NOTES

THE ELEPHANT IN THE ROOM: DANGERS OF HEDGE FUNDS IN OUR FINANCIAL MARKETS

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I. INTRODUCTION

Hedge funds are our modern titans of industry, and like their predecessors they now represent the best and the worst of the new global economy. These minimally regulated investment entities— in which historically only super-rich investors could have an interest—have recently had profound impacts on financial markets around the world. In early 1992, for example, George Soros, the now-famous hedge fund manager, made it big by using his hedge fund, Soros Fund Management LLC, to leverage a massive bet that the British pound would be ejected from the European Exchange Rate Mechanism. The bet reportedly earned Mr. Soros over a billion dollars and the title of “the man who broke the Bank of England.” A few years later, after another huge currency bet, the Malaysian Prime Minister accused Mr. Soros of bringing down the Malaysian currency.

1. For a more detailed definition of hedge funds, the investment strategies they pursue, the risks and benefits they produce, and other attributes commonly associated with them, see infra notes 28–33 and accompanying text.

2. See infra notes 39–51 and accompanying text (discussing the exemption available to hedge funds under the Securities Act of 1933 when offerings are privately given to “accredited investors”); infra notes 63–65 and accompanying text (discussing the exemption available to hedge funds under the Investment Company Act of 1940 when the beneficial owners are “qualified purchasers”). But see infra notes 209–52 and accompanying text (describing the increasing problem of hedge funds directly and indirectly reaching unsophisticated retail investors who do not meet the statutory wealth requirements).

3. Hedge funds are typically structured as limited partnerships (LPs) or limited-liability companies (LLCs) for the tax advantages and limited liability associated with these organizational structures. U.S. SEC. & EXCH. COMM’N, STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION: IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 9 n.27 (2003), available at http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter SEC: HEDGE FUND GROWTH]. However, some hedge funds also structure themselves as corporations or business trusts. Id.


5. Adam Shell, $363M Is Average Pay for Top Hedge Fund Managers, USA TODAY, May 26, 2006, at 1B.

In the summer of 1998, Long-Term Capital Management (LTCM), an extremely over-leveraged hedge fund,\textsuperscript{7} burst onto the public scene after its bets turned sour, nearly causing a catastrophic collapse of the world banking system.\textsuperscript{8} LTCM used approximately $2.2 billion in investors’ funds to leverage approximately $125 billion worth of borrowed money, which LTCM further leveraged into $1.25 trillion in open trading positions.\textsuperscript{9} The U.S. Treasury Department came to the rescue when these positions turned against LTCM and arranged a buyout of LTCM’s defaulted positions.\textsuperscript{10}

In September 2006, Amaranth Advisers, another highly leveraged hedge fund, lost roughly $5 billion in value in a week when it lost its bets on the natural-gas market.\textsuperscript{11} Further, in the first two months of 2007, Red

\begin{thebibliography}{11}
\bibitem{7} “Financial leverage is increased by having greater amounts of debt in the capital structure of the firm.” \textsc{Stanley G. Eakins, \textit{Finance} 350} (2d ed. update 2005). “[L]everage allows the debt-financed firm to take advantage of strong sales more effectively than the all-equity firm.” \textit{Id.} at 343. A common example of leveraging, especially during real-estate booms, is to use real property as collateral to borrow the funds necessary to purchase other real property or business assets.


\bibitem{10} See Paredes, \textit{supra} note 8, at 984. See generally \textsc{Roger Lowenstein, \textit{When Genius Failed: The Rise and Fall of Long-Term Capital Management}} (2000) (providing an in-depth discussion of LTCM, its managers, and their trading strategies, which ultimately led to the fund’s momentous failure and the near collapse of the world banking system).

\bibitem{11} See Ann Davis, \textit{Private Money: The New Financial Order—Blue Flameout: How Giant Bets on Natural Gas Sank Brash Hedge-Fund Trader}, WALL ST. J., Sept. 19, 2006, at A1; see also Daisy Maxey, \textit{At Hedge Funds, Study Exit Guidelines}, WALL ST. J., Sept. 23, 2006, at B4. The Amaranth collapse is particularly worrisome given that some commentators have claimed that Amaranth’s huge losses were at least partly due to John Arnold—the manager of a rival hedge fund, Centaurus Energy—using his fund to drive gas prices against Amaranth’s bets. See Ann Davis et al., \textit{Hedge-Fund Hardball: Amid Amaranth’s Crisis, Other Players Profited}, WALL ST. J., Jan. 30, 2007, at A1. As more hedge funds enter the market, typical investment strategies stop working and many investment positions are squeezed as more hedge funds invest in the same positions. See Susan Pulliam, \textit{Private Money: The New Financial Order—The Hedge-Fund King is Getting Nervous}, WALL ST. J., Sept. 16, 2006, at A1. There is also a danger that if hedge funds sell their positions en masse, the share price would tumble, leaving other investors holding the bag. See \textit{id.}

Kite Management’s hedge fund lost nearly twenty percent of its $1 billion metals-trading investments when its bets that copper and zinc futures would rise met sharply declining spot prices.\textsuperscript{12}

The above incidents all involved hedge funds engaging in legal activities. However, many recent events have exposed the hedge fund industry as one wrought with illegality.\textsuperscript{13} For example, in 2003, a number of hedge funds were implicated in the mutual fund market-timing scandal that rocked Wall Street.\textsuperscript{14} Within the last couple of years, the Securities and Exchange Commission (SEC) has investigated instances of insider trading by numerous hedge funds, including one of the nation’s most prominent funds, Pequot Capital Management.\textsuperscript{15} And in early March 2007, the SEC brought one of the largest insider-trading actions since the mid-1980s, and the individuals charged included several hedge fund
employees. These examples are just a small sampling of the numerous instances in which hedge funds have had potentially disastrous effects on the market, pushed the limits of legal activities, or become entangled in criminal activities. But most worrisome is unsophisticated investors’ new found access to hedge funds through endowments, pensions, and other charitable entities, funds of hedge funds (FOHFs), and publicly traded shares of hedge fund management companies.

Against this backdrop of illegality, the D.C. Circuit, in *Goldstein v. SEC*, vacated an SEC rule intended to protect investors from hedge fund abuses. This rule, the “Hedge Fund Rule,” would have allowed the SEC to gather vital information about the secret and elusive world of hedge funds. Unfortunately, the *Goldstein* court’s unsound and narrow reasoning serves as a prime example of the extent to which the current regulatory regime has ignored the fundamental motivations of our securities laws.

This Note argues that the current judicial and regulatory stances on hedge funds fail to appreciate and account for the tremendous dangers that hedge funds pose not only to the security of our financial markets but also to the individual investors that securities regulations are designed to protect. To appreciate fully these failures, it is necessary to understand...
better the history of hedge funds and their recent explosion in popularity and in market power.\textsuperscript{27} To aid in this understanding, Part II of this Note discusses the four principal acts that regulate the securities markets and how hedge funds exist and function outside those regulations. Part III analyzes the \textit{Goldstein} decision and explains the administrative law and normative failures of the court’s analysis. In Part IV, this Note discusses the unsatisfactory reactions to \textit{Goldstein} and offers a few modest proposals to address the dangers that hedge funds pose. Part V concludes.

\section*{II. The Existence and History of Hedge Funds}

Definitions for hedge funds abound,\textsuperscript{28} but the following is an accurate and still comprehensible definition: “[T]he term ‘hedge fund’ . . . generally is used to refer to an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act.”\textsuperscript{29} Hedge funds are distinguished from other investment vehicles by a number of unique characteristics, which typically include the following: requiring the hedge fund manager to invest a substantial amount of her own assets in the fund,\textsuperscript{30} charging significant management and performance fees,\textsuperscript{31} and using

\begin{itemize}
  \item \textsuperscript{27} As will be discussed more thoroughly throughout this Note, a number of factors have contributed to the surge in popularity and power of hedge funds. Some of these factors are positive (e.g., hedge funds help make markets more efficient and help some investors manage their investment risk), see infra notes 99–102 and accompanying text, while others are negative (e.g., speculating investors looking for the type of returns they saw during the dot-com boom, and risk-taking hedge fund managers pushing the limits of legality or even trouncing upon the law), see infra notes 103–15 and accompanying text.
  
  
  \item \textsuperscript{29} SEC: HEDGE FUND GROWTH, supra note 3, at 3 (footnote omitted).
  
  \item \textsuperscript{30} See, e.g., Erik J. Greupner, Comment, \textit{Hedge Funds Are Headed Down-Market: A Call for Increased Regulation?}, 40 SAN DIEGO L. REV. 1555, 1559 (2003).
  
  \item \textsuperscript{31} See Willa E. Gibson, \textit{Is Hedge Fund Regulation Necessary?}, 73 TEMP. L. REV. 681, 684 (2000); Greupner, supra note 30, at 1559. The typical hedge fund charges a management fee of 1%–2% of the total assets and a performance fee of 20% of the profits. See, e.g., Gibson, supra, at 684. However, these fees are only typical, and many hedge fund managers charge higher management and performance fees. See, e.g., Pulliam, supra note 11 (noting that one hedge fund manager keeps 50% of the fund’s gains and charges a 3% management fee); Shell, supra note 5 (noting that the highest paid hedge fund manager in 2006 made $1.5 billion by charging a 5% management fee and a 44% performance fee). Although there is no scholarship investigating the similarity between performance fees in the hedge fund setting and options grants in the corporate setting, the similarities are obvious. Both assume that managers’ interests will be more closely aligned with investors because of these performance-based incentives. However, the recent
aggressive investment strategies. However, despite these unique characteristics, hedge funds are ultimately distinguished “by the extent to which the [SEC] does not regulate them. The standard hedge fund structure [ensures] that a hedge fund is not subject to the principal regulatory requirements of the federal securities laws.” How is it that hedge funds escape those principal regulatory requirements?

A. Hedge Funds: The Products of Loopholes

Most hedge funds structure themselves to avoid registration under the four principal securities regulations: the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act), the Investment Company Act of 1940 (Company Act), and the Investment Advisers Act of 1940 (Advisers Act). The remainder of Part II.A discusses how hedge funds avoid registration under each of these acts.

1. Exemption from the Securities Act

Hedge funds typically avoid registering under the Securities Act by providing interests in the hedge fund only through private offerings. By offering an interest through a private offering, hedge funds take advantage of the private-placement exemption from registration found in § 4(2) of the Securities Act.
In the seminal case addressing § 4(2)’s private-placement exemption, *SEC v. Ralston Purina, Co.*, the U.S. Supreme Court stated that for an offering to fall within the exemption, the parties receiving the offer must be able to fend for themselves. That is, parties receiving the offer cannot be the type of party that the Securities Act is meant to protect. Further, the availability of the exemption depends on the knowledge of the parties receiving the offer and is limited to situations when those parties receive information comparable to that afforded by registration under the Securities Act.

To clarify the requirements of this exemption, the SEC promulgated Rule 506 of Regulation D, which provides a safe harbor for offering parties that meet the conditions of the Rule. Generally, hedge funds may use this safe harbor by privately offering interests in the hedge fund only to “accredited investors.” Roughly, accredited investors include individuals with a net worth above $1,000,000, individuals with an annual income above $200,000, or institutional investors with over $5,000,000 in assets. In sum, hedge funds avoid registration under the Securities Act.
by privately offering interests only to fairly wealthy individuals or institutions, both of which are presumed to be able to fend for themselves.

2. Exemption from the Exchange Act

Hedge funds typically avoid registration under the Exchange Act by having fewer than 500 owners of record. This exemption is available because § 12(g) of the Exchange Act requires registration only for classes of securities having 500 or more owners of record and over $1 million in assets. Because hedge funds avoid registering under § 12(g), they are generally able to avoid the beneficial-ownership reporting requirements under § 13 and § 16 of the Exchange Act. However, a hedge fund will be required in some instances to report its ownership of other equity securities that are registered under § 12.
3. Exclusions from the Company Act

Although hedge funds fit within the general definition of an investment company,56 the Company Act provides two statutory exclusions57 from the definition.58 First, under § 3(c)(1), the Company Act excludes any investment company that has 100 or fewer beneficial owners of its securities and that does not plan to make a public offering.59 In general, each investor in a hedge fund is counted toward the 100-investor limit.60

v. SEC, 451 F.3d 873 (D.C. Cir. 2006), which is discussed at length in Part III infra—has claimed that he will sue the SEC again if it attempts to enforce one of § 13’s reporting requirements. See Editorial, Hedge Fund Secrets, WALL ST. J., Dec. 21, 2006, at A16. Mr. Goldstein claims that the SEC’s reporting requirements under § 13 effectively allow the SEC to seize a hedge fund manager’s intellectual property rights. See id. This is a novel claim, but it seems to have little merit. However, there is a recent trend in intellectual property to grant patents for “unique processes.” See William A. Drennan, The Patented Loophole: How Should Congress Respond to This Invention?, 59 Fla. L. Rev. 232, 237–44 (2007) (discussing the patenting of tax loopholes as unique processes). Professor Drennan questions the wisdom of granting such patents in most circumstances because they may undermine some of the rationales for intellectual-property protection. See id. at 271–96. By analogy to the patentable tax loophole, a hedge fund manager may be able to patent an investment process if it is truly unique and worthy of protection as intellectual property, but the same concerns Professor Drennan raises in the tax arena will apply to patents in the hedge fund arena. For a brief discussion of the merits of such intellectual-property protection of hedge fund managers’ strategies, see infra notes 276–80 and accompanying text.

