NOTE

THE SEC’S INEFFECTIVE MOVE TOWARD GREATER REGULATION OF OFFSHORE HEDGE FUNDS: THE FAILURE OF THE HEDGE FUND REGISTRATION REQUIREMENT

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INTRODUCTION ................................................. 796
I. BACKGROUND AND DESCRIPTION OF OFFSHORE HEDGE FUND REGULATION ............................................. 801
   A. Structure of Offshore Hedge Funds and Previous SEC Regulation ............................................. 801
   B. SEC Registration Provisions for Hedge Fund Advisers ............................................ 807
   C. Criticisms of the Hedge Fund Adviser Registration Rule ................................................ 810
II. THE SEC’S INACTION IN RESPONSE TO CONCERNS FROM MUTUAL FUND AND LEGAL INSIDERS DURING THE RULE-MAKING PROCESS AND POSSIBLE EFFECTS OF IGNORING REGISTRATION OF OFFSHORE HEDGE FUNDS .............. 812
   A. SEC Inaction ....................................... 812
   B. Likely Creation of Parallel Funds Offshore to Avoid Registration Requirements and Movement of U.S. Investors’ Funds to Offshore Havens................ 813
   C. Increased Risk of Fraud ......................... 814
III. HOW OTHER U.S. REGULATORY BODIES HAVE DEALT WITH THE OFFSHORE PROBLEM ............................. 817
   A. Internal Revenue Service ........................... 817
   B. U.S. Department of Labor, ERISA, and Pension Fund Investment Offshore ..................... 819
   C. Commodity Futures Trading Commission and Pooled Assets Offshore ......................... 821
IV. WHETHER AND HOW THE SEC SHOULD ALTER ITS HEDGE FUND REGULATORY REGIME .............................. 822

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A. The SEC’s Inability to Regulate Hedge Funds
   Effectively ............................................. 822

B. Possible Fixes for the SEC Registration Regulation . . 827
   1. Redefine “Accredited Investor” and “Qualified
      Purchaser” ............................................. 827
   2. Encourage Voluntary Disclosure .................... 828
   3. Educate Investors ..................................... 829
   4. Rely on Existing Regulatory Mechanisms .......... 830

CONCLUSION ................................................... 830

INTRODUCTION

Despite having little knowledge about the internal structure and
investment methods of hedge funds, Americans have invested in
these elusive funds at exponentially increasing rates in recent years.

1 See, e.g., Comment, Paul R. Davis, Attorney, Boston, Mass., on Proposed Rule: Registration
   Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act
   www.sec.gov/rules/proposed/s73004/prdavis9213.htm (“[T]he real reason for this [hysteria
   associated with hedge funds] is that they operate in cloaked environments, in stealth
   mode, unlike mutual funds or other comparable investment vehicles.”); President’s Work-
   ing Group on Fin. Mkts., Hedge Funds, Leverage, and the Lessons of Long-Term Capital
   Management 1 (1999) (“The term ‘hedge fund’ is commonly used to describe a variety
   of different types of investment vehicles that share some similar characteristics.”); Marcia
   L. MacHarg, Waking up to Hedge Funds: Is U.S. Regulation Really Taking a New Direction?,
in Hedge Funds: Risks and Regulation 55, 57 (Theodor Baums & Andreas Cahn eds., 2004)
(“The term ‘hedge fund’ is frequently used in the United States to identify a broad range
of private investment vehicles that actively trade a variety of securities and commodities
through a multitude of investment strategies, with an almost unbounded range of risk and
return objectives.”); Hedge Funds and the SEC: Still Free, ECONOMIST, July 1, 2006, at 68 (quot-
ing Senator Orrin Hatch as calling hedge funds the “Wild West” of America’s financial
system); Steven Rattner, Don’t Fence in Hedge Funds, BUS. WK., Jan. 16, 2006, at 104 (“[T]he
secret to understanding hedge funds is to first accept the irrelevance of the term ‘hedge
fund.’”).

2 No concrete figures exist as to the extent of U.S. investment in hedge funds. See, e.g., Recent Development
   in Hedge Funds, Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs, 108th Cong. 8 (2003)
   (statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission), available at http://frwebgate.access.gpo.gov/cgi-
   bin/getdoc.cgi?dbname=108_senate_hearings&docid=f:92703.wais.pdf (estimating that
   there are 5,700 hedge funds in the United States that manage approximately $600 billion
   in total assets); President’s Working Group on Fin. Mkts., supra note 1, at 1 (estimating
   that as of mid-1998, there were 2,500 to 3,500 hedge funds that managed “between $200
   billion and $300 billion in capital, with approximately $800 billion to $1 trillion in total
   assets”); Brett Duval Fromson, Hedge Funds Today: Fortunes Favor the Brave, WALL ST.
   J., Nov. 22, 2005, at A14 (estimating that there are 8,000 hedge funds that manage approximately
   $1 trillion in total assets); Jayesh Punater, Registration Pro and Con, SEC. INDUSTRY NEWS,
   Oct. 24, 2005, at 4 (“[H]edge funds . . . have been growing at an exponential rate, with
   assets under management now exceeding $1 trillion. The SEC knew hedge funds were
   growing, but it had no reliable data indicating just how many funds there were and exactly
   how much money they were managing.”); Andy Serwer, Carlo’s Way: This Zany Hedge Fund
   Manager Preaches Peace—and Wages War, FORTUNE, Nov. 14, 2005, at 73 (“[T]here are more
   hedge funds than Taco Bells in the U.S.” (quoting hedge fund manager J. Carlo Cannell));
   Paul F. Roye, Dir. of Inv. Mgmt., SEC. & Exch. Comm’n, Keynote Address at the Tenth
Not only does U.S. law fail to define “hedge fund,” it also creates loopholes such that most hedge funds and their advisers do not need to register with a regulatory body such as the Securities and Exchange Commission (SEC). While hedge funds may occasionally fall under the regulatory authority of other agencies, hedge fund advisers and administrators strive to avoid disclosure and additional regulation. Avoiding disclosure and regulation reduces costs for investors and improves funds’ returns.
The SEC\textsuperscript{7} and other U.S. regulatory bodies\textsuperscript{8} have noted the increased investment interest in hedge funds. As a result, the SEC considered increasing its regulatory presence in the hedge fund arena. Historically, hedge fund advisers have not been subject to the strict requirements of the Investment Advisers Act of 1940.\textsuperscript{9} This changed in 2004, when the SEC expanded its regulatory reach by creating a mandatory registration provision for many hedge fund advisers,\textsuperscript{10} which would subject hedge fund advisers to the registration requirements of the Investment Advisers Act. The new rule mandated registration with the SEC by February 1, 2006.\textsuperscript{11} In enacting these provisions, the SEC emphasized the need to collect data to fill in informational gaps for U.S. investors interested in investing in hedge funds, to deter and detect fraud by hedge fund advisers,\textsuperscript{12} to prevent unfit advisers from managing hedge funds, to adopt measures to protect hedge fund investors, and to limit the marketing of hedge funds to unsuitable investors.\textsuperscript{13} Even though nearly one thousand hedge funds registered with the SEC,\textsuperscript{14} more than one hundred subse-
quently deregistered following the District of Columbia Circuit’s decision in Goldstein v. SEC, which invalidated the registration requirement.

Although the registration requirement sought to increase the SEC’s regulatory strength over hedge fund advisers as a whole, it did little to regulate offshore hedge funds and their advisers. Considering the SEC’s reasons for enacting the amendments to the registration requirements of the Investment Advisers Act, this lack of oversight for offshore hedge funds contravenes the purposes of the amendments. By regulating onshore hedge funds with higher scrutiny than offshore funds, the SEC encouraged onshore advisers to move their funds offshore or to create parallel offshore fund structures and subsequently move invested capital to the offshore funds. Once advisers move funds offshore, the SEC will be unable to achieve its goals of detecting and deterring fraud and generally protecting hedge fund investors.

Therefore, regulation of offshore hedge funds is important to the safety and integrity of U.S. markets. By registering only onshore fund advisers, the SEC not only encouraged hedge fund advisers to move offshore, but it also gave small investors a false sense of security when investing in hedge funds, both onshore and offshore. New commercial products, which are available to all investors, evaluate hedge fund returns and could augment this misleading sense of security.

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16 451 F.3d 873 (D.C. Cir. 2006).

17 See id. at 883–84.

18 See supra notes 12–13 and accompanying text.

19 But see Alex R. McClean, Note, The Extraterritorial Implications of the SEC’s New Rule Change to Regulate Hedge Funds, 38 CASE W. RES. J. INT’L L. 105, 107 (2006) (“Hedge funds . . . are not moving anywhere[,] . . . because market conditions, foreign regulators, and provisions of the new rule make moving offshore impractical.”). However, in making this claim, McClean initially ignores the fact that even prior to registration, many U.S. hedge funds had already created parallel funds offshore. Later in his Note, McClean contradicts his earlier assumptions about the willingness of hedge fund managers to go offshore. See id. at 132 (“Hedge funds can change domiciles quickly and cheaply since they do not own any physical assets. The only asset that a hedge fund would have to transport would be its human capital.”). For a discussion of some of the motivations for hedge fund managers to go offshore, see Mara Der Hovanesian, For Hedge Funds, Some Sweet Deals, BUS. WK., May 8, 2006, at 11.

20 See, e.g., Anne Tergesen, Sizing up a Hedge, BUS. WK., Nov. 28, 2005, at 128 (“With hedge funds booming—and investors worried about getting burned—mutual fund tracker Morningstar and bond rater Moody’s Investors Service plan to launch hedge fund research tools [in 2006] and make them available to individual investors.”). The Web site www.hedgebay.com also lists more than 600 offshore hedge funds and allows the funds to take...
This Note contends that the SEC’s amended registration requirements were insufficient to address potential problems with offshore hedge funds. It also suggests that in enacting the amendments, the SEC did not address its own concerns raised during internal discussion of the amendments. In particular, the amendments did not address the loopholes that allow offshore fund advisers to operate largely unregulated. Part I provides background by explaining how offshore hedge funds have historically operated and by contrasting the SEC’s treatment of onshore hedge funds with its treatment of offshore hedge funds. It also clarifies the changes that the amendments made to the existing hedge fund regulation regime and summarizes criticisms of the rule and its effects. Part II elaborates on the concerns that the SEC staff, financial institution insiders, and legal insiders raised during the rule-making process and shows how the SEC systematically rejected measures that would have empowered it to regulate offshore hedge fund advisers. Part II also discusses how the registration requirement would allow fraud to flourish in the offshore market, thus increasing the risk to U.S. investors and markets. Part III describes how other U.S. regulatory bodies, including the Internal Revenue Service (IRS), the U.S. Department of Labor as mandated by the Employee Retirement Income Security Act (ERISA), and the Commodity Futures Trading Commission (CFTC), have regulated offshore investments and advisers. Part IV suggests possible fixes for the SEC’s registration regulation.

