PRIVATE INVESTMENT COMPANIES IN THE WAKE OF THE FINANCIAL CRISIS: RETHINKING THE EFFECTIVENESS OF THE SOPHISTICATED INVESTOR EXEMPTION

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ABSTRACT

As was appropriately observed amid the Great Depression, the performance of securities markets affects economic activity. Indeed, since millions of individuals and enterprises rely on the markets as a fundamental source of capital, economic turmoil is often intensified by severe market volatility and other related harms. To mitigate these harms, Congress passed the federal securities laws to ensure the safety and reliability of the public capital markets. The Securities and Exchange Commission ("SEC") is the regulatory body that is charged with implementing these laws and it fulfills this obligation by actively pursuing its mission to protect investors, maintain fair, efficient, and competitive markets, and facilitate capital formation. While considerable disagreement exists with respect to the policies and mechanisms utilized by the SEC, the proper implementation of its mission is absolutely necessary because the markets are inextricably linked to the health of the national economy.

However, securities transactions that are considered 'private' are not subject to extensive federal oversight based on the assumption that they do not affect the broader national economy. These transactions include those that are restricted to sophisticated investors, which are statutorily defined as institutional or high net-worth individuals who can presumably use their resources to protect themselves from undue risk. Yet, many private investment companies that rely on the sophisticated investor exemption to avoid substantial regulation are avid participants

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in the public capital markets. This has blurred the distinction between public and private vehicles. Moreover, these vehicles are also capable of creating negative externalities that adversely affect unsuspecting third parties as well as the national economy. For example, the hedge fund industry, which may account for nearly half of the daily trading volume on the New York and London stock exchanges, and can 'move markets' through its speculative trading activities, was entirely exempt from SEC oversight because these vehicles are restricted to sophisticated investors. Accordingly, this Article argues that the sophisticated investor exemption is no longer a reliable mechanism for separating private and public investment companies. This Article broadens this analysis by examining the extent to which the sophisticated investor exemption has undermined the SEC's ability to fulfill its mission to protect the public capital markets, and whether this failure has left the general public inadequately protected. This analysis is both necessary and timely because it could help ensure that the new regulations promulgated under the Dodd-Frank Act are closely tailored to the problems that the previous regulatory approach created.

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I. INTRODUCTION

> Many wealthy people, pension trustees and portfolio managers turned out to be just as incompetent as any amateur. This is a group of people defined by statute as "accredited" or "sophisticated" investors. The farce is that there is no test, license or registration required to be "accredited" as a "sophisticated" investor.[1]

A sophisticated investor is a wealthy individual or institution, such as a pension plan, insurance company, charitable institution, or bank.[2] Generally speaking, individuals must earn over $200,000 per year or own over $1 million in net assets in order to qualify as a sophisticated investor.[3] Since these investors are presumed to have the resources to

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[1] John E. Girouard, *The Sophisticated Investor Farce*, FORBES.COM (March 24, 2009, 12:30 PM), http://www.forbes.com/2009/03/24/accredited-investor-sec-personal-finance-financial-advisor-network-net-worth.html?partner=contextstory.

[2] The term "accredited investor" is defined under the Securities Act of 1933. 15 U.S.C. § 77b(a)(15) (2006) & 17 C.F.R. § 230.501 (2011). The terms "sophisticated investor" and "accredited investor" will be used interchangeably within this Article.

[3] 17 C.F.R. § 230.501(a)(5)-(6) (2011). The Dodd-Frank Act revised the accredited investor standard for natural persons. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010) ("The Commission

sufficiently protect themselves, Congress designed the federal securities laws in a manner that excludes sophisticated investor transactions from extensive SEC oversight.[4] The SEC considers these transactions "private"; therefore, they retain greater investment flexibility and the SEC permits the private investor to engage in riskier investments, while providing limited disclosure to the underlying investors.[5]

However, the reliability of this exemption has been frequently criticized for several reasons. First, the SEC does not require these investors to be knowledgeable about a prospective investment in order to qualify as "sophisticated."[6] The Bernard L. Madoff ("Madoff") scandal is probably the most notable example of this critique, since it resulted in over $20 billion in aggregate losses to wealthy and institutional investors.[7] This scandal was riddled with distressing stories of prosperous individuals who had little to no financial acumen losing their entire fortunes to Madoff's Ponzi scheme.[8] In many cases, instead of doing their due diligence, these investors simply relied on Madoff's reputation for guaranteeing high returns and attracting other prominent investors.[9]

Second, this exemption relies on the status of individual investors, as opposed to the actual investment activities of a particular entity, to determine whether substantial regulation is necessary.[10] For this reason, some sources have found that the poor investment decisions of

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shall adjust any net worth standard for an accredited investor . . . so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than $1,000,000 . . . excluding the value of the primary residence of such natural person . . . ."). The Dodd-Frank Act also requires the SEC to periodically review this accredited investor standard every four years and make adjustments "as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy." *Id.* § 413(b). Knowledge is not a prerequisite for becoming an accredited investor. *See* 17 C.F.R. § 230.501(a) (2011).

[4]*See* C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J., 1081, 1132-36 (1988) ("As a historical matter, Congress did not design the securities laws to protect investors capable of protecting themselves.").

[5]*See generally* U.S. SEC. & EXCH. COMM'N, THE IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 8-13 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter SEC STAFF REPORT] (examining hedge funds and the regulatory exemptions upon which they rely).

[6]*See* 17 C.F.R. § 230.501(a) (2011).

[7]*Times Topics*, *Bernard L. Madoff*, N.Y. TIMES (last updated Sept. 30, 2011), http://topics.nytimes.com/top/reference/timestopics/people/m/bernard_l_madoff/index.html.

[8]*See generally* David Ellis, *Congress Looks for Answers in Madoff Scandal*, CNN MONEY, (Jan. 5, 2009, 5:49 PM), http://money.cnn.com/2009/01/05/news/companies/madoff_hearing/index.htm (explaining how the Madoff Ponzi scheme has also impacted individuals).

[9]*See Times Topics*, Bernard L. Madoff, *supra* note 7.

[10]*See* 17 C.F.R. § 230.501(a) (2011).

sophisticated investors who engaged in risky financial transactions facilitated the so-called Great Recession.[11] The bulk of these transactions were intricately intertwined in the sub-prime mortgage crisis, which precipitated the worst global economic crisis since the Great Depression.[12]

To eradicate comparable problems within the investment company industry, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act")[13] subjects larger hedge funds to increased regulation based on the premise that they can contribute to systemic risk.[14] While the Dodd-Frank Act requires many hedge fund advisers to register under the Investment Advisers Act of 1940 ("Advisers Act"),[15] the sophisticated investor exemption is still valid with respect to various other registration requirements. For instance, hedge funds can still rely on the sophisticated investor exemption to avoid registration under the Investment Company Act of 1940 ("Company Act"),[16] which is the primary legislation that oversees the "organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities."[17] The Company Act imposes concrete restrictions on advisers' abilities to engage in riskier

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[11]*See, e.g.*, Jennifer S. Taub, *The Sophisticated Investor and the Global Financial Crisis*, *in* Corporate Governance Failures: The Role of Institutional Investors in the Global Financial Crisis 188, 188-92 (James P. Hawley, et al. eds., 2011) (describing involvement of sophisticated investors in risky mortgage securities); Heidi Moore, *Debunking the Myth of the 'Sophisticated Investor'*, WASH. POST, May 2, 2009, at G2, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/05/01/AR2010050100205.html; Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Speech for Council of Institutional Investors Spring Meeting: Facilitating Real Capital Formation (Apr. 4, 2011) (transcript available at http://www.sec.gov/news/speech/2011/ spch040411laa.htm) (discussing role of massive and unregulated private market of mortgage-backed securities in the financial crisis).

[12]*See* Aguilar, *supra* note 11.

[13]Title IV of the Dodd-Frank Act is the section that regulates hedge funds. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 401-416, 124 Stat. 1376, 1570-1580 (2010). To avoid undue confusion, this Article refers to Title IV simply as the "Dodd-Frank Act," although the formal name of Title IV is the "Private Fund Investment Advisers Registration Act of 2010." *Id.* § 401.

[14]*See generally* Cary Martin, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry*, 86 ST. JOHN'S L. REV. (forthcoming 2012) (manuscript at 17-30), *available at* http://ssrn.com/ abstract=1901666 (explaining that the Dodd-Frank Act's primary focus is preventing systemic risk).

[15]Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2006).

[16]Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (2006).

[17]*The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/ about/whatwedo.shtml (last modified Oct. 24, 2011).

transactions, and it requires that they implement stringent investor protection measures.[18] Since the sophisticated investor exemption has been largely upheld despite its limitations, this Article argues that it is no longer a reliable mechanism for separating private and public investment companies. This Article broadens the analysis by showing how reliance on the sophisticated investor exemption has compromised the SEC's ability to fulfill core aspects of its mission, which is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[19]

By and large, the sophisticated investor exemption has served as a mechanism for private investment companies to actively participate in the public capital markets, which has made it difficult for the SEC to adequately protect these markets from undue risk.[20] For example, hedge funds engage in extensive speculative trading activities.[21] This exemption has also derailed the SEC's mandate to protect investors since institutions that qualify as "sophisticated" are exposing retail investors to unregulated investment schemes.[22] Moreover, the participation of exempt investment companies in derivatives trading and other risky investments has exposed the markets to increased systemic risk.[23] Overall, private vehicles should be able to absorb their own losses, as opposed to having such a monumental impact on the reliability of the markets for which the general population depends.

This Article contributes to the existing literature on this topic by more clearly identifying the problem that the Dodd-Frank Act is trying to resolve. Instead of blaming private investments for certain market failures, this Article blames the framework that fails to adequately separate private and public investment companies. This piece extends this analysis by showing how this flawed framework compromises the SEC's ability to fulfill its mission, which is another novel contribution to the literature on this topic. While the SEC's policies are subject to considerable debate, the proper implementation of its mission would greatly improve the integrity of the markets. In fact, this Article seeks to more clearly define the boundary that delineates public and private investment companies so that the SEC's mission is actually attainable.

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[18] *See* discussion *infra* Part II.C.

[19] *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 17.

[20] *See* SEC STAFF REPORT, *supra* note 5, at 11-13.

[21] *See infra* Part V.

[22] *See infra* Part IV.

[23] *See* discussion *infra* Part V.C.

Accordingly, Part II begins by providing a general description of the public capital markets, and continues by explaining the broader impact that these markets have on the national economy. It proceeds with a brief overview of the legislation that seeks to protect the public capital markets from the abuses that were revealed during the Great Depression.[24] These laws protect the markets by mandating investor protection measures for retail investors and by creating clear standards of conduct for the trading activity that occurs on the national exchanges.[25] Part II concludes with a synopsis of the legislation that further regulates investment company structures, which create unique fiduciary concerns with respect to the relationship between the advisers and their underlying investors.[26]

Part III outlines the origins of the sophisticated investor doctrine. In effect, private offerings are not intended to be covered by the federal securities laws based on the principle that they do not invoke the national public interest.[27] However, when the private offering exemption evolved into the sophisticated investor doctrine through a series of judicial interpretations and regulations promulgated under the federal securities laws, this distinction became less clear.[28] Furthermore, the expansion of this exemption has led to the creation of considerable unregulated sectors within the investment company marketplace, which has further blurred the distinction between public and private investment companies.[29]

Part IV begins a more detailed analysis of how the operation of the sophisticated investor exemption within the investment company industry has undermined the SEC's ability to fulfill its mission to protect the public capital markets. Part IV tackles the first component of the SEC's mission by highlighting the exposure of retail investors to unregulated investment schemes.[30] This section also explains why sophisticated investors may no longer be able to adequately fend for themselves or their underlying constituents given the growing complexity of the strategies and instruments traded by private investment vehicles.[31] Many researchers in this area have concluded that sophisticated investors are not entitled to investor protection measures,

[24] *See* discussion *infra* Part II.A.
[25] *See* discussion *infra* Part II.B.
[26] *See* discussion *infra* Part II.C.
[27] *See* discussion *infra* Part III.A.
[28] *See* discussion *infra* Part III.B-C.
[29] *See* discussion *infra* Part III.D.
[30] *See* discussion *infra* Part IV.A.
[31] *See* discussion *infra* Part IV.B.

despite the complexities of these underlying instruments.[32] However, this Article contends that in order to uphold investor protection as a viable mechanism for maintaining the integrity of the markets, the assumptions that support the sophisticated investor exemption must be consistently reexamined by both researchers and regulators.[33]

Part V examines the extent to which the sophisticated investor exemption has affected the second component of the SEC's mission to maintain fair, orderly, and efficient markets. For the most part, the participation of private investment companies in the public capital markets has made it exceptionally difficult for the SEC to effectively monitor the majority of the trading activity.[34] In this regard, preventing over-speculation and monitoring excessive market control are significant issues within this mission that warrant further discussion.[35] Part V also examines the extent to which the collective trading activities of hedge funds could increase systemic risk on the markets.[36] This could threaten the reliability and sustainability of the public capital markets, which in turn threatens all economic activity.[37] This exposure to systemic risk further erodes the distinction between public and private vehicles since these kinds of activities clearly affect the broader economy.[38]

Part VI analyzes how the sophisticated investor doctrine has undermined the SEC's ability to facilitate capital formation—the third component of the SEC's mission. Part VI begins by explaining the general concept of capital formation and continues with an analysis of how the sophisticated investor exemption has made it difficult for sophisticated investors to make optimal investment decisions, which in turn affects capital formation for any underlying retail investors.[39] Part VI concludes by exploring the broader impact that these issues have on the general capital markets, which could compromise the reliability of

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[32]*See, e.g.*, Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 990-91 (2006) (asserting that the government should not expand investors protection principles to hedge fund investors); Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 713-14 (2000) (arguing that hedge fund protection through federal legislation is unnecessary).

[33]*See* discussion *infra* Part VIII.

[34]*See* discussion *infra* Part V.A.

[35]*See* discussion *infra* Part V.A-B.

[36]*See* discussion *infra* Part V.C.

[37]*See* discussion *infra* Part V.C.

[38]*See* discussion *infra* Part V.C.

[39]*See* discussion *infra* Parts VI.A-B.

the exchanges and thereby affect the ability of issuers to effectively raise capital.[40]

Although the general scope of this Article is limited to identifying the regulatory gaps associated with the sophisticated investor exemption, Part VII begins a larger discussion that evaluates alternative frameworks that could help ensure the proper implementation of the SEC's mission. The primary goal of these frameworks is to modernize investment company regulation to reflect the impracticalities of relying on the sophisticated investor exemption, and to separate private and public investment companies.[41] Part VII also proposes expansion of transparency within the industry, an area which the Dodd-Frank Act has had a minimal impact.[42] However, simply requiring registration under the Company Act will likely be ineffective since it has not been sufficiently modernized to accommodate the distinctions of the hedge fund industry. But enhanced transparency can be partially accomplished through the creation of a self-regulatory organization ("SRO"), which could formulate a risk-reporting framework for the hedge fund industry and scrutinize ongoing trading activities of these types of private vehicles.[43] Part VII concludes by proposing considerations of a global regulatory framework for the investment company industry, which exerts immense control over global markets.[44]

II. OVERVIEW OF FEDERAL SECURITIES LAWS

> This legislation aims definitely to shut the door for all time upon those financial methods of the past that brought disaster to thousands of investors and, to a great extent, destroyed the broad base of public confidence upon which our economic structure depends.[45]

Part II begins by explaining how the public capital markets affect the national economy. It proceeds with a brief overview of the legislation that seeks to protect the public capital markets from the

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[40] *See* discussion *infra* Part VI.C.
[41] *See* discussion *infra* Part VII.
[42] *See* discussion *infra* Part VII.B.
[43] *See* discussion *infra* Part VII.C.
[44] *See* discussion *infra* Part VII.F.
[45] Garland S. Ferguson, Jr., Comm'r, Fed. Trade Comm'n, Address on the Securities Act of 1933, at 2 (Sept. 12, 1933) (transcript available at http://www.sec.gov/news/speech/1933/091233ferguson.pdf).

abuses that were revealed during the Great Depression. Part II concludes with a synopsis of the legislation that further regulates investment company structures.

A. *The Importance of the Public Capital Markets*

The United States capital markets consist of all the securities[46] trading within the nation's economy.[47] The public capital markets encompass securities transactions that are available to the general public and exclude private offerings.[48] These markets are further divided into primary markets, where new securities are issued, and secondary markets, where investors trade in securities that have already been issued through the primary market.[49] Trading in securities is generally conducted through systems that effectively match buyers and sellers, some of which include the national exchanges, over-the-counter markets, and electronic communication networks.[50] These various systems make it easier for investors to liquidate these instruments, which make them an attractive investment opportunity.[51] Investors often choose to allocate resources to secondary securities markets because it provides them greater liquidity than other types of investments.[52] This is a vital attribute of the public capital markets because it helps attract investors who would otherwise allocate their resources to different establishments.[53]

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[46]A "security" is a financial instrument that represents an ownership interest or debt obligation in a particular enterprise. DAVID L. SCOTT, WALL STREET WORDS: AN A TO Z GUIDE TO INVESTMENT TERMS FOR TODAY'S INVESTOR 334 (3d ed. 2003). The most common type of security is stock, which is a slice of ownership of a particular company that represents a claim on the residue of a company, often accompanied by certain voting rights. *Id.* at 72.