56. See Investment Company Act of 1940 § 3, 15 U.S.C. § 80a-3(a)(1)(A) (2000) (defining an investment company as an issuer that “is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities”).

57. Technically, there is a difference between exemptions and exclusions: the former are not specifically provided for in the statutory language, but the latter are. See HAZEN, supra note 40, § 20.3, at 753. For example, a statute may explicitly exclude teachers, lawyers, and accountants from registering as investment advisers, but may exempt from registration those individuals who advise only sophisticated individuals. See, e.g., Investment Adviser Act of 1940 § 202, 15 U.S.C.A. § 80b-2(a)(11)(B), (a)(11)(E) (West 2007). The practical effect is that none of the statutory requirements apply to the excluded parties, but all statutory requirements other than registering apply to the exempted parties. See HAZEN, supra note 40, § 21.2[3], at 796–98.

58. 15 U.S.C. § 80a-3(b)(2000). The Company Act does include exemptions; however, those exemptions are generally not available for hedge funds. See id. § 80a-6.

59. See id. § 80a-3(c)(1); see also SEC: HEDGE FUND GROWTH, supra note 3, at 11–12; Gibson, supra note 31, at 693–97. Hedge funds must follow the requirements of § 4(2) of the Securities Act to qualify for the exclusion for not making a public offering. See Gibson, supra note 31, at 695. For a discussion of § 4(2) of the Securities Act, see supra notes 39–51 and accompanying text. Additionally, although it is not required to meet § 3(c)(1)’s exclusion under the Company Act, hedge funds will pursue only accredited investors to avoid registration under the Securities Act. Cf. supra notes 39–51 and accompanying text (discussing the requirements for exemptions under the Securities Act).

60. See Gibson, supra note 31, at 694–95 (noting that most hedge funds have fewer than 100 investors but that hedge fund managers must pay close attention to the number of investors to continue to qualify for § 3(c)(1)’s exclusion). Spouses who have jointly invested in a hedge fund are counted as one beneficial owner under the Company Act. See 15 U.S.C. § 80a-3(c)(1).
However, if a hedge fund claims an “investing entity” as an investor\(^{61}\) and that investing entity holds 10% or more of the outstanding voting shares of the hedge fund, then the hedge fund must “look through” the investing entity and count the number of individual investors in the investing entity.\(^{62}\)

Second, under § 3(c)(7),\(^{63}\) the Company Act excludes from its reach any investment company whose outstanding securities are owned exclusively by “qualified purchasers.”\(^{64}\) The Company Act generally defines a qualified purchaser as (1) any person who owns not less than $5 million in investment assets, (2) any family-owned company that owns not less than $5 million in investment assets, (3) any trust not formed for the purpose of investing in a § 3(c)(7) fund and whose trustor(s) or settlor(s) are qualified purchasers, and (4) any person, acting on her own account or on the account of other qualified purchasers, who owns and invests on a discretionary basis not less than $25 million.\(^{65}\) Thus, hedge funds are

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\(^{61}\) Investors that are corporations are “investing entities” under the Company Act. See 15 U.S.C. § 80a-3(c)(1)(A).

\(^{62}\) See id. § 80a-3(c); see also SEC: HEDGE FUND GROWTH, supra note 3, at 11 n.34; Gibson, supra note 31, at 694–95. The “look-through” concept becomes important, as discussed in Part III infra in reference to the Goldstein case, because as in the Company Act scheme, whether a hedge fund has to look through an entity determines its registration requirements under the Advisers Act. Although there is no case law on point, under the Company Act this look-through concept seems to be of little consequence because a crafty hedge fund manager could just set up a Russian-doll framework to avoid registering even if an investing entity was going to hold more than 10%. That is, if an investing entity will own more than 10% of outstanding voting shares, the hedge fund could simply require the investing entity to set up another entity to hold 100% of the interests in the investing entity. Thus, when the hedge fund looks through the investing entity, all there is a single entity, which will not increase the count to the 100-investor limit. It seems such a Russian-doll setup could go on \textit{ad infinitum}. See infra Part III.

\(^{63}\) This exclusion did not exist until Congress passed the National Securities Markets Improvement Act of 1996 (NSMIA), Pub. L. No. 104-290, § 209(a), 110 Stat. 3416, 3432 (codified at 15 U.S.C. § 80a-3(c)(7) (2000)). This is important because prior to 1996, hedge funds could depend only on the § 3(c)(1) exclusion, which limited hedge funds to having 100 or fewer accredited investors. See supra notes 59–62 and accompanying text. As discussed more thoroughly below, the NSMIA has had an enormous effect on the hedge fund industry. See infra notes 87–98 and accompanying text.

\(^{64}\) See 15 U.S.C. § 80a-3(c)(7). A hedge fund may have an unlimited number of qualified-purchaser investors and still be excluded from the Company Act under § 3(c)(7); however, as a practical matter, to avoid registering under the Exchange Act, hedge funds limit the number of qualified purchasers to 499. See SEC: HEDGE FUND GROWTH, supra note 3, at 13. For a discussion of the registration exemption under the Exchange Act, see supra notes 52–55 and accompanying text.

\(^{65}\) See 15 U.S.C. § 80a-2(a)(51)(A). As discussed below, the fourth possibility for constituting a qualified purchaser is worrisome because the person who is actually managing the $25 million or greater in investments does not have to exhibit any level of “sophistication.” See infra notes 224–32 and accompanying text (discussing endowments’, pensions’, and charitable organizations’ beneficiaries and how the beneficiaries, who are generally not sophisticated and therefore need SEC protection, are the ones who will be harmed by a hedge fund manager’s investment decisions).
excluded from the Company Act because they allow only a small number of extremely wealthy persons to invest in the hedge fund.

4. Exemption from the Advisers Act

“Virtually all hedge fund [managers] meet the definition of ‘investment adviser’ under the Advisers Act.” 66 Section 202(a)(11) of the Advisers Act defines “investment adviser” as follows:

[A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . . 67

However, prior to the SEC’s enactment of the Hedge Fund Rule 68 and now again after the Goldstein court vacated the Rule, 69 most hedge fund managers avoid registering under the Advisers Act by meeting three requirements. 70 The hedge fund manager (1) cannot hold herself out to the public as an adviser, 71 (2) cannot advise any registered investment company, 72 and (3) must have fewer than fifteen clients during the preceding twelve months. 73 The third requirement is a de minimis one 74

66. SEC: HEDGE FUND GROWTH, supra note 3, at 20; see also Gibson, supra note 31, at 696 (“The general partner of a hedge fund falls within the definition of an investment adviser . . . .”).
69. See infra Part III (arguing that the Goldstein court improperly vacated the SEC’s Hedge Fund Rule).
70. See SEC: HEDGE FUND GROWTH, supra note 3, at 21–22. Notwithstanding a hedge fund manager’s ability to avoid registering under the Advisers Act, prior to the Goldstein decision some managers had voluntarily registered as investment advisers. In 2003, the SEC estimated that approximately two-thirds of hedge fund managers were not registered as investment advisers. Id. at 22. Prior to the Goldstein decision, many hedge fund managers voluntarily registered with the SEC in anticipation of the Hedge Fund Rule, but after the decision, hundreds of managers withdrew their registration from the SEC. Siobhan Hughes, More Hedge Funds Leave the Ranks of SEC’s Registry, WALL ST. J., Dec. 15, 2006, at C4. Approximately two months after the Goldstein decision, 106 hedge fund managers had withdrawn, and within five months that number increased to 275. Id.
71. 15 U.S.C. § 80b-3(b)(3) (2000). The SEC has stated a few behaviors that will cause it to consider a party as holding itself out to the public as an investment adviser: maintaining a listing as an investment adviser in a telephone or business directory; expressing a willingness to accept new clients; or using letterhead indicating any investment-adviser activities. See Gibson, supra note 31, at 698.
73. Id.
74. See SEC: HEDGE FUND GROWTH, supra note 3, at 21 (referring to the fifteen-client
with a complicated history, the end result of which is the *Goldstein* decision.  

### B. A Brief History of Hedge Funds

By avoiding regulation under the four principal securities acts, hedge funds have for years existed in the shadows of the financial world. The hedge fund industry began modestly in 1949 when Alfred Jones began a hedge fund that used moderately leveraged money to take long positions in undervalued stocks and short positions in overvalued stocks. Mr. Jones’s fund had a 670% rate of return from 1955 to 1965, reportedly higher than any other fund in the world. Hedge funds still use this long–short strategy, but more complex and aggressive strategies have...
emerged as the industry has grown.\textsuperscript{82}

The number of hedge funds and the assets they managed increased steadily from the 1960s to the mid-1980s.\textsuperscript{83} However, in the roughly ten years from the mid-1980s to mid-1990s, two elements combined to provide the catalyst for the recent explosive growth of hedge funds.

The first element was the SEC’s promulgation of Rule 203(b)(3)-1, which is a safe-harbor rule\textsuperscript{84} that contains a no-look-through provision.\textsuperscript{85} Rule 203(b)(3)-1 permits a hedge fund manager to count the hedge fund as her client, and not the individual investors, when determining whether she must register under the Advisers Act.\textsuperscript{86} The second element was Congress’s enactment of the National Securities Markets Improvement Act of 1996 (NSMIA).\textsuperscript{87} The NSMIA amended various provisions of the Company Act, and the most important amendment for hedge funds was the addition of § 3(c)(7).\textsuperscript{88} Section 3(c)(7) of the Company Act permits a hedge fund to sell to an unlimited number of qualified purchasers without having to register as an investment company.\textsuperscript{89} The combination of safe-
harbor Rule 203(b)(3)-1 and the unlimited-qualified-purchasers provision has caused the phenomenal growth recently seen in the hedge fund industry. 90

In 1990, approximately 300 hedge funds managed $39 billion in assets. 91 By 2001, those numbers had grown to nearly 6,000 hedge funds managing over $550 billion in assets. 92 And by 2006, over 9,000 hedge funds 93 managed at least $1.89 trillion in assets. 94 Further, by 2006, numerous hedge funds each managed over $10 billion in assets. 95 The sheer growth of hedge funds is certainly impressive, and this growth is even more impressive compared to that of other market participants—hedge funds have outpaced nearly everyone.

From 2002 to 2006, the assets in mutual funds approximately doubled, but the assets in hedge funds almost quadrupled during the same period. 96 Moreover, hedge funds engage in enormous volumes of trading, accounting for 40%–50% of the daily trading volume in the major securities markets. 97 And alarmingly, a couple of hedge funds each account qualified purchaser investors in each fund without having to register under the Company Act (14 x 499 = 6,986)). See SEC: HEDGE FUND GROWTH, supra note 3, at 89 n.292. Again, such a high number of investors certainly is not de minimis. Cf. supra notes 74, 86 and accompanying text (describing the fifteen-investor limit as a de minimis requirement and contrasting that with the large number of investors hedge funds are able to accept without registering).

90. See Greupner, supra note 30, at 1562–63 (“Based on the growth of total hedge fund assets before and after 1996, it appears that NSMIA has in part served as a catalyst for the increase.”).

91. See id at 1561. Because the hedge fund industry shrouds itself in secrecy, all of the statistics available to the public are necessarily incomplete. See SEC: HEDGE FUND GROWTH, supra note 3, at 77–78. The SEC admits that it lacks “accurate information about how many hedge funds operate in the United States, their assets or who controls them.” Id. at 77.