21 As a preliminary disclosure, the author interned at the CFTC’s Division of Enforcement in the Eastern Region. The views expressed here are hers alone and do not reflect the views of the CFTC.
BACKGROUND AND DESCRIPTION OF OFFSHORE HEDGE FUND REGULATION

A. Structure of Offshore Hedge Funds and Previous SEC Regulation

Offshore hedge funds with ties to the United States are usually established as corporations in the Cayman Islands, or Bermuda. Traditionally, offshore hedge funds have attracted investment from U.S. tax-exempt entities, including foundations, endowments, charitable trusts, and pension

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22 See, e.g., DIV. OF INV. MGMT., supra note 7, at 9. Whereas offshore hedge funds are typically set up as corporations, onshore funds are normally set up as limited partnerships. See id. at 10. For a pictorial depiction of hedge fund structures for both onshore and offshore hedge funds, see HAMMER ET AL., supra note 4, §§ 4.3–4.4. These offshore hedge funds organized under non-U.S. law may only make a private offering to U.S. investors “if after the private offering the foreign fund’s securities are held by no more than 100 beneficial owners resident in the United States, or if all of the beneficial owners resident in the United States are ‘qualified purchasers’ . . . .” PRESIDENT’S WORKING GROUP ON FIN. MKTS., supra note 1, at app. B n.3.

23 See, e.g., SIMONE BORLA & DENIS MASETTI, HEDGE FUNDS: A RESOURCE FOR INVESTORS 75 (2003); COMPARATIVE JURISDICTION GUIDE: WHERE TO SET UP AND, PERHAPS, MANAGE A HEDGE FUND? 19–20 (Carol Bonnett & Sarah Barham eds., 2005); GORDON DE BROUWER, HEDGE FUNDS IN EMERGING MARKETS 12 (2001); Alan L. Kennard, The Hedge Fund Versus the Mutual Fund, 57 Tax Law. 133, 158 (2003); James Eedes, Cayman Islands: Offshore, on Target, Banker, July 1, 2006, at 106 (stating that the Cayman Islands’ regulator had more than 1700 hedge fund registrations in 2005 and that the regulator estimates that it currently regulates 80% of hedge funds worldwide); Hedging and Betting, Int’l Money Marketing, Sept. 9, 2004, at 25; Neal Lomax, Hedge Funds, MONDAQ, June 12, 2006, available at 2006 WLNR 10049660 (stating that of the approximately 8,000 active funds that will be registered in the Cayman Islands by the end of 2006, approximately 95% will be hedge funds).

24 See, e.g., BORLA & MASETTI, supra note 23, at 75; COMPARATIVE JURISDICTION GUIDE: WHERE TO SET UP AND, PERHAPS, MANAGE A HEDGE FUND?, supra note 23, at 11–12; de Brouwer, supra note 23, at 12; Kennard, supra note 23, at 158; Hedging and Betting, supra note 23. But see, e.g., Jeremy Grant & Richard Lapper, Boost for Offshore Regulation, Fin. Times (U.K.), Feb. 12, 2007, at 5 (“Hundreds of hedge funds based in the US and Europe face tighter regulation as the British Virgin Islands prepares legislation that will require funds registered in the offshore financial centre to conduct regular audits and appoint whistleblowers to root out fraud.”).


26 See Testimony Concerning the Regulation of Hedge Funds, Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs (2006) (statement of SEC Chairman Christopher Cox) [hereinafter Cox Statement], available at http://www.sec.gov/news/testimony/2006/ ts072506cc.htm (“Nearly two-thirds of endowments invest in hedge funds, and those that do allocate an average of 18% to them. Whether or not this sort of institutional investment directly impacts retail investors, it surely is increasing the potential impact that hedge funds might have on our capital markets.”).
funds. Select private U.S. investors have also looked to offshore hedge funds because of the IRS’s favorable tax treatment of these funds. This changed somewhat when Congress enacted the Taxpayer Relief Act of 1997, which “abolished the requirement that the principal office of a non-U.S. entity that trades for its own accounts must be outside the United States for that entity to avoid being treated as engaged in a U.S. trade or business.”

27 Some data indicate that investments of pensions in hedge funds increased from $13 billion in 1997 to $72 billion in 2004. See Regulation of the Hedge Fund Industry: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs, 108th Cong. 27 (2004) (statement of Charles J. Gradante, Managing Principal, Hennessee Group LLC), available at http://banking.senate.gov/_files/gradante.pdf; see also Protecting America’s Pension Plans from Fraud: Will Your Savings Retire Before You Do?: Hearing Before the S. Comm. on Health, Education, Labor, and Pensions, 109th Cong. 54 (2006) (“Pension plans and other investors are counting on the SEC to protect them.”); Comment, S. Waters, Individual Investor, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172 (Sept. 16, 2004) [hereinafter Waters Comment], http://www.sec.gov/rules/proposed/s73004/swaters9240.htm (“The population most at risk for exploitation is senior citizens . . . . When this class of investors roll over their 401Ks and take their pensions, they may have just enough money to . . . become hedge fund targets. This population is vulnerable with no way to recover financially in old age from risky investments.”); Div. of Inv. Mgmt., supra note 7, at 10; Cynthia M. Fornelli, Regulatory Risk for Hedge Funds, in MANAGING HEDGE FUND RISK: STRATEGIES AND INSIGHTS FROM INVESTORS, COUNTERPARTIES, HEDGE FUNDS AND REGULATORS 359, 363–64 (Virginia Reynolds Parker ed., 2005); Helen Parry, Hedge Funds, Hot Markets and the High Net Worth Investor: A Case for Greater Protection?, 21 NW. J. INT’L L. & BUS. 703, 703 (2001) (“Hedge funds, so often booted and hissed by politicians and regulators, are now strut the stuff in the limelight to the acclaim of pension funds, unit trusts and private investors.”) (quoting Sprucing up Their Appearance, MONEY OBSERVER, Sept. 19, 2000)); Carrie Johnson, Appeals Judge Questions SEC’s Hedge Fund Rule, WASH. POST, Dec. 10, 2005, at D1 (“Average investors and pension funds increasingly are investing in . . . [hedge] funds.”); Joseph Nocera, Offering up An Even Dozen Odds and Ends, NY. TIMES, Dec. 24, 2005, at Cl (“Hedge fund managers need to understand that as they push to become a mainstream part of institutional investing—used not just by clever endowment managers but also by plain-vanilla pension funds—they need oversight. Otherwise, they will remain what they are today: the world’s best-paying cottage industry.”); Gregory Zuckerman, Hedge Funds Grow Popular with Investors, WALL ST. J., Jan. 3, 2006, at R12 (“[I]n 2005, . . . more institutional investors adopt[ed] the view that [hedge funds] can play an important role in a portfolio, providing returns that often don’t correlate to the overall stock and bond markets. Pension plans and other institutional investors increased their allocations to hedge funds . . . .”) Recently, Congress has suggested its commitment to protect those who have invested pension funds in hedge funds. See, e.g., 152 Cong. Rec. S11429, 11439–41 (daily ed. Dec. 7, 2006) (statement of Sen. Arlen Specter) (explaining the Criminal Misuse of Material Nonpublic Information and Investor Protection Act of 2006, which called for the registration of hedge funds, prescribed compliance expectations, and limited investments by pension funds); Ron Orol, Dodd to Focus on Hedge Funds, DAILY DEAL, Dec. 8, 2006, available at 2006 WLNR 21194614 (“I’m worried about pensioners, who are not sophisticated investors. . . . We bear a responsibility that there is transparency for that kind of investor.”) (quoting Senator Christopher Dodd, Chairman, Senate Banking Committee)).

28 See Hammer et al., supra note 4, § 4.4(1), at 98.


30 Hammer et al., supra note 4, § 4.4(1), at 98–99.
The Taxpayer Relief Act of 1997 thus extended the U.S. government’s reach over offshore hedge funds, but offshore hedge funds nevertheless have remained popular with investors for other reasons. First, unlike their onshore counterparts, offshore hedge funds can keep the identities of their investors confidential from the U.S. government.\textsuperscript{31} Second, U.S. tax-exempt investors, including pension funds and charitable trusts, prefer offshore funds because they are organized as corporations and thus do not expose these investors to taxation. By contrast, investing in onshore hedge funds, which are typically structured as limited partnerships, exposes investors to taxation.\textsuperscript{32}

Previously, both onshore and offshore hedge fund advisers did not have to register with the SEC under the Investment Advisers Act of 1940\textsuperscript{33} in the way that mutual fund advisers must register.\textsuperscript{34} This disparity created a huge advantage for hedge fund advisers and their investors, because the registration obligations carry high costs.\textsuperscript{35} For example, registered advisers must meet extensive reporting require-

\textsuperscript{31} See id. § 4.4(1)(i), at 99; THOMAS P. LEMKE ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 8:20, at 205 (2005) (“[T]he activities of many offshore fund managers and administrators are still conducted outside the U.S. for a number of reasons, such as . . . maintaining investors’ anonymity.”). Hammer notes, however, that the offshore fund “reserve[s] its rights to disclose each investor’s identity and information about the investor to cognizant U.S. or non-U.S. governmental authorities to the extent required under anti-money-laundering laws.” HAMMER ET AL., supra note 4, § 4.4(1)(i), at 99.

\textsuperscript{32} See Div. of Inv. Mgmt., supra note 7, at 9.


\textsuperscript{35} See, e.g., Barry P. Barbash, Ten Years After Unibanco: The Extraterritorial Reach of the U.S. Investment Advisers Act of 1940, in INTERNATIONAL SECURITIES MARKETS 2002: ADDRESSING CROSS-BORDER LEGAL & BUSINESS CHALLENGES 335, 339 (2002) (“Compliance with the provisions of the Advisers Act is not an inconsiderable task; the Act imposes significant fiduciary duties, restrictions and responsibilities on entities that come within its definition of ‘investment adviser’ and that must be registered under the Act.”); Paredes, supra note 3, at 1006 (“The SEC paid relatively short shrift to the cost of regulating hedge funds.”). Even for unregistered funds, the need to keep administrative costs low is mounting as the number of hedge funds multiplies. This increasingly crowded field complicates the hunt for those winning investment strategies that have made hedge fund investments so desirable. See, e.g., Regulating Hedge Funds: Thorns in the Foliage, ECONOMIST, Apr. 1, 2006, at 61 (“New funds are set up almost every day: [A]cross the world there are now more than 8,000. More dollars are pursuing the same strategies, reducing returns for many.”). Some argue that further oversight will prevent the innovation necessary for even honest hedge funds to develop winning strategies. See, e.g., Rattner, supra note 1, at 104; Dale A. Oesterle, Regulating Hedge Funds 2 (Ohio State Univ. Moritz Coll. of Law, Pub. Law & Legal Theory Working Paper Series No. 71, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913045 (“Tighten up hedge fund regulation and we threaten their competitive advantage.”).
ments and pay an associated annual fee.\textsuperscript{36} They are also subject to surprise inspections by accountants\textsuperscript{37} and by the SEC.\textsuperscript{38} Moreover, registration as an investment adviser would obligate hedge fund managers to make the necessary periodic filings under the Securities Exchange Act of 1934.\textsuperscript{39} Finally, registration imposes both a fiduciary duty\textsuperscript{40} and a code of ethics\textsuperscript{41} on investment advisers.

