects of the securities markets and securities transactions, and imposes quarterly reporting requirements on issuers who have more than 499 investors.[85] Although a fund otherwise exempt from registration pursuant to section 3(c)7 of the Investment Company Act must register pursuant to the Exchange Act if it has more than 499 investors, a fund can avoid registration with the SEC simply by keeping its number of investors below this statutory threshold.[86] The Exchange Act also requires a holder of securities over a certain percentage beneficial ownership to disclose the same.[87] Therefore, if a hedge fund owns more than the threshold amount of securities permitted under the Exchange Act's requirements, it must file the appropriate schedules with the SEC and disclose information related to the fund (just as would other investors with such percentage ownership), its officers, directors, principal business and the transactions which resulted in such beneficial ownership.[88] As evidenced by the current disclosures required by the Exchange Act for funds owning over a certain percentage of securities (and in contrast to what some proponents of increased regulation argue),[89] it is not as though hedge funds never have to make disclosures with the SEC. Further, although hedge funds and other private pools of equity can benefit from the private offering exemption to the Securities Act, these issuers must provide investors with extensive information about the securities for sale so that investors can make an educated decision; this information is

---

[83] *Id.*
[84] *See* STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at 89 n. 292.
[85] THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at B-3.
[86] *Id.*
[87] 15 U.S.C. § 78m (2006).
[88] *Id.*
[89] STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at 19-20.

contained in a detailed private placement offering memorandum.[90] Through these offering memorandums and disclosures of beneficial ownership, investors can obtain information pertinent to a fund and its management in order to determine whether to make an investment.

The Advisers Act regulates the practices of statutorily defined "investment advisers," including but not limited to pension fund managers, trust fund managers and mutual fund advisors.[91] The Advisers Act defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . ."[92] The statute specifically excludes from its definition of an "investment adviser" (a) banks and bank holding companies; (b) lawyers, accountants, engineers or teachers whose performance of such services is solely incidental to the practice of his profession; (c) brokers or dealers whose performance of such services is solely incidental to the practice of his profession; and other persons including newspaper publishers of financial publications, for example, who are not deemed within the intent of the statute as determined by the SEC from time to time.[93] If no exemption applies, the Advisers Act has the effect of requiring hedge funds, venture capital funds and other types of private equity to register with the SEC.

> Section 203(b)(3) of the Advisers Act provides an additional exemption from registration to any company who might otherwise qualify as an investment advisor but who, during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as

---

[90] *Monthly Feature: Hedge Fund Offering Documents*, HEDGE FUND LAW BLOG, Aug. 3, 2008, http://www.hedgefundlawblog.com/monthly-feature-hedge-fund-offering-documents.html.

[91] Thomas R. Lamme, *Registration Under the Investment Advisers Act of Certain Hedge Fund Advisers*, THOMPSON & KNIGHT CLIENT ALERT, Feb. 3, 2005, at 1, http://www.tklaw.com (follow "Publications" hyperlink; then search "Registration Under the Investment Advisers Act").

[92] 15 U.S.C. § 80b-2(a)(11) (2006).

[93] *Id.*

> an investment adviser to any investment company registered under subchapter I of this chapter, or a company which has elected to be a business development company pursuant to section 80a-53 of this title and has not withdrawn its election.[94]

The so-called "private adviser" or "small adviser" exemption to the Advisers Act (referred to herein as the "private adviser exemption") goes on to state that "no shareholder, partner, or beneficial owner of a business development company, as defined in this subchapter, shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner."[95] The current law permits each limited partner of a hedge fund, for example, to be viewed as an individual client, as opposed to each *individual investor* within each limited partnership being viewed as a client for the purposes of the statute.[96] The private adviser exemption is crucial to hedge fund managers because it allows them to potentially serve hundred of individual investors, so long as they have less than fifteen limited partner "clients" whose assets they manage.[97] Note that although the private adviser exemption allows these funds to avoid registration with the SEC under the Advisers Act, these funds are not exempt from the anti-fraud provisions of the federal securities laws (hedge fund fraud is discussed briefly in Part VI).[98] Again, it is important to note, however, that it is not as if hedge funds are currently utterly unregulated by federal securities laws. As discussed in Part VI, the SEC does not have ample resources to effectively combat fraud within hedge funds, and further, fraud is generally only dealt with after investors have already suffered a loss.[99] Pursuant to Rule 203(b)(3), the private adviser exemption,

---

[94] 15 U.S.C. § 80b-3(b)(3); U.S. Sec. & Exch. Comm'n Rule 203(b)(3)-1, 17 C.F.R. § 275.203(b)(3)-1 (2009).
[95] *Id.*
[96] *Id.*
[97] THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at B-16 ("As noted above, many hedge fund managers rely on the exemption from registration in § 203(b)(3) and rule 203(b)(3)-1.").
[98] *Id.* at B-13-B-14.
[99] Donahue, *supra* note 4, at 244 ("One problem is the SEC's inability to detect or deter the increased instances of hedge fund fraud. Most of the fraud occurs before the Commission is able to detect the problem, and

only applies if the investment advice provided is based on the objectives of, and provided solely to, the limited partnership, and not the individual investors which comprise such limited partnership.[100] As discussed in Part IV, below, the definition of "client" under the Advisers Act has been a source of great contention within the industry in recent years.

IV. Prior Attempts to Regulate Hedge Funds, Venture Capital Funds and More Common Types of Private Equity

In 1998, the then U.S. hedge fund giant, Long-Term Capital Management ("LTCM"), was bailed out under the supervision of the Federal Reserve by other banks and investment banks, after it suffered drastic losses in a downturn precipitated by global market conditions, including the 1997 East Asian financial crisis and the 1998 Russian financial crisis.[101] In the aftermath of the bailout and eventual folding of LTCM, regulators sought increased oversight over hedge funds to avoid a repeat occurrence of such a wide-spread financial crisis.[102] Despite this earlier discussion of increasing regulation, the regulation that later ensued could not rationally be called a reaction to the near collapse of LTCM; in fact, the bailout of LTCM did not immediately precipitate additional regulation and did not cause a decline in hedge fund investments.[103] The bailout did cause the SEC to look into the risks posed by large hedge funds such as LTCM and their trading activities in order to determine the potential for fraud.[104] In so doing, the SEC changed its approach to hedge funds, and in 2004, shortly after completing the study, the

---

therefore, investors are unable to get their money back."); STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at 76-77.

[100] THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at B-3 n.16.

[101] *See* KEVIN DOWD, CATO INSTITUTE, TOO BIG TO FAIL? LONG-TERM CAPITAL MANAGEMENT AND THE FEDERAL RESERVE 3 (1999); *see also* JOMO K.S., UNITED NATIONS, UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, GROWTH AFTER THE ASIAN CRISIS: WHAT REMAINS OF THE EAST ASIAN MODEL 30 (2001).

[102] *See* DOWD, *supra* note 101, at 9; *see also* ROGER LOWENSTEIN, WHY GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 143-60 (2000).

[103] Donahue, *supra* note 4, at 243 (stating that the amount of money in hedge funds doubled from 1999 to 2004).

[104] STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at x-xi.

SEC enacted a new rule that issued changes to certain regulations affecting investment advisers under the Advisers Act (the previously defined Hedge Fund Rule).[105]

The Hedge Fund Rule had the effect of requiring most hedge fund advisers (the general partner or hedge fund manager of the fund) to register as investment advisers with the SEC by a February 1, 2006 deadline.[106] Specifically, the Hedge Fund Rule redefined the term "client" to include shareholders, limited partners, members or beneficiaries of a "private fund" within its definition.[107] Under the new rule, for example, even funds with fewer than 15 investors would be subject to the new registration requirement if even *one* of their investors was a limited partnership comprised of more than one individual investor. Therefore, the Hedge Fund Rule had the effect of closing the private adviser exception discussed in Part III, supra, because limited partners of a fund usually contain well over fifteen individual investors (so all but the smallest funds would fall under the purview of the new Hedge Fund Rule).