92. See Greupner, supra note 30, at 1561.


95. See, e.g., Davis et al., supra note 11 (describing a hedge fund with over $13 billion under management); Pulliam, supra note 11 (noting that Steven Cohen’s hedge fund manages over $10 billion in assets); Landon Thomas, Jr., With Cash in Hand, Hedge Fund Chiefs Join Political Fray, N.Y. TIMES, Jan. 25, 2007, at A1 (indicating that a hedge fund managed by Richard Perry has $12 billion in assets).

96. Compare Erin E. Arvedlund, Hedging Their Bets: Fund Groups Offer Vehicles Once Meant Only for the Rich, BARRON’S, Jan. 7, 2002, at F3 (noting that in 2001 mutual funds had $4.6 trillion in assets and hedge funds had $450 billion), with John Waggoner, Mutual Funds Top $10 Trillion in Assets, USA TODAY, Nov. 10, 2006, at 1B (noting that in 2006 mutual funds assets had reached $10 trillion), and Hedge Funds Closed, supra note 94 (noting that in 2006 hedge fund assets had reached $1.89 trillion).

97. See, e.g., Paredes, supra note 8, at 986 (noting that a number of studies indicate that
for as much as 2%–3% of daily trading volume.98

This enormous growth in hedge funds is arguably beneficial on purely economic grounds because hedge funds can increase market efficiency,99 provide liquidity to capital markets, and allow investors to manage their investment portfolio’s risk.100 These benefits accrue largely because hedge funds account for 40%–50% of the trading on the New York Stock Exchange and the London Stock Exchange; Greg Ip & Henny Sender, Private Money: The New Financial Order—Cash Machine: In Today’s Buyouts, Payday for Firms Is Never Far Away, WALL ST. J., July 25, 2006, at A1 (stating that hedge funds are the biggest source of trading volume, accounting for half the daily volume on the New York and London stock exchanges).

98. See Davis et al., supra note 11 (estimating that Kenneth Griffin’s hedge fund, Citadel Investment Group, accounts for 3% of daily trading on the New York Stock Exchange); Pulliam, supra note 11 (indicating that Steven Cohen’s hedge fund, SAC Capital Partners, accounts for 2% of the overall stock market activity on a typical day); see also Marcia Vickers, The Most Powerful Trader on Wall Street You’ve Never Heard of, BUS. WK., July 21, 2003, at 66 (noting that Cohen’s fund accounts for as much as 3% of the daily trading on the New York Stock Exchange and 1% on the NASDAQ).

99. See SEC: HEDGE FUND GROWTH, supra note 3, at 4. However, at least two prominent economists think that hedge fund benefits are vastly overstated. See Burton G. Malkiel & Atanu Saha, Hedge Funds: Risk and Return, FIN. ANALYSTS J., Nov.–Dec. 2005, at 80, available at http://www.cfapubs.org/doi/pdf/10.2469/faj.v61.n6.2775 (arguing that publicly reported hedge fund statistics are skewed because hedge funds that perform poorly simply do not report and that numerous hedge funds close each year); see also Steve Hays, Hedge Funds’ Success May Not Be All It Seems—Study, REUTERS NEWS, Feb. 11, 2005 (reporting on Professors Malkiel and Saha’s study). Over thirty years ago, Professor Malkiel earned public prominence for his book, A Random Walk Down Wall Street, because he argued that a monkey throwing darts could pick stocks as well as expert analysts. David Henry, Will Winning Advice Defeat S&P 500?, USA TODAY, May 18, 1999, at 3B. Malkiel’s argument is known as the efficient market hypothesis because it postulates that the market cannot be “beat” in the long run because it is perfectly efficient, or nearly so, and the market’s movements are random. See Burton G. Malkiel, The Efficient Market Hypothesis and Its Critics, J. ECON. PERSP., Winter 2003, at 59, 59–61; see also Stephen Bainbridge, Random Stock Traders at the EC MH; with a Review of Malkiel’s Random Walk, http://www.businessassociationsblog.com/lawandbusiness/comments/random_stock_traders_an_d_the_ecmh_with_a_review_of_malkiel_random_walk/ (last visited Nov. 13, 2007). Thus, according to Malkiel, statistically there is about a fifty–fifty chance that any hedge fund will beat the market two years in a row. See Hays, supra.

100. See SEC: HEDGE FUND GROWTH, supra note 3, at 4; Metzger, supra note 28, at 15. Former Federal Reserve Chairman Alan Greenspan has stated: “I do think it is important to remember that [hedge funds]—by what they do—they do make a contribution to this country.” Hedge Fund Operations: Hearing Before the H. Comm. on Banking and Financial Servs., 105th Cong. 50 (1998) (testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System). Nonetheless, many have argued that hedge funds actually harm the markets because they increase volatility, speculate, receive “favorable” treatment from brokers, and engage in aggressive short-term trading strategies to the detriment of long-term investors. See, e.g., Pulliam, supra note 11; Scannell & Smith, supra note 15; Daniel Altman, Managing Globalization Blog: All Talk and No Action, INT’L HERALD TRIB. BLOGS, Feb. 23, 2007, http://blogs.iht.com/tribtalk/business/globalization/?p=375. Moreover, the worry of another LTCM-type collapse and the systemic risk that such a collapse poses still lurks within the hedge fund industry. See Paredes, supra note 8, at 983–85 (describing systemic risk and a systemic ripple
funds “take the side of the trade that others do not want to take”\textsuperscript{101} and because their active trading and research contribute to price efficiencies.\textsuperscript{102}

Unfortunately, however, there is a dark side to hedge funds, and that side has become more prominent and glaring in recent years.\textsuperscript{103}

One of the SEC’s biggest worries recently has been that absent some sort of regulation of hedge funds, it could not timely identify fraud and other misconduct until after investors suspect illicit activity and contact the SEC.\textsuperscript{104} Further, the SEC is worried about the growing popularity of FOHFs, the increasing investments by endowments and pensions, and the ability of hedge fund companies publicly to offer interests in their hedge fund management companies\textsuperscript{105} because more unsophisticated individual investors are impacted by hedge fund activities through these products.\textsuperscript{106}

The SEC’s worries are well founded because hedge funds continue to reach more investors and have been recently implicated in numerous criminal activities.

For example, from 2002 to 2005, the SEC filed seventy-eight enforcement actions against hedge funds, and most actions involved fraud against the hedge fund’s own investors.\textsuperscript{107} The SEC has examined one hedge fund on eighteen separate occasions because of the fund’s trading that occurred, on a much smaller scale than LTCM, in May 2005); Ip, supra note 17.

\textsuperscript{101} Metzger, supra note 28, at 15.

\textsuperscript{102} McClean, supra note 28, at 114. Because hedge funds are always exploring new investment opportunities, they are also willing to bet on industries and emerging markets that other investors steer clear of. See, e.g., Jim Carlton, \textit{Biodiesel Powers Up on Financing}, \textit{Wall St. J.}, Feb. 21, 2007, at B13 (noting that hedge funds have invested in the fledgling alternative fuels industry); Alex Frangos & Jennifer S. Forsyth, \textit{Private Funds Show Interest in WTC Site, a Move That Could Bolster Development}, \textit{Wall St. J.}, Feb. 12, 2007, at A3 (describing potential hedge fund participation in the development of the new World Trade Center); Kate Kelly, \textit{Creative Financing: Defying the Odds, Hedge Funds Bet Billions on Movies}, \textit{Wall St. J.}, Apr. 29, 2006, at A1 (noting that some hedge funds invest heavily in movies).

\textsuperscript{103} In addition to the criminal activities the SEC has focused on, some hedge fund managers worry that the increase in the number of hedge funds is limiting their ability to profit, and therefore the managers must engage in riskier investments. See Pulliam, supra note 11. Moreover, as discussed more thoroughly below, there is a speculative frenzy surrounding hedge funds. See infra notes 247–52. “I think [the hedge fund industry is] an area where you have to be particularly cautious, particularly when people are rushing like lemmings to get into [hedge funds].” Hays, supra note 99 (quoting Professor Malkiel).


\textsuperscript{106} See id.

\textsuperscript{107} See Bogdanich & Morgenson, supra note 15. From 1997 to 2002, the SEC brought 150 enforcement actions against hedge funds. Greupner, supra note 30, at 1569. Moreover, many of the actions involved wholesale misappropriations of significant amounts of investors’ funds. Id.
practices. In March 2002, during a period of massive hedge fund fraud cases, the SEC prosecuted one hedge fund manager for covering up $400 million in losses. Further, in August 2005, Bayou Management LLC, a $440 million hedge fund, closed down without returning any money to its investors. Additionally, numerous hedge funds have been recently implicated in illegal market-timing practices and insider trading.

Another particularly troubling illegal practice that has only recently come to light is hedge funds’ use of borrowed shares to affect shareholder voting in publicly traded companies. In one instance of this practice, a hedge fund borrowed shares, shorted the underlying stock, voted against a buyout that would have increased the stock’s value, and then reaped profits on the short sale when the stock plummeted by 18% the following day. The current SEC chairperson, Christopher Cox, expressed concern about this practice and indicated that a regulatory response might be necessary. However, as seems to be the lesson from recent experiences with hedge funds, “‘[t]he rules and . . . law simply haven’t caught up with the marketplace for sophisticated trading techniques.’”

108. See Bogdanich & Morgenson, supra note 15.
110. See Milestones, supra note 6. A federal bankruptcy judge later ruled that investors who lost money when Bayou failed could sue other investors who cashed out before the collapse. See I anthe Jeanne Dugan, Moving the Market: Bayou Holders Can Sue Others Who Cashed Out Before the Collapse, WALL ST. J., Feb. 26, 2007, at C3; see also Peg Brickley, Bayou Investors Who Got Out Early Lose Their Bid for Pretrial Victory, WALL ST. J., Aug. 11, 2007, at A4 (noting that the bankruptcy judge denied the defendants’ motion to dismiss, reasoning that the investors who got burned were creditors of the hedge fund and therefore entitled to the protection of the bankruptcy laws). This is an interesting ruling, and if it is not overturned, it could impact the hedge fund industry by making hedge funds riskier investments. Dugan, supra. As one attorney associated with the case said in reference to the ruling, “I call it the ‘Hotel California’ syndrome for hedge funds. You can check out anytime you like, but you can never leave.” Id. Perhaps in a response to this ruling, after its collapse, Amaranth sent letters to its former investors in an effort to stem the potential litigation against it. Week in Review, MONEY MGMT. EXECUTIVE, Apr. 9, 2007; see also supra note 11 and accompanying text (discussing Amaranth’s massive loss in value in 2006). The letter offered to distribute the fund’s remaining assets more quickly to investors who agreed not to sue the fund. See supra note 11 and accompanying text. Like the ultimate disposition of the Bayou litigation, this recent move by Amaranth deserves watching because other hedge fund managers are surely interested to see if such a move could insulate them from litigation in the event of their own fund’s collapse. But see infra note 224 (noting that an Amaranth investor has already sued the failed hedge fund).

111. See supra notes 13–16 (discussing hedge funds charged in market-timing scandals, insider-trading activities, and other illicit actions).
113. Id.
114. Id.
115. Id. (quoting a partner in a New York law firm whose clients include hedge funds).
III. **Goldstein’s Improper Invalidation of the Hedge Fund Rule**

The SEC’s Hedge Fund Rule seemed to be exactly what was needed and none too late; it was a rule that would not overly burden the hedge fund industry but would nonetheless allow the SEC to learn vital information about the industry.\(^{116}\) However, Phillip Goldstein, a co-owner of the general partner of a hedge fund, Opportunity Partners L.P., did not see the Hedge Fund Rule this way, and unfortunately the D.C. Circuit saw it his way.\(^{117}\)

In *Goldstein v. SEC*, Mr. Goldstein challenged the SEC’s Hedge Fund Rule,\(^{118}\) which amended the Advisers Act and would have required him to register as an investment adviser.\(^{119}\) The Hedge Fund Rule required hedge fund managers to look through the hedge fund and count shareholders, limited partners, members, or beneficiaries as “clients.”\(^{120}\) This Hedge Fund Rule changed the SEC’s 1985 safe-harbor rule, which designated the hedge fund as the manager’s client and not the individual investors in the fund.\(^{121}\) Mr. Goldstein challenged the Hedge Fund Rule’s modified definition of “client.”