To avoid registration, nearly all offshore hedge funds relied on the § 4(2) exemption of the Securities Act of 1933, which applies to firms that sell securities through a nonpublic offering to accredited investors.\textsuperscript{42} Accredited investors for the purposes of § 4(2) include: certain institutional investors, registered broker-dealers, ERISA and other employee benefit plans;\textsuperscript{13} private business development companies;\textsuperscript{14} tax-exempt organizations with assets over $5 million;\textsuperscript{45} certain individuals associated with the issuer of the private offering;\textsuperscript{46} trusts with $5 million in total assets and investment decisions that a sophisticated person made;\textsuperscript{47} individual investors “whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds $1,000,000”;\textsuperscript{48} and individual investors “who had an individual income in excess of $200,000 in each of the two most re-

\textsuperscript{36} See Investment Advisers Act of 1940 § 203A(d), 15 U.S.C. § 80b-3a(d) (2000); see also Giselle Abramovich, Hedge Funds Gear up for Registration, \textit{Money Mgmt. Executive}, Nov. 28, 2005, at 1 (“[T]he hard part is complying with the recordkeeping requirements . . . [which] require[ ] that advisors maintain copies of their policies and procedures along with any revisions. They must also conduct an annual review of these policies and maintain all records documenting this review. And they must retain all of these records for five years.”); Zuckerman, supra note 27 (“The move toward adviser registration will force funds to upgrade their compliance and record-keeping efforts, which can create a burden, especially for smaller funds.”).


\textsuperscript{39} Id. § 78m.


\textsuperscript{42} See 15 U.S.C. § 77d(2).


\textsuperscript{44} See id. § 230.501(a)(2).

\textsuperscript{45} See id. § 230.501(a)(3).

\textsuperscript{46} See id. § 230.501(a)(4).

\textsuperscript{47} See id. § 230.501(a)(7).

\textsuperscript{48} Id. § 230.501(a)(5).
cent years or joint income with that person’s spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.” The common characteristic of each of these accredited investors is that they are either in a position to manage or possess a significant amount of money such that there is a presumption of financial sophistication.

The Investment Company Act of 1940 also contains two registration exemptions, §§ 3(c)(1) and 3(c)(7). Generally, § 3(c)(1) excludes funds that are not making a public offering and that have no more than 100 beneficial owners of their securities. Determining who is a beneficial owner is a thorny issue, but offshore funds benefit from this arrangement because they “need only count U.S. beneficial owners toward the 100-beneficial-owner threshold.” Furthermore, a corporate investor counts as a single beneficial owner. Offshore funds take advantage of this counting method by organizing as corporations. According to legislative history, Congress chose not to regulate these privately held companies with few investors because they “do not rise to the level of federal interest under the Investment Company Act.”

49 Id. § 230.501(a)(6).
51 Id. § 80a-3(c)(7).
52 See id. § 80a-3(c)(1).
54 LEMKE ET AL., supra note 31, § 8:16.
55 See Div. of Inv. Mgmt., supra note 7, at 11. There is, however, an important exception to this rule:

If a corporate investor that is a registered investment company, or a company relying on Section 3(c)(1) or Section 3(c)(7), beneficially owns [10%] or more of the outstanding voting securities of the Section 3(c)(1) fund, the Section 3(c)(1) fund must “look-through” that corporate investor and count each of its investors as a beneficial owner of the Section 3(c)(1) fund for purposes of the 100-investor limitation. A hedge fund that relies on Section 3(c)(1) and that accepts investments from registered investment companies or entities relying on Section 3(c)(1) or Section 3(c)(7), therefore, must ensure that those investors do not acquire more than [10%] of the hedge fund’s outstanding voting securities so that the hedge fund may continue to rely on Section 3(c)(1).

57 Div. of Inv. Mgmt., supra note 7, at 11–12; see Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency, 76th Cong. 179 (1940) (statement of David Schenker, Chief Counsel, Securities and Exchange Commission).
Funds are likewise exempt from registration under § 3(c)(1) so long as they make offerings to accredited investors. These investors, according to the Securities Act of 1933, include certain banks, registered investment companies, small business investment companies, ERISA plans, and individual investors who are accredited "on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management." The Securities Act allows accredited investors to invest through private placements. Because the Securities Act does not consider characteristics other than an individual investor’s wealth, some commentators have suggested a broader standard because “the only way to assure adequate [investor] protection is to require hedge funds to make an assessment of the level of an investor’s sophistication and determine whether the investor’s ‘expertise’ is suitable for the investment in question.”

While § 3(c)(1) exempts hedge funds limited to accredited investors, § 3(c)(7) exempts funds that do not make public offerings and have only “qualified purchasers,” whose numbers can exceed 100. Qualified purchasers include individual investors with investments worth at least $5 million, family companies with investments worth at least $5 million, certain trusts, and companies that own or manage

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58 See Div. of Inv. Mgmt., supra note 7, at 12. Even if the hedge funds can make offerings to accredited investors, they cannot engage in a general solicitation or general advertising of their shares. See id.
60 Id. § 77b(a)(15)(ii); see also Recommendations by the President’s Working Group on Fin. Mkt., Hearing Before the H. Comm. on Banking and Fin. Servs., 106th Cong., 69 (2000) (statement of George Crapple, Chairman, Managed Funds Association) (“[P]rivately offered investment funds such as hedge funds are offered to sophisticated investors whose ability to make informed investment decisions and to impose their own demands for information generally obviate federally-imposed disclosure requirements.”); 17 C.F.R. § 230.501(a)(5)–(6) (stating the asset requirements to be an accredited investor as “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds $1,000,000” or “[a]ny natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person’s spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year”).
61 See de Brouwer, supra note 23, at 13.
62 Edwards, supra note 4, at 44 (“Such a ‘suitability’ standard would shift the responsibility of limiting access to hedge fund investments to hedge funds and other marketers of these products, and would relieve investors of the responsibility of determining whether hedge fund investments are suitable for them.”). Many commentators have suggested that the SEC should pay little attention to investments that accredited investors make. See, e.g., Parry, supra note 27, at 718 (“Regulators generally do not spend sleepless nights worrying about the plight of millionaires who invest unsuccessfully in alternative markets such as hedge funds . . . .”); John Berlau, Hedge Funds Today: Who Is Watching the Watchdog?, WALL St. J., Dec. 9, 2005, at A14 (“[T]here has been . . . a widespread consensus that [accredited] investors don’t need the additional protection of the registration process, and that it is essential for the capital markets that these entities be able to move quickly.”).
investments worth at least $25 million. In certain situations, “qualified institutional buyers” and “knowledgeable employees” can be qualified purchasers. Again, offshore funds that rely on the § 3(c)(7) exemption need only count U.S. investors as qualified purchasers.

Given that the definitions of accredited investor and qualified purchaser include only high-worth individuals, it is clear why the Investment Company Act of 1940 generally exempts hedge funds: The federal government should not bear the responsibility for protecting high net-worth investors who are in a better financial position to assume risk in their investments.

Hedge fund advisers can also take advantage of a fourth exemption from registration: the Investment Adviser Act’s de minimis exemption, also called the “private adviser exemption.” The de minimis exemption excuses from registration “any investment adviser 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 an investment adviser to any [registered] investment company.” Legal organizations such as hedge funds count as only one client under the de minimis exemption, because “[i]n computing the number of clients, a limited partnership counts as only one client of the general partner or any other person acting as investment adviser to the partnership.”

B. SEC Registration Provisions for Hedge Fund Advisers

Following a 2004 three-to-two vote by the SEC Commissioners, many hedge fund advisers could no longer take advantage of the de minimis exemption. By eliminating the de minimis exemption, the
SEC required hedge fund advisers to employ a new method for counting their clients.\(^{75}\) The new rule\(^{76}\) adopted a look-through approach and “no longer count[ed] a [hedge] fund as one advisory client but rather look[ed] through to the fund’s investors as advisory clients.”\(^{77}\) Nevertheless, the SEC adopted a completely different counting method for certain offshore advisers:\(^{78}\) The SEC allowed those who “ha[d their] principal office and place of business outside the United States”—almost all offshore hedge funds—to treat their fund and not their investors as clients.\(^{79}\)

The registration regulations did not change the minimum level of assets that a hedge fund adviser must manage to mandate registration with the SEC.\(^{80}\) This decision runs against the suggestions of

\(^{75}\) See 17 C.F.R. § 275.203(b)(3)-2.

\(^{76}\) The new rule does not literally apply to hedge funds. Rather, hedge funds fall under the definition of “private funds” and thus the registration requirements apply. See id. § 275.203(b)(3)-2(a); see also Waters Comment, supra note 27 (“Labeling hedge funds is critical. Today, identifying whether an investment is a hedge fund can be almost impossible for the individual investor.”).


\(^{79}\) 17 C.F.R. § 275.203(b)(3)-2(c).

many industry insiders. The SEC, however, contended that including the minimum asset level in federal regulation would violate state regulation, as forty-nine states already have statutory minimums for registered advisers. Moreover, when calculating a hedge fund’s assets to determine whether registration is necessary, “[a]n adviser [has to] exclude proprietary assets invested in the fund, and need not include the value of assets attributable to non-U.S. investors.”

According to some commentators, the registration requirement was part of the SEC’s effort to increase regulation of offshore funds. In a report that the SEC issued:

The SEC has chosen to limit . . . extraterritorial application . . . by providing that an offshore adviser to an offshore private fund may treat the fund . . . and not the investors . . . as its client for most purposes under the Act. The offshore adviser will register under the Act and keep certain books and records as required by SEC rules, and will remain subject to examinations by SEC staff. Other requirements, including the . . . compliance rule, custody rule, and proxy voting rule, would not apply to the registered offshore adviser. In addition, SEC staff is exploring ways to obtain and share information with foreign authorities with oversight of hedge fund advisers that may register with the SEC.
Essentially, the SEC’s Office of International Affairs allowed several obvious loopholes for offshore funds and their advisers. The Office of International Affairs explained that it was “exploring ways to obtain and share information with foreign authorities” rather than providing actual regulatory guidance to offshore funds and their advisers.

C. Criticisms of the Hedge Fund Adviser Registration Rule

Despite the SEC’s assertion that the registration provisions of the Investment Advisers Act would strengthen regulation of offshore hedge funds, letters that industry leaders sent to the SEC during the rule-making stage suggested that these provisions would be insufficient to regulate offshore funds and advisers. For example, one industry leader said that mandatory registration would encourage some hedge fund advisers to relocate offshore, which would defeat the effectiveness of the regulations. Similarly, former Federal Reserve Board Chairman Alan Greenspan commented that “[a]ny direct U.S. regulations restricting [the hedge funds’] flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. . . . If the funds move abroad, our oversight will diminish.”

The movement of funds overseas and the resulting loss of U.S. jurisdiction contravene the SEC’s goal of protecting investors from unfit advisers and potential fraud.

The implications of registration create additional concerns. First, depending on their fund’s structure, some hedge fund managers, particularly managers of previously unregistered and smaller funds, might find the registration requirements difficult to meet. Second, with registration comes implied fiduciary duties and the SEC’s mandatory disclosure and filing requirements. Additionally, the SEC likely lacks adequate resources to deal with the periodic filings,

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86 Office of Int’l Affairs, supra note 85, at 692.
87 See, e.g., Letter from John G. Gaine, President, Managed Funds Ass’n, to The Honorable William H. Donaldson, Chairman, Sec. & Exch. Comm’n (Nov. 21, 2003), available at 1422 PLI/Corp 777 (Westlaw).
88 See id.
89 Id.
90 See, e.g., Seward & Kissel Comment, supra note 81 (“[W]e believe that the required registration of private fund advisers . . . will likely cause many smaller advisers to close.”); Christopher Faille, The Cost of Compliance, in It’s the Rule: The New SEC Adviser Regulation for Hedge Funds, supra note 78, at 30, 30 (“What this rule is going to do . . . is make it virtually impossible to take . . . $50 million or . . . $75 million and start a hedge fund. The costs associated with this are a huge hurdle.”). For an example of a rule that would affect hedge fund managers once they register, see Maintenance of the Indicia of Ownership of Plan Assets Outside the Jurisdiction of the District Courts of the United States, 29 C.F.R. § 2550.404b-1(a)(2) (2006).
91 See Hazen, supra note 9, § 21.3[1].
while few hedge funds likely have the infrastructure in place to meet the necessary reporting requirements.  