[47]BD. OF GOVERNORS OF THE FED. RESERVE, THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 109 (9th ed. 2005), *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf; *see also* SCOTT, *supra* note 46, at 52.

[48]For an explanation regarding the distinction between public and private vehicles, see *infra* Part III.A.

[49]*See, e.g.*, STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 1 (1st ed. 2005) (explaining how companies and investors participate in the primary and secondary markets).

[50]*See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 13-14 (6th ed. 2009); *see also* WILLIAM A. KLEIN, JOHN C. COFFEE, JR. & FRANK PARTNOY, BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 432-33 (11th ed. 2010) (describing evolution of electronic communications network trading systems).

[51]*See* KLEIN ET AL., *supra* note 50, at 422.

[52]*See* CHOI & PRITCHARD, *supra* note 49, at 13.

[53]*See, e.g.*, STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: THE ESSENTIALS 15 (2008) ("Reducing the costs of buying or selling shares makes share ownership

The public capital markets are the backbone of our current economic structure for several reasons. First, enterprises frequently rely on these markets to raise money to support their operations.[54] Consequently, the overall performance of the capital markets directly affects the productivity, sustainability, and growth of businesses, which in turn affects aggregate business activity and employment opportunities.[55] Second, capital markets provide investors with the tools for risk management, such as security diversification and strategic hedging.[56] Third, individual investors rely on the markets to finance retirement funds, supplement personal savings, fund higher education costs, and for other personal uses.[57] As a result, the performance of the public capital markets affects the collective wealth of the general population.[58] Massive losses, manipulations, and abuses within the public capital markets adversely affect the broader national economy and often precipitate debilitating economic downturns.[59]

The countless abuses that infected the public capital markets during the early twentieth century were significant causes of the Great Depression.[60] During the years preceding this era, the securities markets suffered devastating losses that had a ripple effect on the national economy.[61] Some estimates have shown that in the ten years prior to 1933, "total investor losses through worthless securities were approximately $25 billion, or half of all those issued."[62] These losses created severe financial distress for thousands of individuals who

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more attractive."); ALAN R. PALMITER, SECURITIES REGULATION: EXAMPLES AND EXPLANATIONS 3 (4th ed. 2008) (explaining the importance of liquidity to investors' decisions to invest in securities markets).

[54] *See* HAZEN, *supra* note 50, at 9.

[55] *See, e.g.*, *id.* at 8-9 (explaining how securities used as instruments within the capital markets affect businesses and governmental entities).

[56] *See, e.g.*, PALMITER, *supra* note 53, at 3-4 ("Securities markets permit investors to minimize risk by diversifying and hedging their investments.").

[57] *See, e.g.*, HAZEN, *supra* note 50, at 9 (discussing how investors use securities in the capital markets).

[58] *See id.*

[59] *See, e.g.*, Joseph Karl Grant, *What the Financial Services Industry Puts Together Let No Person Put Asunder: How the Gramm-Leach-Bliley Act Contributed to the 2008–2009 Capital Markets Crisis*, 73 ALB. L. REV. 371, 373 (2010) ("In America, both Wall Street and Main Street have been rocked by the collapse of the capital markets. Neighborhoods are uninhabited due to foreclosures; banks and other financial institutions have gone under water; industrial giants have been forced into bankruptcy; individuals have lost their life's savings; and retirement and pension plans have all felt the sting of the collapse.").

[60] *See* RALPH F. DE BEDTS, THE NEW DEAL'S SEC: THE FORMATIVE YEARS 7-10 (1964); PALMITER, *supra* note 53 at 19-20.

[61] DE BEDTS, *supra* note 60, at 10-11.

[62] *Id.* at 11.

invested their life savings in securities that later became worthless.[63] This in turn destroyed the public's confidence in the securities markets, which further eroded the nation's economic stability.[64] Numerous sources found that these losses resulted from a pervasive abandonment of "fair, honest, and prudent dealing[s]" by underwriters and dealers.[65] For instance, many company insiders were speculating against their own companies, certain pools of assets were specifically formed to manipulate stocks, and several NYSE specialists were participating in fraudulent activities for their own personal gains.[66] Moreover, the national credit system was being used to fuel the over-speculation of the numerous financial instruments, which caused the severe market crashes that facilitated the Great Depression.[67] Additionally, issuers were not mandated to disclose material facts to investors that would be essential to estimating the true value of the offered securities.[68]

B. *Protecting the Public Capital Markets*

To help restore the public's confidence in the dilapidated financial system,[69] Congress passed the Securities Act of 1933 ("Securities Act")[70] and the Securities Exchange Act of 1934 ("Exchange Act").[71] Congress passed these acts to improve the reliability of the markets by directly regulating the national securities exchanges, and by implementing investor protection measures for all retail investors.[72]

As to enhancing investor protection, Congress accepted the view that the disclosure of pertinent information regarding offered securities

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[63]*See* Comm. on Interstate & Foreign Com., House Report on Securities Act of 1933, H.R. REP. NO. 73-85, at 2 (1933).

[64]*See* DE BEDTS, *supra* note 60, at 10-11, 16.

[65]H.R. REP. NO. 73-85, at 2.

[66]*See* DE BEDTS, *supra* note 60, at 14; BARRIE A. WIGMORE, THE CRASH AND ITS AFTERMATH: A HISTORY OF SECURITIES MARKETS IN THE UNITED STATES, 1929–1933, at 336 (1985).

[67]*See* DE BEDTS, *supra* note 60, at 6-11.

[68]*Id.* at 7-8, 11; Comm. on Interstate & Foreign Com., House Report on Securities Exchange Act of 1934, H.R. REP. NO. 73-1383, at 5-6.

[69]*The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 17.

[70]Securities Act of 1933, 15 U.S.C. §§ 77a-77mm (2006).

[71]Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (2006).

[72]*See id.* § 78b. Retail investors are individuals and households, as opposed to institutions. *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1025, 1030 (2009).

would help protect investors from fraud.[73] Thus, this legislation requires issuers to publicly disclose all material information with respect to its offered securities.[74] More specifically, all issuers that offer new securities to the public through interstate commerce, must file a public registration statement with the SEC that includes detailed descriptions regarding the actual security being offered, the company's overall financial health, its underlying management practices, and any other information that is relevant to the security being offered.[75] The Exchange Act created additional disclosure obligations on issuers for securities that are traded on the secondary market, where investors purchase securities or assets from other investors, rather than purchasing them directly from the issuing companies.[76] These issuer disclosure obligations include the public filing of periodic reports that describes any updated or new information.[77] The Securities Act and the Securities Exchange Act create civil and criminal liability for issuers who fraudulently disclose or withhold material information.[78]

In regulating the exchanges, Congress rejected the previously held notion that these entities were private institutions that only affected its underlying members.[79] Instead, Congress adopted the view that the activities of these entities had a direct and profound impact on the general public which was evidenced by the market crashes that precipitated the Great Depression.[80] Thus, the Exchange Act created clear standards of conduct for broker-dealers and other market participants,[81] and "fix[ed] margins on (a) all loans on securities from brokers to customers, and (b) loans from banks and others to customers made on equity securities and to carry or purchase securities."[82] It also

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[73] *See* DE BEDTS, *supra* note 60, at 48.

[74] *See* Securities Act of 1933, 15 U.S.C. §§ 77k-77j (2006).

[75] *Id.* §§ 77g-77aa.

[76] *See* Securities Exchange Act of 1934, 15 U.S.C. § 78l (2006).

[77] *See id.* § 78m.

[78] *See* Securities Act of 1933, 15 U.S.C. §§ 77k, 77l, 77q (2006); Securities Exchange Act of 1934, 15 U.S.C. §§ 78j, 78ff (2006).

[79] *See* DE BEDTS, *supra* note 60, at 12, 15-16, 17, 61.

[80] Securities Exchange Act of 1934, 15 U.S.C. § 78b (2006) ("For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . . .").

[81] *See* H.R. REP. NO. 73-1383, at 7-11; Securities Exchange Act of 1934, 15 U.S.C. §§ 78o, 78h, 78k (2006).

[82] H.R. REP. NO. 73-1383, at 7; *see also* 15 U.S.C. § 78g (articulating the requirements and regulations of margins).

prohibited certain manipulative devices that had been used to fictitiously depict stock activity and affect stock prices.[83] Additionally, the Exchange Act sought to prevent insider trading by requiring that company insiders disclose specific information with respect to their company holdings, and any profits resulting from sale of an insider's company stock within six months of purchase would be disgorged.[84]

The Exchange Act also authorized the creation of the SEC, which is the regulatory body charged with implementing and enforcing the federal securities laws.[85] The SEC fulfills this undertaking by actively pursuing it mission to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[86] The SEC implements this mission by "interpret[ing] federal securities laws; issu[ing] new rules and amend[ing] existing rules; oversee[ing] the inspection of securities firms, brokers, investment advisers, and ratings agencies; oversee[ing] private regulatory organizations in the securities, accounting, and auditing fields; and coordinat[ing] U.S. securities regulation with federal, state, and foreign authorities."[87] Hence, the fulfillment of this mission is integral for ensuring the proper implementation of the federal securities laws, which in-turn protects the public capital markets from the harms that adversely affect the national economy.[88]

C. *Investment Company Regulation*

Shortly after the passage of the Securities Act and the Securities Exchange Act, Congress passed the Company Act and the Advisers Act to further regulate investment companies and their advisers.[89] While a security is a single financial instrument that represents an ownership interest in a particular enterprise, an investment company is a type of pooled investment vehicle that invests in numerous securities on behalf of multiple investors.[90] Thus, investors in these structures rely on the

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[83] *See* DE BEDTS, *supra* note 60 at 76; *see also* Securities Exchange Act, 15 U.S.C.S. §§ 78i, 78-j (2006).

[84] *See* DE BEDTS, *supra* note 60, at 76.

[85] 15 U.S.C. § 78d.

[86] *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 17.

[87] *Id.*

[88] *See id.*

[89] *See* 15 U.S.C. § 80b-1 (Findings).

[90] *See Investment Companies*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/mfinvco.htm (last modified Oct. 24, 2010). The performance of the investment

aptitude and judgment of the underlying advisers, to make the best possible investments on their behalf.[91] This investment structure creates unique fiduciary concerns with respect to the relationship between the investors and the advisers, especially since the advisers receive a fee in exchange for advising how the pool of assets should be invested.[92] However, investors often find investment companies more appealing than investing in a single security because they provide easy access to a diversified portfolio.[93] Additionally, each investor shares in the profits and losses in proportion to the investor's ownership interest in the investment company.[94]

The need to create additional regulations for these vehicles became apparent in the 1920s and 1930s, when evidence revealed that investment companies "suffered from a number of conspicuous abuses, including self-dealing, inordinately complex capital structures, self-perpetuating managements, and excessive fees."[95] Between 1929 and 1936, the SEC estimated that "investment company shareholders lost 40 percent of their investments."[96] As a result, Congress requested the SEC to conduct a "comprehensive study of the investment company industry, looking specifically at the functions and activities of investment companies, their corporate structures and their investment policies."[97] The results of the study confirmed the pervasive occurrence of investor abuses.[98]

It became apparent to Congress that the trading activities of investment companies affect the national economy because they "constitute a substantial part of all transactions effected in the securities markets of the Nation."[99] Congress also found that investment companies

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company will be based on the performance of the securities and other assets that the investment company owns. *Id.*

[91]*See id.*

[92]*See* Comment, *The Investment Company Act of 1940*, 50 YALE L.J. 440, 440-41 (1941).

[93]*Id*. at 441.

[94]*See id.*

[95]Richard M. Phillips & Robert G. Bagnall, *The Investment Company Act of 1940: A Time For Reassessment, in* 22ND ANNUAL INSTITUTE ON SECURITIES REGULATION 593, 596 (Practising Law Institute Corporate Law and Practice Course Handbook Series No. 713, 1990).

[96]Paul Roye, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Speech, A Celebration of the 60th Anniversary of the Investment Company Act (Oct. 4, 2000) (transcript available at http://www.sec.gov/news/speech/spch405.htm).

[97]*Id.*

[98]*Id*. ("The Investment Trust Study, and the subsequent Congressional hearings, found that, to an alarming extent, investment companies were being organized and operated to benefit the interests of their affiliates rather than the interests of their shareholders. In short, a number of fund sponsors abandoned their fiduciary obligations and acted without regard to any stewardship on behalf of fund investors.").

[99]Investment Company Act of 1940, 15 U.S.C. § 80a-1(a)(2).

"are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into capital markets."[100]

The passage of the Company Act intended to mitigate these abuses and the accompanying effect on the national capital markets by mandating various reporting, disclosure, and fiduciary obligations for entities falling within the definition of an "investment company."[101] Unlike the Securities Act and the Exchange Act, the Company Act includes various "merit regulation" provisions, which explicitly prohibit certain conduct and business activities.[102] The Company Act also includes several investment restrictions placed on the actual assets of registered investment companies.[103] For example, investment companies are limited in their abilities to use leverage, and to invest in futures, options, and other financial instruments.[104]

The Advisers Act regulates the activities of investment advisers, which are individuals or firms that are paid by a client to give advice about certain securities.[105] For instance, individuals or firms that receive compensation for giving advice on investing in stocks, bonds, mutual funds, or investment companies are classified as investment advisers.[106] The Advisers Act imposes certain disclosure requirements on registered advisers, such as descriptions of the advisory services offered, material conflicts of interest, any pending disciplinary actions, advisory fees charged, and other general business descriptions.[107] It also subjects advisers to additional fiduciary obligations[108] and record-keeping requirements.[109] Under this Act, the SEC also has the authority to conduct random inspections of registered advisers to ensure that they are in compliance with the act and its corresponding regulations.[110]

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[100] *Id.* § 80a-1(a)(4).

[101] *See generally id*. § 80a-1(b) (declaring policy to prevent both the national public and investors' interests from being disserved); *id.* § 80a-3(a) (defining "investment company").

[102] Gerard S. DiFiore & Ronald L. Francis, *Impact of an Old Law in a New Age: Is the Investment Company Act of 1940 on a Collision Course With the New Economy*?, N.J. LAW., Dec. 2000, at 46, 47.

[103] *See id.*

[104] *The Differences Between Mutual Funds and Hedge Funds*, INV. CO. INST. (Apr. 2007), http://www.ici.org/investor_ed/brochures/faqs_hedge.

[105] Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2006) (defining "Investment Adviser").

[106] *Id*.

[107] *See id.* § 80b-4.

[108] *See id.* § 80b-6.

[109] *See* Investment Advisers Act of 1940, 15 U.S.C. § 80b-4 (2006).

[110] *See id.*

III. PRIVATE INVESTMENTS AND THE SOPHISTICATED INVESTOR DOCTRINE

> [T]he increased proportion of institutional private placements has substantially reduced the scope of the Securities Act of 1933, in effect representing the most significant erosion of the federal securities laws' mandatory disclosure system since the New Deal period.[111]

Part III summarizes the private offering exemption and explains how the sophisticated investor doctrine derived from this provision. It then illustrates the expansion of the sophisticated investor exemption through the passage of Regulation D, as well as through other safe harbors promulgated under the Company Act. Part III concludes by explaining how the expansion of the sophisticated investor exemption created unregulated sub-parts within the investment company marketplace, which has blurred the distinction between public and private investment companies. While this section is limited to providing descriptions of these private vehicles, the remaining sections in this Article specifically examine how the participation of these vehicles in the public capital markets has undermined the SEC's ability to fulfill its mission.

A. *Private Offering Exclusion*

The federal securities laws discussed herein subject financial securities and investment companies to substantial regulation, but they are not intended to regulate transactions that are considered private in nature[112] or "where the public benefits are too remote."[113] Under the Securities Act, any transaction not involving a public offering is exempt from the Act's registration requirements.[114] This exclusion is supported by the concept that private transactions do not affect the national economy because they are limited in scope and effect.[115] For this reason,

[111] JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 609 (2d ed. 1995).

[112] *See* Securities Act of 1933, 15 U.S.C. § 77d(2) (2006).

[113] Comm. on Interstate & Foreign Com., House Report on Securities Act of 1933, H.R. REP. NO. 73-85, at 5 (1933).

[114] 15 U.S.C. §77d(2).