Mr. Goldstein challenged the propriety of the amendment on two separate grounds. First, he argued that within the Advisers Act, the term “client” was not ambiguous and the SEC misinterpreted the term.\(^{122}\) Second, Mr. Goldstein argued in the alternative that even if “client” were ambiguous, the SEC’s definition fell “outside the bounds of reasonableness.”\(^{123}\) Clearly, the *Goldstein* court should have resolved this

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\(^{116}\) As one scholar stated: “Even opponents of more hedge fund regulation generally concede that the SEC’s adopted rule change is a measured step . . . .” Paredes, *supra* note 8, at 990. The SEC noted an even more positive result from its investigations into the possible burden of requiring hedge fund managers to register under the Advisers Act: “No [hedge fund manager] identified any provision of the Advisers Act or Commission rules that, if applied to hedge fund advisers, would [impede the operations or investment activities of hedge fund advisers].” SEC: *HEDGE FUND GROWTH*, *supra* note 3, at 91.

\(^{117}\) *See Goldstein v. SEC*, 451 F.3d 873, 884 (D.C. Cir. 2006).

\(^{118}\) *See id.* at 874.


\(^{120}\) 17 C.F.R. pts. 275, 279 (2006), *invalidated by Goldstein*, 451 F.3d 873. In practical effect, this change would have caused Mr. Goldstein, and most other hedge fund managers, to register with the SEC as investment advisers. *See Goldstein*, 845 F.3d at 874. As a reading aid and to avoid the cumbersome repetition of the phrase “the term ‘client’” throughout this Note, “client” (and its derivatives) is set off in quotes when discussing its definition or its interpretation by the *Goldstein* court or the SEC.

\(^{121}\) *See supra* notes 84–86 and accompanying text (describing the SEC’s 1985 safe-harbor rule and its effect on the hedge fund industry).

\(^{122}\) *See Goldstein*, 845 F.3d at 874.

\(^{123}\) *See id.* at 878.

\(^{124}\) *See id.* at 880–81.
case within the highly deferential framework of the *Chevron* doctrine.\textsuperscript{125} However, the court’s decision to vacate the Hedge Fund Rule\textsuperscript{126} is at odds with the *Chevron* doctrine and, more importantly, showed a lack of understanding both of the purposes of securities regulations and of the dangers that hedge funds pose to unsophisticated individual investors.

A. The Small Problem: The Goldstein Court’s Misapplication of the *Chevron* Doctrine

Since 1984, when the Supreme Court decided *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,\textsuperscript{127} much has been written about the two-step procedure for analyzing an agency’s interpretation of a statute.\textsuperscript{128} It is beyond the scope of this Note to discuss the *Chevron* doctrine at length; however, to understand the inadequacy of the Goldstein court’s administrative-law reasoning, a basic understanding of *Chevron*’s two-step procedure, and the high degree of deference that the procedure demands,\textsuperscript{129} is necessary.

The *Chevron* doctrine derives from the following statement by the Court:

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes the legislative delegation to an agency...


\textsuperscript{126} See Goldstein, 451 F.3d at 884.

\textsuperscript{127} 467 U.S. 837 (1984).


\textsuperscript{129} See, e.g., Merrill & Hickman, supra note 128, at 833–35 (describing the result of this deferential mode of analysis and the changes it has wrought in the court system).
on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.\(^\text{130}\)

This language has led courts to develop a two-step procedure known as the \textit{Chevron} doctrine.\(^\text{131}\) The first step asks whether the statute at issue has a gap or ambiguity, and if so, the second step asks whether the agency’s interpretation is reasonable.\(^\text{132}\) The second step of the \textit{Chevron} doctrine is extremely deferential to the agency’s interpretation.\(^\text{133}\)

Thus, if an agency can show a gap or ambiguity in a statute, a court will typically uphold the agency’s interpretation.\(^\text{134}\) The reason for this is simple. For a court to invalidate an agency’s interpretation of an ambiguous statute, the court must conclude that the agency, which is presumably the foremost governmental expert in its domain,\(^\text{135}\) interpreted the statute “arbitrarily, capriciously, or manifestly contrary to the statute.”\(^\text{136}\) Moreover, the Supreme Court seems to endorse the idea that \textit{Chevron} deference is mandatory in most agency interpretation situations because Congress implicitly intends for courts to apply \textit{Chevron}.\(^\text{137}\)

\(^{130}\) \textit{Chevron}, 467 U.S. at 843–44 (footnote omitted).


\(^{133}\) See, e.g., Nat’l R.R. Passenger Corp., 503 U.S. at 417 (noting the high level of deference that \textit{Chevron} compels); Beall v. United States, 467 F.3d 864, 869 n.19 (5th Cir. 2006) (same); Conn. Office of Prot. & Advocacy for Persons with Disabilities v. Hartford Bd. of Educ., 464 F.3d 229, 239 (2d Cir. 2006) (same); see also Merrill & Hickman, supra note 128, at 833–34 (same).

\(^{134}\) See, e.g., Nat’l Cable, 545 U.S. at 986 (upholding an agency interpretation as reasonable under \textit{Chevron} step two); INS v. Aguirre-Aguirre, 526 U.S. 415, 425 (1999) (same); Nat’l R.R. Passenger Corp., 503 U.S. at 417–18 (same). \textit{But see} Brown & Williamson Tobacco Corp., 529 U.S. at 160–61 (finding that \textit{Chevron} applied but that there was no ambiguity in the statute at issue and therefore the agency’s interpretation was outside the scope of its power).

\(^{135}\) See, e.g., Gonzales v. Oregon, 546 U.S. 243, 255 (2006) (acknowledging that agencies have expertise and knowledge of their fields); \textit{Brown & Williamson Tobacco Corp.}, 529 U.S. at 132 (citing Rust v. Sullivan, 500 U.S. 173, 187 (1991)) (noting that agencies have greater familiarity with the facts and circumstances surrounding the subjects they regulate); United States v. O’Hagan, 521 U.S. 642, 673 (acknowledging that an SEC rule is entitled to \textit{Chevron} deference).


\(^{137}\) See Merrill & Hickman, supra note 128, at 870–73. Merrill and Hickman argue that the strongest and most plausible argument in favor of applying \textit{Chevron} is based on the presumption that Congress has implicitly commanded the courts to do so. \textit{Id.} at 870–71. Merrill and Hickman also discuss the benefits and implications of analyzing \textit{Chevron} questions with this idea of a
Therefore, the Goldstein court should have explicitly applied the deferential two-step Chevron doctrine, also known as Chevron deference.

1. Chevron Step One: Is “Client” Really Ambiguous?

Under Chevron step one, the Goldstein court had to decide whether the Advisers Act left a gap or an ambiguity in the definition of “client” that the SEC is charged with filling or clarifying.\(^{138}\) The Goldstein court initially pointed out that “client” may not be ambiguous; therefore, the SEC’s Hedge Fund Rule should fail at Chevron’s first step.\(^{139}\) Under Chevron step one, the words of a statute must be read in context—in consideration of the whole statutory scheme and with a view toward the problem Congress sought to solve—to determine whether Congress has foreclosed agency interpretation.\(^{140}\)

The Goldstein court had two main rationales for why “client” is not open to the SEC’s interpretation: First, a congressional amendment in 1970 clarified that investment company entities, and not their shareholders, are an adviser’s clients.\(^{141}\) Second, other sections of the Advisers Act, the SEC’s own prior statements, and a Supreme Court decision all demonstrate that “client” is clearly defined.\(^{142}\)

Both of the Goldstein court’s rationales are without merit. The first rationale is unpersuasive because it is contrary to prior and subsequent legislative history. The court first looked to a 1970 amendment to the Advisers Act that eliminated an exemption for advisers that advised only companies registered under the Company Act.\(^{143}\) Using this amendment as justification, the Goldstein court reasoned that there would have been no need to eliminate the exemption if Congress intended shareholders or investors in registered companies to count as clients.\(^{144}\) However, at the time of the 1970 amendment, Congress disavowed any effect of the

\(^{138}\) See Chevron, 467 U.S. at 843–44.

\(^{139}\) See Goldstein v. SEC, 451 F.3d 873, 878–81 (D.C. Cir. 2006). The court noted that “[t]he lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous,” id. at 878, which is certainly true. Nonetheless, the Supreme Court has stated that in the absence of a statutory definition “[t]he existence of alternative dictionary definitions . . . each making some sense under the statute, itself indicates that the statute is open to interpretation.” Nat’l R.R. Passenger Corp., 503 U.S. at 418.


\(^{141}\) Goldstein, 451 F.3d at 879.

\(^{142}\) Id. at 879–80.


\(^{144}\) Goldstein, 451 F.3d at 879.
amendment on “the existing exemptions from registration for investment advisers . . . other than those advising investment companies.”\textsuperscript{145}

Moreover, in 1980, when Congress again amended the Advisers Act, it acknowledged the ambiguity of “client” but chose not to define the term, except in reference to business development companies (i.e., venture capital companies).\textsuperscript{146} Indeed, other than in the business development context, Congress stated that the amendment does not suggest whether “each shareholder, partner or beneficial owner . . . should or should not be regarded as a client.”\textsuperscript{147} Thus, at the very least, Congress knew of and chose not to eliminate the ambiguity of “client.”

The second rationale is unpersuasive because none of the sources that the court refers to either speak to or about Congress’s definition of “client.” The court looked to the Advisers Act’s definition of “investment adviser,” the SEC’s own prior statements, and a Supreme Court decision to demonstrate that “client” is clearly defined.\textsuperscript{148} However, taken together these sources do not begin to show that Congress clearly defined “client.” Rather, at best, they explain that a client typically receives advice directly from an adviser who owes a fiduciary duty to the client, and such an explanation of behavior is certainly not a definition of “client.”\textsuperscript{149} Under the \textit{Chevron} doctrine, the question is whether Congress has left a gap or ambiguity in the statutory text, and not whether the SEC or the courts have clearly defined terms within that text.\textsuperscript{150} It is doubtful that former SEC statements or Supreme Court decisions can be used to show congressional clarity at \textit{Chevron} step one; therefore, only the language of the Advisers Act is truly probative to a proper analysis. Indeed the SEC’s 1985 safe-harbor rule, which the \textit{Goldstein} court marshals in as evidence that “client” is clearly defined, did not even conclusively foreclose differing interpretations of “client.”\textsuperscript{151} Moreover, \textit{Lowe v. SEC},\textsuperscript{152} which the \textit{Goldstein} court used to show that the Supreme Court clearly defined “client,” actually has no bearing on the definition of “client” because, as the \textit{Goldstein} court admits, “the \textit{Lowe} Court was not rendering an interpretation of the word ‘client.’”\textsuperscript{153}

The \textit{Goldstein} court acknowledged that its rationales were unconvincing and that “client” is ambiguous when it summarily concluded

\begin{itemize}
\item \textsuperscript{147} See id.; see also \textit{Goldstein}, 451 F.3d at 879.
\item \textsuperscript{148} See \textit{Goldstein}, 451 F.3d at 879–80.
\item \textsuperscript{149} See id.
\item \textsuperscript{150} See supra notes 130–37 and accompanying text.
\item \textsuperscript{151} See Brief of the SEC, Respondent, at 29–30, \textit{Goldstein}, 451 F.3d 873 (No. 04-1434).
\item \textsuperscript{152} 472 U.S. 181 (1985).
\item \textsuperscript{153} See \textit{Goldstein}, 451 F.3d at 880.
\end{itemize}
that “the Advisers Act does not foreclose the [SEC’s] interpretation.” 154
Properly applying precedent to this conclusion should have compelled the Goldstein court to uphold the Hedge Fund Rule as a reasonable interpretation of the Advisers Act.155 However, the court did not properly apply precedent and instead went on to invalidate the Hedge Fund Rule under the arbitrary and capricious standard of Chevron step two.156

2. Chevron Step Two: Is It Arbitrary and Capricious to Equate “Investor” with “Client”?

Under Chevron step two, a court must defer to an agency’s interpretation if that interpretation is reasonable or permissible.157 Therefore, unless the SEC’s interpretation of “client” was “utterly unreasonable and thus impermissible,”158 the Goldstein court should have upheld the Hedge Fund Rule.159 Despite giving lip service to the high degree of deference required at Chevron step two, the Goldstein court set forth three rationales that purported to demonstrate that the SEC’s interpretation was unreasonable.160

First, the court reasoned that the SEC’s interpretation of “client” would create a conflict of interest by requiring the hedge fund manager to be a “servant[] of two masters”—the hedge fund and the individual investors.161 Second, because the fundamental relationship between hedge fund managers and hedge fund investors had not changed since 1985, the court reasoned that the SEC could not change its interpretation of “client”

154. Id. at 880–81.
155. The Goldstein court probably would have preferred to dispose of the Hedge Fund Rule at Chevron step one because of the difficulty in persuasively and rationally overcoming the high degree of deference that Chevron step two demands. See supra notes 134–37 and accompanying text (describing the high level of deference that Chevron step two demands and the difficulty of demonstrating that an agency’s interpretation is arbitrary and capricious).
156. See Goldstein, 451 F.3d at 880–84. Although the Goldstein court strained itself in its attempts to show that “client” is not ambiguous, the court’s own admissions mitigate the force of its arguments. The court admitted that “[c]lient may mean different things depending on context” and noted that an attorney–client relationship is different from an architectural firm’s client relationship. Id. at 878; see also Nat’l R.R. Passenger Corp. v. Boston & Me. Corp., 503 U.S. 407, 418 (1992) (noting that if various dictionary definitions make sense, then a statute is open to interpretation); Brief of the SEC, supra note 151, at 29–30 (indicating the various dictionary definitions for “client”).
158. Goldstein, 451 F.3d at 881.
159. See supra note 157 and accompanying text.
160. Goldstein, 451 F.3d at 881–84.
161. Id. at 881.
from the one embodied in the 1985 safe-harbor rule.\textsuperscript{162} Finally, the \textit{Goldstein} court reasoned that the SEC’s interpretation did not meet the policy goals underlying the Advisers Act.\textsuperscript{163} As explained below, none of the \textit{Goldstein} court’s rationales are persuasive, and they all fail to give the proper level of deference required under \textit{Chevron} step two.