Immediately prior to the effective date of the registration regulation, members of the hedge fund and mutual fund industries, attorneys who specialize in hedge fund regulation, worldwide regulators, and academics formally challenged the regulation. One hedge fund manager, Phillip Goldstein, took the SEC to federal court to challenge the registration regulation, alleging that the SEC exceeded its authority in adopting the rule, that the rule was “not a reasonable interpretation of the [Investment] Advisers Act,” and that the rule was “arbitrary and capricious.” Initially, legal commentators speculated that Goldstein’s arguments would not hold any weight in court because they believed that “‘[i]f the SEC wants oversight in a particular jurisdiction, they’re going to get it.’”

Nevertheless, the D.C. Circuit invalidated the registration requirement. Circuit Judge Arthur Raymond Randolph examined the ambiguous meaning of the term “client” in the Investment Advisers Act and discussed the duties that arise in an adviser-client context, including a fiduciary duty and a duty of loyalty. Judge Randolph held that the SEC had “not adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter.” The D.C. Circuit was so emphatic in its rejection of the registration requirement that days after the invalidation, SEC Chairman Christopher Cox issued a statement declaring that the SEC would not seek en banc review.

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94 See Brief of Petitioners at 26, Goldstein v. SEC, No. 04-1434 (D.C. Cir. June 23, 2005) [hereinafter Brief of Petitioners].
95 Id. at 35.
96 Id. at 47.
97 See, e.g., Jeff Benjamin, Suit over Hedge Fund Registration on, But Industry Isn’t Holding Its Breath, Inv. News, Oct. 17, 2005, at 3 (“[T]here are many in the hedge fund industry who are not pinning their hopes on a victory for [the adviser] . . . . To some, the lawsuit is little more than a desperate attempt at finding a loophole.”).
98 Id. (quoting Jeff Joseph, Managing Director, Alternative Investments, Rydex Global Advisors, Inc.).
100 See id. at 878–84 (“The client of a laundry occupies a very different position than the client of a lawyer.”).
101 See id. at 879–80 (discussing Lowe v. SEC, 472 U.S. 181 (1985)).
102 Id. at 882.
103 See S.E.C. Decides It Won’t Appeal on Hedge Funds, N.Y. Times, Aug. 8, 2006, at C9 (“[F]urther appeal would be futile and would simply delay and distract from our goal of advancing investor protection.” (quoting SEC Chairman Christopher Cox)); Press Re-
THE SEC’S INACTION IN RESPONSE TO CONCERNS FROM MUTUAL FUND AND LEGAL INSIDERS DURING THE RULE-MAKING PROCESS AND POSSIBLE EFFECTS OF IGNORING REGISTRATION OF OFFSHORE HEDGE FUNDS

A. SEC Inaction

According to a 1999 statement from the President’s Working Group on Financial Markets, “requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity.” Despite this statement, the SEC conducted a comment period after drafting the Proposed Rule, taking comments from both its staff and the public.

Some commentators argued that the comment period was insufficient “to solicit meaningful input on this important proposal” and indicated.

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104 The President’s Working Group on Financial Markets is a group comprised of leading members of the Department of the Treasury, Board of Governors of the Federal Reserve System, the SEC, and the CFTC. See Exec. Order No. 12,631, 53 Fed. Reg. 9,421 (Mar. 18, 1988).

105 PRESIDENT’S WORKING GROUP ON FIN. MKTS., supra note 1, at B-16 (emphasis added); see also Comment, Sheila C. Bair, Dean’s Professor of Fin. Regulatory Policy, Univ. of Massachusetts-Amherst, Former Assistant Sec’y for Fin. Instrs., U.S. Dep’t of the Treasury, Former Comm’r and Acting Chairman, Commodity Futures Trading Comm’n, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172, at 3 (Sept. 15, 2004) [hereinafter Bair Comment], http://www.sec.gov/rules/proposed/s73004/scbair091504.pdf (“Given the fact that hedge funds do not account for a disproportionate share of fraud cases, it would seem that market discipline is by and large working. SEC registration could weaken that discipline.”).

106 See, e.g., Comment, Managed Funds Ass’n, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, 69 Fed. Reg. 45,172, at 1 (Oct. 18, 2004) [hereinafter MFA Comment], http://www.sec.gov/rules/proposed/s73004/mfa101804.pdf (“The SEC received 156 letters as of October 13th, 124 of which were either for or against the proposal. The overwhelming number of the 124 comment letters that took a position opposed the SEC Proposal . . . .”)

107 See, e.g., Div. of Inv. Mgmt., supra note 7.

108 See, e.g., MFA Comment, supra note 106, at 1 (“Those who oppose this proposal include not only major hedge fund groups, industry participants, the leading trade association representing this industry and top legal professionals and law firms who represent hedge fund managers, but also major business groups such as the U.S. Chamber of Commerce.”).

cated that the “limitation of the comment period . . . was obviously designed to reduce comment on the proposed rule.”  

In adopting the final rule, the SEC ignored important suggestions, both internal and external. Namely, the SEC did not specify the types of disclosures it would mandate for registered fund advisers, require “Board Adopted Valuation Procedures,” identify and encourage industry “Best Practices,” or develop programs for investor education.

B. Likely Creation of Parallel Funds Offshore to Avoid Registration Requirements and Movement of U.S. Investors’ Funds to Offshore Havens

Because of the ambiguity regarding how the registration requirements pertained to offshore hedge funds, onshore hedge funds could still create “two parallel funds, one fund for non-qualified investors which is subject to the 100 holder limit, and a second fund solely for qualified investors which can admit an unlimited number of qual-

EXECUTIVE, Dec. 12, 2005, at 7 (“In a recent speech deriding what he called an ‘undi
ciplined approach’ to rulemaking at the SEC, Commissioner Paul Atkins said, ‘We are
discovering that the benefits of registration might fall short of our expectations, since [the
registration form] will not yield the type of information that would be needed for mean-
ingful oversight.’”); Mark Hendrickson, Commissioner Atkins Says Hedge Fund Rules Stretch SEC Too Thin, SEC, We., Oct. 10, 2005, at 7 (“[SEC Commissioner Paul] Atkins . . . criticized the agency for not listening to other regulators at the time the hedge fund rule was adopted.”); Jaime Levy Pessin & Phyllis Plitch, SEC’s Atkins: Hedge-Fund Rule Yields Little Info So Far, DOW JONES NEWS SERVICE, Nov. 9, 2005 (“‘Now our own staff is saying, duh, we’re not getting the information we need.’” (quoting Commissioner Atkins in a speech at a Securities Industry Association conference on November 9, 2005)).

110 Brief of Petitioners, supra note 94, at 52.  
111 See, e.g., MFA Comment, supra note 106, at 1 (“[M]any commentators provided al-
ternatives to the SEC Proposal that, to our knowledge, the Commission has yet to con-
sider.”); Comment, Richard M. Whiting, Executive Dir. & Gen. Counsel, Fin. Servs. Round-
table, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund A

112 See Div. of Inv. Mgmt., supra note 7, at x, 96–97.  
113 Id. at 99.  
114 Id. at x, 101.  
115 See id. at x, 103. Investor education is not a point that should have been lost on the SEC, particularly following a false news release the agency placed on the Internet, advertising the fictitious hedge fund Guaranteed Returns Diversified Inc. (Symbol GRDI, pronounced “Greedy”). See Joseph Hellrung, Hedge Fund Regulation: Investors Are Knocking at the Door, But Can the SEC Clean House Before Everyone rushes In?, 9 N.C. BANKING INST. 317, 317 (2005). The funds advertised on the hedge fund’s Web site included one that claimed to have generated returns of 148% since 2000 and another that claimed to have consistent returns of up to 99%. See id. “Despite the outrageous claims by [the fund], the site received over 80,000 hits in a ten month period.” Id.  
116 See supra Part I.B.
fied purchasers.”117 The adviser therefore could continue to avoid registration. This structure took advantage of the preexisting loophole that foreign investors do not count toward the hundred-person limitation.118 In practice, however, some funds found such a drastic alteration in fund structure too inconvenient and opted to register.119

C. Increased Risk of Fraud

Simply put, “[f]raud is bad.”120 One of the SEC’s goals in enacting the registration regulation was to prevent fraud, and some commentators believed that the hedge fund registration requirement would force hedge funds “to become a lot more open as SEC regulators increase their surveillance over the financial markets in an effort to protect investors.”121 Other commentators have noted that “[t]he

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117 Joel Scharfstein & Brian Kniesly, Section 7704 and Publicly (or Non Publicly) Traded Partnerships, in 10 TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2005, at 275, 288 (2005); see also Recommendations by the President’s Working Group on Financial Markets: Hearing Before the H. Comm. on Banking and Fin. Servs., 106th Cong. 9 (2000) (statement of Hon. Richard H. Baker, Chairman, Subcomm. on Capital Markets, Securities and Government Sponsored Enterprises of the House Comm. on Banking and Financial Services) (“I do not support regulating hedge funds directly. I do not want to take any action that would result in the relocation of this industry to an unregulated offshore domicile.”); H.R. 2924—The Hedge Fund Disclosure Act: Hearings Before the Subcomm. on Capital Mkts., Secs. and Gov’t Sponsored Enters. of the H. Comm. on Banking and Fin. Servs., 106th Cong. 5 (2000) (statement of Rep. Patrick J. Toomey) (“[This move toward regulation] will be detrimental to American financial institutions, in part by encouraging hedge fund activity to just take place offshore, beyond the reach of American regulators.”); Fin. Servs. Roundtable Comment, supra note 111, at 2 (“[A]dditional regulation of hedge fund advisers could lead them to relocate offshore.”); PRESIDENT’S WORKING GROUP ON FIN. MKTS., supra note 1, at 42, 43 (“It is possible . . . that directly regulating these institutions could drive some of them offshore, which could make regulation less effective. . . . The increase in cross-border financial flows . . . highlights the importance of an appropriate financial regulatory structure.”); Julie Dalla-Costa, Guarding Against Hedge Fund Fraud, EUROMONEY (U.K.), Nov. 2004, at 58 (describing how hedge fund adviser Charles L. Harris admitted to moving funds offshore).

118 See Scharfstein & Kniesly, supra note 117, at 288.

119 See id.


121 Jack O’Hara, Hedge Funds Likely to Receive Additional Scrutiny, LEGAL INTELLIGENCER, June 14, 2005, at 5; see, e.g., Alexander M. Ineichen, On Myths, Bubbles and New Paradigms in the Hedge Fund Industry, in HEDGE FUNDS: RISKS AND REGULATION, supra note 1, at 5, 3 (“Hedge fund managers have different incentives than Wall Street talking heads where self-promotion is a key to success. If you have a trading strategy or investment process with superior risk/reward trade-off in absolute return space, why do you want to tell it to the world for free . . . ?”); Nocera, supra note 27 (“Hedge fund managers fear that the [SEC] isn’t sophisticated enough to understand their complex trading strategies . . . . Secrecy is the Achilles’ heel of the hedge fund industry. It’s scary that nobody knows what hedge funds are doing . . . .”); see also Davis Comment, supra note 1 (“The potential for abuse for investors in hedge funds, as well as to the general public who invests in securities contemporaneously, is enormous.”); Gary Duncan, Hedge Funds—Weapons of Mass Financial Destruction, TIMES (U.K.), Oct. 25, 2004, at 22 (“[T]he burgeoning operations of hedge funds [are] operations that may now pose a threat greater than Saddam Hussein and his elusive
growth in hedge funds has . . . been accompanied by troubling growth in the number of . . . hedge fund enforcement cases.”