Although apparently enacted to tighten regulation on hedge funds, the Hedge Fund Rule contained various exemptions. First, funds could avoid registration if their "lock-up" period was two years or longer.[108] This exemption would apply to funds with longer term investment strategies (customarily including private equity funds and venture capital funds).[109] In fact, in response to the Hedge Fund Rule, many hedge fund managers changed their lock-up period to two years or longer in order to take advantage of this loophole in the now defunct regulation.[110] Second, certain hedge funds interpreted the Hedge Fund Rule as only applicable to new investments.[111] Lastly,

---

[105] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,054 (Dec. 10, 2004). The rule that was created by this release was vacated on June 23, 2006. Lanzkron, *supra* note 6, at 1509 n.3.
[106] 69 Fed. Reg. 72,054, 72,087-89.
[107] *Id.*
[108] Jeff Benjamin, *Hedge Funds Exploit a Loophole*, INVESTMENT NEWS, Sept. 26, 2005, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20050926/SUB/509260745/1009/TOC.
[109] Thomas & Young, *supra* note 11, at 26.
[110] *Hedge Fund Lock-Up Period*, HEDGE FUND LAW BLOG, Dec. 17, 2008, http://www.hedgefundlawblog.com/hedge-fund-lock-up-period.html.
[111] *See* Thomas Kostigen, *Hedge Fund Hideaways: New Rules Don't Add Much Oversight*, MARKETWATCH, Nov. 15, 2005, http://www.marketwatch.com/story/new-rules-wont-add-much-oversight-on-hedge-funds?print=1&siteid=mktw.

funds that managed less than $25,000,000 of assets were not required to register under the Hedge Fund Rule.[112] This last exemption is actually more restrictive than some of the similar thresholds discussed in pending legislation. As discussed in Parts VI and VII, , some legislation currently pending before Congress proposes the adoption of a $30 million or a $50 million threshold.[113] Under this proposed legislation, hedge funds whose assets under management fall below the threshold would not be subject to new registration requirements and other related regulation.

In 2006 the Hedge Fund Rule was challenged in the United States Court of Appeals for the District of Columbia Circuit by petitioner Phillip Goldstein, on behalf of an investment advisory firm he co-owned and a hedge fund in which this advisory firm was the general partner and investment adviser.[114] In an opinion by Judge Randolph, the District of Columbia Circuit vacated the Hedge Fund Rule, holding that the SEC, in enacting the rule, failed to adequately explain "how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter."[115] In the opinion, Judge Randolph explained that it was more likely that the

---

[112] Anuj Gangahar, *SEC Rule Ignores Highest-Risk Category of Fund Fraud*, WEALTH BULLETIN, Oct. 31, 2005, http://www.wealth-bulletin.com/home/content/537169/.

[113] Mark W. Weakley, et al., *President Obama's Regulatory Reform Proposal Targets All Private Investment Funds*, HOLME ROBERTS & OWEN ALERT, June 19, 2009, at 1, http://www.hro.com/ (follow "Publications" hyperlink; then follow "President Obama's Regulatory Reform Proposal Targets All Private Investment Funds" hyperlink); G. Michael O'Leary, et al., *Obama Administration Announces Financial Regulatory Overhaul*, ANDREWS KURTH, June 24, 2009, http://www.akllp.com/pressroom-publications-641.html (follow "Press Room" hyperlink; then search "Publications" for "Obama Administration Announces Financial Regulatory Overhaul"), stating that:

> Although the [Obama administration's] Plan does not define the "modest threshold" for registration, there is one bill in the Senate (with one co-sponsor) that proposes a $50 million threshold, and other bills introduced in Congress that propose a $30 million threshold. Currently, investment advisers required to register must do so with the SEC if they have $30 million or more in assets under management.

[114] Goldstein v. U.S. Sec. & Exch. Comm'n, 451 F.3d 873, 874 (D.C. Cir. 2006).

[115] *Id.* at 882.

"client" referenced in the Advisers Act section 203(b)(3) is the limited partnership of the particular hedge fund, and not the individual partners or investors.[116] Further, the court did not find the SEC's purported policy goal (to reduce the national impact of hedge funds) related to the goal of the Hedge Fund Rule (which appeared to focus on investor protection).[117] The Hedge Fund Rule was ultimately vacated and remanded to the SEC for review.[118] After *Goldstein*, hedge funds were once again able to seek exemption from registration under the private adviser exemption to the Advisers Act.

Between the date of the *Goldstein* decision until the peak of the current economic crisis in late 2008, there have been no real attempts at new regulation in the area of hedge funds and private equity. In February 2007, the President's Working Group on Financial Markets rejected further regulation of hedge funds, instead positing that the industry should follow voluntary guidelines.[119] In 2007, the market was not yet experiencing visible symptoms of the soon to come financial crisis; in fact, in 2007, hedge funds enjoyed a highly successful year.[120]

V. The Current Economic Landscape Is the Impetus for New Regulation

Beginning in 2007, low interest rates, a steady influx of foreign funds,[121] a housing market that appeared impervious to loss or devaluation, and easy access to credit combined with several other factors (some disputed, some alleged), precipitated a (perhaps overly) optimistic view of the national economy.[122] When some of these

---

[116] *Id.* at 880.
[117] *See* Ladi, *supra* note 8, at 111.
[118] *See* Goldstein, 451 F.3d at 884.
[119] Press Release, U.S. Dep't. of the Treasury, President's Working Group Releases Common Approach to Private Pools of Capital Guidance on Hedge Fund Issues Focuses on Systemic Risk, Investor Protection (Feb. 22, 2007) (available at http://www.treasury.gov/press/releases/hp272.htm); Stephen Labaton, Officials Reject More Oversight of Hedge Funds, N.Y. TIMES, Feb. 23, 2007, at A1.
[120] Ladi, *supra* note 8, at 103.
[121] *When a Flow Becomes a Flood*, 390 ECONOMIST 75, 75 (2009).
[122] *See generally* KATALINA BIANCO, THE SUBPRIME LENDING CRISIS: CAUSES AND EFFECTS OF THE MORTGAGE MELTDOWN (May 2008) (stating that several factors including the housing bubble and unregulated lending spurred an overly optimistic view of the nation's economy in 2007).

components (including the housing and credit bubble) became more fragile, individual investors began rapidly defaulting on their mortgages and loans.[123] At the same time, larger institutions such as investment banks and hedge funds found themselves with little financial leeway to absorb losses resulting from multiple loan defaults. With larger banks and financial institutions unable to extend credit to others in the market, what resulted was the financial difficulty the nation has experienced in the past two years (the "2007-2009 Economic Downturn").[124]

Secretary Timothy F. Geithner's written testimony recently issued to the United States House of Representatives Financial Services Committee on September 23, 2009, aptly described the peak of the financial crisis as follows:

> In September [of 2008] alone, Fannie Mae and Freddie Mac were put into government conservatorship. Lehman Brothers collapsed. Merrill Lynch, Wachovia and Washington Mutual were acquired in distress. A $62 billion dollar money market fund "broke the buck." The world's largest insurer avoided bankruptcy only with the help of $85 billion in emergency aid. Goldman Sacks and Morgan Stanley announced they would protect themselves by becoming bank holding companies. When Congress' first attempt to pass the Emergency Economic Stabilization Act (EESA) failed, the stock market took a historic plunge.[125]

In addition to an already tumultuous economic climate, instances of fraud within the financial system, such as the Madoff scandal, a Ponzi-scheme of staggering proportions,[126] surfaced in the media.