\textbf{a. Imagined Conflicts}

The \textit{Goldstein} court reasoned that investors cannot be owed a fiduciary duty, which they would be owed if treated as “clients,” because such a requirement would conflict with the fiduciary duty owed to the hedge fund.\textsuperscript{164} “If the investors are owed a fiduciary duty and the [hedge fund] is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest.”\textsuperscript{165} However, this conclusion is flawed because it does not acknowledge that hedge fund managers generally owe investors a fiduciary duty under applicable statutory provisions\textsuperscript{166} and under common-law precedents.\textsuperscript{167}

Hedge funds are typically organized as limited partnerships (LPs) or limited-liability companies (LLCs).\textsuperscript{168} Under the laws controlling LPs, a general partner, the hedge fund manager, owes a fiduciary duty to all of its limited partners, the investors.\textsuperscript{169} Likewise, under LLC statutes, the managing member, the hedge fund manager, owes a fiduciary duty to the other members, the investors.\textsuperscript{170} Thus, independent of the SEC’s
interpretation of “client,” a hedge fund manager necessarily owes a fiduciary duty to its investors in virtue of the mere organizational structure of the hedge fund.\(^{171}\)

Moreover, almost thirty years ago, the Second Circuit implicitly concluded, in *Abrahamson v. Fleschner*,\(^{172}\) that hedge fund managers owe a fiduciary duty to their investors.\(^{173}\) In *Abrahamson*, the Second Circuit concluded that hedge fund managers were covered as investment advisers under the Advisers Act because they were engaged “in the business of advising others.”\(^{174}\) The Second Circuit found that the plaintiffs, hedge fund investors, were clients of the defendant, a hedge fund manager, within the meaning of the Advisers Act;\(^{175}\) therefore, the investors were owed fiduciary duties.\(^{176}\)

The *Goldstein* court, however, attempted to dismiss the persuasive effect of the *Abrahamson* decision by limiting the holding to the “proposition that investors in a hedge fund may sustain an action for fraud against the fund’s adviser.”\(^{177}\) This limitation is unconvincing given that the *Abrahamson* decision repeatedly uses the terms “investor” and “client” interchangeably, indicating its conclusion that hedge fund investors were clients under the Advisers Act and thus owed fiduciary duties.\(^{178}\)
compensation for managing the limited partners’ investments. . . . [R]ecommendations were intended to cover persons who made purchases and sales of securities with their clients’ funds. . . . [M]any investment advisers ‘advise’ their customers by exercising control over what purchases and sales are made with their clients’ funds.” (emphasis added)). Thus, the Abrahamson court concluded that hedge fund managers were advisers to their investors and that those investors are clients within the meaning of the Advisers Act. See id. However, the Goldstein court emphasized one omission by the Abrahamson court. See Goldstein, 451 F.3d at 879. The Goldstein court noted that the original Abrahamson opinion stated that general partners were advisers “to the limited partners,” but that in the final opinion, those four words were omitted. See id. Thus, the Goldstein court believed this omission indicated that the Abrahamson court “expressly declined to resolve any ambiguity in the term ‘client.’” Id. Taken in isolation, the Goldstein court’s reading may be persuasive; however, given the entirety of the Abrahamson opinion, there is much evidence that the Abrahamson court concluded that hedge fund investors were clients within the meaning of the Advisers Act.

179. The reason for this is obvious: hedge fund entities are mere “legal artifice.” See Brief of the SEC, supra note 151, at 40–41. The Goldstein court postulated that if a hedge fund was contemplating filing for bankruptcy, then the manager would be conflicted because the interests of the hedge fund and those of its investors are not aligned. See Goldstein, 451 F.3d at 881. Specifically, the court suggested that the hedge fund manager, acting in the best interests of each party, would advise the hedge fund to remain solvent but would advise the investors to get out with as much money as possible by selling as soon as possible. Id. This suggestion, however, is blind to the reality that most hedge fund managers invest substantial sums of their own money in the fund. See supra note 30 and accompanying text. Therefore, a hedge fund manager would never advise the hedge fund, which is mere legal artifice, in any way that would be adverse to the investors, including the manager herself. In reality, the hedge fund is a mere shell, and all of the investors’ and the manager’s interests are directly aligned toward maximizing profit. Thus, no conflicts exist because there is only one interest—the investors’. Admittedly, as the Goldstein court notes, “form matters,” Goldstein, 451 F.3d at 882; however, the court should not have elevated form so far over substance as to create conflicts where none exist.

180. See Goldstein, 451 F.3d at 882.

b. Failure to Acknowledge Changed Factual Circumstances

The Goldstein court next concluded that because the fundamental nature of the relationship between hedge fund managers and investors had not changed, it was unreasonable for the SEC to change its interpretation of “client.” In 1985, the SEC passed a safe-harbor rule that allowed hedge fund managers to count the hedge fund, and not the individual
investors, as a client, and the Goldstein court seemed to think that this rule should forever bind the SEC. The court stated, “the [SEC] has failed adequately to justify departing from its own prior interpretation of § 203(b)(3)” of the Advisers Act because the SEC has not shown “any change in the nature of investment adviser–client relationships since the safe harbor rule was adopted.”

However, this reasoning contradicts administrative-law precedents. The Supreme Court has long recognized that administrative agencies may change their rules and interpretations, even in direct contradiction to their old rules and interpretations. For example, in a 1973 decision, the Supreme Court stated:

[An] agency may flatly repudiate [its prior] norms, deciding, for example, that changed circumstances mean that they are no longer required . . . to effectuate congressional policy. Or it may narrow the zone in which some rule will be applied, because it appears that a more discriminating invocation of the rule will best serve congressional policy.

Similarly, the Supreme Court suggested in Chevron that agency interpretations must be subject to change because “the agency . . . must consider varying interpretations and the wisdom of its policy on a continuing basis.”

Likewise, in a 1996 decision, the Court reasoned that “the mere fact that an agency interpretation contradicts a prior agency position is not fatal. . . . [T]he whole point of Chevron is to leave the discretion provided by the ambiguities of a statute with the implementing agency.” Thus, the Goldstein court’s suggestion that it was unjustifiable for the SEC to depart from its prior interpretation is contrary to administrative-law principles and ignores the SEC’s reasons for changing its interpretation of “client.”

The SEC justified its Hedge Fund Rule by noting drastic changes in the

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181. See id. at 879 n.5, 882–83. However, the Goldstein court failed to appreciate that the SEC was not foreclosing differing interpretations of “client” in passing the 1985 safe-harbor rule. See supra note 151 and accompanying text.

182. Goldstein, 451 F.3d at 883.

183. Id.


hedge fund market, including the following: (1) hedge fund assets grew by 260% from 1999 to 2004, (2) hedge funds increasingly reached ordinary investors, and (3) hedge funds have been increasingly involved in fraudulent activities. Thus, “in response to changed factual circumstances,” the SEC changed its interpretation of “client.” Clearly then, the Goldstein court’s conclusion—that the fundamental nature of the relationship between hedge fund managers and investors must change to justify the SEC’s new interpretation— is invalid.

**c. Substituting Judgment**

Blatantly out of line with administrative-law principles, the Goldstein court substituted its own judgment for the judgment of both the SEC and Congress. According to the court, the SEC should have used different criteria in choosing how to define “client.” The Goldstein court stated, “If there are certain characteristics present in some investor–adviser relationships that mark a ‘client’ relationship, then the [SEC] should have identified those characteristics and tailored its rule accordingly.” Thus, the court admits that the SEC gave a reason for reinterpreting “client,” but the court would have preferred if the criteria were narrowed. Under Chevron step two, however, the court is not permitted to substitute its own

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188.  Nat’l Cable, 545 U.S. at 981.
189.  See Goldstein, 451 F.3d at 883.
190.  See supra notes 184–86 and accompanying text. If the Goldstein court’s reasoning was valid, agencies would be handicapped in reacting to changed factual circumstances. For example, the EPA would never be able to amend its list of pollutants because the fundamental nature of a compound (i.e., its chemical structure) never changes even if the surrounding factual circumstances change dramatically (i.e., the EPA learns that the compound is destroying the ozone layer).
191.  See Goldstein, 451 F.3d at 882–83. In addition to the changed factual circumstances, the SEC noted that investors have different contractual terms (e.g., different management and performance fees, lock-up periods, and “side pocket” arrangements) with hedge fund managers. See id. at 882.
192.  Id. at 883. The Goldstein court’s mention of tailoring is interesting here because only a few lines further down in the opinion, the court criticized the SEC for carving out an exception solely for entities with fewer than one hundred but more than fourteen investors. Id. Thus, the Goldstein court simultaneously criticized the SEC for not tailoring narrowly enough and for tailoring too narrowly.
193.  That is, hedge fund managers and investors often negotiate different terms for their advising relationship. See supra note 191 and accompanying text.
194.  Indeed, the court criticized the SEC for “painting with such a broad brush.” Goldstein, 451 F.3d at 883. Again, and it bears repeating, the court is not even internally consistent because it later criticizes the SEC for tailoring too narrowly. See supra note 192 and accompanying text.
judgment for the judgment of the SEC. 195

Moreover, the Goldstein court went even further and substituted its own judgment for that of Congress when it wrote: “[I]f Congress meant to exclude regulation of small operations, it chose a very odd way of accomplishing its objective—by excluding investment companies with one hundred or fewer investors and investment advisers having fewer than fifteen clients.” 196 Whether these exemptions are odd or not, they are the exemptions Congress chose. 197 Congress did not choose “volume of assets under management” 198 or “indebtedness of a hedge fund” 199 as its exemption criteria; rather, Congress chose absolute numbers of investors, and the SEC was obligated to fit within that framework. 200 Thus, any argument by the Goldstein court that the SEC should have used other criteria to make its rule not only violates the Chevron doctrine but also attempts to usurp Congress’s judgment. 201

By not employing the proper level of deference, the Goldstein court improperly applied the Chevron doctrine and ruled in a way that conflicts with the applicable administrative-law principles. 202 Further, and more
importantly, the Goldstein court failed to appreciate how its decision would undermine the primary purposes of the four principal securities regulations.

**B. The Big Problem: The Normative Failures of Goldstein and Their Implications on Regulatory Approaches**

Although the administrative-law shortcomings of the Goldstein opinion are disappointing, the normative failures are much more significant and detrimental because they serve as evidence, not only of the court’s failure, but also of the current regulatory failures. First, securities laws are generally designed to ensure investor confidence in the securities markets, and unregulated hedge funds will increasingly undermine investor confidence. Second, unregulated hedge funds pose significant dangers to the individual beneficiaries of pensions, endowments, and other

agency’s interpretation because of the high degree of deference required at that step. See supra note 155 and accompanying text.