122 The number of hedge fund enforcement cases will most likely grow, and ineffective SEC regulation has led some lawmakers to investigate alternative ways to rein in hedge funds. 123

See, e.g., Hedge Funds and Independent Analysts: How Independent Are Their Relationships?: Hearing Before the S. Comm. on the Judiciary, 109th Cong. 369 (2006) (statement of Sen. Arlen Specter, Chairman, Senate Comm. on the Judiciary), available at 2006 WLNR 11262786 (stating that if the SEC is unable to find ways to regulate fraudulent hedge funds,
There is an industry-wide concern that the registration requirement would give the public a false sense of security about investing in hedge funds. As the number of American millionaires who qualify as accredited investors and sophisticated investors increases, these new millionaires will likely jump into hedge fund investment. New tools on the market will aid these investors in making their investments. For instance, investors today have access to online informa-

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124 See, e.g., Bair Comment, supra note 105, at 1–2 (“[I]t is far from clear whether requiring hedge fund advisers to register with the SEC will help or inadvertently harm investors by creating unrealistic expectations . . . . perhaps emboldening investors who otherwise would not invest in such funds to do so, out of the belief that the SEC will protect them.”); Parry, supra note 27, at 719 (“The relatively new rich are particularly ripe targets for unscrupulous . . . hedge fund advisers and managers.”). The public generally finds out about certain funds through word of mouth because the law historically has not permitted hedge funds to solicit funds from the public. See, e.g., Davis Comment, supra note 1 (“Hedge funds relatively new to the public now are starting to reach the mainstream media.”); de Brouwer, supra note 23, at 13; Div. of Inv. Mgmt., supra note 7, at ix–x, 16; President’s Working Group on Fin. Mkt., supra note 1, at 3.

125 See, e.g., O’Hara, supra note 121, at 5; Parry, supra note 27, at 719 (“Unlike the traditional . . . target for an investment scam . . . ‘Aunt Agatha’—a term redolent with images of elderly upper class spinsters, replete with inherited wealth but with no husband to look after it—the new rich of today are more likely to be entertainers, sports stars or those who have amassed wealth in the dot.com sector, and they may have practically no knowledge of or experience of any significance with financial markets or investing.”). For definitions of accredited and sophisticated investors, see supra text accompanying notes 50–67.

126 See, e.g., Borla & Masetti, supra note 23, at 79 (“Within the world of hedge funds . . . , we are seeing the emergence of a series of associations, web sites, organ[i]zations and special[i]z[ed] organ[i]z[ations whose objective is to provide information, research, reports, databases and organ[i]z[ations and conferences and events.”).
tion tools\textsuperscript{127} and can investigate hedge funds on their own—for a cost—by hiring detective agencies that specialize in hedge fund investigation.\textsuperscript{128}

These investigative tools may give the average U.S. investor a false sense of security, thus exposing an increasing number of American households to fraud.\textsuperscript{129} Currently, not only is it difficult for the average investor to garner information about hedge funds (short of hiring one of the private agencies),\textsuperscript{130} but hedge funds are also inherently riskier than the typical investment vehicles in which the average U.S. investors currently entrust their money. However, despite the recent mutual fund scandals,\textsuperscript{131} a great deal of curiosity surrounds hedge fund investment.\textsuperscript{132} Thus, the SEC needs to be diligent in providing measures to protect investors who may be accredited or qualified\textsuperscript{133} by definition but perhaps are not so in actuality.\textsuperscript{134}

III

HOW OTHER U.S. REGULATORY BODIES HAVE DEALT WITH THE OFFSHORE PROBLEM

A. Internal Revenue Service

Historically, offshore hedge funds were an investment haven because of U.S. tax law’s favorable treatment.\textsuperscript{135} As long as the offshore fund is deemed not to be “engaged in a U.S. trade or business,” the

\textsuperscript{127} See, e.g., Tergesen, supra note 20.\textsuperscript{R}

\textsuperscript{128} See, e.g., Jane J. Kim, Digging for Hedge Fund Dirt, WALL ST. J., Aug. 8, 2005, at C1; Anne Tergesen, Hedge Fund Sleuths, BUS. WK., Nov. 21, 2005, at 142 (“[The investigative firms’] fees range from $1,000 to $30,000, depending on the number of funds or managers involved. . . . If a manager has spent time overseas, they’ll investigate there.”).\textsuperscript{R}

\textsuperscript{129} See, e.g., Hellrung, supra note 115, at 329; Erik J. Greupner, Note, Hedge Funds Are Headed Down-Market: A Call for Increased Regulation?, 40 SAN DIEGO L. REV. 1555, 1573–78 (2003); Lori Pizzani, Registered Hedge Funds Gain in Popularity, INVESTMENT MGMT. WKLY., May 3, 2004, at 7. But see, e.g., Helm & Babikian, supra note 53, at 796–97; Jeff Benjamin, Hedge Funds May Gain New Fans: Registration Makes Them More Palatable to Financial Advisers, INVESTMENT NEWS, Nov. 1, 2004, at 1 (“[The] decision by the [SEC] to require the majority of hedge fund managers to register as investment advisers could have the unintended consequence of creating a seal of approval for the $870 billion hedge fund industry.”). Because the new regulations will give the guise that investment in U.S. funds will have improved antifraud measures, larger funds’ investments will likely move offshore, away from the SEC’s arm of regulation, thus increasing the risk of fraud.\textsuperscript{R}

\textsuperscript{130} See supra notes 127–128 and accompanying text.\textsuperscript{R}

\textsuperscript{131} See Rory B. O’Halloran, Comment, An Overview and Analysis of Recent Interest in Increased Hedge Fund Regulation, 79 Tul. L. Rev. 461, 489–90 (2004).\textsuperscript{R}

\textsuperscript{132} See supra note 2.\textsuperscript{R}

\textsuperscript{133} For definitions of accredited and sophisticated investors, see supra text accompanying notes 50–67.\textsuperscript{R}

\textsuperscript{134} See supra note 122.\textsuperscript{R}

\textsuperscript{135} See Helm & Babikian, supra note 53, at 773–75. Little has been done to legislate for the movement of funds offshore to avoid U.S. taxes. See, e.g., C. Bryan Cloyd et al., Firm Valuation Effects of the Expatriation of U.S. Corporations to Tax-Haven Countries, J. AM. TAX’N ASS’N, Jan. 1, 2003, available at 2003 WLNR 5773157; Amy Hamilton, REPO Act Targets Inve-
IRS will impose only a withholding tax on certain income. Because of this loophole, hedge fund advisers strive to ensure that they are not “engaged in a U.S. trade or business.” Arguably, this loophole protects U.S. investors from offshore hedge fund solicitation. Yet, even though hedge funds cannot advertise to the public, they seem undeterred from finding U.S. investors because U.S. investors are a hotbed of assets.

Although the Taxpayer Relief Act of 1997 eliminated some of the previous favorable treatment toward offshore entities, the IRS still affords offshore hedge funds multiple loopholes. For instance, fund investors bear a great tax burden if the fund is deemed to be a “foreign corporation” with U.S. investors owning “more than 50[\%] of . . . the total combined voting power of all classes of stock of [the offshore hedge fund] entitled to vote, or the total value of the stock of such [offshore fund].” The IRS would consider the fund a “controlled foreign corporation” (CFC) and would tax its U.S. investors at an unfavorable rate. Offshore hedge funds can generally avoid CFC status by organizing as a noncorporation, such as a limited liability partnership, such that the fund “is less likely to be considered a CFC.”

Offshore funds are also careful to ensure that they do not fall under the U.S. Treasury Department’s rules for “passive foreign investment companies” (PFICs). Under these rules, the IRS taxes certain distributions from PFICs to U.S. investors at the highest possible rate for individuals and subjects these distributions to a deferred inter-
2007] OFFSHORE HEDGE FUNDS 819

est tax charge.\textsuperscript{145} Generally, this high tax would offset most of the benefits that the U.S. investor would otherwise have.\textsuperscript{146} However, a loophole exists to avoid some of this unfavorable tax treatment.\textsuperscript{147}

B. U.S. Department of Labor, ERISA, and Pension Fund Investment Offshore

With an increasing number of pension plans, endowments, and charities investing in hedge funds, the activities of hedge funds play a larger role in the lives of small, individual investors.\textsuperscript{148} Pension plans have a fiduciary relationship to their beneficiaries, so when pension plans invest in hedge funds, these plan fiduciaries arguably expose their beneficiaries to greater risks with their retirement income.\textsuperscript{149} Potential losses stemming from risky hedge fund investments question the pension plan’s ability to satisfy its requirements as a fiduciary to the beneficiaries of the plan.\textsuperscript{150}

ERISA, the legislation with the greatest impact on pension plans, together with its regulations, limits the entities that are qualified to hold “plan assets” in offshore funds.\textsuperscript{151} ERISA places limitations on plan fiduciaries,\textsuperscript{152} establishes a standard of conduct,\textsuperscript{153} makes guidelines for complying with the “prudent conduct” standard,\textsuperscript{154} prohibits certain transactions,\textsuperscript{155} creates a bonding requirement,\textsuperscript{156} and explains the proper custody of plan assets.\textsuperscript{157} The custody of assets pro-

\textsuperscript{145} See id. § 1291.
\textsuperscript{146} See LEMKE ET AL., supra note 31, § 8:22.
\textsuperscript{147} See I.R.C. §§ 1293, 1295 (qualified electing fund provisions).
\textsuperscript{148} See O’Hara, supra note 121, at 3; see also Riva D. Atlas & Mary Williams Walsh, Pension Officers Putting Billions into Hedge Funds, N.Y. Times, Nov. 27, 2005, at 1 (“Faced with growing numbers of retirees, pension plans are pouring billions into hedge funds, the secretive and lightly regulated investment partnerships that once managed money only for wealthy investors.”).
\textsuperscript{149} See Roye Speech, supra note 2.
\textsuperscript{150} See id.
\textsuperscript{152} Section 404(a)(1) of ERISA sets forth the basic responsibilities and expectations of an ERISA plan fiduciary. See 29 U.S.C. § 1104(a)(1)(A) (“exclusive benefit” rule); id. § 1104(a)(1)(B) (“prudence” rule); id. § 1104(a)(1)(C) (“diversification” rule “so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so”); id. § 1104(a)(1)(D) (requiring action by fiduciaries in accordance with plan documents and the other provisions of ERISA).
\textsuperscript{153} See supra note 152.
\textsuperscript{155} See id. § 1106. There are some exemptions to the prohibited transactions. See id. § 1108.
\textsuperscript{156} See id. § 1112.
\textsuperscript{157} See id. § 1104(b)–(c).
vision specifically states that ERISA assets cannot be held outside the jurisdiction of U.S. district courts unless certain conditions are met.158

Hedge funds that specifically and intentionally target investment by pension plans are structured in such a way as not to be subject to ERISA and its regulations159 because of the fiduciary responsibilities placed on ERISA plan fiduciaries. For example, a hedge fund adviser can be deemed an ERISA plan fiduciary if the adviser takes compensation for his or her investments, renders advice about the ERISA plan assets, and either has control over some plan assets or renders advice pursuant to an agreement.160 One important inquiry is to determine whether hedge fund assets are plan assets: If 25% or more of the hedge fund’s assets are plan assets, the hedge fund adviser is deemed an ERISA plan fiduciary.161

Some funds face a tradeoff between accepting regulation under ERISA and attracting investors to their hedge fund.162 On the one hand, accepting ERISA plan funds entails the expense of the fiduciary duty.163 On the other hand, because pension funds can bring in large amounts of assets,164 some fund advisers are willing to accept the fiduciary duty that comes with managing ERISA funds.165 Typically, before a pension plan invests in a hedge fund, the ERISA fiduciary “will require assurances from the hedge fund adviser that it will not be liable under ERISA for any misconduct on the part of the hedge fund adviser in managing the plan assets.”166 Hedge fund advisers can ordinarily protect ERISA plan fiduciaries from liability for such misconduct if the hedge fund adviser registers with the SEC as an investment adviser.167

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158 See id. § 1104(b); Maintenance of the Indicia of Ownership of Plan Assets Outside the Jurisdiction of the District Courts of the United States, 29 C.F.R. § 2550.404b-1 (2006).