[115] *See* H.R. REP. NO. 73-85, at 5-7.

private offerings are not subject to the same disclosure requirements and trading restrictions as offerings that are considered public.[116]

Since the statute does not explicitly define what constitutes a public offering, it has been subject to various interpretations by the SEC and the courts.[117] In 1935, the SEC issued an opinion that provided a list of factors that should be used to determine whether an offering is public.[118] Those factors include "(1) [t]he number of offerees and their relationship to each other and to the issuer. . . . (2) [t]he number of units offered. . . . (3) [t]he size of the offering," and "(4) [t]he manner of offering."[119] The opinion suggested that an issuer would have to weigh these various factors to determine whether it can actually rely on the non-public offering exemption.[120] Thus, determining whether an offering is public pursuant to this SEC opinion depends heavily upon the specific facts of each particular offering.[121]

B. *Origins of the Sophisticated Investor Doctrine*

In *SEC v. Ralston Purina Co.*,[122] the Supreme Court provided additional guidance on the definition of "public," which provided the foundation for the sophisticated investor doctrine.[123] The Court held that an offering to those who can "fend for themselves" is a transaction "not involving any public offering."[124] In particular, the Court reasoned that if the offerees have access to the same type of information that would be available in a registration statement, then they do not need the protections guaranteed under the federal securities laws.[125] In *Ralston*, the Court found that even though the purchasers of the securities were employees of the issuer, it was not shown that the employees had access to the same kind of material information that would have been found in a registration statement, and therefore, they were unable to adequately fend

[116]*See id.*
[117]SEC STAFF REPORT, *supra* note 5, at 14
[118]Letter of General Counsel, Securities Act Release No. 285, 11 Fed. Reg. 10,952 (Jan. 24, 1935).
[119]*Id*. at 10,952-53.
[120]*Id.* at 10,952.
[121]*See* Non-Public Offering Exemption, Securities Act Release No. 33-4552, 27 Fed. Reg. 11,316 (Nov. 6, 1962).
[122]346 U.S. 119 (1953).
[123]SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
[124]*Id.* at 125.
[125]*See id.* at 125-26.

for themselves and the non-public offering exemption did not apply.[126] The offering in *Ralston* was deemed public even though it was limited to approximately 500 offerees.[127] Accordingly, determining whether an offering is public is a very fact-specific inquiry, which makes it difficult for issuers to predict whether they can legitimately rely on this holding.[128]

C. *The Expansion of the Sophisticated Investor Doctrine*

In 1982, to mitigate the uncertainty of relying on the private offering exemption, as well as to clarify the holding provided under *SEC v. Ralston Purina*, the SEC promulgated Regulation D,[129] which is a safe harbor providing an alternative framework for ensuring compliance with the non-public offering exemption.[130] According to the SEC, Regulation D was designed to "facilitate capital formation while protecting investors by simplifying and clarifying existing exemptions for private or limited offerings, expanding their availability, and providing more uniformity between federal and state exemptions."[131] Among the rules included within this regulation are Rules 504, 505, and 506, each of which the SEC intended to provide clear standards for complying with the private offering exemption.[132]

Investment companies often rely on Rule 506 because it is the least restrictive.[133] Under this rule, an issuer can sell an unlimited amount of securities to an unlimited number of accredited investors.[134] Accredited investors are various institutional investors such as banks, broker-dealers, insurance companies, registered investment companies, and several other enterprises.[135] Accredited investors are also "any

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[126]*Id.* at 127.

[127]*See Ralston Purina Co.*, 346 U.S. at 121, 127.

[128]*See* Non-Public Offering Exemption, Securities Act Release No. 33-4552, *supra* note 121, at 11,316.

[129] Regulation D, 17 C.F.R. §§ 230.501-508 (2011).

[130]*See* James R. Tanenbaum & Anna T. Pinedo, *The Law: Legal and Regulatory Framework*, *in* PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY 77, 80 (Steven Dresner & E. Kurt Kim eds., 2d ed. 2006).

[131]Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. 45,116 (proposed Aug. 10, 2007) (to be codified at 17 C.F.R. pts. 200, 230, 239).

[132]*See generally* 17 C.F.R. §§ 230.504-506 (2011) (qualification conditions for private placement exemption).

[133]*See* Tanenbaum & Pinedo, *supra* note 130, at 81 ("The rule most often relied on for Reg D private placements is Rule 506, the exemption for limited offerings and sales without regard to dollar amount.").

[134]17 C.F.R. § 230.506 (b).

[135]*See id.* § 230.501(a)(1)-(8).

natural person[s] whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000," or who has individual income exceeding $200,000 or joint income in excess of $300,000.[136] Specific knowledge with respect to the offered securities is not a prerequisite for becoming an accredited investor.[137] The test simply relies on the institutional status or financial net worth of each investor.[138] It is assumed that such investors can use their resources to obtain adequate safeguards, and as a result, they do not need the protections afforded by the Securities Act.[139] For purposes of this Article, the terms "sophisticated investor" and "accredited investor" will be used interchangeably.

In 1996, the sophisticated investor doctrine was also expanded through the adoption of Sections 3(c)(1) and 3(c)(7) under the Company Act, which made it easier for investment companies to receive exemption from the arduous registration and disclosure requirements prescribed under this Act.[140] Under Section 3(c)(1), a fund with fewer than 100 beneficial owners that "does not presently propose to make a public offering of its securities" is not considered an investment company, and is therefore exempt from registration requirements.[141] Funds that rely on this exemption must also restrict their offerings to accredited investors.[142] Under Section 3(c)(7) of the Company Act, funds that restrict their offerings to "qualified purchasers" are also exempt from the registration requirements of the Act.[143] Qualified purchasers are similar to accredited investors, but they are subject to higher net-worth requirements.[144] They

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[136] *Id.* § 230.501(a)(5)-(6).

[137] *See* 17 C.F.R. § 230.501(a) (2011) (defining "accredited investor").

[138] *See id.*

[139] *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) ("An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

[140] *See* Privately Offered Investment Companies, 62 Fed. Reg. 17,512, 17,512-13 (Apr. 9, 1997) (to be codified at 17 C.F.R pt. 270).

[141] Investment Company Act, 15 U.S.C. § 80a-3(c)(1) (2006).

[142] As stated above, Section 3(c)(1) provides that a fund with fewer than 100 beneficial owners is excluded from the definition of an investment company so long as it does not "presently propose to make a public offering of its securities." *Id.* The SEC has generally interpreted this non-public offering condition consistently with non-public offering exemptions under Section 4(2) of the Securities Act. SEC STAFF REPORT, *supra* note 5, at 12 n.36.

[143] 15 U.S.C. § 80a-3(c)(7); *see also* 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, 704 (2001) (explaining that the SEC added the section 3(c)(7) exemption based on its belief that the exemption provided in section 3(c)(1) was too restrictive considering the state of the market and expanding number of sophisticated investors).

[144] *Compare* 15 U.S.C. § 80a-2(a)(51)(A)(i) (2006) ("'Qualified purchaser' means—(i)

include institutions that own at least $5,000,000 in investments as well as any natural person who owns not less than $5,000,000 in investments.[145] This test primarily focuses on the financial net worth of the investors as a proxy for sophistication. As with the accredited investor standard, qualified purchasers are not required to have specific knowledge with respect to the offered securities.[146]

D. *Division of the Investment Company Industry*

Expansion of the sophisticated investor doctrine has blurred the distinction between public and private vehicles. While registered investment companies, such as mutual funds, became an extremely popular investment vehicle for the general public, exempt investment vehicles, such as hedge funds and private equity funds, have become extremely popular among sophisticated investors.[147] These exempt vehicles are considered private, even though they are often avid participants in the public capital markets and frequently invoke the national public interest.[148]

1. Mutual Funds

Mutual funds are one of the most prevalent registered investment company structures in the United States.[149] At the end of 2010, the

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any natural person . . . who owns not less than $5,000,000 in investments . . . ."), *with* 17 C.F.R. § 230.501(a)(5) (2011) ("Accredited investor shall mean . . . . (5) [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.").

[145] *See* 15 U.S.C. § 80a-2(a)(51)(A).

[146] *See* S. REP. NO. 104-293, at 10 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3416, 3426-3436 ("The qualified purchaser pool reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections. Generally, *these investors can evaluate on their own behalf* matters such as the level of a fund's management fees governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.") (emphasis added).

[147] Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Speech for Spring 2009 Hedgeworld Fund Services Conference: Hedge Fund Regulation on the Horizon — Don't Shoot the Messenger (June 18, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch061809laa.htm) (discussing the growth of the hedge fund industry since 1949).

[148] *Id.* ("[A]lthough hedge funds represent just 5% of all U.S. assets under management, they account for about 30% of all U.S. equity trading volume."). *See* discussion *infra* Part V.B (discussing hedge funds and other private investment vehicles' sizable influence on the national trading market).

[149] *See 2011 Investment Company Fact Book*, INVESTMENT COMPANY INST. 9 (51st ed.

United States mutual fund market consisted of $11.8 trillion in assets under management, which represents about 48 percent of the global mutual fund industry.[150] Essentially, mutual funds are investment vehicles that are formed by advisers who collect money from a large number of investors.[151] These advisers then invest the pool of money into various classes of securities such as stocks, bonds, and money market instruments.[152] These underlying mutual fund investments help investors achieve higher levels of diversification than would otherwise be possible with an investment in a single security.[153] The performance of mutual funds is normally measured against a benchmark such as a stock or bond market index.[154] Since they are open to investment by the general public, they are also subject to significant regulatory oversight under the Securities Act, the Exchange Act, Company Act, and Advisers Act.[155] As a result, they must comply with the rigorous disclosure requirements and investment constraints imposed under these laws.

2. Hedge Funds

Hedge funds have become one of the most prevalent and controversial exempt investment company structures in the United States.[156] In 2009, there were over 18,000 hedge funds in existence, with total assets under management of approximately $1.5 trillion.[157] They now account for as much as fifty percent of the daily trading volume on

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2011), http://www.ici.org/pdf/2011_factbook.pdf.

[150] *Id.* at 22.

[151] U.S. SEC. & EXCH. COMM'N, MUTUAL FUNDS: A GUIDE FOR INVESTORS 4 (2010), *available at* http://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf [hereinafter MUTUAL FUND GUIDE].

[152] *Id.*

[153] *Id.* at 6.

[154] *Id.* at 9.

[155] *See* MUTUAL FUND GUIDE, *supra* note 151, at 5 (explaining that mutual funds, unlike hedge funds, are subject to numerous regulations including liquidity requirements, redemption rights, pricing requirements, leverage regulations, and disclosure requirements); *see also Mutual Funds*, U.S. SEC. & EXCH. COMM'N (last modified Dec. 14, 2010), http://www.sec.gov/ answers/mutfund.htm (noting that mutual funds are registered with the SEC and subject to SEC regulation).

[156] *See* SEC STAFF REPORT, *supra* note 5, at vii-xi; *see generally* Aguilar, *supra* note 147 (expressing concerns that hedge funds have posed).

[157] *Hedge Fund Adviser FAQ's*, MANAGED FUNDS ASS'N, https://www.managedfunds.org/hedge-fund-investors/faqs/hedge-fund-advisor/ (go to "How big is the hedge fund industry?") (last visited Feb. 29, 2012); *see also* SEC STAFF REPORT, *supra* note 5, at 1 n.2 (estimating that approximately 6,000 hedge funds currently operate in the United States).

the New York and London stock exchanges.[158] This exponential growth resulted from the ease through which hedge funds remain exempt from the arduous registration requirements imposed by the federal securities laws.[159] The expansion of the sophisticated investor doctrine[160] made it easier for advisers to create exempt investment vehicles.[161] These exemptions gave hedge funds more flexibility to invest its assets into multiple financial instruments and pursue multiple investment strategies, allowing them to seek higher absolute returns under various market conditions.[162]

Structurally, hedge funds are very similar to mutual funds: they are investment vehicles that are formed by investment advisers who solicit money from a number of investors.[163] However, they differ with respect to their registration status, legal structures, and investment constraints. As briefly noted above, since hedge fund investments are restricted to sophisticated investors, they are not subject to the rigorous disclosure and registration requirements mandated under the Securities Act, Exchange Act, Company Act, and Advisers Act.[164] In addition, the term "hedge" refers to the fact that these funds can use various strategies in order to hedge, or protect, their portfolios against market losses—strategies that are of limited availability to mutual funds.[165] For example, a hedge fund adviser could simultaneously take long and short positions

[158] Greg Ip & Henny Sender, *Private Money: The New Financial Order; Cash Machine: In Today's Buyouts, Payday For Firms Is Never Far Away; New Owners Extract Stream of Charges and Dividends, Running Up Company Debt*, WALL ST. J., July 25, 2006, at A1; *see also Regulation of Hedge Funds*: *Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 109th Cong. 32 (2006) (prepared statement of Christopher Cox, Chairman of SEC), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-109shrg50245/pdf/CHRG-109shrg50245.pdf [hereinafter *Testimony of Chairman Cox*] ("[Hedge funds] account for about 30% of all U.S. equity trading volume.").

[159] *See* Parry, *supra* note 143, at 704.

[160] *See supra* Part III.C.

[161] *See supra* Part III.C.; *supra* notes 144-45 and accompanying text.

[162] *See* SEC STAFF REPORT, *supra* note 5, at 33-34.

[163] GERALD T. LINS ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 1.1 (2010-2011 ed.).

[164] *See generally* SEC STAFF REPORT, *supra* note 5, at 11-18 (discussing the exemptions that hedge funds typically rely upon).

[165] JOSEPH G. NICHOLAS, INVESTING IN HEDGE FUNDS: STRATEGIES FOR THE NEW MARKETPLACE 25 (1st ed. 1999) ("Hedge funds differ from mutual funds in the range of allowable investment approaches, the goals of the strategies that they use, and in the breadth of tools and techniques available to investment managers to achieve those goals for investors."). The author notes, however, that the distinction between hedge funds and mutual funds is becoming increasingly blurred as mutual fund regulatory changes have allowed certain hedge fund strategies to operate under the mutual fund structure. *Id.*

in the same type of instrument in order to ensure a return in both high and low markets.[166] Mutual funds, however, are limited in their ability to take short positions, which makes it difficult for them to ensure returns in decreasing markets.[167] In addition, hedge funds can theoretically employ unlimited amounts of leverage,[168] which refers to amplifying investment returns through the use of borrowed money or various derivative contracts.[169] Leverage provides hedge fund advisers the potential to increase returns of a particular fund without having to increase the actual amount of capital invested.[170] Moreover, unlike mutual funds, hedge fund advisers are able to receive a fee that is based on the actual profits of the fund[171] and they are not required to adhere to any diversification requirements with respect to their actual trading strategies.[172]

This great investment flexibility afforded to hedge funds, combined with their prevailing market influence and recent exponential growth, has proven to be problematic from a regulatory perspective.[173] Several prominent hedge fund failures have created a need for greater regulatory oversight, especially since many hedge funds can fall within the "too big to fail" category.[174] For example, the near failure of Long-

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[166]*See* SEC STAFF REPORT, *supra* note 5, at 34-35.

[167]*See* Investment Company Act of 1940, 15 U.S.C. § 80a-12(a)(3) (2006); *see also* SEC STAFF REPORT, *supra* note 5, at 38 ("Although registered investment companies [such as mutual funds] may use leverage and sell short, their ability to use these tools is more limited than is the case with hedge funds.").

[168]SEC STAFF REPORT, *supra* note 5, at 37-38 ("A hedge fund's limitation on its use of leverage is often dictated by any margin or collateral requirements imposed on lenders or on others (e.g., broker-dealers), and the willingness of lenders or other counterparties to provide it with credit.").

[169]*See id.* at 37.

[170]*See id.*

[171]*See* Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 AM. J. COMP. L. 295, 306 (2010). Hedge fund advisers also receive a fixed fee, which is based on a percentage of a fund's net asset value. *See Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/hedge.htm (last modified Mar. 26, 2008). Mutual fund advisers also receive these fixed fees. S*ee Mutual Fund Fees and Expenses*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/answers/mffees.htm (last modified Aug. 8, 2007).

[172]*Recent Developments in Hedge Funds: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 108th Cong. 34 (2003) (prepared statement of William H. Donaldson, Chairman of SEC), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-108shrg92703/pdf/CHRG-108shrg92703.pdf.

[173]*See* Administrative Law—Judicial Review of Agency Rulemaking—District of Columbia Circuit Vacates Securities and Exchange Commission's "Hedge Fund Rule."—Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006), 120 HARV. L. REV. 1394, 1400-01 (2007).

[174]Azam Ahmed, *Is No Hedge Fund Too Big to Fail?*, N.Y. TIMES DEALBOOK, (Jan. 31, 2011, 1:37 PM), http://dealbook.nytimes.com/2011/01/31/is-no-hedge-fund-too-big-to-fail

Term Capital Management ("LTCM"), a Connecticut based hedge fund, almost devastated the global economy.[175] When this fund was close to shutting its doors, it had over $100 billion in debt, even though it only had about $2.3 billion in equity.[176] In essence, the failure of LTCM would have rendered these highly leveraged contracts obsolete, and the corresponding losses of the banks that were counterparties to these transactions could have precipitated a global financial crisis.[177]

The federal government had to arrange a deal among the LTCM counterparties to prevent the actual failure of this fund.[178] The fact that a single exempt investment vehicle could cause a severe economic crisis created a political and public outcry for enhanced regulation of the industry.[179] Other notable hedge fund failures include the failure of Amaranth Advisors, Bailey Coates Cromwell Fund, and Sowood Capital Management.[180] Former money managers at Harvard Management Company launched Sowood Capital Management and its total losses exceeded $1.5 billion.[181] Despite the staggering losses of several prominent hedge funds, prior to the passage of the Dodd-Frank Act it was difficult for regulators to pull hedge funds within the existing rubric of our federal securities laws.[182] This was partially due to the long-standing belief in the legitimacy of the sophisticated investor doctrine.[183]

3. Private Equity Funds

Private equity funds are another class of private investment companies that are primarily restricted to sophisticated investors.[184] It

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(considering that some, including those at the SEC, view hedge funds as a systemic risk).

175 *See* PRESIDENT'S WORKING GRP ON FIN. MATTERS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 18, 20-21 (1999), *available at* http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf [hereinafter LTCM REPORT].