While incidents such as the Madoff scandal did not specifically involve hedge fund fraud, a fear has grown amongst the public that the lack of transparency amongst hedge funds and similar vehicles could result in their involvement in a fraud of a similar

---

[123] FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 2.
[124] *Id.*
[125] Press Release, U.S. Dep't. of the Treasury, *supra* note 13.
[126] *Times Topics: Bernard L. Madoff*, N.Y. TIMES, Aug. 11, 2009, http://topics.nytimes.com/top/reference/timestopics/people/m/bernard_l_madoff/index.html.

magnitude.[127] Prior to such cataclysmic events in the financial industry, hedge funds and other private actors were largely able to operate within the gray area provided by exemptions to regulation, and were infrequently successfully infiltrated by the SEC in relation to allegations of fraud.[128] It is within this framework that the Obama administration seeks to move forward with increased and comprehensive regulation of the financial industry, proposing to make regulations consistent between agencies, and eliminate provisions which provide exemptions to certain financial institutions but not others (despite shared characteristics). Although the 2007-2009 Economic Downturn is in some ways an opportune justification for a complete review of the financial system (the Securities Act and the Exchange Act are, after all, products of the Great Depression), regulators should take heed to not simply reinstate rules which were previously unsuccessful, and to observe the different risks and problems created by each market participant, in order to avoid the enactment of heavy-handed regulations which may have the effect of stifling growth in sectors of the industry, and forcing economic development and capital formation to leave the United States for more amenable jurisdictions.[129]

---

[127] Benjamin N. Alpert, *Madoff Reminds Investors (Painfully) to Do Their Homework*, MORNINGSTAR, Jan. 29, 2009, at 1, http://hedgefunds.datamanager.morningstar.com (follow "Research" hyperlink; then follow "Madoff Reminds Investors (Painfully) to Do Their Homework" hyperlink).

[128] Joseph Lanzkron, *The Hedge Fund Holdup: The SEC's Repeated Unnecessary Attacks on the Hedge Fund Industry*, 73 BROOK. L. REV. 1509, 1531 (2008) (stating that in 2004, then-SEC Commissioner Paul Atkins concluded that only twenty-six cases of fraud would have been prevented by the Hedge Fund Rule within an industry then comprised of 7,000 funds); *see also* Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Testimony before the U.S. House of Representatives Comm. on Fin. Servs., 111th Cong. (2009) (statement of Mary L. Schapiro, Chairman, U.S. Sec. and Exch. Comm'n) ("The securities laws have not kept pace with the growth and market significance of hedge funds and other private funds and, as a result, the Commission has very limited oversight authority over these vehicles.").

[129] Ladi, *supra* note 8, at 136; STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at 10 (explaining the benefits of other jurisdictions' laws relating to hedge funds).

VI. The Reform Proposal Does Not Provide Exemptions for Other Types of Private Equity and Venture Capital Funds, Contains Various Ambiguities and Does Not Provide Protection Against the Actual Risks Posed to the Market by Hedge Funds, Venture Capital Funds and Private Equity

The Reform Proposal is an amalgamation of opinion developed with input from various members of Congress, including United States House of Representatives Financial Services Chairman Barney Frank (D-MA),Senate Banking Committee Chairman Chris Dodd (D-CT) and other stakeholders.[130] As discussed in Part I of this article, the Reform Proposal's regulations would sweep across all sectors of the financial system, and would specifically authorize the centralization of the financial system and appointment of the Federal Reserve to police the market and liaise with other agencies in order to ensure compliance, as well as the creation of a new Consumer Financial Protection Agency (a proposal which has already lost muster as of the date of this writing).[131]

Within the broad category of promoting "robust supervision and regulation of financial firms,"[132] the Reform Proposal specifically discusses the proposed registration of hedge funds, venture capital funds and other pools of private equity, as discussed in Part I of this article. Currently, some funds that trade commodities or futures are required to register with the United States Commodity Futures Trading Commission (the "CFTC").[133] Other hedge funds volunteer to register based on their preference.[134] The Reform Proposal envisions a regime in which all funds would register, regardless of the securities or commodities they trade and for some

---

[130] Edward G. Eisert & Mark J. Duggan, *The Obama Plan for Financial Services Regulatory Reform: A New Foundation or An Ambitious Renovation?*, K&L GATES, June 22, 2009, http://www.klgates.com (follow "Newsstand" hyperlink; then search "A New Foundation or An Ambitious Renovation"; then follow "The Obama Plan for Financial Services Regulatory Reform: A New Foundation or An Ambitious Renovation?" hyperlink).

[131] *Id.*; Chris Walters, *Consumer Financial Protection Agency Gets Watered Down*, THE CONSUMERIST, Sept. 24, 2009, http://consumerist.com/5367103/consumer-financial-protection-agency-gets-watered-down.

[132] FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 10.

[133] O'Leary, et al., *supra* note 113.

[134] *Id.*

funds, regardless of their preference.[135] Further, "[o]nce a hedge fund [or other regulated fund under the Reform Proposal] is an SEC-registered investment adviser," the regulation of the fund does not end.[136] The Reform Proposal goes on to state that these SEC-registered investment advisers should, following registration, be subject to "recordkeeping requirements with respect to investors, creditors, and counterparties."[137] While it is unclear how the SEC will use such information, some predict that requirements will be imposed to ensure that a third-party verifies a fund's assets, "meaning another entity is certifying there are assets in the portfolio, so there is no such situation that people are making up assets and that the assets are valued properly."[138]

Specifically, new regulation affecting hedge funds and private equity would require these funds to make disclosures to their investors, creditors and counterparties, be subject to SEC targeted examinations for compliance purposes, and report on a confidential basis the particular fund's NAV, as well the percentage they are leveraged, including off-balance sheet liabilities.[139] The purpose for these additional "enhanced" disclosures would be to provide regulators with a tool by which they could assess which registered investment advisers (hedge funds, venture capital funds etc., as the case may be) are too large, too leveraged or too interconnected, thereby fitting in to the category of "Tier 1 FHCs" (which would include investment banks and the largest, most interconnected financial institutions), which the Reform Proposal argues require increased supervision and regulation.[140]

As stated by Chairman Mary L. Schapiro in her July 22, 2009 testimony concerning the Reform Proposals before the United States House of Representatives Committee on Financial Services, the SEC currently

---

[135] *Id.*
[136] Ivy Schmerken, *Obama Plan Would Require Hedge Funds to Register with the SEC and Report on Exposures*, WALL STREET & TECHNOLOGY, July 15, 2009, http://www.wallstreetandtech.com (search "Obama Plan Would Require Hedge Funds to Register"; then follow "Obama Plan Would Require Hedge Funds to Register with the SEC and Report on Exposures" hyperlink).
[137] *Id.*; FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 37.
[138] Schmerken, *supra* note 136.
[139] O'Leary, et al., *supra* note 113.
[140] *Id.*

> only has authority to conduct compliance examinations of those funds and advisers that are registered under one of the statutes [administered by the SEC] . . . . [P]rivate funds and many of their advisers are outside the purview of the SEC, and we have no detailed insight into how they manage their trading activities, business arrangements or potential conflicts-of-interest.[141]

Further, Chairman Schapiro highlighted the fact that lack of registration and reporting requirements applicable to hedge funds and private equity prevent the SEC form obtaining detailed information concerning these funds' "trading activities, business arrangements (including any leverage) and conflicts-of-interest," leaving the SEC with no choice but to base the data it compiles on hedge funds and other unregistered private equity funds (which is supplied to Congress as requested) on unreliable industry sources.[142]

However, it is unclear that increased supervision in the form suggested by the Reform Proposal will actually protect against the kind of system-wide financial collapse that contributed to the 2007-2009 Economic Downturn. For example, some argue that hedge funds do not present any more risk to the market than larger, more interconnected and "conventional" financial institutions—especially those institutions engaged in risky practices such as high degrees of leveraging or unfettered investment in the subprime mortgages which contributed to the financial collapse.[143] Regulatory measures may better protect market stability and investors alike if they were to focus on the assets that funds and institutions may invest in, the amount of leverage made available to funds and the sophistication of the investors. These arguments are discussed here, in Part VI and in Part VII.