159 See LEMKE ET AL., supra note 31, § 4:52.


161 See 29 C.F.R. § 2510.3-101; see also Bronislaw E. Grala et al., Summary of ERISA Issues for Hedge Fund Managers Considering Exceeding the 25% Threshold on Benefit Plan Investors, in PENSION PLAN INVESTMENTS 2005: CONFRONTING TODAY’S ISSUES 329, 329 (2005) (“Once benefit plan investors cross the 25% threshold, the hedge fund manager will be subject to fiduciary standards and prohibited transaction rules of ERISA.”); Steve Zwick, 2006: Hedge Funds Get Regulated, FUTURES, Dec. 1, 2005, at 60 (“Any fund manager who gets more than 25% of his money from pensions is subject to the same fiduciary responsibilities as pension funds themselves under . . . ERISA . . . which is administered by neither the SEC nor the CFTC, but by the Department of Labor.”).

162 See DIV. OF INV. MGMT., supra note 7, at 28.

163 See supra text accompanying notes 151–158.

164 See DIV. OF INV. MGMT., supra note 7, at 96–97.

165 See id. at 28.

166 Id.

C. Commodity Futures Trading Commission and Pooled Assets Offshore

Although the Commodity Exchange Act,\textsuperscript{168} like all other federal securities legislation, does not define the term hedge fund, the CFTC has had some success in requiring the registration of hedge fund advisers.\textsuperscript{169} However, CFTC insiders recognize that the CFTC’s regulatory methods concerning offshore investment are imperfect.\textsuperscript{170} For instance, if the hedge fund trades futures contracts or commodity options, the hedge fund adviser must register with the CFTC as a commodity pool operator\textsuperscript{171} or a commodity trading adviser\textsuperscript{172} unless an exemption is available.\textsuperscript{173} Once the hedge fund adviser registers with the CFTC, he or she becomes subject to the Commodity Exchange Act’s antifraud provisions\textsuperscript{174} and extensive disclosure requirements.\textsuperscript{175}

However, the Commodity Exchange Act still allows for loopholes in the registration of offshore hedge fund advisers.\textsuperscript{176} For example, hedge funds regulated by other federal or state law—most offshore hedge funds—can take advantage of Commodity Exchange Act Rule 4.5, which is intended to avoid double registration.\textsuperscript{177} Another exemption exists for commodity pool operators that register with the National Futures Association before beginning to operate the pool: The operators may claim a specific exemption from all disclosures and reporting requirements of registered commodity pool operators as well as many recordkeeping requirements.\textsuperscript{178}

The Commodity Exchange Act rules include many exemptions that offshore advisers can use. For instance, the CFTC rules exempt offshore funds from registration when the adviser receives no compensation\textsuperscript{179} and when there are limited investments and investors in


\textsuperscript{169} See, e.g., HAMMER ET AL., supra note 4, § 2.9; Ernest E. Badway, Hedge Funds Under Fire: Is There Body Armor Out There?, METROPOLITAN CORP. COUNS., June 2005, at 33.

\textsuperscript{170} See To Consider the Reauthorization of the Commodity Futures Trading Commission: Hearing Before the S. Comm. on Agric., Nutrition and Forestry, 109th Cong. 3 (2005) (statement of Sharon Brown-Hruska, Chairman, Commodity Futures Trading Commission) (“Congress may wish to review whether the CFTC has clear and adequate authority to police retail fraud, particularly in the foreign exchange area.”).

\textsuperscript{171} See 7 U.S.C. § 1a(5).

\textsuperscript{172} See id. § 1a(6).


\textsuperscript{174} See 7 U.S.C. § 4b(a)(i).

\textsuperscript{175} See 17 C.F.R. pt. 4; see also DE BROUWER, supra note 23, at 15 (“The [Commodity Exchange] Act requires funds to be registered, to report information about risks, historical performance, fees, business background, and conflicts of interest to the . . . CFTC . . . and maintain records for possible inspection by the CFTC and . . . Department of Justice.”).

\textsuperscript{176} See, e.g., 17 C.F.R. §§ 4.13(a)(3)–(4) (exemptions from registration as a commodity pool operator), 4.14(a)(8) (exemptions from registration as a commodity trading adviser).

\textsuperscript{177} See id. § 4.5.

\textsuperscript{178} See id.; Div. of Inv. Mgmt., supra note 7, at 25.

\textsuperscript{179} See 17 C.F.R. § 4.13(a).
the pool. In addition, two recently adopted Commodity Exchange Act rules allow hedge fund advisers to qualify for exemptions from commodity pool operator and commodity trading adviser registration. First, if a commodity pool operator operates a pool under a registration statement, sells only to certain high net-worth investors, and limits its commodity futures activities, then the operator may be exempt. Second, commodity pool operators that operate pools that advertise and sell to only certain high net-worth investors may also be exempt. Additionally, the Commodity Exchange Act and its corresponding regulations contain a de minimis exemption that is similar to the SEC’s de minimis exemption. Generally, because of the similarities between the Commodity Exchange Act exemptions and the Investment Advisers Act exemptions, “hedge fund advisers that are exempt from registration as an investment adviser also are usually exempt from registration as a [commodity trading adviser].”

IV
WHETHER AND HOW THE SEC SHOULD ALTER ITS HEDGE FUND REGULATORY REGIME

A. The SEC’s Inability to Regulate Hedge Funds Effectively

Notably, during the recent shift to increase the SEC’s regulation of hedge funds, there have been no moves to eliminate the investment vehicle entirely. In fact, some commentators have noted a need for hedge funds in the marketplace. With the average investor’s interest in hedge funds increasing, market overseers have expressed a desire to protect unsophisticated investors from potential fraud. However, the SEC’s efforts seem shortsighted and ignore the concerns of government officials from other regulatory agencies as well as

180 See id.
181 See President’s Working Group on Fin. Mkt., supra note 1, at C-3.
183 See id. § 4.13(a)(4).
186 See, e.g., Quarles Statement, supra note 3; Federal Reserve’s First Monetary Policy Report for 2004: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs, 108th Cong. 37 (2004) (testimony of Alan Greenspan, Chairman, Federal Reserve Board), quoted in Fin. Servs. Roundtable Comment, supra note 111, at 1–2 (“[H]edge funds have been very helpful to liquidity and hence the international flexibility of our financial system.”); Justin Fox, Fear of a Black Box, FORTUNE, Nov. 14, 2005, at 174 (“[H]edge funds appear to deliver better returns—and returns that don’t just follow the ups and downs of the stock market—than the heavily regulated, transparent, largely blowup-free mutual fund industry.”).
187 See supra note 2 and accompanying text.
188 See supra Part II.C.
hedge fund and mutual fund insiders, investors, academics, and attorneys who specialize in the regulation of financial institutions.180

For instance, the SEC staff did not consider whether the SEC has the means to effectively enforce the registration regulation.190 Like many Americans, many SEC employees do not understand the workings and investment strategies of hedge funds.191 Had the court in

180 See supra Part II.A.

190 See Comment, W. Nieves, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Adviser Act Release No. 2266, (Oct. 26, 2004), http://www.sec.gov/rules/proposed/s73004/wnieves102604.htm; President’s Working Group on Fin. Mktgs., supra note 1, at 42 (“[D]irect regulation of hedge funds could present formidable challenges in terms of cost and effectiveness.”); see also Bair Comment, supra note 105, at 4 (“I would hate to see that luster tarnished a few years from now by a hedge fund scandal because a well-intentioned SEC prematurely decided to take responsibility for an industry it did not have sufficient resources to oversee.”); MFA Comment, supra note 106, at 2 (“[T]he SEC has only 495 employees responsible for examining 8,000 mutual funds with about 91 million investors, managing $7 trillion. The SEC has not made clear that the agency would have the needed expertise to monitor thousands more hedge fund advisers.”); Comment, Joseph H. Omansky, President, Sky Fund LLC, SkyRank System of Hedge Fund Ratings, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. 2266 (Sept. 24, 2004), http://www.sec.gov/rules/proposed/s73004/jhomansky1880.htm (“The SEC alone cannot reduce fraud through the registration of hedge funds . . . .”); Schulte Roth & Zabel Comment, supra note 77, at 9 (“[T]he average tenure of the inspection staff currently is approximately 1.9 years . . . . The turnover rate among examiners, combined with length of the Commission’s inspection cycle, makes the likelihood of uncovering fraud even less likely.”); Amend, supra note 109, at 7 (“[SEC Commissioner Paul Atkins] doesn’t think the SEC has enough manpower to adequately police hedge funds.”); Vineeta Anand, SEC Requests Industry Group Help in Training, INVESTMENT NEWS, Oct. 24, 2005, at 32 (“The [SEC] has asked the hedge fund industry to help train SEC staff to inspect the estimated 1,260 hedge fund investment advisers expected to register by February [2006].”); Susan L. Barreto, SEC Not Prepared for the Registration Flood?, HEDGEWORLD NEWS, Sept. 29, 2005 (“‘How adequately [is the SEC] defending investors if they too are overwhelmed?’” (quoting Brian Shapiro, president of Carbon360, a research and advisory firm that works with hedge fund managers)); Hendrickson, supra note 109, at 7 (“In a blistering September 29 speech before the Managed Funds Association, [SEC Commissioner Paul] Atkins . . . said . . ., ‘[W]e have neither the resources nor the expertise to oversee all the potential new registrants . . . . The precious time and attention of our examination staff is being diverted to advisers that manage the money of a relatively tiny number of sophisticated investors . . . . [Y]ou have to wonder if the SEC is doing the right thing.’”); Don Noone, Letter to the Editor, No SEC Cops Walking the Hedge Fund Beat, WALL ST. J., Dec. 7, 2005, at A19 (“There are no cops on the hedge fund beat; frauds are only coming to light because defrauded investors are talking out and the media is listening. . . . The SEC’s regulation of hedge funds is a square-pegged solution praying it finds a square-holed problem.”). Likewise, one could argue that money that the SEC would have to divert to the hedge fund regulatory scheme could be better spent elsewhere in its regulatory fold. See Paredes, supra note 3, at 989.

