The Challenges of Hedge Fund Regulation After the Pequot Investigation and *Goldstein v. SEC*

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Hedge Funds are the investment product of the early 21st Century. Hedge Fund managers are the new Masters of the Universe. They have captured the popular imagination; their growth has been phenomenal. According to the New York Times, almost 9,000 hedge funds exist with total investment assets of $1.2 trillion.

With this popularity has come increased pressure to regulate these secretive entities. It is difficult to read the daily business or financial press without seeing some story about hedge funds and their growing clout and effect on the financial markets. Stories about hedge funds abound on business networks like CNBC and Bloomberg.

The dangers of unregulated hedge funds are not limited just to the well-to-do. More and more pension funds, university endowments, charitable organizations, and foundations are investing a significant portion of their money in hedge funds. Additionally, broker firms are packaging hedge funds into funds-of hedge funds and marketing them to more Main Street clients. Hedge funds themselves are reported to account for approximately 30% of all daily trading on U.S. stock exchanges.

The SEC's interest in regulating hedge funds began with the failure of Long Term Capital Management in 1998 and continues with the saga of International Management in Atlanta.[2] When the definitive history of the Hedge Fund Era – and attempts to regulate them – is written, the date of Friday June 23, 2006, will surely merit at least a footnote, if not more.

That morning, readers of the New York Times were greeted with a story about an SEC investigation of Pequot Capital Management ("Pequot"), one of the oldest and largest hedge funds managers.[3] According to the story, the SEC was investigating Pequot for possible trading on material non-public information. Stock exchange officials had referred 18 matters of suspicious trading to the SEC for further investigation. In just one of those instances in July 2001, Pequot is reported to have

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[2] International Management made the front page of the Wall Street Journal on March 9, 2006 when it was reported that the SEC had sued the hedge fund and its adviser for fraud. International Management had between $115 and $185 million in assets and counted several NFL football players among its investors. The court appointed receiver, however, could only locate approximately $150,000. Wall Street Journal, March 9, 2006, http://online.wdj.com/article_print/SB114187433315493405.html viewed on July 30, 2006.

[3] New York Times, June 23, 2006, http://nytimes/2006/06/23/business/23fund/html?ei=5094…a51076bca7&hp=&ex=1151121600&partner=homepage&pagewanted+print viewed on June 23, 2006 (hereinafter "NY Times").

made $18 million by investing in companies shortly before the announcement of a major corporate merger. Pequot reportedly bought $44 million in Heller Financial before the public announcement of its takeover by General Electric Capital Corporation in a $5.25 billion buyout. Heller's share price rose 50% after the announcement. Pequot is also reported to have shorted $36 million in GE stock before the merger announcement.

What made this story memorable was that the SEC was publicly accused of firing the attorney who was leading the investigation into possible trading by the hedge fund while in possession of material non-public information because he wished to take the investigative testimony of the chairman of a major broker-dealer regarding his tenure as chairman of yet another major broker-dealer.

Gary Aguirre ("Aguirre"), the former SEC attorney, sent an 18-page whistleblower letter to Senator Chuck Hagel, the Republican chairman, and Christopher Dodd, the ranking Democratic member, of the Senate Subcommittee on Securities and Investment in which he complained that he had been fired after SEC officials had turned down his request to take the investigative testimony of John Mack ("Mack"). Mack is currently the chairman of Morgan Stanley, is the former chairman of Credit Suisse First Boston, and briefly served as chairman of Pequot. He is also a financial contributor to the Bush administration.

SEC officials refused to permit Aguirre to issue a subpoena to Mack on the ostensible grounds that he had not made a strong enough case for taking Mack's deposition. In his whistleblower letter, Aguirre wrote that his supervisor told him that it would be difficult to receive authorization to subpoena Mack because of his "powerful political connections."[4]

Aguirre continued to press the issue with his supervisors and on up the SEC's chain of command. Aguirre was fired on September 1, 2005, while he was on vacation.[5]

Before this controversy erupted, however, the SEC considered Aguirre a model employee. His immediate supervisor wrote in his June 2005 performance evaluation of Aguirre that:

> "Gary has an unmatched dedication to this case (often working well beyond normal work hours) and his efforts have uncovered evidence of potential insider trading and possible manipulative trading by the fund and its principals. He has been able to overcome a number of obstacles opposing counsel put in his path on the investigation. Gary worked closely with the Office of Compliance Inspection and Examinations to develop the case and worked with

[4] Letter dated May 30, 2006 from Gary J. Aguirre to Sens. Hagel and Dodd, p. 10 ("Aguirre Letter").
[5] *Id.* at 11.

several self-regulatory organizations to develop a number of potential leads. He has gone the extra mile and then some."[6]

On August 21, 2005, Aguirre received a rare two-step merit pay increase based on his handling of the hedge fund investigation.[7] Less than two weeks later, he was fired. According to the Times story, Michael Clampitt, the head of the SEC's union, said that he knew of no one who got a pay increase – particularity a significant one – and was then fired with no written warnings.[8]

On Friday, July 21, 2006, the SEC announced that its staff would question Mack regarding the possibility that he could have tipped Pequot off to certain merger deals.

While the public and the markets were still digesting and reacting to the news about the Pequot investigation, the Court of Appeals for the District of Columbia Circuit struck down the SEC's rules on hedge fund adviser registration in Goldstein *v. SEC*, No. 04-1434.[9]

In a well-reasoned opinion, Circuit Judge Randolph gave a primer on hedge funds, their particular characteristics, and the background on the SEC's attempt to regulate hedge funds by changing the definition of the term "client" as it appears in the Investment Advisers Act.[10] Ultimately, the Court held that the SEC's definition of "client" was not reasonable in this context.

Judge Randolph set forth many of the reasons for the difficulty in regulating hedge funds. The first – and most obvious – reason is that hedge funds are not easily defined. This lack of a generally accepted definition makes it difficult to draft a rule or regulation that would cover the great variety of hedge funds without being so general and vague that it would be subject to attack on those grounds.

The Court noted that nowhere is the term "hedge fund" defined in any of the federal laws and that industry participants are unable to agree on a single definition. For example, government and industry publications contain at least 14 different definitions of a hedge fund. The catchall definition cited by the Court is that a hedge fund is "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[11]

In its definitional search, the Court then attempted to define hedge funds by discussing what they were not.

Hedge funds are not investment companies under the Investment Company Act of 1940 ("the 1940 Act").[12] Although, at first glance, hedge funds would seem to be

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[6] *Id.*
[7] *Id.*
[8] NY Times at 6.
[9] 451 F.3d 873 (D.C. Cir. 2006).
[10] 15 U.S.C. § 80b-1 *et seq*.
[11] *Id.* at 875 (citations omitted).
[12] 15 U.S.C. § 80a-1 *et seq*.

investment companies as defined, they are exempt from coverage under the 1940 Act because they either (i) have 100 or fewer beneficial owners, (ii) do not offer their securities to the public, or (iii) their investors are all "qualified" high net worth individuals or institutions. Unlike mutual funds, such entities have never been understood to offer the same possible dangers to investors as mutual funds, which are available to the public at large.[13]

In their operations, hedge funds are almost the exact opposite of mutual funds. Mutual funds must register with the SEC and disclose their investment positions and financial conditions. For all practical purposes, they must have at least one public director on their Board of Directors. Mutual funds are unable to trade on margin or engage in short sales and need shareholder approval to take on significant debt or to invest in certain types of assets such as real estate or commodities.[14]

In contrast, hedge funds often take long and short positions in stocks and bonds to reduce risk. They trade in all sorts of assets, from stocks, bonds, and currencies to derivatives and even non-financial assets.[15]

The management structure of hedge funds is also drastically different than that of mutual funds. Mutual funds must comply with detailed requirements for their independent boards of directors and require shareholder approval of certain actions and transactions. In contrast, domestic hedge funds are usually structured as limited partnerships. Such limited partnerships achieve the maximum separation possible of ownership from management. In most hedge funds, the general partner manages the fund for a fixed fee and a performance fee, *i.e.*, a percentage of the gross profits from the fund.[16] Such performance fees can be as high as 20%.