176 *Id.* at 12.

177 *See id.* at 17-19.

178 *See* Richard W. Stevenson, *Officials Assess Impact of a Fed-Brokered Deal*, NY. TIMES, Sept. 25, 1998, at C4.

179 *See Testimony of Chairman Cox*, *supra* note 158, at 31-35.

180 *See* Lydie N.C. Pierre-Louis, *Hedge Fund Fraud and the Public Good*, 15 FORDHAM J. CORP. & FIN. L. 21, 69 (2009).

181 *Id.*

182 *See generally* SEC STAFF REPORT, *supra* note 5, at 11-32 (discussing hedge fund regulations and exemptions).

183 *See* Jerry W. Markham, *Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?*, 12 YALE J. ON REG. 345, 346, 354 (1995) (discussing disparate treatment of sophisticated or institutional investors and retail investors).

184 *See* SEC STAFF REPORT, *supra* note 5, at 7.

has been estimated that at the end of 2009, private equity funds under management totaled approximately $2.5 trillion.[185] There are several types of private equity fund structures, including venture capital funds, leveraged buy-outs, and mezzanine financing.[186] For the most part, private equity funds invest directly into private companies and typically acquire large blocks of illiquid securities.[187] Private equity funds "are seen as helping create new businesses, fostering innovation, and assisting businesses in need of restructuring."[188] The majority of private equity investors consist of sophisticated investors who are able to invest for long periods of time since such investments often demand long holding periods.[189] Unlike registered funds, a private equity fund is usually a closed-ended vehicle, meaning that it does not accept new investors once it acquires the majority of its initial capital and it does not permit investor withdrawals until the fund dissolves.[190]

Private equity funds have not been subject to the same level of controversy experienced by the hedge fund industry. For example, they are less likely to engage in the speculative trading activities and market manipulations[191] because they typically do not actively trade in the public capital markets.[192] However, similar investor protection and capital formation issues arise[193] because the underlying assets of such funds are often difficult to value. As indicated by a study administered by the Government Accountability Office, the major challenges associated with private equity investments include "the variation of performance among private equity funds, which is greater than for other asset classes, and the difficulty of gaining access to funds perceived to be top performers, as well as valuation of the investment, which is difficult to assess before the

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[185] *Private Equity 2010*, THECITYUK 2 (Aug. 2010), http://www.thecityuk.com/assets/Uploads/Private-equity-2010.pdf.

[186] *See* Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 8-9 (2008) (describing the various transactions classified under the "private equity" label); *see also Regulating Hedge Funds and Other Private Investment Pools: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. 34 (2009) (prepared statement of Andrew J. Donohue, Dir., Div. of Inv. Mgmt., SEC), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111shrg54883/pdf/CHRG-111shrg54883.pdf [hereinafter *Testimony of Director Donohue*].

[187] *See* Cheffins & Armour, *supra* note 186, at 10-12.

[188] *Testimony of Director Donohue*, *supra* note 186, at 35.

[189] Cheffins & Armour, *supra* note 186, at 10-14.

[190] *See id.* at 11.

[191] *See* discussion *infra* Part V.

[192] *See* Cheffins & Armour, *supra* note 186, at 9-10.

[193] *See generally infra* Parts IV, VI.

sale of fund holdings."[194] Moreover, many private equity funds have been made indirectly available to retail investors.[195]

IV. INVESTOR PROTECTION

> After all, a single sophisticated institutional investor, whether it is a bank, pension fund, mutual fund, or other entity, often represents investments from many individual retail investors. And these small investors ultimately bear the cost.[196]

Part IV begins a more detailed analysis of how the operation of the sophisticated investor exemption within the investment company industry has undermined the SEC's ability to fulfill its mission to protect the public capital markets. Section A underscores the increasing exposure of retail investors and other unsuspecting constituents to unregulated investment schemes, and how the sophisticated investor doctrine undermines the Commission's ability to adequately protect retail investors. Section B explains why sophisticated investors may no longer be able to adequately fend for themselves. Finally, Section C concludes Part IV with an examination of the limitations on the SEC's ability to successfully pursue hedge fund adviser fraud.

A. *Retail Investor Exposure*

As discussed in Part II, the federal securities laws are designed to protect retail investors from harmful activities of company insiders and other market participants by deterring fraud and encouraging the full disclosure of all material information.[197] In essence, retail investors constitute the "general public" for whom the federal laws are intended to

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[194] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-885, PRIVATE EQUITY: RECENT GROWTH IN LEVERAGED BUYOUTS EXPOSED RISKS THAT WARRANT CONTINUED ATTENTION 43 (2008), *available at* www.gao.gov/new.items/d08885.pdf.

[195] *See, e.g.*, Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Speech for Compliance Week 2010 Conference: Market Upheaval and Investor Harm Should Not be the New Normal (May 24, 2010) (transcript available at http://www.sec.gov/news/speech/2010/spch052410laa-1.htm); *see also* discussion *infra* Part IV.A.

[196] Aguilar, *supra* note 195.

[197] *See supra* Part II.B; *see also* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (noting that one of the central purposes of securities laws is to protect investors through full disclosure requirements); SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 861 (2d Cir. 1968) (indicating that securities laws are intended to protect investors against fraud).

protect.[198] The SEC's Division of Corporate Finance helps them to enforce investor protection by monitoring and reviewing the mandated disclosures provided by public companies, as well as by providing ongoing interpretations of the federal securities laws.[199] The SEC's Division of Enforcement further implements investor protection by investigating and prosecuting potential violations of the federal securities laws.[200]

Since sophisticated investors are deemed to have the resources to adequately protect themselves, they have not historically been entitled to investor protection under the federal securities laws.[201] Yet, various types of prominent institutions that qualify as sophisticated investors have indirectly exposed retail investors to unregulated investment schemes.[202] The SEC and other researchers in this area have further explored these risks since pension plans, insurance companies, charitable trusts, and other institutional investors have been increasingly investing into these vehicles.[203] A 2007 study conducted by McKinsey & Company found that institutional investors accounted for approximately 37% of hedge fund assets through direct investment, and another 23% through indirect funds-of-funds investment.[204] A more recent study found that most hedge fund managers expect institutional investor participation in hedge funds

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[198]SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (noting that securities laws are intended to protect retail investors).

[199]*See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 17.

[200]*Id.*

[201]*See supra* Part III.B.

[202]*See* Aguilar, *supra* note 195; *see also* Alexander R. Roche, *The Regulator Strikes Back: A Look at the SEC's Most Recent Attempt to Regulate Hedge Funds and What it Missed*, 33 U. DAYTON L. REV. 145, 153 (2007) (noting that the SEC has found retail investors indirectly exposed to hedge funds through investments made by pension funds and other investment schemes).

[203]William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n, Testimony Concerning Investor Protection and the Regulation of Hedge Funds Advisers (Before the U.S. S. Comm. on Banking, Housing, & Urban Affairs, July 15, 2004), U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/news/testimony/ts071504whd.htm (last modified July 15, 2004) (transcript); *see also Testimony of Chairman Cox*, *supra* note 158, at 31 ("[T]he Securities and Exchange Commission is working closely . . . with the other members of the President's Working Group on the questions of the systemic market risks posed by hedge fund activity, and the investor protection issues that stem from the increasing exposure of retail investors to hedge fund investment opportunities."); *see also* Roche, *supra* note 202, at 153-54 (discussing the SEC's concerns with retail investors being indirectly exposed to hedge funds).

[204]DIANA FARRELL ET AL., MCKINSEY GLOBAL INST., THE NEW POWER BROKERS: HOW OIL, ASIA, HEDGE FUNDS, AND PRIVATE EQUITY ARE SHAPING GLOBAL CAPITAL MARKETS 99 (2007), (accessible at http://www.mckinsey.com/Insights/MGI/Research/ Financial_Markets/ How_the_new_power_brokers_are_shaping_global_capital_markets.).

to increase significantly by 2013.[205] Overall, these institutional investors, as opposed to wealthy individuals, are becoming the dominant investor class within the hedge fund industry,[206] even though these vehicles are supposed to be restricted to sophisticated investors.[207] This undermines the SEC's ability to adequately protect retail investors, even though this is a vital component of their mission.

1. Pension Plans

Since pension plans qualify as sophisticated investors, they are permitted to invest in exempt investment companies even though the underlying investors of pension plans encompass the general public.[208] For instance, a pension plan in Fairfax County, Virginia invested 12% of its assets into hedge funds, while another pension plan in that same county invested about 20% of its assets into similar investments.[209] Another pension fund, the City of Danbury Retirement Plan, invested as much as 27% of its assets into private investment vehicles, and that percentage will likely increase over time.[210] Pension plans have been increasing their investments into private vehicles due to the pressure of ensuring positive returns to their underlying constituents.[211]

Some pension plans have incurred significant losses from these private investments that have resulted in reduced payouts to its retirees.[212] For example, in September 2006, a San Diego pension fund

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[205] *See* Madison Marriage, *Institutional Investors Driving Investment in Hedge Funds*, HEDGE FUNDS REV. (Feb. 12, 2011), http://www.hedgefundsreview.com/hedge-funds-review/news/2025856/institutional-investors-driving-investment-hedge-funds.

[206] *See id.* ("[T]he [hedge fund] industry is continuing to move towards institutionalisation . . . .").

[207] *See* discussion *supra* notes 184-90 and accompanying text.

[208] *See, e.g.*, Heidi Moore, *Debunking the Myth of the 'Sophisticated Investor'*, WASH. POST, May 2, 2010, at G2, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/05/01/AR2010050100205.html (noting that pension funds are considered "sophisticated investors" but their funds, and their losses, belong to regular retired workers).

[209] Tomoeh Murakami Tse, *Public Pension Systems Betting on Hedge Funds*, WASH. POST, July 24, 2007, at D1, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/07/23/AR2007072301728.html.

[210] Steve Eder et al., *Pensions Leap Back to Hedge Funds*, WALL ST. J. ONLINE (May 27, 2009), http://on.wsj.com/iL51yw.

[211] *See, e.g.*, Tse, *supra* note 209.

[212] *Id.*; *see also* Rami Grunbaum, *Offshore Hedge Fund is Trouble for Seattle's Pension Fund*, SEATTLE TIMES, Apr. 11, 2010, at C1, *available at* http://seattletimes.nwsource.com/html/ businesstechnology/2011570587_sundaybuzz11.html (discussing a Seattle pension fund that has lost a significant amount of assets to hedge fund

incurred substantial losses when its hedge fund investments were overexposed to losses in the natural gas industry.[213] The pension plan's strategy included a group of hedge funds, which initially helped the plan to achieve higher returns than the rest of its portfolio.[214] Yet, the subsequent losses of those hedge funds caused the pension fund to incur corresponding losses that adversely impacted its 33,000 county workers.[215]

This San Diego pension fund probably did not have sufficient knowledge of the hedge funds' overexposure to certain natural gas trades since there were inadequate disclosure requirements placed on the hedge funds.[216] Similarly, the Massachusetts secretary of state further noted that "[b]ecause of [hedge funds'] unpredictability, because of the flexibility they're afforded, and the lack of transparency, [pension plan fiduciaries] really don't know exactly what they're buying."[217] Even though many pension plans do perform extensive due diligence on prospective hedge fund investments,[218] one study found that pension plans are not adequately investigating the valuation mechanisms of hedge fund investments.[219] These valuation mechanisms are often extremely complex and inconsistent across a range of hedge funds, which can make it particularly difficult to properly evaluate the corresponding risks of those investments.[220]

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investments).

[213]Mary Williams Walsh, *Pension Fund Tallies Losses and Rethinks Its Strategy*, N.Y. TIMES, Sept. 9, 2006, at C4, *available at* http://www.nytimes.com/2006/09/20/business/20pension.html.

[214]*Id.*

[215]*Id*.

[216]*See* Alistair Barr, S*an Diego Pension Fund Sues Amaranth*, WALL ST. J. MARKETWATCH (Mar. 30, 2007, 3:34 PM), http://www.marketwatch.com/story/san-diego-pension-fund-sues-amaranth-alleging-fraud ("SDCERA's complaint centers on whether Amaranth informed investors properly that it was taking such big bets and if the firm took enough steps to control risk.").

[217]Tse, *supra* note 209.

[218]*See* Martin, *supra* note 14, at 31 (citing Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 992-93 (2006)).

[219]*See* Tse, *supra* note 209; *see also* Martin, *supra* note 14, at 31.

[220]*See generally* Martin, *supra* note 14, at 30 (assessing issues with respect to investor protections involving the hedge fund industry's lack of standardization in risk calculations and valuation mechanisms).

2. Endowments

Two-thirds of financial endowments have substantial hedge fund investments because endowments qualify as sophisticated investors.[221] Generally, an endowment is "a gift of money or property to an institution (such as a university) for a specific purpose, [especially] one in which the principal is kept intact indefinitely and only the interest income from that principal is used."[222] Many non-profit groups, academic institutions and other organizations rely on endowments to support their various functions.[223]

Unfortunately, many endowments have suffered significant losses due to their investments in unregulated investment vehicles, stripping away funding for various functions.[224] For example, Harvard's endowment lost 27.3% of its value in 2009 mostly due to losses incurred by its hedge fund and private equity investments.[225] Yale's endowment also suffered a 30% loss due to private investments.[226] One source found that "university endowments lost an average of 18.7 percent in [2009], the worst returns since the Great Depression."[227] This study "also found that in the last year, many endowment managers increased the move from traditional fixed-income instruments and stocks into alternative investments like private equity, hedge funds, venture capital and private-equity real estate—all of which performed badly in fiscal 2009."[228]

3. Fund-of-Funds

As of 2005, fund-of-funds account for 30% of the total amount of assets in the hedge fund industry.[229] Fund-of-funds are investment

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[221] *See Testimony of Chairman Cox*, *supra* note 158, at 32.

[222] BLACK'S LAW DICTIONARY 608 (9th ed. 2009).

[223] *See* Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 9 & n.20 (1990).

[224] *See* Tamar Lewin, *Investment Losses Cause Steep Dip in University Endowments, Study Finds*, N.Y. TIMES, Jan. 28, 2010, at A14, *available at* http://www.nytimes.com/2010/01/28/ education/28endow.html.

[225] Geraldine Fabrikant, *Harvard and Yale Report Losses in Endowments*, N.Y. TIMES, Sept. 10, 2009, at B3, *available at* http://www.nytimes.com/2009/09/11/business/11harvard.html.

[226] *Id*.

[227] Lewin, *supra* note 224.

[228] *Id*.

[229] Jane J. Kim, *Hedge Funds Target Smaller Investors*, WALL ST. J., Apr. 27, 2005, at D1, *available at* http://online.wsj.com/article/0,,SB111455921032617720,00.html.

vehicle structures that are often available to retail investors, even though they directly invest into a large number of underlying hedge funds.[230] They are usually "used by investors who have smaller investable assets, limited ability to diversify within the hedge fund arena, or who are not that experienced with this asset class."[231]

Yet, many fund-of-funds have also incurred significant losses that have exposed retail investors and other less sophisticated investors to undue risk.[232] For example, many fund-of funds were over-exposed to losses associated with the Madoff scandal.[233] While fund-of-fund managers typically allocate their assets across a broad range of managers, the scandal revealed that many fund-of-funds allocated the majority of their assets with Madoff.[234] As one source noted, "[t]he scandal showed that some of the largest fund-of-funds operators, such as Fairfield Greenwich, Tremont and Kingate, had the majority of their clients' money with Madoff, providing little diversification."[235] Fairfield Greenwich lost $7.3 billion to its investment with Madoff, which amounted to over half of the value of its entire portfolio.[236]

4. Fee Structure

Many exempt investment companies receive exorbitant fees that could, in fact, induce excessive risk taking behavior at the expense of unsuspecting retail investors.[237] Registered investment companies are

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[230] *See* NICHOLAS, *supra* note 165, at 45; Ryan Barnes, *Hedge Funds Go Retail*, INVESTOPEDIA (Mar. 26, 2007), http://www.investopedia.com/articles/mutualfund/07/mutual_fund_retail.asp.

[231] Zoe Van Schyndel, *Fund of Funds – High Society for the Little Guy*, INVESTOPEDIA (Sept. 27, 2009), http://www.investopedia.com/articles/mutualfund/08/fund-of-funds.asp#axzz1OsbsZOY0; *see also* NICHOLAS, *supra* note 165, at 45-46 (noting by investing in a fund-of-funds, investors can invest in multiple hedge funds that they would not have access to individually).

[232] *See* Alistair Barr, *Fund-of-Funds Niche Shrinking at Record Pace, HFR Says*, WALL ST. J. MARKETWATCH (June 16, 2009, 4:30 PM), http://www.marketwatch.com/story/funds-of-funds-niche-shrinks-at-a-record-pace?pagenumber=.

[233] *See* Amy Or, *Funds of Hedge Funds Try Smaller, Niche Funds*, WALL ST. J. (Apr. 22, 2011, 3:47 PM), http://online.wsj.com/article/SB10001424052748703387904576279270504296608.html.

[234] *See id.*

[235] Barr, *supra* note 232.

[236] Katherine Burton, *Fairfield Sent Madoff $7.3 Billion as Funds Took Fees*, BLOOMBERG, (Dec. 15, 2008, 6:22 PM), http://www.bloomberg.com/apps/news?pid=newsarchive &sid=a4DPPfKKvPsM&refer=home.