191 Part of what makes hedge funds so profitable is their secret and unique investment methods, so it is only logical that the average SEC employee would not understand them. See, e.g., Anand, supra note 190, at 32 (“The SEC’s office of compliance inspections and examinations has called upon members of the Washington-based Managed Funds Association, which represents the hedge fund industry, to speak at training sessions the SEC has begun to hold for its staff in preparation for when [the] new rule kicks in . . . .”); Joe Hutnyan, New Hedge Fund Rule Poses Unique Challenges for SEC, SEC. WK., Sept. 26, 2005, at 10 (“The new system is going to be a huge learning curve for SEC staff.” (quotations omitted)).
Goldstein not invalidated the registration regulations, the SEC would have faced great costs in educating its staff to examine and process the information gleaned from registration.\footnote{\textbf{192} See, e.g., Comment, Nora M. Jordan et al., Davis Polk & Wardwell, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, File No. S7-30-04, at 3 (Sept. 15, 2004) [hereinafter Davis Polk & Wardwell Comment], \url{http://www.sec.gov/rules/proposed/s73004/nora091504.pdf} ("We believe that the Commission underestimates the costs and market effects of registration and incorrectly infers that registration imposes only minimal burdens on advisers.").} Until the SEC has the resources necessary to survey the hedge fund market and to enforce actions against violative hedge fund advisers,\footnote{\textbf{193} See supra note 190.} fund registration will strain the SEC's existing resources. Therefore, the registration requirements would be less effective at preventing and detecting fraud, two goals that the SEC stated explicitly when it enacted the registration requirement.\footnote{\textbf{194} See supra text accompanying notes 12–13.}

In establishing the registration regulations, the SEC also did not consider whether it has jurisdiction to create such a rule and to change its regulatory regime by redefining "client."\footnote{\textbf{195} See supra notes 75–79 and accompanying text.} Even prior to the Goldstein decision, some commentators argued that the SEC had exceeded its powers by using a "look-through" provision\footnote{\textbf{196} 15 U.S.C. § 80b-3(b)(3) (2000); 17 C.F.R. § 275.203(b)(3)(1)–(2) (2006); see Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054, 72,067 (Dec. 10, 2004) ("[Rule 203(b)(3)(2)] requires an advisor to 'look through' a hedge fund to determine whether it is eligible for the private advisor exemption . . . .")} to define client.\footnote{\textbf{197} See, e.g., MFA Comment, supra note 106, at 2; see also Comment, Marco V. Masotti, Chair, Comm. on Private Inv. Funds, Ass'n of the Bar of the City of New York, on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266, File No. S7-30-04, at 1–2 (Sept. 15, 2004) [hereinafter Ass'n of the Bar of the City of New York Comment], \url{http://www.sec.gov/rules/proposed/s73004/mvmasotti091504.pdf} ("[W]e are concerned with . . . the statutory authority of the Commission to count clients using the 'look-through' method as provided in the . . . Rule."). According to the Committee on Private Investment Funds of the Association of the Bar of the City of New York, it is unclear how the look-through provision would affect offshore advisers of offshore funds. See Ass'n of the Bar of the City of New York Comment, supra, at 5 ("The 'look-through' requirement in the . . . Rule becomes even more problematic in the context of an offshore adviser to an offshore fund where the adviser would only be required to count U.S. investors. The . . . Rule is unclear on whether the same 'look-through' requirement would apply."). A comment letter from the law firm Davis Polk & Wardwell echoes the Association's concerns. See Davis Polk & Wardwell Comment, supra note 192, at 3, 10 ("We suggest various technical clarifications to the . . . Rule, including clarifications of . . . the extraterritorial reach of the . . . Rule. . . . We are concerned that this lack of guidance will create significant ambiguity in the . . . Rule and its application.").} Instead, the SEC has the power to carry out the will of...
Congress, as expressed by statute, to adopt regulations to effect congressional will.\textsuperscript{199} Since Congress adopted the Investment Advisers Act, it clearly did not account for a look-through provision by the SEC for counting clients, as the \textit{Goldstein} court observed.\textsuperscript{200} Thus, at the very least, the SEC should have allowed for additional comments during the official comment period and should have paid closer attention to its own authority in promulgating a registration requirement.

By allowing the current ambiguities regarding offshore hedge funds and offshore advisers to stand, the SEC has created additional problems. An SEC official has even acknowledged that by early 2005, 70\% of the hedge fund market consisted of offshore hedge funds.\textsuperscript{201} Obviously, this is only an estimate because the SEC staff was unable to develop reliable figures in making its recommendation.\textsuperscript{202} However, leaving the regulation as enacted continues to confuse advisers who oversee perhaps billions of dollars offshore. Furthermore, if there are so many funds domiciled offshore, the registration requirement is inherently inefficient because it allows loopholes for offshore advisers who accept investment funds from U.S. investors.\textsuperscript{203}

Determining where to draw the line on regulation is difficult. On the one hand, the SEC should keep hedge fund investment largely unregulated and allow investors to continue reaping the benefits of the funds’ risky investment strategies without forcing the average American taxpayer to pay to protect wealthy, sophisticated investors from their inherently risky investment decisions.\textsuperscript{204} On the other hand, now that more unsophisticated investors are aware of the great

\begin{footnotes}
\textsuperscript{199} See 15 U.S.C. §§ 77s(a), 78w(a).
\textsuperscript{200} See \textit{Goldstein} v. SEC, 451 F.3d 873, 878–79, 883 (D.C. Cir. 2006); \textit{see also} \textit{Ernst & Ernst v. Hochfelder}, 425 U.S. 185, 213–14 (1976), \textit{quoted in MFA Comment, supra note 106, at 2.}

\textsuperscript{201} See Matt Piotrowski, \textit{SEC Regulation Concerns Hedge Funds}, On. Dally, Apr. 12, 2005.


\textsuperscript{203} See Wright Comment, \textit{supra note 81, at 1–2 (asking for clarification of the proposed rule as to offshore funds).}

\textsuperscript{204} See, \textit{e.g.}, Comment, Max Rottersman, President, Fund Forensics, on Proposed Rule: \textit{Registration Under the Advisers Act of Certain Hedge Fund Advisers}, Investment Advisers Act Release No. 2266, File No. S7-30-04 (Sept. 15, 2004) [hereinafter Fund Forensics Comment], http://www.sec.gov/rules/proposed/s73004/mrotterson5801.htm (“Perhaps cold-hearted, but modestly wealthy people who lose their money in un-regulated hedge funds have only themselves to blame. If a hedge fund commits fraud the American taxpayer should not foot the bill through the S.E.C.”); Paredes, \textit{supra note 3, at 990 (“[T]he SEC has deferred to such well-heeled investors to protect themselves through market discipline.”); Robert C. Pozen, \textit{Hedge Funds Today: To Regulate or Not?}, WALL ST. J., June 20, 2005, at A14 (“Should the SEC establish regulatory safeguards to protect investors in hedge funds that underperform? No. These investors are almost all wealthy individuals and institutions who should be able to protect themselves . . . . absent fraud for which they already have legal claims . . . .”).
opportunities offered by hedge funds, these investors will likely seek to invest without truly knowing the associated risks.\textsuperscript{205} The question comes down to how the SEC or Congress should strike a balance between these two scenarios.

While requiring hedge fund advisers to register with the SEC and to undergo periodic SEC examinations would seem to benefit investors,\textsuperscript{206} registration comes with enormous costs.\textsuperscript{207} Currently, many unregistered hedge funds do not have the infrastructure necessary to meet the SEC’s disclosure requirements.\textsuperscript{208} When it hastily required hedge fund advisers to register with the SEC by February 1, 2006, the SEC forced some hedge funds to develop ad hoc reporting mechanisms that will likely need future correction.\textsuperscript{209} For funds without strong existing compliance or reporting mechanisms, the need to quickly establish such programs will come at a high cost to the hedge fund’s investors.\textsuperscript{210} This high cost could mean the end of small hedge funds. Furthermore, once hedge funds have their reporting mechanisms in place, U.S. taxpayers—many of whom do not meet the minimum requirements to invest in a hedge fund—will pay an enormous amount of money to cover the additional SEC employees necessary to process all of the disclosures and periodic filings.

\textsuperscript{205} Unsophisticated investors have been able to gain access to hedge funds through funds of hedge funds, see Leslie Rahl & Stephen Rahl, Institutionalization of Hedge Funds: How Can Hedge Funds Be Tamed Without Breaking Their Spirit or Negatively Impairing Their Performance?, in Hedge Fund Strategies: A Global Outlook 69, 69–70 (Brian R. Bruce ed., 2002), as well as the new publicly traded hedge funds, see Barbara Kiviat, Hello, Hedge Funds, Time, Dec. 4, 2006, at 62, and Merrill Lynch’s and Goldman Sachs’s new index-based products that offer hedge fund exposure, see Hedge Funds: Attack of the Clones, Bus. Wk. Online, Dec. 4, 2006, http://www.businessweek.com/investor/content/dec2006/pi20061204_627321.htm?campaign_id=Rss_topStories.

\textsuperscript{206} See Div. of Inv. Mgmt., supra note 7, at xi.

\textsuperscript{207} See, e.g., Schulte Roth & Zabel Comment, supra note 23, at 11 (“We are concerned that the Commission underestimates the full extent of these costs.”); De Brouwer, supra note 23, at 212 (“The cost to regulators—and ultimately the tax-payer—could include an increase in staff at domestic and international institutions to process, analyze and disseminate the information, and costs of publication of the results.”); Emmett Ryan, A Roadmap to SEC Registration for Hedge Fund Invest Advisers, in It’s The Rule: The New SEC Adviser Regulation for Hedge Funds, supra note 78, at 107, 111 (“While the SEC registration process is not difficult, keeping up with compliance regulations is a Herculean . . . task for many investment advisers to hedge funds.”).

\textsuperscript{208} See, e.g., Faille, supra note 90, at 30–31 (discussing how the regulations create a “huge hurdle” to smaller hedge funds).

\textsuperscript{209} See, e.g., Netage Solutions, The Risks of Selecting an Investor Relations and Compliance Management System, in It’s The Rule, The New SEC Adviser Regulation for Hedge Funds, supra note 78, at 101, 101 (“Choosing an investor relations and compliance management system is not . . . easy, because a host of risks often get unnoticed. Either out of lack of experience or because of the pressure to choose a solution quickly, hedge funds can end up with a ticking time bomb if they do not anticipate the . . . risks.”).