The Reform Proposal's treatment of these funds is problematic for three reasons: (A) the Reform Proposal fails to recognize an exception for venture capital funds and other private equity funds that are in many ways dissimilar to hedge funds and therefore should not be governed by one blanket regulation; (B) the

141 Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Testimony before the U.S. House of Representatives Comm. on Fin. Servs., *supra* note 128.
142 *Id.*
143 Ladi, *supra* note 8, at 128.

Reform Proposal contains certain ambiguities that need to be addressed by pending or enacted legislation; and (C) the Reform Proposal does not comprehensively address the risks and problems posed to the industry by hedge funds or private equity any better than the now defunct Hedge Fund Rule.

A. The Reform Proposal Fails to Recognize an Exception for Venture Capital Funds and Other Private Equity Funds

In its discussion of hedge fund and private equity registration, the Reform Proposal explains that the new regulations would impose a registration requirement on "[a]ll advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold . . . to register with the SEC under the [Advisers Act]."[144] Further, "[t]he advisers should be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability."[145] These "private pools of capital" are not itemized specifically in the Reform Proposal, however, and the category will likely include investment funds (such as venture capital funds and private equity) that currently rely upon exemptions from registration under the Investment Company Act.[146]

The Reform Proposal, by requiring registration of hedge funds, private equity, and venture capital funds, essentially supports the adoption of the Hedge Fund Rule in its entirety but makes important revisions including the eliminations of certain exemptions discussed in Part IV, above (specifically, the exceptions for funds requiring a two-year (or more) lock-up and the $25,000,000 threshold).[147] Notably, the Reform Proposal does not call for the elimination of the private adviser exception to the Advisers Act, but

---

[144] FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 12.
[145] *Id.*
[146] Eisert & Duggan, *supra* note 130.
[147] *See supra* at Part IV; *see also* Weakley, et al., *supra* note 113, at 1 ("While the short-lived SEC rule did not apply to funds that required two-year capital lock-ups (essentially a carve out of customary private equity and venture capital funds) the Reform Proposal applies to all private investment funds.")

pending legislation, discussed in Part VII, appears to do so.[148] The Reform Proposal states that it may treat various pools of equity differently from a regulatory perspective, but it is unclear as of yet whether legislation will in fact use a scalpel or a hatchet to regulate in this area.[149] What is certain is that the Obama administration is strongly advocating the regulation of previously unregulated funds; for example, Secretary Geithner recently reaffirmed the Reform Proposal's application to hedge funds in his testimony before the United States House of Representatives House Financial Services Committee, stating that the new regulations will "bring unregulated firms and markets in to the system by requiring the registration of hedge funds, and setting clear rules for all derivatives markets."[150] However, some commentators believe it is possible that requirements regarding a fund's obligation to report specific information to the SEC may differ depending on the type of hedge fund or other private equity pool.[151] Different tiers of regulation are warranted given the broad range of risks and trading practices employed by hedge funds, venture capital funds and private equity investments. As discussed in Part III, venture capital funds do not leverage themselves to anywhere near the degree as do hedge funds, and do not trade in real-time on public markets;[152] instead, venture capital funds invest in the infrastructure of a company and manage and help grow the company until an exit point, usually an IPO.[153]

While hedge funds may arguably be susceptible to certain risks that may need to be supervised by the government (even if the industry cannot agree on how to do so), venture capital funds, which have for the first time become the subject of proposed regulation, do not contribute to most of those risks.[154] Venture capital funds make up an extremely small, some say almost negligible, percentage of the market in relation to other comparable investment vehicles,[155] and

---

[148] *See infra* at Part V; *see also* Eisert & Duggan, *supra* note 130.
[149] *See* FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 37.
[150] Press Release, U.S. Dep't. of the Treasury, *supra* note 13.

[151] O'Leary, et al., *supra* note 113.
[152] *See supra* at Part III; *see also* National Venture Capital Association, *supra* note 54.
[153] Zider, *supra* note 53, at 132.
[154] *Trade Group Resists Obama's Financial Regulatory Plan*, WRAL.COM, June 18, 2009 http://www.wral.com/business/story/5381869/.
[155] National Venture Capital Association, *supra* note 54.

further, as discussed in Part III, many argue that venture capital investment is currently on the decline.[156] Some within the venture capital and private equity industry, such as the Private Equity Counsel, a Washington, D.C. based organization, have stated that "[w]hile we and most experts agree that private equity firms do not create systemic risk, we also support the concept of data collection from market participants and we look forward to reviewing more detailed proposals as the legislative process unfolds."[157] The Private Equity Council includes such members as "Apax Partners; Apollo Global Management LLC; Bain Capital Partners; The Blackstone Group; The Carlyle Group; Hellman and Friedman LLC; Kohlberg Kravis Roberts & Co.; Madison Dearborn Partners; Permira; Providence Equity Partners; Silver Lake; and TPG Capital," and because of the inclusion of such industry giants within the Private Equity Council, some have posited that no serious challenge to the Reform Proposal will be heard from within the private equity community.[158]

On the other hand, the National Venture Capital Association has also voiced its opinion on the issue of increased oversight for venture capital funds in light of the 2007-2009 Economic Down-

---

[156] *See supra* at Part II; *see also* H.R. 711, 111th Cong. (2009); Jonathon M. Aberman, *The Decline of the United States Venture Capital Industry*, AMPLIFIER VENTURE PARTNERS, Sept. 21, 2009, http://www.amplifierventures.com/tabid/237/Default.aspx; Anthony Ha, *It's Official: Venture Investment Declined in Q1*, VENTUREBEAT, Apr. 18, 2008, http://venturebeat.com/2008/04/18/its-official-venture-investment-declined-in-q1/; *Venture Capital Fund Raising Drops 71 Percent in Q4*, *supra* note 59;

Skelly, *supra* note 59; *Venture Capital Performance Statistics Decline Across All Time Horizons in the Fourth Quarter*, Apr. 27, 2009, http://www.nvca.org/ (follow tab hyperlink "Research"; then follow "VC Industry Statistics Archive"; then follow "Search Documents"; then search "Venture Capital Performance Q4 2008"; then follow "Venture Capital Performance Q4 2008" hyperlink).

[157] Press Release, Private Equity Council, Private Equity Council Issues Statement on Administration's Financial Regulatory Proposal (June 17, 2009) (available at http://www.privateequitycouncil.org/press-releases/2009/06/17/pec-issues-statement-on-administrations-financial-regulatory-proposal/).

[158] Weakley, et al., *supra* note 113, at 3.

turn.[159] While it agrees reform is needed, the organization asserts that the Reform Proposal is overbroad, "sweeping in" venture capital funds that, as a small business helps to assist innovation and entrepreneurs, do not pose the same risks as hedge funds on the market.[160] For example, the venture capital industry has contributed to the growth and eventual IPOs of many small businesses, particularly in the "dot com" boom of the 1990s, and in areas such as Silicon Valley, where entrepreneurs took financial risks to provide funding for many new innovations and technological advancements.[161] According to Secretary Geithner, any reform to the financial system should be careful not to reduce innovation in consumer financial products.[162] However, the Reform Proposal appears to do literally just that, not only by proposing regulations which could change the character of venture capital funds, hedge funds, and the like, but by advocating for the regulation of the very types of funds that have supported innovation and advancement in other industries as well.

---

[159] *Trade Group Resists Obama's Financial Regulatory Plan*, *supra* note 154.
[160] *Id.*
[161] Jonathan M. Aberman, the Managing Director of Amplifier Venture Partners, wrote:

> Over the last 30 years, the private venture capital industry has been a primary driver for technology company creation, intellectual property commercialization and small business employment in the United States. Simultaneously, the federal government has played a strong role as a driver of basic research and intellectual property creation. The symbiotic relationship between the federal government's encouraging invention and the private venture capital market's financing of innovation has created new industries and commercialized a wide range of technologies.