203. It is interesting, but perhaps not ultimately surprising, that the SEC decided not to appeal the Goldstein decision. See Stephen Labaton, *Is the S.E.C. Changing Course?,* N.Y. TIMES, Mar. 1, 2007, at C1. One law professor thinks that the current SEC “is starting to take an historic shift away from investor interests.” *Id.* Indeed some investor advocates think that the current SEC is “moving closer to the business view that the administration overreacted to the corporate scandals that began with the collapse of Enron in 2001.” *Id.* One author notes that the current SEC chairperson, Christopher Cox, is a longtime proponent of deregulation of securities markets. Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation,* 38 CONN. L. REV. 393, 393–94 (2006). Much like the Goldstein court, the current SEC is failing to appreciate the normative standards established by the main securities regulations. There is great irony in the SEC’s failure to appeal the Goldstein decision and its nice statements to the press: “If America’s markets aren’t transparent and open, investors lose . . . we all lose . . . .” Kara Scannell, *SEC to Investors: More Internet, Less Hedge Funds,* WALL ST. J., Dec. 14, 2006, at C1 (quoting Christopher Cox, SEC Chairperson). The SEC’s failure to appreciate the dangers hedge funds pose and its willingness to support extremely pro-business measures is probably just an instance of the larger phenomenon of the backlash against protections enacted after the Enron and WorldCom scandals of the early 2000s. See generally Gerding, *supra* (describing the recent backlash against the Sarbanes-Oxley Act and the pro-business effects this backlash has to the detriment of individual investors).

204. This Part’s discussion of the normative failures of the Goldstein court applies equally to the current regulatory regime. Therefore, this Note uses Goldstein as a microcosm example of the failures within the regulatory and political arenas at large. Part IV of this Note explicitly addresses the shortcomings of the current regulatory proposals for dealing with the dangers that hedge funds pose.

205. *See* United States v. O’Hagan, 521 U.S. 642, 658 (1997) (stating that the animating purpose of the Exchange Act is “to insure honest securities markets and thereby promote investor confidence”); *see also* Paredes, *supra* note 8, at 990 (“[T]he SEC is charged with ensuring that investors are sufficiently confident in the integrity of securities markets so that they do not withdraw from the market.”); Greupner, *supra* note 30, at 1579–80 (noting that the Exchange Act was passed to restore investor confidence and reinvigorate markets).

206. *See infra* notes 210–23 and accompanying text.
charities that invest heavily in hedge funds. Finally, the growing numbers of FOHF's and publicly traded hedge fund management companies have allowed hedge funds to reach the individual investors whom securities regulations are designed to protect.

First, one of the primary purposes of securities regulations is to ensure investor confidence in the markets. But the Goldstein court failed to take any account of this purpose. This failure was a major misstep because hedge funds, and the increased exposure of their illegal activities, erode investor confidence. As one commentator writes, "Retail investors [i.e., unsophisticated investors] in particular might come to believe that the market is rigged against them as they continue to read about hedge fund antics." On that note, because hedge funds handle enormous sums of money, they have access to services and information that few other market participants have. These service and information asymmetries are

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207. See infra notes 224–32 and accompanying text.
208. See infra notes 233–52 and accompanying text.
209. See supra note 205; see also Karmel, supra note 14, at 936 ("[T]he SEC was created to be the policeman of Wall Street, a regulator of the stock exchanges and securities industry . . . .").
210. See supra notes 13–16, 107–15 and accompanying text. Even with the SEC’s increased awareness of hedge funds acting illegally and the corresponding increase in enforcement proceedings, without regulation or registration requirements, the SEC can gain only anecdotal evidence about hedge fund activities. See Greupner, supra note 30, at 1572. Moreover, given the SEC’s scant resources, it may be limited to bringing actions only in high profile cases while ignoring others. See id. Thus, neither the SEC nor anyone else knows the true extent of the illegal activities of hedge funds. This ignorance is particularly troubling because of the power hedge funds have over the securities markets and all investors therein. See supra notes 91–98 and accompanying text.
211. See Paredes, supra note 8, at 1002 (noting that illegal activities by hedge funds may damage investor confidence in the markets and that the SEC’s failure to regulate hedge funds may further damage investor confidence); Ng, supra note 15 ("[T]he appearance of unethical conduct by market participants could erode confidence in the securities and derivatives markets.").
212. Paredes, supra note 8, at 1002.
213. See supra notes 94–95 and accompanying text.
214. See Laurie P. Cohen, Private Money: The New Financial Order—In the Know: Seeking an Edge, Big Investors Turn to Network of Informants, WALL ST. J., Nov. 27, 2006, at A1 (discussing a “consulting” firm, the Gerson Lehrman Group, that has a network of 180,000 informants who disclose information about their employers to high-paying subscribed investors—often hedge fund managers); Brody Mullins & Kara Scannell, Private Money: The New Financial Order—Political Intelligence: Hedge Funds Hire Lobbyists to Gather Tips in Washington, WALL ST. J., Dec. 8, 2006, at A1 (indicating that hedge funds are increasingly hiring lobbyists and paying them up to $20,000 per month for “political intelligence,” much of which is market-moving information, from Congress); Henny Sender & Anita Raghavan, Private Money: The New Financial Order—First Call: Worry Amid Hedge Fund Boom: Privileged Access to Information, WALL ST. J., July 27, 2006, at A1 (describing the “symbiotic relationships” between hedge funds and securities firms that compel those firms to give privileged information to hedge funds in exchange for continued hedge fund brokerage fees).
contrary to the principles underlying securities regulations and allow hedge funds to make nearly risk-free bets. This leaves individual investors with information from "the public domain [that] is worthless in terms of making money." Thus, it is difficult for individual investors to remain confident in an inherently risky market when the market’s biggest players play by different rules and without any of the attendant risks.

Moreover, the investment strategies that hedge funds use can raise costs and lower performance for long-term investors. In general, unlike more common long-term investors, hedge funds want volatile markets because they make their money on volatility. As hedge funds continue to grow in terms of assets and trading volume, their increased access to unique information from the public domain is worthless in terms of making money.

215. See Paredes, supra note 8, at 1005 ("[F]ederal securities regulation is primarily orientated toward investor protection in the sense of remedying information asymmetries . . . .").

216. See, e.g., Sender & Raghavan, supra note 214 (providing an example of four hedge funds that "used privileged information to make substantial capital gains with certainty"); see also Mullins & Scannell, supra note 214 (describing one instance when hedge funds profited from their large stakes in asbestos companies when Congress announced it was planning to implement a $140 billion public trust fund for asbestos-related liability claims). This practice of using "political intelligence" to place sure bets is growing; hedge fund managers have begun looking at many political issues, including Internet gaming bills, Medicaid reimbursements, foreign ownership of U.S. ports, and corporate tax legislation. Mullins & Scannell, supra note 214. As one lawyer put it, "There are a lot of savvy investors who have realized that there is a lot of money to be made from what Congress does," id., but only hedge funds have access to that money-making information.

217. Cohen, supra note 214 (quoting a partner in a private investment firm that uses the Gerson Lehrman Group’s consultant network to gather implicitly non-public information).

218. When discussing the early success of a hedge fund, one writer stated the advantage that hedge funds have over other market participants like this: "Muttering began that fast-trading [hedge fund] managers . . . enjoyed an unfair advantage over Main Street investors—that they were, in essence, playing cards with a rigged deck." Pulliam, supra note 11.

219. See Burns, supra note 14. Steven Cohen, one of the most prominent hedge fund managers, admitted as much when he stated: "The old guard wasn’t crazy about me. I used to hear it all the time. We were trading more than investing, and people frowned on it." Pulliam, supra note 11 (quoting Steven Cohen).

220. See Karmel, supra note 14, at 929 (noting that institutional investors, like hedge funds, "do not invest for the long term, but have a trader’s mentality . . . . [and] such trading strategies are harmful . . . to the markets" (footnote omitted)).

221. See id. at 927 (stating that one strategy used by hedge funds, market timing, “results in rapid trading during the course of a single day. Such trading contributes to market volatility and is inconsistent with any concept of a shareholder as an owner of a corporation.” (footnote omitted)); Alistair Macdonald & Margot Patrick, ‘Macro’ Gang Hangs Tough, WALL ST. J., Feb. 15, 2007, at C1 (“Global macro, like other hedge-fund strategies, profits from bets on big swings, or volatility.”); Thomas, supra note 12 (“Hedge . . . funds have been cited as contributing to volatility in the commodity markets . . . .”). Thus, during the market’s collapse in early March 2007, one hedge fund manager made roughly $250 million on the market’s volatility, while “a number of small investors making more-mundane stock-market bets were left holding the bag.” Susan Pulliam et al., As Market Fell, Some Big Names Won Their Bets, WALL ST. J., Mar. 1, 2007, at A1.

222. See supra notes 91–98 and accompanying text.
information and their desire for volatile markets will continue to further erode investor confidence. Thus, by ignoring the effects its decision would have on investor confidence, the Goldstein court undermined one of the fundamental purposes of the securities laws—promoting investor confidence.223

Second, the Goldstein court failed to appreciate the significant dangers hedge funds pose to the individual beneficiaries of pensions, endowments, and charitable organizations.224 Although pensions, endowments, and charities may fit within the statutory exemptions for sophisticated investors,225 there is no requirement that their trustees be sophisticated. Using wealth as a proxy for sophistication does not work with pensions and endowments226 because the beneficiaries are the ones who are truly exposed to the risks of hedge funds.227

There are numerous examples of hedge fund activities harming endowments and charitable entities.228 For example, when a hedge fund lost nearly $1.4 billion of its assets, numerous college endowments were affected, including those of Yale University and Brown University.229

223. The Goldstein court mentioned the underlying purposes of the securities acts only when it admitted that the Advisers Act was meant to “‘substitute a philosophy of full disclosure for the philosophy of caveat emptor’ in the investment advisory profession.” See Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)). This admission is certainly important to the issue in Goldstein, but it is also limited insofar as it fails to account for the other purposes of the other principal securities acts, which all work together to promote the same goal of ensuring investor confidence. See supra note 205 and accompanying text.

224. See Partnoy, supra note 77 (indicating that one in five pension funds invest in hedge funds and that pension funds, university endowments, and other charitable organizations invest an average of 10% of their assets in hedge funds). After the collapse of Amaranth, resulting in losses of more than $6 billion, a pension fund was the first party to sue Amaranth. See Ann Davis, San Diego Pension Fund Sues Amaranth Advisors, WALL ST. J., Mar. 31, 2007, at A7. Apparently the pension fund was not interested in a quick disbursement of the meager assets remaining in Amaranth. For a brief discussion of the Amaranth collapse and its attempt to limit its exposure to litigation, see supra notes 11, 110 and accompanying text.

225. See supra notes 41–51, 65 and accompanying text.

226. Arguably, this proxy does not work well in any circumstance, but it is certainly much less effective when it does not apply to the actual decision maker. See supra notes 50–51 and accompanying text.

227. See Karmel, supra note 14, at 934 (“[T]he beneficiaries of [pensions, endowments, and charities] are exposed to the risks of hedge fund trading.”).

228. In fact, the SEC noted that the pace of pensions and endowments investing in hedge funds has increased in recent years. See SEC: HEDGE FUND GROWTH, supra note 3, at 82–83. As the SEC stated, “The collective indirect investment of the assets of less sophisticated individuals into vehicles that are managed by entities that are not examined by the [SEC] leaves open the possibility that the [SEC] will be unable to anticipate problems involving hedge funds that may invest on behalf of these institutions.” Id.

229. See Milestones, supra note 6; see also Gregory Zuckerman & Henny Sender, Exclusive Club: Ex-Trader Creates a Hot Fund, and a Traffic Jam, WALL ST. J., Jan. 12, 2005, at A1 (noting
Similarly, in 2001, the Chicago Art Institute endowment lost at least $43 million when the hedge fund it had invested in nearly collapsed. Although the SEC explicitly justified its Hedge Fund Rule with reference to the participation of pensions, endowments, and charities in hedge funds, the Goldstein court simply dismissed this justification as irrelevant in regards to the reasonableness of the SEC’s interpretation of “client.”

Finally, the Goldstein court’s decision undermines the normative principle, inherent in securities laws, that the SEC should protect individual investors. Within the last few years, two new hedge fund products have caused the “retailization” of hedge funds: FOHFs and publicly traded shares of hedge fund management companies.
Significant numbers of investors are purchasing interests in FOHFs, which are investment funds that invest primarily in hedge funds. Today, approximately 20% of hedge fund assets come from FOHFs. Because the underlying hedge funds are completely opaque to the FOHF manager and the individual investors buying into the FOHF, the SEC worried about the public investing in FOHFs without any restrictions. This opacity—a problem for sophisticated investors buying directly into hedge funds—is compounded in the FOHF product because the FOHF manager may unknowingly duplicate risky investments and magnify the FOHFs' risk exposure.