Hedge fund advisers, while they fulfill all the definitions of investment advisers under the Investment Advisers Act, are generally exempt from registration under the "private advisor exemption" in § 203(b)(3) of the Advisers Act. That section exempts from registration "any advisor who during the course of the preceding twelve months had had fewer than fifteen clients and who neither hold himself out generally to the public as an investment advisor nor acts as an investment to any investment company registered" under the 1940 Act. Traditionally, the SEC had interpreted this provision to refer to the partnership or the entity itself as the adviser's client.[17] The Court noted that even the largest hedge fund managers usually ran fewer than fifteen hedge funds.[18] For all practical purposes, hedge fund managers were thus exempt from registration as investment advisers.

After the near collapse of Long Term Capital Management, a hedge fund that had more than $125 billion in assets under management at its peak, the SEC renewed its

[13] *Goldstein* at 875.
[14] *Id*.
[15] *Id*. at 876.
[16] *Id*.
[17] *Goldstein* at 876.
[18] *Id*.

push for greater regulation of hedge funds.[19] After reviewing reports from both a joint working group of the major federal financial regulators and an SEC staff report, the SEC issued rules in December 2004.[20] The Hedge Fund Rules were issued over the dissent of two of the five SEC commissioners.

Among the Hedge Fund Rules was an amendment to Rule 203(b)(3)-1 to define a private fund as an investment company that (a) is exempt from registration under the Investment Company Act by virtue of having fewer than one hundred investors or only qualified investors, (b) permits its investors to redeem their interest within two years of investing, and (c) markets itself on the basis of the "skills, ability or expertise" of the investment adviser.[21] The rule then specifies that, for the purposes of the private adviser exemption, the shareholders, limited partners, members or beneficiaries of the fund are to be counted as "clients."[22]

This had the effect of requiring most hedge fund advisers to register and thus subject themselves to SEC inspection. Additionally, a registered investment adviser cannot charge a performance fee unless the clients have a net worth of $1.5 million or more or at least $750,000 under management with the adviser.[23]

The Court noted that the Advisers Act does not define the term "client" and rejected the SEC's argument that this lack of a definition renders the statute "ambiguous as to a method for counting clients."[24]

> "There is no such rule of law. The lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous, just as the presence of a definition does not necessarily make the meaning clear. A definition only pushes the problem back to the meaning of the defining terms. *See Alarm Indus. Commc'ns Comm. v. FCC*, 131 F.3d 1066, 1068-70 (D.C. Cir. 1997); *Doris Day Animal League v. Veneman*, 315 F.3d 297, 298-99 (D.C. Cir. 2003)."[25]

In discussing the interpretation of a term susceptible to more than one meaning, the Court held that just because Congress employed such a term, it does not follow that an agency has the latitude to choose any one of such meanings. Such a term must always be read in context.

The Court noted that, in a 1970 amendment to §203 of the Advisers Act, Congress appeared to suggest that investment company entities and not the shareholders were the advisers' clients. Congress had eliminated a separate exemption from registration

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[19] *Id.* at 877.
[20] *See* Registration Under the Advisers Act of Certain Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts 275, 279) ("the Hedge Fund Rules.")
[21] *Goldstein* at 877.
[22] *Id.*
[23] 15 U.S.C. § 80b-5, *Goldstein* at 877, n. 3.
[24] *Id.* at 878.
[25] *Id.*

for advisers who advise only investment companies and explicitly made the 15-customer exemption unavailable to such advisers.[26] Such a prohibition would have been unnecessary if the individual shareholders of the investment companies were to be counted as "clients."

While the Advisers Act does not define "client," the Court noted that the definition of investment adviser does provide support for the view that Congress did not intend for shareholders, limited partners, members or beneficiaries of a hedge fund to be counted as clients. The Advisers Act defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either *directly* or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[27]

An investor in a hedge fund may benefit from an adviser's advice but he does not receive the advice *directly* from the adviser. Once the investor buys into the hedge fund, he becomes passive. If the adviser to the fund is not an investment adviser to each individual investor, then each investor cannot, buy definition, be a client of the adviser.[28]

This was the SEC's view until it reversed direction in the Hedge Fund Rules. In 1997, the SEC explained that:

> "A client of an investment adviser typically is provided with individualized advice that is based on the client's financial situation and investment objectives. In contrast, the investment adviser of an investment company need not consider the individual needs of the company's shareholders when making investment decisions, and thus has no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder."[29]

Likewise, in 1985, the SEC promulgated a rule that the "client" for purposes of the 15-client registration exemption for an investment company set up as a limited partnership is the limited partnership and not the individual partners. Under the Safe Harbor Rule, when "an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of the participants as a group, it appears appropriate to view the pool – rather than each participant – as a client of the adviser."[30]

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[26] *Id*. at 879 (citation omitted).
[27] *Id*. (emphasis in original), citing 15 U.S.C. §80b-2(11).
[28] *Id.* at 880.
[29] Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15,098, 15,102 (Mar. 31, 1997) cited in *Goldstein* at 880.
[30] Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740, 8741 (Mar. 5, 1985) cited in *Goldstein* at 880.

In *Lowe v. SEC*,[31] the Supreme Court held that publishers of certain financial newsletters were not "investment advisers." That Court held that the existence of an advisory relationship depended on the character of the advice rendered. Investment advisers provided "personalized advice attuned to a client's concerns,"[32] and" fiduciary, person-to-person relationships" were "characteristic" of the "investment adviser-client relationship."[33] As the *Goldstein* Court noted, "[t]his type of direct relationship exists between the adviser and the fund but not between the adviser and the investors in the fund. The fund is concerned with the fund's performance, not with each investor's financial performance."[34]

In holding that the SEC's definition of "client" under the Hedge Fund Rules was "outside the bounds of reasonableness"[35] and "came close to violating the plain language of the statute,"[36] the *Goldstein* Court focused on the existence of fiduciary duties owed by the adviser to the fund and not to the fund's investors.

> "The Commission recognizes more generally that the duty of loyalty 'requires advisers to manage their clients' portfolios in the best interests of clients,' and imposes obligations to 'fully disclose any material conflict the adviser has with its clients, to seek best execution for client transactions, and to have a reasonable basis for client recommendations.' [Hedge Fund Rule, 69 Fed. Reg.] at 72,054.
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> If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest. Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to an investor in the fund, however, would likely be to sell. For the same reason, we do not ordinarily deem the shareholders in a corporation, the 'clients' of the corporation's lawyers or accountants. . . . While the shareholders may benefit from the professionals' counsel indirectly, their individual interests easily can be drawn into conflict with the interests of the entity."[37]

The Court found none of the SEC's arguments persuasive and failed to justify this departure from its previous interpretations of §203(b)(3). The Court rejected the SEC's attempt in the Hedge Fund Rules to carve out an exception from the "safe harbor" for general partners of limited partnerships solely for investment entities that have fewer than 100 but more than 14 investors. "The Commission does not justify this

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[31] 472 U.S. 181 (1985)
[32] *Id*. at 208.
[33] *Id*. at 210.
[34] *Goldstein* at 880.
[35] *Id*. at 881.
[36] *Id*.
[37] *Id*. (citation omitted).

exception by reference to any change in the nature of the investment adviser-client relationships since the safe harbor was adopted. Absent such a justification, its choice appears completely arbitrary."[38]

The future of the SEC's regulation of hedge funds is completely up in the air after the *Goldstein* decision. Some commentators have predicted a massive rush to de-register by hedge fund advisers. Others have predicted that many, if not most, of the advisers who registered because of the Hedge Fund Rule will remain registered, if only to present such registrations as a kind of "Good Housekeeping Seal of Approval."

Chairman Christopher Cox of the SEC had testified before the Senate Banking Committee that the agency need to move quickly to fill the "hole" left by the *Goldstein* decision. According to news reports of that testimony, Cox will recommend that the SEC write a new anti-fraud rule that would ensure hedge fund advisers have a fiduciary duty to investors in their funds.

To this observer, Cox's plan would seem to be an impossible task under the *Goldstein* analysis. Even if such a rule could be crafted that would comply with *Goldstein*, the SEC, to date, has not demonstrated the willingness to regulate hedge funds with the tools it does have at its disposal, as suggested by the Pequot affair. Such new rules could end up being part of a regulatory scheme that is nothing more than a show for public consumption.

[38] *Id*. at 885.