[237] *See, e.g.*, Andrew W. Lo, Risk Management for Hedge Funds: Introduction and Overview 30 (June 7, 2001) (unpublished working paper), *available at*

generally not permitted to receive incentive fees.[238] In contrast, hedge fund advisers typically receive a fixed fee that is based on the aggregate assets in its pool, as well as an incentive fee that is based on the profits of the fund.[239] These fees are typically 20% of the profits earned by the underlying asset pool.[240] Hedge fund advisers, however, do not incur a personal loss if the pool experiences losses.[241] This incentive fee structure effectively creates an environment that is conducive to excessive risk taking, since these advisers have little to lose if the pool incurs a substantial loss.[242]

B. *Sophisticated Investor Limitations*

Since many institutional investors qualify as "sophisticated," and thus are exempt from many regulations, they are essentially assuming the SEC's role to provide investor protections to its underlying retail investors.[243] Although some institutions put forth a concerted effort to provide comparable investor protections to its constituents,[244] many fail to deliver because of the complexities of unregulated investment schemes.[245] For example, many hedge funds rely on intricate mathematical models to implement their investment strategies, making it exceedingly difficult for sophisticated investors to fully understand the corresponding risks of a prospective hedge fund investment.[246]

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http://papers.ssrn.com/sol3/papers.cfm?abstract_id=283308.

[238] Ordower, *supra* note 171, at 306. *But see* NICHOLAS, *supra* note 165, at 46 (noting that a general partner, who is a registered investment adviser, may charge for incentive fees at regular intervals).

[239] NICHOLAS, *supra* note 165, at 51.

[240] *Id.*

[241] *Id.* at 40, 52 (noting that losses flow through to the investor and use of high water marks allows managers to receive incentive fees once losses are made up).

[242] Ordower, *supra* note 171, at 312.

[243] *See* Martin, *supra* note 14, at 48 (arguing that retail investors can only be protected by protecting sophisticated investors because sophisticated investors control a retail investor's investments).

[244] *See id.* at 59 ("[M]any hedge funds are already disclosing comparable information to investors.").

[245] *See generally id.* at 30-44 (providing a detailed explanation of the complex investor protection issues that are created by the hedge fund industry, some of which include a lack of standardization with respect to valuation policies, risk assessments, and disclosure practices).

[246] Katherine Burton & Jenny Strasburg, *Highbridge, Goldman 'Quant' Hedge Funds Lose Money*, BLOOMBERG (Aug. 9, 2007, 5:11 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arsD8QnMC6zw; *see also* Jenny Anderson & Julie Creswell, *Top Hedge Fund Managers Earn Over $240 Million*, N.Y. TIMES (Apr. 24, 2007), http://www.nytimes.com/2007/04/24/business/24hedge.html? (explaining how some hedge fund strategies use computers and complex mathematical models to derive returns).

Furthermore, many of the financial instruments that are traded by hedge funds and private equity funds have become increasingly difficult to value, which makes it hard to assess the true nature of a prospective investment.[247] Despite the fact that some private funds employ low-risk trading strategies that are relatively straightforward, other funds rely on high-risk trading strategies dependent on complex derivatives to ensure positive returns.[248] Overall, these issues could expose retail investors to undue risk.

1. Derivatives Trading

A derivative is a "financial instrument whose value derives from that of something else."[249] That "something else" could be a physical commodity, a security, or even a price index, and these instruments are referred to as the "underliers" of derivatives contracts.[250] Futures are a common example of a derivatives contract where "[a] party agrees to either buy or sell an underlying commodity or security at a specified priced on a specified date in the future."[251] Hedgers use futures contracts to protect against the risk of price fluctuations within various markets, while speculators use futures contracts to profit from inefficiencies within those same markets.[252] Essentially, speculators make a prediction of what the price of a particular commodity or instrument might be at some future date.[253] They then use futures, or other types of derivatives, to profit from the probability of their prediction actually coming true.[254] If their predictions are accurate, then speculators earn substantial profits.[255] Conversely, if their predictions are wrong, then they suffer significant losses.[256] Other familiar examples of derivatives instruments include forwards, swaps, and options.[257]

Hedge funds often rely on derivatives to ensure positive returns irrespective of market conditions,[258] even though they are often

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[247] *See* Martin, *supra* note 14, at 43.
[248] *Id.* at 31.
[249] MICHAEL DURBIN, ALL ABOUT DERIVATIVES 3 (2006).
[250] *Id.* at 1.
[251] *Id.* at 25.
[252] *See id.* at 4-5.
[253] *See* DURBIN, *supra* note 249, at 5.
[254] *See id.*
[255] *See id.*
[256] *See id.*
[257] *See* DURBIN, *supra* note 249, at 2.
[258] *See* Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial*

considered riskier investments.[259] The trading of derivatives by mutual funds is highly regulated because of the intrinsic reliance on leverage by such instruments.[260] For example, "[w]hen you enter into a security futures contract, you are required to make a payment referred to as a 'margin payment' . . . to cover potential losses."[261] The amount of margin required to secure a futures position is usually 5% to 10% of the actual cash value of the contract.[262] If the closing price of a futures contract moves slightly away from an adviser's expectations, this will produce losses much greater than the initial margin payment.[263] Due to the amplification effect of leverage, a fund's losses can quickly outpace its initial investment, and might lead to the fund's failure.[264] Additionally, derivatives transactions usually constitute a zero-sum game, where one party's gains depend on the other party's equivalent losses.[265] Thus, a party engaging in a derivatives transaction will either earn handsome profits or lose 100% of their initial investment, or more.[266]

Furthermore, even though some derivatives are simple contracts that are relatively easy to value, other derivatives are highly complex and require the assistance of computer programs to ascertain reliable valuations.[267] For instance, a computer program could take days to value certain collateralized debt obligations ("CDO"),[268] which are investment

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Innovation and Investor Protection, 6 BERKELEY BUS. L.J. 240, 245 (2009) ("[Hedge funds'] massive outperformance of the general market in the worst of economic conditions suggests that the funds deserve their namesake.").

[259]*See* DURBIN, *supra* note 249, at 73-74, 173.

[260]*See* Shadab, *supra* note 258, at 254 (noting that hedge funds are not subject to the same restrictions as registered investment companies, such as mutual funds).

[261]*Security Futures—Know Your Risks, or Risk Your Future*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/Investors/InvestmentChoices/P005912 (last visited Nov. 19, 2011). The term "margin" in the context of futures contracts refers to collateral, not partial payment. *See* CFTC Glossary: A Guide to the Language of the Futures Industry, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_m (last visited Nov. 19, 2011).

[262]*Futures Fundamentals Tutorial*, INVESTOPEDIA 8 (2010), http://i.investopedia.com/inv/pdf/tutorials/futures.pdf.

[263]*Security Futures—Know Your Risks, or Risk Your Future*, *supra* note 261.

[264]*See, e.g.*, LTCM REPORT, *supra* note 175, at 14 (describing the near collapse of Long-Term Capital Management, which resulted from the fund being overly leveraged).

[265]*See* DURBIN, *supra* note 249, at 87-88.

[266]*See* V. Leelakumar Peesapati, Comment, *Freedom of Markets or License to Loot: Proposed Commodity Futures Trading Commission Regulation 1.35*, 8 ADMIN. L.J. AM. U. 97, 120 n.125 (1994).

[267]*See* DURBIN, *supra* note 249, at 9-11 (noting that while many calculations for derivatives only require moderate arithmetic, others involve advanced statistics and calculus).

[268]*See* Jennifer S. Taub, Enablers of Exuberance: Legal Acts and Omissions that Facilitated the Global Financial Crisis 2 (Sept. 4, 2009) (unpublished manuscript) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1472190.

vehicles that offer securitized interests in a pool of loan or debt instruments.[269] Similarly, collateralized mortgage obligations ("CMO"), which are investment vehicles that offer securitized interests in a pool of mortgages,[270] are so complex that counterparties within a CMO transaction could yield different values for the same CMO interest.[271] Consequently, some of the instruments that hedge funds are permitted to trade are extremely difficult to value, even for the most sophisticated investor. Moreover, since the sophisticated investor doctrine does not require such investors to be sufficiently knowledgeable about these investments, it is even more likely that some of these investors are being exposed to undue risk with respect to certain hedge fund investments.[272]

2. Dynamic Trading Strategies

Since trading strategies of hedge funds tend to be dynamic, it can be challenging for sophisticated investors to properly assess the corresponding risk of these strategies.[273] More specifically, hedge funds can employ highly active strategies where they are allowed to trade varying quantities of instruments on a daily basis, and can change their investment strategies with minimal notification to investors.[274] Hedge fund managers have great latitude to use a wide range of trading strategies and instruments to achieve their performance targets.[275]

The dynamic nature of these strategies further expose sophisticated investors to a dynamic range of risk exposures that have proven extremely difficult to measure.[276] Andrew Lo, a leading authority on hedge fund research, specifically states that "while modern financial economics has much to say about the risk of *static* investments—the market beta is sufficient in this case—there is currently no single

[269] *See id.* at 5; *see also* *Collateralized Debt Obligation*, RISK GLOSSARY, http://www.riskglossary.com/link/collateralized_debt_obligation.htm (last visited Sept. 29, 2011).

[270] *Collateralized Mortgage Obligations (CMOs)*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/tcmos.htm (last modified Sept. 2, 2011).

[271] *See, e.g.*, CHARLES R. MORRIS, THE TRILLION DOLLAR MELTDOWN 42 (2008) (detailing how a sophisticated hedge fund manager and his lender banks came up with different results for the value of his securities).

[272] *See* 17 C.F.R. § 230.501(a) (2011).

[273] *See* Lo, *supra* note 237, at 13.

[274] *See* MORRIS, *supra* note 271, at 108; Lo, *supra* note 237, at 11-12.

[275] *See* Lo, *supra* note 237, at 11-12.

[276] *See id.* at 12.

measure of the risk of a dynamic investment strategy."[277] Accordingly, it is difficult for sophisticated investors to adequately assess their risk exposure to hedge fund investments that employ dynamic trading strategies.[278]

C. *Fraud Exposure*

The sophisticated investor exemption has made it difficult for the SEC to monitor the extent to which hedge fund advisers engage in fraudulent activities, which is an integral part of the SEC's mission to protect investors.[279] Although sophisticated investors are not technically entitled to investor protection under the federal securities laws,[280] the SEC is still mandated to prevent fraud with respect to these vehicles.[281] In effect, the anti-fraud provisions of the federal securities laws still apply to private advisers, even though they are largely exempt from federal oversight.[282]

However, since the SEC had no power (prior to the Dodd-Frank Act) to proactively collect meaningful information from these exempt advisers,[283] it was often the case that the SEC became aware of fraudulent activities when disaster had already hit.[284] Director of the SEC's Division of Investor Management, Andrew J. Donohue, emphasized the limitations of relying on anti-fraud provisions to adequately prevent fraud by hedge funds, stating: "It is not uncommon that our first contact with a [hedge fund] manager of a significant amount of assets is during an investigation by our Enforcement Division."[285] As further noted by the SEC, "The Commission typically identifies frauds and other misconduct involving hedge funds only after fund investors or service providers suspect fraudulent activity and contact the Commission. Thus, the Commission often finds itself instituting enforcement action against

[277] *Id.*
[278] *See id.* at 12-13.
[279] SEC STAFF REPORT, *supra* note 5, at 76-78.
[280] *See id*. at 12-13.
[281] *See id.* at 79.
[282] *See id.* at 21. Hedge fund advisers must comply with the anti-fraud provisions provided under the following provisions: Securities Act of 1933, 15 U.S.C. § 77q (2006); Securities Exchange Act of 1934, 15 U.S.C. § 78j (2006); Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 (1)-(2) (2006); 17 C.F.R. § 240.10b-5 (2011); 17 C.F.R. § 275.206(4)-8 (2011).
[283] SEC STAFF REPORT, *supra* note 5, at 77 & n.264.
[284] *Id.* at 76.
[285] *Testimony of Director Donohue*, *supra* note 186, at 34.

an unregistered hedge fund adviser only after significant losses have occurred."[286]

The number of hedge fund fraud investigations has increased in recent years, revealing billions of dollars in losses to investors.[287] For example, from 1999 to 2004, the SEC investigated 51 hedge fund fraud cases where investors lost over $1.1 billion.[288] More recently, in the past five years, the SEC "has brought over 100 cases involving hedge fund fraud."[289] A recent example of hedge fund fraud occurred at the onset of the financial crisis during 2007, where the SEC charged two former Bear Stearns hedge fund managers with fraud for misleading investors about the funds' financial state.[290] In this case, the investors suffered approximately $1.8 billion in losses after these funds took highly leveraged trades within the subprime mortgage-backed securities markets.[291] The SEC further alleged that in the early months of 2007, "when the hedge funds took increasing hits to the value of their portfolios . . . and faced escalating redemptions and margin calls, [then-Bear Stearns] senior managing directors Ralph R. Cioffi and Matthew M. Tannin deceived their own investors and certain institutional counterparties about the funds' growing troubles."[292]

V. MAINTAIN FAIR, ORDERLY, AND EFFICIENT MARKETS

> The [Exchange Act] proceeds on the theory that the exchanges are public institutions which the public is invited to use for the purchase and sale of securities listed thereon, and are not private clubs to be conducted only in accordance with the interest of their members.[293]

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[286]SEC STAFF REPORT, *supra* note 5, at 76 (citations omitted).

[287]*See id.* at 2.

[288]Jane J. Kim, *Digging for Hedge-Fund Dirt*, WALL ST. J., Aug. 8, 2005, at C1.

[289]*Federal and State Enforcement of Financial Consumer and Investor Protection Laws: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 240 (2009) (prepared statement of Elisse B. Walter, SEC Comm'r), available at http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg48871/pdf/CHRG-111hhrg48871.pdf.

[290]Press Release, U.S. Sec. & Exchange Comm'n, SEC Charges Two Former Bear Stearns Hedge Fund Managers With Fraud (June 19, 2008), http://www.sec.gov/news/press/2008/2008-115.htm.

[291]*Id.*

[292]*Id.*

[293]Comm. on Interstate & Foreign Com., House Report on Securities Exchange Act of 1934, H.R. REP. NO. 73-1383, at 15 (1934).

This Part examines how the sophisticated investor doctrine has undermined the second component of the SEC's mission to maintain fair, orderly, and efficient public markets. For the most part, the participation of private investment companies in the public capital markets has made it exceptionally difficult for the SEC to effectively monitor the majority of the trading activity that occurs on the exchanges.[294] Related to this undertaking are issues of deterring over-speculation and monitoring excessive market control.[295] This Part explains how the sophisticated investor doctrine led to a massive regulatory loophole for speculative trading activities, even though the federal securities laws are partially designed to deter this kind of market activity.[296] It continues by investigating the extent to which the collective investment activities of hedge fund traders contributed to the extreme market volatility that intensified the Great Recession.[297] This Part concludes by showing how the trading activities of hedge funds could contribute to systemic risk, even though these are considered private vehicles.[298]

A. *Speculation*

One of the fundamental purposes of the federal securities laws is to deter over-speculation in the public capital markets.[299] Notably, in the run up to the Great Depression, a contributing factor to the financial turmoil was the fact that the federal government had inadequate control over the national credit system, and this encouraged over-speculation in securities.[300] Speculation generally refers to buying securities "on the basis of its potential selling price rather than on the basis of actual value."[301] Although speculation can help promote more efficient markets, it can also lead to devastating losses when the price of a particular asset moves too far away from its fundamental economic

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[294] *See infra* Part V.B.
[295] *See infra* Part V.A-B.
[296] *See infra* Part V.B.
[297] *See infra* Part V.A-B.
[298] *See infra* Part V.C.
[299] *See, e.g.*, Comm. on Interstate & Foreign Com., House Report on Securities Act of 1933, H.R. REP. NO. 73-85, at 2 (1933) ("Equally significant with these countless individual tragedies is the wastage that this irresponsible selling of securities has caused to industry. Because of the deliberate overstimulation of the appetites of security buyers, underwriters had to manufacture securities to meet the demand that they themselves had created.").
[300] *See* SELIGMAN, *supra* note 111, at 3-4.
[301] SCOTT, *supra* note 46, at 351.

value.[302] This scenario often leads to market bubbles that inevitably burst when the fundamental value of an asset reveals itself to the markets.[303] The bursting of a market-bubble can lead to economic devastation, which President Franklin D. Roosevelt highlighted as one of the primary causes of the Great Depression.[304] President Roosevelt remarked:

> [U]nregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted 'boom' which had so much to do with the terrible conditions of the years following 1929. . . . [I]t should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.[305]

Federal securities laws deter speculation by regulating the required margins for securities loans provided by brokers and banks, as well by giving the SEC the broad authority to directly regulate the national securities exchanges.[306] The SEC's Division of Trading and Markets helps to implement this mission by directly overseeing the activities of several market participants such as the securities exchanges, securities firms, SROs, clearing agencies, transfer agents, securities information processors, and credit rating agencies.[307] The Division of Risk, Strategy, and Financial Innovation, which was created in September 2009, further executes this mission by identifying and researching financial innovations, trends, and systemic risk to determine whether these factors inhibit the SEC's regulatory functions.[308]

Since deterring excessive speculation is one of the principal purposes of the federal securities laws, the SEC must ensure that the collective trading activities that occur on the exchanges do not contribute to over-speculation. The SEC has not sufficiently monitored speculative

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[302]*See* David Mengle, *The Economic Role of Speculation*, INT'L SWAPS & DERIVATIVES ASS'N, 1 (2010), http://www.isda.org/researchnotes/pdf/SpeculationRN.pdf.

