Hedge Funds: Their Advisers Do Not Have to Register with the SEC, but More Information and Other Alternatives are Recommended

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I. INTRODUCTION

Hedge funds have been defined in various ways,¹ but the term commonly means any pooled investment vehicle that is privately organized, professionally administered, and not widely available to the public.² Globally, hedge fund assets are estimated at over a trillion dollars.³

Because of the growing number and size of hedge funds, the broadening exposure of investors to hedge fund risk, and the growing number of instances of malfeasance of hedge fund advisers,⁴ the Securities and Exchange Commission ("SEC") promulgated the Registration Under the Advisers Act of Certain

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2. Id. (citing President's Working Group on Financial Markets, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1 (1999)).
Hedge Fund Advisers ("Hedge Fund Rule") by amending and adding a rule under the Investment Advisers Act of 1940. The Investment Advisers Act of 1940 requires investment advisers to register with the SEC unless exempt. Hedge fund advisers were typically exempt from this requirement because they fell within the private adviser exemption of the Act. Under this exemption, if the investment adviser had fewer than fifteen clients over the last fifteen years, and neither held himself out generally to the public as an investment adviser nor acted as an investment adviser to any registered investment company, then he did not have to register with the SEC. Under the Hedge Fund Rule, private funds have to count the following investors as clients: shareholders, limited partners, members, or beneficiaries of the private fund.

According to this new definition of "client," most hedge fund advisers had to register with the SEC by February 1, 2006. However, the Hedge Fund Rule was vacated on June 23, 2006, by the Court of Appeals for the District of Columbia Circuit in Goldstein v. Securities and Exchange Commission. The appeals court deemed the rule "arbitrary" and found that the SEC inadequately explained why hedge fund investors were to be treated as clients of the fund under the rule.

This article examines hedge fund regulation, as well as Goldstein and its impact. Part II discusses the Hedge Fund Rule, as well as the federal regulation of hedge funds prior to the implementation of the new rule. Part III discusses the Goldstein v.

5. Id.
7. Id. § 80b-3(a). The non-exempt investment advisers may not use the mail or interstate commerce unless registered. Id.
8. Id. § 80b-3(b)(3).
9. Id. For determining the number of clients, no shareholder, partner, or beneficial owner of a business development company is a client of an investment adviser unless the person is a client of the investment adviser separate and apart from the status as a shareholder, partner, or beneficial owner. Id.
11. 451 F.3d 873 (D.C. Cir. 2006).
12. Id. at 884.
13. Id. at 883.
Securities and Exchange Commission case, which vacated the Hedge Fund Rule. Part IV examines what investors, hedge fund advisers, the SEC, and Congress could and should do concerning hedge funds. The SEC should adopt the recommendations of the two SEC Commissioners who dissented from the Hedge Fund Rule by not only obtaining information from other sources before imposing mandatory registration,14 but also by increasing oversight of advisers who are registered.15 If deemed necessary, Congress could also enact hedge fund regulation to close the gap left by Goldstein.16 Congress should also revisit the definition of a qualified purchaser, thus raising the bar to protect more investors. Part V concludes by noting that, although the Goldstein case correctly vacated the Hedge Fund Rule, the alternatives suggested in Part IV are a more appropriate means of regulating the hedge fund industry.

II. HEDGE FUNDS

The term “hedge fund” was reportedly first used to describe a fund managed by Alfred Winslow Jones in 1949.17 Mr. Jones’s fund balanced long and short equity positions to “hedge” the portfolio’s risks.18 Hedge fund advisers now use a wide variety of investment strategies to maximize returns for the investors.19 While many trade in securities,20 bonds, and currencies, some also

15. Id. at 72091.
17. Vaughan, supra note 1 (citing Roger Lowenstein, WHEN GENIUS FAILED (2000)).
20. Id.
trade in derivatives and other assets, such as movies21 and even the rights to soccer players.22

There is no statutory or regulatory definition of “hedge fund.” However, hedge funds are typically organized by professional investment managers who frequently have a stake in the funds they manage and also receive a management fee that includes a share of the performance of the fund.23

Before analyzing the development and application of the Hedge Fund Rule, it is important to consider the state of hedge fund regulation prior to the SEC’s passage of the Hedge Fund Rule.