Aberman, *supra* note 156, at 1; Venture Capital Investment Firms, *The History of Venture Capital*, http://www.venturecapitalinvestmentfirms.com/history-venture-capital (last visited Nov. 14, 2009) ("The emergence of Silicon Valley in California made San Francisco into a center for venture capital investment.").
[162] Press Release, U.S. Dep't. of the Treasury, *supra* note 13.

B. The Reform Proposal Contains Certain Ambiguities That Need To Be Addressed by Pending or Enacted Legislation

There are various ambiguities within the Reform Proposal that could have potentially detrimental effects on the hedge fund and private equity sector depending on how these proposals are interpreted and enacted into law. There is almost no detail provided in the Reform Proposal concerning the specific types of funds to be regulated. One long-standing ambiguity that the Reform Proposal does not address in any way is the lack of a workable definition of a hedge fund. In 2003, the SEC issued comments arising out of a Roundtable on Hedge Funds that recognized at least a dozen different definitions for the term used to describe the investment vehicle.[163] With such broad-reaching potential consequences (including the imposition of registration and reporting requirements as detailed in the Reform Proposal) following the conclusion that a particular fund is a "hedge fund" for purposes of the federal securities laws, it seems only appropriate that the Reform Proposal make an effort to clearly delineate the boundaries of this category. As the United States Court of Appeals for the District of Columbia Circuit stated in *Goldstein* (concerning the definition of the word "client" in the Advisers Act), just because a term is "susceptible of several meanings, as many terms are, it scarcely follows that Congress has authorized an agency to choose *any* one of those meanings."[164] To avoid the ambiguity of terms that lead to *Goldstein*, legislation should address the lack of a proper definition of a hedge fund and make an effort to clearly define the term, lest it be subject to multiple meanings, each with different regulatory consequences.

Another ambiguity within the Reform Proposal is its failure to specify which funds would be too small to regulate. Historically, United States securities laws have espoused the policy that certain financial institutions may be too small to have a large impact on the market, and the costs of registering them may be too large for those institutions to bear, therefore, these smaller investment vehicles

---

[163] Lanzkron, *supra* note 6, at 1512; David A. Vaughan, Comments for the U.S. Sec. and Exch. Comm'n Roundtable on Hedge Funds, Selected Definitions of "Hedge Fund" (May 13, 2003) (available at http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm).

[164] Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 878 (D.C. Cir. 2006) (emphasis in original).

should be exempt from registration.[165] Although the Reform Proposal makes clear that only funds above a "modest" threshold of assets under management are implicated, there is no guidance concerning what a "modest" threshold is. If the threshold is too low, all but the smallest funds will be forced to register pursuant to new legislation. Pending legislation may provide guidance on the amount below which registration is not required; however, the numbers listed in pending bills before the House of Representatives and Senate differ in their interpretation of "modest," with proposals of \$30 million to \$50 million in assets under management.[166]

C. The Reform Proposal Does Not Significantly Advance Regulation Beyond the Now Defunct Hedge Fund Rule, Because It Does Not Address the Actual Risks That Hedge Funds, Venture Capital Funds and Private Equity Pose to the Market

While the Reform Proposal updates and revises the vacated Hedge Fund Rule by removing the exemptions concerning the two-year lockup exception, for example, the Reform Proposal does not suggest a more comprehensive and thoughtful approach to regulating hedge funds and private equity. Although it contains a caveat that certain pools of equity may be treated differently, there is no guarantee that legislation will follow the Reform Proposal and choose to do so.[167] Further, the Reform Proposal requires that registered investment advisers that are determined by the Federal Reserve to be "Tier 1 FHCs" will be subject to increased supervision and regulation.[168] As discussed above, this higher level of scrutiny

---

[165] Gibson, *supra* note 4, at 689.
[166] O'Leary, et al., *supra* note 113; Weakley, et al., *supra* note 113.
[167] FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 37.
[168] Financial Services Practice Group, Winston & Strawn LLP, *Obama Administration Proposes Comprehensive Reform of Financial Regulation: SEC Registration of Advisers to Hedge Funds and Other Private Pools of Capital; Harmonization of Securities and Futures Regulation and Investment Adviser/Broker-Dealer Regulation*, June 19, 2009, at 2, http://www.winston.com/ (follow "Resources" hyperlink; then follow "Publication" hyperlink; then follow "Briefings" hyperlink; then follow "Obama Administration Proposes Comprehensive Reform of Financial Regulation: SEC Registration of Advisers to Hedge Funds and Other Private

could leave hedge funds and private equity with no choice but to modify their trading strategies, and adopt practices more similar to those currently used by mutual funds and other larger institutions.

Alternatively, if hedge funds wish to continue operating in the same manner which they currently do, hedge funds have the option of moving off-shore to jurisdictions such as the Cayman Islands where hedge fund regulation is lax, in order to maintain their autonomy in trading strategies and leverage practices.[169] The risk of hedge fund managers moving to jurisdictions with "friendlier regulatory schemes" has been previously cautioned.[170] Particularly in the wake of the 2002 Sarbanes-Oxley Act ("Sarbanes-Oxley"),[171] "capital flight" was documented in studies as precipitated by increased regulation in the United States.[172] For example, some in the industry argue that the costs of compliance with Sarbanes-Oxley contributed to a reduction in the overall number of global IPOs ("IPOs of foreign companies that sell their shares outside their

---

Pools of Capital; Harmonization of Securities and Futures Regulation and Investment Adviser/Broker-Dealer Regulation" hyperlink).

[169] Ladi, *supra* note 8, at 136; STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at 10 (explaining benefits of other jurisdictions' laws relating to hedge funds).

[170] One commentator wrote:

> Domestically, increased regulation might well result in increased public confidence in the investor protection and market stability functions of the government. The advent of invasive regulation in the United States, however, could also result in the flight of hedge fund managers to countries with friendlier regulatory regimes. Further, overburdening regulation could make the U.S. securities industry less competitive, prohibiting the most efficient use of capital and decreasing the liquidity of American markets.

Matthew Lewis, *A Transatlantic Dilemma: A Comparative Review of American and British Hedge Fund Regulation*, 22 EMORY INT'L L. REV. 347, 383 (2008).

[171] Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002).

[172] Pierre Lemieux, *Capital Flight: The U.S. Sarbanes-Oxley Witch Hunt Has Forced IPOs Overseas. Canada Shouldn't Make the Same Mistake*, FIN. POST (CANADA), Nov. 30, 2006, http://www.independent.org/newsroom/article.asp?id=1862 ("Dr. Zingales attributes the relative decline of American capital markets partly to "excessive regulation and overly burdensome litigation risk" in the post-Sarbanes-Oxley period.").

domestic market"),[173] which is an "indicator of the dynamism of the U.S. economy."[174] As others have recognized, capital flight can be partially attributed to "improvements in regulation or financial sophistication by . . . overseas competitors."[175]

However, the domestic regulatory environment also plays a key role. For example, after Sarbanes-Oxley, it was observed by some that while global capital markets became more competitive, the United States was "likely to be punished for over-regulation."[176] Evidence of a new wave of capital flight has already been observed in light of the 2007-2009 Economic Downturn; when the large, formerly independent investment banks (and prime brokers to hedge funds)[177] Morgan Stanley and Goldman Sachs were converted into bank holding companies last year,[178] others predicted that the shift would cause "a serious contraction in the hedge-fund industry, which in turn would lead to sales of all manner of assets held by hedge funds."[179] In fact, to prevent such a capital flight from occurring throughout the hedge fund industry, some hedge funds imposed restrictions on redemptions and withdrawals of funds by investors.[180] Recently, law makers in the United Kingdom (a jurisdiction currently

---

173 Luigi Zingales, Initiative on Global Markets Is the U.S. Capital Market Losing its Competitive Edge? 2 (Univ. of Chicago Graduate Sch. of Bus., Working Paper, Nov. 2006).