[303]*See* Adam M. Zaretsky, *Bubble, Bubble Toil and Trouble: Asset Prices and Market Speculation*, REG'L ECONOMIST (Apr. 1999), http://www.stlouisfed.org/publications/re/articles/?id=1739 (describing the ability of speculative bubbles to burst, causing the stock market crashes of 1929 and 1987).

[304]*See* DE BEDTS, *supra* note 60, at 61.

[305]H.R. REP. NO. 73-1383, at 2.

[306]*Id.* at 1, 8.

[307]*The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 17.

[308]*Id.*

activities by hedge funds because the sophisticated investor exception exempts hedge funds from SEC oversight.[309] While certain large trading positions of specific companies must be disclosed by hedge funds pursuant to rules provided under the Exchange Act,[310] these rules are not sufficient to fully understand how the trading activities of these vehicles contribute to speculation. Given the growing complexities of speculative trading strategies, which often combine a variety of instruments (some of which are not subject to regulation by the SEC) and dynamic trading strategies to yield a positive return, the effectiveness of such reporting rules need to be re-evaluated.[311] The SEC, as well as hedge fund investors and other market participants, will need access to a holistic view of the ongoing trading strategies utilized by such vehicles to determine the net effect that such speculative activities have on the fairness and efficiency of the overall markets.

This issue deserves heightened attention since many hedge fund advisers earn their profits solely through the exploitation of market price inefficiencies, and are "one of the significant forces in speculative markets."[312] For example, some funds use various arbitrage strategies to exploit price inefficiencies within certain debt, securities, or currency instruments.[313] In some cases, hedge funds speculate on actual events that may occur with respect to particular markets, enterprises, or

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[309]*See* SEC STAFF REPORT, *supra* note 5, at ix-x.

[310]Under the Securities Exchange Act of 1934, qualified institutional buyers and advisers that own more than 5% of publicly-traded securities must disclose such acquisition. 15 U.S.C. § 78m(d) (2006). In addition, advisers with "investment discretion over $100 million or more of publicly traded equity securities to file quarterly reports disclosing these holdings and the type of investment and voting authority exercised by the manager." LINS ET AL., *supra* note 163, at § 7:3; 15 U.S.C. § 78m(f) (2006).

[311]Under the Dodd Frank Act, all registered investment advisers to private funds, including certain exempt advisers, may be required to provide additional disclosures to the SEC beyond the specific disclosures requirements set forth under the Advisers Act. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376, 1572 (2010) (to be codified at 15 U.S.C. § 80b-4). It seems that these disclosures are designed to help the SEC identify whether certain hedge funds pose a systemic risk to the economy. *See id.* Hedge funds that pose a systemic risk could also be identified as "Designated Companies" by the new "Oversight Council," which would subject them to additional reporting requirements and investment constraints. *Id.* §§ 111-12. However, the SEC has not yet defined systemic risk or identified ways in which systemic risk can be measured.

[312]Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission is Appropriate?*, 80 NOTRE DAME L. REV. 909, 913 (2005).

[313]LINS ET AL., *supra* note 163, at § 1:2.

transactions.[314] These funds also use speculative strategies, such as short-selling, to guarantee positive returns irrespective of market conditions.[315] This is often the primary selling point for investing in these vehicles.[316]

There is also evidence that certain hedge fund advisers may have engaged in manipulative tactics in order to guarantee profits in short trading activities.[317] Many hedge funds rely on short trades to ensure positive returns in down markets.[318] In order to engage in a short trade, a hedge fund adviser must first borrow the underlying financial instruments from an investment bank or other comparable counterparty.[319] The adviser then sells those instruments in the secondary markets.[320] After this initial sale, the adviser waits until the price of those instruments decreases, and then buys back those same instruments and returns them to the counterparty.[321] Profit in a short sale transaction is the difference between the price at which the instrument was sold and the cost to replace it.[322] Short-traders rely on downward movements in the prices of the underlying financial instrument, in order to guarantee a profit.[323]

Some market participants have suggested that hedge fund advisers publicly distributed negative reports regarding their short selling targets in order to guarantee a profit on such trades.[324] If so, then the price of that company's stock will eventually decline.[325] According to Professor Pierre-Louis, "[w]hat is often not revealed is that investigative business news articles written by the reputable business reporters are to a large extent, based on data supplied to the reporters by hedge funds, primarily the negative research report."[326] In fact, some hedge fund advisers pay

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[314]*Id.* § 1:1.

[315]*Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, *supra* note 171.

[316]LINS ET AL., *supra* note 163, at § 1:1.

[317]Pierre-Louis, *supra* note 180, at 72.

[318]*Id.* "A short sale is the sale of a stock that an investor does not own or a sale which is consummated by the delivery of a stock borrowed by, or for the account of, the investor." *Short Sales*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/shortsale.htm (last modified Sept. 6, 2011).

[319]*Short Sales*, *supra* note 318.

[320]*Id.*

[321]*Id.*

[322]*Glossary: Short Sale*, INVESTOR.GOV, http://investor.gov/glossary/glossary_terms/short-sale (last visited Jan. 18, 2012).

[323]Pierre-Louis, *supra* note 180, at 72.

[324]*Id.*

[325]*See id.*

[326]*Id.*

researchers significant amounts of money in order to uncover negative information about companies in which hedge funds are short-trading.[327]

These distribution activities can be beneficial to the capital markets, in that they can serve as a price discovery tool.[328] In particular, they can help reveal the accurate value of a company's stock, if in fact the information provided is true.[329] However, there have been a few credible claims that have implicated hedge fund advisers for fraudulently manipulating the prices of securities in short sales transactions.[330] In these cases, companies accused hedge funds of publicly distributing false and negative information to induce a widespread sell-off of their respective stocks.[331] This would inevitably drive down the stocks' prices.[332] For example, Overstock.com recently charged a hedge fund with "wag[ing] a campaign to drive down the company's share price,"[333] which caused the stock's prices to decrease 77% within a two-year period.[334] Overstock.com's CEO has also led a broader discussion regarding these market-trading abuses. He alleges that such abuses are a "pervasive market problem" that cause "dramatic distortions" in share prices of numerous publicly traded companies.[335] Although the SEC is currently investigating the feasibility of a real-time reporting framework for all short-trade positions of publicly traded securities, the fact that hedge funds often profit from speculative trades can create an environment that fosters this sort of price manipulation.[336]

A more recent study has found direct evidence which suggests that a large number of hedge funds manipulate stock prices on a quarterly

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[327]Jane Sasseen et al., *The Secret Lives of Short-Sellers*, BLOOMBERG BUSINESSWEEK (Apr. 10, 2006), *available at* http://www.businessweek.com/magazine/content/06_15/b3979084.htm (describing the practice of hiring private investigators to discover negative information about companies which engage in short-trading).

[328]*See, e.g.*, Andrew Baker, *Why Short Selling is Good for Capital Markets*, FIN. TIMES (London), Feb. 21, 2011, at 10 ("Short selling plays an important role in capital markets for a variety of reasons, including more efficient price discovery . . . .") (quoting the International College of Securities Regulators).

[329]*Id.*

[330]Pierre-Louis, *supra* note 180, at 87.

[331]*Id.*

[332]*Id.*

[333]*Overstock Says It Settles With Hedge Fund*, REUTERS (Dec. 8, 2009, 6:18 PM), http://www.reuters.com/article/2009/12/08/overstock-suit-idUSN0821943720091208.

[334]Liz Moyer, *Naked Short Victim Strikes Back*, FORBES.COM (Feb. 2, 2007, 6:35 PM) http://www.forbes.com/2007/02/02/naked-short-suit-overstock-biz-cx_lm_0202naked.html.

[335]*Id.*

[336]Short Sale Reporting Study Required by Dodd-Frank Act Section 417(a)(2), Dodd-Frank Act Release No. 34-6438, 76 Fed. Reg. 26,787 (May 9, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-05-09/pdf/2011-11188.pdf.

basis, to inflate the returns that are reported to their underlying investors.[337] According to this study:

> [Certain] hedge funds pump up end-of-month prices of the stocks they own in order to improve their performance. This apparent "signal jamming" leads to substantial distortions of end-of-month market prices and is not restricted to specific periods; rather, it constitutes a permanent negative externality for anyone using end-of month prices (e.g., for benchmarking, contracting or trading purposes). . . . [O]ur results call into question the widely accepted idea that hedge funds improve the quality of market prices.[338]

Although these vehicles are considered private under the federal securities laws, this study proves that they can potentially distort the stock prices for which the general public relies.[339]

Overall, the SEC has grown increasingly concerned with the possibility of hedge fund managers colluding with other unaffiliated advisers to acquire the necessary capacity to move certain markets for their own speculative gains.[340] According to Rashkover and Kleiman:

> The concern appears to be that due to the size of the hedge fund industry in general and the magnitude of assets controlled by certain funds in particular, hedge funds are now in a position not only to control companies but to move markets—especially if two or more funds comprise a "group" working together to maximize return with respect to a specific issuer or strategy.[341]

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[337]Itzhak Ben-David, Francesco Franzoni, Augustin Landier & Rabih Moussawi, *Do Hedge Funds Manipulate Stock Prices?* (Fisher Coll. of Bus., Working Paper No. 2011-03-005, 2011), *available at* SSRN: http://ssrn.com/abstract=1763225.

[338]*Id.* at 1.

[339]*Id.* at 26.

[340]Barry W. Rashkover & Laurin Blumenthal Kleiman, *SEC Enforcement and Examinations Concerning Hedge Funds*, 52 N.Y. L. SCH. L. REV. 599, 620-21 (2007-2008).

[341]*Id.*

The combined secrecy, market power, and interconnectedness[342] of this industry create an environment that is extremely conducive for these kinds of collusive activities to occur.

Despite these well-documented cases regarding the potential adverse impact that these trading activities can have on the capital markets, the extent to which private vehicles actually manipulate the markets to facilitate their speculative gains has not been adequately investigated.[343] As one source reiterated, "Even though there have been innumerable cases of often serious market manipulations reported in securities markets worldwide, surprisingly little is documented about the trading behavior of major players in manipulated markets."[344] This is partially because those "major players" have been historically exempt from regulatory oversight, making it difficult for the regulators to have a holistic overview of these trading activities.[345] The regulatory structure of the sophisticated investor exemption has allowed private vehicles to become major players in the securities markets, without being sufficiently monitored.[346] Furthermore, the private offering exemption was probably not intended to exclude vehicles from regulation that derive profits solely from speculative trading activities, since the federal securities laws are specifically designed to prevent this.[347]

B. *Market Impact*

Notwithstanding the many controversies associated with hedge funds and other private vehicles, each can provide numerous benefits to the national securities markets.[348] In many cases, they can help maintain market efficiency, facilitate capital formation, and provide liquidity to the national securities exchanges.[349] For example, many hedge funds seek investment opportunities in undervalued securities, which can help

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[342]Pierre-Louis, *supra* note 180, at 66-67.

[343]*See, e.g.*, John J. Merrick, Jr. et al., *Strategic Trading Behavior and Price Distortion in Manipulated Market: Anatomy of a Squeeze*, 77 J. FIN. ECON. 171, 172 (2005) *available at* http://mason.wm.edu/documents/faculty/Anatomy_of_a_Squeeze_JFE.pdf.

[344]*Id.*

[345]*Id.*

[346]*Id.* (discussing how lack of regulation of hedge funds allows for the possibility of large-scale price manipulation).

[347]*Testimony of Chairman Cox, supra* note 158, at 32.

[348]*See, e.g.*, *id.* ("It is undeniable that . . . hedge funds also provide investors and our national security markets with benefits. They contribute substantially to capital formation, market efficiency, price discovery, and liquidity.").

[349]*Id.*

move the securities' actual price closer to their fundamental values.[350] In addition, hedge funds often increase the liquidity of securities markets through their significant participation in the buying and selling of securities.[351] They are also willing purchasers of several types of derivatives, which can help other counterparties to reduce their own risks.[352] Moreover, hedge funds can provide investors with a unique risk management opportunity to guarantee positive returns, irrespective of market conditions.[353] Sophisticated investors have consistently taken advantage of this opportunity, which is largely unavailable in other investment company structures.[354]

However, in order to produce these benefits, hedge fund advisers collectively control a substantial amount of trading activity on the national exchanges, even though they are considered private vehicles and have thereby been exempt from significant regulatory oversight.[355] In fact, they conduct up to 50% of daily trades that occur on the London and New York Stock Exchanges.[356] According to a recent survey, "[h]edge funds are responsible for nearly 30% of all U.S. fixed-income trading, . . . 55% of U.S. activity in derivatives with investment-grade ratings, and also 55% of the trading volume for emerging-market bonds."[357] According to this survey, "[i]n some corners of the U.S. debt market, hedge funds practically are the market. For instance, hedge funds generated more than 80% of the trading for derivatives with high-yield ratings, and more than 85% of volume in distressed debt . . . ."[358] Thus, the SEC was not able to adequately monitor these activities, even though this is the primary regulatory agency that is charged with ensuring that the national exchanges are efficient, fair, and competitive.[359]

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[350]William A. Roach, Jr., Note, *Hedge Fund Regulation: What Side of the Hedges Are You On?*, 40 U. MEM. L. REV. 165, 173 (2009).

[351]*Id.*

[352]*Testimony of Chairman Cox*, *supra* note 158, at 32.

[353]*Id.*

[354]*See, e.g.*, *id.*

[355]Craig Karmin, *Credit Crunch: Market's Ride: Hedge Funds Do About 30% of Bond Trading, Study Says*, WALL ST. J., Aug. 30, 2007, at C3 (describing the market dominance hedge funds exert over the debt market).

[356]*See* Ip & Sender, *supra* note 158; *see also Hedge Fund Information for Investors*, FED. BUREAU INVESTIG., http://www.fbi.gov/about-us/investigate/white_collar/hedge-fund-fraud (last visited Oct. 20, 2011) (noting that hedge funds are responsible for up to 50% of the trades on the New York Stock Exchange).

[357]Karmin, *supra* note 355.

[358]*Id.*

[359]*See Testimony of Chairman Cox*, *supra* note 158, at 32.

As a result of this immense market control, several sources have found that hedge fund activities contributed to the erratic market volatility that intensified the Great Recession.[360] One source found that hedge fund advisers sold billions of dollars of securities to meet the demands of their withdrawing investors, which caused the Dow Jones Industrial Average to suffer its biggest two-day decline since October 20, 1987.[361] Additional sources have also suggested that the substantial de-leveraging, employed by both hedge funds and private equity funds during the financial crisis, caused a significant strain on the markets.[362] This is problematic because "[d]eclining market prices not only injure those creditors and counterparties directly involved, but also affect market participants not affiliated with the hedge funds."[363]

The sophisticated investor exemption has created an immense regulatory loophole for private investment vehicles, which has made it difficult for the SEC to effectively control their impact on public exchanges. While excessive market control by hedge funds does not automatically infer adverse effects, it does create a normative question as to whether hedge funds should still be considered private entities, especially in light of the fact that these investment vehicles are major participants in public capital markets.[364] This also seems to contradict the original intent of the federal securities laws, which sought to give the SEC broad authority to oversee the trading activities executed through national exchanges.[365] The public offering exemption was likely designed to exclude smaller-scale transactions that would have a minimal impact on the markets, as opposed to large investment vehicles that frequently move markets to implement their underlying investment strategies.[366]

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[360] *See, e.g.*, Jenny Strasburg & Gregory Zuckerman, *Hedge Fund Selling Puts New Stress on Market*, WALL ST. J., Nov. 7, 2008, at A1 (noting that hedge fund sell-offs contributed to a large decline in the stock market in late 2008).

[361] *Id.*

[362] *See, e.g.*, Anita K. Krug, *Financial Regulatory Reform and Private Funds*, BERKELEY CTR. FOR LAW, BUS. & ECON. (July 13, 2009), at 1, 1 (citing U.S. Dept. of Treas., *Financial Regulatory Reform: A New Foundation* (June 17, 2009)), *available at* http://www.law.berkeley. edu/files/FinancialRegulatoryReform_Krug.07.09(1).pdf.

[363] Gibson, *supra* note 32, at 705.

[364] *See* discussion *supra* Part V.A-B.

[365] *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. § 78b (2006) (noting the necessity of regulating securities).

[366] *See supra* Part III.A.