A. Regulation of Hedge Funds

Hedge funds may be regulated by a number of federal laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. However, hedge funds often escape regulation because they fall within the exemption provisions of these acts.24

1. The Securities Act of 1933

The Securities Act of 193325 requires public securities offerings to be registered with the SEC26 and also requires that a prospectus be provided to investors. Hedge fund offerings probably fall into the definition of securities under the 1933 Act,

26. Id. § 77(e)(c).
which defines a security as any note, stock, treasury stock, security future, bond, debenture, or evidence of indebtedness, among other investment vehicles. However, hedge fund securities offerings may avoid registration under the 1933 Act by relying on the "private offering" or "private placement" exemption located in Section 4(2) of the Act. A private offering is defined as a transaction by an issuer which does not involve any public offering. In the alternative, registration may also be avoided under the 1933 Act by relying on Rule 506 of Regulation D, which involves an offering only to accredited investors. Most hedge fund securities offerings can probably take advantage of these exemptions.

2. The Securities Exchange Act of 1934

Some provisions of the Securities Exchange Act of 1934 may also apply to hedge funds. Under the 1934 Act, dealers who are engaged in buying and selling securities for their own accounts must register with the SEC, whereas traders, who buy and sell securities that are not part of a regular business, do not. The 1934 Act also has a registration and reporting provision which may apply to hedge funds. Section 12(g) of the 1934 Act and Rule 12g-1 require that an issuer register equity security with the SEC when the issuer has 500 holders of record, who have a class of non-exempt securities and assets in excess of $10 million at the

27. Id. § 77b(a)(1).
28. Id. § 77d(2).
30. 17 C.F.R. § 230.506 (2005). Rule 506 establishes safe harbor conditions. Id. If an offering is only to accredited investors, no specific information has to be provided. Id. Offerings and sales under Rule 506 cannot be made using any form of "general solicitation or general advertising," and there are resale restrictions. Id.
32. Id. § 78l.
33. Id. § 78c(a)(5). Hedge fund managers are generally not considered to be broker-dealers and do not have to register with the SEC. See Willa E. Gibson, Is Hedge Fund Regulation Necessary?, 73 TEMP. L. REV. 681, 692 (2000).
conclusion of the most recently ended fiscal year. Registration of a class of equity security subjects the domestic registrant to periodic reporting requirements.\textsuperscript{36} Most hedge funds, however, avoid registration under the 1934 Act by having fewer than 500 holders of record.\textsuperscript{37}

Though hedge funds may escape some regulation under the 1934 Act, there are some regulatory provisions of the Act which hedge funds may not escape. Hedge funds are subject to the 1934 Act's requirement of disclosure when an investor has direct or indirect beneficial ownership of more than five percent of any class of registered voting equity securities.\textsuperscript{38} Insider reporting is triggered under the 1934 Act when hedge funds acquire more than ten percent of a class of registered voting securities.\textsuperscript{39} Short swing profits provisions of the 1934 Act may also apply to hedge funds. They require insiders to disgorge any profits an insider earns from any purchase or sale of the issuer’s security in a six month period.\textsuperscript{40}

3. The Investment Company Act of 1940

The Investment Company Act of 1940\textsuperscript{41} directs the SEC to regulate investment companies.\textsuperscript{42} While hedge funds could be classified as investment companies, they may avoid regulation under this Act by one of two statutory exemptions. First, the Investment Company Act excludes from the definition of investment companies those issuers whose outstanding securities are not owned by more than 100 investors and who do not

\textsuperscript{37} SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 19 (2003).
\textsuperscript{38} 17 C.F.R. § 240.13d-3 (2004). Beneficial ownership is defined broadly as the power to vote and dispose of any equity securities or the power to direct the voting or disposition of those securities. \textit{Id.}
\textsuperscript{39} 15 U.S.C. § 78p(e) (2005). Each officer or director of the issuer of the security is also deemed an insider. \textit{Id.}
\textsuperscript{40} \textit{Id.} § 78p(b).
\textsuperscript{41} \textit{Id.} § 80a.
\textsuperscript{42} \textit{Id.} § 80a-1.
presently propose to make a public offering of their securities.\textsuperscript{43} Second, the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of the securities, are "qualified purchasers."\textsuperscript{44} A qualified purchaser is any natural person or family-owned company owning more than $5 million in investments, or a trust of which the settler and trustee are qualified purchasers, or any person acting for his or her own account or the accounts of other qualified purchasers and who owns and invests more than $25 million in investments.\textsuperscript{45}