174 *Id.*

175 Richard A. Epstein, *The Dangers of "Investor Protection" In Securities Markets*, 12 TEX. REV. L. & POL. 411, 423 (2008).

176 *Capital Flight*, WALL ST. J., Dec. 2, 2006, at A8; *Is Sarbanes-Oxley the Main Reason IPO Business is Going Overseas?*, SEEKING ALPHA, Aug. 7, 2006, http://seekingalpha.com/article/15088-is-sarbanes-oxley-the-main-reason-ipo-business-is-going-overseas.

177 *Emerging Markets Capital Flight Exacerbated by Goldman and Morgan Stanley Becoming Banks*, NAKED CAPITALISM, Oct. 28, 2008, http://www.nakedcapitalism.com/2008/10/emerging-markets-capital-flight.html.

178 Michael J. de la Merced, Vikas Bajaj & Andrew Ross Sorkin, *As Goldman and Morgan Shift, a Wall St. Era Ends*, N.Y. TIMES, Sept. 21, 2008, http://dealbook.blogs.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies/.

179 Robert Peston, *Goldman, Hungary, and Regulators*, BBC NEWS, Oct. 27, 2008, http://www.bbc.co.uk/blogs/thereporters/robertpeston/2008/10/goldman_hungary_and_regulators.html.

180 Cyrus Sanati, *Starting a Hedge Fund in a Shell-Shocked Age*, N.Y. TIMES, June 26, 2009, http://dealbook.blogs.nytimes.com/2009/06/26/starting-a-hedge-fund-in-a-shell-shocked-age/.

comparable to the United States in its favorable treatment of hedge fund managers),[181] when discussing the potential costs and benefits of increased regulation on hedge funds, recognized that any regulation would likely have the detrimental effect of forcing fund managers to reorganize their businesses off-shore.[182]
With the threat of capital flight already on the horizon and recognized by other jurisdictions, the United States should take care not to regulate the alternative investment vehicle industry to the point where the country is no longer an attractive jurisdiction to hedge fund managers.[183]

Increased supervision may appear to be the correct protection against the widespread failure of the financial system which resulted in the 2007-2009 Economic Downturn. However, this may not be the case. If hedge funds are forced to engage in the same practices as larger, more interconnected firms, what happens when the trading practices adopted by all firms is too risk-prone?[184] In a 2006 interview, Harvard Professor and Nobel Prize winner in Economics, Robert Merton, explained exactly how the distinct trading practices utilized by hedge funds can actually operate to benefit the health and stability of the financial system as a whole:

> From the point of view of the financial system, [a hedge fund's] function is important because they act as intermediaries of intermediaries. In this global world, the financial systems of different countries are not at all coordinated; the most clear example is that there are different currencies, tax systems, accounting . . . there are institutional rigidities that

---

[181] Ladi, *supra* note 8, at 121 ("London is second only to New York for location of hedge fund managers."); *see generally id.* for a comparative treatment of hedge fund regulation in US, UK and Germany.
[182] FINANCIAL SERVICES AUTHORITY, HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT ¶ 8.2, at 65 (June 2005) ("We recognise the highly mobile and international nature of the hedge fund industry and are conscious that it would not be beneficial if regulatory action caused the hedge fund industry to move to more lightly regulated jurisdictions.").
[183] Ladi, *supra* note 8, at 104 ("The United States and United Kingdom attract significant onshore hedge funds and hedge fund managers . . . .").
[184] Isabella Lafont, *"'Hedge Funds' are a Safety Valve,"* Jan. 15, 2006, http://www.people.hbs.edu/rmerton/Interview%20Madrid%20Spain%2010%2005%20on%20Hedge%20Funds.pdf (interview with Professor Robert C. Merlon, Nobel Prize Winner and Professor at Harvard Business School).

> impose restrictions on banks and insurance companies. The reduction of the impact of these rigidities has to come from someone who is not subject to them. There is a need for a different kind of institution on the other side that is not a bank. *Hedge funds* do that, they soften the effect of these rigidities. That is why we need to be flexible with regulating them.[185]

The same view was advanced in the September 2003 Staff Report to the SEC, discussing the ramifications of the growth of the hedge fund industry:

> Hedge funds often provide markets and investors with substantial benefits. For example, based on our observations, many hedge funds take speculative, value-driven trading positions based on extensive research about the value of a security. These positions can enhance liquidity and contribute to market efficiency. In addition, hedge funds offer investors an important risk management tool by providing valuable portfolio diversification because hedge fund returns in many cases are not correlated to the broader debt and equity markets.[186]

In light of the acknowledged benefits that hedge funds contribute to the industry, regulatory measures may better serve their purported goals of investor protection and market stability[187] by not focusing on the category of investment vehicle, and instead scrutinizing the assets in which funds are investing, the percentage by which such assets are leveraged, and the overall sophistication of the investors investing in the same.

From an investor protection standpoint, new regulation could protect investors' interests in a more direct way by strengthening applicable limitations imposed on the types of individuals and institutions who can invest in hedge funds and private equity, i.e., by increasing the financial net worth threshold in the definition of

---

[185] *Id.*
[186] STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at viii.
[187] FINANCIAL REGULATORY REFORM PROPOSAL, *supra* note 1, at 4, 15.

"accredited investor" under Regulation D.[188] The "accredited investor" threshold has not been changed since its inception in 1982; however, in the last two decades, inflation combined with an increase in gross income and average housing values bumped a large portion of the nation's individual investors into the "accredited investor" category.[189] Perhaps regulation aimed at investor protection should close the gap by bringing Regulation D up-to-date; in response to critics who argue that hedge funds are unsuitable for average investors, this would be the logical regulatory step.[190] Further, regulation aimed at combating fraud could focus on increasing the ranks of the SEC's fraud prevention team, and giving the SEC the resources it needs to effectively investigate claims of fraud and deter future acts of the same.[191]

From a market stability standpoint, the key problem with hedge funds and other types of private equity is their high percentage of leverage, which many in the industry argue contributes to a "systemic risk" industry-wide.[192] The term "systemic risk" is used to refer to the possibility of one event causing a series of simultaneous loan defaults by various financial institutions, thereby creating a chain reaction of sorts within the financial system and causing the other institutions dependent on funds from the borrower institutions to go into default on their own loans.[193] Instead of scrutinizing hedge funds, the government could limit the amount of leverage available to hedge funds and other industry participants. The problem with leverage is well-illustrated by the collapse of LTCM, which had a leverage ratio of twenty-five to one shortly before it was bailed out

---

188 See discussion of Regulation D and accredited investor definition, *supra* in Part III.

189 STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at 81 (mentioning an increased number of retail investors who can qualify as "accredited investors" under Regulation D); Donahue, *supra* note 4, at 246-47 (discussing the cause of the jump in the number of accredited investors).

190 Donahue, *supra* note 4, at 246-47; Gibson, *supra* note 4, at 713.

191 Donahue, *supra* note 4, at 244 ("One problem is the SEC's inability to detect or deter the increased instances of hedge fund fraud. Most of the fraud occurs before the Commission is able to detect the problem, and therefore, investors are unable to get their money back.").

192 *See, e.g.*, STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at 1; THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at 23; *see generally* NICHOLAS CHAN, ET AL., FED. RESERVE BANK OF ATLANTA, DO HEDGE FUNDS INCREASE SYSTEMIC RISK? (2006).