C. *Systemic Risk*

The collective trading activities of hedge fund advisers have contributed to systemic risk within the broader economy even though hedge funds are considered private vehicles.[367] Systemic risk generally refers to the "the risk of a broad-based breakdown in the financial system, often realized as a series of correlated defaults among financial institutions . . . that occurs over a short period of time and typically caused by a single major event."[368] More specifically, systemic risk often results from the failure of a large bank, or several banks, which leads to a series of market failures that typically precipitate an economic crisis.[369] For instance, the failure of Lehman Brothers in 2008 deteriorated investor confidence in the financial system, which had a cascading effect on the global economy.[370] With respect to the hedge fund industry, systemic risk is created through the symbiotic relationship that these vehicles have with their investment bank counterparties.[371] Hedge funds enter into various lending and trading arrangements with banks, which can expose the banks to the accompanying risks of the underlying hedge fund strategies.[372] Thus, the failure of a highly leveraged hedge fund could expose its investment bank counterparty to considerable losses, which in turn could spread to the broader economy and to other unsuspecting third parties.[373]

Systemic risk is amplified within the hedge fund industry because they are permitted to use unlimited leverage[374] and often rely on derivatives trading to guarantee positive returns.[375] Derivatives, which

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[367]LTCM REPORT, *supra* note 175, at 20.

[368]*Hedge Funds and the Financial Market: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 27, 29-30 (2008) (written testimony of Andrew W. Lo, Professor, MIT Sloan Sch. of Mgmt) [hereinafter *Testimony of Andrew W. Lo*].

[369]*Id.*

[370]*E.g.*, *Times Topics*, *Lehman Brothers Holdings Inc.*, N.Y. TIMES (last updated Aug. 26, 2011), http://topics.nytimes.com/top/news/business/companies/lehman_brothers _holdings_inc/index.html ("Lehman's demise set off tremors throughout the financial system. The uncertainty surrounding its transactions with banks and hedge funds exacerbated a crisis of confidence. That contributed to credit markets freezing, forcing governments around the globe to take steps to try to calm panicked markets.").

[371]Nicholas T. Chan et al., *Systemic Risk and Hedge Funds* 1 (MIT Sloan Sch. of Mgmt., Working Paper No. 4535-05, 2005), *available at* http://papers.ssrn.com/ sol3/papers.cfm? abstract_id=671443.

[372]LTCM REPORT, *supra* note 175, at 6.

[373]*Id.* at 6, 20.

[374]*See supra* notes 168-70 and accompanying text.

[375]*See supra* notes 272-73 and accompanying text.

inherently rely on leverage, are often associated with numerous hedge fund failures and other systemic risk events because they can expose funds to losses that substantially exceed their available assets.[376] Warren Buffet's firm reiterated this view in its 2002 annual report, which states, "derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."[377] Furthermore, "[h]edge funds also accounted for a good portion of the trading in mortgage-backed securities, asset-backed securities, collateralized debt obligations and other parts of the [derivative] debt market that have suffered recently [due to the failure of the subprime mortgage market]."[378] As one source stated:

> [D]uring the build-up to the subprime crisis, there were a large number of hedge funds with tremendous assets available to invest in CDOs. Wall Street firms encouraged originators to make risky loans to troubled borrowers, which they could securitize and sell to investors, such as hedge funds—among these firms' favorite clients.[379]

Thus, even though hedge funds were exempt from extensive oversight, they were permitted to participate in markets that created severe distress to the national capital markets.[380]

Additionally, the interconnectedness of hedge funds' investment strategies has increased in recent years, which has created additional concerns with respect to systemic risk within the public capital markets.[381] This increased interconnectedness is commonly referred to as "contagion," and it measures the correlation of hedge fund strategies that occurs "over and above what one would expect from economic fundamentals."[382] This increased contagion means that a large number of hedge fund advisers will react similarly to certain external events, with

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[376] *See* discussion *supra* Part IV.B.1.

[377] BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT (2003), *available at* http://www.berkshirehathaway.com/2002ar/2002ar.pdf.

[378] Karmin, *supra* note 355.

[379] Barbara Crutchfield George et al., *The Opaque and Under-Regulated Hedge Fund Industry: Victim or Culprit in the Subprime Mortgage Crisis?*, 5 N.Y.U. J.L. & BUS. 359, 397 (2009) (internal citations omitted).

[380] *See supra* discussion Part III.D.2.

[381] *See generally* Nicole M. Boyson et al., *Hedge Fund Contagion and Liquidity Shocks*, 65 J. FIN. 1789, 1789 (2010) (characterizing the clustering of negative hedge fund returns as "contagion").

[382] *Id.*

respect to their trading positions.[383] This is potentially problematic because an external event that causes the value of a certain asset class to decline could lead to coordinated margin calls for this asset class among a large number of hedge fund advisers.[384] This interconnectedness can lead to systemic liquidity restriction:

> Coordinated margin calls can lead to coordinated trading to satisfy those calls, which can cause liquidity in those stocks to dry up. When this happens, their trades can move prices away from fundamentals, which can create systemic risk in the financial system, especially if banks and other financial institutions have similar positions and so are also moving prices in the same directions with their trades as they tighten risk management.[385]

In effect, since hedge funds collectively control a large share of trading activity that occurs within the public capital markets and can "decide to withdraw liquidity at a moment's notice, . . . a coordinated withdrawal of [hedge fund positions] . . . could have disastrous [effects on the economy]."[386]

While considerable disagreement remains over the extent to which systemic risk can or should be controlled, the fact that systemic risk is created through many types of hedge fund investments extends the normative question as to whether these vehicles should still be considered private.[387] Furthermore, the SEC has historically had limited oversight over the extent to which these vehicles impact the public capital markets due to their private status.[388] The trading activities of these vehicles could therefore create negative externalities that adversely impact the reliability and sustainability of the public capital markets,

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[383]*See* Dale B. Thompson, *Why We Need a Superfund for Hedge Funds*, 79 MISS. L.J. 995, 1015 (2010).

[384]Boyson et al., *supra* note 381, at 1789.

[385]Stephen J. Brown et al., *Hedge Funds in the Aftermath of the Financial Crisis*, *in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 157, 164 (Viral V. Acharya & Matthew Richardson eds., 2009).

[386]Amir E. Khandani & Andrew W. Lo, What Happened to the Quants in August 2007? 56 (November 4, 2007) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/ papers.cfm?abstract_id=1015987.

[387]*See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. § 78b (2006) (giving the justifications for regulating securities, many of which would apply to hedge funds).

[388]*See supra* Part III.D.2 (explaining that SEC rules exempt hedge funds because they are limited to sophisticated investors).

even though they are restricted to sophisticated investors.[389] Investment vehicles that are truly private in nature should be able to absorb its own losses, as opposed to having such a monumental impact on the overall economy.[390]

VI. CAPITAL FORMATION

> The financial environment . . . influences both the amount and the composition of the capital formation that an economy like that of the United States undertakes.[391]

This Part analyzes how the sophisticated investor doctrine has undermined the SEC's ability to facilitate capital formation, which is the third component of the SEC's mission.[392] It begins by explaining the general concept of capital formation and continues with an analysis of how the sophisticated investor exemption has made it difficult for sophisticated investors to make optimal investment decisions for themselves and for their counterparts. It concludes by exploring the broader impact that these issues have on the public capital markets for which issuers rely as a fundamental source of capital.

A. *Capital Formation Explanation*

Capital formation generally refers to "[t]he creation of productive assets that expand an economy's capacity to produce goods and services."[393] It also symbolizes "additions to the stock of tangible goods within the country."[394] The role of private savings is significant because it "facilitates capital formation by allowing resources to be diverted to corporate investment rather than individual consumption."[395] The SEC is required to consider the extent to which its proposed rules and

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[389] *See, e.g.*, Boyson et al., *supra* note 381, at 1815.

[390] *See* discussion *supra* Part III.A (explaining the justification for not regulating private securities).

[391] Benjamin M. Friedman, *Financing Corporate Capital Formation: An Introduction and Overview*, *in* FINANCING CORPORATE CAPITAL FORMATION 1 (Benjamin M. Friedman ed., 1986).

[392] *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 17.

[393] SCOTT, *supra* note 46, at 50.

[394] SIMON KUZNETS & ELIZABETH JENKS, CAPITAL IN THE AMERICAN ECONOMY: ITS FORMATION AND FINANCING 16 (1961) (emphasis removed).

[395] SCOTT, *supra* note 46, at 50.

regulations impact capital formation for all affected parties that rely on the public capital markets and it must also determine the net effect its proposed rules have on the "public interest."[396] More specifically, the SEC must ensure that its proposed rules do not negatively impact the capital markets on which the general public relies.[397] The SEC must also ensure that its rules do not unnecessarily hinder the abilities of issuers to effectively raise capital on the primary market.[398] In this regard, the SEC must prevent excessive costs to businesses associated with new regulatory compliance measures.[399] With respect to investors, the SEC must ensure that its rules help investors to efficiently allocate their limited capital to the primary market, as well as to the ongoing trading activity that occurs on the secondary market.[400] The Division of Investment Management assists the Commission in executing this task by directly overseeing the $26 trillion investment management industry.[401] This division also ensures that disclosures about these investments are useful to retail customers and that the resulting regulatory costs are not excessive to the underlying vehicles.[402]

B. *Capital Formation for Investors*

Regulators seek to implement rules that promote the efficient allocation of capital for investors who rely on the public capital markets to produce returns for personal savings, retirement funds, and for other personal reasons.[403] Generally speaking, capital is efficiently allocated when investors have access to pertinent information regarding a potential investment.[404] In essence, this helps investors to make better decisions about how to best spend limited resources, and it ensures that their

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[396] *See, e.g.*, Securities Act of 1933, 15 U.S.C. § 77b-1(b) (2006) (requiring SEC's consideration of promotion of efficiency, competition, and capital formation); Securities Exchange Act of 1934, 15 U.S.C. 78c(f) (2006) (requiring same); Investment Company Act of 1940, 15 U.S.C. § 80a-2(c) (2006) (requiring same).

[397] Comm. on Commerce, Securities Amendments of 1996, H.R. REP. NO. 104-622, at 16 (1996), *available at* http://www.gpo.gov/fdsys/pkg/CRPT-104hrpt622/pdf/CRPT-104hrpt622.pdf.

[398] *Id.*

[399] *Id.*

[400] *See id.* at 17-19.

[401] *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 17.

[402] *Id.*

[403] *See id.*

[404] *Id.*

investment allocations are closely aligned with the risks they are willing to absorb.[405] A mandatory disclosure regime helps to guarantee that investors have access to this material information, particularly since private actors do not always have the incentives to disclose all such information.[406] The efficient allocation of capital was further reiterated in a recent speech given by Commissioner Aguilar on this subject:

> Facilitating true capital formation is about helping investors and other capital providers to make informed decisions. Almost all investments have risks, and while we all understand the need for investors to take risks, I want them to take informed risks. Capital formation is about ensuring that the companies with the best ideas, even if those ideas are risky, can get the financing to make those ideas a reality. The goal is for issuers to provide potential investors with appropriate information so that investors can assess the risk of investing their capital. For that goal to be reached, we need strong and effective securities regulation that fosters appropriate disclosures.[407]

Essentially, it is extremely difficult for investors to make optimal investment decisions without having sufficient information about a prospective opportunity.[408]

However, hedge funds and other private investment vehicles are not subject to a mandatory disclosure regime even though they have become an important component to the overall investment portfolio of many prominent institutions.[409] These prominent institutions include pension plans, endowments, insurance companies, and banks.[410] Yet, since these institutions are not entitled to investor protection measures, it is difficult for them to adequately protect themselves against the unique informational challenges created by these industries.[411] These unique issues encompass an overall lack of standardization, particularly with

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[405]*See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 17.

[406]*See id.*

[407]Aguilar, *supra* note 11 (internal citation omitted).

[408]*Id.*

[409]*See* discussion *supra* Part III.D.2.

[410]*See* discussion *supra* Part IV.

[411]*See* discussion *supra* Part IV.

respect to risk controls and valuation procedures.[412] Since these vehicles often trade complex and illiquid assets, inconsistent valuation procedures make it difficult for investors to know the true value of a particular investment, especially as it relates to their own risk-return portfolios.[413] Furthermore, private funds have great latitude in how to perform their valuation procedures, which could create significant conflicts of interests since adviser fee calculations rely to a large extent on valuations.[414] With respect to risk controls, some funds have substantial risk management practices while others perform limited or inadequate risk diligence, which exposes their investors to undue risk.[415]

This lack of standardization, coupled with a limited public disclosure regime, makes it exceptionally difficult for investors to adequately investigate a particular hedge fund investment.[416] In addition, investors cannot effectively choose an optimal hedge fund investment because these informational challenges make it difficult to compare a large range of hedge fund opportunities,[417] which is perhaps the greatest benefit of a public disclosure regime. Although there are approximately 22,000 distinct hedge funds as of 2009, [418] this seems to be the only industry with so many participants without an organizational or regulatory structure broadly supporting it.[419]

These informational challenges have had a monumental effect on capital formation for sophisticated investors. Although some sources found that hedge funds have yielded higher returns than the public markets during the Great Recession, other sources found that hedge funds do not always outperform the markets.[420] For example, in 2007, the average hedge fund returned 7.7%, while the S&P 500 index yielded a

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[412]*See generally* Martin, *supra* note 14, at 30-44 (discussing the overall lack of standardization in the hedge fund industry).

[413]*Id.* at 39-40.

[414]*Id.*

[415]*Id.* at 31-32.

[416]Martin, *supra* note 14, at 30.

[417]*See generally id.* at 34-38 (discussing the inadequacies in comparing hedge fund investments).

[418]Meredith A. Jones, *PerTrac's 2009 Hedge Fund Database Study*, PERTRAC 3 (2010), http://www.pertrac.com/assets/Uploads/PerTrac-2009-Hedge-Fund-Database-Study2.pdf. (analyzing performance data reported by over 18,000 distinct hedge funds). It is difficult to track the total number of hedge funds because there is no mandatory reporting framework that would require all such funds to register.

[419]RICHARD HORWITZ, HEDGE FUND RISK FUNDAMENTALS: SOLVING THE RISK MANAGEMENT AND TRANSPARENCY CHALLENGE 143 (2004).

[420]Tse, *supra* note 209.

return of 9%.[421] Furthermore, private equity funds performed below the public markets at the end of 2010, when they "returned 7.6% for the quarter, compared with the S&P 500's return of 10.8% for the same period."[422] Moreover, the existing indexes that track hedge fund performance are all voluntary reporting mechanisms.[423] There is currently no reporting mechanism that requires all hedge funds to report past performance.[424] In addition, the Great Recession resulted in the failure of approximately 1,500 hedge funds, exposing investors to staggering losses, and it is not clear that those indexes took into consideration the losses associated with those funds.[425]

In addition, the losses of sophisticated investors can directly impact retail investors. Even though the overall impact on retail investors is not entirely clear, unquestionably they are being increasingly exposed to private fund investments.[426] Many of these institutions are relying on hedge fund investments as a short-term source of profit, but others are unaware and/or unable to fully understand the corresponding risks of investing in these vehicles.[427] Moreover, some analysts predict that losses incurred by these institutional investors "could eventually lead to reduced payouts to retirees, higher taxes so state governments can fulfill their promises, or less cash available for colleges to give out as financial aid."[428]

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[421] *Id.*

[422] Cambridge Assocs., *Private Equity and Venture Capital Funds Closed 2010 With Seventh Consecutive Quarter of Positive Returns, According to Cambridge Associates' Benchmarks*, FIN. CONTENT (June 7, 2011, 10:23 AM), http://markets.financialcontent.com/stocks/news/read/18659373/Private_Equity_and_Venture_Capital_Funds_Closed_2010_With_Seventh_Consecutive_Quarter_of_Positive_Returns.

[423] Aguilar, *supra* note 147.

[424] *See id.*

[425] David Reilly, *Hedge Funds Get to Feel Like 'Smart Guys' Again*, BLOOMBERG (July 1, 2009, 12:01 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aMIX3xXmjVHE; *see also* Aguilar, *supra* note 147; Swiss Analytics, *Hedge Fund Due Diligence . . . More Than Just a Background Check*, BARCLAYHEDGE 1 (May 2009), http://www.barclayhedge.com/research/hedge-fundduediligence/2009/20090507/Due_Diligence_More_Than_Just_Background_Check.pdf ("It is estimated that 2,000 hedge funds have closed . . . their doors since the onset of the financial crisis and that as many as 2,000 more may follow suit over the next 18 months.") (emphasis removed).

[426] *See* discussion *supra* Part IV.A.

[427] *See* Tse, *supra* note 209.

[428] Rachel Beck & Joe Bel Bruno, *College, State Pension Funds, Endowments are Hurting*, USA TODAY (Dec. 3, 2008, 8:58 PM), http://www.usatoday.com/money/perfi/retirement/2008-12-03-pension-funds-endowments_N.htm.

C. *Capital Formation for Issuers*

Securities regulation is often criticized as a deterrent for issuers to raise capital effectively because compliance can be costly for companies. However, the extent to which our regulatory system needs strengthening in order to guarantee the structures that allow institutions to raise capital warrants further discussion. For example, many issuers rely on the national securities exchanges in order to raise sufficient capital for creation of productive assets.[429] Adequate regulation creates reliable securities exchanges so that this kind of benefit actually accrues to its users. With respect to the investment company industry, the lack of regulation has exposed the capital markets to unregulated speculation, possibly creating a "zone" of manipulative schemes.[430] Speculative schemes produce both undervalued and overvalued assets, which adversely affect the reliability of the markets.[431] In addition, the creation of systemic risk by private vehicles could restrict the liquidity of the public capital markets, which could force investors to allocate their capital to other investment opportunities.[432] Consider the government intervention in the LTCM crisis:

> [T]here was a likelihood that a number of credit and interest rate markets would experience extreme price moves and possibly cease to function for a period of one or more days and maybe longer . . . . Most importantly, this would have led to further increases in the cost of capital to American businesses.[433]

The Great Recession further proved that the losses of sophisticated investors can even lead to capital destruction. The United States Government had to spend billions of dollars in federal financial rescue programs to compensate for losses largely driven by the poor investment decisions of institutional investors—the same who qualify as

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[429] *See* discussion *supra* Part II.A.