4. The Investment Advisers Act of 1940

The final federal regulation that may apply to hedge funds is the Investment Advisers Act of 1940.\textsuperscript{46} Usually, hedge fund advisers also meet the definition of investment adviser under this Act. An investment adviser is defined as any person who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.\textsuperscript{47} Unless exempt, investment advisers must register with the SEC.\textsuperscript{48} There is exemption from registration for any investment adviser who had fewer than fifteen clients in the preceding twelve months and who neither generally holds himself or herself out to the public as an investment adviser, nor acts as an investment adviser to any registered investment company.\textsuperscript{49} The Investment Advisers Act of 1940 does not specify

\textsuperscript{43} Id. § 80a-3(c)(1).
\textsuperscript{44} Id. § 80a-3(c)(7).
\textsuperscript{45} Id. § 80a-2(a)(51)(A).
\textsuperscript{46} Id. § 80b-1.
\textsuperscript{47} Id. § 80b-2(a)(11). This definition also includes those who, for compensation and as a part of a regular business, issue or promulgate analyses or reports concerning securities. Id. This definition does not include those such as a bank which is not an investment company, the publisher of any bona fide newspaper or business publication of general circulation, or any lawyer, accountant, or teacher whose performance of such services is incidental to the practice of his or her profession. See id.
\textsuperscript{48} Id. § 80b-3(a).
\textsuperscript{49} Id. § 80b-3(b)(3). Other exemptions are available for investment advisers whose clients are all in-state, for investment advisers whose only clients
how to count clients for the purpose of the private adviser exception. In 1985, the SEC adopted a rule allowing investment advisers to count each pooled investment vehicle as a single client. This exemption for fifteen or fewer clients was often used by hedge fund advisers to avoid registration. Registered advisers cannot charge their clients a performance fee unless the client has a net worth of at least $1.5 million or at least $750,000 under management. Under the Investment Advisers Act, it is also illegal for any investment adviser, exempt or non-exempt, registered or not, to defraud any client or prospective client.

B. The First Major Hedge Fund Collapse and the Aftermath of the Collapse

The ability of hedge funds to use legal exemptions to avoid much of the federal regulation of hedge fund advisers led to what has since been called the first major event in the hedge fund industry. In 1998, there was a collapse of the massively overleveraged hedge fund, Long Term Capital Management ("LTCM"). This event, which resulted in a bailout of over $3.5 billion, is the largest-ever bailout of a hedge fund by private insurance companies, and an investment adviser that is a charitable organization. Id. § 80b-3(b).

51. 17 C.F.R. § 275.203(b)(3)-1(b)(3) (2004). This rule was revoked by the Hedge Fund Rule, which now defines clients differently. See 17 C.F.R. pts. 275, 279.
financial institutions. In response to this collapse, several reports and recommendations were made for how to regulate the hedge fund industry.

The President's Working Group on Financial Markets issued a report which recommended measures to constrain excessive leverage in the nation's financial system, but recommended no changes to either the exemptions for hedge funds under the Investment Company Act or the exemptions for hedge fund advisers under the Investment Advisers Act.

The SEC held a Hedge Fund Roundtable in 2003, and William Donaldson, who was Chairman of the SEC at that time, requested that the staff issue a report based upon the findings and recommendations of the hedge fund study. The staff issued a report called the Implications of the Growth of Hedge Funds, which listed as a concern the potential for retailization. The report noted market benefits of hedge funds, including providing market efficiencies and enhancing liquidity. It also noted that hedge funds play an important role by assuming risk in a financial system where risks are spread over different financial instruments. While the staff did not uncover evidence of a significant number of retail investors investing in hedge funds, there was a concern that less sophisticated investors may not have the understanding or market power to require a hedge fund adviser to provide sufficient information. Taking into account whether