193 CHAN, ET AL., *supra* note 192, at 49.

with the assistance of the Federal Reserve Bank of New York.[194] Specifically, the fund had $125,000,000,000 of investments financed with $5,000,000,000 of assets under management.[195] Leverage is not necessarily problematic in a stable market; however, in a highly volatile market, leveraged funds are susceptible to total failure because their losses could be magnified exponentially, especially where the funds are not hedging other risks inherent in the trading strategies they adopt.[196]

However, leverage also plays an important role in financial markets. Secretary Geithner explained that "[s]tripped of its complexities, the purpose of a financial system is to let those who want to save . . . save . . . [and] let those who want to borrow—whether to buy a house or build a business—borrow."[197] Regulating the extent to which hedge funds can use leverage could have the effect of altering the trading practices that these funds can employ, thereby causing hedge fund managers to seek other jurisdictions where more flexible structures and leveraging practices are permitted.[198] Because not all funds leverage their assets to the same degree, many may argue that some funds do not pose a risk to the financial system and therefore those funds should not need to register with the SEC and potentially be subject to increased oversight.[199] Perhaps a better method for controlling against systemic risk is to regulate other actors in the market which contribute to such risk, not only by managing the credit of hedge funds, but other larger and more interconnected financial institutions as well.[200]

The use of market discipline has been advocated by some as a method for reducing systemic risk by requiring counterparties to hedge funds and others who provide leverage to follow stricter procedures concerning their lending practices.[201] Hedge funds are not

---

194 THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at 13.
195 *Id.* at 12; Donahue, *supra* note 4, at 247.
196 Gibson, *supra* note 4, at 705.
197 Press Release, U.S. Dep't. of the Treasury, *supra* note 13.
198 Ladi, *supra* note 8, at 136.
199 *The Future of Hedge Fund Regulation: Q&A With Ezra Zask and Gaurav Jetley of Analysis Group*, FINALTERNATIVES, Sept. 14, 2009, http://www.finalternatives.com/node/9070.
200 Gibson, *supra* note 4, at 706-07.
201 *See* THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at 25; JOHN KAMBHU, TIL SCHUERMANN & KEVIN J. STIROH,

the only market actors who are subject to systemic risk; and during the subprime mortgage crisis, financial parties other than hedge funds, particularly the institutions issuing the underlying mortgages, sustained losses that damaged the financial system by greater magnitudes.[202] Further, some recent studies may demonstrate that hedge fund trading activity has a stabilizing effect on the market.[203] The years 2008 was a sporadic year for hedge funds: some had phenomenal gains[204] and some had devastating losses.[205] But it appears that the hedge funds who suffered the greatest losses invested largely in asset-backed securities such as subprime mortgages,[206] a loss that reverberated through the entire industry and was not isolated to hedge funds alone.[207] Not surprisingly, there is no industry consensus on whether regulation would be a positive or negative for the funds themselves: some industry experts state that they "believe mandatory registration of investment advisers is the right approach" to hedge fund regulation,[208] and others believe that funds should not be regulated directly and instead, the parties

---

STAFF, FED. RESERVE BANK OF NEW YORK, HEDGE FUNDS, FINANCIAL INTERMEDIATION, AND SYSTEMIC RISK 4 (2007).

[202] *See, e.g.*, BIANCO, *supra* note 122, at 12 ("Due to the collapsing subprime market, Ameriquest, formerly the country's largest subprime lender, closed its doors and laid off 3,800 employees. In addition to the plunge in the housing market, Ameriquest made a $325 million settlement with 30 states' Attorneys General over deceptive marketing and lending practices.").

[203] Gibson, *supra* note 4, at 712.

[204] Louise Story, *What Crisis? Some Hedge Funds Gain*, N.Y. TIMES, Nov. 9, 2008, at B1.

[205] Tomoko Yamazaki, *Hedgefunds Worldwide Post Record Losses in September*, BLOOMBERG, Oct. 22, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aDWTICZmrtTo.

[206] Nick Clark, *Hedge Funds Suffer Mass Redemptions*, THE INDEPENDENT (UK), Sept. 23, 2008, http://www.independent.co.uk/news/business/news/hedge-funds-suffer-mass-redemptions-938959.html (discussing hedge fund losses due to "investments in risky instruments including collateralised debt obligations and asset backed securities"); Jenny Strasburg, *Bear Stearns Shuts Asset-Backed Hedge Fund After Loss*, BLOOMBERG, Jan. 9, 2008, http://www.bloomberg.com/apps/news?sid=a9I6nAlAzktU&pid=20601087.

[207] *See* Lanzkron, *supra* note 6, at 1547 n.119; BIANCO, *supra* note 122, at 14.

[208] Curtis, *supra* note 7.

responsible for managing hedge fund credit should be regulated instead.[209]

As some have mentioned, "[t]he Reform Proposal is long on generalities and extremely short on specifics. It will now take on a life of its own in Congress. There is no way to predict what ultimately will survive the upcoming political process."[210] The Reform Proposal is not law or even proposed law—it is just a roadmap of the Obama administration's thinking on the shape future legislation and regulation should take.[211] Pending legislation, discussed in Part VII, will shed more light on the potential laws that could affect the hedge fund and private equity industry.

VII. Pending Legislation that Proposes the Registration and Increased Regulation of Hedge Funds, Venture Capital Funds and Other Pools of Private Equity is not Tailored to Addressing the Actual Risks that These Investment Vehicles Pose to the Market.

Legislation currently pending in the 111th Congress will be modified multiple times before it is negotiated and signed into law. As of the date of writing, three bills are currently in Committee in the House and Senate, two propose amendments to the Advisers Act, the other proposes amendments to the Investment Company Act.[212] Legislation currently pending before the House includes a proposal to close the regulatory gap created by the Advisers Act, the private adviser exception. This is the Hedge Fund Adviser Registration Act, House Bill 711, which would "require anyone who manages hedge funds to register with the SEC."[213] House Bill 711 is a one page,

[209] THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 27, at 25.
[210] Weakley, et al., *supra* note 113, at 2.
[211] Financial Services Practice Group, Winston & Strawn LLP, *supra* note 168, at 1.
[212] Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong. (2009); Hedge Fund Transparency Act, S. 344, 111th Cong. (2009); Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009).
[213] James Hamilton, *Obama Administration Seeks Federal Regulation of Hedge Funds*, CCH FINANCIAL CRISIS NEWS CENTER, June 19, 2009, http://www.financialcrisisupdate.com (search "*Obama Administration Seeks Federal Regulation of Hedge Funds*"; then follow article hyperlink) (discussing the Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009)).

essentially one sentence piece of legislation, that proposes the deletion of "subsection (b)(3)" to section 203(b)(3) of the Advisers Act, thereby doing away with the private adviser exemption once more.[214] House Bill 711 takes an even more simplistic approach to this reform than did the Hedge Fund Rule, by avoiding altogether the tricky definition of "client" under the Advisers Act (which was already criticized in *Goldstein*),[215] and omitting any qualifications to the rule, including those regarding lock-up periods or thresholds for a fund's assets under management. As discussed in the analysis of the Hedge Fund Rule (in Part IV) and the Reform Proposal (in part VI), the private adviser exemption is important for hedge funds because they typically have several limited partner clients who themselves are comprised of hundreds of individual investors. If the private adviser exemption is removed from the Advisers Act (as the Hedge Fund Adviser Registration Act proposes), and a fund has more than 15 individual investors in the aggregate, including every one of the investors within each of the limited partners it advises, the funds will have to register with the SEC and will be subject to the Advisers Act as are mutual funds.[216]

Pending legislation includes Senate Bill 344, a companion bill to the Hedge Fund Adviser Registration Act, entitled the "Hedge Fund Transparency Act," which proposes amendments to the Investment Company Act.[217] This bill, if enacted, would require hedge funds to register and disclose information to the SEC, essentially the same requirements currently imposed on "traditional investment companies" like mutual funds.[218] Specifically:

> The Hedge Fund Transparency Act would require hedge funds to register with the SEC, file an annual public disclosure form with basic information, and cooperate with any SEC information request or examination. Public disclosures pursuant to the Act would include a listing of beneficial owners, a detailed explanation of the fund's structure, an identification of affiliated financial institutions, as

---

[214] Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong. (2009).
[215] Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 874 (D.C. Cir. 2006).
[216] *See* U.S. Sec. and Exch. Comm'n, *supra* note 20 (comparing hedge funds to mutual funds).
[217] Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009).
[218] Hamilton, *supra* note 213.