[430] *See, e.g.*, *supra* Part V.A (explaining how many hedge funds derive their profits solely from speculation, which could create incentives to participate in market manipulations).

[431] *See* Zaretsky, *supra* note 303; *see also* Ben-David et al., *supra* note 337.

[432] *See* discussion *supra* Part V.C.

[433] John Kambhu et al., *Hedge Funds, Financial Intermediation, and Systemic Risk*, FRBNY ECON. POL'Y REV., Dec. 2007, at 6, *available at* http://www.newyorkfed.org /research/epr/07v13n3/0712kamb.pdf (quoting William J. McDonough, President, Fed. Reserve Bank of N.Y.).

sophisticated.[434] Not only was the integrity of the marketplace crippled, but also the public felt the devastating effects because the national securities markets are inextricably linked to the economic stability of the entire nation.[435] Along these lines, millions of jobs were lost during the Great Recession and the resulting budget deficit caused by the job losses will likely curtail creation and sustainability of government programs, even though the vast majority of the population was completely excluded from the markets that triggered the crisis.[436]

Although the actual participation of hedge funds and other private vehicles in the recent financial crisis has been rigorously contested, the events leading to the crisis serve as a dire warning to re-evaluate the existing regulatory structures (or lack thereof). This is particularly important with respect to the investment company industry, since exempt vehicles have a significant impact on the collective trading activity that occurs on the exchanges.

VII. ALTERNATIVE PROPOSALS

> Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.[437]

While the overall scope of this Article is limited to identifying a problematic loophole with respect to the investment company industry, Part VII begins a larger discussion that evaluates alternative frameworks that could help ensure the proper implementation of the SEC's mission. The primary goal of these frameworks is to modernize investment company regulation in order to reflect the impracticalities of relying on the sophisticated investor exemption to separate private and public investment companies. Reliance on the sophisticated investor exemption as a gatekeeper for substantive regulation could be exposing the general public to undue risk, as well as contributing to the misallocation of the

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[434] *See generally* David Goldman, *CNNMoney.com's Bailout Tracker*, CNN MONEY, http://money.cnn.com/news/storysupplement/economy/bailouttracker/ (last modified Nov. 16, 2009).

[435] *See* discussion *supra* Part II.A.

[436] *Long-Term Unemployment: Causes, Consequences, and Solutions*: *Hearing Before the J. Econ Comm.*, 111th Cong. 35, 36 (2010) (prepared statement of Lawrence F. Katz, Harvard University), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57058/pdf/CHRG-111shrg57058.pdf.

[437] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Frederick A. Stokes Co. 1914) (1914).

nation's limited capital. Investment company regulation should also be re-conceptualized so that it monitors the actual activities of investment companies, as opposed to relying on the status of its underlying investors as a proxy for regulation. Relatedly, the ways in which the various regulatory bodies oversee the activities of these vehicles must be re-examined, since the existing structures seem to be lacking in efficiency, coherency, and consistency in this regard.

This Part begins by identifying the limitations of the Dodd-Frank Act and proceeds by highlighting the benefits of enhanced transparency. It continues by proposing various mechanisms that could be used to execute this recommendation. To that end, simply requiring registration under the Securities Act, Exchange Act and/or the Company Act, without considering the complexities of the hedge fund industry, will likely be ineffective since these laws have not been sufficiently modernized to incorporate these distinctions. This Part also examines the challenges associated with implementing these mechanisms, particularly since much of the material information with respect to hedge funds has been deemed proprietary. Additionally, this Part recommends imposing specific limitations on hedge funds' leverage exposure and speculative trading activities and proposes consolidation of certain regulatory agencies in order to streamline the process through which the markets are monitored. This Part concludes with a proposal to consider a global regulatory framework for the investment company industry, since these markets exert immense control over global markets.

A. *Limitations of Dodd-Frank Act*

The Dodd-Frank Act subjects hedge funds to regulatory oversight based on the premise that they contribute to systemic risk.[438] However, this new regulation leaves several open issues regarding the future regulatory landscape within the investment company industry. For example, newly registered hedge funds will be required to disclose extensive systemic risk data to the SEC, but the SEC has not yet determined how it will measure and/or control systemic risk with respect to these vehicles.[439] In addition, investors are not entitled to receive this systemic risk data since it has been deemed proprietary by hedge fund

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[438]*See generally* Martin, *supra* note 14, at 17-30 (explaining that the Dodd-Frank Act's primary focus is preventing systemic risk).

[439]Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376, 1571-72 (2010) (to be codified at 15 U.S.C. § 80b-4).

advisers.[440] Moreover, the myopic focus on systemic risk prevention leaves additional unresolved issues with respect to capital formation and financial stability, both of which are integral aspects of the SEC's mission.[441]

B. *Benefits of Enhanced Transparency*

Increasing transparency to hedge fund investors beyond the mandate prescribed under the Dodd-Frank Act would help to ensure that the SEC's mission is being sufficiently implemented.[442] From an investor protection standpoint, enhancing transparency would provide investors with pertinent information to make better investment decisions.[443] It would also help to ensure that the prices of such investments are accurate and would incorporate relevant information that reflects the true values of these underlying investments.[444] Additionally, it would level the playing field for all investment advisers, since they would each be required to report comparable information in a standardized format. Similarly, enhanced transparency would reduce the likelihood of fraud by providing investors with immediate access to information that would make it easier to detect fraudulent activities before they cause significant losses.[445]

Improved transparency would also help to decrease the possibility of systemic risk and other negative externalities that occur on the exchanges. As stated by SEC Chairman Mary Schapiro, one form of systemic risk regulation is "the traditional oversight, regulation, market transparency and enforcement provided by primary regulators that helps keep systemic risk from developing in the first place . . . ."[446] A mandatory disclosure regime would give analysts and other industry

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[440]*Id.* It is also not clear whether the sophisticated investor doctrine has been specifically invalidated within the investment company industry. *See id.*

[441]*See supra* note 19 and accompanying text.

[442]*See generally* Martin, *supra* note 14, at 57-58 (discussing benefits of increased transparency).

[443]*See* SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 27 (Richard Schmalensee ed. 1981) (indicating that SEC adheres to philosophy of full disclosure as a means to further investor protection).

[444]*See* discussion *supra* Part IV.B.

[445]*See* discussion *supra* Part IV.C.

[446]*Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. 69, 70 (2009) (prepared statement of Mary L. Schapiro, Chairman of SEC), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111shrg55278/ pdf/CHRG-111shrg55278.pdf.

specialists who represent the interests of sophisticated investors, more information to better monitor hedge fund activities and assist with the prevention of systemic risk. While the Dodd-Frank Act gives the SEC broad authority to collect systemic risk data from registered hedge fund advisers,[447] it is not clear that the SEC will be able to identify systemically relevant activities before they rise to the level of threatening the general capital markets.

With respect to capital formation, enhancing transparency would help investors to determine how to best allocate their limited capital. If all hedge funds are subject to a mandatory reporting framework, then investors will be in a better position to optimize their hedge fund investments. Generally speaking, hedge funds are prohibited from advertising,[448] and their investors must then rely on their broker-dealers and extensive due diligence procedures in order to identify an optimal hedge fund investment. But this selection process is not conducive to comparing a large range of hedge funds, which makes it exceedingly difficult to identify the ideal hedge fund strategy for a particular risk-return profile.[449] Moreover, hedge funds are not required to adhere to consistent valuation and risk reporting frameworks, which makes the process of comparing multiple hedge funds even more difficult.[450] These issues deserve greater attention since there are currently over 18,000 hedge funds in existence.[451]

C. *Enhanced Transparency Mechanisms*

Enhanced transparency frameworks should be developed through an SRO for investment advisers, which would be primarily comprised of members of the hedge fund industry.[452] An SRO is "[a non-governmental] entity that regulates its industry through the adoption and enforcement of rules governing the conduct of its members."[453] The

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[447] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376, 1571-574 (2010) (to be codified at 15 U.S.C. § 80b-4).

[448] 17 C.F.R. § 230.502(c) (2011).

[449] *See* discussion *supra* Part IV.B.

[450] *See supra* notes 217-20 and accompanying text.

[451] Jones, *supra* note 418, at 3.

[452] Martin, *supra* note 14, at 50-52.

[453] *Glossary of Analyst Research Report Terms: Self-Regulatory Organization (SRO)*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/GlossaryofAnalystResearchReportTerms/P011885 (last visited Nov. 22, 2011). For example, "[the Financial Industry Regulatory Authority] is the largest SRO in the securities industry. Its mission is to bring integrity to the markets and confidence to

federal securities laws were designed to incorporate self-regulation as a primary component of securities regulation because it is more cost effective.[454] Of course, all final decisions and actions of this SRO would be subject to final approval by the SEC. Also, to mitigate costs, this SRO could be combined with the Financial Industry Regulatory Authority, ("FINRA"), the existing SRO for broker-dealers.[455] This would be an efficient alternative since there is significant overlap between the activities of investment advisers and broker-dealers.

An SRO of this nature would likely be the most workable solution to resolve these transparency issues for several reasons. First, there is tension between information investors would like to have, and information deemed proprietary by hedge fund advisers. Hedge fund advisers contend that the disclosure of such information would destroy their competitive standing in the marketplace because other advisers could potentially replicate their strategies. However, an SRO could help advisers find an appropriate balance with respect to this claim. For example, certain risk measures regarding a fund's leverage exposure, volatility, diversification and liquidity, could perhaps be disclosed to investors, while specific trading positions would remain proprietary. Additionally, since hedge fund advisers are permitted to trade many complex and illiquid instruments, the SEC may not have the resources or human capital to effectively develop standardized disclosure models. By relying on an SRO to develop these mechanisms, the SEC will be able to utilize the knowledge within the hedge fund industry without needing to expend additional resources developing its own.

This SRO could enhance transparency through many different ways. First, it can develop standardized valuation mechanisms for certain instruments and/or strategies so that investors can effectively rely on the performance figures that these vehicles yield. In addition, an SRO could develop a risk-reporting framework for these vehicles, which would force advisers to appropriately disclose and monitor their risk management practices. This model would also allow investors to more easily compare a larger range of hedge funds, which would help them to more effectively optimize their hedge fund investments. Moreover, a risk-reporting mechanism would help mitigate systemic risk because

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investors." *Id.*

[454]Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,256 (proposed Dec. 8, 2004) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.gpo.gov/fdsys/pkg/FR-2004-12-08/pdf/04-26154.pdf.

[455]FINRA was previously known as the National Association of Securities Dealers (NASD). *NASD Rulemaking*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/rules/sro/nasd.shtml (last modified Dec. 8, 2010).

regulators as well as market participants will have a holistic snapshot of risks that hedge funds are collectively employing with respect to the capital markets.

D. *Limits on Leverage and Speculation*

In addition to expanding transparency, the possibility of imposing specific limitations on hedge funds' leverage exposure and speculative trading activities should be further explored, since overindulgence in these undertakings could expose the general public to excessive harms.[456] Alternatively, if reliable limitations were imposed on leverage and speculation, the possibility of permitting public investment companies, such as mutual funds, to comply with such revised limitations, should be further explored. Currently, mutual funds are limited in their abilities to employ leverage and make speculative investments, such as engaging in short trading, which restricts the ability to guarantee returns in decreasing markets.[457] A broader range of investors could experience the benefits of hedge funds, such as ensuring positive returns and promoting financial innovation, if other investment vehicles were allowed to participate in limited speculation and leveraging.

E. *Consolidate Regulatory Agencies*

The current regulatory system is extremely multidimensional, which makes it tremendously difficult for regulated entities to effectively comply with the various layers of regulation.[458] The SEC holds primary responsibility for enforcing the federal securities laws and regulating the securities industry,[459] the Commodity Futures Trading Commission (the "CFTC") regulates commodity futures and option markets,[460] and FINRA regulates the activities of broker-dealers.[461] As a result, many investment vehicles that trade in both the securities and commodities markets have

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[456] *See* discussion *supra* Part V.C.

[457] *See* discussion *supra* Part. III.D.1.

[458] *See* J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 831-32 (2007).

[459] *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 17.

[460] *Mission & Responsibilities*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/About/MissionResponsibilities/index.htm (last visited Nov. 22, 2011).

[461] *About the Financial Industry Regulatory Authority*, FIN. INDUS. REG. AUTH., http://www.finra.org/AboutFINRA/ (last visited Nov. 22, 2011).

to either separately register with, or obtain exemptions from, the CFTC, the SEC, and the FINRA.[462] Furthermore, this flawed design makes it particularly difficult for regulators to receive the information that they need to effectively monitor the markets. This is problematic because the SEC holds primary responsibility for ensuring that the capital markets are safe and reliable, but the CFTC directly regulates the derivatives industry, which is the main culprit for many of the economic crises that have occurred in recent history.[463] In addition, the extent to which hedge funds participate in the shadow banking system[464] and maintain significant leverage exposure could potentially invoke jurisdiction by the Federal Deposit Insurance Corporation and the Federal Reserve, since these organizations monitor the nation's banking system and monetary policies, respectively.[465]

The consolidation of the CFTC with the SEC could streamline the process through which the markets are monitored. In addition, the possible benefits of this merger would be greater efficiency, removal of regulatory ambiguities, and synergy between the agencies. More importantly, this would make it easier to effectively monitor the extent to which various market participants adversely impact the markets. Since the SEC is the primary regulator charged with this task, then they should directly receive information from all types of instruments that could negatively affect the national exchanges.

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[462] Verret, *supra* note 458, at 831-32.

[463] *See* Zachary J. Gubler, *The Financial Innovation Process: Theory and Application*, 36 DEL. J. CORP. L. 55, 87 (2011) ("While OTC derivatives were not the 'proximate cause' of the financial crisis, they are thought to have exacerbated the crisis in two principal ways: by laying the foundation for faulty risk modeling, and by contributing to bank-like runs.") (citation omitted); *see also* Mark J. Roe, *The Derivatives Market's Payment Priorities As Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 583 (2011) ("And, thus far, only derivatives priorities have exacerbated a major financial crisis and economic downturn.").

[464] Generally, "shadow banking system" refers to bank-type activity occurring outside the reach of state and federal regulations. *See generally* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 27-38 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (discussing the shadow banking system and its role in the 2008 financial crisis).

[465] *Who is the FDIC?*, *About FDIC*, FED. DEPOSIT INS. CORP., http://www.fdic.gov/about/learn/symbol/index.html (last updated Aug. 11, 2010); *The Structure of the Federal Reserve System*, *About the Fed*, BOARD GOVERNORS FED. RES. SYS. http://www.federalreserve.gov/pubs/frseries/frseri.htm (last updated July 8, 2003).

F. *Global Framework*

The feasibility of a global regulatory framework should also be investigated since the international financial markets have become more interconnected in recent years.[466] This interconnectedness was most recently demonstrated during the Great Recession where the market failures experienced by the United States rapidly spread to the global economy.[467] In addition, private investment companies are major participants in the international capital markets, and thus their underlying trading activities could impact the worldwide economy. Establishing global consistency with respect to investment company regulation could also prevent regulatory forum shopping, where private vehicles simply operate in other less restrictive regulatory regimes. While there are admittedly challenges associated with creating a coordinated global regulatory approach, it is worth investigating since the financial markets of respective countries can collectively affect the global economy.

VIII. CONCLUSION

The sophisticated investor exemption is no longer a viable mechanism to separate private and public investment vehicles. Although private vehicles may restrict their investments to sophisticated investors, they may be indirectly available to the general public. In addition, the actual investment activities of these vehicles could have an adverse impact on the national economy, which seems to contradict the original intent of the private offering exemption. As a result—and contrary to legislative intent—the operation of the sophisticated investor exemption in the investment company marketplace has undermined the SEC's ability to fulfill its mission to adequately protect the public capital markets. A new regulatory framework that focuses on increasing transparency within these industries is of the utmost importance. The processes and mechanisms through which our regulators monitor the markets need to be re-considered because exempt investment companies utilize a variety of instruments and strategies to yield returns. Since the

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[466]INT'L MONETARY FUND, UNDERSTANDING FINANCIAL INTERCONNECTEDNESS 4 (2010), *available at* http://www.imf.org/external/np/pp/eng/2010/100410.pdf.

[467]*See* OTMAR ISSING ET AL., CTR. FOR FIN. STUD., NEW FINANCIAL ORDER: RECOMMENDATIONS BY THE ISSING COMMITTEE PART I, at 7-8 (2009), *available at* https://www.ifkcfs.de/fileadmin/downloads/publications/white_paper/White_Paper_No_1_Final.pdf.

public capital markets are closely intertwined with the overall well-being of the national economy, it is extremely important to re-evaluate the existing regulatory structures that may no longer be justifiable in the current financial marketplace. Given the dire consequences of relying on the sophisticated investor exemption as a gatekeeper for substantive regulation, our regulators must fully acknowledge and resolve the accompanying limitations of this doctrine.