Similar dangers are posed by the recent trend of hedge funds going public with their management companies. When Fortress Investment Group LLC went public, its shares promptly almost doubled in value before closing 68% higher than their IPO price. As one commentator put

237. See supra note 235 and accompanying text.
239. See SEC: HEDGE FUND GROWTH, supra note 3, at 36, 81–82. Hedge funds dictate how they value their funds; therefore, investors cannot accurately judge the performance of individual hedge funds, much less accurately compare the performance of any hedge funds. See Robert C. Pozen, Hedge Funds Today: To Regulate or Not?, WALL ST. J., June 20, 2005, at A14 (“Although several services now promulgate performance statistics for a substantial number of hedge funds, there is no standard method for measuring performance or categorizing types of hedge funds. Moreover, the existing performance statistics have a serious survivor bias: Any hedge fund with a terrible record can simply shut down and reopen under a different name.”).
240. See Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006) (noting that the SEC, in part, justified its interpretation of “client” with reference to the “birth of ‘funds of hedge funds’”).
241. The SEC noted that “[t]he absence of any form of independent oversight over hedge fund pricing raises significant questions about the quality and fairness of the prices at which investors buy or redeem interests in some hedge funds.” SEC: HEDGE FUND GROWTH, supra note 3, at 80.
242. See id. at 82. The underlying hedge funds do not disclose their investment positions; therefore, the FOHF manager cannot know whether each hedge fund she invests in is placing the same bet and increasing the risk of her investments. See id.
243. See Annelena Lobb, Q&A: Opening the Hedges—What Will a Hedge-Fund IPO Mean for the Industry and Investors?, WALL ST. J. ONLINE, Dec. 17, 2006, http://online.wsj.com/article/SB116611696223650358.html (noting that one hedge fund expert believed that after Fortress Investment Group LLC, the management company for the Fortress hedge fund, went public many other hedge funds would follow suit); see also Eleanor Laise, Hedge Fund Beckons Small Investors, WALL ST. J., Feb. 14, 2007, at D1 (noting that many industry experts expect hedge funds to make similar public offerings); Alistair MacDonald, Hedge Funds to Tap the Public, WALL ST. J. ONLINE, Jan 10, 2007, http://online.wsj.com/article/SB116837977930171843.html (noting that two large hedge funds are planning on listing on the U.S. public exchanges and another is planning on listing on the London exchange).
244. See Zuckerman et al., supra note 236. As of August 2007, shares of Fortress were down approximately 5% from the IPO price. See Megan Davies, Tumbling Markets Cause U.S. IPO Jitters, REUTERS NEWS, Aug. 19, 2007 (noting that Fortress’s IPO price was $18.50 and that as of mid-August 2007 it was trading at around $17.50). Although Fortress was the first hedge fund
publicly to issue securities in the U.S., nineteen private-equity firms and hedge funds sold shares on foreign markets in 2006 (up from ten firms in 2005). See Zuckerman et al., supra note 236. In March 2007, after completing the largest private-equity buyout in history, Blackstone announced that it planned to go public. See Dennis K. Berman & Henny Sender, Big Buyout Firm Prepares to Sell Stake to Public, WALL ST. J., Mar. 17, 2007, at A1. After this move, it is expected that other large private-equity firms, including Carlyle, KKR, and TPG will go public. Id. Obviously, private money in the form of hedge funds and private-equity firms is looking to tap the larger public markets, and, in doing so, individual investors will be more widely exposed to investment risks. For an interesting discussion of some of the current legal issues that private-equity firms face, see generally Jessica Jackson, Note, Much Ado About Nothing?: The Antitrust Implications of Private Equity Club Deals, 60 FLA. L. REV. (forthcoming July 2008).

245. Laise, supra note 243. Although no one has discussed the inherent conflicts between the hedge fund management company’s duties to its shareholders and the management’s duty toward its hedge fund investors, this conflict is apparent. In fact it is similar to the worry that many have expressed in regards to mutual fund managers becoming hedge fund managers. See, e.g., Greupner, supra note 30, at 1585 (“There are still some potentially troubling issues that the SEC should monitor as a result of recent trends. Most notable are potential conflicts of interest for a manager running a mutual fund alongside a hedge fund. . . .”); Arvedlund, supra note 96 (“Conflicts of interest could arise from the widely different fees, which create an incentive for ‘cherry-picking’—allocating good trades to hedge funds at the expense of mutual funds.”). Thus, a manager may be bearish, and take short positions with its hedge fund, which would negatively impact its long positions in a mutual fund or the individual investors in the fund’s publicly traded management company. See SEC: HEDGE FUND GROWTH, supra note 3, at 84 (“The investment adviser [who manages a mutual fund and a hedge fund] may determine that an equity security that the mutual fund holds long is appropriate for the hedge fund to sell short. The short sale may . . . have a negative effect on the mutual fund’s performance.” (footnote omitted)). As the number of publicly traded hedge fund management companies grows, scholars should take the opportunity to analyze the inherent conflicts because the courts will certainly have to deal with these issues eventually.

246. See SEC: HEDGE FUND GROWTH, supra note 3, at 78. In 2003, when the SEC published its Implications of the Growth of Hedge Funds, it stated: “Although we did not observe an existing retail market for hedge funds, the potential for that market is clearly at hand.” Id. Obviously, in 2008, a retail market for hedge funds does exist, just as the SEC feared it would.

sophisticated investors is well documented, and given the results of Fortress’s IPO, it seems individual investors, whose access to exotic hedge funds previously had been blocked, will turn to those funds without accounting for the risks or demonstrable benefits. Importantly, the SEC is also charged with controlling speculative stock market behavior, and the Hedge Fund Rule would have served as a stop gap for some of the speculative behavior that is rampant, and is sure to increase, in the hedge fund industry. Once again, however, the Goldstein court failed to appreciate this purpose of the Hedge Fund Rule, and this failure undermined the SEC’s ability to control dangerous speculation.

248. See, e.g., McClean, supra note 28, at 135 (noting in reference to investors lacking information about a hedge fund that “[i]t appears investors are speculating and exhibiting the type of behavior consistent with a ‘bubble’ being present in the market”); Paredes, supra note 8, at 996–97 (“The concern is that if investors develop a ‘taste’ for hedge funds . . . they may not give due attention to the terms and conditions of their investments or may get comfortable investing in a hedge fund that is not appropriate for them.”); Zuckerman & Sender, supra note 229 (discussing one hedge fund—whose manager is a first-time hedge fund manager who had not managed money in years and would not disclose his trading strategy—charging over a 20% performance fee yet still having to turn investors away). Zuckerman and Sender further state that “big investors today are throwing money at the most promising hedge funds” just as they threw money at dot-com startups during the 1990s bubble. Zuckerman & Sender, supra note 229. Further, “Just as the earlier frenzies [i.e., the dot-com boom] ended badly, this one [i.e., the hedge fund boom] is starting to show signs of fraying around the edges.” Id. The connection between the 1990s boom and bust and the current behavior of investors in the hedge fund industry is gaining traction. See, e.g., Zuckerman et al., supra note 236 (“Frenzied investors are rewarding Fortress richly, striking chords of the dot-com boom of the 1990s, when newly minted companies went public and soared in their first days of trading.”).

249. See supra note 244 and accompanying text.

250. This speculation has two layers: the individual investors speculating in the FOHF or in the publicly traded hedge fund management companies; and the underlying hedge funds engaging in speculative investments. As one author describes hedge funds’ speculative investing nature, “Hedge funds in particular are one of the significant forces in speculative markets.” Karmel, supra note 14, at 913. Unfortunately, bubble behavior seems to be inevitable, and only proper regulation, which the SEC is charged with implementing, can keep it in check. See supra notes 247–48 and accompanying text. Even more unfortunate is that “the financial regulatory agencies, including the SEC, have been more concerned about the promotion of trading efficiencies . . . than they have been about preventing securities speculation.” Karmel, supra note 14, at 947–48.

251. See Karmel, supra note 14, at 913.

252. Unfortunately, the Goldstein court failed even to mention this fundamental principle of securities law, either because it was unaware or because it substituted its judgment for the SEC’s,
In the end, under two separate analyses, the Goldstein court failed to reach a proper decision. First, it diverged from the applicable administrative-law principles. Second, it failed to recognize the normative principles underlying the SEC’s Hedge Fund Rule and the securities regulations in general. Unfortunately, the SEC seems to be suffering from the same failures of reasoning by retreating from its Hedge Fund Rule and from investor protection in general. In effect, the current regulatory proposals reflect the short-sighted rationale of the Goldstein opinion, and the proposals will be ineffective in addressing the problems that hedge funds pose to individual investors.

IV. THE AFTERMATH OF GOLDSTEIN

A. The Inadequacy of Current Regulatory Proposals

The SEC chose not to appeal the Goldstein decision; instead, it has proposed raising the financial requirements for investing in hedge funds.

by concluding that hedge funds really do not implicate the dangers of speculation. In either situation, this was a significant failure on the court’s part. After the D.C. Circuit subsequently vacated another SEC rule, former SEC chairperson Harvey Pitt suggested that the SEC should have won the case and that the D.C. Circuit simply does not trust the SEC anymore. See Kara Scannell, Court Throws Out SEC Rule Protecting Certain Accounts, WALL ST. J., Mar. 31, 2007, at A6. Whatever the merits of trust in general, it should have no bearing on judicial reasoning.

253. See supra note 203 and accompanying text (discussing the SEC’s recent pro-business trends).

254. See supra note 203.

255. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 404–06 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230, 275); see also, e.g., Stephen Labaton, S.E.C. Eases Regulations on Business, N.Y. TIMES, Dec. 14, 2006, at C1 (noting that the SEC’s proposal would raise “qualifications for investors in hedge funds, to a net worth of $2.5 million from the current standard of $1 million”); Deborah Solomon, Regulators’ Hedge-Fund Approach: Hands Off, WALL ST. J., Feb. 23, 2007, at C1. For a discussion of the current financial requirements that the SEC is proposing to change, see supra notes 46–51 and accompanying text. The public’s response to this proposal is interesting, if only because the public seems to want even less protection than it already has. See Bethany McLean, SEC Slammed Over Hedge Fund ‘Wealth’ Test, CNNMONEY.COM, Feb. 11, 2007, http://money.cnn.com/2007/02/11/magazines/fortune/sec.fortune/?postversion=20070211116. Although the SEC subsequently finalized a portion of this proposed rule (i.e., the portion regarding the prohibition of fraud by hedge fund managers), the SEC deferred a final decision about whether to raise the minimum financial requirements for investing in a hedge fund. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44756, 44756 n.2 (to be codified at 17 C.F.R. pt. 275). The SEC justified its deferral of raising the minimum financial requirements on the ground that it needed more time to consider the comments submitted to it in May 2007. See id. This is an interesting justification if only because the SEC was apparently able to sufficiently consider the comments regarding the fraud provision, which were also submitted in May 2007. See id. Perhaps this is merely another example of the current pro-business SEC’s unwillingness to extend any practical protections to individual
Further, as a member of the President’s Working Group (PWG), the SEC is encouraging hedge funds both to give more meaningful disclosures to investors and to adhere to a set of non-binding principles and is asking counterparties and creditors (i.e., banks and other lending institutions) to help manage risks. Unfortunately, none of these proposals will effectively address the dangers hedge funds pose to individual investors.

Admittedly, raising the minimum financial requirements is a necessary first step to help limit, to some extent, the number of unsophisticated investors buying directly into hedge funds. Unfortunately, however, raising the requirement for direct purchases of interests in hedge funds does not address the dangers posed to beneficiaries of pensions and endowments or to unsophisticated investors by FOHFs and publicly traded hedge fund management companies. Moreover, raising the financial requirements does nothing to bolster investor confidence or correct the information asymmetries that exist between hedge funds and all other market participants.


258. In 1982, when the SEC adopted the original safe-harbor rule for accredited investors, approximately 1.87% of all U.S. households were qualified to invest in hedge funds; however, 8.5% are qualified today. Scannell, supra note 203. By increasing the requirement from $1 million to $2.5 million, only 1.29% will be qualified to purchase interests in hedge funds. Id.

259. See supra notes 224–32 and accompanying text (discussing the dangers hedge funds pose to beneficiaries of pensions, endowments, and other charitable entities).