> well as the number of investors and the fund's value and assets under management.[219]

The SEC could use information received pursuant to this disclosure requirement to limit the trading practices and leverage of such registered investment advisers, which could force funds to completely change the types of investments they currently make available to investors. With these ramifications, the Hedge Fund Transparency Act fails to live up to Secretary Geithner's testimony that the reform to the financial system should not have the effect of prohibiting innovation.[220] As discussed in Part VI, the detailed and onerous disclosure requirements proposed by the Reform Proposal and embodied in Senate Bill 344 would have the effect of subjecting hedge funds to a regulatory regime akin to mutual funds; currently, the only thing stopping that from happening is the availability of exemptions under the federal securities laws.[221]

The third piece of pending legislation is Senate Bill 1276, entitled the "Private Fund Transparency Act of 2009."[222] Senate Bill 1276 would require "investment advisers to private funds, including hedge funds, private equity funds, venture capital funds and others to register with the [SEC], and for other purposes."[223] Introduced by Senator Jack Reed (D-RI), the bill, which has been read twice and referred to the Committee on Banking, Housing, and Urban Affairs, would eliminate the private adviser exemption in § 203(b)(3) of the Advisers Act, and retain only a limited exception for "foreign private advisers" defined by the new Bill.[224] The elimination of the private adviser exemption, and furthermore, the *retention* of an exception as to statutorily defined "foreign private advisers" who have no assets within the United States, all but pushes hedge fund managers off-shore to the Cayman Islands, and other hedge fund friendly locales. Section 4 of the proposed legislation proposes an amendment to § 204 of the Advisers Act, granting the SEC extensive authority to obtain information and records from investment advisers, in order to supervise systemic risk and make available to other agencies reports

---

219 *Id.*
220 *See* Press Release, U.S. Dep't. of the Treasury, *supra* note 13.
221 *See* JICKLING, *supra* note 28, at 1 ("Hedge funds are essentially unregulated mutual funds.").
222 Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009).
223 *Id.*
224 *Id.*

and/or records received from registered, reporting investment advisers.[225] The types of records the SEC could require under Senate Bill 1276 would consist of the same records required to be furnished by an investment company under the Investment Company Act.[226] Although the Private Fund Transparency Act of 2009 does require in § (4)(d), that all reports furnished to the SEC pursuant to the bill would be confidential (except insofar as disclosures are required to other federal departments or agencies, to any "self-regulatory organization" requesting the same, or to comply with a federal court order in an action brought by the SEC),[227] there is no limit on federal agencies' authority to use information received to impose further regulations on registered investment advisers.

On July 15, 2009, the Obama administration delivered yet another legislative proposal to Capitol Hill.[228] The "Private Fund Investment Advisers Registration Act of 2009"[229] would "require all advisers to hedge funds and other private pools of capital, including private equity and venture capital funds, to register with the [SEC]."[230] This proposed legislation is based on the Private Fund Transparency Act of 2009, proposed earlier this year and discussed in the paragraph previous paragraph.[231] Pursuant to the proposed legislation (as with the others discussed herein), the private adviser exemption would be eliminated from the Advisers Act, and particular reporting requirements would be imposed for advisers to "private funds."[232] As with the Private Fund Transparency Act of 2009, a

---

[225] *Id.*
[226] *Id.*
[227] *Id.*
[228] Fact Sheet, U.S. Dep't of The Treasury, Administration's Regulatory Reform Agenda Moves Forward: Legislation for the Registration of Hedge Funds Delivered to Capitol Hill (July 15, 2009) (available at http://www.treas.gov/press/releases/tg214.htm).
[229] Private Fund Investment Advisers Registration Act of 2009, H.R. 3818, 111th Cong. (2009).
[230] Fact Sheet, U.S. Dep't of The Treasury, *supra* note 228.
[231] Investment Management & Private Funds Practices, Paul, Hastings, Janofsky & Walker, *Treasury Proposes Legislation for Regulation of Private Funds*, PAUL HASTINGS, July, 2009, at 1, http://www.paulhastings.com (follow "Publications" hyperlink; then search "Treasury Proposes Legislation for Regulation of Private Funds"; the follow title hyperlink).
[232] *See The Private Fund Investment Advisers Registration Act of 2009*, GIBSON, DUNN & CRUTCHER, July 16, 2009, http://www.gibsondunn.com

limited foreign private adviser exception would continue to apply.[233] Furthermore, the threshold for exemption from registration would remain at $25 million of assets under management.[234] The Private Fund Investment Advisers Registration Act was referred to the Committee on Financial Services on October 15, 2009.[235]

The time line for when legislation promulgated pursuant to the Reform Proposal will be signed into law is uncertain. Although some members of Congress have stated that legislation will be ready for President Obama's signature by year-end, other legislation, including proposed reforms to the nation's health care system, may compete for congressional time. [236] Further, there is still opportunity for additional legislative proposals to be proposed and sponsored.

VIII. Conclusion

As discussed herein, hedge funds, venture capital funds, and private equity investment vehicles have significant differences, although they are often grouped together in one class of alternative investment vehicles. The availability of exemptions to federal securities laws permits these investment funds the flexibility they need in order to operate in their individual capacities; upon losing such exemptions, these funds could easily move to more amenable jurisdictions such as the Cayman Islands.[237] The diverse trading strategies employed by such funds as well as their distinct purposes (for example, the diversification of risk which can help hedge funds

---

(search "The Private Fund Investment Advisers Registration Act of 2009"; then follow title hyperlink).

[233] Private Fund Investment Advisers Registration Act of 2009, H.R. 3818, 111th Cong. (2009).

[234] *Id.*

[235] *Id.*

[236] *See* Luke Mullins, *Obama's Financial Regulation Reform: 7 Things You Need to Know*, U.S. NEWS & WORLD REP., June 17, 2007, http://www.usnews.com/money/blogs/the-home-front/2009/6/17/obamas-financial-regulation-reform-7-things-you-need-to-know.

[237] *See Hedge Funds Remain Attractive Regardless of Returns*, CAYMAN NET NEWS, Feb. 26, 2007, http://www.caymannetnews.com/cgi-script/csArticles/articles/000120/012062.htm; Elena Moya, *Hedge Funds in Cayman Islands Withdraw from UK Banks*, GUARDIAN, June 15, 2009, http://www.guardian.co.uk/business/2009/jun/15/private-equity-tax-avoidance-cayman-islands.

stabilize the market,[238] or the support for entrepreneurship and technological innovation by venture capitalists)[239] can have a beneficial impact on the market and the economy.

The Reform Proposal and pending legislation, although they aim to increase oversight in an effort to promote consumer protection and strengthen market stability, do not advance their goals by requiring hedge funds to register with the SEC and comply with reporting and information requirements. If anything, such regulation would have the effect of subjecting hedge funds to a regulatory regime akin to mutual funds. New regulation would do better to assess and limit the amount of leverage over a healthy amount which can be offered to investment funds, heighten the threshold for accredited investors in light of inflation and new economic conditions, and arm the SEC with the tools it needs to combat fraud where it does exist. Further, new rule makers should painstakingly attempt to ensure that blunt regulation does not stamp out the very innovation in capital markets that the administration recognizes is so important to protect.

---

[238] STAFF, U.S. SEC. AND EXCH. COMM'N, *supra* note 5, at viii.

[239] *See Trade Group Resists Obama's Financial Regulatory Plan*, *supra* note 154.