57. Etter, supra note 3. Because of a concern that the collapse of LTCM would adversely affect the nation's financial markets, the Federal Reserve facilitated a private sector recapitalization of LTCM. SEC, supra note 37, at 8.
58. SEC, supra note 37, at 3 (citing President's Working Group on Financial Markets, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999)).
59. SEC, supra note 37, at vii.
60. Id. at viii.
61. Id. at 78.
62. Id. at 4.
63. Id. Further, hedge funds can serve as a risk management tool for investors by diversifying the portfolio. Id. at 5.
64. Id. at 80-81. The report noted that perhaps the biggest change in indirect exposure of investments in hedge funds was the frequency with which pension plans, universities, endowments, and foundations are investing in hedge funds. Id. at 81.
the benefits outweighed the burdens of registration, the staff recommended that the SEC require hedge fund advisers to register under the Investment Advisers Act.65

C. The Hedge Fund Rule66

Because of the growth of hedge funds, the broadening exposure of investors to hedge fund risk, and the growing number of instances of malfeasance by hedge fund advisers,67 the SEC promulgated the Registration Under the Advisers Act of Certain Hedge Fund Advisers, or the Hedge Fund Rule.68 The SEC acknowledged the important role that hedge funds play in financial markets, and further acknowledged that the lack of regulation of hedge funds has been a factor in their growth.69 The new Hedge Fund Rule defined “client” as any natural person,70 thus overriding the 1985 definition of “client.”71 When counting clients under the Hedge Fund Rule, the shareholders, limited partners, members, or beneficiaries of a private fund72 must all be counted.73

65. Id. at 89. See generally Erik J. Greupner, Comment, Hedge Funds Are Headed Down-Market: A Call for Increased Regulation?, 40 SAN DIEGO L. REV. 1555 (2003). A working draft of this comment was used by the SEC staff in preparing the Staff Report.


67. Id. at 72059. In a five-year period up to 2004, the SEC brought fifty-one cases alleging that hedge fund advisers either defrauded investors or used the fund to defraud others, resulting in losses of over a billion dollars. Id. at 72056.

68. See generally id. at 72054.

69. Id. at 72059.


71. Id. § 275.203(b)(3).

72. Id. § 275.203(b)(3)-2(a).

73. Id. § 275.203(b)(3)-2(b). This is the “funds of hedge funds” provision. Without this provision, a hedge fund adviser could provide services to fourteen or fewer mutual funds. Id. Under the Hedge Fund Rule, each investor in the mutual fund would be counted as a client. Id. A fund of hedge funds is an investment company that invests in hedge funds. SEC, Hedging your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds, available at http://www.sec.gov/answers/hedge.htm. Under the Hedge Fund Rule, the hedge fund adviser had to “look through” the private fund and count all the clients of
counting requirements have the effect of requiring many more investment advisers to register with the SEC. The SEC believed that the ability of the hedge fund advisers to function effectively would not be significantly impaired by the new registration requirements.

The rule also addressed counting requirements for certain owners of investment companies and offshore hedge fund advisers. If investment advisory services were provided to a private fund in which a registered investment company was, directly or indirectly, an owner, then the owners of that investment company were also counted as clients. This required the investment adviser to "look through" the private fund to count clients. The final rule imposed the same counting requirements on offshore hedge fund advisers; an offshore hedge fund adviser was required to look through each private fund it advises. By February 1, 2006, each adviser


76. A private fund is defined as an investment company under the Investment Company Act of 1940 but for the exemptions that permit its owners to redeem any portion of their ownership interests within two years and that offer its interests based upon the investment advisory skills ability or expertise of the investment adviser. 17 C.F.R. § 275.203(b)(3)-1(d)(1) (2004), invalidated by Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

required to register under the new rule, which included most hedge fund advisers, had to have its registration effective.\footnote{Id. at 72077. The majority of SEC commissioners, when conducting the cost-benefit analysis, stated that there would be benefits to hedge fund investors, mutual fund investors, other investors and markets, regulatory policy, and to hedge fund advisers, even though registration would impose additional costs. See generally Hellrung, supra note 18; Liffman, supra note 55; Jonathan Bevilacqua, Comment, Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds, 54 BUFL. L. REV. 251 (2006).}