260. See supra notes 233–42 and accompanying text (discussing how FOHFs endanger individual investors); see also supra notes 247–52 and accompanying text (explaining that hedge funds encourage dangerous speculative investing).

261. See supra notes 243–46 and accompanying text (discussing the dangers of publicly traded hedge fund management companies); see also supra notes 247–52 and accompanying text (explaining that hedge funds encourage dangerous speculative investing).

262. See supra notes 209–23 and accompanying text (discussing the erosion of investor confidence as a result of hedge funds’ activities in markets, particularly as a result of the information asymmetries).
The PWG’s non-binding proposals will be even less effective in addressing the problems and risks associated with hedge funds. As one investor advocate stated, “These vague recommendations [by the PWG] lack substance and specifics, making them unenforceable.” Moreover, the recommendations are a mere restatement, even if in a quasi-authoritative form, of the principles that already undergird hedge fund activities.

Moreover, none of the PWG’s proposals will help to mitigate the dangers hedge funds pose to individual investors. For example, hedge funds are already legally obligated to provide all material information to their investors, and many hedge fund groups have released various best practices. Similarly, the Treasury Department and Federal Reserve already regulate all hedge fund creditors and counterparties; however, these creditors and counterparties are willing to take unreasonable risks for their hedge fund clients. Thus, the PWG’s proposals are really nothing

263. Solomon, supra note 255 (quoting the Attorney General of Connecticut, Richard Blumenthal). Mr. Blumenthal also chided the PWG because its “inaction and inertia will invite—indeed, fuel—state initiatives.” Id.

264. The PWG admits that it is not specifying any new standards when it states, “Since we last made a statement on [private pools of capital] in 1999, the market has matured and expanded considerably, and these fundamental principles have increasingly been reflected in best practices. The current regulatory structure, which is also based on these principles, is working well.” PWG AGREEMENT, supra note 256, at 1. The principles that the PWG refers to include the following: “Private pools of capital can be an appropriate investment vehicle for more sophisticated investors,” id.; “Investors in private pools of capital should obtain accurate and timely . . . material information,” id. at 2; and “Concerns that less sophisticated investors are exposed indirectly to private pools through holdings of pension funds, fund-of-funds, or other similar pooled investment vehicles can best be addressed through sound practices on the part of the fiduciaries,” id. Thus, the PWG did not say much in its agreement, but what the PWG did say assured hedge funds that it would not pursue any form of regulation. As one commentator sardonically noted: “Well, it shouldn’t have come as a surprise. President George W. Bush’s working group on hedge funds finished its work with the stunning conclusion that . . . there should be no new regulations.” Altman, supra note 100 (ellipsis in original).

265. See supra notes 41–44 and accompanying text (indicating that to meet the exemption requirements of the Exchange Act, a hedge fund must disclose information that is comparable to that required for publicly offered securities). Of course, whether hedge funds ever give sufficient disclosures is a largely unanswered question that motivated, in part, the Hedge Fund Rule. One of the SEC Staff’s recommendations in 2003 was to require hedge funds to deliver to investors a disclosure brochure specifically designed by the SEC for hedge funds. See SEC: HEDGE FUND GROWTH, supra note 3, at 97. For a brief description of the disclosures hedge funds typically give to their investors, see supra note 44.

266. See Paredes, supra note 8, at 1033–34 (noting that the hedge fund industry has promoted a number of best practices and general guidelines and providing examples of such practices and guidelines).

267. See, e.g., David Crawford & Carrick Mollenkamp, Bad Bet: How a Hedge-Fund Mogul Disrupted an Austrian Bank, WALL ST. J., Jan. 25, 2007, at A1 (noting that after a hedge fund made substantial money for a bank, the bank continued to aid the fund in its failed investments). Moreover with the loosening of banking requirements, which has allowed financial institutions to
operate securities business within their banking institutions, there is a significant danger of collusion. See Michael J. de la Merced, Guilty Pleas and Charges Filed in Two Couples’ Insider Cases, N.Y. TIMES, May 11, 2007, at C2 (noting that employees of Bank of America Corp. were charged with participating in the largest insider-trading conspiracy since the mid-1980s). Such dependence on lending institutions to self-police their behavior is particularly worrisome because there is a dangerous trend in the industry to keep less money in reserve, which puts consumers at risk. See Robin Sidel & David Reilly, No Worries: Banks Keeping Less Money in Reserve, WALL ST. J., Feb. 27, 2007, at C1.

Unfortunately for all parties, “‘[w]e tend to legislate and regulate by crisis,’” and “‘[i]n the absence of crisis, things go slowly.’” Mara Der Hovanesian & Dawn Kopecki, Where’s the Heat on Hedge Funds?, BUS. WK. ONLINE, June 19, 2006, http://www.businessweek.com/magazine/content/06_25/b3989062.htm (quoting Jonathan M. Winer, former deputy assistant Secretary of State and partner in the Washington D.C. office of Alston & Bird LLP). Unfortunately, the next time a hedge fund catastrophically fails, there may be a knee-jerk governmental reaction similar to the one experienced after the Enron collapse and the corresponding outcries that the government reactions resulted in overly burdensome regulations. See supra note 203 (discussing the backlash against the ostensibly overly burdensome regulations that Congress enacted in a knee-jerk fashion after the major corporate collapses of the early 2000s).

See supra note 203 (discussing the current pro-business trend of the SEC).

When the new Democrat-controlled Congress took control, the American Bar Association noted that “‘[s]peculation abounds that businesses ranging from government contractors to hedge funds to pharmaceutical companies could soon feel the heat of congressional investigations.” Molly McDonough, D.C. Firms Gear Up for a New Congress, ABA J. eREPORT, Dec. 15, 2006, http://www.abanet.org/journal/ereport/d15memo.html. However, at least one observer views congressional intervention as extremely problematic. “If the SEC gets knocked out, Congress picks it up. And I think everyone would rather avoid oversight by a bunch of politicians.” Mara Der Hovanesian, The SEC Isn’t Finished with Hedge Funds, BUS. WK. ONLINE, July 17, 2006, http://www.businessweek.com/magazine/content/06_29/b3993055.htm.


For all the dangers hedge funds pose, they do benefit our securities markets and economy by improving efficiency and promoting growth in areas where more risk-averse investment entities will not invest. See supra notes 99–102 and accompanying text.
B. Modest Proposals to Protect Individual Investors

Congress should consider the following four alternative measures to protect individual investors from the dangers hedge funds pose. First, the simplest and perhaps most effective way for Congress to moderately regulate hedge funds is to amend the Advisers Act to incorporate the Hedge Fund Rule’s interpretation of “client.” Due in part to the procedural ease of this step, it would be worthwhile, cost-effective, and feasible because the SEC has already gathered the material facts and issued its expert opinion on the matter. Perhaps more importantly, Congress could easily pass legislation substantially similar to the Hedge Fund Rule because it could use the SEC’s expertise as a justification to insulate itself from a potential political backlash.

Second, Congress should look into granting intellectual property rights to hedge fund managers who engage in truly unique and beneficial investment processes. Bestowing intellectual property rights would not only protect hedge fund managers who are truly benefiting the market with their investment strategies, but also would provide incentives to managers to invent better investment techniques, further benefiting market efficiency and all market participants. Most importantly, granting intellectual property rights to hedge fund managers would limit the number of hedge funds because once a beneficial and unique investment process is patented, the patent holder would effectively monopolize the process. Such a monopoly would permit the hedge fund manager to charge other managers a licensing fee or to keep the process to herself. Either way,

274. See supra note 116 and accompanying text (describing the Hedge Fund Rule as an unburdensome and measured step); supra notes 187–88 and accompanying text (noting the SEC’s justifications for passing the Hedge Fund Rule).
275. Using the SEC’s expertise as its justification for amending the Advisers Act may be the only politically feasible option that Congress has because as hedge funds have grown in economic influence, so too has their political influence. See, e.g., Jenny Anderson, Big Money Still Learning to Lobby, N.Y. TIMES, Mar. 13, 2007, at C1 (noting that Senator Charles Schumer invited over a $100 billion worth of hedge fund managers to a dinner to advise them that “[i]f [they] want Washington to work with [them], [they] had better work better with one another”); Thomas, Jr., supra note 95 (indicating that hedge funds’ political-campaign contributions doubled from 2000 to 2006). Thus, as with all political issues, lobbyists have substantial power, and politicians are loath to anger their political supporters. See generally ARIANNA HUFFINGTON, PIGS AT THE TROUGH: HOW CORPORATE GREED AND POLITICAL CORRUPTION ARE UNDERMINING AMERICA 77–150 (Crown Publishers 2003) (discussing the massive sums of money paid to politicians and lobbyists in hopes of encouraging favorable legislation).
276. For a discussion of such patents in another arena, see generally Drennan, supra note 55 (discussing the patenting of tax loopholes as unique processes).
277. See supra note 55 (describing Phillip Goldstein’s threat of filing another suit against the SEC on the ground that the SEC is stealing his intellectual property rights).
278. See Drennan, supra note 55, at 246–54.
279. See id. at 262.
fewer managers would have unfettered access to unique and beneficial investment strategies, which would likely raise standards for hedge fund managers. 280

Third, Congress should require hedge fund managers not only to determine the wealth of their investors but also to assess qualitatively each investor’s financial sophistication before allowing the investor into the hedge fund. Undoubtedly, this is a feasible requirement because both the SEC’s former regulations and Britain’s current regulations include this requirement. 281 Furthermore, there is no evidence that such a qualitative assessment is overly burdensome or was overly burdensome in the past. In fact, any argument by a hedge fund manager as to the possible burden should be met with skepticism given the ultimate economic benefit most hedge fund managers derive from managing their investors’ money. 282 Best of all, this requirement would make wealth only a necessary and not sufficient condition for investing in a hedge fund, thus eliminating the dubious proxy that wealth currently serves for financial sophistication. 283 Thus, wealthy but unsophisticated investors would still be protected from the dangers of investing directly in hedge funds.

Finally, Congress should consider imposing wealth and sophistication standards on potential investors in FOHFs and in publicly traded hedge fund management companies. 284 This measure would most effectively protect individual investors from hedge fund dangers; however, it is probably the least likely to receive congressional support because it would effectively eliminate these two investment products from the market. FOHFs and publicly traded hedge fund management companies would probably be eliminated because they are deliberately tailored to reach unsophisticated investors who cannot afford to invest directly in hedge funds. 285 Despite this potential for failure, Congress should discuss the merits of these investment products before foreclosing the idea of imposing wealth and sophistication requirements on investors seeking to buy into them.

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280. In theory, a new market would develop where only patented processes would be attractive investment vehicles because they would be the truly unique and beneficial investment strategies. Thus, those managers who could not invent a new investment process or could not afford to license one from another manager would fall out of the picture; therefore, the quality of hedge fund managers should increase.

281. See supra note 51 and accompanying text.

282. See Shell, supra note 5 (noting that the highest paid hedge fund manager earned $1.5 billion in 2005 and that the average pay for the top hedge fund managers was $363 million).

283. See supra notes 50–51 and accompanying text.

284. The risks of investing in FOHFs and publicly traded hedge fund management companies are the same as those attendant to investing directly into hedge funds because they are effectively the same product. See supra notes 233–51 and accompanying text. Investor protection measures should apply equally to all products with similar risks.

285. Indeed, FOHFs and publicly traded hedge fund companies opened for the primary purposes of tapping the capital available in the market from investors who are not wealthy enough to buy directly into hedge funds. See supra notes 243–44 and accompanying text.
V. Conclusion

For better or worse, hedge funds impact our financial markets in profound ways. These impacts reach sophisticated and unsophisticated investors alike, and although there once was a time when hedge funds could be ignored as a marginal investment product, hedge funds have become a major influence on global markets. The SEC’s Hedge Fund Rule, which would have required hedge funds to open their books from time to time to regulators, was perfectly suited to deal with the looming dangers posed by these lightly regulated investment entities.

Unfortunately, in Goldstein, the D.C. Circuit failed to give proper deference to the SEC and, much like our current regulatory and political regimes, failed to appreciate the normative values that form the foundation of our securities regulations. The Goldstein court improperly vacated the Hedge Fund Rule and consequently re-exposed the markets to the unmitigated dangers of hedge funds.

Going forward, the SEC’s new proposals will be ineffective in securing our financial markets for the individual investors it is charged with protecting. Thus, Congress is left to do the job that the SEC no longer wants, and it will take both a bold and measured Congress to implement effective reforms for the hedge fund industry. Let us all hope that Congress can walk that fine line before it is too late.