\textsuperscript{210} See, e.g., Davis Polk & Wardwell Comment, supra note 192, at 12 (“Our view is that such costs are substantial and increasing and will in some form be passed on to, and affect returns realized by, hedge fund investors.”).
B. Possible Fixes for the SEC Registration Regulation

In fixing the registration requirement, the SEC must consider certain limitations it faces as a federal agency. As this Note has stated, the majority of SEC employees do not specialize in hedge funds.\textsuperscript{211} In addition, hedge fund enforcement would overstretch the SEC’s limited resources.\textsuperscript{212} Therefore, it is important that the SEC fix the registration requirement in a way that the agency can easily implement without a substantial financial commitment. Arguably, this discussion is moot, because hedge funds cannot advertise and thus average investors who meet the statutory requirements would likely not learn of hedge fund investment opportunities. However, this argument does not hold weight in the age of the Internet, when any investor with Internet access can find information on hedge funds on Morningstar and Moody’s.\textsuperscript{213} While registration does increase the necessary investment level and investor net-worth levels, it does so only slightly.\textsuperscript{214} The SEC should thus reevaluate how it defines “accredited,” “sophisticated,” and “qualified” such that the annual income and net-worth figures would increase with inflation, for example, rather than rely on static, outdated figures.\textsuperscript{215}

1. Redefine “Accredited Investor” and “Qualified Purchaser”

To improve the registration requirement, the SEC could look to the ideas and history behind hedge fund investment. Hedge fund advisers intended to attract wealthy, sophisticated investors who could absorb the losses from a poor investment.\textsuperscript{216} The SEC should create new standards for “accredited investor” and “qualified purchaser”\textsuperscript{217}

\textsuperscript{211} See supra note 191 and accompanying text.
\textsuperscript{212} See supra note 190–192 and accompanying text.
\textsuperscript{213} See, e.g., supra note 20.
\textsuperscript{214} See, e.g., Div. of Inv. Mgmt., supra note 7, at xii (“[R]egistration of hedge fund advisers under the Advisers Act would effectively increase the minimum investment requirement for direct investments in certain hedge funds because registered advisers are generally prohibited from charging performance fees unless investors have $750,000 invested with the adviser or have a net worth of $1.5 million.”).
\textsuperscript{215} See, e.g., Fund Forensics Comment, supra note 204 (“[T]he minimums need to keep up with market valuations. The acid test . . . should be, what amount of money would a citizen need to hire a team of lawyers and accountants to monitor and defend their interests in the hedge fund? Or, put another way, what level of wealth is insufficient to protect an investor from an unscrupulous hedge fund?”).
\textsuperscript{216} See Paredes, supra note 3, at 980–84 (discussing the high-risk nature of hedge funds).
\textsuperscript{217} See, e.g., Cox Statement, supra note 26 (“I am concerned that the current definition, which is decades old, is not only out of date, but wholly inadequate to protect unsophisticated investors from the complex risks of investment in most hedge funds.”); MFA Comment, supra note 106, at 3 (“Accredited investor standards . . . should be raised so that the monetary thresholds reflect the inflation in wealth and incomes since 1982 or by imposing a similar enhanced accredited investor standard under the Advisers Act for hedge fund investors.”). Until the SEC adopts higher standards for individual investors, many industry
because the Commission has not updated the specified wealth amounts since 1982. At that time, a much smaller percentage of the American public had the wealth necessary to be deemed an accredited investor or a qualified purchaser.\textsuperscript{218} As the number of millionaires who will meet the SEC’s statutory requirements for hedge fund investment despite having little education in hedge fund investment or general investment increases,\textsuperscript{219} the likelihood of fraud on the market increases as well, which could in turn discourage investment in the securities markets.\textsuperscript{220}

Currently, the SEC is accepting comments on a proposed rule to redefine “accredited investor.”\textsuperscript{221} The new definition would, among other things, raise the minimum asset level of accredited investors, whom the new rule labels “accredited natural persons.”\textsuperscript{222} An accredited natural person would still need a net worth of at least $1 million but would also have to possess $2.5 million in “investments,” which will be adjusted every five years for inflation.\textsuperscript{223} From the comments received thus far, it appears that the accredited natural person standard could follow the path of the \textit{Goldstein} litigation, as several commentators have already referred to the new minimum investment level of accredited natural persons as “arbitrary.”\textsuperscript{224}

2. \textit{Encourage Voluntary Disclosure}

One way to ease into a new regulatory regime might be to encourage voluntary disclosure. Indeed, one of the SEC’s general goals is to improve the dissemination of information to investors through

\begin{itemize}
\item\textsuperscript{218} See, e.g., Daniel P. Collins, SEC’s ‘Solution in Search of a Problem’?, \textit{FUTURES}, Dec. 2003, at 60.
\item\textsuperscript{219} See, e.g., Britney Hit by Hedge Fund Scandal, \textit{supra} note 122.
\item\textsuperscript{220} \textit{Cf.} Schlanger v. Four-Phase Sys. Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982) (“[I]t is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?”).
\item\textsuperscript{222} \textit{Id.} at 400 n.6, 405–07.
\item\textsuperscript{223} Id. at 414 (proposing to amend 17 C.F.R. § 230.215 and add 17 C.F.R. § 230.216).
\end{itemize}
disclosures.\textsuperscript{225} By not instituting a system of voluntary disclosure before promulgating the mandatory registration requirement, the SEC has ignored a potential solution to the information-asymmetry problem with hedge funds. While hedge funds are eager to get new, wealthy investors, many investors are reluctant to make the minimum investment and pay the exorbitant management fees without knowing more about the funds. By voluntarily disclosing information, funds could reap tremendous benefits from investors whom the voluntary disclosures wooed. Furthermore, the SEC staff itself has suggested the need for disclosure to hedge fund investors.\textsuperscript{226} By starting with a voluntary disclosure system, those funds that are ready to make disclosures to investors may profit because of their openness. This profit could encourage nonreporting funds to implement reporting systems.

3. 

Educate Investors

Underlying the desire for disclosure is a related need for investor education. U.S. investors are largely uneducated in the investment techniques of hedge funds and generally do not fully understand the risks associated with such investments.\textsuperscript{227} Furthermore, the statutory language does not provide a definition of “hedge fund.”\textsuperscript{228} While investor education would come at a great cost to both the SEC and hedge funds, having knowledgeable investors would presumably help the SEC meet its goal of deterring fraud. Mandatory disclosures will do little to deter fraud unless it is paired with investor education, because investors would not know how to treat the disclosed information. Further, investor education would help those statutorily deemed “sophisticated investors” to make better investment decisions within the hedge fund world.

\textsuperscript{225} Interestingly, a recent study has shown that hedge funds that registered in anticipation of the February 2006 deadline historically had better past performance, more assets, and higher quality than those funds that did not register. See Stephen Brown et al., \textit{Optimal Disclosure and Operational Risk: Evidence from Hedge Fund Registration} 33–34 (Yale Sch. of Mgmt., Int’l Ctr. for Fin., Working Paper No. 06-15, 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=918461. The study ultimately concluded that economically, registration achieved some of its goals, see \textit{id.} at 33, because there was “evidence that the information in the form has the potential to add value to the investor decision-making process,” \textit{id.} at 4.

\textsuperscript{226} See Div. of Inv. Mgmt., supra note 7, at xi (“The [SEC] staff further recommends that the [SEC] consider amending its rules to require that registered hedge fund advisers file with the [SEC], and deliver to investors, a disclosure statement specifically designed for hedge fund investors.”).

\textsuperscript{227} See supra text accompanying note 1.

\textsuperscript{228} See supra text accompanying note 3.
4. **Rely on Existing Regulatory Mechanisms**

Arguably, the current enforcement mechanism is sufficient and no further regulation of hedge funds is necessary. For instance, in enacting the registration regulation, the SEC sought to prevent and deter fraud. However, further regulation is not the answer; looking at the recent hedge fund scandals, each hedge fund adviser had broken the law.\(^\text{229}\) If existing criminal statutes can protect investors from the behavior that the SEC is trying to prevent, there is no need to change the regulatory regime and to create more rules that will be not only expensive for the funds to implement—a cost likely passed down to investors—but also difficult for the SEC to enforce given its already stretched resources.

Further, expanding the regulatory regime may discourage innovation and competition in U.S. markets.\(^\text{230}\) When the Department of Treasury asks the SEC to loosen its restrictive reign, this is a sign that the SEC has gone too far.Granted, investors have called for stricter regulations on investment companies since scandals such as mutual fund market timing, Enron, and Amaranth rocked newspaper headlines. On the other hand, investors would likewise call for the SEC to loosen the regulatory regime if draconian regulations resulted in a lack of innovation and prevented the investors from turning a profit. While the SEC’s current model of hedge fund regulation is clearly imperfect, the other regulatory agencies have had enough success in achieving the SEC’s goals. Thus, the SEC should not try to make any dramatic changes to the current regulatory regime.

**CONCLUSION**

Rather than institute onerous registration requirements that leave open loopholes for potentially 70% of the hedge fund market,\(^\text{231}\) the SEC should rethink its definitions of “accredited” and

\(^{229}\) See, e.g., Ben Heath & Julie Fishman-Lapin, *Funds Face Further Regulation*, ADVOCATE (Oct. 27, 2006, available at 2006 WLNR 18650451 (“I am no apologist for fraud . . . but we have a lot of statutes that restrict fraud on federal and state levels.” (quoting Paul Roth, founding partner of Manhattan-based Schulte Roth & Zabel, a law firm representing about 1,500 hedge, private equity, and offshore funds))).  


\(^{231}\) See, e.g., Anand, supra note 190, at 32 (“Hedge fund advisers may circumvent the registration requirements if they agree to lock up investors’ money for at least two years.”)); Hamilton, supra note 93 (“[S]ome fund managers are going out of their way to avoid the agency. Funds must be registered if they allow investors to redeem their holdings within two years. Therefore, many funds’ lock-ups have been extended to two years instead of one . . . . ‘This is not heavy-handed regulation.’”); Hendrickson, supra note 109, at 7
“qualified,” should encourage voluntary disclosure from hedge fund advisers, and should develop educational programs for potential investors. The recently invalidated registration requirement overlooked offshore hedge funds and their advisers, leaving a loophole for the vast majority of U.S. assets currently invested in hedge funds. While the IRS and CFTC provide loopholes similar to those in the registration requirement, perhaps the SEC should consider the costs and benefits of enacting provisions such as the ones in ERISA, which would imply a fiduciary duty for hedge fund advisers. Even though this proposal would help the SEC rein in offshore hedge fund advisers, it is not a necessary fix. State authorities would be the appropriate bodies to create such duties, and hedge funds are already subject to antifraud provisions that the fiduciary duty would imply.

In the end, commentators may be correct that the average U.S. investor should stick to stocks, bonds, and mutual funds. But as long as there is hype around hedge funds, there is a need, at the very least, to educate investors.

(noting that SEC Commissioner Paul Atkins believes that “rules requiring hedge funds to register with the SEC . . . hav[ ] little effect on finding fraudsters, but stretch[ ] the agency’s examination staff perilously thin”); David Hoffman, One on One with Ron Baron of Baron Capital Group Inc., INVESTMENT NEWS, Dec. 19, 2005, at 69 (“I think lawyers for private institutions are highly paid and will, in most instances, be able to navigate the rules that the government puts forth. If people don’t want to be regulated, they won’t be.”); Chidem Kurdas, Use of Registration Loophole Seen as Risky, HEDGEWORLD NEWS, Nov. 17, 2005 (“[T]he assets already managed don’t have to be locked up; only new money is subject to the lock-up provision. So what if the manager does not take any new money? By the logic of the rule as written, there has been an inference that such managers would also be exempt.”); Janet Lewis, New Twists Emerge in Registration Saga, INVESTMENT DEALERS DIGEST, Nov. 21, 2005, at 9 (“[H]edge fund advisers looking to avoid registration with the [SEC] by extending their funds’ lockup periods will be able to do so regardless of the wishes of their investors, according to lawyers and consultants in the field.”); Nocera, supra note 27 (“The new rule . . . includes a ridiculously big loophole, exempting any hedge fund that locks up investors’ money for two years or more.”); Zuckerman, supra note 27 (“Some big-name hedge funds have imposed restrictions on when investors can withdraw money, among other steps, which permits them to opt out of registering.”); Gregory Zuckerman & Ian McDonald, Hedge Funds Avoid SEC Registration Rule—Some Big Firms Change Lockups, Stop Accepting New Investments to Take Advantage of Loopholes, WALL ST. J., Nov. 10, 2005, at C1 (“A large number of major hedge-fund firms won’t be registering with the [SEC] despite new rules aimed at forcing most hedge-fund advisers to sign up by early next year.”).