Two SEC commissioners dissented to the Registration Under the Advisers Act of Certain Hedge Fund Advisers.\footnote{79. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054-01, 72089 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279). Commissioners Cynthia Glossman and Paul Atkins dissented. Id.} Calling the rulemaking "the wrong solution to an undefined problem,"\footnote{80. Id. at 72098. The dissenters observed that the majority contended that the retailization of hedge funds is a growing problem, but it is unclear how registration would be helpful in this regard. Id.} the dissenter urged the majority to consider better alternatives, including gathering more information on hedge funds from other sources, such as other regulators and market participants.\footnote{81. Id. at 72089, 72098. The SEC first must ascertain what information is wanted or needed. Id. The form used to register advisers is unlikely to provide the needed information, according to the dissenters. Id. at 72090.} The SEC should have enhanced its oversight of existing registrants.\footnote{82. Id. at 72091.} According to the dissenting commissioners, since the SEC lacks the resources to do hedge fund adviser examinations,\footnote{83. Id. at 72093.} the expansion of the number of registrants would dangerously spread scarce resources over even more registrants.\footnote{84. Id. at 72094.}

During the period for public comment, about 187 comments were received,\footnote{85. SEC, Comments on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, available at http://www.sec.gov/rules/proposed/s73004.shtml.} including a comment from Phillip Goldstein, the plaintiff in \textit{Goldstein v. Securities and Exchange Commission}. Nevertheless, the rule went into effect and many hedge fund advisers registered by the deadline.\footnote{86. Kara Scannell, Some Hedge Funds Pull SEC Registration Plans, WALL ST. J., July 20, 2006, at C3.}
III. GOLDSTEIN v. SEC

Philip Goldstein, along with Kimball & Winthrop, an investment advisory firm Goldstein co-owns, and Opportunity Partners, a hedge fund in which Kimball & Winthrop is the general partner and investment adviser, challenged the Registration Under the Advisers Act of Certain Hedge Fund Advisers. On June 23, 2006, the Court of Appeals for the District of Columbia Circuit agreed with Goldstein and advocated and remanded the Hedge Fund Rule. Because the more demanding Investment Company Act exempts funds of 100 or fewer investors, while the Investment Act exempts investment advisers with fifteen or fewer clients (defined under the Hedge Fund Rule as investors), the Hedge Fund Rule was deemed "arbitrary" by the appeals court.

Goldstein alleged that the SEC misinterpreted the exemption from the Investment Advisers Act, which exempts advisers with fewer than fifteen clients. The Investment Company Advisers Act does not define "client," but the court of appeals stated that just because a statute does not define a term does not necessarily mean that the term is ambiguous or that an agency may choose any possible meaning for the term. The appeals court pointed out that

90. Id.
92. Goldstein, 451 F.3d at 884.
93. Id. at 877. The dissenting SEC commissioners leveled the same allegation. Id. at 878.
95. Goldstein, 451 F.3d at 878. The SEC contended that a 1980 amendment to the exemption from registration which stated that, "[f]or purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company . . . shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner," could lead to the conclusion that an
Congress, in another section of the Investment Advisers Act, as well as the SEC itself, did not consider investors, such as shareholders and limited partners of a hedge fund, to be counted as clients. According to the appeals court in Goldstein, the Supreme Court in Lowe v. Securities and Exchange Commission also believed that the client relationship was between the adviser and the fund, not the adviser and the investors in the fund. The appeals court did recognize that the Securities and Exchange Commission was correct because the Supreme Court in Lowe did not rule on the interpretation of “client,” but rather on an exception to the definition. Thus, the appeals court stated that Lowe should not be given too much weight.

The court of appeals further stated that if the investment adviser owes a fiduciary duty to both the hedge fund and to the investors, then the adviser will face a conflict of interest. Similarly, in a corporate setting, corporate counsel does not serve the shareholders as clients.

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96. The Act does not define client, but suggests that Congress did not intend shareholders, limited partners, members, or beneficiaries of a hedge fund to be counted as clients. 15 U.S.C. § 80b-2(11) (2005).

97. The Commission stated in 1997 that the investment adviser of an investment company need not consider the individual needs of the company’s shareholders when making investment decisions. Goldstein, 451 F.3d at 880.


100. Id. at 881. The example given by the appeals court was if the hedge fund was about to become bankrupt, the investment adviser’s recommendation to the fund would be to do whatever it took to remain solvent, while the advice to the investors would be to sell. Id.
The appellate court may have been more sympathetic to the Hedge Fund Rule if the relationship between hedge funds and investors had changed, but the Commission neither showed any evidence of such a relationship, nor explained why hedge fund investors were clients of hedge fund advisers. Finally, the number of clients in a hedge fund, or the number of investors in the Hedge Fund Rule, does not achieve the goal of exempting only small funds; assets under management or debt of a fund would be a better measure. Thus, the Hedge Fund Rule was vacated.

IV. RECOMMENDATIONS

The SEC’s Hedge Fund Rule, which counted investors as clients of hedge funds, resulted in many hedge funds having to register with the Commission. Registration was required because the funds no longer had fewer than fifteen “clients” to qualify for the exemption from registration under the Investment Advisers Act. The Hedge Fund Rule was struck down by the Court of Appeals for the District of Columbia Circuit in June 2006 by Goldstein v. Securities and Exchange Commission.

There are currently more than 8,000 hedge funds and more than 2,500 registered with the SEC. Though the Goldstein case correctly vacated the Hedge Fund Rule, several options remain for
investors, hedge fund advisers, the SEC, and Congress to regulate the hedge fund industry.

Investors in hedge funds should heed the advice of the SEC and read a fund’s prospectus or offering memorandum and other materials to understand the level of risk associated with the fund. Investors should understand how a fund’s assets are valued, ask questions about fees, research the hedge fund adviser’s background, and be aware of any limits on the rights to redeem shares.

Advisers of hedge funds that registered by the February 2006 deadline could voluntarily remain registered with the Commission, if it is deemed advantageous, such as being able to tell clients that the adviser is registered with the SEC. Some advisers have already filed to withdraw registration since the Goldstein decision.

The SEC should engage in information gathering from other agencies and private sources, as well as other alternatives suggested by the dissenting commissioners. The dissenting commissioners stated that before attempting to collect information, it must be determined what information is wanted or needed, and it was hoped that the public would comment on that issue. The oversight of existing registrants should be increased, as suggested by the dissenting commissioners. While this may cause more hedge funds to deregister, it will render registration more valuable to the client. Although it is not clear if current Commission Chairman Cox will follow the rulemaking of his predecessor Chairman Donaldson, the Commission could draft rules consistent with their mandate. The anti-fraud provisions are being enforced against hedge funds, as they were before the enactment of the

113. SEC, supra note 73.
114. Id.
115. Id.
117. Id.
118. See id.
Hedge Fund Rule,119 and the SEC should continue to investigate and prosecute fraud.

Congress could preemptively act to allow more regulation of, or more information from, hedge funds before another spectacular hedge fund collapse occurs.120 It is time to raise the limits on what it takes to be a qualified purchaser for the purposes of the Investment Company Act.121 By raising the bar on a qualified purchaser, for example, from an investor with more than $5 million in investments to $10 million, and from a person acting on the person's own account or other qualified investors' accounts from $25 to $50 million, then more investors will be protected.122 If deemed necessary, Congress could also require the managers of hedge funds, who are the clients of the hedge fund, but the advisers to the investors, to register.

V. CONCLUSION

There has been a lack of regulation of hedge funds due to their ability to escape federal regulation. The SEC's response to this was to enact the Hedge Fund Rule, which required hedge fund investors to register with the SEC. Though the court in Goldstein correctly vacated the rule, there are other more effective options for enforcing regulation. However, these options require the cooperation of Congress, the SEC, investors, and hedge fund advisers in order to prevent another hedge fund collapse.

The problems associated with hedge funds are not going away, and investors who are not the hedge fund adviser's clients must be

119. Mara Der Houanesian, The SEC Isn't Finished with Hedge Funds, BUS. WK., July 17, 2006, at 34. Chairman Cox says the SEC has "significant resources" to investigate activities of hedge funds. Id.


122. Although it would not necessarily protect investors, perhaps the amount should also be raised from $750,000 to $1 million in assets under management, and net worth from $1.5 to $2 million before the adviser can charge a performance fee. See 17 C.F.R. § 275.205-3 (2004).
sophisticated and willing to accept the risk associated with hedge funds. Investors in the largely unregulated hedge fund industry should be aware of the inherent risk and be financially sound enough to bear any loss. Finally, if more regulation and protection are not provided, the investors need to be aware that there most likely will be a hedge fund failure on a large scale and there may not be a bailout of the fund the next time.